EDITORIAL NOTE: NO SUPPRESSION APPLIED.

IN THE DISTRICT COURT
AT AUCKLAND

CIV-2015-004-001139
[2017] NZDC 13334

BETWEEN	ELITE UNDERLAY LIMITED Plaintiff
AND	ECO RUBBER INDUSTRIES LIMITED Defendant

Hearing: 9 May 2017

Appearances: M D Branch and T S Burtenshaw for the Plaintiff
M Donovan for the Defendant

Judgment: 17 July 2017

JUDGMENT OF JUDGE B A GIBSON

Introduction

[1] On or about 22 October 2013, by written agreement, the plaintiff sold its assets and business to the defendant, a company to be incorporated by Messrs B Jennings and B L C Ballan prior to the agreement becoming unconditional. They became directors and shareholders in the defendant on incorporation.

[2] The agreement became unconditional three working days after it was signed with the defendant carrying on the business the plaintiff had been operating from a factory at 47 North Way Street, Hamilton and which involved recycling rubber crumb obtained from the tyre industry and using it to manufacture carpet underlay.

[3] Part of the assets included in the sale, which was described in the agreement as a "lease to own" arrangement, was an oven, valued in February 2014 for insurance purposes at $408,000 plus GST. The written agreement was prepared by Mr Ballan, then a director of a business, Super Turf Limited, which company was involved in the supply and installation of artificial turf. The agreement that provided for the

plaintiff to manage the marketing of the carpet underlay from 1 November 2013, the date of the takeover of the business by the defendant. The particular provisions of the agreement concerning management were as follows:

> *For the first 36 months after 1st of November: ERIL will pay EUL a fee of $3,000 plus GST per month, to manage staff, manage the production, document the manufacturing process and train new staff as required.*
>
> *After 36 months ERIL will pay EUL $4,000 plus GST per month, plus a management bonus of 20 cents per square metre for first grade product over 5,000 square metres in a month.*
>
> *This agreement will continue until it is mutually agreed that it should cease, or earlier if in ERIL's reasonable opinion, EUL has been negligent in its management responsibilities and EUL having been advised in writing of ERIL's reasonable concerns, EUL fails to address the concerns to ERIL's reasonable satisfaction, within 30 days.*

[4] From 1 November 2013 until June 2014 payments were made by the defendant to the plaintiff in terms of the foregoing clause. However from that date the defendant discontinued the management fee payment and paid the plaintiff $1,000 per month plus GST, a total of $1,150. These payments, the defendant maintained, were not management fees but were part of the lease to own payments the defendant was obliged to make under the agreement for 36 months from 1 November 2013 for the purchase of the plaintiff's assets.

[5] The plaintiff commenced proceedings seeking judgment for the difference between the payment of $4,000 plus GST ($4,600) and that actually paid by the defendant from July 2014 onwards, and also for a declaration that the defendant remains liable to pay that sum until 31 October 2023, in accordance with the terms of the written agreement.

Interruption to the business

[6] In January 2014 a fire broke out in the oven at the Hamilton factory. It partially destroyed a substantial part of the oven and conveyor system. Production of carpet underlay then ceased pending repairs to the oven.

[7] The plaintiff still held the insurance policy over the machine and so lodged an insurance claim and received $392,500 following its acceptance. It then paid $340,000 to the defendant for repairs to the machine so the business could continue.

Mr S S Nanua, the Director and shareholder of the plaintiff company, maintained the difference between the two sums represented GST on the money, which he held back. Later he discovered that the defendant had paid GST on the $340,000 and so he utilised the balance himself, paying only the GST on $52,500 being the amount retained by the plaintiff from the insurance payment.

[8] Work began on repairs to the oven, conveyor system and combustion chamber and, to the extent that it was possible to do so, work continued from the Hamilton premises where the machine was located.

[9] The defendant directors were, in the months immediately after the fire, having reservations over the quality of the work being produced under Mr Nanua's supervision and the necessity of maintaining the premises at Hamilton when the defendant had large premises at Wiri, near Auckland, from which the manufacturing of underlay could be carried out. Consequently, consideration was given to moving the entire processing plant there.

[10] By July 2014, when the plant was again valued for insurance purposes, the valuer noted that the machinery, which had been largely reconstructed, was valued at $1,187,500 exclusive of electrical or gas 'hook up'. The directors of the defendant company, shortly thereafter, made a decision not to finish rebuilding the oven and decided not to carry out further production. Mr Nanua recorded in an email to Mr Ballan of 1 December 2014, that the decision was purportedly based on lack of sales.

[11] In July 2014 Mr Nanua, on behalf of the plaintiff, invoiced the defendant management fees of $4,000 (plus GST) which he considered payable under the agreement. They were not paid. The only payment made that month and in the succeeding months was the payment for the monthly lease to buy of $1,150. In that respect the agreement provided as follows:

> *For 36 months after the 1st of November ERIL will make a Lease to Own payment for all the assets of the business of EUL, including any Intellectual Property. The monthly Lease to Own payment will be $1,000 plus GST, regardless of production volumes, and 65 cents plus GST for every square metre of first grade product produced in a month.*

> *All monthly payments to EUL by ERIL are due within 14 working days of the date of invoice.*
>
> *EUL agrees the monthly Lease to Own payments must firstly be applied to the ANZ Bank such that within 24 months, or earlier from 1st of November 2013, EUL and SN undertakes that the ANZ's security over the assets and plant of EUL will be discharged and all EUL's assets are able to be passed free and unencumbered to ERIL.*

[12] Mr Nanua wrote to Mr Ballan, a director of the defendant company, concerning the failure to pay the monthly management fee and received a reply on 19 August 2014, that payment would not be made as there was no-one left for the plaintiff to manage given the last employee had left at the end of June. The email further provided:

> *Clearly you have continued to do some things, which you need to be paid for, but they should be on a time basis. I would suggest $25 an hour plus GST. Can you estimate your time spent last month so we can pay for that. Brett and I are still working towards a long-term solution for the oven. In the meantime we need to lease the premises* [the Hamilton premises] *as they are just soaking up our resources.*

[13] Consequently Mr Nanua, having disposed of the plaintiff's business in an arrangement he believed would, with a combination of fixed and production-related payments for managing the plaintiff's business and the monthly lease to own payment, have generated an annual income for the first 36 months of at least $48,000 plus GST, found the monthly income for the plaintiff had reduced to $1,000 plus GST per month. Rubbing salt into the wound he also discovered that after ceasing production from the Hamilton factory and moving the oven and processing plant to Wiri, the defendant was advertising the oven and plant on *Trade Me* for sale at $1,375,000.

[14] While the defendant company in the aftermath of the fire may well have contemplated repairing the machinery and continuing the business, the primary motivation for bringing the business to a halt is readily explained by the valuation report of July, 2014. The defendant had an asset, which it could sell, and which appeared to be worth $1,187,500 and for which it had only to pay $36,000 plus GST with the payments to be paid in equal monthly instalments pursuant to the 'lease to own' provision of the agreement.

[15] The plaintiff asserted the defendant was not entitled to unilaterally terminate the management aspect of the agreement between the parties and deny it ongoing monthly payments of $4,000 plus GST. It asserted the agreement had set out the circumstances in which the payments could come to an end and the defendant's decision to cease production, and thereby deny the plaintiff the ability to manage production, was not one of them.

[16] The clause in the agreement concerning termination of the management provisions came sequentially after the specific terms concerning management by the plaintiff and provided:

> *This arrangement will continue until it is mutually agreed that it should cease, or earlier if in ERIL's reasonable opinion, EUL has been negligent in its management responsibilities and EUL having been advised in writing of ERIL's reasonable concerns, EUL fails to address the concerns to ERIL's reasonable satisfaction, within 30 days.*

[17] Further, the agreement contemplated the possibility of a sale of the defendant company to a third party by providing for continued payment of royalty payments to the plaintiff for use of its intellectual property within the ten year period agreed under the written agreement between the parties. However no provision was inserted to protect the management payments or plaintiff's role in managing the manufacturing business.

[18] The agreement did not address the possibility of the defendant ceasing production and ceasing to pay the management fees. Nevertheless it did provide:

> *Notwithstanding any other clause in this Agreement, all parties must agree in writing that for this Agreement to cease or be changed, that those changes be noted accordingly and signed by all parties to the agreement.*

Management provisions as part of the purchase price

[19] The plaintiff submitted that the management agreement was an integral part of the purchase price for the business and to see it otherwise defied commercial common sense. It referred to the insurable value of the oven at the time of sale, $392,500 against the $36,000 (plus GST) attributable to the sale of the oven in the agreement and the improbability of the plaintiff being willing to sell the business for that sum. It submits the management fee ought to be treated as an integral part of the

purchase price, notwithstanding the absence of any such provision in the terms of the written agreement itself.

[20] Mr Nanua's evidence was that, when discussing the contract price with Messrs Ballan and Jennings early in October 2014 and prior to the agreement being signed, he emphasised the need for continuing income for the plaintiff with the "bottom figure" being $1,000 per week, having initially sought $100,000 per annum. He rejected the defendant's initial proposal of payment based solely on production and believed, from his discussions with Mr Ballan in particular, that he would receive $4,000 a month for ten years and that Mr Ballan had told him that the management fee would be paid even if the defendant stopped production. For that reason, he agreed the agreement should not contain a minimum production fee as part of the management fee claim as he did not expect to be working in a management role for longer than three years which was why he said there was a reference to that period in that part of the agreement set out at para [3] herein.

[21] Mr Nanua said that in a meeting with Messrs Ballan and Jennings on 3 October 2013 he told them he thought his business was worth at least $400,000 but he indicated he was willing to leave "money in" subject to an acceptable payment plan. He also emphasised that he believed acquiring the plaintiff's business would save the defendants $480,000 per annum as they would no longer have to source materials from Australia, as they were currently doing, but could obtain them at better rates through the plaintiff's business.

[22] While Mr Ballan was prepared to accept Mr Nanua had suggested there would be savings of $40,000 to the defendant company each month, he did not accept that would be so and did not recall Mr Nanua saying he thought his business was worth $400,000. His recollection was that Mr Nanua had said he would accept $100,000 for the purchase price but given the defendant did not have cash available, Mr Nanua accepted, after some negotiation, a combination of management and production payments and for royalties for a ten year period. He did not accept there was any agreement that the management contract would continue for ten years. He said that had the business continued in operation then, with a combination of the lease to buy payments and the payments made for first grade rubber, the plaintiff

could have expected to have received $153,000 over the first three years. That would have produced a figure close to Mr Nanua's bottom figure of $1,000 per week. However the defendant's view was that the payments, other than the lease to buy payments, and any royalty payments only remained on foot for as long as the defendant continued to operate the business and it was entitled, for reasons relating to the management of its own business, to make a decision not to use the oven for production purposes at any time it chose. Consequently Mr Ballan's view was that if, a day after the agreement had been signed, the defendant chose not to carry on production it was still entitled to obtain the oven on payment of the regular lease to buy payments, a total of $36,000 plus GST.

[23] The plaintiff asserted it would never have agreed to the arrangements had they understood this was the position and it was certainly not what Mr Nanua believed he had negotiated. He took advice from his accountant, Mr NH Maisey, and showed Mr Maisey a draft of an agreement prepared by Mr Ballan and sent to him on 4 October 2013 following on from the discussions the preceding day. Mr Maisey said he was told by Mr Nanua that he was negotiating to sell all of the assets of his business to the defendant but the defendant could not afford to pay him a lump sum for the business and the draft agreement provided for the purchaser to pay for the business over time. His evidence supported Mr Nanua's contention that he would never have sold the business for $36,000 plus GST when he believed it to be worth far more, and in particular Mr Maisey said that in their discussions he was told by Mr Nanua that he thought the oven was worth roughly $300,000 plus GST. He accepted he was not told by Mr Nanua what he thought the value of the business as a whole was. Mr Maisey's objection to the form of the agreement was that it allowed the defendant all the tax advantages of the arrangement as the payments were revenue based rather than capital in nature and so the defendants would be entitled to a tax deduction for each payment made.

[24] Consequently, the tax deductions available for the payments on the lease to buy arrangement meant the defendant effectively obtained the oven, on one view of it, for significantly less than the $36,000 plus GST they were obliged under the final form of the agreement to pay.

[25] Various drafts of the agreement were prepared by Mr Ballan following discussions with Mr Nanua and changes were incorporated in the drafts according to the accepted positions taken by one party or the other. However the issue of the term of the management payment being for ten years and the payment being due regardless of whether the defendant elected to continue using the business for production of carpet underlay were not raised. Although Mr Nanua sought accounting advice he did not seek legal advice from a solicitor experienced in the drafting and giving of advice on commercial contracts concerning the sale of business assets and/or businesses.

[26] Mr Ballan said that a ten year term was never discussed in the way asserted by Mr Nanua but he said they went out of their way to indicate it was not acceptable to the defendant. Messrs Ballan and Jennings asserted they had little available cash, a position accepted by Mr Nanua, and so I think it is unlikely they would have agreed to a fixed term for ten years. The issue was raised but was in all likelihood deflected to a ten year term for royalties and to the ten year restraint of trade provision in the agreement.

[27] Moreover, Messrs Ballan and Jennings held the stronger position in the negotiation. Not only were they unable, or unwilling, to part with a lump sum to achieve an outright sale but they were aware the plaintiff company was in financial difficulties with a creditor, Advance Adhesives, about to take steps against the plaintiff. They also saw a GST return from the plaintiff, which was disclosed in the course of negotiation, and which indicated $200,000 of claimed expenses but no sales. Mr Ballan said that after going to the plaintiff's premises it did not seem to him that the business was highly successful.

[28] On the face of it the defendant has obtained an asset, namely the oven, worth more than $300,000 for a fraction of that amount. However its worth, as the valuer, who assessed the value of the machine on 1 February 2014 on a pre-damaged market value only if it were offered for sale as part of a going concern. The valuer noted that Mr Ballan had informed him that production in November and December 2013 was between 4,000 and 4,310 m^2, but it was anticipated that production would increase to 10,000 m^2 in February 2014, and 20,000 m^2 per month thereafter.

Consequently I accept the evidence from Mr Nanua that at the time he entered into the contract the machine, which in all likelihood represented virtually all of the value of the business, was worth in excess of $300,000, but that was because it was being operated on an on-going basis. Both parties, I accept, contemplated that would continue. It was the unexpected event of a fire and subsequently the decision of the defendant's directors to discontinue production that led to the loss of the management contract. There was nothing left to manage and the plaintiff had negotiated with the defendant for much of its remuneration to be derived from management and the royalty fees paid from production.

[29] While Mr Nanua may have had an asset worth $300,000 as at October 2013 its value depended on its continued use in production. He was not able to achieve an outright sale to the defendant and he accepted a contract where payment to the plaintiff company was partly based on production and partly based on the management fees it could obtain from the production, as well as the lease to buy payments. The fact that a contract appears unduly favourable to one of the parties is not a sufficient reason for supposing that it does not mean what it actually says it means; *Chartbrook Limited v Persimmon Homes Limited*[1] and the weakness of Mr Nanua's negotiating position on behalf of the plaintiff provides a clear reason why he was not able to obtain a contract more favourable to the plaintiff.

[30] The real issue is whether the parties intended their contract to mean that management fees remained payable even when no management services were able to be provided and whether the management fees formed part of the purchase price for the agreement.

[31] For the plaintiff to succeed it would need to demonstrate an ambiguity in the agreement that would lead to the interpretation it seeks. There was no pleading of mistake or, for that matter, of rectification. The rules concerning the interpretation of contracts by reference to pre-contractual negotiations and materials are well known; *Vector Gas v Bay of Plenty Energy Limited*[2] where, at p 461 Tipping J said:

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[1] [2008] 2 All ER (Comm) 387 at para 20 (HL)
[2] [2010] 2 NZLR 444 (SC)

> The foregoing analysis requires that, generally speaking, issues of contractual interpretation arise in three circumstances: mistake; ambiguity; and special meaning. A mistake can represent either a drafting error or a linguistic error. Errors of this kind are primarily the subject of rectification. But a clear drafting or linguistic error, combined with equal clarity as to what was intended, can be remedied by way of interpretation, and in that respect context can and should be taken into account. An ambiguity arises when the language used is capable of more than one meaning, either on its face or in context, and the Court must decide which of the possible meanings the parties intended their words to bear. Special meaning exists when the words used, even after the contractual context is brought to account, are linguistically still capable of only one meaning, or are wholly obscure; but it is nevertheless evident from the objective context that the parties by custom, usage or agreement meant their words to bear a meaning which is linguistically impossible … or represents a specialised and generally unfamiliar usage.

[32] The fact that the contract may well have been commercially disadvantageous to the plaintiff does not seem to me to be of any moment if the contract was freely negotiated and the words are capable of clear unambiguous meaning. Here, the plaintiff asserts that management fees remained payable even after the services for which the management fees were paid had ceased. The fee of $3,000 plus GST per month, payable for the first 36 months, clearly related to the management of staff, production and the manufacturing process. While there was a termination provision that provision concerned failure on the part of the plaintiff to carry out its management responsibilities. It did not cover the absence of those responsibilities because the defendant, which was operating the business, determined for business operational reasons that it was no longer feasible to carry on.

[33] I accept the defendant's submission that the termination provision referred to in para [3] herein assumed management services were still required and were being carried on by the plaintiff, but had to be unsatisfactory before the provision could be invoked in the sense that the plaintiff had to be negligent or the parties agreed that the plaintiff no longer wished to manage the production. There is no provision in the agreement requiring agreement on the basis that the defendant no longer wishes to carry out production and I do not see that can be implied into the agreement. Such a term is not reasonable or necessary or 'go without saying' for the agreement to

operate according to the test in *BP Refinery (Western Port) Pty Limited v Shire of Hastings*[3] where Lord Simon, for the majority, said:

> Their Lordships do not think it necessary to review exhaustively the authorities on the implication of a term in a contract which the parties have not thought fit to express. In their view, for a term to be implied, the following conditions (which may overlap) must be satisfied: (1) it must be reasonable and equitable; (2) it must be necessary to give business efficacy to the contract so that no term will be implied if the contract is effective without it; (3) it must be so obvious that "it goes without saying"; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract.
>
> Their Lordships venture to cite only three passages – albeit they are familiar to every student of this branch of the law. In *The Moorcock* (1889) 14 PD 64 at 68; [1886-90] All ER Rep 530 at 534, Bowen LJ said: "I believe if one were to take all the cases, and they are many, of implied warranties or covenants in law, it will be found that in all of them the law is raising an implication from the presumed intention of the parties with the object of giving to the transaction such efficacy as both parties must have intended that at all events it should have. In business transactions such as this, what the law desires to effect by the implication is to give such business efficacy to the transaction as must have been intended at all events by both parties who are business men. …

[34] I am satisfied that Messrs Ballan and Jennings, negotiating on behalf of the defendant, never intended the payment provisions of the contract, other than the lease to own for the assets, to be anything other than production based and for the plaintiff to actually exercise a role in managing the production while it was a continuing operation. There was no intention on their part to guarantee payments to the plaintiff irrespective of whether the business continued save only the payment for the assets. That is the agreement the plaintiff entered into. There was no element of coercion. Mr Nanua was fully involved in the negotiations. Consequently, there is no basis to imply any provision to allow the construction the plaintiff seeks and the plain words of the agreement do not allow that interpretation. It is not for the Court to fill in a gap to the advantage of only one party, the plaintiff, where an intention for the agreement to operate in the way contended by the plaintiff cannot be presumed and was not expressed.

[35] The plaintiff also submitted that the *contra proferentum* rule applied but having taken the view that the contract is plain in its words and that a term cannot be implied to the effect that the fees had to be paid regardless of whether production

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[3] (1977) 16 ALR 363 at 376 (PC)

continued and there was no longer a requirement to manage, there does not seem to me to be any ambiguity. That rule only applies where one party drafts the agreement.

[36] I accept that Mr Ballan drafted the agreement but there were a number of changes, principally over the method of payment, in the course of the various drafts as a result of the negotiations between the parties. This was not a standard form printed contract. Neither party contemplated a fire or the defendant determining not to continue with production in the months following the fire, and I am satisfied at the time the agreement was entered into the defendant did intend to use the machine for the business for the foreseeable future. Circumstances changed but given the payment schedule related in part to management and production, once those services ceased the agreement was silent as to any further payment to the plaintiff for management and so I accept the defendant was not contractually bound to continue the payments.

[37] The *contra proferentum* rule only applies where the words are capable of more than one meaning and, in those circumstances, the agreement is construed against the person who prepared the agreement. Williamson J noted in *Victor Hydraulics v Engineering Dynamics*[4]

> The contra proferentum rule of construction only applies if there are ambiguities. Strained or tortured constructions upon which to base ambiguities are not appropriate.

[38] There is, on the plain wording of the agreement, nothing from which to construct the interpretation the plaintiff contends for.

[39] Indeed, one of the earlier drafts specifically provided a clause that may have been capable of invoking the *contra proferentum* rule, namely a draft which provided:

> If circumstances beyond EUL's control cause a month's first grade production to be less than 5,000 square metres then a minimum payment of $4,250 plus GST will be payable by ERIL to EUL.

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[4] [1996] 2 NZLR 235 at 241

That clause was not included in the final draft as it was omitted as a result of the parties' negotiations. In any event it was still production based and contemplated a continuing operation but with a month where production was less than 5,000 m^2.

[40] The plaintiff also argued that the management fee was part of the purchase price because it defied commercial common sense for it not to be. That argument essentially revolved around the sense of the plaintiff agreeing to sell an asset worth $300,000 or more for $36,000 plus GST paid over 36 months. The agreement, however, was clear that the lease to own payments amounted to the purchase price for the business. That provision, referred to at para [3] herein, noted that the lease to own payment was for all the assets of the business including intellectual property. There is no ambiguity. The words bear only one meaning. This was, as events subsequently revealed, no more than a bad bargain made by reason of the agreement reached between the parties failing to include the clause which the plaintiff needed to protect itself from the unforeseen eventuality of the fire and the defendant subsequently determining, as it was entitled to, to cease production. Had production continued, as Mr Ballan, I am satisfied, at least in February 2014 clearly intended it would, then substantial payments and management fees and royalties, as well as the lease to own payments would have been made to the plaintiff.

[41] Accordingly, the plaintiff's claim must fail. The plaintiff also sought a declaration that the defendant was liable to pay $4,000 plus GST per month to the plaintiff until 31 October 2023 in accordance with the agreement. Because of the way in which I have determined the claim in relation to the interpretation of the contract the claim for that remedy must also fail.

[42] In conclusion the plaintiff's claim fails and judgment is accordingly entered for the defendant. Memoranda concerning costs and disbursements may be filed and served within 21 days of the date of this judgment.

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B A Gibson
District Court Judge