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Variation of contracts: The law of unintended consequences

Clients often ask us whether or not they have varied their commercial contracts by their conduct or acquiescence or by verbal agreement with the other parties. The background to this is that a well drafted written agreement will usually provide that it can only be varied by the parties in writing. A number of recent cases have highlighted the fact that the conduct of the parties after the execution of an agreement can have significant and sometimes unintended consequences on their contract, even without a formal written variation of the contract.

Oral variation

Contracts typically contain "anti-oral variation clauses", which generally require any amendments to the contract to be in writing (and sometimes signed by all parties to the contract). The purpose of such clauses is to ensure contracts are not accidentally varied (for example, by a casual exchange of emails) and to avoid disputes that can arise where parties disagree about whether a variation was agreed or what the variation was. However the recent Court of Appeal judgement in *MWB Business Exchange Centres Ltd v Rock Advertising Ltd* has cast doubt on how effective such clauses are.

The judgement suggests that even where a contract does contain an anti-oral variation clause, this does not preclude the parties subsequently agreeing an amendment to the contract orally or even by conduct. The Court stated that:

> "*The parties have freedom to agree whatever terms they choose to undertake, and can do so in a document, by word of mouth, or by conduct. The consequence in this context is that in principle the fact that the parties' contract contains [an anti-oral variation clause] does not prevent them from later… varying the contract by an oral agreement or by conduct.*"

Commercial parties are unlikely to welcome this judgement which increases uncertainty and leaves them vulnerable to frivolous (but potentially costly) claims based on alleged undocumented variations to carefully drafted contracts. Two points should, however, be noted:

i. the burden of proof will be on the party seeking to rely on the alleged variation to persuade the court that the other parties agreed to the variation (in writing, orally, or by conduct);

ii. the court did suggest that where a party alleges that there was an oral variation of an agreement and that agreement contains an anti-oral variation clause, this may be prima facie evidence that the parties did not in fact intend to vary the agreement. There may therefore be some value in continuing to include such clauses, although parties should be aware that they will not negate the need to be careful not to say anything to the other parties (or indeed act in a way) that may be taken as agreement to a variation to the agreement.

Variation by conventional behaviour

Where parties have conducted themselves on a basis which is, wittingly or unwittingly, different from the basis they originally agreed they may be estopped (i.e. prevented) from later relying on their strict rights under a written agreement.

In *Dixon and another v Blindley Heath Investments Ltd*, a new investor ("***A***") became a shareholder of EFI (Loughton) Ltd ("***EFI***") in 2001 and the existing shareholders and A agreed, in an exchange of letters, that they would each have pre-emption rights with respect to the issue or transfer of shares (the "***2001 Agreement***").

By 2009 the shareholders had forgotten of the existence of the 2001 Agreement and subsequently a number of further shares were acquired by A and the transfers were approved and registered by the board of directors without the issue of pre-emption rights being raised. In 2010 two of the other shareholders in EFI decided to sell their shares to Blindley Heath Investments Ltd ("***Blindley***"). The shares were transferred in 2011 and the transfers approved by the board of directors of EFI, again without the issue of pre-emption rights being raised. Shortly afterwards A discovered the 2001 Agreement and raised the issue of pre-emption rights and objected to the registration of the transfer of shares to Blindley as A argued the transfer was in breach of the pre-emption rights contained in the 2001 Agreement.

The court held that, while the 2001 Agreement created valid pre-emption rights, A was prevented from objecting to the transfer since: (a) the parties had shared a common assumption that there were no valid rights of pre-emption and had conducted themselves on that basis; (b) A had benefited from this assumption when he acquired the additional shares in 2009; and (c) it was consequently unconscionable for him to seek to rely on the pre-emption rights as a ground for refusing registration of the transfer to Blindley.

Variation of articles of association by conduct

Under the long established "Duomatic Principle", where it can be shown that **all** shareholders assent to some matter which a general meeting of the company could carry into effect, that assent can often be as binding as a resolution in general meeting would be[1]. Such assent can be through conduct or even through acquiescence provided it is unanimous; and is given in full knowledge of what it is they are consenting to.

This principle has clear benefits in that it allows shareholders in smaller companies to give their consent to reserved matters in a more informal way.

The recent case of *The Sherlock Holmes International Society Ltd v Aidiniantz* illustrates that this principle can even apply to an amendment of a company's articles of association, which are considered to be a contract between the shareholders. The Sherlock Holmes International Society Ltd (the "***Company***") had articles of association which provided that only members of the Company could be appointed as directors. The Company had, in fact, appointed non-members as directors on

[1] The Duomatic Principle cannot be applied to bypass a statutory procedure which is intended to protect the interests of parties other than the members of the company e.g. the creditors of the company.

three previous occasions without objections from any members. A shareholder in the Company later challenged the validity of the appointment of the Company's sole director on the basis that he was not a member of the Company.

The court held that the members' conduct in appointing non-members as directors of the Company was explicable only as demonstrating an intention on the part of all the members to amend the articles of association, since this was the only way non-members could be validly appointed. The articles were therefore deemed to have been amended under the Duomatic Principle to allow non-members to be appointed as directors.

This case highlights the need for shareholders to be cautious when acquiescing to conduct that violates their strict rights under the articles of association. Where a shareholder wishes to do so on a one off basis it should ensure that its agreement is carefully documented (e.g. by means of a waiver letter) to ensure its conduct is not later interpreted as an agreement permanently to amend the articles.

Agreement by conduct

In order to ensure parties are not bound by an agreement before they intend to be, a proposed contract often contains a clause stating that it is not binding until signed by both parties. However a recent Court of Appeal judgement confirms that such a clause will not necessarily prevent a party being bound by such a contract even if unsigned provided their conduct implies agreement.

In *Reveille Independent LLC v Anotech International (UK) Ltd*, Reveille Independent LLC ("***Reveille***") had sent its standard form "Deal Memo", which included a signature requirement on both parties, to Anotech International (UK) Ltd ("***Anotech***"). Anotech amended the Deal Memo, signed it and returned it to Reveille. Reveille never signed the amended Deal Memo but performed all of its obligations as set out in the amended Deal Memo. Anotech later argued that there was no contract as Reveille had never signed the amended Deal Memo and hence the signature requirement had not been complied with.

The court found that notwithstanding the signature requirement, Reveille had accepted the terms of the amended Deal Memo through its conduct.

Parties should ensure, especially when using standard form contracts, that identical versions are signed by all parties and should be wary of starting to perform their obligations before a written contract has been concluded.

Conclusion

These cases highlight the dangers of assuming that a written agreement will necessarily prevail over subsequent informal arrangements, discussions and conduct. Parties should be wary of agreeing or acquiescing to conduct that violates their contractual rights even on a one off basis. Where they do wish to do so they should ensure that such agreement is carefully documented and they take professional advice where necessary.