The Association of Corporate Treasurers

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Briefing note

Letters of Comfort

A practical guide

TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

London, April 2007

NOTE

This briefing note does not constitute legal advice. It is written in general terms. Its application to specific situations will depend on the particular circumstances involved. In addition it does not attempt to include all points which might arise or be relevant in any particular case. Readers should therefore take professional advice. This guide should not be relied upon as a substitute for this advice. Although the ACT has taken all reasonable care in the preparation of this note, no responsibility is accepted by the ACT for any loss, however caused, occasioned to any person by reliance on it.

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The Association of Corporate Treasurers

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The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through education, training, conferences, and publications, including *The Treasurer* magazine.

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For further information visit www.treasurers.org).

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/resources/manifestosept2006.pdf.

This briefing note was drafted by The ACT's Policy and Technical Department (e-mail: technical@treasurers.org) and commented on by members of the Policy and Technical Committee and others to all of whom thanks are due.

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Introduction

"Letters of comfort" are used in many spheres of industry, commerce, regulated and state-controlled activities, government and regulation. They may be mere expressions of goodwill, vary through representations or statements giving rise to potential liabilities or be enforceable undertakings by way of guarantee or indemnity.

This briefing note addresses just letters of comfort addressed by private sector parent companies or group members to providers of credit or of credit based services[1] ("banks") to a subsidiary or fellow subsidiary, incorporated joint venture, etc..

Advice on letters of comfort is one of the most frequent requests to the ACT's Technical Queries Service. We hope that this note will answer most questions.

Summary

- It is assumed that letters of comfort of the kind considered here are not usually intended to impose on the issuer any enforceable contractual obligations to the recipient banks, their subsidiaries or anyone.
- The receiving bank treats them as
  - confirming that the subsidiary is indeed a group member and that the issuer knows of the provision of the service
  - and possibly as confirming one or two simple facts
- Care is needed to ensure that drafted letters satisfy the intention without giving rise to enforceable obligations or possible claims in contract.
- Representations or statements made can give rise to legal liability, for example for negligent mis-statement. Care is therefore needed to check that facts are stated accurately. Liability for mis-statement may be contractual or tortious.

How to use this note

For a quick practical guide read:

These sections are indicated by a red side-bar for ease of identification

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To understand more – some of the subtleties, the legal background and so on:

- Read the document as a whole, including all Appendices.

[1] Credit based services include, for example, provision of automated payments services, foreign exchange services, letters of credit, etc. where the provider has a credit exposure prior to settlement.

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Letters of comfort?

In this note, letters of comfort are taken to be communications, in whatever medium, to a bank about its relationship with the user of the credit based service, that are not intended to give rise to legally enforceable obligations on the part of the issuer with regard to the credit exposure of the bank[2]. Such letters may go under a variety of other names, for example letters of awareness or letters of introduction.

They have been used for a very long time, indeed before the term came into common use. Many examples were found in the expansion overseas, especially into the then British Empire, of British companies in the inter-war years. No doubt they were in use for centuries before.

It is important to ensure that all communications to a bank which could be interpreted as including content which would normally be found in a letter of comfort are recognised as letters of comfort and dealt with accordingly.[3] Of course, communications which could be interpreted as containing enforceable undertakings also need their own treatment.

Letters of comfort and the treasurer

Key concerns of a (group) treasurer with regard to letters of comfort may include:

- To be aware of all such letters issued by or on behalf of the company (or companies within the group and incorporated joint ventures)[4].

[2] The terminology is confused by the US background. US companies, for all the usual reasons (see Reluctance to issue guarantees or undertake binding obligations, page 9), often preferred not to give banks guarantees or indemnities to support subsidiary activity. Rather they preferred to give collateral undertakings - to make representations or to give collateral warranties which might give rise to actions in damages. These were often called letters of comfort rather than by a more suitable name. Accordingly when discussing letters of comfort with US institutions, it is particularly important to be clear at a very early stage about what you have in mind.

[3] Vigilance is needed.

- E-mails are often sent unchecked.
- Oral comments, for example made over lunch by Chairmen, CEOs, etc (at which the treasurer should always be present) or thank-you notes after such a luncheon can give rise to problems. Assume that nothing is off the record with the bank and that the bank *will* make a contemporaneous note (see footnote 4, below).
- If parent company or group treasury staff take any part in the negotiation of the credit service to be provided to a subsidiary or associate, it must be made clear that, in this context, they do that as advisers to the receiver of the credit service and not in any way representing the parent company or representing or warranting the accuracy of information provided or the reliability of opinions expressed by the subsidiary.
  [Of course, they will anyway not allow subsidiary staff to mislead or act in bad faith:
  - for corporate internal control reasons
  - for their own scruples and
  - under their obligations, if they are members of one, to their professional body under its ethical code (e.g. the ACT's, http://www.treasurers.org/membership/resources/EthicalCode06.pdf).]

[4] Banks are inveterate record keepers and have been known to produce twenty or thirty year old, badly worded letters at inconvenient times

- To be sure that such letters do not create unintended legal obligations to anyone
- To control the risk of liability arising outside the comfort letter itself, by ensuring that all statements made are factually accurate and expressions of opinion are made in good faith and reasonably based
- To be confident of the likely effect of the issue of such letters on the relationships with the bank in the case concerned and, more generally, with other providers of credit, who may not have received such a letter, both under normal circumstances and following any financial distress or default by the receiver of the credit service
- To be confident that such letters do not create unexpected tax consequences
- To be sure of the position with regard to other shareholders In the case of subsidiaries with minority shareholders, associates or incorporated joint ventures.

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Checklist

A treasurer's checklist on the life of a letter of comfort can be found in Appendix 1, page 24. This can form a starting point for a chapter of a Finance/Treasury Policy/Procedures Manual.

Why letters of comfort?

If the letter of comfort is by definition not intended to create any legal obligations to anyone, why would the issuer provide it - or the recipient want to receive it?

How the bank sees it

That its customer is, in practice, in many ways, ostensibly controlled by another company[5] can be an important factor for the bank in considering the credit relationship. The control may be a positive or a negative factor in evaluating the credit. If the bank has any concern either about that control or about its customer considered on its own, it may see a hierarchy of possible risk mitigations:

- It may prefer the controlling party to issue a fully enforceable guarantee, or equivalent, for the credit exposure[6].
- It could ask the controlling party to issue some sort of collateral warranty or representation. Breach of the representation or warranty could then give rise to a claim in tort or possibly in contract[7]. The representation may be about
    - the credit-using company and its circumstances, or
    - the controlling party's intentions towards the credit using company, perhaps about it
        - maintaining a controlling shareholding in the credit user or
        - maintaining it as its local importer, distributor, licensee, franchisee, etc. or as a (key) supplier, processor, assembler, etc. or
        - ensuring that the credit using company be adequately capitalised to be able to meet its obligations as they fall due
        - and so on.

    If the representation was simply as to the issuer's intentions, then under English law it ought to be actionable only if it was an untrue statement of the controller's intentions at the time the statement was made. A subsequent bona fide change of intention, e.g. a decision no longer to maintain a controlling shareholding, would not be viewed as a breach of the original

[5] Or, companies, in the case of an incorporated joint venture.

[6] With a guarantee the bank normally has no duty of mitigation of any loss, guarantees often including as a standard term a statement that the guarantee is to be payable on demand (subject only to the primary debtor having defaulted in payment) despite the absence of any steps taken by the bank to enforce payment by the primary debtor.

[7] If a representation is made which is not accurate, and the issuer of the letter knew, or should have known that the recipient would rely on the representation etc. and was negligent or reckless in making it, there may be liability in tort (or the local equivalent in non-common-law jurisdictions) and/or in contract. A claim in contract may arise as (under English law) consideration for the promise (here, undertaking the credit service) only has to leave one party to the contract (the bank); it does not have actually to go to the other (the issuer of the letter containing the promise) if the other requirements for a contract are also met. These include the intention to create legal relations. A well-drafted letter of comfort will therefore expressly deny any intention to create legal relations.

statement of intention. An English court would be unlikely, in the absence of special circumstances, to treat such a bona fide statement as implying a continuing undertaking not to change the original intention. Other jurisdictions may take a different view (see for example footnote 22 below on page 19, below).

If the controlling party will not undertake contractual obligations at all, the bank may take some comfort from some mere expression of goodwill.

Here the letter of comfort comes into its own.

It can at least assure the provider of the credit service that the parent company is aware of the credit relationship and of its magnitude. If need be, it can explain how, at the time of writing, the recipient of the service fits into the group overall. And it may be able to address other issues of concern to the bank without the parent undertaking any potential contractual obligation or liability to anyone.

How the issuing company sees it

Reluctance to issue guarantees or undertake binding obligations

The company issuing the letter of comfort may have many reasons for not wanting to undertake legally enforceable obligations to the bank.

- A small number of companies are unable under their documents of incorporation (charter, memorandum and articles, etc.) to issue guarantees or equivalents.
- Companies may have given undertakings to others, usually other lenders, that they will not issue any third party guarantees or will do so only under certain defined circumstances.
- In some countries, guarantees and equivalents are subject to taxation (stamp duty or similar levies)[8]. In others they must be disclosed in the official gazette. These are disincentives to issuance.
- Guarantees once issued, unless they contain an explicit expiry or other limitation date. can only be withdrawn or cancelled with the bank's consent. Sometimes they can be terminated after a given period of notice (enabling the bank to demand payment of the guaranteed debt in the meantime and, if it is not paid, to demand payment under the guarantee). Banks may be reluctant to release guarantees even after the obligation has been satisfied by the subsidiary until the possibility of insolvency proceedings and the application of the rules about unfair preference have long died.
- Guarantees of obligations of companies, especially foreign companies, by a parent/fellow subsidiary, can change the tax status of those companies[9].

[8] In such cases, companies are known to issue what they then call "letters of comfort", actually worded so as to provide enforceable undertakings, without fitting the local (tax) definition of a guarantee. These are not "letters of comfort" in the terms we are using them here, but collateral undertakings.

[9] For example in the UK, HMRC's tax notes:

o From OT22050 - Interest and Financing (*emphasis* added)

- Giving guarantees of the subsidiary's obligations without receipt of a fee, can give the parent problems with its own tax regulations on transfer pricing.

- In some cases what is to be seen as a stand-alone project can be carried on through a subsidiary. In view of the risk, jurisdiction, etc. the parent may take the view that the subsidiary must stand or fall, after initial or planned capitalisation, on its own cash flows ("project finance"). External liabilities then must be without recourse to the parent.

- While it is unusual, a holding company may quite legitimately take the "stand alone" attitude to its subsidiaries generally, as a matter of policy.

- When considering subsidiaries or incorporated joint ventures in other jurisdictions, parent companies commonly regard banks', especially local banks', exposure to the credit of the subsidiary/joint venture as a small measure of protection against expropriation, arbitrary loss of operating licences, import/export licences, etc. as banks may have some influence locally to "help" in such circumstances. If the parent issues guarantees it can remove the credit exposure to the potentially weakened customer and so also the incentive to help.

- Guarantees and other enforceable obligations are contingent liabilities and so require disclosure in the issuing company's own report and accounts. They may also require to be recognised as liabilities at some value in its balance sheet and profit and loss account[10].

Reluctance to issue letters of comfort

Most companies would have a self-image of responsible behaviour. Many, finding a subsidiary in financial difficulty will, without any obligation, prefer an orderly closure, settling all obligations as appropriate[11].

In international tax matters the usual yardstick acceptable to OECD countries, including the UK, is the arm's length arrangement. That is, in looking at UK group subsidiaries with a common overseas parent it may be necessary to limit the interest deduction to the arm's length level of interest charged on a total debt level no bigger than that which the relevant consolidated UK grouping would or could borrow from a third party without outside support. Outside support includes *guarantees***,** back to back loans, external collateral, *letter of comfort* etc., provided by other UK groupings or overseas parts of the world-wide multi-national group.

o From DT1919D - Non-residents: UK income: returns and reports: enquiries by FICO - form 4450/I part 2 (emphasis added)

Sometimes the borrowing is from a bank, etc., but the amount has been influenced by a *guarantee* given by an overseas parent. The influence can also be by way of a *letter of comfort or a letter of awareness*. International Division 4/5, Melbourne House would like to see any cases where excessive finance seems to have been obtained by such means.

[10] Proposals from the International Accounting Standards Board, first made in an exposure draft in June 2005, are likely to change IAS 37 so as to bring more guarantees on balance sheet, the amount so recognised being based on the probability of a claim.

[11] Since the early 1970s, this has been referred to in statements to the UK parliament by successive Secretaries of State for Industry, in the context of their own relationship with government controlled companies, as "best private sector practice".

However, even such parent companies have been known to allow the subsidiary to go into insolvent liquidation. And, of course, by the time any financial difficulty arises in the unit using the credit service, the management of the parent company may have changed entirely or the parent may itself have been acquired by another one[12]. Managers are reluctant to tie the hands of their successors by even a moral commitment, without good reason.

Companies must also be clear that there is some clear benefit to them in issuing the letter, since otherwise they risk acting outside the powers and authority of the company and the directors. This may not be obvious where the issuer is not the parent company.

Companies usually seek to minimise the number of comfort letters they issue.

- They may be uncomfortable with the possible risk to their reputation if the letter of comfort is not fully supported to the bank's satisfaction.
- They will certainly be concerned with the comfort letter's being interpreted by the courts as giving rise to legally enforceable obligations.
- Issue of a letter of comfort re the obligations of a company, especially a foreign company, can alter the tax status of the company[9].
- "Comfort letters" from the parent could defeat the purpose of project vehicles, operating without recourse to the parent with external credit purely on the basis of their own cash flows.
- They wish to avoid the administrative burden
    - Of issuing them.
    - Of control. Commonly, letters of comfort are controlled and reported within the parent company as if they were guarantees (except that there is no impact on external reporting).

  In a large group the number of possible occasions in which letters of comfort could be issued can be very large.

A Checklist: processes for the life of a letter of comfort, is provided at page 24, below. This can form a starting point for a chapter of a Finance/Treasury Policy manual.

[12] And, of course, the bank's staff dealing with the issue will probably have changed too.

Unenforceability of letters of comfort

By definition, a letter of comfort of the kind discussed in this note should not contain anything enforceable as a guarantee or collateral warranty or representation or otherwise. Attention to the wording is necessary to ensure this. In particular it is very important not to use language which can be construed as any kind of promise. Furthermore the conduct of the issuer of the letter must be consistent with an intention of unenforceability.

The wording must survive scrutiny in all jurisdictions which may consider the letter, not just the issuer's jurisdiction.

In confirming awareness of the credit relationship of a subsidiary or incorporated joint venture with a bank, a parent company may intend only to let a bank know that it will not mind if the local relationship goes ahead - it will not damage the relationship at group level.

The issuer *may* also want to indicate some moral inclination to the bank – that it *might* at least *consider*, ex gratia and *without any obligation whatsoever*, making the bank whole if it suffered a loss at the end of the day[13]. Issuers will, however, appreciate that liability in tort can follow from a statement or representation made in a comfort letter which is not accurate when made.

Enforceability is, in the end, a matter for the courts. Banks will, naturally seek to choose courts most favourable to their interpretation of the letter.

- This raises the question of whether it is sensible to include in a comfort letter a governing law clause and, perhaps also, an exclusive jurisdiction clause. The disadvantage, of course, is that such provisions are legalistic and work against the idea that the letter is not intended to give rise to legal relations. Certainly, such provisions are not usual. However, they could be helpful in trying to avoid courts which apply a more interfering attitude to business matters than the English courts or, if those courts had jurisdiction, in trying to get them to apply English law to the construction of the letter. It may be more natural to include governing law and jurisdiction clauses if part of the comfort letter, e.g. confidentiality provisions, were intended, and expressed, to be legally binding even though the "comfort" part of the letter were not so intended (and were expressed not to be legally binding). But see also the caution at the end of the second paragraph under Confidentiality undertaking, on page 16, below

Given the frequent informality of business relations, many court systems do not regard casual language and absence of form itself as evidence of no intention to enter into a contract. They may look instead at other evidence of intentions. This is discussed in the Appendix, Recent cases, page 28. In those cases, the difference between the attitude of the Australian Courts, which seem more inclined to find a contract and the UK, Singapore and Canadian which are more willing to analyse the text more closely is illuminating.

[13] The timing is important. The bank must not be discouraged from doing what it can to limit its losses/make maximum recoveries if things do go wrong. (See also reference to expropriation etc., page 10.)

In any case, inclusion in a letter of comfort of a disclaimer of any intent to create enforceable obligations is a highly advisable, if not necessarily an entirely reliable prophylactic (see Disclaimer, page 14).

In looking to see if the document was indeed intended to be binding, the courts may take the view that its being subject to intense or prolonged negotiation would be an indicator that it was intended to create binding obligations. Accordingly, "heavy drafting" and multiple drafts should be avoided – it is, after all, supposed to be a unilateral expression of mere goodwill. If they have to exist, successive drafts circulated to the bank should always be covered by a note reminding it that the letter is intended just to be a unilateral expression of goodwill, not a binding undertaking (and those covering notes should be retained).

Precedents: after the group member's financial distress

Commercially, and to avoid weakening the unenforceability of letters of comfort, do not allow a bank to form the impression that the company will as a matter of course "bail out" group members in financial distress or settle the group member's obligations to selected creditors including banks having received letters of comfort.

In such cases there will almost certainly be communication between the parent and the bank involved at some point. It may be desirable to avoid giving the wrong impression to the recipient of the letter of comfort by notifying it at an early opportunity that while any recapitalisation or other action involving directly or indirectly the issuer of the letter of comfort will be/is taking place, this is after consideration *only* of the interests of the company and the group themselves, commercially and as investors.

Features of letters of comfort

Disclaimer

It is advisable to include this in every letter of comfort. For example

- This letter is not intended to give rise to any enforceable agreement with or any undertaking soever to any person or persons whatsoever.

Sometimes this will exclude certain specified paragraphs, such as a confidentiality paragraph (see Confidentiality undertaking, page 16), or perhaps a paragraph undertaking to notify the bank after any change of the shareholding of the issuer of the letter in the receiver of the credit service (see Information undertakings, page 16).

This wording does not however exclude liability in tort, for example for negligent mis-statement. It is important therefore to check the factual accuracy of all statements carefully. If the disclaimer *is* intended to cover any such liability, its wording needs to be explicit in excluding liability in tort and even then it may not be effective to disclaim all liability, even under English law. Other laws will need to be considered if it seems likely that they may be relevant.

Specified addressee

A bank could assign its rights under a comfort letter – if it has any. While this may be a risk, there may be a greater disadvantage in adding language that attempts to make the letter personal to the bank, in that it could be taken to be evidence of an intention to create legal relations. In most circumstances therefore, it may be appropriate simply to address the letter to the named bank and say no more. (See also Confidentiality undertaking, page 16.)

Specified user of credit service

The letter of comfort should be in relation to a specific company (the subsidiary or incorporated joint venture). It should not be capable of being interpreted as applying to "our subsidiaries in country x" or to subsidiaries or associates of the subsidiary to which the letter relates, and so on.

In specifying the company, avoid going on with language such as "our distributor in…" or "our local franchisee" etc. (See Statement of continuing commercial relationship, page 18.)

Specified credit service

The letter of comfort should be in relation to

- provision in a specified country or specified countries of the credit service
- a specified service – a particular line of credit (expiry date noted) or letter of credit facility (expiry date for new issue noted) or automated payment service or foreign exchange line, etc. of x, y or z million currency units[14].
    - It is poor practice to put several services in any one letter.
      If the unit ceases to use a service and the letter remains outstanding

[14] Identification of the credit service should include identification of the terms/document in which terms are set out, so that what is really a new service after any change in those terms is not seen as included automatically.

the bank will be less likely to query its re-instatement, providing opportunities both for the fraudulent clerk (for his own reasons) and the local company finance director (who may, for example, find the possibility of reinstating a line of credit while overlooking the need to consult the group treasury to be a way of avoiding internal reporting of unexpected/temporary working capital peaks between internal reporting dates)

While specifying the service to which it relates, it is preferable to:

- avoid stating that the letter is provided as a condition precedent or requirement for use of the credit facility in question: this could be taken to be evidence of consideration, and hence of intention to create legal relations

- avoid setting an "expiry" date for a letter of comfort. This can make it look as if it is intended to be some sort of legal commitment. Rather, it is merely an expression of awareness and goodwill: how can that have an end date? This is especially important if the statement is simply a statement of *current* policy.

    - A credit facility, for example, is usually granted for a period of time (even overdraft facilities[15] are usually "marked" for a period of time, even though they can be cancelled and advances recalled without notice). Any related letter of comfort should refer to that (the better to identify the facility, of course). Eventually, the issuer should ask the bank to return the letter of comfort at expiry of the credit facility/service provision. A "renewal" or new facility or a change in terms and conditions should have a new letter which states that it supersedes any previous letter and the old letter should be returned[16].

Statement of awareness

Letters of comfort often start by stating that the issuer is aware of the (intended) provision by the bank of credit services as set out. Letters of comfort containing only this statement are sometimes referred to as "letters of awareness".

Statement of holding

There would often be a statement that X Ltd/plc/Ltda/SpA etc. is, at the time of writing, a subsidiary/affiliate etc., the holding company having at present an x% holding. It is important that this is stated to be true only at the particular time so it is less likely to be able to be interpreted as an undertaking to maintain the holding.

A claim in damages may lie if the statement is not true when made[17].

It would be courteous to advise the bank if the holding changes (see Information undertakings, page 16.)

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[15] Not legal in some jurisdictions
[16] See the *Leigh* case in the Appendix, Recent cases, page 29,
[17] This is generally low risk: companies usually know their shareholdings in subsidiaries. There is a risk, however, regarding companies in some jurisdictions where incumbent management can issue shares without shareholder approval, especially where the (overseas) parent has only a majority holding. Requesting confirmation by the unit of the parent's holding in the unit and receiving the expected answer soon before issuing the letter is probably sufficient to avoid negligence or recklessness.

Possible binding obligations in a letter of comfort

While a letter of comfort as considered in this note is intended to contain no binding obligations relating to the credit of the receiver of the credit service(s) in contemplation, it can contain other obligations, though these are best avoided.

Confidentiality undertaking

The company will issue a letter of comfort in the context of its overall relationship with a bank. It is, remember, usually concerned to ensure that it is undertaking only a possible moral obligation. It will not want the bank to think that there is anything the bank could transfer to any other party (for example someone to whom it sells the credit risk). However, the parent may not want other bankers to the subsidiary to know of the letter[18]. Furthermore, companies do not want to be pressed for letters of comfort by other banks generally.

Accordingly, while companies would often, understandably, like to include a confidentiality clause which they may hope is binding on the bank, it may be difficult to do so without providing evidence of intention to create legal relations and hence possibly finding the whole letter of comfort enforceable against them.

Information undertakings

Banks would often like an undertaking that the issuer of the letter of comfort would advise the bank (even "promptly") if its holding in the recipient of the credit service should be reduced. While it may not seem unreasonable to agree this, the issuer of the letter of comfort should be wary of making any promise which could contribute to the creation of other legally enforceable obligations. For this reason, indeed, there is often a statement that there is *no* obligation to notify any change. It would, however, be a politeness to advise the bank in any case.

Budgets and plans

Banks sometimes ask to be assured that the parent reviews and approves the unit's plans and budgets. Such an assurance might contain dangers if the unit gets into financial distress. If the issuer's negotiating position is very weak, the following might be considered:

- It is our present practice to review the plans and budgets of members of the group for the purposes of preparing an overall group plan or budget.

Again the statement is to be true when made but with no maintenance undertaking. The wording implicitly acknowledges the responsibility of the board of the subsidiary for its own affairs. The purpose of the review is stated to be for *group* purposes, with nothing said about the parent ensuring appropriateness etc. for the unit itself.

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[18] This should not necessarily be seen as discriminating unfairly, or at all, between banks. Most companies would not see the issuance of a letter of comfort generally as making any difference in practice to their responsible approach to bankers to units in financial distress.

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Not found in letters of comfort

The following examples are all taken from requests for inclusions made by banks.

Statements of support

Statements that "[the company] will support the subsidiary's business ventures" and similar are potentially an enforceable collateral undertaking possibly going further than a simple guarantee to the bank as extending beyond just the liability of the unit to the bank[19]. Any statement which could be characterised as a promise runs the risk of being enforceable itself and may add weight to arguments about enforceability intentions in relation to other matter in the letter.

Statement of continuing commercial relationship

Banks would often like an undertaking that the parent company would ensure that existing commercial relationships between other group members and the unit receiving the credit service would be maintained (at least during the life of the service).

This goes well beyond comfort letter matter and almost certainly would, except in more difficult cases, be too restricting for the group.

There may of course be contracts between the units[20]. Because of the relationship of the units with the parent however, such contracts are commonly terminable without notice or at short notice. Even if this does not apply, the group will generally assume determinability by "agreement" with the unit. Accordingly, such contracts are probably of little comfort to the bank.

An issuer in a weak negotiating position might be willing to state that the unit is "currently" the local importer, distributor, licensee, franchisee, etc. or current supplier, processor, assembler, etc.. In the more difficult cases, the issuer may go so far as to agree to notify the bank if the licence etc. were determined for any reason..

Statements of financial involvement

An "assurance of the holding company's financial involvement with its subsidiary" is either without significance (the financial involvement is limited to the position as shareholder) or capable of many interpretations. The issuer of the letter of comfort will not want to expose itself to whatever the bank's counsel can persuade the courts the letter really meant.

Not found

[19] Such a statement may be found in "letters of comfort" issued in lieu of a guarantee to get round tax consequences of or prohibitions on guarantees as defined in tax codes or a company's founding documents. In such cases the issuer's intention is probably to pay off the debt in such circumstances directly, as if it were a guarantee, not through the subsidiary at all. Care is needed to ensure that third parties do not gain rights under this.

[20] They may be required under local import/export, exchange control etc. regulations but are usually to protect intellectual property and to ensure that cancellation/termination is explicitly provided for.

Statement of responsibility for the subsidiary's policy, etc.

An assurance "that the holding company is responsible for the overall policy of its subsidiary" would raise many difficulties. The holding company is not "responsible for" anything about the subsidiary or affiliate, unless it has explicitly entered into a agreement to be so responsible or has incautiously acted so as to have become responsible as a shadow director[21] of the company. A holding company, in making such a statement, could be well on the way to admitting being a shadow director of the company and might well create an enforceable obligation in favour of the bank to ensure the continued solvency of its subsidiary.

Internal control policies

Banks would often like some specific indication of the group's internal control policy. Issuers will be reluctant to do this as they would think the bank is looking for some sort of warranty as to the reliability of internal audit and other control processes in the group, and so in the unit.

UK listed companies will have made general group internal control disclosures in their report and accounts and the subsidiary can draw attention to this. Less usefully, US reporting companies under Sarbanes Oxley warrant adequacy of processes involved in preparing the published group accounts.

The following indicates the sort of thing which might be given if the issuer's negotiating position is weak:

- It is currently our policy that members of the group follow certain group guidelines on formation of policy and on appropriate internal control, budgeting and planning systems they might adopt.

Note the emphasis on being true at the time of writing ("currently") with no undertaking about maintenance[22]. The effect of the policy is stated as internal to the receiver of the credit service. There is also no undertaking about appropriateness, enforcement or effectiveness of the policy and no undertaking to advise the bank if the policy changes (although it would be polite to do so).

Statements of condition

A bank may ask for a statement that "[the subsidiary] *will* be in a position to fulfil its obligations to the bank"[19]. Again, this is potentially a collateral undertaking which may be more costly to fulfil than a simple guarantee to the bank. For the *subsidiary* to fulfil its obligations to the bank it would have to fulfil them also to equal and higher ranking creditors and need funding to at least that level. If the obligations include timeliness, insolvency proceedings may have to be avoided, when the funding would have to satisfy all creditors.

A statement that "[the subsidiary] *should* be in a position to meet its liabilities to the lender" while perhaps merely expressing an opinion or current expectation or being just statement of the company's ideas of the responsibility of any debtor to the creditor, raises problems. Does it amount to a promise for the future? Even if not,

[21] A shadow director is a person in accordance with whose directions or instructions the directors of a company are accustomed to act.

[22] In Australia it has been held that a simple statement "It is our policy…" implies an undertaking to maintain that as the policy. It seems less likely that the English courts would take such a view.

was the statement made after due enquiry? What if the issuer later begins to have doubts? It could open a can of worms and should be avoided.

Subsidiary solvency policy and other reassuring policies

Banks may want something along the lines of "It is our policy that subsidiaries should manage their business in a manner so as to be able to meet their liabilities as they fall due".

Of course the ability to meet liabilities as they fall due is the test for solvency in many jurisdictions' insolvency laws. No doubt companies do not expect their subsidiaries to trade while insolvent. But, in any case, to make such a statement opens up new areas for banks to look for the possibility of enforceability and companies should normally avoid this, although a statement beginning "it is our present policy" is at least arguably only a statement as to current fact rather than a promise as to future conduct[22]. Nevertheless, based on the Australian cases noted in Appendix 2, the Australian courts would appear to regard references to policy as a promise for the future; and other countries' courts, too, might be persuaded that this is how the words should be construed.

A company in a weak negotiating position may concede something along the following lines:

- It is currently our policy that members of the group manage their business so that they can expect to be able to meet their obligations as they fall due. Nothing in this statement should be taken to impose on us any obligation to notify you of any future change in policy.

Note the emphasis on being true at the time of writing ("currently") with no undertaking about maintenance[22]. The effect of the policy is internal to the receiver of the credit service. There is also no undertaking about enforcement or effectiveness of the policy and no undertaking to advise the bank if the policy changes (although it would be polite to do so in the unlikely event that it should change).

In a worse negotiating position, a company may need to concede a similar statement addressing the particular bank

- It is our present policy to ensure that [name of company] is in a position to meet its obligations to you. Nothing in this statement should be taken to impose on us any obligation to notify you of any future change in policy.

Again, it would be polite to tell the bank in the event that it should change.

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Letters of discomfort (non-recourse)

Companies are usually reluctant formally, explicitly to put a bank on notice that they will not consider any credit support at all to a particular subsidiary/incorporated joint venture. The risk is that a bank will then consider that there is implicit comfort in respect of all other units.

However, in some circumstances this is considered essential. Instances normally are either where companies are uncertain of the extent of their real control of the unit as is sometimes the case for non-wholly-owned subsidiaries, for incorporated joint ventures and so on, or for self contained project vehicles where non-recourse to the parent is important.

“Letter of discomfort” is a handy term for the notification to the bank.

Letters of discomfort must usually be individually crafted in view of the particular circumstances.

Such a letter will include a paragraph saying that

- the company has no intention to consider support for or investment in the unit above the level which it considered from time to time to be appropriate either because of its group’s commercial relationship with the unit or as an investor and
- the credit institution must make its own enquiries, investigations and analyses and do its own fact checking and form its own view of the credit risk involved in doing business with the unit without reliance in any way on the unit’s relationships with the parent or the rest of the group.

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Appendix 1

Checklist: processes for the life of a letter of comfort

- **Process awareness**
  Ensure that all staff (including board members) dealing with banks are aware of the internal control processes regarding making of statements in any media which could be interpreted as letters of comfort.

  Especially, ensure that colleagues know who is authorised to offer a letter of comfort to a provider of credit or to discuss the content. As a practical matter it is more difficult to negotiate back to a position of no letter of comfort being available or to a letter with acceptable wording if someone in the company has already offered one or indicated that some other wording may be possible.

- **Control of outstanding letters**
  Ensure that all previously issued letters of comfort issued (in whatever medium or context) by any member of the group to providers of credit or credit services are centrally controlled and
  - are properly documented
  - have been reviewed to ensure there are no potentially binding undertakings and that if there are binding undertakings
    - they are recognised and properly reported, and
    - if they are unwelcome, that a process for agreeing with each bank in each case individually that they be cancelled (and, if need be, replaced) is put in hand and followed up to completion
    - if they are acceptable, that an internal process is in place to ensure that they are followed
  - have been reviewed to ensure they contain no inaccurate statements of fact
  - are reported internally
  - are known about and taken account of in all decision taking processes about the affected subsidiary/incorporated joint venture or its relationship with the parent/fellow subsidiaries, etc.

- **Issue of new letter of comfort**
  Before issuing new letters of comfort
  - Ensure that the issue process is centrally controlled and documented
  - Review to ensure that the most appropriate group member (normally the parent) is issuing the letter
  - Ensure that the bank is aware that only a letter of comfort is being contemplated and not some binding obligation related to the credit
    - Remind the bank of this in every communication about it prior to issue – retain a copy of each reminder

Process checklist

- Try to use only a standard letter of comfort text which the issuer is happy with in most jurisdictions. If modifications are made, try to do this with standard paragraphs.
- If there are binding aspects to the letter – perhaps confidentiality, or an undertaking to notify of changes in shareholdings of the parent in the company using the credit service – ensure that these are acceptable and that processes are in place/put in place to ensure they are observed
- Ensure the accuracy of all statements is checked and verifiable
- Avoid "heavy negotiation" of the terms of the letter. In any case a note sent with each new draft reminding the bank that it is not intended to produce binding obligations may be helpful – and a copy of all such notes should be permanently retained
- Ensure that the letter of comfort relates only to a specific advance, loan, facility, service, etc. on terms you recognise and not to existing business on changed terms or to whatever business the bank chooses to do with the subsidiary/incorporated joint venture
- Ensure your legal advisers review the proposed letter to ensure no unintended potential liabilities to the bank or to third parties may be being imported, in the context of the jurisdictions of at least
  - the incorporation of the issuer of the letter
  - the location of the office from which the issuer is proposing to issue to letter
  - the bank recipient
  - the branch of the bank providing the credit service
  - the unit receiving the credit service and
  - wherever the service will be provided
- Ensure your tax advisors review the proposed letter to ensure no unintended tax consequences for
  - the unit receiving the credit service - in its country of incorporation, or in the jurisdiction where the service will be provided or received
  - the issuer of the letter
- Ensure the user of the credit service undertakes to notify the issuer of the letter if it stops using the credit service or a credit service among several dealt with in the same letter or is considering changing the terms of a service
- Ensure that there is some clear benefit *to the company issuing the letter*, since otherwise they risk acting outside the powers and authority of the company and its directors.

- **Expiry**
  When the/a particular reason for issuing the letter of comfort has expired
  - and is not being renewed
    - Advise the bank that you have noted that the/a reason for the letter has ceased and
      - ask the bank to return the letter of comfort (follow up to ensure receipt)

        - where appropriate provide a new letter covering only the remaining credit services (better a separate one for each service)
    - and is being renewed
        - The new letter should
            - note that it supersedes the old letter
            - ask the bank to return the old letter of comfort (follow up to ensure receipt)

- **Financial distress or insolvency**

  If the unit in respect of which with letter of comfort has been issued nears financial distress and the parent recapitalises it or provides other financial support, or the company becomes insolvent and the parent makes whole the bank or other selected creditors
    - Consider making clear to the bank directly that the decision to take such action was after consideration *only* of the interests, commercial and as an investor, of the parent/group

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Appendix 2

Recent cases

Cases on letters of comfort have been uncommon, but some recent cases are briefly summarised below[23]

- Kleinwort Benson Ltd. V. Malaysia Mining Co. Berhad ([1989] 1 W.L.R. 379)
- Hong Kong and Shanghai Banking Corporation Ltd v Jurong Engineering Ltd [2000] 2 S.L.R. 54
- Banque Brussels Lambert SA v. Australian National Industries Ltd, (1989) 21 NSWLR 502
- The Toronto Dominion Bank v. Leigh Instruments and others (1999), 40 B.L.R. (2d) 1 and 178 D.L.R. (4th) 634
- Gate Gourmet Australia (in Liquidation) v Gate Gourmet Holding AG & Ors [2004] NSWSC 149

The judge in the Court of Appeal in England in the Kleinwort case[24], after careful analysis of the wording, held that the comfort letter as imposed no more than a moral responsibility to meet the company's debt.

In the Leigh case[25], there was again careful textual analysis. A submission by Counsel for the new owner of the defendant was quoted with approval in the judgement of the Ontario Appeal Court:

> "In this marketplace, both parties have experience in situations where a parent, for reasons it deems appropriate, refuses to give a legally binding assurance and a bank, for reasons it similarly considers appropriate agrees to accept something less, perhaps believing that when, and if, "push comes to shove", the parent would pay for any or all of the "non-legal" commercial considerations of reputation, fear of adverse publicity, higher future borrowing costs and a myriad other reasons and possibilities depending on the circumstances."

The Australian Courts however have difficulty, in the absence of clear language stating an intention to be non-binding, in accepting that a non-binding letter would be either sent or accepted as part of a commercial relationship. They have deprecated judgement based on close textual analysis.

The cases indicate that

- inclusion in a letter of comfort of a disclaimer of any intent to create enforceable obligations is a highly advisable, if not necessarily an entirely reliable prophylactic (see Disclaimer, page 14 above)
- it is advisable to avoid "heavy drafting" or negotiation of the letter.

[23] These summaries make no attempt to be complete and it should not be assumed that they are accurate: reference should be made to original sources.

[24] Kleinwort Benson Ltd. V. Malaysia Mining Co. Berhad ([1989] 1 W.L.R. 379)

[25] The Toronto Dominion Bank v. Leigh Instruments and others (1999), 40 B.L.R. (2d) 1 and 178 D.L.R. (4th) 634

The leading British case

Kleinwort Benson Ltd. V. Malaysia Mining Co. Berhad ([1989] 1 W.L.R. 379)

Malaysia Mining Co. Berhad ("MM") gave two comfort letters to Kleinwort Benson Ltd. ("KB") which provided a credit facility to an MM subsidiary.

Each comfort letter said it was the policy of MM to ensure that the subsidiary was at all times in a position to meet its liabilities to KB.

The subsidiary went into liquidation. KB sued MM, winning at first instance.

On appeal it was held that, on the basis of the exact wording and in the light of the surrounding circumstances, the statement in the letters merely stated MM's policy at the time and did not contain a promise that it would be continued in the future. The statement imposed at most a moral, and so unenforceable, obligation on MM.

Singapore

Hong Kong and Shanghai Banking Corporation Ltd v Jurong Engineering Ltd [2000] 2 S.L.R. 54

The Court applied the principle that, having been created in a commercial setting, the letter would generally be intended to create binding obligations. Jurong had to rebut this presumption.

A key paragraph of the letter said that if the subsidiary was unable to meet its obligations, the parent would endeavour to make funds available to it sufficient to meet the obligations. The subsidiary, failing to make other payments, was wound up by another creditor.

Jurong did not include a specific or general disclaimer of liability in its letter of comfort. However, HSBC repeatedly pressed for Jurong to replace the letter of comfort with a guarantee, lending weight to a lack of intention for enforceability of the letter.

The Court distinguished the case from the Australian case Banque Brussels Lambert because the heavy negotiation of the letter was absent.

The Court found that

- HSBC had not placed any reliance on the letter
- qualifying the apparent undertaking with "will endeavour" rendered it no more than confirmation of moral obligations

and concluded that the letter as a whole and the parties' conduct in its negotiation did not disclose any intention to create legal relations on the part of Jurong.

Canada

Toronto Dominion Bank v. Leigh Instruments and others (1999), 40 B.L.R. (2d) 1 and 178 D.L.R. (4th) 634

Toronto Dominion Bank ("TD") was in receipt from The Plessey Company plc (a UK company) ("Plessey") of a series of comfort letters about advances to Leigh Instruments Ltd ("Leigh"), an Ontario company. Leigh went into bankruptcy[26].

[26] Allegations of a separate fraud were dismissed by the court.

The comfort letters were provided to TD's London branch as the facility was from time to time renegotiated. They

- confirmed Plessey was aware of the credit
- included an undertaking by Plessey not to reduce its 100% ownership without prior notice to TD
- included a statement that it was Plessey's policy that its wholly-owned subsidiaries be managed in such a way as to be always in a position to meet their financial obligations and that this included Leigh and its obligation to TD
- The last of the comfort letters contained new language stating that the letter "does not constitute a legally binding commitment".

The last letter (issued after Plessey had been acquired by GEC-Siemens), which stated that it superseded all previous such letters, was accepted by TD without comment, and no one at the bank acknowledged having read the letter at the time – though the court found that a senior banker had "received, read and accepted the letter on behalf of the bank".

The bank asserted (alternatively or additionally) that

- the comfort letters generally and in particular the policy paragraph included a "contractual commitment by Plessey to directly or indirectly pay the bank the amount of the Leigh loan".
- the policy paragraph contained in each comfort letter was untrue and constituted a negligent or fraudulent misrepresentation

On the contractual assertion, the court concluded that

- TD had received, read and accepted the last letter including
    - the supercession language
    - the non-binding language

  so there was no contractual liability
- but in any case, based on either market practice regarding comfort letters or the specific language in these comfort letters, the policy paragraph did not amount to a promise

On the second assertion, the court took the view that:

- in providing the letters of comfort Plessey indeed had a duty of care to avoid making any negligent misrepresentation
- the policy statement was a continuing representation not limited to the time at which the letters were issued

but that in this case the policy statement was factually true.

Australia (1)

Banque Brussels Lambert SA v. Australian National Industries Ltd, (1989) 21 NSWLR 502

Australian National Industries Ltd ("ANI") was ultimate effective parent company of Spedley Securities Ltd ("SSL") and issued Banque Brussels Lambert ("BBL") with a letter of comfort which:

- confirmed that ANI was aware of and consented to the granting of the loan facility by BBL

- stated that it would not be ANI's intention "to reduce our shareholding … from the current 45% during the currency of this facility. We would, however, provide your bank with ninety (90) days notice of any subsequent decisions taken by us to dispose of this shareholding…"
- took the opportunity "to confirm that it is our practice to ensure our affiliate Spedley Securities Ltd will at all time be in a position to meet its financial obligations as they fall due. These financial obligations include repayment of all loans made by your Bank under the arrangements mentioned in this letter."

There was extensive negotiation of the text of the letter. For example ANI proposed a paragraph saying that the letter "does not constitute a guarantee" and this was rejected by BBL who said the "comfort letter" was "in [BBL]'s mind a binding obligation…. If this is not he case, then the facility won't be granted."

SSL went into liquidation. It was common ground that ANI had breached its obligation regarding notice of a reduction in its shareholding in SSL, but BBL accepted that this was not the immediate cause of loss.

BBL submitted that ANI was in breach of contract by not honouring the obligation it claimed was implicit in the policy statement [27].

Eventually the Supreme Court, considering the case, reviewed the *Kleinwort* case (above). Rogers C.J. said that the Australian authorities did not accept the sufficiency of Lord Denning's statement under English law[28] that a statement was promissory if it was made for the purpose of inducing the other party to act upon it, and that it did actually cause the other party to act upon it and enter into the contract. "There should be no room in the proper flow of commerce for some purgatory where statements made by businessmen, after hard bargaining and made to induce another business person to enter into a business transaction would without any express statement to that effect, reside in a twilight zone of merely honourable agreement." He agreed not with the Appeal Court but with the court of first instance in England (that had been overruled) that "high regard" should be paid "to the fact the comfort letters came into existence as part and parcel of a commercial banking transaction and that the promises were an important feature of the letters."

It was held that the first statement (on the shareholding) was clearly an enforceable promise. And on the second, the conclusion was reached that "it is our practice to ensure…" had the same effect as "we promise to ensure…". Rogers J, in justifying this, criticised the approach of the Appeal Court in *Kleinwort* in subjecting "the letters to minute textual analysis… Courts will become irrelevant in the resolution of commercial disputes if they allow this approach to dominate their consideration of commercial documents."

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[27] There was also

- allegation that ANI gave the warranties in the letter while knowing them to be untrue
- a request that ANI should be estopped from denying
  - the truth of the two statements made in the letter
  - that the promises made were legally binding
- allegation of deceptive and misleading conduct (under the Commonwealth Trade Practices Act) by not notifying BBL of its intention not to abide by the statements and promises in the letter and a request for relief on grounds of unjust enrichment and unconscionability.

[28] Dick Bentley Productions Ltd v. Harold Smith (Motors) Ltd [1965] 1 W.L.R. 623

However, the statements in the letter were not an undertaking to pay simply on default by Spedley but "… remote from the liability of [SSL] to repay the facility. By reason of this, a failure to adhere to the statements made will, at best, give rise merely to a claim for damages and throw up considerable questions of causation".

Australia (2)

Gate Gourmet Australia (in Liquidation) v Gate Gourmet Holding AG & Ors [2004] NSWSC 149

This case concerns a "letter of comfort" issued by a Swiss parent company, Gate Gourmet Holding AG ("GGHAG") to the directors of its Australian holding company Gate Gourmet (Holdings) Pty Limited ("GGHPty") [i.e. not a letter of comfort as used elsewhere in this note]. It illustrates the difficulty that the Australian courts have in accepting (in the absence of specific language) that as part of a wider commercial transaction a letter would be sent from one party and accepted by the other if it was never intended to be legally binding.

The letter to GGHPty said that the ultimate parent would provide the financial support necessary to allow the holding company and its subsidiaries to meet their financial commitments as and when they fell due. Without this, the poor business situation of Gate Gourment Australia Pty Limited, the operating subsidiary ("GGAPty"), meant that the directors of GGHPty and GGAPty would be unable to sign a declaration for accounts purposes that they had reasonable grounds to believe that the companies would be able to pay their debts as and when they fell due.

Over the next year GGAPty's situation became worse. GGHAG provided the directors of GGHPty with a second letter with similar "support", adding

> "This letter of support will not be withdrawn before [GGHPty] and its controlled entities have sufficient means to meet their obligations without the support of the parent entity."

During the next year, the commercial situation got even worse. GGHAG advised the directors of GGAPty that they were prepared to make a payment to Westpac bank but to no other creditors. GGAPty went into liquidation.

The liquidator relied on the second letter of comfort as a contract enforceable against GGHAG, but the latter said there was no legally binding relationship between it and GGAPty (and in any case that as it was not addressed to them GGAPty could not enforce any such purported binding relationship).

In its judgement, the Court cited both *Kleinwort* and *Banque Brussels Lambert*.

The court held that while the extensive negotiation in *Banque Brussels Lambert* was absent, GGAPty could enforce the letter of comfort against GGHAG

- in commercial transactions there is an intention to create legal relations
    - if there are statements that are promissory, then they are enforceable in the absence of a clear statement to contrary
- the letter used technical language – e.g. "controlled entities" and "ability to meet its financial commitments" – indicating intention to create legal relations
- the letter contained promises themselves showing that GGHAG felt itself bound – e.g. the promise that the letter of comfort would not be withdrawn until certain conditions were met

- the letter did not say how GGHAG would provide the support, but this was not so vague as to be a bar to it being an enforceable obligation
- it was clear from the letter that GGAPty was intended to benefit from its terms
- without the letter, the trading company had always been insolvent and it was always clear that the directors of GGAPty would rely upon the letter

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TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

Briefing note

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A practical guide

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