Turning a sober eye to Southern Comfort:
Does the law adequately recognise letters of comfort?

By Jonathan Nicholas Gill

When making a loan to one of a group of companies, the prudent course is to take a guarantee from the parent company ... only in this way can the lender be certain that the assets of the group will be available to meet the obligations of the legal borrower. Unfortunately, what is prudent for the lender is not always acceptable to the parent company ... thus, the compromise position is the letter of comfort [emphasis added].
That summation, capturing the essence of a letter of comfort, comes from a paper entitled “Southern Comfort”, part of a collection of online papers about Australian banking law1. In general terms, a letter of comfort is a document given by a parent company to the bank of its subsidiary in response to a loan given by the bank to the subsidiary, offering some form of “comfort” that the parent company will ensure the subsidiary is able to repay the loan. A letter of comfort normally includes:

1 a statement of awareness of the financing;
2 a commitment to maintain ownership interest;
3 the degree of support required by the lender.

This raises the question of whether such “comfort” is worth having as it is not a guarantee.

An example of a letter of comfort is as follows:

“We hereby confirm that we know and approve of these facilities and are aware of the fact that they have been granted to M M C Metals Ltd because we control directly or indirectly M M C Metals Ltd.

“We confirm that we will not reduce our current financial interest in M M C Metals Ltd until the above facilities have been repaid or until you have confirmed that you are prepared to continue the facilities with new shareholders.

“It is our policy to ensure that the business of M M C Metals Ltd is at all times in a position to meet its liabilities to you under the above arrangements.”2

Since 1988, letters of comfort given in similar factual circumstances containing similar statements have managed to produce completely different results in various jurisdictions. Invariably, these results have ignored the essence of compromise within a letter of comfort. Letters of comfort are the product of the tension between lenders seeking to better secure their loan and holding companies attempting to avoid as many of their subsidiaries’ obligations as possible.

Australian courts consider that strongly worded letters of comfort impose legal liability on the letter of comfort’s provider in the nature of a guarantee, whereas English and New Zealand courts are at the other end of the spectrum, holding that letters of comfort do not attract any legal liabilities.

Clearly, a letter of comfort is not a guarantee (a type of contract) and may not even be a contract. In light of the difficulties in establishing legal obligations for letters of comfort in contract law (called primary obligations) and the inappropriateness of contractual damages awarded (called secondary obligations), letters of comfort should not be treated as contracts. This is not to say, however, that letters of comfort should not attract any legal liabilities.

In the next section, the current law on letters of comfort in England, Australia and New Zealand is briefly considered, followed by an assessment of the reasons for and limitations of preferring equitable estoppel and the Fair Trading Act 1986 over contract law in the treatment of letters of comfort. In light of the limitations that exist in estoppel and the Fair Trading Act 1986, perhaps the only way to adequately recognise the compromise that exists in a letter of comfort is through legislative intervention.

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2 Kleinwort Benson Ltd v Malaysia Mining Corp Bhd [1988]. All ER 714 (QB) [1989]. 1 All ER 785 (CA) (emphasis added).
The English case of Klienwort Benson\(^3\) produced the fundamental decision on letters of comfort. The case was decided at the first instance by Justice Hirst at Queen's Bench level, but his decision was overturned by the English Court of Appeal. The Court of Appeal held that letters of comfort had no contractual status and were unenforceable by lenders. In Australia, the Queen's Bench has been followed by Chief Justice Rogers, while in New Zealand, the English Court of Appeal decision has been adopted.

In Klienwort Benson\(^4\), Justice Hirst, at first instance, held that the letter of comfort had contractual status and that the defendant was liable under the letter of comfort as if it was a guarantee. In reaching this decision, His Honour applied the decision in Edwards\(^5\) that there was a rebuttable presumption that the letter of comfort had contractual status and that on the facts, the presumption had not been rebutted. In other words, Justice Hirst focused on the intention of the parties, as opposed to the wording of the letter of comfort.

The English Court of Appeal reversed this decision and held that the letter of comfort was not contractually binding. In reaching this conclusion, the Court of Appeal objectively focused on the wording of the letter of comfort as opposed to the intention of the parties. This approach is fundamental to the law of contract. It is essential to first establish that a clear promise has been made\(^6\), before the intentions of the parties are examined.

Nevertheless, the leading case in Australia, Banque Brussels\(^7\), adopted the Queen's Bench decision of Klienwort Benson\(^8\). Chief Justice Rogers focused on the intention of the parties rather than the wording of the letter of comfort, preferring the circumstances in which the letter of comfort was provided as opposed to the wording of the letter. As an alternative, Chief Justice Rogers also found liability under the doctrine of estoppel. Accordingly, he awarded damages to the bank as if the letter of comfort had been a guarantee. This finding of liability and the quantum of damages fail to distinguish a letter of comfort from a guarantee.

In New Zealand, the English Court of Appeal decision in Klienwort Benson\(^9\) has been followed by the New Zealand Court of Appeal in BNZ v Ginivan\(^10\) and by the High Court in Genos Developments Ltd\(^11\).

In light of the above decisions from England, Australia and New Zealand, it can be seen that the results lie at either end of the spectrum of liability – liability as if the letter of comfort had been a guarantee or no liability at all. Both these results fail to recognise that the parties clearly intended a compromise. But can a middle ground be found in the law between a guarantee and no guarantee at all?

**CAN A DISTINCTION BE MADE BETWEEN A GUARANTEE AND A LETTER OF COMFORT?**

A distinction needs to be made between guarantees and letters of comfort. The cases to dates have failed to achieve this.

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\(^1\) Ibid.
\(^2\) Ibid.
\(^3\) Edwards v Skyways [1964] 1 All ER 494.
\(^4\) A “promise” is defined as a declaration or assurance by which a person undertakes a commitment to do or refrain from doing a specified act or gives a guarantee that a specified thing will or will not happen, be done, etc. (See The New Shorter Oxford English Dictionary).
\(^5\) Banque Brussels v Australia National Industries (Supreme Court, NSW (Commercial Division) No:50196/89).
\(^6\) Ibid note 2.
\(^7\) Ibid.
\(^8\) [1991] 1 NZLR 178 (CA).
\(^9\) Genos Developments Ltd v Cornish Jenner & Christie Ltd (High Court Auckland, CP 556/90, July 10, 1990).
The courts’ present application of the law of contract to establish legal liability under a letter of contract is illegitimate.

distinction, but is it possible to achieve? To answer this question, contract, equity and the Fair Trading Act 1986 must be examined. To achieve a distinction between a letter of comfort and a guarantee, therefore, an area of law must be found that secures primary obligations between the parties to a letter of comfort and that provides adequate damages that recognise that letters of comfort are a compromise. As alluded to previously, the courts’ present application of the law of contract to establish legal liability under a letter of contract is illegitimate.

This is not to say that letters of comfort will not attract legal liability, only that liability based in contract law may be inappropriate. If no appropriate areas of the law can be identified, however, then letters of comfort will not attract any legal liability and they will remain mere statements of present intention unless there is legislative intervention.

THE LAW OF CONTRACT

Primary obligations under the law of contract

The law of contract is not the correct area of law in which to find primary obligations with respect to letters of comfort even though Justice Hirst in Klienwort\(^\text{12}\) and Chief Justice Rogers in Banque Brussels\(^\text{13}\) used the case of Edwards\(^\text{14}\) to find liability within the law of contract.

Intention to create legal relations

In the case of Edwards\(^\text{15}\), the defendants made a promise that pilots declared redundant would be given an ex gratia payment. The company then later purported to rescind its decision to make the ex gratia payment. The company admitted that the agreement was supported by consideration, but contended that it had no legal effect because there was no intention to enter into legal relations. Justice Megaw rejected this because in commercial transactions there was a presumption of an intention to enter into legal relations.

With letters of comfort, however, the principal question is whether the language of the letter of comfort contains a contractual promise. In Edwards, the language was obviously promissory and so the subsequent question of intention to create legal relations was asked. Thus, when establishing a contract, Edwards does not sanction the jump to the subsequent question of intention to create legal relations, whilst ignoring the fundamental question of whether the language was promissory. If courts were to jump to the presumption in Edwards, it could follow that every statement in the course of commerce is presumed to be contractual. Hence, it is submitted that Edwards cannot be applied to letters of comfort to find contractual liability, at least until the primary matter of objectively examining the language for a contractual promise is first determined.

Secondary obligations under the law of contract

If courts continue to treat letters of comfort as binding in contract, they must at least attempt to distinguish letters of comfort from guarantees in the remedies awarded.

Causation

If a letter of comfort is a compromise, then such a letter of comfort cannot attract the same quantum of damages as a guarantee. Questions of causation will be relevant. If the parent company’s undertaking is only to maintain its present involvement in the subsidiary, then it is

\(^{12}\) Ibid note 2.
\(^{13}\) Ibid note 1.
\(^{14}\) Ibid note 5.
\(^{15}\) Ibid.
unlikely that a damages award would equate with the sum in default on the loan. This is because an undertaking to maintain a level of shareholding in a company does not guarantee the solvency of that company and a mere transfer of shares involves no drain on the company funds. Thus the default could not be entirely attributed to the parent company's failure to maintain its participation in the subsidiary.16

On the other hand, if the parent company's obligation is to provide its subsidiary with the financial means to meet its obligations, there is a direct causal link between the parent company's breach and the subsidiary's default. This was the situation in Banque Brussels17, for the strongly worded paragraph in the letter of comfort was an assurance of the subsidiary's ability to meet its financial obligations. Accordingly, Chief Justice Rogers awarded damages to the full extent of a guarantee. It appears that when there is a direct causal link to the loss suffered, the parties' compromise cannot be reflected in the damages awarded in contract law unless there is legislative intervention.

2 Apportionment of damages

In New Zealand, legislative intervention in the "apportionment" of contractual damages between the parties (where the damages payable by an unsuccessful defendant are reduced to reflect the parties' compromise) may exist in the form of the Contributory Negligence Act 1947. However, the application of this Act to breaches of contract remains unsettled.

16After finding that primary obligation could be grounded in contract, Chief Justice Rogers, in Banque Brussels, ibid note 7, held that damages will "throw up considerable question[s] of causation" (emphasis added).
17Ibid note 7.
Even if a contract could be found between the parties, contractual damages may not be able to reflect the parties' compromise because the application of the Contributory Negligence Act 1947 without legislative amendment would be unsound. Therefore, other potential sources of obligation must be considered.

**EQUITABLE ESTOPPEL**

The full implications of the doctrine of estoppel in enforcing letters of comfort have not yet been realised. As previously noted, however, Chief Justice Rogers raised the issue of estoppel in the case of Banque Brussels.

**Primary obligations under equitable estoppel**

Equitable estoppel was developed in Waltons Stores. In this case, Justice Brennan set out the following elements of an equitable estoppel claim:

1. the plaintiff assumes or expects that a particular legal relationship then existed or would exist, that the defendant would not be free to withdraw from;
2. the defendant has induced the plaintiff to adopt that assumption or expectation;
3. the plaintiff acts or abstains from acting in reliance on the assumption or expectation;
4. the defendant knew or intended him to do so;
5. the plaintiff's action or inaction will occasion detriment if the assumption or expectation is not fulfilled; and
6. the defendant has failed to act to avoid that detriment whether by fulfilling the assumption or expectation or otherwise.

These criteria are to direct the inquiry toward the over-arching issue of unconscionability.

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22 Ibid note 18.
23 Ibid note 21 at 25.
24 Ibid note 7.
where an overall judgment, weighing the particular circumstances, is required. If these conditions were met by a letter of comfort, the issuer would be estopped from denying its support in the letter of comfort, irrespective of contractual liability. Certainly in Banque Brussels, Chief Justice Rogers was right in that the defendant knew that the plaintiff regarded it as part of the security and had knowingly given the letter of comfort on that basis. For this reason, Chief Justice Rogers held it unconscionable for the defendant to deny liability, having induced the plaintiff to act to its detriment.

However, Chief Justice Rogers in Banque Brussels placed little emphasis on the necessary element of reliance and, in particular, the reasonableness of the promisee’s reliance. The language of the letter of comfort in Banque Brussels was strongly promissory, but the circumstances in which the letter of comfort was given were not strong enough to make the bank’s reliance reasonable. The difficulty in finding reasonable reliance in commercial transactions was emphasised in the case of Austotel Pty Ltd v Franklins Selfserve Pty Ltd.

The role of a bank is to lend money and then to take security to ensure its due repayment. However, banks are also aware that commercial risks must be taken to achieve higher levels of profitability. A bank merely satisfied with a letter of comfort is an example of commercial risk-taking. Accordingly, it is only in very special circumstances that the courts should find reasonable reliance, because banks are fully aware that they are taking commercial risks. Therefore, even though the letter of comfort in Banque Brussels was strongly promissory, the commercial circumstances surrounding the giving of the letter of comfort make a finding of reasonable reliance tenuous.

It is worth noting that letters of comfort are not limited to banking matters. The case of Genos Developments concerned a commercial tenancy arrangement. Being a commercial transaction, however, reasonable reliance will again be hard to prove. Nevertheless, it is possible to envisage a case where a landlord may not be a commercial entity and may not be well advised. In such a case, if the language of the letter of comfort was strongly promissory and the conduct of the giver of the letter of comfort was unequivocal, reliance may be reasonable and estoppel would be an appropriate basis for primary obligations.

Secondary obligations under equitable estoppel

If equitable estoppel is an appropriate basis for primary obligations, we must turn our attention to damages. The court in Waltons, in determining relief, applied the principle of the “minimum equity to do justice”. This principle is unsettled and it is not within the scope of this paper to discuss this point further. It is worth noting, however, that prima facie, the cases have seemed to adopt whichever approach is just on the facts, as in the case of Verwayen. The flexible nature of this principle linked with equity’s “clean hands” approach serves to support the idea of the apportionment of damages between the parties to reflect the relative fault of the defendant and the plaintiff. This flexibility would allow for an appropriate compromise once primary obligations are found to exist in equitable estoppel.

Conclusion on liability in equitable estoppel

From the above discussion, it is suggested that in a non-commercial context, estoppel may establish primary obligations and suitable damages that reflect the parties’ compromise in a letter of comfort. This leaves us with one
final avenue for finding a medium of liability for statements contained in letters of comfort.

**THE FAIR TRADING ACT 1986**

**Primary obligations under Section 9**

Liability for a letter of comfort may also arise in a claim under Section 9 of the Fair Trading Act 1986. Section 9 has two main limbs:

1. the conduct must be "misleading or deceptive"; and
2. this conduct must be in the course of "trade".

Under the first limb, the recipient would need to prove that when the letter of comfort was given, it was not likely to be or intended to be honoured. In Australian Bridal Centre, Justice Cole held that a representation that was false at the time it was made was a contravention of Section 9. Under the second limb, given the commercial use of the letters of comfort, they would involve conduct, "in trade". It is submitted, therefore, that this brings letters of comfort within the scope of Section 9. It is important to note, however, that if a plaintiff cannot show that the intention in the letter of comfort was false at the time, then the letter of comfort will fall outside Section 9.

**Secondary obligations under Section 43**

If primary obligations can be found under Section 9, then what about the damages? In Goldsbro v Walker, the New Zealand Court of Appeal held that the making of an award by way of damages under Section 43 of the Fair Trading Act 1986 was entirely a matter of discretion. This means that the plaintiff's damages could be reduced in proportion to the extent to which his or her own fault contributed to the loss. It is suggested, therefore, that the Fair Trading Act also reflects the nature of compromise within letters of comfort.

**Conclusion on liability under Section 9**

Where the intention in the letter of comfort is false at the time it is made, then primary obligations will be established under Section 9, and pursuant to Section 43, courts will be able to apportion responsibility between the parties. Establishing primary obligations for letters of comfort under Section 9 may be onerous, however, as false intention will be difficult for the plaintiff to prove.

**CONCLUSION**

The task of establishing liability within the existing law that reflects the nature of the parties' compromise in letters of comfort is not an easy one. Letters of comfort do not ordinarily satisfy the strict criteria of legal contractual obligation and such letters of comfort within a commercial context will rarely establish liability pursuant to the doctrine of estoppel.

In non-commercial circumstances, however, primary obligations pursuant to estoppel could be established and secondary obligations could be found that recognise the compromise of the parties. Primary obligations could also be established under Section 9 of the Fair Trading Act 1986 when the intention in the letter of comfort was false at the time it was made and this could lead to an apportionment of damages under Section 43. Both estoppel and the Fair Trading Act 1986 allow damages to reflect the nature of the parties' compromise. Nevertheless, it would appear that the majority of letters of comfort fall into the realm of non-binding statements of present intention. Accordingly, perhaps the only possible avenue through which to adequately recognise the compromise between the parties is through legislative intervention.

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37 (Supreme Court, NSW, Justice Cole, September 13, 1990).
38 [1993] 1 NZLR 394.