

Letters of Comfort

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Letters of comfort remain problematic documents to enforce. The risks are highlighted in the recent Victorian Court of Appeal decision in the *Atco Controls* case¹.

BACKGROUND

Letters of comfort, or letters of support are usually in the form of a letter given by a parent company, in circumstances where its subsidiary, or its board, needs a written expression of the parent company's ongoing financial support.

The parents' letter may be addressed, for example, to:

- (a) a local bank used by the subsidiary;
- (b) the local subsidiary's auditors;
- (c) the subsidiary company, or
- (d) the directors of the subsidiary board.

To determine if the promise in the letter is legally enforceable, its beneficiary will need to consider issues such as:

- (a) is the letter legally binding as a contract, namely:
 - (i) was there an intention to create a legally binding obligation;
 - (ii) was there any consideration;

¹ *Atco Controls Pty Ltd (in liq) v Newtronics Pty Ltd (recs & mgrs apptd) (in liq)* 2009 VSCA 238.

- (b) if so, what are its enforceable terms;
- (c) if so, who may enforce it;
- (d) was misleading or deceptive conduct involved?
- (e) is there an estoppel available against its maker?

Why use a letter of comfort?

If letters of comfort are such problematic documents, then why are they used?

A parent company may give a letter of comfort instead of a formal guarantee, in the hope of achieving an outcome required by its subsidiary, without the risk of legal recourse. The parent is trying to avoid a legal obligation, whereas the recipient hopes the promise will be honoured, even if it is not binding. A letter may be proffered by a parent to assist a subsidiary because:

- (a) the parent company may have enough market sway, to be able to persuade a recipient, such as a bank, to only take a letter and not a guarantee when funding a subsidiary;
- (b) the parent company may not wish to reveal a “contingent liability” in its accounts, which a formal guarantee may create; or
- (c) the parent may have strict borrowing covenants, which limit its ability to provide a formal guarantee.

A director of a subsidiary company which is dependent on parent funding for its solvency, may seek a letter of comfort from the parent:

- (a) for the purpose of the execution of a director’s declaration as to the going concern nature of the subsidiary’s accounts; or
- (b) as a possible defence to an insolvent trading claim, using section 588H(2), namely to try to prove that at the time when a debt was incurred, the director had reasonable grounds to expect, and did expect, that the subsidiary was solvent at that time or would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

It is worth keeping in mind that Section 588V of the *Corporations Act* provides that a holding company may be liable for the loss or damage suffered by the insolvent trading of its subsidiary. So even if a parent uses a letter of comfort to try to protect its liability, it will not always be able to escape liability after an insolvent subsidiary’s liquidation.

An auditor of a subsidiary may seek a letter of comfort from a parent to sign off the accounts of its subsidiary on a going concern basis. If the subsidiary is insolvent without its parent’s support, then the auditor’s reliance on an informal letter of comfort may be somewhat risky.

Arguably the reliance on such a letter by a board, company or auditor, should be disclosed in the subsidiary's accounts.

When considering whether to rely on a letter of support, its recipient must face the reality that the parent has chosen not to enter into a formal legally binding guarantee. Further, if the recipient has sought a formal binding assurance from the parent and it has not been provided, then arguably it may no longer be reasonable for the recipient to expect to have received a legally enforceable document, when an informal letter is given instead. As the Victorian Supreme Court of Appeal noted in the joint judgment in the Atco Controls case:

"... assuming that the Newtronics' board [subsidiary] were endowed with at least a rudimentary level of commercial common sense, and so understood that holding companies tend to conduct operations through limited liability subsidiaries in order to avoid liability in the event of the subsidiary's failure, it might also have well understood and accepted that Atco's undertakings to provide support were intended not to be legally binding."

The Atco Control's case is a recent case in which the Victorian Supreme Court of Appeal found that an alleged support arrangement was not legally binding. Special leave to appeal to the High Court was recently refused. This contrasts with the earlier Gate Gourmet case², in which Einstein J of the Supreme Court of New South Wales held that a letter of comfort was legally enforceable.

Gate Gourmet Case

The facts in this case were complicated. They are simplified in this paper. We will leave to one side the complication that an interposed Australian parent in fact received the letter of comfort.

In May 2010, PricewaterhouseCoopers (**PWC**) the Australian subsidiary's auditor, sought a letter of comfort from the Gate Gourmet Swiss parent. PWC drafted the letter of support. The parent provided the first letter of comfort to PWC, worded as follows:

"To whom it may concern

Letter of support

This is to confirm that the parent entity, Gate Gourmet International AG, will provide the financial support that may be necessary to enable Gate Gourmet (Holdings) Pty Ltd and its controlled entities to meet its financial commitments as and when they fall due. This guarantee will not be withdrawn before Gate Gourmet (Holdings) Pty Ltd and its controlled entities have sufficient means to meet their obligations without support of the parent entity."

² *Gate Gourmet Australia Pty Ltd (in liq) v Gate Gourmet Holding AG* (2004) NSWSC 149.

The Australian director gave evidence that he signed the subsidiary's statutory accounts on a going concern basis, on the assumption that the parent would continue to provide the necessary financial support. He also gave evidence that without the letter of support, the declaration that the Australian group could meet its debts would have been false.

In February 2001, PWC again emailed a sample letter of support to the parent using the same style as the letter of the year before. The Vice President of Finance of the parent, deleted the word "*guarantee*" from the body of the letter and replaced it with the word "*letter of support*". The secretary of the Australian group emailed the Vice President, asking for the letter to be addressed to the directors of the Australian holding company, but not noticing the other changes to the letter. Mr Neilson from the parent company then sent a further email to the secretary, asking why the letter could not be addressed to the auditors. The secretary of the Australian group replied, saying:

"No... no!!!

The guarantee needs to be provided to the directors of the company so they can carry on the business within Australian statutory legislation. PWC only require proof (copy) that a 'letter of comfort' exists."

The parent officer agreed to this request and arranged to have the amended letter signed. A director of the Australian entities gave evidence that he was never told by any officer of the Swiss company that they did not consider themselves bound by the letter. He gave further evidence that if he had been aware that the Swiss parent did not intend to honour the letter he would have called a board meeting to discuss the matter and would have placed the local subsidiary companies into voluntary administration.

The Australian director then signed the statutory accounts, saying in his evidence that he relied upon the letter to do so. The director's declaration noted the going concern basis of the accounts and the assumption that the parent entity would provide the necessary financial support to enable the subsidiary to continue to pay its debts as and when they were due and payable.

At a later date, Westpac became nervous about the two Australian subsidiaries' financial position and required an amended facility agreement, an acknowledgement that the Australian operations were solvent and a payment by the parent reducing the Westpac debt by the Swiss parent. The Australian director signed the acknowledgement, saying in evidence that he did so on the basis that the parent company had agreed to pay down a substantial amount of the facility and that the letter of comfort was in place.

Ansett was then placed into voluntary administration. Gate Gourmet had provided the food services to their planes. The financial position of the Gate Gourmet Australian group was by then precarious. The local director called the CEO of the Swiss parent company asking whether they would stand by the letter of support. The Swiss parent CEO said that there was not sufficient money to do so. A voluntary administrator was then appointed to the Australian trading company by the local board. The eventual liquidator of the Australian

trading company, then sued the Swiss parent, seeking to enforce the second letter of comfort of February 2001.

The subsidiary pleaded in its claim that:

- (a) the letter evidenced a contract between the Swiss parent and the Australian holding company, which promises were held on trust by the Australian holding company for the benefit of the Australian trading company;
- (b) the Australian holding company unreasonably neglected or refused to enforce those promises for the benefit of the Australian trading company;
- (c) the letter was misleading or deceptive, or likely to mislead or deceive, in contravention of section 52 of the *Trade Practices Act*;
- (d) by reason of the conduct of the Swiss parent, two of its officers aided and abetted counselled or procured the contravention of section 52 of the *Trade Practices Act*;
- (e) the Swiss parent was estopped from departing from the express terms of the letter.

Einstein J held that the letter of comfort was legally binding, after his examination of:

- the commercial purpose of the letter;
- the circumstances in which the words were used;
- the mutually known matrix of facts in which it came to be written;
- the words used in the letter;
- the intent to enter into a contract; and
- its proper construction.

His Honour was influenced by a number of factors, namely:

- (a) it was clear that there was mutually known and understood circumstance that each of the letters of support was needed for the directors to discharge their responsibilities;
- (b) in examining the circumstances objectively, they showed an intent to enter legal relations;
- (c) the letters made it plain by their words that they would “*not be withdrawn before Gate Gourmet Holding Pty Ltd and its controlled entities have sufficient means to meet their obligations without the support of the parent entity.*”

His Honour also upheld the section 52 claim. The Swiss parent did not establish that it had reasonable grounds for making the representations as to the future matters stated in the letter. His Honour found it unnecessary to consider the estoppel argument. The question of whether there was any consideration for the promise in the letter was also not raised in this case.

Atco Controls Pty Ltd (in liq) v Newtronics Pty Ltd (Receivers & Managers Appointed) (in liq)

At the first instance hearing in the Atco Controls case, the subsidiary (in liquidation) succeeded in enforcing a comfort arrangement against the parent company. The subsidiary obtained an award of damages for \$17 million plus interest. The Victorian Supreme Court of Appeal overturned that decision and concluded that there was no binding comfort arrangement. The subsidiary then sought special leave to appeal to the High Court. Leave was refused on 28 April 2010.

Facts

Newtronics designed, manufactured and supplied electronic components. Its parent, Atco, carried on a business as a lighting manufacturer. Pitcher Partners audited both companies. From 1994 to 2000, Atco lent money to Newtronics.

In 1994, a letter of support was provided by Atco, addressed to the subsidiary's (Newtronic's) auditor, saying:

“Newtronics Pty Ltd – Letter of Support

Atco Controls Pty Ltd – being the ultimate holding company of Newtronics Pty Ltd, hereby confirm the following:

1. *That the amount owing by Newtronics Pty Ltd to Atco Controls Pty Ltd of **[\$amount owed]** as at **[date of relevant financial year]** shall not be called upon within the current period to the detriment of all other unsecured creditors.*
2. *That if necessary, funds or additional bank security will be provided to Newtronics Pty Ltd or its debt financier to ensure that it can meet its **current trading obligations** they would have or that would be incurred.”*

[Emphasis added]

This letter of comfort was first provided to the Newtronic's auditors in 1994 by Atco, as a result of an Atco directors' resolution. The accounts in that year of both Newtronics and Atco, did not refer to that letter of support.

In April 1995, at the auditor's suggestion, Newtronics executed a mortgage debenture to secure the loans made to it, and to be made, by its parent Atco. Atco did not provide a letter of support to Newtronics in 1995 or 1996, nor did the accounts of either company referred to a letter of support.

In 1997, a letter of support was again provided. Newtronics' accounts referred to its going concern assumption being dependent upon the continued support of the parent. Atco's 1997 accounts did not refer to the letter of support. In 1998, there was no letter of support provided and no accounts referred to it. In 1999, there was a letter of support provided, but the accounts did not refer to it.

In 2000, the Newtronics' accounts referred to support being provided. Atco's accounts for 2000 noted a contingent liability, saying: "*The company has provided an undertaking that if necessary, funds or additional bank security will be provided to a controlled entity, Newtronics Pty Ltd or its debt financier to ensure that it can meet its **current trading obligations** as and when they fall due.*" A letter of support was provided, addressed to the auditors.

In 2000, legal action was commenced against Newtronics by Seeley, being a product liability claim of \$18 million in respect of their faulty air conditioners.

In 2001, the Newtronics accounts were not signed. The draft accounts for discussion purposes noted that Atco had provided an undertaking to assist Newtronics to meet its debts. Atco gave Newtronics a letter of support dated 20 July 2001 but its accounts did not refer to it. In September 2001, Atco up stamped its security debenture to \$15 million.

In December 2001, the Federal Court found against Newtronics and ordered that it pay Seeley \$8.9 million damages, plus interest and costs.

On 21 December 2001, Atco made a formal demand on Newtronics for the payment of all monies due under its charge. This demand was not met. On 8 January 2002, Atco appointed receivers and managers to Newtronics, pursuant to its charge. A liquidator was subsequently appointed. The receivers sold the business of Newtronics to a new Atco subsidiary, being the highest offer made for the business. The inter-company debt was then offset against the purchase price.

The Claim

At the first instance hearing, Newtronics sought to enforce a support agreement and alleged that the receiver's appointment was invalid. The liquidator alleged that this agreement was to be implied and inferred from the circumstances, including the existence of the letters of support and the signing of the going concern accounts, which were reliant on them. They also brought a conversion claim against the receiver for the loss and damage Newtronics suffered by their appointment. They also sought the payment of the Seeley debt from Atco, as a "current trading obligation" incurred in the 2001 period of the letter of support.

The judge in the lower court found that:

- 1 A binding support agreement existed between the parent and subsidiary, in which the letters formed an integral part.
- 2 The letters of support contained the essential terms of the agreement.
- 3 The agreements were relied upon and intended to be relied upon.
- 4 The consideration for the agreement was that Newtronics continued to trade.
- 5 Atco breached the contract by making its demand, appointing the receiver and failing to put Newtronics into funds to pay the judgment debt of Seeley.

The Appeal

Legally binding concluded bargain?

The Victorian Court of Appeal looked at the issue of how a contract might be inferred or implied. They quoted from earlier cases saying:

“The question in this class of case is whether the conduct of the parties viewed in the light of the surrounding circumstances shows a tacit understanding or agreement. The conduct of the parties however, must be capable of proving all the essential elements of an express contract...”: McHugh JA, in *Integrated Computer Services Pty Ltd v Digital Equipment Corp (Aust) Pty Ltd* (1988) 5 BPR 11, 110.

“...The essential question in such cases is whether the parties’ conduct, including what was said and not said including evident commercial aims and expectations of the parties, reveals an understanding or agreement or as sometimes expressed, a manifestation of mutual assent, which bespeaks an intention to be legally bound to the essential elements for contract”: Allsop J. in *Branir Pty Ltd v Owston Nominees (No2) Pty Ltd* [2001] FCA 1833.

The Court of Appeal looked at the parties’ conduct in order to determine whether objectively viewed, at some point they had reached a legally binding agreement. They noted that the letters of support were provided in years when the auditor asked for them and not in the years when the auditors failed to ask for them. They felt this was equivocal.

It was argued for Atco and accepted by the Court of Appeal, that the existence of the alleged contract was inconsistent with the charge created between Newtronics and Atco. The Court of Appeal said on this point:

“... the significance of the conduct displayed by and in the letters of support was to be assessed objectively in light of the circumstances known to both parties at the times at which the letters were provided. These circumstances include the [charge]...”

The Court of Appeal felt it was inherently unlikely in the context of the charge, that both parties intended to bind themselves to some support agreement.

Director's reliance

The Lower Court Judge thought it was plain from the accounts signed by the Newtronics directors, that they could only have signed the accounts after relying upon the continuing letter of support from Atco. He therefore inferred that that the parties intended that the letters of support should be binding. The Court of Appeal did not agree with this reasoning. They thought it was equally as likely that the directors may have made the declaration in the accounts believing the letter was not legally binding, but on the reasonable or probable ground or expectation that the company would be able to pay its debts based upon non-binding assurances.

The Court of Appeal said:

"It does not seem to us at all unlikely that the directors of Newtronics would have been prepared to accept and rely upon a non-binding undertaking by Atco to provide Newtronics with support.... They knew it was in Atco's interests to keep Newtronics going. They also knew that Atco was prepared to provide Newtronics with support... assuming that the Newtronics board were endowed with at least a rudimentary level of commercial commonsense and so understood that holding companies tend to conduct operations through limited liability subsidiaries in order to avoid liability in the event of the subsidiaries failure, they might also of well understood and accepted that Atco's undertakings to provide support were intended not to be legally binding."

"... the directors of Newtronics were entitled to assume that the undertakings, albeit not legally binding, would be honoured and so to declare that there were reasonable grounds to conclude that Newtronics would be able to pay its debts as and when due and payable..."

The Court of Appeal supported the statement of Mahoney J.A. at page 244 G in *Dunn v Shapowloff* [1978] 2 N.S.W.L.R. 235, namely:

"It would, I think, be proper, in a particular case, for account to be taken appropriately of a promise, legally binding or otherwise, to provide money or financial assistance, by loan, subscription, for share capital, or (as was suggested in this case) by the provision of a guarantee."

Insolvent Trading Defence

The above statements provide fertile ground for the use of letters of comfort as a possible defence to an insolvent trading claim, depending of course on all of the surrounding circumstances. It might be reasonable for a director, who for many years had relied upon a parent company providing informal financing for a subsidiary, to continue to expect that this

financing will be provided, if the parent company provides a letter of comfort each year to the auditors. The fact that that may not be legally binding, may not matter.

Estoppel

The Court of Appeal noted that it was conceivable that an estoppel might have prevented Atco from resiling from some of the undertakings, or not resiling from them without at least giving reasonable notice given the Newtronics' directors reliance. Estoppel had never been pleaded however and so it could not be raised in the appeal.

Current Trading obligations

The Court of Appeal looked at the precise wording of the letter of support given to the auditors. Part of that letter stated that the funds would be provided to Newtronics, or its debt financier, to ensure that it could meet its current trading obligations.

The Seeley judgment debt was held not to be a current trading obligation. Therefore there could be no breach of the alleged agreement, if Atco refused to meet that obligation. The Court found a number of flaws in Newtronics' argument on this point, namely:

- (a) The Seeley claim was not a current obligation, as it did not just cover one year;
- (b) The liability to Seeley was not incurred by Newtronics as a current obligation until a judgment was entered. Up until then, it was merely a contingent obligation;
- (c) Further, the judgment may have been an extraordinary liability, due to its relationship to prior years' activities;
- (d) Prior to commencing the 2001/2002 financial year, Atco and Newtronics knew Seeley was claiming damages of \$18 million. The Court found it difficult to try to construe an intention that current trading obligations would refer to this claim, when Atco would be converting its secured creditor position and subordinating it as an unsecured creditor.

Lack of consideration

The Court of Appeal held that the fact that Newtronics had relied upon the letter of support, was not sufficient to create the necessary promissory consideration. Newtronics would have had to have proved that Atco requested Newtronics to continue to trade, in return for the support undertaking and that Newtronics had acted on that request. The Court noted that the evidence seemed to point the other way. The problem was that Atco tended to run Newtronics and had no need to request anything to be done. There was also a problem of trying to define the extent of the request. The Court of Appeal distinguished the Gate Gourmet case, as in that case there was an express request for support and other contextual considerations differed. Further, the consideration point was not argued there.

In the end, the Court of Appeal was persuaded that the clearest evidence of the objective intention of the parties was the creation of the binding charge, which was inconsistent with there being a binding support agreement. There were not sufficient other acts and conduct which could overcome this situation.

Conclusion

Letters of comfort are not easy to enforce as contracts. This is because:

- (a) the factual matrix surrounding the creation of a letter of comfort may be complex;
- (b) their wording may be equivocal; and
- (c) the consideration given for the provision of the letter may be hard to find.

The two cases examined in this article readily evidence the problem.

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