



Update

Property & Projects

7 July 2010

Letters of Comfort

So called “letters of comfort” are commonly used in business today, either to give comfort in relation to the performance of agreed commercial obligations, or for one party to “support” the financial obligations of another. But what value do they really have? Are they binding? If not, what is the point of having them?

The Victorian Court of Appeal has recently reconsidered the enforceability of letters of comfort. In *Atco Controls Pty Ltd (in liq) v Newtronics Pty Ltd (recs & mgrs apptd) (in liq)* the court found that a letter of support given by a parent was not binding. In coming to this decision the court looked closely at an earlier NSW decision (*Gate Gourmet Australia Pty Ltd (in liq) v Gate Gourmet Holding AG (2004)*) in which it was held that a letter of support was binding.

The two decisions, which on their face appear to be at odds with each other, were distinguished on their facts. The basic principles of contract formation were applied in each case but produced different results because of the different circumstances.

In short, the question is whether it is clear from the language used, and the surrounding circumstances, that there was an intention to create a binding legal relationship, and if so, whether the key elements of that commercial relationship are agreed and recorded.

While each situation will turn on its own facts, the circumstances examined in these two cases are not unusual and are instructive in understanding what circumstances and conduct might be the difference between avoiding a legal obligation and creating one.

Gate Gourmet Case

In the *Gate Gourmet* case, the parent company, in response to a request from the auditor of a subsidiary, provided a letter promising financial support to the

Australian group, one of which was the subsidiary in question. When the Australian group got into financial difficulty, the parent refused to honour the letter of support.

The New South Wales Supreme Court found that the letter of support was binding. An objective consideration of all the circumstances led to the conclusion that there was an intention to create legal relations. These are some of the circumstances that supported that conclusion:

- the words used in the letter itself evidenced “promissory intent” – the letter stated that support “will not be withdrawn before Gate Gourmet (Holdings) Pty Ltd and its controlled entities have sufficient means to meet their obligations without support of the parent entity”. Objectively this was the expression of a real obligation, which by its language evidenced “promissory intent”; and
- a director of the Australia group had signed the statutory accounts of the subsidiary with a notation to the effect that they had been prepared on the assumption that financial support from the parent would be available when necessary. The Court found that the Australian directors were reasonably entitled to take the parent’s promise into account when preparing financial reports, and that this was evidence of an intention that the agreement would be binding.

The parent was also found to have engaged in misleading and deceptive conduct under section 52 of the Trade Practices Act 1974 in that it had no reasonable grounds for making representations as to future support.



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Atco Controls Case

In this case the subsidiary was involved in a commercial dispute with a third party and was found to be liable for damages. To meet that liability the subsidiary called on a letter of support given by its parent.

Here the Victorian Court of Appeal found that the letter was not binding. Leave to appeal to the High Court was refused in April this year. Circumstances which the Court found to be relevant include:

- the letter contained a statement that funds or security would be provided to the subsidiary "...to ensure that it can meet its current trading obligations". The subsidiary's liability for damages was found not to be a "...current trading obligation...";
- there was no valuable consideration given. (At first instance it was found that the consideration for the parent's promise of support was an agreement by the subsidiary to continue trading, however the Court of Appeal found that this was artificial as the parent effectively ran the subsidiary);
- the subsidiary had granted a charge to the parent to secure money owed to the parent and in the circumstances this was considered to be inconsistent with a binding agreement to provide financial support; and
- this particular letter and others previously provided, had been given intermittently over time, and only when requested by the subsidiary's auditor.

The Court accepted that the directors of the subsidiary may have had a reasonable expectation that they could rely on the parent's expression of financial support (and that they signed the accounts in this expectation), but found that this was not the same as believing that a binding legal contract had been formed.

Conclusion

There is always a fundamental question to be asked, which goes to the heart of whether a letter of comfort or support is binding – why has the promisor chosen to provide an informal letter of comfort or support, rather than executing a more formal legal undertaking? It could be, indeed it often is, because they did not intend to be bound.

In the *Atco Controls* case, where the letter of support was found not to be binding, the Court made this very telling statement:

"...assuming the Newtronics' board 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".

A letter of comfort or support will not be binding unless:

1. there is, from the words of the particular document and the surrounding circumstances, an objective intention to be bound;
2. valuable "consideration" for the promise is provided; and
3. any other essential terms are agreed.

Finally, although not raised in either of these cases, it is possible that even where the letter itself is not binding, the conduct of the parties might be such as to create an "estoppel". Estoppel is a subject for another day, but in short, a party is bound by an obligation which would not otherwise be binding, where it knows that the other party has relied, to its detriment, on an expectation that the obligation was binding, and the first party has not corrected that misunderstanding.



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