Comfort letters: are they binding under South African law?

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Comfort letters have attracted more than mere passing attention abroad. A perusal of foreign publications on comfort letters reveals that these instruments attracted the attention of the writers only after certain problems concerning the juridical nature of comfort letters arose in practice. To date, there are no pressing problems concerning comfort letters in South Africa. Perhaps that is why no reference to comfort letters could be traced in any South African court case, textbook, legal journal or legal dictionary. However, comfort letters are used extensively in the South African legal practice. Therefore, it would seem appropriate at this stage to introduce formally the concept of comfort letters in South African legal literature. That is the purpose of this article, in which the writers define comfort letters and attempt to establish the juridical nature thereof. Alternative bases of liability are also briefly surveyed and a few practical guidelines for the drafting of comfort letters are provided.

Cosmology delineated

Comfort letters are known in both the auditing and legal professions. However, the emphasis in this article is not on the auditors' perception of comfort letters, but rather on the lawyers' perception. We refer briefly to the role of comfort letters in the auditing profession.

Comfort letters in the auditing sphere

In the auditing sphere a comfort letter is frequently requested by underwriters who are required to make a reasonable investigation of information that has not been examined and certified by an independent auditor, but which is nevertheless part of any registration document. In these cases the certifying auditor may cover one or more of the following subjects in his comfort letter:

1. His independence as certifying auditor.
2. That the audited statements comply with the Johannesburg stock exchange (JSE) rules.
3. A negative assurance that nothing came to his attention to cause him to believe that unaudited financial statements included in the registration statement do not comply with JSE rules or do not present fairly the information shown.
4. A negative assurance in that there has been no change in capital stock or long-term debt between

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the balance sheet date and an agreed date in the registration process and that no decreases in specified financial statement items such as net sales, net income, or net working capital in relation to a comparable prior period have occurred.

Comfort letters in the legal sphere

Comfort letters are instruments issued by a parent company to the creditor of its subsidiary instead of simple straightforward guarantees. In fact, one may say that comfort letters are a soft alternative to a guarantee.

Typical provisions found in comfort letters

Comfort letters vary in their wording, but most will contain one or more of the following provisions:

1. The parent company indicates that it is aware of its subsidiary's loan.
2. The parent company states that it will not reduce its shareholding or participation in the subsidiary during the currency of the loan.
3. The parent company states that it will provide its subsidiary with the financial means to meet its obligations.
4. The parent company states that it will do everything in its power to ensure that the subsidiary is properly managed in accordance with prudent fiscal policies so as to ensure repayment of any loan.
5. The parent company states that it will exercise its influence on the subsidiary to meet its obligations.
6. The parent company states that it is its policy to ensure that the subsidiary is in a position to meet its obligations.
7. The parent company states that it is its policy to support its subsidiary.
8. The parent company states that it has complete confidence in the management of its subsidiary.
9. The parent company states that it has always regarded its subsidiary's obligations as its own.
10. The parent company states that it will arrange for the subsidiary's commitments to its creditor to be performed in a satisfactory way.
11. The parent company states that it will exert its full influence over the subsidiary to repay the credit on maturity.

The reasons why comfort letters are issued instead of guarantees

There are various reasons why a parent company may prefer to issue a comfort letter instead of a guarantee. The following are probably the principal reasons:

1. The parent company may wish to avoid a legal obligation and merely make a policy statement or moral commitment (Frigianni op cit 55).
2. The parent company may not want to show its commitment as a contingent liability in its balance sheet (Wood (1980) op cit 307).
3. The parent company may wish to avoid unfavourable tax consequences.
4. The parent company may be concerned about its general credit standing and credit rating and consider it to be below its standard to issue a guarantee for its subsidiaries.
5. The parent company may wish to avoid the payment of stamp duty on a guarantee.
6. The parent company, being a non-resident issuer, may want to avoid compliance with foreign exchange regulations.
7. The parent company may itself be subject to negative pledges; covenants in existing loan agreements preventing it from providing security in the form of guarantees at a later date.

The difference between a comfort letter and a guarantee

The word "guarantee" has more than one meaning under South African law. "Guarantee" is frequently used as a synonym for suretyship or warranty. It further has the connotation of a primary undertaking regarding the contractual obligation or performance of a third person. Lastly, it has the connotation of the assumption of a primary obligation. A guarantee is usually drawn in clear language. A guarantee usually contains stringent and detailed provisions to facilitate prompt enforcement in case of default by the principal debtor and it may give rise to a pure monetary claim for a precisely ascertainable figure.

The language of comfort letters is usually (intentionally) ambiguous and unclear. Claims are generally not for a liquidated sum, but for damages, the quantification of which may be quite complicated. This quantification is also always subject to the plaintiff's duty to mitigate its own damages.

The problem delineated

As indicated above comfort letters may contain different forms of commitment ranging from undertakings not to reduce shareholding in the subsidiary during the currency of the loan, to the assurance that the subsidiary will be properly managed so as to ensure repayment of any loan. However, because of their respective motives, it is often convenient for the parties to frame comfort letters in such a way as not to constitute any legal obligation. The recipient is happy because there is a moral commitment never to be dishonoured on the part of the issuer, whilst the issuer feels satisfied because moral commitment does not appear on any balance sheet and involves no actual money. Thus Straughton J stated in Chemco Leasing SpA v Rediffusion PLC:9

"When two business men wish to conclude a bargain but find that on some particular aspect of it they cannot agree, I believe that it is not uncommon for them to adopt language of deliberate equivocation, so that the contract may be signed and their main object achieved. No doubt they console themselves with the thought that all will go well and that the terms in question will never come into operation or encounter scrutiny."

However, at times comfort letters may backfire and accusations may be hurled back and forth that the apparent moral commitments are in fact legal obligations. In these cases one must then determine whether the "lawyer's cover-up of a disagreement" gives rise to any legal obligation.
Do comfort letters create contractual obligations?

A comfort letter can give rise to contractual obligations only if it is itself a contract. An agreement will be a contract only if it is concluded with the intention of creating an obligation or obligations. It is the existence of this intention to create obligations which distinguishes a contract from any other agreement. Therefore, a comfort letter will be a contract only if it is proved that there was a common intention to create obligations. There are various pointers which may be utilized to determine the common intention. A brief survey of principal pointers now follows (Joubert op cit 59-65):

1. The intention must be determined from the language used in any particular comfort letter.
2. Each word in the comfort letter should be given its normal grammatical meaning except if this leads to an absurdity or an uncontrived situation or if it can be proved that the words was used in its technical sense.
3. The comfort letter should be interpreted as a whole.
4. Evidence of background circumstances is always admissible. Evidence of surrounding circumstances is admissible only if the language is ambiguous. However, the case law is hardly settled as to the difference between background circumstances and surrounding circumstances (Swart v Cape Fabrix (Pty) Limited 1979 1 SA 195 (A)). This has led a writer to conclude that no distinction should be made between background and surrounding circumstances and that the latter should always be admissible in order to determine the intention of the parties (Kerr op cit 247 et seq).
5. If the language of the comfort letter is so obscure that no intention can be determined, the instrument is void for vagueness.

Alternative bases of liability

In the above it was argued that if the parent company and the creditor of its subsidiary intended to create obligations their agreement would be a contract. Therefore, the contract would be the basis of any ensuing liability. But are there any alternative bases of liability?

Delict as a basis of liability

Two situations must be distinguished. In the first place, one finds the situation where the comfort letter is not a contract. In this case if all the general requirements for delict are present, there is no reason why liability should not be delictual. The argument can be raised that the parent company has a legal duty to provide correct information to the recipient of the comfort letter. If it can further be proved that the parent company knew or subjectively foresaw who would respond to this information, it can be held delictually liable if the information proves to be wrong at a later date and this causes damage to the creditor of the parent company's subsidiary.

The second situation is where a comfort letter is in fact a contract. In this case, the contract is the basis of liability. The question, however, may well be asked whether in this case too delictual liability may not ensue if all the general requirements for a delict are present. Theoretically there should be no objections against this argument. However, in the light of Lillicrap Wassenaar and Partners v Pilkington Bros (SA) (Pty) Limited 1985 1 SA 475 (A) it may be difficult to prove the existence of a legal duty independent of the contractual obligation.14

Estoppel as a basis of liability

There may be situations where a comfort letter is not a contract. However, if one of the parties subsequently acts as though the comfort letter was a contract which created a legal obligation, that party may be estopped later from denying the existence of that legal obligation.15

Practical hints for the drafting of comfort letters

The use of comfort letters as opposed to other more definite forms of obligations like a guarantee may give rise to an initial inference that the parties do not wish to create legal obligations. This inference may be verbally reinforced or dispelled by the actual language of comfort letters. Comfort letters should, therefore, be drafted very meticulously so as to reflect clearly the true intentions of the parties. A few practical hints which may be useful for the meticulous drafting of comfort letters follow:

1. A comfort letter should clearly stipulate the nature of the support which a parent company intends to give to its subsidiary. A statement of the effect that a parent company will "fully support its subsidiary" is vague because no indication is given as to the nature of the support. It could be of either a financial or non-financial nature.
2. A comfort letter should clearly stipulate the extent of the support which a parent company intends to give to its subsidiary. Reliance can be placed only on obligations which clearly fall within the ambit of the comfort letter. If a comfort letter is issued in connection with loan A, the recovery of loan B cannot take place under the same comfort letter. If the intention is to cover any loan, then the words "all the loans made to our subsidiary" would be clear enough. However, wording like "we will support our subsidiary in all its trading operations" may not be sufficient to identify particular loans. In fact, it may even be difficult to establish whether any loan falls within the "trading operations" of a particular subsidiary. Whether "trading operations" include loans in a particular case depends upon the nature and business of that particular subsidiary.
A comfort letter should clearly stipulate the period for which the letter is operative. A letter issued in respect of a particular loan will generally be construed to cover the period until repayment. A stipulation concerning the period of operation is extremely important in the case where a subsidiary goes into liquidation prior to the repayment of its loan. In this case, the comfort letter must be construed to determine whether it provides any cover in the case of liquidation. This contingency should always be borne in mind and the intention of the parties as to whether a comfort letter should cover liquidation or not should be clearly stated. Declarations to the effect that it is a parent company's policy to provide full financial support to its subsidiary to ensure that the latter fulfils its obligations, should be avoided. The word "policy" does not connote a particular period of time. One could assume that "policy" refers to a current state of affairs and that a parent company should notify a recipient of a comfort letter every time the former's policy towards its subsidiary changes so as to prevent the parent company from being estopped from denying that the initial policy still applies. However, the use of the word "policy" on its own would appear to be vague and might even render the comfort letter void. Perhaps a better solution would be to use the words "present policy", "present and future policy" or even "the policy at all times".

It is always useful for the issuer of a comfort letter to confirm that it approves of its subsidiary's loan or that it is at least aware of the existence of the loan and its terms and conditions. This facilitates the recipient's task of proving at a later stage that the parent company knew that the recipient relied to a certain extent upon the comfort letter in granting the loan. Where the parties intend their comfort letter to be binding it is always useful to indicate a period of time within which the parent company must be informed that the recipient of a letter will exercise its rights. If no express provision to this effect is inserted, a date will have to be implied. In order to determine a reasonable period for which notification must be given the facts and circumstances of each particular case must be considered. In particular the following factors may be considered by a court:

1. The extent of the obligation undertaken by the

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NOVEMBER 1988
parent company in its comfort letter.

2 The importance of notice in relation to the parent company's ability to satisfy its obligations. Whether a prompt notice would have enabled the parent company to minimize or exclude its liability.

The notice, like any other notice, must be clear and indicate that reliance is placed on an identified comfort letter.

Principal advantage and disadvantage of comfort letters

The principal advantage of comfort letters is that they create a semblance of agreement between a parent company and the creditor of its subsidiary even in those cases where no actual agreement exists. Comfort letters, therefore, serve as effective cover-ups of disagreements. The loan transaction between the creditor and the subsidiary is concluded and all the parties hope no problems will arise in the future.

The principal disadvantage of comfort letters would appear to be the time it takes to bring an action to enforce them and the uncertainty about what damages a court will award, because if the obligations in the comfort letter are dishonoured, it will not be a question of payment between surety and creditor under a debt instrument, but a liability for damages in a contractual relationship where there has been a breach of contract.

Conclusion

In spite of the uncertainties surrounding the legal nature of comfort letters, they are used increasingly in South Africa, and only time will show the significance which South African courts will attach to these letters, the legal scope of which ranges from clearly non-committal language (often referred to as "cold comfort letters") over a legally grey area to letters which come close to, or are identical with, guarantee by the parent company for the respective subsidiary's financial standing and ability to meet at all times its financial obligations. The comfort letter is one of the new instruments used as a security arrangement for major credit facilities with banks in South Africa and abroad. However, according to Wood (1980) (op cit 307)

"comfort letters are only of use where political assurances are considered better than legal assurances (this is almost never) or where a shadow of a guarantee is considered better than nothing at all (only just). They are inappropriate for lenders who require a serious legal claim."

Whether they ultimately bind parties is of course dependent on the parties' intention. In order to facilitate the determination of the parties' intention, drafters of comfort letters should ensure that comfort letters convey a clear message.

Footnotes

1 In this article the term "comfort letter" is used throughout. There are, however, many other terms: letters of awareness; letters of intent; letters of responsibility; cold letters; keep-well letters; lettres de patronages; Patronaterklaerungen; lettere di conforto; hensigterklaering.


4 Wood (1980) op cit 307 defines a "comfort letter" as "a letter written usually by a parent company, or even by a government, to the lender giving comfort to the lender about a loan made to a subsidiary or a public entity".

5 In South Africa it appears that one does not have to contend with any tax consequences. See, however, Note 1978 International Business Lawyer 289.

6 Note 1978 loc cit.

7 Stamp Duties Act 77 of 1968, schedule 1, item 20.

8 Cilliers "Waarborg en garanste in die Suid-Afrikaanse kontraktereg" 1982 THRHR 244; Kahn "Guaranteed - what a word!" 1973 Businessman's Law 28; Pretorius "Diners Club South Africa (Pty) Ltd v Durban Engineering (Pty) Ltd 1980 3 SA 55 (A)" 1982 THRHR 75; Caney The law of suretyship in South Africa (1982).

9 (QBD) 19-7-1985 (unreported); upheld: 1986 CA (transcript 113S). Cited in Kleinwort Benson Limited v Malaysia Mining supra 719-720.


12 As was pointed out, the real intention of the parties to a comfort letter is usually unclear. Straughton J adverted to this in Chemeo Leasing SPA v Redifussion PLC supra, when he remarked:

"A gentleman's agreement is an agreement which is not an agreement, made between two persons neither of whom is a gentleman, whereby each expects the other to be expressly bound without himself being bound at all."

Although comfort letters do not fall precisely within that description, one has to look beyond the name and see what exactly is, in law, agreed.

13 Van der Walt Delict: principles in cases (1979) 20-103.

14 Wunsch "Aspects of the contractual and delictual liability of attorneys" 1988 TSAR 3.

15 For the general requirements of estoppel, see Joubert (ed) "Estoppel" AWP 367.

16 Note 1978 loc cit.