CANADA: HOW COMFORTING IS A COMFORT LETTER?

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INTRODUCTION

It can be very hard for a prospective borrower to attain financing without a guarantee, especially when that borrower has affiliates that would logically be in a position to guarantee the borrower's indebtedness (e.g. a parent corporation). While it is well within an affiliate's rights to choose not to guarantee a debt, it puts the prospective debtor in a very tough situation. As a compromise, an affiliate of the borrower can give some kind of assurance to a creditor that falls short of a guarantee. This assurance often takes the form of a comfort letter, which is a statement made by the affiliate indicating their intention to ensure that a debt will be repaid.

Classifying and categorizing the legal rights that flow from one of these comfort letters is very tricky. There must be some purpose to a comfort letter, some value that is provided by the author of the letter that induces a creditor to extend credit where they otherwise would not. That being said, ostensibly the letter is not a full guarantee, otherwise the author of the comfort letter would have simply agreed to give a guarantee in the first place. Comfort letters are commonly requested, and their inclusion in a financing is often the subject of intense negotiation, as is the precise wording of the document.

This article will endeavour to show the development of the law regarding comfort letters by analyzing leading decisions in other jurisdictions, and then looking to the leading case in Canada to distil the current state of the law.

KLEINWORT BENSON LTD. V. MALAYSIA MINING CORP. – A MATTER OF HONOUR, A GRATUITOUS PROMISE

The first case we will explore in this paper is Kleinwort Benson Ltd. v. Malaysia Mining Corp.

["Kleinwort"][1] an English Court of Appeal case from 1988. In this case the plaintiff, Kleinwort Benson Ltd. ("KBL"), granted a £5 million credit facility to MMC Metals Ltd., a subsidiary of Malaysia Mining Corp. ("MLC").

In negotiating the credit agreement, KBL requested that MLC be a party to the loan, or failing that, a guarantor of the loan. MLC rejected both options, and after rigorous negotiations agreed to provide a "letter of comfort" as a compromise. The letter recounted the terms of the loan to the subsidiary and provided statements designed to provide some level of comfort to the lender, the most important of which read:

> *"It is our policy to ensure that the business of MMC Metals Limited is at all times in a position to meet its liabilities to you under the above arrangements."*

A second credit facility of £5 million was extended on the same terms as the original indebtedness, and was accompanied by an identical letter of comfort. Soon after these financings were provided, MMC Metals Ltd. went out of business, due to a collapse in the market price of tin.

KBL then requested payment of the outstanding amounts on these loans from MLC, who denied liability. MLC took the position that the comfort letters did not create a legally binding promise to pay in favour of KBL. Naturally, KBL initiated a claim against MLC for repayment of the debt.

The litigation that ensued required the English Court of Appeal to consider the nature of the statements contained in a comfort letter. The document title "comfort letter" was held not to have any inherent legal meaning. This first step of the analysis in Kleinwort gives us the proposition that a comfort letter must be classified before any other analysis can take place. Accordingly, the language and surrounding circumstances of each letter must be analyzed to determine its effect.

The Court of Appeal's analysis of the comfort letter in Kleinwort turned on the interpretation of the statement in the letter reproduced above, and specifically whether the statement could be considered a promise as to future conduct or as a contractual warranty. It was noted that the use of the future tense is an indicator of an intention to make a promise

about future conduct. However, the court also conceded that the use of the present tense did not bar the conclusion that the language in the statement above was an enforceable contractual promise.

In deciding whether the language was promissory in nature, the court also looked to the intention of the parties in including it in the letter. Because KBL asked for, and did not receive, a full guarantee from MLC, it followed that the lack of promissory language (e.g. a statement that the above would **continue** to be MLC's policy) was purposeful, and indicated that MLC was **intentionally** avoiding making a promise in the letter.

The court also noted that the letter contained other statements that would be rendered irrelevant if the letter were in fact tantamount to a guarantee. If MLC were giving a guarantee there would be no need for assurances that MLC would maintain its ownership of MMC Metals Ltd. The redundancy of the additional terms where the letter was interpreted as a guarantee also served as an indicator that MLC was intentionally not giving a guarantee.

The court held that to interpret the words of the letter as promissory would be to improperly read the extra words "and will continue to be" into the statement in question where there was no evidence to show that those were the words the parties intended to use. Instead of a contractual promise, the court held that the above statement was merely a moral commitment or a matter of the signor's honour. Without a factual context to indicate a contractual intent, the court would not attach contractual liability to language that was clearly not promissory.

BANQUE BRUSSELS LAMBERT SA V. AUSTRALIAN NATIONAL INDUSTRIES LTD. – A BINDING OBLIGATION

Just after *Kleinwort*, the Supreme Court of New South Wales in Australia considered the enforceability of comfort letters in the case of *Banque Brussels Lambert SA v. Australian National Industries Ltd*. ["Brussels"].[2]

In *Brussels*, Banque Brussels Lambert S.A. ("BBL") provided Spedley Security Ltd. ("SSL") with a line of credit. In negotiating the line of credit BBL sought a guarantee from the parent company of SSL, Australian National Industries Ltd. ("ANI"), but could not procure one. In the end, ANI provided BBL with a comfort letter including the following salient terms:

> *"(1) We acknowledge that the terms and conditions of the arrangements have been accepted with our knowledge and consent and state that it would not be our intention to reduce our share holding in Spedley Holdings Limited from the current level of 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 share holding, and furthermore we acknowledge that, should any such notice be served on your bank, you reserve the right to call for the repayment of all outstanding loans within thirty (30) days.*
>
> *(2) We take this opportunity to confirm that it is our practice to ensure that our affiliate, Spedley Securities Limited, will at all times 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."*

Years after the line of credit was extended, ANI sold off its shares in SSL without giving BBL any advance notice, meaning that BBL lost the chance to demand payment of the debt prior to the sale. Additionally, it was clear that ANI did not make efforts to ensure that SSL was in a position to meet its financial obligations.

SSL did not repay the loan, and so BBL attempted to recover the loans from ANI by bringing an action for breach of contract. ANI took the position that the reasoning in *Kleinwort* protected them from any liability under the comfort letter. The Supreme Court of New South Wales disagreed.

Once again the court in this case held that a comfort letter had to be interpreted in light of its language, but also in the context of its surrounding circumstances. The facts of *Brussels* differed from those of *Kleinwort* in a few ways. The course of the negotiations showed that BBL was looking for very strong language in the letter, and went so far as to reject a draft that expressly stated that the letter was not a guarantee. Additionally, ANI was given notice that BBL considered comfort letters to create binding obligations. In determining the nature of the obligations created by the comfort letter, the court considered whether 1) the contextual evidence indicated an intention to contract; and 2) whether the language in the letter was promissory in nature. Ultimately it was held that the requisite intention and language was present, and that ANI was liable for SSL's debt.

The reasoning behind this decision was based largely on the premise that business people do not just write up documents for fun, and to hold comfort letters as creating no legally binding obligation would render the document useless. The court reasoned that if the language contained in a document is promissory on its face and there is no indication that the parties do not intend the obligations in the letter to be enforceable, the court is duty bound to hold the contracting parties to their bargain. The fact that BBL requested a guarantee from ANI and was denied did not preclude this finding.

The court relied on the case of *Edwards v. Skyways Ltd*. for the proposition that an intention to contract is assumed in commercial transactions, unless there is strong evidence to the contrary.[3] The Australian court was critical of the reasoning in Kleinwort, arguing that minute textual analysis can twist the meaning of a document, and to treat a comfort letter as a matter of honour was to disregard the purpose for which it was given in the first place.

This analysis led the Australian court to hold ANI liable for the debt of SSL, giving legal effect to the comfort letter in this case.

TORONTO DOMINION BANK V. LEIGH INSTRUMENTS LTD. (TRUSTEE OF) – THE CURRENT STATE OF THE LAW

Ten years after the decisions in *Brussels* and *Kleinwort*, the Canadian courts were tasked with settling the law surrounding comfort letters in Canada in the case of *Toronto-Dominion Bank v. Leigh Instruments Ltd. (Trustee of)* ["***Leigh***"].[4] The facts in Leigh were very complicated. However, a short summary will suffice for the purpose of extracting the rules and reasoning behind the case.

Toronto Dominion Bank ("**TD**") extended a great deal of credit to Leigh Instruments Ltd. ("**LIL**"), at first by way of transferring a debt owed by LIL's parent company, itself a subsidiary of Plessey Company PLC ("**Plessey**"), and subsequently directly to LIL. TD extended $45 million in credit to LIL, and in the course of those financings asked for and received five comfort letters. Each of the letters contained the following statement, among others:

> *"It is our policy that our wholly owned subsidiaries, including Leigh Instruments Limited, be managed in such a way as to be always in a position to meet their financial obligations including repayment of all amounts due under the above facility."*

The fifth and final letter was identical in substance to the first four, except for one provision at the end that read:

> *"This letter replaces our letters of 31st August 1989, 31st March 1989 and 30th June 1989 and does not constitute a legally binding obligation."*

In the end, LIL went bankrupt and TD demanded payment from Plessey, who refused to pay.

The court held that the language added to the fifth comfort letter was reviewed and accepted by senior TD officials. Therefore, Plessey had demonstrated and TD had taken notice of a clear intention to not have the promises in the final comfort letter treated as legally binding. As such, Plessey could not be held to account for LIL's failure to pay its debts.

While this conclusion may not surprise anyone, interestingly the court held that the ruling in this case would have been the same even without the new wording in the final letter. This finding hinged on the court's willingness to allow evidence of the circumstances surrounding the contract to aid in the interpretation of the contract. It should be noted that the court was clear that external circumstances would only be allowed into evidence where there is ambiguity in the wording of the contract, and could only be used to ascertain the intention of reasonable parties similarly situated. External evidence cannot be used to argue what the parties' subjective intent was at the time the contract was made.

It was this external evidence that made all the difference in Leigh. The evidence showed that TD's internal policies considered comfort letters to be documentation, and not a security. Plessey had refused to give a guarantee, and TD's subsequent risk evaluation on the line of credit seemed to reflect the increased risk that would come with a non-guaranteed loan. TD's legal department advised on the ambiguity and uncertainty inherent in receiving a comfort letter pursuant to a financing. Additionally, there was evidence that a primary reason for TD extending the loan was to foster a positive relationship with Plessey, a giant multinational corporation. All of these surrounding facts led the court to the decision that Plessey's comfort letter could not have been intended to be a legally binding contract.

Further to these reasons, the court endorsed the reasoning in Kleinwort. First, that if the statement reproduced above was a binding guarantee, then the rest of the document (which stated and guaranteed many other things) would be meaningless. Also, the statement in question was in the present tense, like in Kleinwort, and the Ontario court was no less hesitant to read the extra words "and will continue to be" into the contract where there was no evidence to prove that those were the words the parties intended to use.

In the end it was TD who was left picking up the tab for LIL's debt, as LIL was bankrupt by the time this litigation was resolved. Plessey did not contribute any money as the court held it had no legal obligation to pay, only a moral one.

CLAIMS FOR MISREPRESENTATION

Although not addressed in the above summaries, the courts in both Kleinwort and Leigh discuss the additional possibility of comfort letters leading to liability even where they are not contractual in nature.

This liability would arise from the law of representations. Representations are statements made that, while not part of the terms of a contract, induce a party to enter into a contract. So, in the case of a comfort letter that is not deemed to be contractual, the author of the letter can still be held accountable for losses associated with the financing if they made representations that were not true.

The law distinguishes between three kinds of false representations: innocent, negligent and fraudulent. An innocent misrepresentation (where the misrepresentation was made with good intentions) would give the party who was induced into the contract the chance to void the contract, but not the opportunity to sue for money. A negligent misrepresentation would be a false statement made where there was no thought or care that went into making the false statement. This type of misrepresentation allows the induced party to sue for money. Fraudulent misrepresentation occurs when a representation is known to be false, but it is made regardless. This most egregious form of misrepresentation allows the induced party to void the contract and to sue for money.

The law of representations makes it important to consider the repercussions of comfort letters outside of contract, because even where the nature of the letter is not contractual, the party giving the letter could suffer monetary losses where statements in the letter are false.

KEY LESSONS

While the cases reviewed in this article seem to be at odds with one another, on closer inspection they actually help to form a coherent understanding of the way in which comfort letters are treated and interpreted.

A Matter of Interpretation

First and foremost, each comfort letter must be interpreted individually. The title "comfort letter" is not determinative of the substance of the letter. Some comfort letters may be contracts while others may be mere statements.

Context Matters

Courts in Canada have shown a willingness to allow evidence of the circumstances surrounding the giving of a comfort letter. These external factors can be used in order to help aid the interpretive process.

Objective Intentions Control the Analysis

A contract is generally to be interpreted according to the plain meaning of the words on the page. However, the courts will trace the reasonable intentions of the parties with an analysis of the contract and the surrounding context where there is ambiguity present in the words of a contract. The court will reconstruct the scenario and consider what the intention of reasonable parties in that situation would have been. This forms the objective standard on which the nature of the statements contained in a comfort letter will be decided.

CONCLUSION

It may seem as though comfort letters have the potential to be absolutely useless in certain circumstances. The question begs as to why a creditor would accept a comfort letter from a guarantor that refuses to give a guarantee when the letter cannot be enforced at law. The commercial reality is that when a business fails to meet its obligations, whether as a matter of law or honour, it reflects poorly on that business. A bad reputation can be much worse for a company than having to repay a loan. While this may not seem like an appropriately harsh punishment for one who fails to honour a non-contractual version of a guarantee, it should be remembered that, unfailingly, the author of a comfort letter will have been asked for a guarantee first, and the author refused.

In addition to this weak punishment, it is entirely possible, and in fact probable, that some comfort letters will be interpreted as binding legal obligations in the future. All it would take is for the wording of a letter to indicate promissory intent (perhaps by using the future tense), and the letter would be held to create legally binding obligations.

If there is one overriding lesson to take away from this line of cases, it is that one should not give a comfort letter lightly. Careful thought should go into drafting a comfort letter, and it is of supreme importance that the words on the page exactly match the intentions of the authors. Otherwise the parties may find themselves in the somewhat ridiculous position of being locked in long and expensive legal battles, arguing over what they thought the other side was thinking as in the cases of *Kleinwort*, *Brussels* and *Leigh*.

Footnotes

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1. *Kleinwort Benson Ltd. v. Malaysia Mining Corp*., [1989] 1 All E.R. 785 (C.A.), revg [1988] 1 All E.R. 714 (Q.B., leave to appeal to H.L. refused [1989] 1 All E.R. 785 (C.A.) at p. 798).

2. *Banque Brussels Lambert SA v. Australian National industries Ltd*. (1989), 21 N.S.W.L.R. 502 (S.C.).

3. *Edwards v. Skyways Ltd*, [1964] 1 All E.R. 494 (Q.B)

4. *Toronto Dominion Bank v. Leigh Instruments Ltd. (Trustee of)* (1998), 40 B.L.R. (2d) 1 (Ont. Ct. (Gen Div.)), affd 45 O.R. (3d) 417 (ONCA), leave to appeal to S.C.C. refused [1999] S.C.C.A. No. 27570 (QL).