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Comfort Letters

Casual Drafting Can Turn One Into a Guaranty

In the realm of commercial lending, comfort letters are usually issued to supplement or clarify the loan documents. Depending on their language and the overall circumstances of the transaction, comfort letters may also serve as a binding assurance that transforms it into a guaranty.

Generally, comfort letters are not intended to be legally binding obligations; therefore, this unexpected transformation could place the issuer of the comfort letter into the unwanted position of having to assume liability on behalf of the borrower contrary to its intentions in issuing the comfort letter.

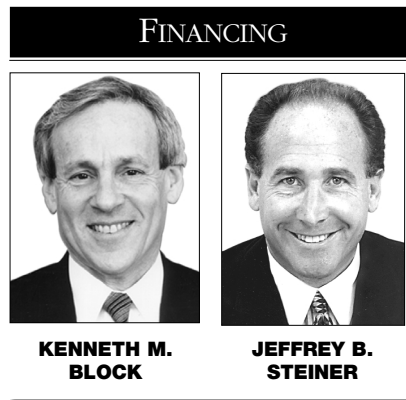
The recent holding of the U.S. District Court for the Southern District of New York in *LaSalle Bank National Assoc. v. Citicorp Real Estate, Inc.*, WL 21671812 (July 16, 2003), which sustained the legal sufficiency of a claim of promissory estoppel based on a comfort letter, warrants a discussion of these seemingly innocuous instruments.

Purpose Of Comfort Letters

"[C]omfort letters are often drafted by a parent company and are aimed at encouraging a lending institution to issue credit to a subsidiary," the court wrote in *LaSalle*.¹

The essence of the comfort letter is to encourage the lending institution (i.e. potential creditor) to enter into a legally binding transaction with the subsidiary company while attempting to avoid liability should the subsidiary (i.e. potential debtor) fail to perform. Because of this dual purpose, comfort letters have been described as "something more than a

Kenneth M. Block and **Jeffrey B. Steiner** are members of *Brown Raysman Millstein Felder & Steiner*. **Alexis B. Hart**, an associate of the firm, assisted in the preparation of this article.



letter of introduction, but something less than a guaranty or suretyship commitment."

On some occasions, a company may prefer to provide an enforceable comfort letter rather than formal guaranty. The reasons for this are usually related to accounting and reporting requirements or restrictions. For example, by issuing an enforceable comfort letter, the parent company may not be obligated to report the letter as a guaranty. However, in the majority of lending transactions the parent company does not wish to incur liability; therefore, it does not wish the comfort letter to be enforceable.

There are times where, despite the drafting party's intentions that the comfort letter not create any legally binding obligations, that the "comfort letter leads to the subsequent involvement of the drafting party in the agreement itself." Courts generally view comfort letters as unenforceable; however, the overall context of the transaction in which the comfort letter was written, as well as the language of the letter itself, may lead a court to find the letter to be part of an implied contract and that the drafter assumed the role of guarantor.

Also, questions of fact surrounding whether or not the creditor justifiably relied on the comfort letter may ultimately preclude summary judgment on this issue.

'LaSalle'

In *LaSalle*, defendant Citicorp, was able to withstand Marriott International, Inc.'s motion for summary judgment when Marriott issued a comfort letter on behalf of a franchisee. There, Brock Suite Greenville, Inc., operated a hotel pursuant to a franchise agreement with Marriott. Brock borrowed \$6.75 million from L.J. Melody & Company in exchange for a promissory note and a mortgage on its hotel property.

At L.J. Melody's request, Marriott issued a comfort letter on Dec. 18, 1997, in which it indicated the procedures it would follow if Brock defaulted on the franchise agreement, most notably that it would notify L.J. Melody of any breach. L.J. Melody then sold the loan to Citicorp and with it assigned "all rights, title and interest in, to and under the note, the mortgage and certain related loan documents."

Citicorp then resold the loan on April 1, 1998, under a Pooling and Services Agreement (PSA) to LaSalle wherein Citicorp made several representations and warranties, namely that "[t]here is no material default, breach or even of acceleration existing under the related Mortgage Note." However, unbeknownst to Citicorp, on March 31, 1998, Marriott sent a notice of default to Brock's parent company, Hallwood Realty Group. Citicorp was not notified of Brock's default until Feb. 5, 2001.

Contrary to its representations in the comfort letter, Marriott did not inform the initial lender, L.J. Melody, that Brock was in default of the loan agreement and L.J. Melody did not learn of Brock's breach until Jan. 15, 1999. LaSalle then brought suit against Citicorp for breach of its warranties and representations under the PSA. Citicorp immediately filed a third-party complaint against Marriott for its failure to notify it of Brock's default. Citicorp alleged that Marriott's failure to notify Citicorp of Brock

Suite's default despite Marriott's undertaking of this obligation in the comfort letter to L.J. Melody gave rise to causes of action for 1) promissory estoppel, 2) indemnity, and 3) negligence.

The court dismissed both the indemnity and negligence claims, but allowed Citicorp to go forward with its promissory estoppel claim.

The court stated, "[b]ecause of the fact-specific nature of the inquiry ... I will not dismiss Citicorp's claim at this stage. ... I have to permit Citicorp the opportunity to develop sufficient facts that show, among other things, that Citicorp in fact relied on the letter and that its reliance was reasonable given the specific transaction and the parties involved, and this claim may proceed."

While there is relatively little case law on the subject of comfort letters in commercial lending, courts will tend to refer to general contract principles to establish the factors to be considered when determining the enforceability of the comfort letter. Those principles include 1) the language of the comfort letter itself, 2) the sophistication of the parties, 3) oral representations, 4) the parties prior dealings, 5) whether or not the instrument is customarily viewed as enforceable in the particular trade or profession at issue, 6) the parties' reasons for using the comfort letter, and 7) the role the comfort letter played in the agreement.³ It is also a principle of general contract law to construe ambiguous provisions of the comfort letter against the drafter.

Courts will use the language within the four corners of the comfort letter to surmise whether or not the issuer's intent was or was not to become liable on its promises in the event of default by the debtor.

The court in *LaSalle* noted that Marriott used "strong language" in the comfort letter. "Marriott stated that it 'will follow' certain procedures and 'will notify Lender' and describes this as an 'obligation.'"

'Westpac'

Similarly, a concurring opinion in *Mutual Export Corp. v. Westpac Banking Corp.*, 983 F.2d 420 (2d Cir. 1993), focused on the use or nonuse of certain contractual phrases such as "guaranty" or "contract." The court in *Westpac* ultimately held that the use of words of promise, although not conclusive, should be viewed as a strong indication that a contractually binding obligation was intended.

In *LaSalle*, the court found that the parties' reason for utilizing the comfort letter "was intended by Citicorp and L.J. Melody as a stand-in for a certificate of good standing or an

estoppel of the franchise agreement."

In Lieu of Estoppel

Additionally, the fact that Citicorp accepted the comfort letter in lieu of an estoppel, which would have been enforceable and transferable, suggested to the court that Citicorp accepted the risk of the informal comfort letter. The court also noted that Citicorp was a sophisticated commercial entity and as such, it should have realized "that the phrase 'comfort letter' indicated that Marriott did not intend to be bound and, more significantly, that courts as a general rule would not hold them to this promise."

In regard to the role that the comfort letter played in the transaction, the court noted that L.J. Melody did not include the comfort letter in the loan packet it submitted to Citicorp and Citicorp did not include it in the material presented to the parties to the PSA.

If the issuer's intent in regard to assuming liability (should the borrower default) is ambiguous or unclear from the face of the comfort letter, the lender can resort to the theory of promissory estoppel. A creditor's reasonable reliance on a letter that induced it to enter into a contract with a debtor can create an enforceable obligation, the court ruled in *Westpac*.

Citicorp's only surviving argument against Marriott was that Citicorp, as the successor mortgagee and therefore the assignee of the promises made in the comfort letter, relied on Marriott's promise to notify of any default under the franchise agreement. "If the recipient of the comfort letter reasonably relied on terms given or implied by the instrument, then that comfort letter's statements, even if promissory language has been avoided, may be held enforceable under a theory of promissory estoppel or detrimental reliance even though the drafter had good reasons for wanting to avoid a formal guaranty."

This opens the door for promissory estoppel claims if the comfort letter does not contain a clear and concise disclaimer or notice that the issuer does not intend to assume liability.

To avoid this result, the following language has been recommended by one commentator: "The parties recognize that no firm commitment can be made ... until a definitive agreement is signed by all parties, each reserves the right to terminate ... all related activities for any reason at any time and without any liability to the other party."⁴

In *Rotterdam Ventures, Inc. v. Ernst & Young*, 752 N.Y.S.2d 746 (2002), various investors brought an action for negligence against Ernst & Young, the auditors of the companies in

which the investors invested.

Ernst & Young issued a report in regard to the financial health of the companies and subsequently issued two separate comfort letters directly to each company reaffirming its prior position regarding each company's financial health.

The court held that the plaintiffs' reliance on the comfort letters was unjustifiable because the disclaimer language expressly stated that they were "not to be used, circulated, quoted, or otherwise referred to for any purpose, including but not limited of the purchase or sale of securities."

An opposite result was reached, in *ML-Lee Acquisition Fund v. Deloitte & Touche*, 320 S.C.143, 463 S.E.2d 618 (S.C. 1995), where the court of appeals reversed the district court's holding that reliance upon a comfort letter was unreasonable as a matter of law notwithstanding the fact that the comfort letter was limited in scope and contained a disclaimer.

The disclaimer stated that Deloitte & Touche "make[s] no representations as to the sufficiency of the foregoing procedures for [ML-Lee's] purposes." The court stated, "[t]he limited scope of the letter and the inclusion of a disclaimer, however, do not require a finding that any reliance on the letter was not justified as a matter of law", and concluded that "whether ML-Lee's reliance on the comfort letter was justifiable, given the disclaimers included in the letter, is a question that should be resolved by the jury."

Conclusion

Unfortunately, there is no clear-cut safeguard that an issuer of a comfort letter can rely on in order to insure that it does not incur liability in the event of a default. "Some courts likely will continue to pigeonhole such instruments as not meeting the strict mandates of traditional contract theory. Others may look to the ever-expanding realm of promissory estoppel or detrimental reliance to find a legally enforceable obligation."⁵

(1) *LaSalle* at *6 [quoting Herbert Bernstein and Joachim Zekoll, *The Gentleman's Agreement in Legal Theory and Modern Practice*, 46 Am. J. Comp. 87, 100 (1998)].

(2) See generally Larry A. DiMatteo and Rene Sacasas, *Credit and Value Comfort Instruments: Crossing the Line from Assurance to Legally Significant Reliance and Toward a Theory of Enforceability*, 47 *Baylor L. Review* 357 (1995).

(3) Bernstein & Zekoll, *supra* note 1.

(4) DiMatteo and Sacasas, *supra* note 2.

(5) DiMatteo and Sacasas, *supra* note 2.