



Welcome to the September edition of *Insight*, Fenwick Elliott's newsletter which provides practical information on topical issues affecting the building, engineering and energy sectors.

In this issue we discuss whether a parent company letter of support is a good enough alternative to a parent company guarantee.

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Parent Company Guarantees - is there an alternative?

Parent company guarantees are a common feature of construction and engineering projects. Their purpose is simple: to provide one party with security in the event the other party fails to comply with its contractual obligations. Sometimes, instead of providing a parent company guarantee, parent companies might alternatively provide a generally worded letter of support confirming that it is the group's policy to ensure its subsidiaries are able to meet their liabilities. But how good is this alternative?

This twenty-seventh issue of *Insight* considers the decision of the Chancery Division in *Carillion Construction Ltd v Zelf Hussain and Robert Jonathan Hunt (the Joint Liquidators of Simon Carves Ltd (in Liquidation))* 2013 EWHC 685 (Ch), an important recent judgment on parent company letters of support, and provides practical advice for those who might issue and receive them.

Carillion

The facts

Simon Carves Limited ("SCL"), a contractor specialising in the design and build of major process engineering projects, entered into two subcontracts with Carillion Construction Limited ("Carillion"). Carillion duly carried out the works under the subcontracts and issued invoices to SCL in the combined sum of around £12 million. SCL subsequently experienced financial difficulties and incurred significant pre-tax losses. By way of response, SCL's Indian parent company, Punj Lloyd Limited ("PLL"), provided three letters of business and financial support to SCL's directors ("letters of support") in the following (extracted) terms:

12 May 2008 letter

"...we, Punj Lloyd Limited, confirm that we shall provide the necessary financial and business support to Simon Carves Limited to ensure that the Company continues as a going concern."

14 May 2009 letter

"We are aware of the financial position of your Company, its state of affairs and the results of its operations, and we hereby agree to provide sufficient funds to the company for these purposes, to enable it to continue operating and to meet its liabilities as and when they fall due for the period until 31 May 2010, to ensure that the Company continues as a going concern."

31 March 2010 letter

"...we, Punj Lloyd Limited, confirm that we shall provide the necessary financial and business support to Simon Carves Limited for a period of not less than 12 months from the date of approval of the accounts, to ensure that the Company continues as a going concern."

Each letter was addressed to SCL's board of directors and was written around the time of the preparation of SCL's annual accounts, which were prepared on a going concern basis on the back of PLL's letters of support. The 2008 letter stated it had been prepared to ensure SCL continued as a going concern, and the two later letters were expressly referred to in the directors' report which accompanied the financial statements of SCL for each year.

On 7 July 2011, PLL withdrew its support, citing prevailing market conditions and SCL's financial condition. One day later, SCL went into administration and its business and assets were sold by pre-pack. Carillion was owed around £12 million, and given SCL was in administration it could only commit to paying four pence in each pound of this debt. Carillion subsequently applied to the court for a declaration that the letters of support constituted binding obligations upon PLL to financially support SCL, and that the withdrawal of that support constituted a transaction defrauding creditors for the purposes of section 423 of the Insolvency Act 1986.

The issue

The issue that fell to be decided by the court was whether the letters of support were legally binding. If they were not, then Carillion's claim would fail.

The decision

The Judge held that whether the letters of support gave rise to obligations enforceable in law depends on their terms and requires an understanding of what the parties intended them to mean, in particular, whether or not the parties intended the letters of support to create legally binding obligations. The parties' intentions should be determined objectively having regard to the terms of the letters of support and the surrounding circumstances.

Applying this to the letters of support in question, the fact that they were addressed to "The Board of Directors" and not simply to the directors as agents of SCL, or SCL itself, was deliberate. Also of significance was the fact that the letters of support were provided in the course of the preparation of SCL's year-end financial statements.

Further, there was nothing in the letters of support that indicated that SCL and PLL intended them to be legally binding. The letters of support did not purport to be contracts and there was no provision whereby they were to be accepted by SCL's directors on behalf of SCL upon signature, as would be expected in the case of a binding letter of support.

Nor was there any indication that any consideration had passed between SCL and PLL. The fact that SCL (as opposed



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to its directors) may have relied upon the letters of support to continue trading would not have constituted valuable consideration that would have warranted the existence of a contract.

The Judge commented that it would be extravagant to read the letters of support as committing PLL to ensuring that SCL should be provided with funds on demand to meet all its liabilities that were due for payment within the following 12 months. SCL's liabilities for the year ending 31 March 2010, for example, amounted to £271.5 million and it was considered very unlikely that the 31 March 2010 letter of support constituted a contractual undertaking by PLL to SCL to guarantee such a large sum of money.

The true purpose of the letters of support was to do no more than provide the directors of SCL and its auditors, and not SCL itself, with evidence from which they could properly conclude that SCL's accounts should be prepared and signed off on a going concern basis. There was nothing in the judgment that suggested it was improper of SCL's directors to do so, and the letters of support were created in the context of the directors' obligation to make a reasonable assessment (all relevant facts and circumstances considered) of the prospects of SCL continuing as a going concern for the following 12 months. This was something the directors had to take a view on and they were entitled to take into account PLL's letters of support in order to do so.

Practical tips

Generally

It is important to remember that for a letter of support to be legally binding, the usual contractual requirements of offer and acceptance, consideration, certainty as to terms, and intention to create legal relations all need to be satisfied. The background against which the letter of support was issued will also be relevant.

For issuers

For parent companies, letters of support can be a useful tool for providing an assurance of support for its subsidiary, and they are also used commercially to inform the decisions of the board as to the continuing trade of a subsidiary in challenging economic times.

The key for parent companies who are considering issuing a letter of support is to consider whether they wish it to be legally binding. There is no standard industry form for letters of support, but as a general rule, to be legally binding, a letter of support must:

- contain an offer and acceptance of financial support between the parent and its subsidiary, either as between the parent and subsidiary of their own account or through the directors in their capacity as agent of the parent or subsidiary;
- provide for a sum of money to pass between the subsidiary and parent by way of valuable consideration;
- make the terms of the letter of support certain such that it is capable of being enforced by a court or tribunal (this is particularly important in relation to the level of financial support that is to be provided);
- confirm the parent's and subsidiaries' intention that they are to be bound by the letter of support and its terms; and
- ensure the letter of support makes sense commercially against the relevant commercial and financial background.

For recipients

Unless a letter of support contains all the constituents that are necessary to create a binding contract as mentioned above, there is no guarantee it will be legally binding and it might possibly even be withdrawn (as was the case in *Carillion*), thereby removing the security it once represented. To be on the safe side therefore, do not take a letter of support at face value.

Instead:

- look behind the letter of support with a view to ascertaining whether the parent company is likely to continue to provide support to its subsidiary

having regard to the financial strength of the subsidiary, the financial strength of the parent company and the parent company's own strategic and commercial aims; and

- consider (as a belt and braces measure) obtaining a qualified audit report to assess the parent's likely actions as far as the subsidiary is concerned.

Conclusion

The wording used in PLL's letters of support was stronger than the wording that is commonly seen in non-binding letters of support, which usually go no further than saying that it is the parent company's present policy to ensure its subsidiary is in a position to meet its liabilities. At first blush therefore, they appear to be binding. The seemingly binding nature of PLL's letters of support was also endorsed by Carillion's audit expert who gave evidence confirming that, had he been acting for SCL, he would not have signed off SCL's financial statements on a going concern basis unless he was satisfied that the letters of support were of a legally binding nature. That being so, the Judge ruled the letters of support were not legally binding.

There is always a risk that letters of support will not have contractual effect. Ultimately, the only way to be confident that any security you might offer or hold is legally binding is to enter into a properly drafted parent company guarantee or bond.

Should you wish to receive further information in relation to this briefing note or the source material referred to, then please contact Lisa Kingston. lkingson@fenwickelliott.com. Tel +44 (0) 207 421 1986

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Fenwick Elliott LLP
Aldwych House
71-91 Aldwych
London WC2B 4HN
www.fenwickelliott.com