1934, whereas the applicability of such provisions to a wholly offshore offering by a non-US issuer would be questionable.

In order to market their obligations in the Euromarket, US issuers must ensure that their Euro-MTNs are exempt from US 30 per cent withholding tax and information reporting and back-up withholding requirements. US as well as non-US issuers of Euro-MTNs must also give some consideration to the US Tax Equity and Fiscal Responsibility Act 1982 (TEFRA). TEFRA is aimed principally at preventing the use by US taxpayers of obligations in bearer form as a means of avoiding taxation. TEFRA and the regulations thereunder specify certain procedures governing the manner in which obligations in bearer form may be issued, effectively restricting their initial issue and sale outside the US and to non-US persons only. Issuers, including non-US issuers, failing to comply with such regulations may be subject to a number of sanctions. Thus, issuers of Euro-MTNs face the same problems posed by US federal tax laws as Eurobond issuers.

A complete discussion of the US Tax Reform Act 1984 (which repealed the US 30 per cent withholding tax with respect to payments of 'portfolio interest'), TEFRA and the US information reporting and back-up withholding requirements is beyond the scope of this article. However, briefly stated, any potential problems raised by such laws can be avoided if, among other things, the following steps are taken: bearer Euro-MTNs and interest coupons bear a legend specified by TEFRA regulations warning of possible penalties imposed on US persons holding bearer securities; payments of interest on bearer Euro-MTNs may be made only outside the US; and bearer Euro-MTNs are sold pursuant to 'arrangements reasonably designed' to ensure that they are sold (or resold in connection with their original issuance) only outside the US to non-US persons.

Lock-up period

For most Euro-MTNs, the procedures required to comply with Release No. 33-4708 will also satisfy the 'arrangements reasonably designed' test under TEFRA, and the regulations provide a safe harbour for issuers who, in reliance on a written opinion of counsel, determine that registration under the 1933 Act is not required because the securities are intended for distribution to non-US persons. Euro-MTNs registered under the 1933 Act (or exempt from the registration requirements thereof for reasons other than compliance with Release No. 33-4708) would also comply with the 'arrangements reasonably designed' test by applying substantially the same procedures except that such Euro-MTNs would not need to be locked-up in global form for any period of time. Such Euro-MTNs could be released in definitive form (on certification of non-US benficial ownership) on their date of issue, although most programmes registered under the 1933 Act nonetheless impose a brief lock-up period of 30 to 45 days after issuance. This brief lock-up is an additional precaution to ensure that, for tax purposes, the Euro-MTNs are not deemed to have been offered to US persons in connection with their original issuance.

A number of potential US tax concerns raised by Euro-MTNs were eliminated by the issuance in December 1986 of new tax regulations by the Internal Revenue Service with respect to TEFRA and the Tax Reform Act 1984. The first problem eliminated relates to the question which arose under the previous rules as to whether a 'permanent' global security (ie one which under no circumstances could be exchanged for definitive notes) would be treated as a registered obligation despite the fact that it was stated on its face as being payable to bearer. This was a concern for US issuers since a debt obligation in registered form may qualify for exemption from the US 30 per cent withholding tax only if the non-US investor delivers a Form W-8, signed under penalties of perjury, setting out the investor's name and address. In contrast, no such requirement applies to bearer obligations qualifying for exemption from 30 per cent withholding. The new regulations, by redefining the term 'registered obligation', make it clear that a global Euro-MTN, as long as it may be exchanged for bearer securities at some time prior to its maturity date, will be considered to be a bearer obligation. Under the new regulations a truly 'permanent' global security, meaning one which cannot at any time be exchanged for a definitive bearer obligation prior to maturity, will be deemed to be an obligation in registered form.

Shorter maturities

Another problem resolved by the new regulations concerns the possibility that under the prior regulations interest paid on any series or tranche Euro-MTN issued by a US issuer one year or less before the maturity date of such series or tranche may not have qualified as 'portfolio interest', and as a result would not have been exempt from 30 per cent withholding. By extending the definition of 'portfolio interest' to include interest on obligations having maturities of less than a year at the date of issue, the new regulations eliminate this concern, and consequently, Euro-MTNs of US issuers need no longer be limited to maturities of more than a year. The new regulations do not alter other provisions under the US Internal Revenue Code pursuant to which discount obligations with a maturity of 183 days or less are exempt from the 30 per cent withholding tax.

Although the scope of the repeal of the 30 per cent withholding tax was broadened by the new regulations, these regulations introduced rather burdensome certification requirements for obligations that were not 'publicly issued'. The intent was to provide a means of enforcing the exclusion from the portfolio interest exemption of interest received by a 10 per cent shareholder of the issuer or a controlled foreign corporation related to the issuer. (See Duncan and Pergam, 'New US tax regulations affect Euromarket procedures', *IFL Rev*, February 1987, p 19) However, because of a number of significant problems raised by this 'publicly issued' limitation (which, among other things, requires that the obligation in question be listed on a securities exchange), the Internal Revenue Service (IRS) announced on February 13, 1987 that this portion of the new regulations would be 'suspended' retroactive to January 21, 1987. The IRS has requested comments on how this proposed regulation should be amended. For the moment, Euro-MTN documentation may ignore this portion of the new regulations.

In addition to the above questions regarding TEFRA and the Tax Reform Act 1984, issuers must also consider the proposed regulations published by the Internal Revenue Service in April of last year concerning the application of the original issue discount (OID) rules under the US Internal Revenue Code. Basically, these regulations provide that any issuer of a publicly offered debt obligation issued with OID above a specified *de minimis* amount must place a legend on the face of each instrument setting forth the amount of OID and certain other information required to assist the holder in complying with US federal income tax laws. Generally, these rules apply only to US issuers. A non-US issuer would be subject to these rules only if: it is 'otherwise subject to US income tax law'; or the issue is listed on an established US securities market (including certain over-the-counter markets) or initially offered for sale or resale in the US. While it is relatively simple to comply with these rules in the case of a distinct Eurobond issue, such as a zero coupon bond, in which the legend on each definitive instrument would be the same, the rules could present operational problems for securities being offered and sold over time, particularly in the case of series or tranche type issues required to be locked-up for extended periods. During the period such Euro-MTNs are in global form, procedures would have to be adopted to enable the clearance systems to track individually each Euro-MTN evidenced by the global security as it passed from one account to another to ensure that the proper OID legend, if any, was affixed to any definitive security evidencing such Euro-MTN.

To the extent Euro-MTNs in any given series or tranche are not issued with the same OID, the Euro-MTNs in such series or tranche would no longer be fungible, at least as far as US taxpayers are concerned. The question of fungibility arises because market discount (the difference between the issue price of an obligation and its secondary market purchase price) is treated differently than OID for US federal income tax purposes. For purposes of discussion, assume that a Euro-MTN (Note A) in the principal amount of US$1,000 is issued on January 1, 1987 at par. On June 30, 1987 another Euro-MTN (Note B) in the same tranche is issued at a price of US$900, in effect with OID of US$100. Note A and Note B are then each resold at a price of US$900. Whereas the purchaser of Note A will have to recognise all or part of the US$100 market discount only at the time of disposition of Note A, the purchaser of Note B will be required to recognise as income the US$100 of OID as it accrues over time and in advance of receipt of any cash upon the disposition of Note B. As a result, a US taxpayer would consider Note A to be a more attractive investment.

Although this nonfungibility problem is not new, it is of greater concern due to the new OID legending requirements discussed above. Because Euro-MTNs will be originally offered and sold only outside the US to non-US persons, the fungibility issue is probably not very significant from a marketing perspective. Nonetheless, the application of the OID legending rules would have to be disclosed to investors in any prospectus for a programme where the issue may arise. □

Comfort letters under Danish law

Danish lenders are doubtful about the legal effects of comfort letters. In the absence of legal precedents, the position is still unclear. By Christian Harboe Wissum of Dragsted, Copenhagen

Over the past few years, the Danish corporate sector has become increasingly internationalised, and financial institutions, lawyers and other business advisers are facing innovations within the laws on loans and guarantees. The comfort letter is one of the new instruments used as a security arrangement for major credit facilities with banks in Denmark and abroad.

The legal status and value that may be attached to the security aspect of the comfort letter are not clear under Danish law. There have been no real legal precedents and the concept has been rarely explored by Danish commentators (see Rimond Jorgensen, 'Letter of Awareness', *Fagskrift for Bankvaesen* 1978 Part 4, p170 ff, and Bernhard Gomard, 'Letters of Intent (*hensigtserklaeringer*)', The 30th Nordic Meeting of Lawyers, Oslo, August 1984, p 250 example 2).

To reach some conclusion on the comfort letter's value and legal treatment, the law and practice in other European countries have to be considered. The terms letter of awareness, letter of intent, letter of responsibility or, in Denmark, *hensigtserklaering* are used interchangeably. There does not seem to be any legal distinction between them.

A comfort letter is generally used where a parent company wants to help a subsidiary obtain credit facilities from a bank, but without acting as surety or issuing a guarantee. The reasons for that can be varied. For instance, it may not want to commit itself to a legally binding declaration. Companies tend to believe that a comfort letter, as opposed to a guarantee, does not have to be noted in the accounts (Section 46(3) of the Danish Company Accounts Act). Another reason is that legally binding sureties are subject to stamp duty under Section 57(1) of the Danish Stamp Act. For non-resident issuers, there may be foreign exchange regulation considerations, as guarantees and sureties often require special permits. The parent 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.

A comfort letter contains information and assurances about the creditworthiness of the borrower/subsidiary and serves as the lender's security where the borrower fails to meet its obligations. The reliance that can be placed on the comfort letter depends, first of all, on its wording. Comfort letters vary in their wording (Manfred Obermüller lists seven categories in *Zeitschrift für Unternehmens und Gesellschaftsrecht* 1975, p 3 ff) but most will include one or more of the following.

Border line

By way of introduction, the parent company declares that it is aware of and accepts the terms and conditions of the credit facility granted to its subsidiary, adding details about ownership of and interests in the subsidiary. The central part of the letter includes — in the case of a weak letter — phrases to the effect that: the parent company has always supported its subsidiary; the parent company has complete confidence in the management of the subsidiary; the parent company has always considered the subsidiary's obligations as its own; or the parent company's policy has always been to maintain the financial standing of its subsidiaries to enable them to honour their commitments.

Phrases of this kind, which are mainly informative and instructive, indicate the present and past policy of the parent company without giving any indication of future policy towards the subsidiary. The parent should be assumed to be free to change its policy, which means that the letter is hardly a promise to the lender — although the parent probably intended it to look like one — and should not be held to involve any legal commitment on the parent's part.

More problematic are letters of comfort with wording that includes an apparent or express promise which is either not clearly defined or does not relate directly to the position of the parent company towards its subsidiary, for instance: 'the parent company shall undertake to arrange for the subsidiary's commitments to the bank to be performed in a satisfactory way'; 'the parent company will exert its full influence over the subsidiary to repay the credit on maturity'; or 'the parent company will maintain its shares in or influence on the company for so long as the subsidiary's credit has not been repaid'.

This type of comfort letter should be regarded as a borderline case between purely informative letters and letters in which the parent company undertakes a legal obligation. There is probably little doubt that the parent company has given a promise. However, the promise is so imprecisely worded that it may be assumed that the promisee will not be able to enforce it under any law. It is difficult in the absence of precedent to determine the extent and scope of expressions like 'performed in a satisfactory way' and 'use its full influence'. The reference to 'maintaining its influence' might seem to carry some sort of objective weight. But the mere fact that a (parent) company has an interest in another company can hardly in itself be a guarantee of the financial status or the creditworthiness of that other (subsidiary) company, as opposed to examples (given below) which refer to the equity capital of the subsidiary. So the lender would not be justified in making any such assumption.

These examples given above do not seem precise enough for a court to enforce. It should be assumed, except where the parent company has acted directly and intentionally in disregard of the letter, that non-performance of the comfort letter may not have any legal significance, and does not give the lender any remedy.

The comfort letters of most interest to banks are those that fall between those already described and actual guarantees and sureties (called *'Die "harte" Patronatserklärungen'* by Jan Schröder in *Zeitschrift für Unternehmens und Gesellschaftsrecht* 1982, p 552 ff). Here it is not just a matter of applying general legal rules of construction since there have been a few cases in international law on this type of comfort letter.

A common feature in this type of 'strong' comfort letter is that to some extent the letter constitutes a statement or promise given by the parent to the lender about the actual credit, such as: 'the parent company shall undertake to provide the subsidiary with adequate funds for it to be able to meet its commitments from time to time'; 'as long as the loan has not been repaid, the parent company shall undertake to maintain adequate capital of its own in the company and, where necessary, to add the capital required for the subsidiary from time to time to meet its commitments as they fall due'. This type of language sets out the parent's obligation fairly clearly and it would be possible to establish whether the promise has actually been kept.

German law

The state of German law in this field has been subject to discussion for the last 10 years and is still not settled. However, two cases decided by German courts have considered specific *'Patronatserklärungen'*. (See *IFL Rev* June 1985, p 15). Both cases concerned comfort letters in which a parent undertook to add funds to another company to the extent that it would be able to meet its commitments when due. In one, it went on 'this obligation shall be valid until the principal, including interest and additional costs, shall have been repaid'. The borrower went bankrupt and the court upheld the lender's claim (decision of October 21, 1981, Stuttgart Oberlandesgericht, mentioned in *Zeitschrift für Wirtschaftsrecht und Insolvensrecht* 1982, appendix 013). An almost similar comfort letter was tried by the Stuttgart Landgericht in July 1984. Here, the borrower also went bankrupt and the court held that the comfort letter constituted an obligation on the part of the company issuing it to prevent the bankruptcy. The company was held liable for failing to fulfil this obligation. The decision was later ratified by the Stuttgart Oberlandesgericht (decision of February 21, 1985, Stuttgart Oberlandesgericht, mentioned in *Wertpapier-Mitteilungen* 1985, number 14, p 455).

In France, the debate about comfort letters has been going on for several years. A 1981 court decision (Tribunal de Commerce de Paris, 5e Chambre, October 27, 1981; the decision has not been printed but is mentioned by Lucien Martin in *Revue Banque* 1981, p 1455 and by Jacques Terray in *IFL Rev* October 1982, p 35) specifically considers a comfort letter. The court held that the concept of a comfort letter constitutes a contractual obligation that may be enforced in the form of compensation should the issuer not fulfil its obligations. However, the decision does not consider the important distinction in French law between a comfort letter which commits the issuer only to the best of his ability and one which involves achieving a specific result.

Moral commitment

Legal judgements, like the comfort letters themselves, will also vary widely. Little significance can be attached to the weakest forms, except for their moral commitment, which may nonetheless carry great weight with the lender. The mid-category, about which international law is the most hesitant, is characterised by statements which look like binding promises, but seem in fact to be more like mere statements of intent. The title of the letter here is important, as 'Letter of Intent' indicates that the company does not wish to undertake a legally binding obligation. Generally, however, if it becomes evident from the letter that the issuer wishes to undertake an obligation, less importance should be attached to the heading than to the contents of the letter. The final factors deciding whether a comfort letter is binding are whether the letter contains a commitment to realise the intent indicated, and whether the contents are sufficiently definite to establish the promise and its terms.

Different considerations would apply to a comfort letter in a financing than to statements of intent made between two parties intending to start joint venture cooperation on the completion of a specific project. These statements of intent or 'preliminary contracts' typically involve two parties each indicating their intent to enter into a contractual relationship, about which, however, there is no further clarification at the time the statement is made. However, in the case of a comfort letter for finance purposes, there are no unresolved issues between the parties, all the details have been settled, and a unilateral statement is being made as consideration for a credit facility. In these cases the legal position is different. A comfort letter should have more weight as a binding statement than a statement of intent.

The strong comfort letters contain elements familiar from the laws of surety and guarantees but are so different on decisive issues that general conclusions may be arrived at only with caution. A comfort letter, as opposed to sureties and guarantees, involves hardly any direct responsibility to the lender. The obligation embodied in the statement is not aimed directly at the lender, but at the borrower. Depending on the wording, the object is to provide the borrower with the necessary funds to enable him to honour his obligations. Contrary to a surety document, for instance, a comfort letter does not institute any duty on the part of the issuer to effect payments direct to the lender in the event of default by the borrower. The lender's claim is at best an indirect claim.

For this very reason, it seems inadvisable to make any major legal distinction between 'strong' comfort letters and guarantees, as the aim for both parties involved is to ensure payment of a debt. The difference seems to depend on the eventual payer of the debt. In some cases, a parent company may be legally forced to meet its obligations. But a comfort letter rarely assures the lender that the borrower will pay his debts when due, and only then if he is able to do so. It is not the will but the capacity to pay which is embodied in the statement. The borrower may, for instance, have made objections or counterclaims. If it is assumed that the strong comfort letter constitutes a legal obligation for the parent company which is enforceable through the courts, it is important to establish who may institute proceedings for a claim based on the letter.

Comfort letters usually appear to have been made for the benefit of a specific lender but may also, depending on the contents, at times be considered as having been made for the benefit of a broad and indefinite circle of company creditors. There are strong arguments against assuming that a comfort letter may be invoked by such third parties. It may be invoked only by the person to whom the letter has been issued or at the most by the person to whom the letter has been assigned. The possibility of a wide circle of the subsidiary's creditors benefiting should naturally be decided on the basis of specific conditions, but should typically be assumed to be outside the prerequisites of the parent company when making the statement.

If the obligations in the 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.

In spite of all these uncertainties, comfort letters are used increasingly in Denmark, and only time will show the significance which Danish courts will attach to these letters and the differentiation to be made between the various categories. □