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KNOWLEDGE NUGGETS

COMFORT LETTERS AS A TOOL FOR CRISIS PREVENTION

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I. WHY THIS TOPIC IS IMPORTANT

A properly drafted letter of support (also known as a "comfort letter" (*Patronatserklärung*)) enables a parent company (the "patron") to prevent its subsidiary or other affiliated group company from becoming over-indebted or illiquid. By strengthening the financial position of the beneficiary company, such letters also provide creditors with additional security. Comfort letters are therefore a widely used instrument in group financing arrangements.

However, achieving these objectives requires a legally effective "hard" comfort letter—only such a letter constitutes a balance sheet asset capable of eliminating over-indebtedness. An inadequately worded or purely "soft" comfort letter lacks this balance sheet effect. If the management of a company fails to file for insolvency despite the absence of a valid comfort letter, the managing directors face civil liability and potential criminal charges. Significant liability and balance sheet risks may also arise for the patron itself—including the requirement to recognize provisions, equity substitution and capital maintenance issues, and the risk of the patron's own financial distress.

II. SOFT VS. HARD COMFORT LETTER

The distinction between a soft and a hard comfort letter is of crucial importance in practice, as only the hard variant establishes legally enforceable claims and produces a positive balance sheet effect:

- **Soft comfort letter:** A soft comfort letter is a non-binding declaration of intent or goodwill (e.g., "the patron will endeavor to provide the company with adequate funding"). It does not establish an enforceable claim against the patron and therefore generally provides no relief under either accounting or insolvency law.
- **Hard (internal) comfort letter:** A hard internal comfort letter is a legally binding obligation of the patron toward the beneficiary company to provide it with sufficient financial resources to ensure that it can meet its liabilities as they fall due (a "liquidity commitment" (*Ausstattungsverpflichtung*)) or to absorb losses (a "loss absorption commitment" (*Verlustübernahmeverpflichtung*)). Only this variant can eliminate over-indebtedness by qualifying as a valuable balance sheet asset. The following requirements must be satisfied: (i) there must be a clear, legally binding and enforceable declaration of commitment—a mere reference to "support" or "endeavors" is insufficient; (ii) the scope of the funding obligation (amount, duration, conditions) must be clearly quantified or objectively determinable; (iii) the patron must be financially capable of fulfilling the obligation;if the patron itself faces financial difficulties, the relieving effect ceases to exist; and (iv) any time limitation or termination clause must not prevent performance when required.
- **Hard (external) comfort letter:** A hard external comfort letter is a commitment by the patron directly to a specific creditor (e.g., a financing bank) to guarantee the fulfillment of the liabilities of the relevant group company. Functionally, it resembles a guarantee (*Garantie*) or surety (*Bürgschaft*) and primarily protects the beneficiary creditor rather than the company's overall balance sheet position in the context of over-indebtedness. Drafters must clearly specify whether the declaration is made to the company (internal) or to individual creditors (external), as this determination governs both the scope of the obligation and the identity of the parties entitled to enforce it.

III. RECOMMENDATIONS

- **Selecting the appropriate instrument:** Carefully assess whether a hard (internal or external) or a soft comfort letter is appropriate in a given case. The choice depends on the intended objective: avoiding insolvency, supporting creditworthiness, or providing security for creditors. Consider alternatives such as equitable subordination agreements (*qualifizierter Rangrücktritt*), shareholder loans, guarantees, or sureties. A combination of instruments may be advisable where a single measure is insufficient to achieve the desired effect.
- **Ensuring legally sound drafting and advice:** Engage specialized legal counsel at an early stage to ensure that the wording is unambiguous and satisfies the requirements established by the courts for a valid and enforceable commitment. Tax advisors should also be consulted, as comfort letters may trigger adverse tax consequences—for example, hidden profit distributions (*verdeckte Gewinnausschüttungen*) or deemed capital contributions (*verdeckte Einlagen*).
- **Monitoring the patron's creditworthiness:** Continuously monitor the patron's financial condition, as only a commitment from a solvent patron provides relief under insolvency law. If the patron's financial circumstances deteriorate, the continued validity and extent of any relieving effect must be reassessed without delay.
- **Capital maintenance and group law considerations:** Verify that the comfort letter does not violate capital maintenance rules, particularly where the patron is a subsidiary providing upstream support to its parent company. Consider group law implications (*konzernrechtliche Fragestellungen*), including the parent company's potential liability for disadvantageous instructions under Section 317 of the German Stock Corporation Act.
- **Accounting treatment:** Disclose the comfort letter as a contingent liability or explain it in the notes to the financial statements. For the patron, assess whether a provision for potential claims should be recognized. For the beneficiary company, only a recoverable claim against a solvent patron may be recognized as an asset.
- **Written documentation and recordkeeping:** Record the comfort letter in writing, even though German law does not generally require a specific form for its validity. Maintain comprehensive documentation of the decision-making process, particularly the creditworthiness assessment and the analysis of the patron's capacity to perform.

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