

Private Fund Side Letters: Negotiating and Drafting Key Terms, Financing and Other Concerns

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Today's faculty features:

Joseph M. Mannon, Shareholder, **Vedder Price**, Chicago

Matthew (Matt) Posthuma, Partner, **Ropes & Gray**, Chicago

Adam S. Tope, Partner, **DLA Piper LLP (US)**, New York

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Introduction

- **What is a side letter?**
 - Side letters are separate agreements between the manager and an investor that supplement or modify the terms of the governing documents of a private fund
- **Who asks for side letters?**
 - Fund of funds
 - Sovereign wealth and other foreign investors
 - Governmental investors (state and local)
 - Other tax-exempt investors
 - Large RIAs / Allocators
 - Pension Plans
 - Insurance companies and other institutional investors
 - Individuals subject to trading or other restrictions

The Investor Agenda

- **When are side letter requested?**
 - Large, seed, and strategic investors often request side letters as part of their investment to address global and investor specific concerns
 - Certain investors often request side letters to address specific restrictions or circumstances applicable to such investors
 - In return for committing capital of a certain amount or being an early investor, an investor seeks to negotiate ***preferential terms***, which may range from discounted fees to additional investment capacity
 - *Investors' desired side letter terms vary greatly by investor type*

Disclosure of Side Letters

- SEC is focused on ensuring that conflicts of interest are adequately disclosed or mitigated
 - Concerned about preferred liquidity, access to information
 - Not concerned about economics, additional investments, MFNs
- If side letters exist, affirmatively say so in offering materials
 - Ensure LPAs allow side letters
- Foreign regulators such as UK FCA have published guidance on disclosure/AFIMD considerations
 - Expected managers to disclose to investors when a side letter was granted and any conflicts that may arise and how they are adequately managed

Side Letter Enforceability

- US
 - ESG Capital Partners II, LP v. Passport Special Opportunities Master Fund, LP
 - Entire Agreement clauses need to contemplate side letters
 - No material and adverse effect on other LPs
- Cayman
 - Re Medley Opportunity Fund Ltd.
 - Landsdowne Limited & Silex Trust Company Limited v. Matador Investments (in liquidation) & Ors
 - Ensure appropriate parties
- Opinions less common in the marketplace as compared to previous years

Common Side Letter Terms

Most Favored Nations (“MFN”)

- MFNs are often the most complex section of any side letter
- Least negotiated, but very important
- Managers should draft their MFNs to require that the investor take the “benefit” and the “burden” of any preferential term granted to another investor

MFN - Continued

- Who gets MFN?
 - Everyone
 - Commitment based
 - Investors over some threshold
 - Specific closing?
 - Investors in prior funds?
 - Relationship investors
- What is a “side letter”?
 - Do subscription agreement and parallel fund changes constitute a side letter?
 - Sponsor emails?
 - Confirmation letters?

MFN - Continued

- To whom does the MFN apply?
 - Fund/feeder/parallel/AIVs/sidecars/separately managed accounts?
 - Should you consolidate certain investors – affiliates, same consultants?
- Carve outs (examples)
 - Excluding legacy investors, separate accounts and employees
 - Fee-only MFNs
 - Investor specific legal/regulatory issues – FOIA, ERISA, etc...
 - “Materiality” [**consider advisory board, transfers, credit facility, reporting**]
- Seek to avoid additional investment restrictions and preferential liquidity terms
- Addressing client reporting needs

The MFN Process

- **MFN Process/Operational Issues**

- *Who should determine whether to grant a side letter?*
 - Internal task force to weigh impact – both economic and operational, successor funds, platform
- *How should the election process occur?*
 - After each close or final?
 - How quickly?
 - How long to elect?
 - Do you provide a summary or the actual side letters?
 - How do investors make the election?
 - Issue A&R side letters?
 - Do you see all side letters to date before closing?
 - Open-end funds
- What about MFNs baked in LPAs?
- *Monitoring compliance with MFN elections*
 - How do firms monitor compliance?
 - Implement standardized reporting templates

Common Side Letter Terms

Transfers of LP Interests

- Fund asked to consent to transfers of LP interest
- Often granted to affiliates, same consultant
- Third party transfers (PTP, competitor considerations)
- *Drafting notes - requirements*
 - Creditworthiness of new LP
 - Subject to LPA requirements
 - Legal opinion necessary?
 - GP not to “unreasonably withhold” consent
 - Admitted as a substitute LP
 - Release from unfunded commitments?

Investment Excusal Rights

- Why do GPs agree to excusal rights?
- What is effect of excusal rights?
- What types of excusal rights apply – regulatory and policy based (e.g., religious) – geography, types of investments
- Trigger LP withdrawal or termination of commitment
- Disclosure considerations
- GP standards in making investments – maximize profits

Reporting/Notification Rights

- Amounts of fees paid, funded commitment, undrawn, write-ups/downs
- FOIA considerations
- Fund of one investors
- Insurance
- Regulatory/Litigation event notifications
- Change in service providers
- Key person
- Investors in investors

Use of Name and Other Disclosure

- Use of name
- Restrictions on disclosing of LP investment

Tax

- ECI/UBTI/CAI provisions
- Important to understand standard of care
- Tax audits
 - Carried interest waivers

Other Side Letter Provisions

- AML/OFAC representations
- LPAC or observer rights
 - Obtain all documents even if not on LPAC or observer rights
- Conflicts of interests
- Sovereign immunity
- Power of attorney
- Reps and warranties of GP/Manager
- Secondary transaction participation rights
- AIVs and parallel funds

Other Side Letter Provisions

- GP Fiduciary Duty/Standard of Care
- Closing Documents
- Jurisdiction/Governing Law

Negotiation Tactics

- Both managers and investors need to develop their own side letter “playbook”
- Investors and managers will want to agree on the standard terms they are willing to offer and/or accept and have a process for handling deviations
 - Large private fund investors often have their own template provisions
 - Managers should develop their own template

Negotiation

- **Co-investments**

- Priority allocation
- Pro-rata allocation

- **Credit Facility**

- Use of ILPA
- ILPA reporting
- Pledges
 - Typical investor request – no pledge, no opinions and only public credit info
- Lender review and involvement
- Disclosure - AIFMD

Other Considerations

- Where to put a side letter term?
 - If side letter, investor has effective veto power over waivers
 - LPA broadens offer to more investor but can amend under amendment provisions
- Side letter terms have become increasingly complex and more administratively and operationally burdensome
 - Expenses of MFN process now clearly a fund expense in the market

Thank You

Joseph M. Mannon
Vedder Price
jmannon@vedderprice.com

Matthew (Matt) Posthuma
Ropes & Gray
matthew.posthuma@ropesgray.com

Adam S. Tope, Partner
DLA Piper LLP (US)
adam.tope@dlapiper.com