

“It’s the territory where everyone hates each other, but at least you’ve spent a sh*tload of money on legal fees so all of the lawyers can go buy a boat.”

This quote from a PE professional refers to side letters, a common feature in the private equity world. Side letters allow general partners (GPs) to offer supplemental or preferential investment terms to individual investors. These terms are separate from the main fund contract, and, when parties agree to them, they often address specific needs or requests, allowing for greater flexibility in investment terms.

In this Strelia PE Series, we’ll explore the key features of side letters, explain why they remain a crucial tool in private equity, and tell you how you can effectively harness their potential.

What are they?

Investors who request side letters typically do so to reduce their downside risk or to ensure that the fund operates in a way that aligns with their specific needs. In the private fund context, side letters serve various purposes but generally offer the investor benefits such as a "most favored nation" clause, which ensures the investor also gets any preferential terms that were granted to other investors. These letters can also provide enhanced transferability rights, improved access to information and reporting, excusal from certain investments, and reduced burdens in indemnification obligations.

Other common provisions can also cover fee structures, redemption rights, notice of significant or key person redemptions, advisory committee seats, alternative investment vehicles, the use of placement agents, representations and warranties, legal opinions, confidentiality concerning the use of the investor's name, and ESG (environmental, social, and governance) commitments.

Should side letters be sidelined?

Side letters have garnered a negative reputation for favoring large investors at the expense of smaller ones. They also operate in secrecy, as they are neither publicly disclosed nor shared with other investors. Negotiating and managing these letters can significantly increase legal and administrative costs. Additionally, they may restrict the fund manager’s discretion, as certain investors (LPs) may request that their capital not be invested in specific industries.

Side letters raise concerns around (i) legal uncertainty—are they always binding and enforceable? (ii) litigation risk, and (iii) regulatory scrutiny. For instance, Europe’s AIFMD requires the disclosure of preferential rights, while the SEC in the US adopted new rules like the Preferential Treatment Rule (which aims to erode the most-favored-nation status) and the Restricted Activities Rule (which restricts certain practices of private fund advisors, unless the advisors comply with newly adopted disclosure or consent requirements, as the case may be).

Despite these challenges, side letters should not be sidelined. They provide deal flexibility, allowing parties to tailor agreements in ways that a single contract cannot. Side letters can also drive market innovation. Until broader standards are in place, keeping side letters as a tool for customization remains valuable. They are also effective for price discrimination and have been successfully used in other sectors, such as the airline industry, making them far from unique to private equity.

How can we tap into their potential?

Ideally, the abovementioned hazards could be remedied by making better use of regulation and standardizing forms. But in the meantime, we should adhere to best practices, such as:

- (1) **Adhere to a clear side letter strategy from the start:** prepare a roadmap setting out who will likely receive side letters and MFN rights, the scope of such MFN rights, and determine which person at the fund manager will be responsible for monitoring compliance with side letter obligations and handling the MFN election process. Standardizing terms across letters would be beneficial.
- (2) **Draft them carefully:** align them with constitutional documents and other supporting documents. Be mindful of entire-agreement clauses, timeline of investment, or deal process, etc. This means aligning the recitals in the side letter, referring to all other documents that apply, and aligning boilerplate clauses and choice-of-law or forum clauses in all relevant documents.
- (3) **Anticipate the more general side letter requests upfront** in the Fund or deal documentation. This means granting all investors access to information in the beginning and anticipating reporting and regulatory needs, giving more information or granting more rights in the LPA, and perhaps even redesigning the side letter by making their contents lighter.
- (4) **Disclose the following information in the Fund's constitutional documents:** list of preferential treatments and what type of investor is eligible for preferential treatment. Inform investors that some have been given preferential treatment before others made their investments. That means, in the Fund formation, use restrictive language so that it does not become a "shopping list."
- (5) **Carefully consider carveouts** to MFN rights.
- (6) **Tailor side letter provisions to specific facts and circumstances:** avoid generic provisions, confirm the terms set out in the LPA, and broaden obligations so that they favor provisions that address the particular needs of a limited partner.
- (7) **Approve and acknowledge side letter elections in writing:** this will clarify obligations owed, provide a fund manager with the opportunity to notify a limited partner if any of its elections falls outside the bounds of the MFN right, and shield all parties from the hassles they face when amending, restating and re-executing side letters to incorporate MFN elections.
- (8) **Make sure proper authorizations are granted** to parties/individuals who enter into side letters.
- (9) **Set up a management tool for all side letters:** grant investors access to it, make sure database is managed properly (i.e., updated regularly, templates are used).

In conclusion, PE side letters are far from being just harmless pieces of paper. They possess the potential to significantly influence investment dynamics. Until full regulation and standardized forms are in place, we must adhere to best practices, ensuring that we leverage their silent power.



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