

Private equity side letters

January 2023

A brief introduction to side letters

Side letters in the private equity world are now industry standard as a means for general partners (GPs) to grant supplemental or preferential investment terms to a given investor outside of the fund's limited partnership agreement (LPA) and other governing documents.

Historically, side letters tended to deal with particular issues relevant to certain categories of investors (eg seed or early close investors). However, owing to the current trend for a fund's investor base to be dominated by institutional investors, and the increased regulation applicable to such investors, it is now industry standard for each investor to demand its own side letter.

As a consequence, the past few years have seen a proliferation not only of the number of side letters being negotiated with investors, but of the kinds of arrangements and provisions included in them.

The Cayman legal context

Legally, a side letter is nothing more than a contract between the fund or the GP and the investor, which sits alongside the other contractual relationships they have in the form of the LPA and the investor's subscription agreement. As such, it supplements those other agreements.

A contract cannot be varied or amended without the consent of all of the parties to it unless the contract itself so provides. Accordingly, while a side letter can vary certain terms of the LPA as between the GP and the investor, it cannot override the interests of the other limited partners or vary the terms of the LPA as applicable to those other limited partners. A GP and an investor who entered into such a side letter would potentially be liable to the other investors for breach of contract.

As Cayman counsel, we are increasingly asked to opine on the enforceability of investor side letters as part of the fund closing process.

Specific points to consider

The issues are complex but, ultimately, whether a side letter is enforceable or not will depend on an analysis of the principles of contract law (ie offer, acceptance, intention to create legal relations and consideration). That said, in the context of a private equity fund, some of the key points we look at as part of our review include:

The LPA's enabling clause

As the fund's governing document, the LPA sets out the powers and authorities specifically afforded to the GP. As such it must specifically authorise the GP to enter into side letters with limited partners that supplement or alter the terms of the LPA vis-à-vis that investor. The enabling clause may limit the categories of concessions the GP can make to limited partners, although market practice is for the enabling clause to be drafted very widely. In any event this clause needs to permit not only side letters in principle but also (or at least does not prohibit) side letters containing the type of terms the GP is proposing to grant to the relevant limited partners.

Entire agreement clauses

Each of the governing agreements of the fund (most obviously the LPA and the subscription agreement) should reference side letters in their 'entire agreement' clauses. An entire agreement clause in a LPA (or a subscription agreement) which excludes side letters can be hugely problematic, even if the LPA contains an enabling clause, and there could be doubt over the enforceability of any side letters entered into in the face of such an entire agreement clause.

Dating

It is self-evident that a side letter cannot predate the date of a fund's formation. If it does, it may be an obligation of the GP in its own right but cannot be enforceable as against the fund, as the GP had no capacity to enter into it on behalf of the fund.

As the GP derives its ability to enter into side letters from the powers conferred upon it by the LPA, the side letter should not predate the LPA. If it does so, it will be necessary for the LPA's enabling clause to contain a ratifying provision whereby the partners expressly ratify the GP's entry into any prior side letter.

If the side letter predates the investor's subscription agreement, the latter's 'entire agreement' clause must reference the side letter (as well as the LPA). If it does not, the side letter may be rendered void as the effect of the subscription agreement, as a subsequent contract, constituting the 'entire agreement', may be to extinguish the side letter as a valid contract as between the GP and the investor.

Preferential rights and the LPA

Supplemental rights granted to a limited partner in a side letter may not materially or adversely affect the other limited partners in a way that would require an amendment to the fund's LPA.

The vast majority of typical side letter clauses, such as most favoured nation provisions, additional excuse provisions, additional confidentiality requirements and rights to additional financial or other information, will not offend against this principle so long as the relevant enabling clause has been drafted widely enough.

On the other hand, careful legal advice should be taken in respect of a side letter provision granting the relevant limited partner, for example, preferential or disproportionate distribution rights other than in accordance with the LPA, or softening the limited partner's capital call obligations in a way which would result in other limited partners having to bear a greater share of any capital call than the LPA prescribes.

PPM provisions (if applicable)

If the fund has a private placement memorandum, it should reference the fact that the fund may enter into side letter agreements with investors. It should also include a risk factor highlighting that side letters may be issued to certain limited partners and not others, and that their terms may supplement or alter the terms otherwise provided in the fund's LPA.

Contacts

A full list of contacts specialising in our market leading private equity practice can be found [here](#).