

FUND FINANCE FRIDAY

A Fresh Look at Side Letters

June 7, 2024



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Side letters have gone through a massive and largely unspoken transition over the last four to five years. From a position where a few investors in a closing might have quite short side letters dealing with niche issues we are now at a point where it is not uncommon to see the vast majority of investors in a closing have the benefit of negotiated side letter protections in side letters that can extend to upwards of 20-30 pages.

Most, if not all lenders will require a review of side letters when entering into a subscription financing but they are also relevant for other fund financing products. And, in the context of a traditional subscription facility, the increased sophistication of side letter provisions means that there are always new considerations for lenders to weigh up.

GP support facilities

When reviewing side letters for the purposes of a GP support facility the main focus will be on provisions that relate to the management or GP profit fee. These provisions can not only adjust the level of the fee payable by a particular limited partner but, perhaps as a symptom of the constrained fund raising market, might also extend to payment holidays for an initial period in the fund's life or may offer a discount not only on the investment in the fund to which the side letter relates but also later as yet unformed vintages.

Another aspect that may be present are restrictions on overcalls when the default of another limited partner in meeting its payment obligations under a capital call relates to a call made to fund management fees. Such a provision is clearly of relevance to a facility that is backed by the management fees but is also of relevance to a subscription facility that allows within its purpose clause an ability to draw under the facility to fund payment of the management fee. Depending on the prevalence of such overcall restrictions in the side letters of a fund it may be advisable for a subscription facility lender to either prohibit the use of the facility for the purpose of paying management fees or only allow such drawings for a short tenor that expires before the next instalment of the management fee is due under the LPA.

NAV financings

We are hearing from a lot of market participants at the moment asking whether or not we are seeing a change in LPA terms as a result of the increased focus on NAV style leverage. Part of the answer to that question actually lies within the side letters themselves and it is perhaps symptomatic of the side-lined position of the side letter in some people's minds that the question does not generally extend beyond the LPA. Given the precedent nature of LPA documentation it is far more likely that a sponsor will agree to a bespoke adjustment to its ability to incur leverage in a side letter than to imbed it in an LPA that will form a template for later vintages.

A side letter review is always advisable when contemplating a NAV financing and, if not feasible for cost or other reasons, then a clear representation should be given as to no conflict with fund documents including the side letters.

We have seen recent instances of sponsors agreeing in side letters to notify particular investors of potential NAV financings and to provide periodic reporting with respect to that financing once it is in place.

We have also seen instances of sponsors acknowledging that the investor has an interest in participating in a NAV style financing.

Subscription facilities

As mentioned above, most lenders in subscription facilities routinely require that side letters be the subject of a due diligence report. Such a report will typically look at matters such as cease funding rights, overcall limitations, sovereign immunity, excuse rights and other matters relevant to the ability to call capital and enforce default rights against an investor.

Some other matters are now either becoming increasingly common place in side letters or are starting to appear for the first time.

One example of a provision that is appearing for the first time is an ability for an investor in a politically sensitive jurisdiction to transfer its LP interest to another person without GP consent if that jurisdiction or investor becomes the subject of sanctions.

Another provision, which although not new, is becoming increasingly prevalent is a requirement for capital call notices to be signed by a person at the GP that has provided a specimen signature through an incumbency certificate issued by the GP. Although there are potential solutions to this in the context of a financing, the need for a specimen signature has the potential to be problematic if the security agent is issuing the capital call notice on enforcement.

We have also seen an increase in the number of investors whose stated commitment under the subscription agreement is actually reduced in the side letter in such a way that it will ratchet up to the full amount specified under the subscription agreement with each close and only actually reach the full amount if the fund-raise reaches its projected amount. Care must be taken here to properly record the actual amount (rather than the stated amount) for the purposes of calculating the borrowing base or financial covenant and to only increase that amount once evidence is received (generally in Europe by way of an updated LP register) that an increase

has occurred. Given the subscription and side letter due diligence reports are often separate it is important that the ratchet mechanic be reflected in both to avoid any misstep.

In the subscription facility context, and as side letters become more complicated and investor requirements more bespoke, it is hoped that fund counsel will be mindful of the position of lenders and negotiate exceptions to provisions that are problematic from a financing perspective for lenders that are making capital calls on enforcement to avoid the need to exclude investors from the included investor pool.