

Fund Finance Friday



Side Letters: A Round-Up of Common Issues for Lenders

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A side letter is an agreement between an investor and a fund that alters the terms of the investor's investment in the fund (i) by superseding some of the applicable terms in the partnership agreement or subscription agreement or (ii) by adding additional terms to the agreements and commitments between the fund and the investor.

Given the popularity of side letters in fund finance transactions today, we thought it would be useful to highlight frequent issues that arise and that are important for lenders to look out for. This guide is not an exhaustive list; it is important to also keep in mind the nature of the collateral and the credit facility and anything that impedes on those concepts.

Cease Funding Rights/Withdrawal Rights - Investor's right to withdraw from the fund/cease funding its obligations.

Often seen relating to placement agent or political contribution regulations; typical with state pension plans but also found in other state side letters. It is a well-known public policy of the State of Michigan that investors will not honor capital calls from third-party lenders.

Overcall Limitations - Limitations on a non-defaulting investor's obligation to make up any shortfall in funding caused by other Investors defaulting.

Common overcall limitations include: (i) management fee overcall limitations, whereby overcalls cannot be made to cover a defaulting investor's share of management fees; (ii) overcalls limited to a percentage of the related capital commitment or a percentage of the initial call; and (iii) overcalls based on diversification standards (i.e., investment-linked concentration limits), whereby overcalls are subject to limits on the percentage that can be called from any investor for a particular investment.

Most Favored Nation (MFN) clauses - Agreement to give the investor the best terms it makes available to any other investor.

If MFN provision is *not* narrowly drafted (for example, limiting regulatory and tax concessions to investors that are in the same jurisdiction or affected by the applicable provision and limiting MFN treatment to investors with equal or larger capital commitments), problem provisions specific to one investor may spread.

Reservation of Sovereign Immunity - If an investor has explicitly reserved sovereign immunity.

Government entities, such as public pensions and sovereign wealth funds, may have immunity from contract claims and other lawsuits unless they waive their immunity. Sovereign immunity provisions may provide for a waiver or may reserve the rights of such investors to waive their immunity. Some jurisdictions may not permit waivers of sovereign immunity except through legislation. Other jurisdictions waive sovereign immunity if an investor is engaging in

“commercial acts.” Lenders should be mindful of different jurisdictions’ sovereign immunity laws and how they may affect an investor’s obligations to contribute capital to a fund.

Certain jurisdictions to pay close attention to include: (1) Texas entities, (2) California counties, (3) Arizona entities, (4) super-national organizations (e.g., UN), and (5) foreign governments/sovereign wealth funds, as the analysis for these entities is different.

Fluctuating Commitments/ Commitment Caps - If the investor’s commitment fluctuates or is capped.

An example of this would be if the investor’s commitment can’t exceed 20% of aggregate capital commitments.

Capital Call Formalities

Examples include: (i) the investor can restrict who can send a capital call (e.g., only officers of the general partner) and (ii) capital calls must come from a specific email or be posted to a specific data site.

Delivery of Investor Letters, Confirmations of Uncalled Commitments, Financials

This issue arises if the side letter limits the ability to require the investor to deliver investor letters (if it is an investor letter transaction), confirmations of commitments or the investor’s financials (e.g., only publicly available financials).

Conditions Precedent

If there are any conditions precedent for the capital commitment to be effective (e.g., delivery of an opinion to the investor).

Investment Exclusion Rights

If the investor has any atypical investment exclusion rights. Common exclusion rights include, but are not limited to, investments in pork, pornography, ammunition, gaming, alcohol, tobacco, firearms, sanctioned countries, regulatory and legal prohibitions (including ERISA and indemnification excuse rights).

Debt Limitations

If debt limitations or caps are included in the side letter that are more restrictive than the Fund’s partnership agreement. If the facility goes above the debt limit or cap, this could restrict a lender’s expectations that the commitments of all investors are available to repay an extension of credit under a loan facility.

Borrowing Clean-downs

If the side letter contains any repayment timelines relating to borrowings (e.g., 90/180 day “clean downs”).

Transfer Rights

If the side letter provides an investor transfer rights that do not permit the timing associated with the mandatory prepayment provisions to work properly (e.g., “deemed consent” or “pre-consented”).

Fund without setoff, counterclaim or defense

If the investor does *not* agree to fund without setoff, counterclaim or defense. Sometimes seen in connection with a state entity or sovereign immunity. Lender does not want the investor’s commitment to be offset against other obligations of the fund or the general partner to the investor.

As investor policies and requests are constantly changing, it is important to thoroughly vet side letters and analyze each issue on a case-by-case basis. Not all issues are fatal -- many can be cured via simple language amendments if caught early enough before the letter is finalized and others may be structured around in the facility documents.