Morgan Lewis

# VENTURE CAPITAL & PRIVATE EQUITY FUNDS
## DESKBOOK SERIES

## Side Letters and the Most Favored Nations Clause

The use of side letters by venture capital and private equity funds has become commonplace—some would say too commonplace. Side letters set out terms that supplement or, in some cases, modify the terms of the governing partnership agreement and are typically memorialized in a letter executed by a fund manager and acknowledged by a negotiating limited partner. Side letters are often used to grant special rights and privileges to important investors (e.g., seed investors, strategic investors, those with large commitments, and employees, friends, and family) or to those subject to government regulation (e.g., ERISA, the Bank Holding Company Act, or public records laws). Side letters are also useful tools for fund managers to accommodate last-minute requests from prospective limited partners on the eve of the initial closing (without tampering with a near-final partnership agreement) and, thereafter, to address the needs of those limited partners participating in subsequent closings without amending the partnership agreement.

While side letter terms will vary from fund to fund, and from investor to investor within a given fund, side letters typically have one thing in common: accommodations that would be advantageous to other limited partners. As a result, many prospective limited partners will negotiate for a most favored nations (MFN) provision that permits the election of certain benefits negotiated by, and granted to, other limited partners via side letter. The following briefly highlights legal and practical issues for consideration by fund managers in connection with the negotiation and execution of side letters, and the use of the MFN provision.

### Potential Hazards

Before determining whether to use side letters, and the related best practices for implementation, a fund manager should be aware of certain potential hazards. For purposes of general overview, many of these hazards fall into one of four broad categories of concern: (i) cost, (ii) administration, (iii) litigation, and (iv) regulation.

#### *Cost Concerns*

During the fundraising period, a fund manager should be prepared to receive several requests for side letter accommodation, particularly in light of the proliferation of standard side letter forms for large, institutional investors. Negotiating separate side letters with these and other prospective limited partners may delay closing, and will increase legal and administrative costs. Also, to the extent a limited partner requests a side letter enforceability opinion, or asserts a claim against the fund manager related to the use of (or compliance with) side letters, additional legal fees will result.

#### *Administrative Concerns*

Administrative hassles requiring the time and attention of a fund manager typically accompany side letters. Throughout the life of a fund, a fund manager will need to keep track of provisions granted, monitor compliance with such provisions, and ensure that the terms of one limited partner's side letter do

not conflict with the terms of any other side letter, or with the partnership agreement, subscription agreement, or other governing document.

Additionally, to the extent MFN protection has been extended to one or more limited partners, a fund manager will need to establish a method for distributing side letters to those limited partners with MFN election rights, reviewing the appropriateness of any elections made, and recording provisions elected by such limited partners.

### *Litigation Concerns*

If the constituent documents of a fund, including its private placement memorandum and partnership agreement, do not disclose the potential use of, or provide a fund manager with the authority to enter into, side letters, a fund manager may be subject to a number of claims. On the one hand, limited partners without the benefit of side letters may assert breach of contract claims (for acting outside the bounds of the partnership agreement) or breach of fiduciary duty claims (for treating certain limited partners more favorably than other limited partners). On the other hand, those limited partners with concerns regarding the enforceability of their side letters may seek to withdraw from the fund, asserting that the investment in the partnership would not have been made without an enforceable side letter. Regardless of the merit or success of any such claims, litigation (and the threat of litigation) is costly and a distraction from the primary investment duties of a fund manager.

### *Regulatory Concerns*

While the scope and frequency of regulatory scrutiny varies from jurisdiction to jurisdiction, both the Securities and Exchange Commission in the United States and the Financial Services Authority in the United Kingdom have raised concerns regarding the use of side letters. These concerns focus on issues of transparency, or whether the use of side letters and, in certain instances, the terms therein have been adequately disclosed to prospective and existing limited partners. Equity considerations and fiduciary obligations are other points of focus, with regulators expressing concern that the provision of special terms to certain limited partners may operate to the detriment of the limited partners as a whole. While much of this scrutiny has historically focused on hedge funds, the distinction between hedge funds and other types of investment vehicles is blurring in the regulatory arena, and venture capital and private equity fund managers are encouraged to consult with counsel in order to establish best practices for regulatory compliance.

### Best Practices

While side letters and MFN rights add to the obligations and administrative duties of a fund manager, the side letter process may be made more manageable through careful consideration of appropriate side letter recipients and by limiting the scope of side letter provisions granted. Please consider the following practices:

- **Begin the formation process with a clear side letter strategy.** Prepare a road map setting out who will likely receive side letters and MFN rights, and 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.

- **Consult with legal counsel regarding appropriate terms in the partnership agreement.** Disclose the potential use of side letters in the private placement memorandum and ensure that the fund's partnership agreement permits the use of side letters.

- **Standardize terms across letters.** Standardizing side letter language to address areas of overlapping concern will ease monitoring and compliance burdens and limit the number of provisions available for MFN election.

- **Consider including the MFN provision in the partnership agreement.** Incorporating the MFN provision directly into the partnership agreement will avoid the need to execute side letters with those who seek only MFN protection and disclose the existence of side letters and the MFN terms to all limited partners.

- **Consider including generally applicable side letter requests in the partnership agreement.** Doing so will cut down on the number of side letter provisions granted, ease the administrative burden, and reduce or eliminate the MFN election process.

- **Employ standard MFN carveouts.** Carefully consider carveouts to MFN rights. Some typical carveouts from MFN protection include (i) the right to appoint an advisory committee member or a designee with observer status; (ii) transfer rights; (iii) disclosure rights; (iv) rights of affiliates or strategic investors; and (v) provisions granted to address legal, regulatory, or policy issues (alternatively, legal, regulatory, and policy-related provisions may be available via the MFN election process to similarly situated limited partners). Fund managers may also tie MFN rights to capital commitments by carving out the ability of limited partners to elect side letter provisions granted to those with greater commitment amounts, thus requiring investors to buy into MFN rights.

- **Avoid inadvertent side letters.** To ensure that obligations outside of the partnership agreement are understood, and noted for compliance purposes, avoid inadvertent agreements to materially supplemental terms in any form (including via email communication or verbal agreement regarding the modification of terms or interpretation of a fund's governing documents) other than the formal side letter reviewed by counsel and signed by both parties.

- **Tailor side letter provisions to specific facts and circumstances.** Avoid generic provisions, confirmation of terms set out in the partnership agreement, and broad obligations regarding "in favor of" provisions that address the particular needs of a limited partner. For a limited partner seeking side letter comfort with respect to compliance with applicable law, regulation, or policy, require acknowledgment of the application of such law, regulation, or policy in the side letter. Additionally, for a limited partner seeking side letter comfort based upon its internal policy, seek confirmation that the policy is formal, in writing, and applicable to all similar investments.

- **Consider preparing a side letter summary.** Summarizing side letter obligations in one document can provide an easy point of reference when negotiating side letter provisions with subsequent investors and for monitoring (and complying with) side letter obligations, particularly in circumstances where there are numerous side letters. Such summary should include each side letter provision granted, without duplication (such that any provision found in more than one side letter appears only once in the side letter summary), and, for compliance purposes, should note the beneficiary of each provision.

- **If possible, distribute side letters for MFN election only after the final closing.** An MFN provision will require delivery of side letters (or the summary described above) to all limited partners with MFN rights so they can exercise their rights to elect the benefit of additional side letter provisions. If this process occurs after each closing (which it typically does), it results in a snowball of multiple iterations of ever-growing side letters. Whenever possible, limit the side letter distribution and election process to one exchange rather than after each closing. This will decrease the time and effort required of fund managers and limited partners alike in connection with the MFN process.

- **Require affirmative limited partner action for MFN elections.** Obligate limited partners exercising MFN rights to set out elections in writing within a designated period of time (typically 30 days), and avoid MFN provisions that automatically extend all applicable side letter rights to the entire investor base. Such a process offers limited partners the flexibility to tailor elections to their particular facts and circumstances, decreases the likelihood of confusion resulting from conflicting side letter provisions, and affords a fund manager a reliable means of tracking obligations as of a certain date.

- **Approve and acknowledge side letter elections in writing.** Avoid nonresponsiveness or verbal approval in favor of a simple, written acknowledgment of MFN elections (i.e., by confirming receipt and acceptance via email or letter signed by the fund manager). Such a process will clarify obligations owed, provide a fund manager with the opportunity to notify a limited partner if any of its elections fall outside the bounds of the MFN right, and shield both limited partners and fund managers from the administrative hassles associated with amending, restating, and reexecuting side letters incorporating MFN elections.

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For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

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