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Side letters: Pitfalls and perils for a financing

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Overview

Subscription-line (or capital call) facilities (referred to in this chapter as "sub-lines") are, generally speaking, loan agreements provided at fund level, with recourse given to the lender over the right to call uncalled capital of investors in the applicable fund (and related rights). The type of fund-level financing products offered by lenders is continually evolving. One constant is the need to ensure that a fund's governing documents do not prohibit or restrict the financing that the fund wishes to raise.

The terms of an investor's investment in a fund are usually governed by three main types of documents. *First*, a limited partnership agreement ("LPA") containing the primary terms applicable to all investors in the fund. *Second*, a subscription document through which an investor subscribes for an interest in the fund, makes certain representations and agrees to adhere to the terms of the LPA. *Third*, each investor may negotiate a side letter (on a bilateral basis) with the fund's general partner ("GP") or manager. A side letter supplements the terms of the LPA applicable to the specific investor (without modifying the application of the LPA to other investors in the fund). The provisions of a side letter may take into account specific regulatory or tax considerations of an investor or supplement the commercial terms applicable to the investor's investment.

It is critical that the terms of the fund documents accommodate any contemplated fund-level financing. For sub-lines, investors constitute the ultimate source of repayment for lenders if the fund defaults such debt. Lenders will therefore diligence the fund documents to check (among other things) restrictions on borrowing and enforceability of investor obligations to the fund. Issues in the fund documents may preclude the uncalled capital commitment of one or more investors counting towards the amount that a fund can borrow under a sub-line (the "borrowing base"). Worse still, restrictions in the fund documents may even preclude a fund from raising finance at all.

This chapter focuses on the final element of the fund documents framework − side letters. Investors increasingly negotiate side letters in connection with their investment in a fund, and the scope of side letter provisions requested by investors is continually developing. As a result, a fund with a large number of investors will almost certainly have a wide array of side letter requirements to navigate. The terms of those side letters may individually, or collectively, affect a sub-line. Consideration of the terms of side letters is critical to sponsors, lenders and their counsel when contemplating fund-level financing.

We consider in this chapter some of the key issues arising in side letters that may impact sub-lines, and suggest practical solutions to specific issues.

Background to side letter considerations

Disclosure

Lenders generally request copies of all side letters so that they can diligence whether the terms of the side letters impact the proposed financing. There are certain (limited) exceptions to this approach.

First, some sponsors are unwilling to provide side letters to a fund's lenders given the sensitive nature of side letter terms and the sponsor's relationship with the fund's investors. In some cases, lenders may be prepared to allow disclosure of side letters to their counsel only, or be comfortable with a summary of the terms of the side letters prepared by borrower counsel. In limited cases, lenders may accept non-disclosure of side letters and instead rely on a repeating representation from the borrower that there are no side letter terms that are materially adverse to the lenders' interests under the finance documents (other than the terms disclosed). The borrower must therefore disclose any such materially adverse terms (but only those terms) to ensure that there is no misrepresentation.

Second, one or more side letters may be subject to investor-specific confidentiality restrictions on disclosure (see below for an analysis of the consequences of such confidentiality restrictions for the financing).

Impact of investor requirements

There is a third perspective to consider in a fund financing in addition to that of lender and borrower – the perspective of investors. Investors' views will impact side letter terms and, consequently, the ability of the fund and lender to put financing in place.

Investor views continue to evolve. The Institutional Limited Partners Association (a trade association for institutional LP fund investors) released guidance in June 2017 ("ILPA Guidelines") recommending (among other things) increased disclosure to investors with respect to the terms and impact of sub-lines. In response to the issuance of the ILPA Guidelines, the Fund Finance Association (a non-profit industry association in the fund finance market) issued its own analysis and recommendations on the ILPA Guidelines in December 2017 ("FFA Analysis"), emphasising that the ILPA Guidelines should encourage and foster greater dialogue and awareness but should not be viewed as "absolute principles". A fulsome discussion of the ILPA Guidelines and FFA Analysis is beyond the scope of this chapter; however, the views of interested parties will continue to shape the scope of side letter provisions requested by investors and their related impact on fund financings.

Focus on side letter provisions

Lenders place great importance on detailed review of the fund organisational documents, including side letters. That due diligence review focuses primarily on the terms that could impact the lender's right to call capital from the fund's investors and enforce its security. Any restrictions on an investor's funding obligations will be a material lender concern.

Timing

The key to ensuring that the terms of side letters do not adversely impact a financing is to keep the sub-line in mind at the time of side letter negotiation. Sub-lines are generally entered into after a fund has had at least one closing (i.e., after the initial subscription for interests by investors). Side letters are therefore not always negotiated at the same time as the sub-line. Best practice is to involve finance counsel from the outset of a fundraising process to ensure that side letter provisions take into account future financing needs and avoid issues down the line.

Limitations on debt incurrence

The fund must be able to incur the debt contemplated by its proposed fund-level financing. This is an LPA (rather than side letter) point, but is sufficiently fundamental to warrant comment! The LPA should expressly permit the incurrence of debt and the giving of any related guarantees and security. The LPA may contain limitations negotiated with investors in respect of the size of the sub-line (for example, up to a percentage of fund size), the purposes for which the sub-line can be used, and the duration for which borrowings may remain outstanding.

Practical considerations

These are key limitations around the use and structuring of the sub-line. With greater investor focus on LPA debt limitations, the scope of permitted debt incurrence is an increasingly important negotiation point.

In that context, the ILPA Guidelines recommended that investors request reasonable thresholds around the use of sub-lines (indicating, as an example, a limit on the size of a sub-line to around 15−25% of uncalled capital). In response, the FFA Analysis stated that a fundamental concern of the FFA was that a "one size fits all" approach to debt incurrence is not appropriate. Funds do not all have the same structure, investment focus or commercial strategy. For example, funds that may need to complete multiple deals in quick succession should ensure flexibility to draw sufficient amounts under the sub-line. Inclusion of a cap on debt incurrence that is too low could impair the fund's ability to complete one or more investments in the desired timeframe, potentially placing it at a competitive disadvantage.

This developing dialogue with investors emphasises the need to consider financing from the outset of the fund's life. This will avoid inadvertently restricting the viability of a sub-line.

Prohibition of direct obligations to lenders

The sub-line security package typically consists of security over the right to call capital of investors and security over bank accounts into which capital calls are paid. Capital call security allows a lender, on acceleration of the sub-line, to step into the GP or manager's shoes and issue drawdown notices to investors (and often have the right to issue drawdown notices either in the name of the GP or manager or in the lender's own name). Any side letter provisions stating that an investor has direct obligations only to fund parties, or otherwise expressly excluding any direct obligations to a lender, could (but do not necessarily) undermine the lender's ability to enforce its security.

Practical considerations

The drafting of the specific side letter provision matters hugely. The devil is in the detail. There are also supplemental regulatory matters to consider (see below).

First, the GP or manager can assign to a lender as part of the capital call security only those rights given to the GP or manager under the fund documents. The capital call security will not otherwise generally purport to give the lender direct rights against the investors. Some investors are concerned about grants to a third party of broad rights generally against the investor (rather than specific assignment of capital call rights). If this is the investor concern, the side letter restriction should be worded to make clear that it does not prohibit the lender from calling capital on enforcement, while accommodating the investor's broader concern.

Second, as a regulatory matter, in certain jurisdictions, capital commitments (either of all investors or only of certain investors that are subject to specific regulatory requirements) may only be paid into bank accounts of the fund. If so, the side letter restriction should be worded to accommodate both investor concerns and regulatory requirements, while still allowing the lender to call capital (albeit into a bank account of the fund).

Administrative requirements of investors

As an administrative matter, certain investors may request that the fund agree to a formal drawdown process. Investors are normally only concerned with practicalities. For example, investors may ask the fund to use headed notepaper for drawdown notices or provide a certified list of authorised signatories. On their face, these requirements seem unobjectionable. However, although unintended, such procedural mechanics may prevent a lender from calling capital on acceleration of a sub-line.

Practical considerations

If the fund addresses the issue during side letter negotiation, the investor may be prepared to adjust the procedural requirements in the side letter to expressly contemplate capital calls by the lender.

Alternatively, it may be possible to structure a solution in the finance documents. For example, the fund could provide the lender with undated drawdown notices (on headed notepaper, if necessary) signed by the relevant fund party and addressed to the investor for the lender to use on enforcement. The fund could also provide a specimen signature list to the investor, which includes an employee of the lender as an authorised signatory of the manager or GP.

Sponsor co-operation with lenders

Some investors may request that, where the GP or manager has assigned its right to call capital to a lender and that lender has enforced such security by issuing drawdown notices to investors, the GP or manager must provide written confirmation to the investors that those drawdown notices have been validly issued in accordance with the fund documents.

Practical considerations

This type of side letter provision presents a clear issue to lenders: in an enforcement scenario, the lender cannot rely on GP or manager co-operation. It is therefore important to ensure that failure by the GP or manager to provide such confirmation does not preclude the investor from its obligation to fund in response to drawdown notices issued by the lender.

Excuse rights

Many investors, for internal policy reasons, negotiate the right to be excused from specific categories of investments. For example, investors may wish to be excluded from participating in investments in alcohol, firearms and tobacco, or in geographies or industries to which the investor is politically or commercially sensitive. The investor has no contractual obligation to honour a drawdown notice with respect to any investment (or, typically, to repay sub-line debt that was used to make such investment) for which it has an excuse right.

Practical considerations

Excuse rights are relatively common. For many investors, such rights are a core requirement without which the investor will not obtain internal approval to invest. Generally, these rights are not negotiated away but are instead accommodated within the financing structure.

How would excuse rights be accommodated in a sub-line? Lenders generally require that excused investors do not count as part of the fund's borrowing base. The fund should ensure that the lender only excludes the investor from the borrowing base in respect of the portion of that investor's remaining capital commitments attributable to the excused investment, and only for the period for which the borrowing for that investment is outstanding.

Some lenders, particularly in the European and Asian fund finance markets, may also ask that an event of default is triggered if the amount of excused capital contributions at any one time, in aggregate, exceeds a cap (e.g., 15% or 20% of uncalled capital). The fund may wish

to negotiate this. Excuse rights, by their nature, are investor-specific and do not indicate an issue with creditworthiness of investors generally, or their appetite to fund capital calls. The fund may therefore view an event of default as too onerous a consequence.

Confidentiality restrictions

Lenders need certain basic information on each investor before they are able to undertake credit analysis on that investor. Certain types of investors (often sovereign wealth funds) insist on provisions that prohibit disclosure of such information, even to lenders. Side letter restrictions that prevent the disclosure of such information are likely to lead to a lender excluding the investor from the borrowing base. For example, if the name and/or contact details of the investor cannot be provided, the lender will not be able to enforce its security against that investor.

Confidentiality provisions also raise additional concerns for lenders that may not be fully addressed by exclusion of the confidential investor from the borrowing base. Fund documents typically require capital calls to be made from all investors, which the lender would be unable to do if the identity of one or more investors is unknown. In addition, lenders are required to carry out certain "know your customer" checks, which can be an issue for lenders if confidential investors make up a significant portion of the investor base.

Practical considerations

It is worth considering the exact scope of an investor's confidentiality requirements when negotiating side letters. The investor may be willing to accommodate exceptions to a blanket restriction on disclosure. For example, an investor may be comfortable with disclosure of its name and contact details to counterparties to the fund (such as a lender), provided the recipient is bound to keep the information confidential and/or the investor is notified of any such disclosure.

Where disclosure of an investor's name is restricted, the sponsor should ensure that it is permitted to provide redacted copies of such investor's fund documents (for diligence purposes). The investor may be willing to agree to disclosure of the investor's name if there is an event of default under the sub-line to enable the lender to serve a drawdown notice on the investor. Alternatively, the sponsor may agree with the lender to call capital from the investor on an event of default, in light of the inability of the lender to do so.

Refusal to acknowledge third-party notifications

Investors may ask for express confirmation in a side letter that they will not have to sign any documentation in connection with a sub-line. These provisions can be problematic if prospective lenders insist on receiving investor letters, investor legal opinions or other additional documents from one or more investors as a condition to providing a sub-line.

Practical considerations

Funds should build into the LPA provisions that will facilitate the incurrence of sub-lines – for example, a waiver by the investors of any rights of set-off or any defences they may have in relation to their obligation to fund capital calls. The LPA should also incorporate certain basic investor representations, covenants and acknowledgments for the benefit of the lenders. If the LPA terms accommodate these points, lenders generally should not require investors to sign a supplemental investor letter in connection with their provision of a sub-line. One exception to this is in the case of separately managed accounts, where, notwithstanding the LPA terms, lenders are likely to require a supplemental investor letter from the single investor.

However, a risk may remain even if the LPA contains terms that the sponsor considers will satisfy lender expectations. If the side letter is entered into before the fund procures financing, the fund will not know for certain at the point of negotiating side letters whether

such a restriction could be an issue. The fund could soften any absolute restriction by instead agreeing to use commercially reasonable efforts to ensure that the investor is not required to sign documents in connection with a sub-line.

Similarly, investors may also resist providing financial information to the fund and any sub-line lender. Lenders and investors often get comfortable with limiting the scope of financial information on an investor to publicly available financial information or, in some cases, only to information that is required by the lender in order to assess the creditworthiness of an investor.

Restrictions on jurisdiction of enforcement

Investors may seek to limit the jurisdictions in which a fund can pursue claims against them. This may be problematic for lenders. Lenders expect flexibility to bring claims in any jurisdiction in the event that they enforce rights to call capital and the investor defaults with respect to payment of such capital.

Practical considerations

Investors that are most sensitive to the jurisdiction of proceedings tend to be sovereign investors, including U.S. state pension plans. Principles of sovereign immunity or statutes applicable to any such investor may prohibit the investor from submitting to the jurisdiction of courts outside of its home jurisdiction. Accordingly, this investor request is usually non-negotiable. The prohibition on bringing a claim against the investor other than in its jurisdiction of organisation limits the enforcement rights of lenders. However, certain lenders may accept the limitations (and nonetheless include the investor in the borrowing base) on the basis of the credit quality of the investor.

Sovereign immunity

Certain entities, including sovereign wealth funds and public pension plans, may benefit from sovereign immunity in relation to contractual claims and/or other lawsuits. Funds may seek a waiver of sovereign immunity by investors. Many sovereign investors will not agree to a waiver and may require a side letter provision that overrides the waiver and reserves such immunity. In some instances, investors will also seek express acknowledgment of the scope of their immunities. This can create an enforcement risk for a lender.

Practical considerations

There is limited scope to negotiate a side letter provision reserving sovereign immunity. It is important to understand the scope of the immunity and whether there are exceptions (such as for commercial contracts) to the immunity that preserve the ability for a claim to be effectively brought against the investor. At a minimum, the side letter of an investor that benefits from sovereign immunity should clarify that the reservation of immunity does not limit the investor's obligations to the fund (including making capital contributions when called). Whether or not a sovereign investor is included in the borrowing base will depend on the specific credit analysis of the lenders to the fund.

Transfers to affiliates

Some investors seek enhanced flexibility in connection with the transfer of their interests to an affiliate and may require that the GP or the manager agrees to consent to any such transfer.

Practical considerations

Lenders will consider whether the affiliate transferee is as creditworthy as the transferor. The affiliate transferee may not be given as favourable treatment by lenders in the borrowing base or may be excluded entirely. Funds can mitigate this risk by limiting the affiliate transfer provision to allow transfers only to affiliates of creditworthiness acceptable to the GP or manager.

Funds may wish to negotiate that, under the sub-line, lenders do not have a consent right to investor transfers, or at least no consent right to transfers to affiliates. Historically, many lenders required a consent right to investor transfers above an agreed threshold, although transfers between affiliates were often carved out from the restriction. The primary rationale for such restriction is that an investor transfer may impact the creditworthiness of the lenders' ultimate source of repayment.

Recently, there has been some movement away from such restrictions as a result of objections by investors. The ILPA Guidelines publicly highlighted to investors that lender consent rights would inhibit investors' ability to transfer. Consequently, sub-line terms on investor transfers are evolving. Increasingly, sub-lines allow investor transfers as long as the transfer does not cause a breach of the borrowing base (with the fund able to control whether a breach occurs, because it can repay debt to ensure compliance with borrowing base requirements).

Overcall provisions and concentration limits

LPAs typically include shortfall funding provisions. In the event that an investor defaults or is excused from an investment, the fund may call the shortfall from the other investors. Typically, only investors that have participated in the funding of an investment benefit from the returns that investment may generate. Investors may seek, either in the LPA or in a side letter, to limit the maximum amount they may be required to fund with respect to any investment in excess of the amount that would have been required had all investors participated in the relevant investment. Such overcall limitations can reduce the likelihood of a lender being fully repaid, as the contractual "overcall" protection against one investor failing to fund is weakened.

Concentration limits, which cap an investor's commitment to the fund at a specified percentage of aggregate commitments, similarly serve to restrict the amount of commitments available to repay indebtedness under a sub-line.

Practical considerations

The interests of the lenders are generally aligned with those of the fund with respect to these provisions, so there are no additional side letter points for a fund to negotiate with the sub-line in mind. Overcall and concentration limits will negatively impact a lender's credit analysis. However, lenders may get comfortable if the limitations are not too far-reaching and there is sufficient headroom above which the borrowing base exceeds the size of the facility.

Pay-to-play provisions (and other withdrawal rights)

As a result of regulations governing corrupt practices involving the use of placement agents, many public pension funds and other governmental investors insist on side letter provisions requiring the fund to represent that it has not used a placement agent, or paid any compensation to such investor's employees or related parties, in obtaining such investor's commitment. The consequences of a breach of such representation may include the unilateral right of such investor to withdraw from the fund.

In addition, LPAs often include limited rights for investors subject to the Employee Retirement Income Security Act of 1974 ("ERISA") to withdraw from the fund if continued participation in the fund will give rise to issues for the fund or the investor under ERISA.

Practical considerations

Pay-to-play provisions are generally required by applicable law, so there is limited room for negotiation. However, the potential withdrawal of an included investor will be a major concern for potential lenders, and funds should take potential lender concerns into account

in negotiating the side letter. One potential mitigant is to provide that the withdrawal right, or termination of an obligation to fund capital calls, does not apply to capital calls made in respect of debt incurred prior to such withdrawal or termination.

With respect to withdrawing investors, lenders will exclude such investors from the borrowing base. Lenders may also request that an event of default occurs if the aggregate of withdrawn commitments exceeds a threshold percentage of uncalled capital.

MFN provisions

Most-favoured nation ("MFN") provisions may allow investors to elect the benefit of terms negotiated in side letters with other investors (or, often, only other investors with a capital commitment equal to or less than the capital commitment of the electing investor). Only certain side letter provisions will be "MFN-electable". For example, the benefit of investor-specific requirements (such as sovereign immunity or internal policy requirements) cannot generally be elected by other investors that do not have the same requirements.

Practical considerations

If investors elect to take the benefit of side letter terms of other investors under MFN provisions, the adverse consequences for a lender of side letter terms that are detrimental to a financing structure are potentially multiplied. The issue highlights the importance of ensuring that side letters do not contain terms adverse to a lender, as MFN provisions could exacerbate the consequences. The point remains relevant when negotiating a side letter with an investor that will be excluded from the borrowing base, as provisions in such an investor's side letter may be electable by investors that are included in the borrowing base through operation of the MFN. Funds may seek to mitigate this issue by carving out side letter provisions that could impact a financing from the scope of side letter provisions that are available for election under the MFN.

Conclusion

Sponsors and their counsel must consider financing flexibility when negotiating side letters. Investors often request side letter provisions that could reduce a fund's sub-line borrowing base, limit the scope of a fund's financing flexibility, or entirely prevent a fund from raising fund-level financing.

Looking forward, we expect lenders to continue to focus their diligence on the side letter provisions. Anticipating and dealing with potential problems during the side letter negotiation process is critical to ensure that a fund avoids major problems with the financing down the line. Plan ahead for the pitfalls and perils!

* * *

Acknowledgments

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