



## SIDE LETTERS

### ■ Purpose

Prospective investors considering a hedge fund investment may request amendments to the fund's offering terms as a pre-condition to their investment. Hedge funds seeking to attract institutional investors who are able to commit significant sums, which will in turn facilitate the hedge fund's pursuit its investment strategy for the benefit of all investors, may want to agree to preferential terms for these institutional investors. The preferential terms sought are commonly intended to better protect an investment and to allow closer monitoring of the underlying investments of the hedge fund. These amendments to a hedge fund's offering terms are typically implemented using a side letter.

### ■ Common Terms

The terms of side letters can range from relatively straightforward terms between the investor and the hedge fund manager relating to rebate arrangements over the manager's fees to more complex arrangements that may require amendments to the hedge fund's constitutional documents.

Those arrangements which require a close examination of the hedge fund's documents include arrangements which seek to restrict the exercise of the hedge fund directors' discretion to make distributions in kind, to compulsorily redeem shares or to reject share transfer requests, arrangements for different liquidity rights including key man provisions, variations of gating or lock up provisions and arrangements for more frequent reporting.

Most favoured nation clauses are a common term but require a thorough monitoring of side letters entered into by the hedge fund. Side letters including these terms should provide for their application only to terms agreed with investors who make an equivalent or smaller investment and who are not affiliated with the manager and should provide for consent to the disclosure of side letter terms to other investors.

### ■ Risks

A thorough review of the hedge fund's documents should be conducted in order to confirm that the creation of side letter arrangements is provided for and that any requirements relating to

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the preparation and approval of side letter arrangements are complied with. Failure to do so may render the side letter unenforceable and expose the hedge fund to complaints and legal proceedings by other investors, on the basis that the side letter investor was given unfair and improper preference that was not disclosed adequately in the offering documents.

Regulators are particularly concerned where side letters seek to provide for enhanced liquidity for certain investors or provide those investors with more or earlier access to information on the underlying assets of the hedge fund. The risk is that these terms will allow an investor with such rights under a side letter arrangement to mitigate or avoid losses where other investors are not able to do so.

## ■ Validity

As with any contract, to be enforceable, a side letter arrangement must either be entered into for valuable consideration or must be entered into as a deed. Any side letter arrangement entered after an investment has been made in the fund will generally require additional consideration other than the investment. Side letter arrangements must also comply with the other requirements for a valid contract including requirements for the capacity of the parties, sufficient certainty of terms, a valid offer and acceptance of those terms and an intention to create legal relations.

## ■ Capacity

The capacity of a hedge fund to enter into side letter arrangements will be determined by reference to its constitutional and offering documents. It is important to check whether the hedge fund's documents include provisions that permit side letter arrangements which are proposed to be entered into and to check what actions might be required to approve and implement those arrangements.

It is important to confirm whether a side letter's terms give rights to the prospective investor that create a separate class of shares, requiring the existing shareholders' approval for such modification. If this is the case and such consent is not obtained the issue of shares to the prospective investor might be rendered invalid.

A separate class of shares is constituted when the rights carried by those shares differ from those attached to other shares, even if there is no express wording to that effect. As a result it is possible for a side letter to inadvertently create a separate class of shares which could have significant unwanted consequences for both the hedge fund and the prospective investor.

The principal rights that a share may carry are: (i) the right to dividends; (ii) the right to vote at meetings of members; and (iii) the right, in the winding up of the company, after the payment of the debts, to receive a proportionate part of the capital or otherwise to participate in the distribution of the company's assets.

Where a side letter provides for a differentiation between these rights as they apply to the prospective investor, the prospective investor may become a separate class of member and their shares may constitute a separate class of shares.

Side letter terms which seek to limit or restrict the fund from pursuing a particular strategy or from employing leverage or which allow the investor to opt out of a particular strategy will also generally require a separate class of shares to be created. Shares may need to be issued as a separate class or series if they have different net asset value or are subject to different lock up provisions and may need to be established as a different class if they are to be granted additional redemption dates. If a fee concession is granted as a discount rather than a rebate it will impact the net asset value of the shares and will need to be accounted for in separate series or classes.

## ■ Disclosure

Where side letters are proposed to be entered into by a hedge fund its offering memorandum should disclose the possibility that side letter arrangements may be entered into and specifically alerting investors that others could be given preferential offering terms.

The potential for provision of enhanced liquidity and transparency terms to certain investors needs particular consideration. Disclosure in the hedge fund's offering documents will certainly be required in order to enable other investors to assess the impact of such rights on their own investment and it is recommended that consideration also be given as to whether enhanced liquidity and transparency rights should be offered to all investors. The preferred approach of regulators and hedge fund industry associations is generally to provide enhanced disclosure transparency rights to all investors providing appropriate confidentiality undertakings.

## ■ Recent Judgments

Two recent Cayman judgments highlight the importance of the above principles.

*Medley Opportunity Fund Ltd v Fintan Master Fund Limited & Nautical Nominees* confirmed that where a side letter is entered into between a hedge fund and the beneficial owner of its shares without the registered shareholder being a party to the side letter the arrangement will be unenforceable. This judgment also provided persuasive authority that where a restructuring agreement is signed which varies the terms of an earlier side letter the shareholder will be bound to the terms of the later agreement.

*Lansdowne Ltd & Silex Trust Company Ltd. v Matador Investments Ltd (in liquidation)* considered a verbal side letter which purported to vary the terms of a hedge fund's constitutional documents. This case was also decided on the basis that the wrong parties had purported to enter into the side letter and as a result it was of no effect but also provided persuasive authority for the principle that a side letter will not override the provisions of a hedge fund's constitutional documents.

## ■ Conclusion

As an overriding principle the directors must act in the best interests of their hedge fund as a whole when considering entry into a side letter and must act in a manner consistent with their fiduciary duties.

A side letter should always be reviewed by the fund's legal counsel and approved by a directors' resolution. Its scope must fall within the side letter disclosure provisions in the offering memorandum and it must not modify existing share rights. The directors' resolution should ideally recite in full the provisions of the offering memorandum and the Articles that permit the creation of side letters, and explain why a subscription on the side letter's terms is in the fund's best interests.

## Praise for the Dillon Eustace Asset Management & Investment Funds Team

- The team is recognised internationally as one of the most innovative and dynamic groups of lawyers in this practice area, with recent awards including *The Leading Law Firm (UCITS Compliant Hedge Funds)* – 2013 Hedge Fund Journal Awards and *Irish Asset Management Law Firm of the Year / Investment Funds Law Firm of the Year* – ACQ Finance Magazine Global Awards 2012.
- Other recent references to the team include the Legal 500 ("Exceptional" Dillon Eustace is an investment fund powerhouse ... the firm has been very active on submissions to regulators on product design and, most recently, on valuations of OTC derivatives, master-feeder structures and real estate fund rule changes") and Chambers ("Clients fell over themselves to praise this funds practice ... it is a clearly established leader in the field with a strong reputation in both the local and international marketplace. The "young, helpful, keen and creative" team offers a "friendly and no-nonsense approach" combined with "flexibility, productivity and clear expertise").

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