STUARTS HUMPHRIES

Guidance Note

Side Letters in the Cayman Islands

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Introduction

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What are Side Letters?

Side letters usually take the form of additional agreements between certain investors and the fund that are separate and distinct from the original subscription agreement, offering memorandum and constitutional documents of the fund. Side letters are often used to grant special rights and privileges to important investors (e.g. seed investors, strategic investors) or to those subject to government regulation (e.g. (i) Employee Retirement Income Security Act of 1974 "ERISA").

They are often used by fund managers to attract larger institutional investors. Side letter arrangements may typically confer the following upon the investor:

- preferential access to information;
- preferential fees;
- waiver of applicable minimum subscription and ongoing holding;
- amounts except to the extent required by applicable law or regulation;
- agreement by the fund to use its commercially reasonable efforts to pay redemption proceeds in cash rather than in-kind;
- agreement by the fund that it will not effect compulsory or mandatory redemption of the investor's investment except in certain limited circumstances (e.g. in the absence of a mandatory redemption, the fund would become "plan assets" subject to the ERISA); and
- "most favoured nation" (MFN) treatment.

What are the problem areas?

There may well be compelling commercial reasons why a large investor, possibly "seeding" the fund, should be given better terms to reflect the size of the contribution being made and risk being taken by that investor. However, that alone may not lead to the arrangements being proper and legally valid, if the improved terms materially prejudice other investors in the fund who do not enjoy the same privileges and may not even know about the uneven playing field on which they participate.

These issues range from:

- failure to contemplate such arrangements in the original fund structure or constitutional documents of the fund;
- failure to make proper disclosure, material misrepresentation, or failure to obtain proper consents;

- potential breach of fiduciary and other duties by directors, general partners and fund managers;
- lack of consideration in relation to the enforceability of the arrangements; and
- authority of the fund manager to bind the fund.

Developing a practice of using side letters also creates an administrative burden which requires time and diligence from the fund manager and its back-office support team. 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 investor's side letter does not conflict with the terms of any other side letter, or the subscription agreement, or other governing document. Equally, to the extent that MFN protection has been extended to one or more investors, a fund manager will need to establish a method for distributing side letters to those investors with MFN election rights, reviewing the appropriateness of any elections made, and recording provisions elected by such investors.

How are these issues being handled?

There are a number of potential pitfalls to avoid when a fund is contemplating using side letters. First, greater attention should be given at the time of structuring the fund to the possibility of side letters conferring preferential treatment. A simple letter between the fund manager and the investor is unlikely to be a sensible way to proceed. The offering documents (and preferably the subscription agreements with the fund itself) should alert investors to the existence or the possibility of the arrangements, so there is no question of non-disclosure or misrepresentation. Ideally, any subsequent arrangement should be notified to all investors. Some regulators argue for detailed disclosure of the arrangement. This poses an interesting question that will surely turn on the nature of the arrangement but, fundamentally, the more advantageous the terms, the greater the risk of attack if such terms are not fully disclosed.

If it is anticipated that the arrangements may be such as to potentially vary the rights of the shares or other interests, the constitutional documents must anticipate and provide for this possibility. Otherwise the proposal will require the necessary votes of the shareholders or limited partners in order for it to be effective. For instance, where the fund structure is a company, it is generally advisable to provide for the directors to be permitted to issue a different class of share for the preferred investor.

Prudent directors, general partners and fund managers (and their advisors) should consider carefully their fiduciary and contractual obligations to all their relevant investors and clients before and when proceeding with these arrangements.

Below are some specific considerations often negotiated by investors:

Confirmation of existing terms

Often an investor will seek a contractual confirmation of certain representations, warranties or other terms that might be contained in the offering documents. Such confirmation would provide the investor with better protection but careful consideration should be given as to whether the correct party is giving such confirmation and whether they have the requisite knowledge to do so.

Directors' discretion

Typically the articles of association of a fund will provide that the directors may exercise their discretion in relation to, for example, the transfer of shares, the payment of redemption proceeds in-kind or a compulsory redemption of shares.

Terms in the side letter which require the directors to exercise their discretion in relation to these matters which may take place in the future should not, if properly drafted, cause unnecessary concern.

Variation of existing terms

Broadly speaking terms in a side letter which purport to vary the existing terms of the shares must be considered on a point by point basis however generally where the proposed terms are contrary to the articles of association of the fund, the terms of the articles (being the constitutional documents of the fund) will prevail and terms which have the effect of varying the rights of existing shareholders in a class will require such shareholders prior consent. In cases where the consent of the existing shareholders is not considered necessary consideration should be given as to whether the terms should be extended to all shareholders to mitigate the impact on them.

Most favoured nation (MFN)

Since these provisions typically level the playing field the concerns they raise are usually administrative only, to the extent that MFN protection has been extended to one or more investors, a fund manager will need to establish a method for distributing side letters to those investors with MFN election rights, reviewing the appropriateness of any elections made, and recording provisions elected by such investors. If the side letter contains a confidentiality provision requiring the contents of the side letter to be kept confidential this will limit the ability to comply with such MFN provisions.

Investment strategy

Terms which permit certain investors to opt out of certain types of investments will require a new class of shares. In this case, consideration must be given to how such provisions concentrate the remaining investors in such strategies and to how such provisions may impact the investment strategy of the fund as a whole.

Fee concessions

A simple discount on the fees may impact the net asset value and might need to be tracked separately as a separate class, however, if the discount is affected by way of a rebate from the fund manager the net asset value will be unaffected.

Information rights

In an era where transparency is becoming more important to investors it is common for certain investors to demand enhanced information rights. However, disclosing information on underlying portfolios may give certain investors the advantage of being able to determine whether to exit the fund ahead of other investors. The effect of these provisions can be mitigated by delaying the information to be provided or by making such information available to all investors with suitable confidentiality provisions.

More favourable liquidity rights

Terms which can present the greatest difficulty are those which purport to enhance the liquidity rights of certain investors, which might include shorter redemption notice periods, key man redemption provisions, variation of lock-up or gate provisions or provide additional redemption dates.

As stated above, where these terms are contrary to the articles of association such terms will be unenforceable. Careful consideration should be given as to whether a new class of shares should be created and consequently what supplementary information should be provided to CIMA and any other consequential implications such as the calculation of ERISA thresholds.

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 enhanced liquidity and transparency rights for certain investors and whether the use of side letters and, in certain instances, the terms therein have been adequately disclosed to prospective and existing investors. For example, a smaller investor with less favourable liquidity options may find that by the time his shares are redeemed, prices have moved against him as certain other investors have been able to liquidate their positions more quickly. Many managers circumvent this inequality between investors by agreeing to enhanced liquidity or transparency terms only where, if invoked, the term would be extended to all investors.

Fiduciary obligations are other points of focus, with regulators expressing concern that the provision of special terms to certain investors may operate to the detriment of investors as a whole.

The Cayman Islands Monetary Authority ("**CIMA**") which regulates investment funds domiciled in the Cayman Islands has expressed the view that standard blanket disclosures permitting the use of side letters in offering documents may not be sufficient, and that side letters should preferably be entered into by the relevant fund and not the fund manager. CIMA has however fallen short on issuing any specific guidance on the matter as it considers that such issues should be resolved by market participants and that any legal and regulatory issues are adequately addressed by the application of the current law and the Mutual Funds Act (as Revised) (the "**Funds Act**"). The position of regulators appears to be consistent with that of industry groups such as the Alternate Investment Fund Managers Association, which reiterate concerns over their use, but suggest that a possible resolution may be to enhance disclosure of such terms to enable other investors to assess the impact of such rights on their own investment.

Regulators are less concerned with terms that address additional investment or entitle the investor to receive treatment as favourable as other investors or limit management fees and incentives.

The Funds Act provides that the offering documents must:

- describe the equity interest being offered in all material respects; and

- contain such *other* information as is necessary to enable a prospective investor to make an informed decision as to subscribe or not for, or purchase the, equity interests.

Side Letters in the Cayman Islands

Who should be the parties to Side Letters?

In *Medley Opportunity Fund Ltd. v. Fintan Master Fund Ltd & Nautical Nominees Ltd (21 June 2012)* the Grand Court of the Cayman Islands ruled on the enforceability of side letters and reiterated a number of points to bear in mind when entering into side letters:

- The side letter is a contract and the general principle of privity of contract under Cayman Islands law (i.e. that only the parties to a contract can enforce it in court) applies. Subject to the provisions of *The Contracts (Rights of Third Parties) Act 2014* (detailed below) which has since come into force, a person cannot therefore enforce the terms of a side letter itself unless it is a party to the side letter;

- The Cayman Courts will always regard a custodian or a nominee as the shareholder of the fund for legal purposes, and therefore ideally, the custodian or the nominee ought to be a party to all agreements concerning the investment, including side letters although, if this is difficult, the provisions of *The Contracts (Rights of Third Parties) Act 2014* may be of some assistance; and

- The fund should be a party to the side letter (as opposed to having the investment manager as a party to the side letter in place of the fund).

The scope of the side letter should be considered carefully. For example, where it is impractical or inappropriate for the custodian or nominee of an investor to also be a party to the side letter, the scope of the side letter should be drafted sufficiently wide (yet with sufficient certainty as to whom should benefit) in order that the terms of the side letter are enforceable by the investor for and on behalf of itself and its nominees, custodians and/or affiliates.

Furthermore, in the case of *Lansdowne Limited & Silex Trust Company Limited v. Matador Investments (in liquidation) & Ors (23 August 2012)*, the Grand Court of the Cayman Islands applied the same principles as those in the *Medley* case and held that, where the identity of the beneficiary of the side letter and the shareholder were different (even if this was due only to nominee/custodian arrangements), the provisions of the side letter would be unenforceable by the shareholder. It was also ruled that a side letter could not operate to achieve the very opposite of what was expressly contained in the articles of association and subscription documents.

In addition, as the dispute related to a specific right in a side letter to require redemption of shares on a preferential/accelerated basis over and above that set out in the articles of association, the Grand Court accepted the submission that, as Section 37 of the Companies Act requires the manner in which any redemption may be effected to be set out (or sufficiently set out) in the articles of association, a side letter would fall foul of these entrenched rights and would be of no effect.

Finally, in *In the Matter of Lancelot Investors Fund, Ltd.* (27 April 2015) the Court of Appeal held that the fund manager had no authority, ostensible or otherwise, to bind the fund by way of a side letter in relation to their terms of redemption. This decision is an important development as many investors may well assume that the fund manager would have

authority to negotiate and enter into a side letter in this regard, however, the Court of Appeal made clear that, on a true construction of the Articles of Association and Confidential Information Memorandum, it was apparent that the fund manager's authority did not extend to something as fundamental as altering a shareholder's rights in relation to the redemption of shares.

Care must be taken to ensure that the contracting party on behalf of the fund has authority to enter into the side letter by building authority into their investment management agreement and ensuring the fund passes the requisite board resolutions (and reflecting such authority in the offering document).

Can third parties enforce the provisions of Side Letters?

The Contracts (Rights of Third Parties) Act, 2014 grants an ability to a person to enforce rights which are conferred upon him pursuant to a contract to which he is not a party ("**third party**"). A third party may only enforce a term of a contract if:-

- that person is expressly identified in that contract by name, as a member of a class or as answering a particular description but the third party need not be in existence when the contract is entered into; and

- that contract expressly provides in writing that such person may enforce the relevant term.

In addition, the law applies to all contracts which are made on, before or after 21 May 2014 if they contain, or are amended to include, terms which comply with *The Contracts (Rights of Third Parties) Act 2014* provided however that a third party may only enforce a right which accrues on or after 21 May 2014.

Accordingly, whilst the provisions of the *Medley* and *Lansdowne* cases referred to above provide useful guidance as to the limitations of side letters, *The Contracts (Rights of Third Parties) Act, 2014* does now allow a third party which is not a party to a contract (including a side letter) to enforce its provisions. However, the limitations of side letters expressed in such *Medley* and *Lansdowne* cases should still be borne in mind when seeking to enter into or rely upon a side letter.

In *In the Matter of Lancelot Investors Fund, Ltd.* (27 April 2015) it was confirmed that only the registered shareholder would have standing to enforce shareholder rights (in the absence of any right that may arise pursuant to *The Contracts (Rights of Third Parties) Act, 2014*; this is even if the shareholder was a custodian acting for a beneficial owner. However, it was also decided that in winding up proceedings, the right to receive a dividend was assignable and therefore the beneficial owner could pursue an action given that the custodian was a bare trustee.

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:

- Side Letter Strategy from the Outset - Provide for side letter arrangements in the original fund structure or constitutional documents of the fund and have a strategy for who will likely receive side letters and MFN rights, and the likely scope of the MFN rights.

- Consult with legal counsel regarding use of side letters – Bearing in mind the number of pitfalls that a fund manager, the fund and/or investors have when signing a side letter, (e.g. as to whether the right persons are party to the side letter, whether there is adequate disclosure of potential use of side letters, whether any third parties whom would seek to rely on the side letter have been appropriately identified, as to whether there is authority within the fund's constitutional documents to enter into side letters, etc.), it is best practice, if not absolutely critical, to consult with Cayman Islands legal counsel on the use of side letters from the formation of the fund to the point of negotiating, agreeing and execution of a side letter and in some cases a legal opinion on the enforceability of the side letter may be warranted.

- Standardise terms across side letters - Standardising side letter language to address areas of overlapping concern will ease monitoring and compliance burdens and limit the number of provisions available for MFN protection.

Guidance

This publication is for general guidance and is not intended to be a substitute for specific legal advice. Specialist advice should be sought about specific circumstances. If you would like further information, please contact:

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