

## Side Letters

### **Hedge Fund Side Letters: The View from the Fund Director's Perspective**

By Victor Murray, *MG Management Ltd.*

Most hedge funds are asked at one time or another by certain investors to provide side letters agreeing to preferential dealing, investment or other strategic terms. As a professional director with more than ten years of hedge fund industry experience, I have seen a broad cross section of side letters. There are clear cases where a side letter would not be acceptable, e.g., it contains plainly egregious terms; has no legitimate purpose; or is clearly contrary to what the hedge fund or hedge fund manager is doing in practice. In most circumstances, however, there is no black and white answer as to what constitutes an acceptable side letter term or where the line should be drawn. In crafting a side letter term that is in the best interest of the hedge fund (and in particular, other investors in the fund), there is a difficult balancing act that managers must perform. On the one hand, the side letter can be used to facilitate a large investment that attracts other strategic investors, which could benefit the fund and the execution of its investment strategy. On the other hand, side letters generally raise various fiduciary and other concerns that must be addressed.

#### *Side Letter Disclosure*

Hedge fund directors must ensure that a manager's authority to enter into side letters and any required disclosures related to side letter terms or information rights are disclosed to investors. A hedge fund manager that wishes to enter into side letters should ensure that it has the authority to do so pursuant to the fund's governing documents.

Such authority, in addition to the fact that the manager may enter into side letters, should be disclosed in the risk factors section or other relevant section of the fund's offering memorandum. Different jurisdictions have varying expectations with respect to the disclosure of side letter terms in fund governing documents. U.K. fund managers are expected to disclose all material terms of their side letters to their investors. The material terms include, among other things, preferential redemption and preferential transparency terms. The non-material terms not requiring disclosure can include provisions addressing fee rebates and most favored nation provisions.

The disclosure can be general in nature and simply reference the material terms themselves rather than going into detail as to what the terms are. The U.K. and U.S. regulatory views are generally aligned with respect to what terms constitute material terms. Additionally, the U.S. Securities and Exchange Commission, during its on-site inspections of fund managers, may review side letters of registered hedge fund managers. In implementing the reforms introduced by the Dodd-Frank Wall Street Reform and Consumer Protection Act, side letters were specifically added to the list of books and records to be maintained by registered investment advisers.

Whether or not a hedge fund manager wishes to share side letter terms with other investors (even on an anonymous basis) will depend on various factors, including contractual obligations, favorability of terms, confidentiality and

commercial sensitivity. Notwithstanding a fund manager's election not to affirmatively disclose side letter terms to investors, investors can request to see the side letters and make an investment decision based on the fund manager's willingness to produce them or, if produced, on their terms.

To ensure that a hedge fund manager can share the terms of a side letter with other investors, a standard provision should be included in all side letters authorizing the fund and the manager to disclose the general terms of the side letter to all investors.

### *Considerations under the Employee Retirement Income Security Act of 1974 (ERISA)*

The effect of side letters on ERISA investors can sometimes be overlooked and should be one of the key priorities to consider when a hedge fund contemplates entering into a side letter.

Where a fund wishes to accept an investment from an ERISA plan investor, it must be mindful of the effect on the hedge fund of the terms of the side letter. If the terms of the side letter are material, the side letter beneficiary's investment may be deemed to constitute a separate class of shares for that investor. The creation of a new class of shares may cause the hedge fund to become a "plan assets" fund if the ERISA plan investor's investment constitutes 25% or more of the total assets of that class of shares of the hedge fund. A hedge fund that is a "plan assets" fund is subject to the fiduciary duty, prohibited transaction and various other provisions of ERISA. See "Hedge Fund Industry Practice for Defining 'Class of Equity Interests' for Purposes of the 25 Percent Test under ERISA," *The Hedge Fund Law Report*, Vol. 3, No. 29 (Jul. 23, 2010).

### *Unsavory Terms*

Proposed side letters sometimes contain terms that should at least be questioned, and sometimes should be rejected outright. A term that may usurp the constitutive documents, such as the Memorandum & Articles of Association, should be carefully evaluated. At a minimum, such an evaluation can put the directors on notice that they may be agreeing to a course of action that offends the constitutive documents. However, even a term that does not contravene the constitutive documents may do so in the future, and directors should consider such terms over time. For example, a term may be or become ultra vires, that is, may commit the directors to a course of action that exceeds the powers and purposes set forth in the fund's constituent documents.

Preferential liquidity terms allowing for a shorter redemption notice period and other preferential redemption rights are often problematic. See "Are Side Letters Granting Preferential Transparency and Liquidity Terms to One Investor Ipso Facto Illegal?," *The Hedge Fund Law Report*, Vol. 4, No. 18 (Jun. 1, 2011). The hedge fund should consider whether the investor being granted preferential redemption rights can evaluate its redemption decision on information not made available to other investors. If the answer to this is yes, then the fund should not agree to the granting of such terms without at least disclosing the terms of such side letter to other investors. The granting of the right for an investor to redeem an investment immediately from a fund upon the occurrence of certain events can be problematic, and the manager will need to consider each situation to determine whether it is appropriate to grant such a right to an investor. For example, if an ERISA investor wishes to redeem an investment as soon as possible in the event that the hedge fund is near the 25% benefit

plan investor ownership threshold that would cause the fund to become a “plan assets” fund subject to ERISA, the fund can consider granting such redemption rights because the operation of the fund would change in that circumstance. However, granting redemption rights to an investor upon a key man event can be inequitable to the other investors, and the directors should have very good reasons in determining to grant such a right, of course with proper disclosure to all investors. See “Key Considerations for Hedge Fund Managers in Developing a Succession Plan (Part Two of Two),” *The Hedge Fund Law Report*, Vol. 5, No. 8 (Feb. 23, 2012).

Another problematic area is the granting of preferable transparency rights, such as the dissemination of estimated mid-month fund net asset value (NAV) to the holder of the side letter before the official NAV is released at the end of the month to other investors. Such rights should not be granted in side letters if the investor has the right to redeem an investment prior to the dissemination of the end-of-month NAV to all investors. The risk is that the preferential transparency rightholder is privy to information otherwise not made available to other investors, thus allowing it to mitigate or avoid losses where the other investors do not have the opportunity to do so.

The preferred method for disclosing information requested by an investor demanding preferential transparency is to make all such information available to all investors at the same time to ensure that all investors are on a level playing field.

### *Shareholder Actions Relating to Side Letters*

In evaluating side letters, directors must also understand the potential for litigation, including understanding shareholder rights. To raise a court action in the Cayman Islands, the plaintiffs must show a prima facie case of fraud, wrongdoing

or other breach of fiduciary duties. This means that the shareholders must show evidence of the fraud, such as the fact that the directors wronged the fund because of certain actions originating under side letters. These “derivative actions” are usually permitted to proceed if the investor has no other legal recourse to commence the action to directly right the wrongdoing done to the Company.

The right to initiate a derivative action is limited in a number of ways, the major hurdle being “reflective loss” (i.e., it was the company that suffered the loss, and if the shareholder was successful, then the shareholder would be doubly compensated). Conversely, if the shareholder suffers a different and separate loss from the company, then it may be able to pursue an action, such as the inability to redeem its investment and avoid a loss. The company would have suffered the same loss regardless of whether the investor was able to redeem or not, but the inability of the investor to do so on the same terms as investors with greater liquidity rights through side letters may give rise to a claim. It is not possible to bring an action by a beneficial owner of shares in Cayman. Only shareholders on the fund register can do so. See “Recent Cayman Grand Court Decision Demonstrates the Practical and Legal Challenges of Investing in Hedge Funds through Nominees,” *The Hedge Fund Law Report*, Vol. 5, No. 29 (Jul. 26, 2012).

### *Lack of Statutory Provisions*

There is no equivalent under Cayman Islands Law of the U.K. Companies Law which provides protection to minority shareholders. In a House of Lords appeal in *CVC/Opportunity Equity Partners Ltd v. Demarco*, [2002] 2 BCLC 108, the court held that the aggrieved minority shareholder can always apply to the court to have a company liquidated.

### *Common Law: Derivative Actions*

These actions permit minority shareholders to bring actions in their own name to request relief for company wrongdoing. To initiate such an action, minority shareholders must demonstrate that the action is being brought for the benefit of the company, and no other remedy is available. The U.K. precedents allow for these actions to be raised where: (1) there is an ultra vires or illegal act – this could apply to side letter terms that vary the terms of the fund constituent documents. The other possible cause of action by prejudiced shareholders could be in respect of fraud on the minority, where the wrongdoers are themselves in control of the company.

### *Fraud on the Minority*

The U.K. Courts have made clear that “fraud on the minority” does not require an element of dishonesty. Thus, where a company allows an investor with side letter rights to redeem on short notice or upon a certain event where the other shareholders do not have the same redemption rights, the court can point to the side letter as evidence that the fund manager and the directors created a fraud on the minority, especially where they are receiving a benefit (i.e., higher management fees).

The majority shareholders or directors may have a defense if they can demonstrate that the side letter was entered into for the benefit of the fund as a whole. Conversely, in *Greenhalgh v. Arderne Cinemas Ltd*, [1946] 1 All ER 512; [1951] Ch 286 (English Court of Appeal), the court noted that if the side letter was entered into “to discriminate between the majority shareholders and minority shareholders so as to give the former an advantage over the latter,” then the action could very well succeed. Side letters present significant risks because

the nature of side letters is the granting of rights to certain investors that have not been granted to other fund investors.

The Cayman Islands court could become involved in two ways where fraud on the minority is alleged: (1) a shareholder with in excess of 20% of the issued shares can petition the court to appoint an inspector to examine the affairs of the company and report to the court; and (2) any shareholder can petition the court to wind-up the fund, but only if the court decides that it is “just and equitable” to do so.

### *Best Practices in Relation to Directors’ Review of Side Letters*

Directors are bound to perform their duties to Cayman Islands companies with a duty of care, in good faith and in the best interests of the company. Fund managers should provide directors with as much time as possible to review the side letter and to provide their input. Side letters should not be presented to the directors on the evening of signing once all of the terms have already been thoroughly negotiated.

A first review of the side letter by directors will reveal any unsavory terms as well as any obligations upon the fund that will require review by the funds’ service providers. A typical review and confirmation is required on the monitoring of ERISA investors by the administrator, where the fund obliges itself to inform the party to the side letter should a class of the fund near the 25% benefit plan investor investment limit, consequently allowing the side letter investor to redeem a portion of its investment.

Where the side letter provides the rightholder with preferential transparency rights, directors would ordinarily request a confirmation that all investors will at least be

granted access to such information either by an update to the offering documents or a notification in the general investor letter from the manager.

In situations where there is a fee reduction granted to an investor through a side letter, it is often overlooked that the fund is legally obliged to pay delineated fees to the manager pursuant to the investment management agreement between the fund and the manager. Therefore, only the manager (and not the fund) can waive the right to receipt of the full payment of its management and incentive fees. This can be

addressed either by making the manager party to the side letter or obtaining a separate written waiver from the manager to the investment management agreement.

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