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Enforceability of Preferential Rights in Side Letters

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The enforceability of preferential terms granted to certain investors in private funds is often a topic of interest. The Delaware Chancery Court provided some additional clarity on this topic in a recent decision.

In *ESG Capital Partners II, LP v. Passport Special Opportunities Master Fund, LP*, C.A. No. 11053-VCL (Del. Ch. Dec. 16, 2015), the Delaware Chancery Court found that a side letter was nullified when a subscription agreement entered into a day later contained an integration clause that did not include the side letter. The court also held that a general partner did not have the authority to grant preferential rights through this side letter because such preferential rights would “materially and adversely” change the rights of the parties.

Side letters are commonly used to interpret, establish rights under, alter, or supplement terms in fund documents. While many general partners mistakenly assume they have the authority to grant preferential terms through side agreements, and many investors assume those side letter agreements are enforceable, this Delaware Chancery Court decision cautioned funds and investors to examine the nuances of fund documents, including limited partnership and subscription agreements. To increase the likelihood that side letters will be enforceable, (i) fund documents should reference side letters, (ii) fund documents should also provide clear authority for general partners to grant additional rights, and (iii) general partners should ensure that the granting of additional rights does not have a material and adverse impact on the other limited partners.

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Background of the Case

ESG Capital Partners (“ESG”) was formed as a Delaware limited partnership to raise money from investors to purchase shares of Facebook stock prior to its anticipated IPO. ESG’s partnership agreement provided for distribution of Facebook shares in proportion to each investor’s equity stake in the partnership, as is typically the case in many similar investment vehicles. Without the other limited partners’ (“LPs”) consent, ESG granted certain LPs priority distribution rights to Facebook shares.

Following ESG’s purchase of Facebook shares, “favored” LPs received preferential distributions of Facebook stock at the expense of “disfavored” LPs. Favored LPs received one share per partnership unit rather than their percentage interest in the partnership, as required by the partnership agreement. Favored LPs refused to return shares or payment at the current market value, so disfavored LPs filed suit.

In their complaint, disfavored LPs alleged that favored LPs received preferential distributions and thus breached the partnership agreement, wrongfully converted property, and were unjustly enriched. Ruling on a motion to dismiss, the court found that the complaint adequately alleged that favored LPs breached the distribution provision of the partnership agreement when they did not receive shares based on their equity interest in the partnership.

The Passport Fund, one of the favored LPs, defended its preferential treatment by pointing to the side letter granting such preferential terms. The side letter provided the Passport Fund with the right to a different share allocation and a specified number of Facebook shares. The Delaware Chancery Court rejected the Passport Fund’s side letter defense on two grounds.

First, the side letter had been entered into a day before the subscription agreement was signed. The subscription agreement contained an integration clause that stated that the subscription agreement constituted the entire understanding among the parties and superseded any prior understanding and agreements among the parties. Because this integration clause did not specifically carve out the prior side letter, the side letter was superseded and nullified.

Second, even if the side letter remained in effect, the preferential rights granted were invalid. The partnership agreement (as is typical) did not explicitly provide a general partner with the authority to grant preferential rights that “would materially and adversely change the specifically enumerated rights or duties of a party or of a class of parties.” Because these preferential rights shifted the risk of losses to other limited partners, they could not be valid without an amendment to the partnership agreement. The Passport Fund was aware of the limitations of the partnership agreement and, as a result, could not rely on the side letter as a defense.

Implications for Side Letters

Side letters are common practice in the alternative investment fund world. Both general partners and investors may take the enforceability of these side deals for granted, but, as the court in this case indicated, more attention should be paid to the specific details of each situation. To increase the likelihood that a Delaware court will enforce a side letter, interested parties should take three steps.

First, integration clauses should be carefully examined so that they do not nullify side letters. Sources of integration clauses that should be analyzed include partnership agreements, subscription agreements, and other fund documents.

Second, fund documents should also explicitly provide general partners with the authority to grant special additional rights. When fund documents are silent as to side letters, courts can invalidate rights granted in such side letters.

Finally, side letters should not contain terms that harm other investors in the fund unless (which would not be typical) the granting of such preferential rights is specifically provided for in the fund documents.

Click the following link for the court opinion:

<http://courts.delaware.gov/opinions/download.aspx?ID=233770>

Please do not hesitate to contact us with any questions.

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