

# The Significance of Investor Side Letters in Venture Capital Financings

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Whether you are raising money for your first priced round, or in some cases in your initial friends and family round of financing or beyond, you may run into investors who request a side letter. These may come in the form of a compliance driven Management Rights Letter (also known as “MRL”) or other compelling contractual need for additional rights to live outside the main set of financing documents in the form of a side letter. Often, it’s generally known by both parties at the term sheet signing stage if a lead investor will require one. Other times, the term sheet is silent and investors coming into a round late, might spring the request on the company in connection with the closing process. It’s your attorney’s job to break down exactly how these letters operate functionally, how the rights included in the letter can affect your relationship with such investors, implications with future financing rounds, and what to consider before quickly replying ‘yes’ in an attempt to close capital.

## What are Side Letters

At their core, side letters are simply a short document, often no more than a couple pages, that lay out contractual rights that the *requesting* investor seeks out for themselves only in connection with the currently contemplated financing and, in some cases, future financings. This letter, and the rights thereunder, will live outside the four corners of the primary financing documents (Stock Purchase Agreement, Investors’ Rights Agreement, Voting Agreement, and Right of First Refusal & Co-Sale Agreement or in the case of a convertible financing, the SAFE or convertible note and purchase agreement).

## Why Investors ask for them

The main reason investors will ask for side letters is to ensure their position within the company is protected as they see fit. This may come by way of asking for participation or information rights despite not meeting the applicable threshold for delivery under the primary financing documents or otherwise be guaranteed the opportunity to consult with management or the board on certain matters, receive board observer rights, or maybe even standalone blocks on the company undertaking certain activities. Because the only parties to the side letter are the investor requesting such rights and the company, the result is often that the investor receives a unilateral block on waiver/amendment of those included rights which they might not otherwise receive had such rights been included in the primary financing documents which waiver/amendment may be controlled by an alternative group of investors.

## Management Rights Letters

In some cases, side letters take the form of management rights letters or MRLs which include a standard set of rights granting the requesting investor the level of rights which would allow an investor to ensure that the investing entity, if it is a venture capital fund, will be given an exemption from the Employee Retirement Security Act of 1974 (“ERISA”).

So whereas, in some cases, a desire for a side letter is driven by governance and other contractual protections, in other cases, where an investor requests a more traditional MRL, it is compliance driven – specifically because that investor may have pension funds covered by ERISA that are invested in that fund. If a pension plan is covered by ERISA, then by default, all of the

fund's assets are treated as assets of the ERISA plan. Accordingly, the partners of the VC fund will be treated as an ERISA fiduciary, so all investments into a startup or portfolio company of that VC must comply with the rules outlining ERISA.

The main rights the National Venture Capital Association ("NVCA") uses for its form of MRL include the following:

- The ability to work with the founders/management on major business issues
- Inspection rights, which allow an investor to examine the books and records of the company and request information at their discretion at reasonable times and intervals
- If an investor is not on the Board, they could request copies of all notices, Board Meeting minutes, and other materials

## Common Requests in Side Letters

Outside of the standard MRL language, investors include a wide variety of rights in a side letter. Below are some of those rights most frequently requested:

- Participation rights in a future financing with major investors in current financing if the requesting investor is *not* considered a major investor in the current financing
- Rights to allow an investor to be considered a major investor for future financings
- Major investor rights for the current financing
- Management consultation rights
  - Gives the investor the right to have company personnel, at the investor's request, meet with the investor to discuss the business plan, financial information, revenue, cash flow, and other related items, which gives the investor the right to consult with and advise the management team of the company.
- Consent of investor to waive future pro rata participation rights
  - This effectively means the company must ask that investor to give them the chance to not participate in a future financing round. This ultimately puts the company in an awkward position if they do not choose to give an allocation to that investor in a future financing.
- Information rights
  - A commitment to receive financial statements on a regular basis from the company.
- Exceptions to the financing documents
  - Some investors may ask for rights that allow certain provisions of the financing documents to not apply to them. These could include:
    - Rights that allow the investor to transfer their shares at their discretion under the Right of First Refusal & Co-Sale Agreement
    - Rights that allow any amendments to the drag-along provisions in the Voting Agreement that would affect the rights or privileges of the investor to *not* apply to the investor if they are implemented
- Strategic Investors
  - Often corporate VCs and other strategic investors ask for rights associated with an ultimate sale of the business running a spectrum from notice rights of receipt of an LOI all the way to a right of first refusal in matching the 3<sup>rd</sup> party offer to purchase the business.

## What to consider if an Investor is asking for a Side Letter or MRL

Sometimes a side letter will be requested by an investor after the initial closing of a financing. At which time they are merely requesting similar rights to that of the lead investors, who have already participated in the initial closing. In this situation, it would be too burdensome to amend the financing documents, and it is easier to execute a side letter with the new investor.

In any event, it's worth taking each side letter request seriously, no matter how big the check size is. Here are some items to consider if an investor is requesting a side letter:

- What rights are being requested by the investor?
- What are they currently contributing to the company, if anything?
  - If they are an existing investor from a prior financing round, take note of how they have contributed since the prior financing and react accordingly.
  - If it's a new investor, take note of what investors from the current round are *also* asking for a side letter. If this investor is cutting a significantly smaller check than the other participating investors, it may be worth it to politely push back and explain that the company is not accepting side letters for the current round.

## Impact on future financing rounds or an exit event

The rights that are given in a side letter could impact a company in a future financing or sale to a strategic buyer or exit event. Side letters may include rights which impact:

- Certain investors from participating in future financings
- The company ability to entertain LOIs for potential sales
- The company from making changes to its hiring practices or the Board structure
- The company's business plan, approach to growth, sales, and overall strategy

Ultimately, a company should think about what the investor is bringing to the table, whether that's via financial contributions, experience with growing similarly situated companies in the same industry, and the rights of other investors in the round.

For more information on side letters, please contact a member of the [VC Team](#).