

Private Credit Insights

Exploring the Challenges of Side Letters in Financing Transactions

As private credit continues its rise as a key source of flexible capital for traditional private equity, there has been a growing focus by credit funds on the use and role of side letters in financing transactions. In many cases, credit funds (and, increasingly, traditional bank lenders) rely on side letters to address internal investment committee requirements, deal with institutional specific issues, and manage documentary risk concerns, without upsetting the broader dynamic between the Sponsor and lender group and putting the relationship between fund and Sponsor at stake.

If documented correctly, there are many benefits to using a side letter, not least the time and cost saving of negotiating additional assurances and protections bilaterally. However, it is important to recognise that documenting key financing terms outside the credit agreement creates its own issues. We have outlined a few of those issues below (along with a few practical points to consider):

- **Enforcement:** In most cases, a side letter will include a specific paragraph stating that it is not a "finance document" for the purposes of the credit agreement. This avoids the need to involve every lender in the negotiation process and prevents other lenders amending the side letter without the relevant fund's consent. However, as a result, a breach of the terms of the side letter will not trigger an event of default under the credit agreement and, therefore, enforcement is typically limited to a claim of damages, which will be difficult to quantify. There are ways to partially mitigate the enforcement issue and put a lender in a more favourable position if the side letter were ever to be litigated, but doing so effectively is a matter of careful and considered drafting.
- **Effectiveness:** A side letter will typically purport to vary certain obligations documented in the credit agreement or otherwise impose additional obligations on the borrower group. Careful attention must be paid to the drafting of these provisions to ensure their effectiveness. In particular, it is important that these provisions do not purport to amend the terms of the credit agreement and cut across the amendment regime documented in the credit agreement.
- **Amendments:** If the credit agreement is amended after the side letter is signed, it is important to ensure that the terms of the side letter remain relevant and that there is no ambiguity or uncertainty as to how such terms might apply. If the side letter needs to be amended, then this should be factored into the broader credit agreement discussions (with funds being cognisant of the fact the borrower may rely on other lenders to push through the credit agreement amendments whilst resisting any changes to the side letter).

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- **Transfers / assignments:** As a drafting matter, a lender should consider aligning the transfer and assignment provision in the side letter with the corresponding regime in the credit agreement or otherwise ensuring it has sufficient flexibility to assign its rights under the side letter to affiliates (in many cases, we have seen a blanket restriction on assignments). The ability to assign or otherwise transfer a side letter in a restructuring scenario can be a valuable and useful tool.
 - **Ongoing monitoring:** Given a side letter is a bilateral arrangement between company and specific lender, it is not uncommon for the obligations in the side letter to be neglected or overlooked by both management and lender over time. Therefore, as a practical point, it is important for external legal counsel and members of the deal team to actively monitor compliance with terms of the side letter—in particular, when the company undertakes a bolt-on acquisition, utilises the incremental facility, disposes of an asset, or otherwise undertakes an action that requires a closer look at the covenants in the credit agreement.
 - **Precedent documentation:** When negotiating commitment papers that refer to a previous suite of "precedent" documentation, it is important to check whether a side letter or similar arrangement was entered into in connection with the precedent deal. If so, this should be factored into the negotiation process to ensure the sponsor either reflects those terms in the new credit agreement or otherwise agrees to enter a similar side letter.
 - **Disclosure:** The purchaser's financing obligations set out in an acquisition agreement typically require copies of the commitment and long-form financing documents to be delivered to the vendor's legal counsel. The drafting of these obligations vary so it is important to analyse these provisions to determine whether the disclosure obligation extends to the side letter.

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As deals continue to grow in complexity and lender groups become more diverse, side letters will play an increasingly important role in the financing process. Given the issues highlighted above, ideally protections critical to a lender should be documented in the credit agreement itself. However, in situations where a lender has a good working relationship with the sponsor, a carefully drafted side letter can save time and cost while providing the lender with an additional tool for managing risk and addressing institution specific concerns.