

# A Sharper Focus: Exploring VC Side Letters

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A side letter in the venture capital sector is an agreement between an investor and the company it is investing in that entitles the investor to certain contractual rights, which supplement and are in addition to other rights specifically provided to the investor as a holder of equity securities under the company's governance documents – the documents negotiated and executed by the larger syndicate of investors as part of a venture capital financing transaction.

Side letters are further distinguishable from the company's governance documents in that side letters are often only signed by the company and the underlying investor receiving rights under the side letter. Side letters have been (and continue to be) commonly used in the venture capital financing context; originally, they were primarily intended to grant follow-on investors participating in a subsequent or additional closing (a closing that occurs within a certain timeframe following the initial closing to fully subscribe the round) certain rights without the company having to amend the existing governance documents – a potentially costly and time consuming process often called *reopening* the documents.

Given the ebbs and flows of the venture capital market over the last several years, Our firm has seen a proliferation in not only the frequency of side letters, but also in the scope of rights included in them. Delaware's recent technical scrutiny over governance rights in *West Palm Beach Firefighters' Pension v. Moelis & Co.*, and the subsequent amending of the Delaware General Corporation Law also serves as a springboard to explore the common and evolving use of venture capital side letters.<sup>[1]</sup> This article does not question the continued use of side letters or the role they play in venture capital financings, rather, it highlights the benefits of a sharper focus when reviewing and assessing the substantive provisions in side letters.

The side letters discussed in this article are specific to venture capital transactions in the emerging and growth equity financing context and are separate and distinct from side letters used by limited partners and general partners in the fund formation context. In the fund formation context, funds typically have governance documents granting the general partner broad latitude to execute side letters on behalf of the fund that are binding upon the fund and its limited partners. That framework facilitates fundraising and accepting capital over time on a rolling basis, a common practice in fund formation.

Venture-backed companies do not share the same governance structure. By way of example, a venture-backed company using standard National Venture Capital Association governance documents (e.g., Certificate of Incorporation, Investors' Rights Agreement, Voting Agreement, and Right of First Refusal and Co-Sale Agreement) does not, by the terms of those documents, have the explicit right to enter into side letters that may affect other investors, as such documents are generally silent on the use of side letters. Viewing a venture-backed

company through this lens, it is typically within the purview of a venture-backed company to grant rights via side letters that do not conflict with the underlying provisions of its governance documents and/or otherwise impact the rights, preferences or privileges of its equityholders. Of course, this is a general assumption, and careful consideration must be given to the proper approvals needed to grant such rights. For example, if a provision in a side letter either expressly or inherently conflicts with the company's governance documents, the side letter may be viewed as an amendment to a substantive governance document that would require formal approvals from the board of the company and a subset of its equityholders.

For brevity we generally place side letter rights into three categories: (i) rights that the company has already granted to existing investors which, absent specific circumstances, do not impact other investors (e.g., standard information and access rights and board observer rights); (ii) rights that the company has already granted to existing investors that could impact the other investors (e.g., "major investor" status, preemptive rights, carve-outs to drag-along provisions); and (iii) novel rights that no existing investors have been granted under the governance documents.

First, consider those rights the company has previously granted to existing investors that, absent specific circumstances, do not impact other investors. Aside from the additional administrative burden on the company, the granting of standard information and access rights to an investor where existing investors have received such rights does not generally prejudice other investors. However, consider the scenario where the existing investors negotiated for a threshold number of securities that an investor needs to hold in order to be granted access and information rights. Situations often arise where a company conducts an initial closing and then looks to bring in additional investors over a period of time following the initial closing to fully subscribe the round. An additional investor is identified and does its diligence, but is adamant that, in order to comply with its internal policies and monitor its investment, it requires information and access rights regardless of whether it satisfies the minimum ownership threshold negotiated by the existing investors. It is possible to envision a scenario where existing investors who participated in the initial closing that also fall below the minimum ownership threshold would also have wanted information and access rights, but were denied their request. So, when do the concessions end? At what point does the company reopen the governance documents and amend the provision relating to the minimum ownership threshold rather than grant the rights in a side letter? Similar considerations should be given to not just the legal implications, but also the ever-important investor relations side of the coin.

Next, consider rights that the company has already granted to existing investors that could impact other investors. Take for example, preemptive rights. Holders of preemptive rights are typically granted the ability to purchase their pro-rata amount of new securities that the company offers in future financings. If an investor's pro-rata amount is defined in the governance documents as the number of securities held by a specific investor divided by the number of securities held by a defined group of investors granted preemptive rights, the company granting preemptive rights to a new investor via a side letter – which increases the number of securities included in the denominator of the pro-rata calculation – effectively reduces the allocation of the existing investors and has the potential to alter their negotiated preemptive rights. Consider also, however, that absent contractual obligations to the contrary, a company is generally free to grant preemptive rights to the investors it desires. Attention must be given to these situations to avoid both future legal foot-faults and investor relations issues.

The last bucket is perhaps the most nuanced – granting novel rights via a side letter that no existing investors have been granted. For example, including a provision in a side letter that prohibits the company from using the

investor's name in press releases or other publications is likely not a material issue, but could the same be said about granting carve-outs to a drag-along provision that applies to all equityholders under the company's governance documents? A drag-along provision is a provision in an agreement requiring all equityholders who executed such agreement to contractually agree to sell their securities on terms and conditions approved by the company's board and/or a subsets of its equityholders. Assume an investor, via a side letter, negotiates certain carve-outs or conditions to the applicability of the drag-along against that individual investor while no other investors with the same class of security receives the benefit of such carve-outs or conditions. In those instances, in addition to investor relations considerations, both the company and the investor must consider whether the provisions in the side letter are enforceable, and the risks associated with them. If the parties are considering granting rights in a side letter that are substantive enough to be material to the company or potentially violate or contradict the governance documents, then the side letter may not be enforceable absent additional board and equityholder approvals to amend the applicable underlying governance document(s). Further, certain items that are requested in a side letter may be items that are required to be in an agreement signed by the company and its equityholders. Take for instance a provision in a side letter stating that certain restrictions on transfer set forth in the governance documents do not apply to the side letter investor. Could other investors claim that all restrictions on transfer (or exceptions) need to be set forth in the underlying governance documents among those investors? In such instances, the purpose of the side letter, namely, to save time and expense by avoiding the reopening of documents, is no longer served.

When viewing the entry into side letters through the company lens, it is important to holistically evaluate the full breadth of the impact of the rights granted through a side letter. It may not be enough to solely assess and measure the company's appetite for granting the rights to the individual investor via a side letter as there are instances, as detailed above, where a side letter is impactful enough that reopening the documents should be considered. Certainly, if the side letter expressly conflicts with the terms of the governance documents, then the side letter needs to be approved by the board and the requisite equityholders. If, after considering all impacts to its current and future governance documents and investors, a company decides that granting side letter rights is in its best interest, then it should make sure to integrate the letter into its governance framework. All side letters should be reviewed each time the primary governance documents are reviewed to ensure the company adheres to the rights and restrictions it granted in the side letter(s).

If we flip the coin and view the entry into side letters from an investor perspective, investors should consider including in the side letter a representation or statement from the company that the company's entry into the letter agreement and its obligations and duties thereunder have been duly authorized by all necessary action on the part of the company and do not conflict with or breach the company's obligations and other restrictions under its governance documents. We acknowledge that the inclusion of this representation or statement can be a sticky point of side letter negotiations; a true battle of expedience versus the importance of explicit enforceability. The inclusion of such a representation or statement is not always a "must have" for every investor, and the lack of such a representation or statement does not, on its own, eliminate the benefits of entering into the side letter. Rather, it means that as part of its overall investment thesis, the investor is aware the enforceability of certain provisions of the side letter could be called into question.

Whether you are an investor or a company, if you would like to learn more about the nuances and trends associated with drafting, negotiating and implementing side letters, the Troutman Pepper Locke team is here to help.

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[1] For further discussion and analysis see: [Delaware Court of Chancery Invalidates Common Governance Rights in Stockholder Agreement](#) and [“Market Practice” 2024 DGCL Amendments Become Effective](#).

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