# Side Letters in Venture Capital Financings: What Founders Need to Know

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When you are raising money, you may receive a request from an investor for a side letter or a management rights letter ("MRL"). The substance of this document may be driven by compliance requirements or a need for additional contractual rights outside of the main set of financing documents. The request may come from your lead investor at the term sheet stage, or it may arrive later from a participating investor who was not party to the initial term sheet negotiation. Before agreeing to a side letter, you should understand how these letters operate, how the rights included in the letter can affect your relationship with investors, their implications for future financing rounds, and what to consider before agreeing to them in a rush to close.

## What are Side Letters?

At their core, side letters are exactly what they sound like: short documents, often no more than a couple of pages, that lay out contractual rights that the requesting investor seeks for themselves only in connection with the currently contemplated financing and, in some cases, future financings. Critically, these rights exist outside the primary financing documents (the Stock Purchase Agreement, Investors' Rights Agreement, Voting Agreement, and Right of First Refusal & Co-Sale Agreement or, in a convertible financing, the SAFE or convertible note and purchase agreement) which has meaningful consequences for how those rights can later be amended or waived.

## Why Investors ask for them

The most common reason an investor requests a side letter is straightforward: regulatory compliance. Many institutional venture funds raise capital from pension plans (e.g. university endowments, public employee retirement systems, and similar entities) that are governed by the Employee Retirement Income Security Act of 1974 ("ERISA"). When a pension plan subject to ERISA invests in a VC fund, federal law can treat the underlying fund assets as assets of the pension plan itself. That designation triggers strict fiduciary obligations for the fund's partners with respect to every portfolio investment. To satisfy those obligations, ERISA-governed investors must secure certain contractual rights directly from each portfolio company, which is exactly where the side letter, and specifically the management rights letter, comes in.

In practice, an ERISA-compliant side letter will typically take the form of a management rights letter and will include the following rights:

- **Consultant Rights**: The right to consult with founders and management on major business matters. In practice, this rarely means the investor will be calling weekly; it establishes the legal basis for their fiduciary compliance.
- **Inspection Rights**: The right to examine the company's books and records at reasonable times

and intervals. Again, standard and largely administrative in day-to-day operation.

- **Board Information Rights:** If an investor is not on the Board, the MRL will typically entitle them to copies of all board meeting notices, minutes, and materials. This keeps the investor informed without requiring a formal board position.

If your investor is requesting an ERISA-driven side letter, treat it as routine. These requests are standard, well-understood across the industry, and largely non-negotiable if the fund needs to comply with ERISA.

Other side letters are not compliance-driven at all. Instead, they reflect an investor's desire to protect or enhance their commercial position within the company beyond what the primary financing documents provide. Such requests may include participation rights in future financings, information rights below the standard threshold, board observer seats, or, at the more aggressive end of the spectrum, standalone consent rights blocking the company from taking certain actions. Because the only parties to the side letter are the requesting investor and the company, the result is often that the investor receives a unilateral block on waiver or amendment of those rights, which is a protection they would not have enjoyed had the same rights been negotiated into the primary financing documents, where amendment thresholds are controlled by a broader group of investors.

Below are some of those rights most frequently requested:

- **Participation Rights:** The right to participate in a future financing that would otherwise be reserved only for major investors in the current round, sought by an investor who does not qualify as a major investor in the current financing.
- **Major Investor Status**: Getting the same rights as "major investors" in the current financing despite not investing enough capital to be considered a major investor under the current financing documents.
- **Management Consulting Rights**: The right to meet with company personnel to discuss the business plan, financial performance, and related matters, and to consult with and advise the management team.
- **Pro Rata Waiver Consent**: Requiring the company to seek the investor's permission before excluding, or cutting back, their allocation in a future financing round, which creates an awkward dynamic if the company does not intend to offer that investor an allocation.
- **Information Rights**: A commitment to deliver regular financial statements to the investor.
- **Exceptions to the Financing Documents:** Some investors may ask for rights that allow certain provisions of the financing documents to not apply to them, such as the right of first refusal in connection with a share transfer or drag-along provisions.
- **Strategic Investor Rights**: Often corporate VCs and other strategic investors frequently request rights tied to a potential sale of the company, ranging from notice upon receipt of a letter of intent to a full right of first refusal to match any third-party acquisition offer.

Side letters are also sometimes requested at a subsequent closing. Where a new investor is simply seeking parity with rights already granted to investors at the initial close, executing a side letter is often the more practical solution than amending the primary financing documents.

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

Take every side letter request seriously, regardless of check size. 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's 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, founders should weigh what each investor is bringing to the table (e.g. financial capital, operating experience, and industry relationships) against the rights being requested, and consider how those rights will appear to future investors and prospective acquirers.

Navigating side letter requests effectively requires experienced judgment on both the legal and commercial dimensions. The terms agreed to today can shape your relationships with investors, and your options at exit, for years to come. We are here to help you think through every request carefully and negotiate outcomes that protect the company's long-term interests.

For more information on side letters, please contact Dan Wilcox.