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The Private Funds Briefing: Navigating Sustainability Side Letter Clauses: Spotlight on U.S. State Plans

February 24, 2026

As sustainability expectations continue to evolve across the global investor landscape, managers are facing increasing pressure to navigate a growing array of jurisdiction-specific requirements.

This first instalment of *The Private Funds Briefing* **Ian Ferguson** and **Rachel Lowe** explore how sustainability clauses in side letters have become a defining feature of private fund negotiations, and why U.S. state plans illustrate a far more nuanced and complex set of expectations for managers to manage.

Navigating the Growing Demand for Sustainability Provisions in Side Letters

Sustainability provisions in side letters have become a persistent feature of private fund negotiations. Once largely associated with a subset of European institutional investors, they now arise across a broad range of global investors, driven by regulatory change, political polarisation and increasingly sophisticated allocator expectations.

For managers, the challenge is not simply that sustainability expectations vary by jurisdiction, but that they do so in nuanced ways on an investor-by-investor basis - intersecting with the manager's own sustainability positioning at the fund level, as well as any applicable firm-wide policies and commitments. Across investors, scrutiny of credibility, fund-level commitments and consistency with the investors' own sustainability stances has intensified, with these expectations increasingly operationalised through side letter provisions.

This article explores some of the key pressures shaping sustainability-related side letter negotiations, with a particular focus on U.S. state plans. Such investors effectively illustrate the complexity that managers face in practice, with requirements and approaches spanning a wide spectrum that do not always align with market assumptions. It also considers how tools such as Proskauer's **ProTrack: U.S. State ESG Investment Law** can assist managers in navigating divergent state-level expectations in the U.S.

U.S. State Plans: Nuance Behind the Headlines

U.S. state plans are often described in binary terms, divided between pro-sustainability and anti-sustainability states. In practice, side letter negotiations are far more nuanced, with investor expectations spanning a broad spectrum of expectations.

At one end of that spectrum, certain states have adopted highly restrictive positions that treat ESG considerations as non-pecuniary by definition. In those jurisdictions, side letters may require explicit certifications that the manager will only consider pecuniary factors in its investment decisions, with no exception for any consideration of ESG factors, and representations committing to the absence of certain institutional affiliations (such as UN PRI signatory status).

However, not all states with "pecuniary factors only" legislation operate in this way. Many allow greater flexibility where sustainability considerations are not the primary purpose of investment decision-making and are clearly linked to financial risk or return.

A further layer of complexity arises from anti-boycott legislation adopted in several states. Such laws are designed to prevent public funds from investing in entities perceived to be boycotting certain industries, most commonly fossil fuel-related activities or the firearms and ammunition sectors and can result in requirements for side letter representations regarding exclusion policies, and, in some cases, requirements to amend or disapply firm-wide policies.

Although often politically framed, the practical application of anti-sustainability U.S. state plans' side letter requirements is highly state-specific and more nuanced than headlines suggest. The position is also not static with continual introduction of new anti-ESG investment laws, meaning that managers cannot approach a fundraising expecting a "re-up" from a U.S. state plan to be on the same terms as a prior vintage.

At the other end of the spectrum, certain state plans adopt an explicitly pro-sustainability approach, treating climate risk, emissions and workforce practices as core fiduciary issues. These investors increasingly use side letters to require decarbonisation or transition plans, including ongoing data provision and timebound targets, with sustainability obligations operating steadily as allocation and retention tools rather than mere disclosure exercises.

Keeping Track of State-Level Expectations

Given the diversity of approaches across U.S. states, managers increasingly benefit from a structured way to anticipate and track investor positions. Proskauer's **ProTrack: U.S. State ESG Investment Law** provides state-by-state visibility on investment law requirements, pro-sustainability and anti-sustainability positions, and common side letter themes, helping managers move from reactive negotiations to more deliberate strategy-setting, thereby reducing friction in the fundraising and negotiation process.

Key Takeaways

Navigating sustainability clauses in side letters is no longer about choosing between "pro-ESG" and "anti-ESG" camps. It requires a manager to have a clear internal position, precision in their contractual language, and a realistic assessment of what can be delivered over the life of a fund. Managers who undertake a thorough analysis of their existing and anticipated investor base ahead of a fundraise are better positioned to anticipate sustainability expectations and reduce the risk of such issues impeding fundraising efforts.

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