April 24, 2022

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

**Re: File No. S7-03-22; Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews**

Dear Ms. Countryman,

We are law professors who study and teach topics related to the proposed rules regarding: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (the "Proposed Rules" or the "Release").

We thank the Commission for the opportunity to comment on the Release, which coincides with our recently completed academic paper (attached as Exhibit A) that directly addresses one of the key issues covered by the Proposed Rules: the practice of preferential treatment in private equity funds through side letters. Our comments therefore focus on the narrow effect of the Proposed Rules on the issue of preferential treatment of certain limited partners through side letters, and they are informed by our own experience as well as our recently completed paper. We would also like to stress that we were not compensated or commissioned in preparing this comment letter or in researching and writing the academic paper, and all opinions hereto are our own.

Our comments are straightforward: we urge the Commission to consider the data that we collected and present in Exhibit A in crafting and revising its proposed rules regarding side letters. We believe that the proposed rules pertaining to side letters are on balance beneficial, and the Commission's focus on appropriate disclosure is merited. That said, we believe that there are some misconceptions about side letters underlying the proposal, and, separately, that some of the real problems raised by side letters were not sufficiently acknowledged and addressed in the Release.

Our starting point is the firm belief that the practice of side letters in private funds is an important private market "tailoring" mechanism that should not be viewed as a problematic practice per se. Moreover, we believe that a light regulatory approach and minimal compliance burdens for private funds are a key feature of the industry, rather than a bug. However, we share some of the Commission's concerns regarding the lack of transparency surrounding side letters and the potential negative impact of certain side letter provisions on all limited partners.

While some commentary, including the Commission's own Release, has highlighted the potential economic impact of side letters, we find that side letters, overall, are far more benign than they have been portrayed to be. We found virtually no explicit fee discounts or other direct financial benefits in our sample of 252 side letters from over 30 years and covering a diverse group of 96 buyout funds. We are therefore skeptical that the key problem raised by side letters is the potential for undisclosed price discrimination among limited partners. In fact, we believe that the regulatory

and political pressure on private equity sponsors *not* to award different economics to different limited partners is partly responsible for the rise of co-investment and separate accounts as a less visible substitute for explicit price discrimination through fee discounts in side letters. Side letters very rarely contain such fee discounts, because sponsors have instead migrated to separate accounts and to (unwritten and non-binding) gentlemen's agreements regarding future co-investment opportunities for certain investors. Yet co-investment and separate accounts are highly inefficient, costly, and complex means of achieving the same result. We therefore urge the Commission not to seek to impose uniform economics on private fund investors, particularly when registered funds for retail investors such as mutual funds and ETFs routinely provide explicit fee discounts to larger investors.

We believe that side letters are problematic for a different reason than the preferential treatment of investors. Our key findings include that side letters have become unnecessarily long and complex, their negotiation and execution are costly, and their opacity and over-modularity are key culprits. The provisions in the Proposed Rules that are focused on obtaining better, more uniform fund and sponsor disclosure for investors and on moving side letter provisions that affect other investors back to the limited partnership agreement align relatively well with our findings.

Yet, the Proposed Rules are unlikely to reduce the significant costs and complexity that current side letters impose on private equity investors. The Proposed Rules may increase legal drafting that attempts to avoid or circumvent the Proposed Rules or to establish select investment options only for the largest of investors, potentially increasing costs to the same investors that the Proposed Rules aim to protect.

We urge the Commission to consider addressing the costs of side letters more systematically, not only by acknowledging the need for more transparency, but also by increasing the incentives for greater standardization of terms and for explicit price differentiation.

We thank the Commission for considering our comments.

Respectfully,

Yaron Nili
Associate Professor of Law
Smith-Rowe Faculty Fellow in Business Law
University of Wisconsin Law School

Elisabeth de Fontenay
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# Exhibit A

## Side Letter Governance

**Elisabeth de Fontenay[*] and Yaron Nili[**]**

ABSTRACT

*A standard feature of the private equity industry, "side letters" are confidential agreements between the sponsor and individual investors that give the latter special rights, beyond those that apply to other investors in the private equity fund. Yet side letters have become a flashpoint for prominent critics of the industry, who argue that they allow private equity sponsors to benefit their favored investors at the expense of smaller, less sophisticated ones. Others have argued that, to the contrary, side letters are merely an efficient means of price discrimination—charging different prices to different investors, according to their willingness to pay—a practice that is common and well accepted in other industries.*

*We find fault with both views. We provide the first empirical analysis of side letters, which disproves some of the most common claims about their content. Specifically, we code the terms of each side letter in a hand-collected sample from thirty years of buyout funds. Contrary to the conventional wisdom, we find that side letters very rarely grant fee discounts to investors or otherwise reallocate the fund economics among investors. Instead, side letters are mostly designed to accommodate a fund investor's regulatory and tax concerns. The view shared by both critics and proponents—that side letters are primarily used to treat investors differentially—is largely mistaken.*

*Side letters remain problematic, but for very different reasons than those raised by critics. We show that side letters have grown substantially in both length and complexity over time. They impose significant costs and delay on private equity capital-raising, and they potentially impinge on funds' operations and investments in unexpected ways. Over time, they have prompted an inefficient arms race among investors, leading to ever longer negotiations and more complex contractual networks for private equity funds, with little benefit for investors or sponsors. Using qualitative interviews with key participants in the industry, we explore the causes, including lawyer agency costs and other contracting frictions.*

*This Article makes three key contributions to the literature. First, using a first-of-its-kind, hand-collected and hand-coded dataset of side letters, it provides much-needed insight into one of the most guarded industries in the U.S. economy. Second, in contrast to the prevailing view in the contract modularity literature, the Article provides a cautionary tale regarding "over-modularity" and its costs. Finally, the Article offers several timely policy recommendations, arguing that, paradoxically, the current inefficient bargaining equilibrium is likely due to the relative lack of regulation of private equity funds. The industry would be better served with either regulation or coordinated industry action focused not on imposing uniform fund economics, but on ensuring more standardized documentation across investors and funds.*

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Table of Contents



*"Private fund advisers, through the funds they manage, touch so much of our economy. Thus, it's worth asking whether we can promote more efficiency, competition, and transparency in this field."*

-- *SEC Chair Gary Gensler (Feb. 9, 2022)*

*"It's the territory where everyone hates each other, but at least you've spent a shitload of money on legal fees so all the lawyers involved can go buy a new boat."*

-- Anonymous quote on the proliferation of side letters[1]

## Introduction

On a chilly November evening in 1988, the "barbarians" finally breached the gates of RJR Nabisco, the American manufacturing conglomerate. After a bitter struggle, the private equity investment group Kohlberg, Kravis, Roberts & Company (KKR) won

[1] Casey Sullivan, *Private-equity firms are locked in a power struggle with their investors, and lawyers are raking in cash no matter what*, BUS. INSIDER, (Sept. 20, 2021) https://www.businessinsider.com/private-equity-lawyers-investors-legal-war-2021-9.

a bidding war to complete a leveraged buyout of RJR Nabisco.[2] On November 30, 1988, after more than a month of heated bidding and multiple rounds of negotiations, KKR succeeded in buying out RJR Nabisco for a record price of $25 billion—the largest leveraged buyout ever at the time.[3] KKR completed this deal despite only investing $15 million of its own money,[4] using other investors' equity and significant debt as the key to finance the deal.[5]

Dubbed the *Barbarians at the Gate* by the iconic and best-selling book (and subsequent Hollywood movie), KKR's acquisition of RJR Nabisco marked the emergence of private equity funds as major players in the U.S. capital markets and in the governance of corporations. While news outlets focused on RJR Nabisco CEO F. Ross Johnson trying to fend off the "barbarians" who wanted to take away his private planes and lavish lifestyle, little attention was paid to the underlying investors in the KKR fund who funded the $1.5 billion in equity[6] for the transaction, or to the relationship between these investors[7] and KKR itself. The retirement funds of companies such as Coca-Cola, Georgia-Pacific, and United Technologies, the endowment funds of Harvard and MIT, as well as pension funds for state employees of Michigan, Iowa, and New York, all were key investors in the KKR fund that acquired RJR Nabisco,[8] but their investment and how it was managed remained in the shadows.

Private equity has since grown to represent a mammoth industry. Among the different private equity investment strategies, buyout funds alone hold over $2 trillion in assets under management worldwide.[9] Over time, buyout funds have become a key

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[2] Sarah Bartlett, *Is RJR Worth $25 Billion?* N.Y. TIMES, (Dec. 2, 1988), https://www.nytimes.com/1988/12/02/business/is-rjr-worth-25-billion.html.

[3] Andrew Beattie, *Corporate Kleptocracy at RJR Nabisco,* Investopedia, (Oct. 19, 2021), https://www.investopedia.com/articles/stocks/09/corporate-kleptocracy-rjr-nabisco.asp.

[4] Jerry Knight, *KKR Only Using $15 Million of its Own in Nabisco Buyout,* WASH. POST, (Dec. 2, 1988), https://www.washingtonpost.com/archive/politics/1988/12/02/kkr-using-only-15-million-of-its-own-in-nabisco-buyout/1e733dd9-9b4e-432e-85c6-5fc594668a0a/.

[5] Private equity funds are structured as limited partnerships, with fund principals serving as general partners and fund investors serving as limited partners. A private equity fund engaging in a leveraged buyout purchases the target company with a combination of equity and debt, the debt being secured by the assets of the target company. *Note on Leveraged Buyouts*, CTR. FOR PRIVATE EQUITY & ENTREPRENEURSHIP, DARTMOUTH, http://pages.stern.nyu.edu/~igiddy/LBO_Note.pdf.

[6] *See* Deborah A. DeMott, *Introduction-the Biggest Deal Ever,* 1989 DUKE L.J. 1 (1989).

[7] Private equity funds are typically structured as a limited partnership. The general partner is responsible for the general management of the fund, while the investors who contribute capital are the limited partners. *The Life Cycle of Private Equity*, BLACKSTONE (Aug. 2020), https://pws.blackstone.com/wp-content/uploads/sites/5/2020/09/the_life_cycle_of_private_equity_insights.pdf.

[8] Anise C. Wallace, *Several Giant Pension Funds Investing in Offer for Nabisco*, New York Times, (Oct. 31, 1988), https://www.nytimes.com/1988/10/31/business/several-giant-pension-funds-investing-in-offer-for-nabisco.html.

[9] McKinsey & Company, McKinsey Global Private Markets Review 2021 (Apr. 2021) at 10 (Exhibit 6).

financial player in the American economy, having acquired some of the most prominent U.S. corporations and prompted a revolution in the corporate debt markets. Yet, despite its large impact on Americans—its investors represent a large swath of the retirement savings of U.S. households—the private equity industry has been operating under a veil of secrecy, with the key agreements between the investors and the sponsors hidden from the public eye.

In a leveraged buyout, a private equity fund acquires a company using a high proportion of debt ("leverage"), then seeks to optimize the company's operations, governance and strategy before eventually exiting the investment through a sale or public offering.[10] Yet private equity buyout funds are distinct not only in their investment strategy—buying and selling whole companies—but also in the formation of the funds themselves. The sponsor[11] that sets up and manages the buyout fund enters into a long-term agreement with investors that governs the relationship among them.[12] This agreement, formally a limited partnership agreement (or LPA), typically bestows on all investors in the fund *the same rights and obligations*. Over time, however, this simple and uniform structure has become far more complex: sponsors routinely enter into separate agreements (or "side letters") with some or all of their investors, under which each investor in question is granted a tailored set of additional rights. Depending on the fund, the terms of any given side letter need not be disclosed to the other fund investors.

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[10] If the target company was a public company before the acquisition, the buyout is referred to as a "going-private" transaction.

[11] We refer to the general partner of the fund (GP) as the sponsor. The sponsor is typically run by one or more of private equity investment professionals who are responsible for forming and running the investment fund.

[12] *See Private Equity Funds: Key Business, Legal and Tax Issues*, DEBEVOISE & PLIMPTON LLP, (2015), https://www.debevoise.com/~/media/files/insights/news/2015/pe_fundskey%20business_legal_tax_issues.pdf.

This feature of the private equity industry has finally come under the spotlight and provoked greater regulatory interest,[13] public attention,[14] and investor concern,[15] culminating in a new and sweeping regulatory intervention. On February 9, 2022, the Securities and Exchange Commission (SEC) voted to propose new rules that, among other changes, specifically address side letters for private investment funds such as buyout funds.[16] The SEC's proposed rules have already triggered what is likely to be a very long battle with fund sponsors and their counsel.[17] Thus far, however, neither side has mustered data to support its preferred policy approach.

Broadly speaking, side letters have elicited two opposing views among policy-makers and academics. The first views them as nakedly exploitative: by enabling sponsors to grant special (and secret) rights to favored investors, side letters put smaller, less sophisticated investors at an economic and informational disadvantage.[18] In this view, the fact that investors in the same fund may be treated very differently is inherently

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[13] Gary Gensler, Chief, Sec. Exchn. Comm'n, Prepared Remarks At the Institutional Limited Partners Association Summit (Nov. 10, 2021); *U.S. Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Economic Policy, Remarks from U.S. Senator Elizabeth Warren*, (Oct. 20, 2021) https://www.warren.senate.gov/newsroom/press-releases/at-hearing-warren-pushes-for-reforming-the-broken-private-equity-industry-and-putting-an-end-to-their-destructive-practices; *see also* Securities and Exchange Commission, *Risk Alert: Observations from Examinations of Private Equity Fund Advisers*, January 27, 2022 (highlighting that "[f]ailing to act consistently with material disclosures to clients or investors" is a leading deficiency among sponsors, according to the SEC's Division of Examinations).

[14] Securities and Exchange Commission, *Risk Alert: Observations from Examinations of Private equity Fund Advisers*, January 27, 2022 ("In the past five years alone, [the SEC's Division of Examinations has] observed substantial growth in reported private fund assets, which have increased by 70% in that period. . . . The size and complexity of advisers vary widely from, for example, an adviser with a private fund limited to investors made up of family and friends, to an adviser with a worldwide footprint managing multiple private funds with hundreds of billions of dollars in assets.").

[15] Letter from Steve Nelson, Chief Exec. Officer, Inst. Limited Partners Ass'n., to Gary Gensler, Chair, SEC (Oct. 26, 2021), https://ilpa.org/wp-content/uploads/2021/10/26.10.21_ILPA-Member-Letter-to-SEC-on-Fee-Transparency.pdf.

[16] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Review (proposed Feb. 9, 2022) (to be codified at 17 C.F.R. pt. 275); Gary Gensler, *Statement on Private Fund Advisers Proposal,* (Feb. 9, 2022).

[17] *See* Blass et. al, *Regulatory and Enforcement Alert: "Transparency Is Not Enough"—SEC Continues Steady March Towards More Intrusive Regulation of Private Funds*, SIMPSON THACHER & BARTLETT LLP (Feb. 9, 2022) https://www.stblaw.com/docs/default-source/publications/regulatoryenforcementalert_02_09_22.pdf (critiquing the SEC's new rules for private investment funds, from one of the top two U.S. counsel for private equity sponsors).

[18] *See* William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1872 (2018) (noting that side letters allow private equity funds to "treat investors differentially," for example by charging lower fees to their favored investors or by granting them a veto right over investments), 36 (stating that, through the use of side letters, "preferential treatment is often given to repeat investors or large institutional clients") and 37 ("Side letters and other arrangements for differential treatment of investors thus raise the distinct possibility that fund assets will be diverted to preferred investors at the expense of non-preferred investors.").

unjust.[19] Senator Elizabeth Warren (D-Mass.) and others have at times called for a flat prohibition on side letters for this very reason.[20] The most recent SEC rule proposal explicitly reflects this view, arguing that side letter terms "can have a material, negative effect on other investors."[21]

The second view argues that side letters—together with other tailored arrangements between private equity sponsors and specific investors, such as co-investments—are simply a form of price discrimination.[22] According to standard economic analysis, under some conditions a sponsor will raise the most capital and achieve the most efficient collective outcome by classifying investors according to their willingness to invest in the sponsor's fund and charging each group a different "price" (in this case, the compensation or "fees" payable to the sponsor for managing the fund).[23] Rather than nefarious collusion between sponsors and the most sophisticated investors, side letters are, according to proponents, simply a rational and efficient response to the fact that private equity investors differ in their "willingness-to-pay." In this regard, private equity would be no different than the airline and pharmaceutical industries, for example, in which different categories of consumers are routinely charged different prices.[24] SEC Commissioner Peirce espoused this view in her opposition to the

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[19] *See* Gary Gensler, *Prepared Remarks At the Institutional Limited Partners Association Summit* (Nov. 10, 2021) ("Each limited partner may be negotiating its own deal. Sometimes, they get their own deal through the use of what's called side letters").

[20] *See* The Stop Wall Street Looting Act of 2019, Sec. 502(c) ("The general partner of a private fund may not provide any term or benefit to any limited partner of the fund unless the general partner provides that term or benefit to all limited partners of the fund."), available at https://www.warren.senate.gov/imo/media/doc/2019.7.17%20Stop%20Wall%20Street%20Looting%20Act%20Text.pdf; "One-Pager" for The Stop Wall Street Looting Act of 2019 (seeking to "end secret side deals that privilege some investors over others"), *available at* https://www.warren.senate.gov/imo/media/doc/2019.7.17%20Stop%20Wall%20Street%20Looting%20Act%20One%20Pager.pdf. The Stop Wall Street Looting Act of 2019. *See also* Magnuson, *supra* note 18 at 52 (advocating for a requirement that private equity firms "grant equal treatment to all investors"); *see also* Gensler, *supra* note 19 ("I have asked staff to consider…whether certain side letter provisions should not be permitted").

[21] Private Fund Advisors; Documentation of Registered Investment Adviser Compliance Reviews, SEC; Exchange Act Release Nos. IA-5955; File No. S7-03-22 (proposed Feb. 9, 2022) (to be codified at 17 C.F.R. pt. 275) Hereinafter [Proposed Rules].

[22] *See* Commissioner Hester Peirce, *Statement on Proposed Private Fund Advisers; Documentation of Investment Advisor Compliance Reviews Rulemaking*, SEC (Feb. 9, 2022) https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922?utm_medium=email&utm_source=govdelivery.

[23] *See* William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. 249 (2017). Note that Professor Clayton's article does not touch on side letters specifically or on fee discounts for certain investors. Rather, it describes price discrimination in private equity funds through two specific channels: coinvestment and separately managed accounts. *See infra* note 125.

[24] *See* Joanna Stavins, *Price Discrimination in the Airline Market: The Effect of Market Concentration*, 83 REV. ECON. & STAT. 200 (2001); Patricia M. Danzon, *Price Discrimination for Pharmaceuticals: Welfare Effects in the US and the EU*, 4 International Journal of the Economics of Business 301 (1997).

SEC's recent rulemaking proposal, stating that "these well-heeled, well-represented investors are able to fend for themselves."[25]

Yet, both views have lacked empirical support for their respective claims. This is because buyout fund agreements are not publicly disclosed and are subject to strict confidentiality requirements,[26] such that only sponsors, select investors, and their respective advisors have access to them. As a result, we are unaware of any large-scale empirical analysis of side letter terms. This Article fills that gap, assembling for the first time a unique sample of 96 limited partnership agreements and 252 side letters from a range of buyout funds, spanning thirty years.[27]

Not only is the data that we have compiled descriptively novel, it also leads us to reject both prominent views of side letters. Before making normative claims about side letters, it is imperative to first accurately describe their content. We hand-coded the material terms of each side letter in the sample, identifying more than eighty substantively distinct side letter provisions. Our dataset paints a far different picture of side letters than do the two competing views described above. We find that side letters very rarely contain true "price" terms (such as fee discounts), and that even terms that could potentially affect the economics of an investor's stake in the fund *indirectly* are relatively rare compared to other categories of side letter provisions. Instead, most side letter provisions simply seek to accommodate the investor's regulatory and tax characteristics. The claim of both critics and proponents that side letters serve primarily to award different economics to different investors is mistaken. The true financial impact of side letter arrangements appears marginal, at best.

Although side letters have considerably less economic importance than either view would suggest, it does not follow that they are harmless. Given how little side letters actually achieve, we argue that the costs of negotiating and complying with them outweigh their collective benefits to investors and sponsors. Moreover, they point to longstanding failures of private equity sponsors to provide basic, uniform disclosure to their own investors.

Indeed, we find that side letters have grown substantially in length and complexity over time. As one example, the "most favored nation" provision—under which one investor may request the benefit of *other* investors' side letter provisions—has given rise to a morass of exceptions and qualifications that only a lawyer could admire.[28]

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[25] Commissioner Hester Peirce, *Statement on Proposed Private Fund Advisers; Documentation of Investment Advisor Compliance Reviews Rulemaking,* SEC (Feb. 9, 2022) https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922?utm_medium=email&utm_source=govdelivery.

[26] *See* Magnuson, *supra* note 18 at 33-34 (describing the operation of confidentiality provisions in limited partnership agreements for private equity funds).

[27] We are aware of an excellent working paper on side letters for impact investment funds. *See* Jessica S. Jeffers & Anne M. Tucker, *Shadow Contracts* (working paper, 2022). Similarly to this Article, the working paper offers select descriptive data on a sample of side letters.

[28] *See* James M. Schell et al., PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS (2018) at § 11.14 (defining the "most favored nation" provision).

Side letters are therefore costly to the industry. Not only do they burden the fund-raising process for buyout funds with ever-increasing delays and legal fees, they also create a highly complex web of contractual arrangements for a fund to comply with, which can restrict the fund's operations and investments in a variety of unexpected ways—an outcome that harms both sponsors and investors. The more investors in the fund, the more one-to-one negotiations between the sponsor and individual investors will weigh on both fund-raising and execution for the private equity industry.

If side letters are both costly and of limited economic importance, why do they exist? Why has the side letter process ballooned in scale and scope, despite widespread dissatisfaction from both sponsors and investors?

The culprit, we find, is a combination of investor collective action problems, sponsor and lawyer agency costs, and other contracting frictions. First, side letters create a prisoner's dilemma for fund investors. Investors *collectively* would be best served by not negotiating them at all. Yet, each individual investor has an incentive to defect from this arrangement: as soon as one investor obtains a side letter from the sponsor, others should seek to obtain one as well. Second, on the sponsor side, there is a widespread belief that limited partnership agreement terms are "sticky" over time. Whether accurate or not, this belief drives sponsors to include the most sponsor-favorable terms possible in the limited partnership agreement, while relegating investor-favorable terms to side letters. Third, lawyers have played a major role in the burgeoning of side letters. The small set of elite law firms that represent large sponsors view their respective limited partnership agreement templates as proprietary: they maintain their "brand" by not permitting any investor-friendly modifications to the limited partnership agreement and by insisting that all documentation in the industry remain confidential. On the investor side, counsel has failed to settle on standardized language for common side letter provisions, because they have little economic incentive to coordinate and to reduce their billings.

Our findings also have important theoretical implications for the emerging academic discourse on contract modularity.[29] While recent scholarship has justly highlighted the benefits of modulatory in the contractual design of complex deals,[30] little has been written on the potential downside of contract modularity.[31] Our findings shed light on one cost of modular design—the potential for over-modularity. In the multi-party, opaque structure of private equity fund formation, modular design may lead to

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[29] *See infra* Part I.C.3 and III.E.

[30] *See* Cathy Hwang, *Unbundled Bargains: Multi-Agreement Dealmaking in Complex Mergers and Acquisitions*, 164 Pa. L. Rev. 1403 (2016); George G. Triantis, *Improving Contract Quality: Modularity, Technology, and Innovation in Contract Design* (Stanford J. L. Bus., Fin., Working Paper No. 450, 2013); Henry E. Smith, *Modularity in Contracts: Boilerplate and Information Flow*, 104 Mich. L. Rev. 1175, 1196 (2006) [hereinafter *Modularity in Contracts*]; Cathy Hwang & Matthew Jennejohn, *The New Research on Contractual Complexity*, 14 Cap. Mkts. L.J. 381, 389 (2019).

[31] We are aware of one recent article focused on interpretive issues with modular structures. *See* Tal Kastner, *Systemic Risk of Contract*, 47 BYU L.R 451 (2021) (criticizing the interpretive stability of modularity).

excessive negotiation and costs and inefficiently push contractual provisions from the main agreement to side letters.

Given these findings, we offer several prescriptions for reforming side letter practice, with the aims of reducing complexity and returning more of investors' desired terms from side letters to the limited partnership agreement.

To reduce the complexity of side letters, we recommend: (1) standardizing the provisions designed to address investors' regulatory and tax concerns, because these risks are functionally identical for all investors of a given type; (2) encouraging, rather than discouraging, sponsors to make any price discrimination among investors explicit in the limited partnership agreement itself, as this would lessen the incentives to discriminate among investors indirectly (and inefficiently) in side letters or through unwritten "gentlemen's agreements" regarding co-investment; and (3) making sponsors bear their share of the legal cost of side letter negotiations.

To ease the side letter arms race among investors, we recommend: (1) requiring side letters to be disclosed to all investors in the fund; (2) moving to the limited partnership agreement (a) all side letter provisions that could negatively affect other investors in the fund and (b) all side letter provisions promising additional reporting or other disclosures by the fund or the sponsor. Indeed, our empirical review of side letter provisions across a large sample of funds reveals no compelling justification for keeping such provisions confidential among investors, whereas disclosing them could dampen investors' enthusiasm for individualized side letters and facilitate greater coordination among investors in negotiating against sponsors.

Finally, we discuss how investors, sponsors and regulators might best implement these recommendations and whether regulation or private ordering is better suited to the task. We also highlight how the private equity industry's deference to path-dependent outcomes, its insistence on secrecy for all documentation, and its failure to simplify and standardize documentation have thrown open the door to the type of regulation that it has always claimed neither to need nor to want.[32] At the same time, the SEC's recent proposed regulations fail to address some of the real concerns that side letters present.

The Article proceeds as follows. Part I provides background on the private equity buyout industry and the rise of side letters. Part II describes our sample of limited partnership agreements and side letters and provides descriptive data. Part III deploys these empirical findings to debunk prominent claims about side letters in the literature, reveals the true problems created by side letters, and discusses their various causes. Part IV then offers a prescription for the future of side letters.

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[32] *See* Madeline Shi & Ryan Prete, *Private equity and hedge funds pan SEC's push for more data disclosure*, PITCHBOOK DAILY PITCH (Jan. 28, 2022) (noting the immediate negative response of the private equity industry to the SEC's attempts to require greater disclosure by private equity funds).

# I. Private Equity and the Rise of Side Letters

## *A. A Brief Primer on Private Equity Funds and Leveraged Buyouts*

It is no exaggeration to say that over its roughly forty-year history, private equity has revolutionized both corporate finance and corporate governance.[33] When it first arose in the 1980s, the private equity buyout represented an entirely novel approach to owning, managing, and financing companies, and its effects on both corporate behavior and the financial markets have been profound.[34] Today, private equity is one of the major global asset classes, and it has attracted a truly staggering amount of capital[35] over a relatively short period of time. It has been the driver behind major changes to and innovations in financial contracting.[36] Staffed with some of the most sophisticated financiers in the world and advised by the most elite law firms,[37] private equity sponsors innovate at a furious pace in their mergers and acquisitions (M&A), financing, fund formation and other contracts, and are relentless in advancing their interests in the financial markets.[38] Understanding how private equity funds themselves are structured and incentivized is therefore crucial for understanding how private equity behaves and affects global finance.

But what exactly is private equity? As originally conceived, private equity involves investors pooling their money to buy and sell whole companies, using a large share of debt to finance the acquisitions.[39] Thus, private equity comprises both (i) a particular channel for investing (pooling money into an *investment fund*) and (ii) a particular investment strategy (the *leveraged buyout*—that is, acquiring companies using debt). This Section describes each of these features, as background for the role played by side letters in private equity today.

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[33] *See* Tim Jenkinson, Hyeik Kim & Michael S. Weisbach, *Buyouts: A Primer* 1 (Working Paper, 2021).

[34] *Id.* at 1–2.

[35] *Id.* at 85 ("In recent years, private funds have raised commitments of about $1 trillion annually from institutional investors, and currently have more than $2 trillion in 'dry powder' that could be invested at the discretion of the funds' [sponsors].")

[36] In particular, private equity played a crucial role in the development of "junk" bonds, leveraged loans, and the securitization of loans through collateralized loan obligations (CLOs). *See* Greg Brown, Bob Harris & Shawn Murray, *Capital Structure and Leverage in Private Equity Buyouts*, 33 J. APPLIED CORP. FIN. 42, 44-45 (2021). For a description of the leveraged loan market, see Sung Eun Kim, *Managing Regulatory Blindspots*, 32 YALE J. REG. 89 (2015).

[37] The law firms Kirkland & Ellis LLP and Simpson Thacher & Bartlett LLP are the leaders among all U.S. law firms in private equity fund representation. *See Private Equity Fund Restructuring*, LEADERS LEAGUE (2022) https://www.leadersleague.com/en/rankings/private-equity-fund-structuring-ranking-2022-law-firm-united-states; Sullivan, *supra* note 1.

[38] See *Buyouts supra* note 32.

[39] *See* Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121 (2009).

### 1. Private Investment Funds

Most investors may choose between holding shares in companies (1) directly (simply by purchasing shares) or (2) indirectly through an *investment fund*. In the latter case, unrelated investors pool their money in a fund, which in turn purchases and holds shares (or other securities) of other companies.[40] The fund itself is typically formed as a separate legal entity, but one that serves no other role than to hold the securities of other companies. As such, it typically has no other assets than cash and securities, conducts no other business, and has no employees.[41] Because an investment fund is simply a pool of capital, someone must make decisions on its behalf, such as selecting which investments the fund should acquire and deciding how and when to liquidate them. Fulfilling that task is the role of the *investment manager*—the group of individual investment professionals (typically organized into one or more separate entities) to whom the fund investors have given the authority to make all major decisions on behalf of the fund and to execute them.[42] In short, investors simply contribute capital to the fund, and the investment manager decides how that capital will be deployed. (In the case of private equity funds, we will hereafter refer to the investment manager as the "sponsor" of the fund.)

Private equity funds are a particular type of *private* investment fund. Such funds are regulated and behave very differently from *public* (or "registered") investment funds, such as mutual funds and exchange-traded funds (ETFs).[43] The public/private distinction among investment funds is a creation of the federal securities laws and has persisted for more than eighty years.[44] Investment funds that are open to retail investors are subject to an onerous regime of regulatory requirements, touching on everything from extensive mandatory disclosure to specific restrictions on (i) the fund's investments, (ii) the investment manager's compensation, and (iii) the fund's governance.[45] By

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[40] *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228 (2014).

[41] *Id.* at 1239.

[42] *See id.*

[43] *Exchange Traded Funds*, FINRA, https://www.finra.org/investors/learn-to-invest/types-investments/investment-funds/exchange-traded-fund); *Mutual Funds*, U.S. SEC. EXCHN. COMM'N., https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-1.

[44] *See* Elisabeth de Fontenay and Gabriel Rauterberg, *The New Public/Private Equilibrium and the Regulation of Public Companies*, 2021 COLUM. BUS. L. REV. 101 (2022).

[45] Among other things, the ICA requires public funds (1) to constrain leverage, (2) avoid incentive compensation, and (3) provide frequent redemptions. On the first point, the ICA only permits open-end mutual funds to become indebted to banks, 15 U.S.C. § 80a-18(f)(1)); prohibits issuing debt securities, id. 80a-18(a)); and requires that total assets must always equal or exceed bank loan principal by a ratio of 3 to 1, id. 80a-18(f)(1)). On the second point, Provisions of the Investment Advisers Act ("IAA") only permit adviser performance fees if the fee is symmetric with poor performance punished to the same extent good performance is rewarded, and performance is based on a benchmark. Investment Advisers Act of 1940, 15 U.S.C. § 80b-5(b)(2) (2018). The ICA prohibits mutual funds from issuing shares for services.

contrast to these registered funds, private investment funds escape virtually all regulations under the securities laws.[46] The economic arrangement among the investors and the investment adviser, the types of investments made by the fund, the disclosure provided to investors, the rights and obligations of both the investors and the investment manager, and fund governance are largely unconstrained by the federal securities laws and must be worked out among the parties themselves through contract.[47]

For this reason, the contractual relationship among the investors, the fund itself, and the investment manager takes on extraordinary importance. It is typically captured in a single contract, referred to throughout this Article as the fund's limited partnership agreement. (This is because large U.S.-based private equity funds are most often formed as Delaware limited partnerships,[48] in which the investment manager is the "general partner" and each investor is a "limited partner.")[49] A highly complex and lengthy document, the limited partnership agreement governs the parties' relationship over the entire life of the fund—typically a minimum of ten years.[50]

Most often, private investment funds escape the burdensome regulatory treatment reserved for registered investment funds by not admitting retail investors.[51] Private equity funds, for example, rely on regulatory exemptions that prevent them from admitting any investors other than high-net-worth individuals or, more commonly, large institutional investors.[52] For this reason, the typical investors in private investment funds

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Investment Company Act, 15 U.S.C. §80a-22(g). Finally, on the third point, see Sections 2(a)(32) (defining redeemable security as a security whose holder, upon presenting it to the issuer, is entitled its proportionate share of net assets) and 22(e) of the Investment Company Act (constraining the suspension of registration rights). Investment Company Act §§ 80a-2(a)(32), 22(e).

[46] While a private investment fund is not subject to the registration and other requirements under the federal securities laws, the *investment manager* of a private investment fund may be required to register under the Investment Advisers Act of 1940. In particular, investment managers of all but the smallest private equity funds are required to register with the SEC. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. IV, 124 Stat. 1376, 1570 (2010). *See also* Debevoise & Plimpton LLP, *supra* note 12, at 86 ("Most U.S. Managers (and their related General Partners) of Funds are now required to register with the SEC under the Advisers Act").

[47] *See* Clayton *supra* note 23. Yaron Nili, *The Rise of Private Equity Buyout Funds: A Corporate Governance Analysis*. Diss. Harvard Law School, 2008.

[48] *See* Debevoise & Plimpton, *supra* note 12, at 5, 8.

[49] In the case of funds organized as limited liability companies, the contract governing the relationship among the investors, the fund, and the investment manager is referred to as the fund's "LLC agreement" or "operating agreement." *See id.* at 6-7. The difference is, for the most part, simply a matter of nomenclature.

[50] *See* Debevoise & Plimpton LLP, *supra* note 12, at 39 (discussing the typical term of private equity funds).

[51] *See Private Equity Funds*, U.S. SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/investment-products/private-investment-funds/private-equity

[52] The Investment Company Act of 1940 exempts from public registration those funds whose investors are all "qualified purchasers" or funds with no more than 100 investors. Investment Company Act § 80a-3(c)(1)–(c)(7).

are institutional investors such as government pension funds,[53] sovereign wealth funds,[54] university endowments,[55] charitable foundations,[56] family offices,[57] and "funds-of-funds,"[58] among others.[59]

### 2. Private Equity Funds and Leveraged Buyouts

Because private investment funds are not limited in their investments by regulation, they cover a panoply of different investment strategies. Each broad category of private investment fund—such as hedge funds,[60] private equity funds, venture capital

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[53] George W. Fenn, Nellie Liang & Stephen Prowse, *The Private Equity Market: An Overview*, FIN. MARKETS, INSTITUTIONS & INSTRUMENTS, November 1997, at 1, 8-9; *see also* William W. Clayton, *How Public Pension Plans Have Shaped Private Equity*, MARYLAND L. REV., forthcoming (2022) (discussing how public pensions became private equity's largest investor). A government pension fund is a retirement plan where, over the course of their careers, government workers and their employers contribute money into a pool of funds which is then invested and paid out to the retired employee each month. *Pension Fund*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/other/pension-fund/ (last visited Feb. 10, 2022); Roberta Romano, *Public pension fund activism in corporate governance reconsidered*, 93 COLUM. L. REV. 795 (1993).

[54] John Legrand, *Sovereign Wealth Funds Turning To Private Capital: Are They Competing or Playing Alongside GPs?*, IQEQ, (June 30, 2021), https://iqeq.com/insights/sovereign-wealth-funds-turning-private-capital-are-they-competing-or-playing-alongside-gps. "A sovereign wealth fund is a state-owned investment fund comprised of money generated by the government, often derived from a country's surplus reserves." Eric Estevez, *Sovereign Wealth Fund (SWF)*, INVESTOPEDIA (Nov. 25, 2020), https://www.investopedia.com/terms/s/sovereign_wealth_fund.asp.

[55] University endowments manage and invest assets that are donated to academic institutions. For a review *see e.g.,* Josh Lerner et al., *Secrets of the Academy: The Drivers of University Endowment Success*, 22 J. ECON. PERSP. 207 (2008).

[56] These include both public charities and private foundations, in either case the investment and the profits are for charitable purposes.

[57] Family offices are private wealth management advisory firms that serve ultra-high-net-worth individuals.

[58] Funds of funds pool investments from various investors and then invest it in several different private equity funds, serving as an intermediate level between the PE fund and investors.

[59] *See* DEBEVOISE *supra* note 12, at 57-65.

[60] A hedge fund is an actively managed investment pool that issues securities to a limited number of wealthy individuals or institutional investors. Morley, *supra* note 39, at 1235. Hedge funds are flexible investment vehicles and generally permit redemptions on a monthly or quarterly basis. *Id. See generally* René M. Stulz, *Hedge Funds: Past, Present, and Future*, 21 J. ECON. PERSP. 175 (2007).

funds,[61] private credit funds,[62] private real estate funds,[63] and private infrastructure funds[64]—is thus characterized by one or more different investment strategies. Venture capital funds, for example, typically make minority equity investments in early-stage, high-growth companies.[65]

While private equity funds have broadened their investment strategies over time, particularly in the last decade, their original and characteristic investment strategy is the leveraged buyout.[66] In a leveraged buyout ("LBO" or, simply, "buyout"), a private equity fund acquires a controlling equity stake in a company, using a significant portion of debt (or "leverage") to finance the acquisition.[67] The target of a leveraged buyout may be either a public or a private company pre-acquisition, but once the acquisition is complete, the company is controlled by the private equity fund (and therefore, indirectly, by the sponsor of the private equity fund) and is usually held as a private company.[68] A private equity fund will typically acquire, hold, and sell several portfolio companies over its lifespan, though not a sufficient number to be considered a diversified fund.

The goal of private equity, like that of all investments, is to earn a positive risk-adjusted return on investors' capital. The most obvious path for doing so is for the fund to sell its portfolio companies at a gain. (This can occur for one of several reasons, including that the private equity fund has increased the company's value by improving its revenues or lowering its costs, or simply because general economic conditions have

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[61] Venture capital funds make debt and equity investments in high-growth opportunities in early-stage firms. Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1461 (1995). A venture capital fund typically lasts seven to ten years. Bob Zider, *How Venture Capital Works*, HARV. BUS. REV. (Nov-Dec 1998), at 131, 135.

[62] A private credit fund is similar to a private equity fund but invests in debt, rather than equity. Private credit funds typically invest in illiquid, higher-yielding debt investments. Shawn Munday, Wendy Hu, Tobias True & Jian Zhang, *Performance of Private Credit Funds: A First Look*, J. ALTERNATIVE INVESTMENTS, Fall 2018, at 31.

[63] A private real estate fund is an actively managed fund that invests in real estate. Kieran Farrelly & Simon Stevenson, *Performance Drivers of Private Real Estate Funds*, 33 J. PROP. RESCH., 214 (2016).

[64] Private infrastructure funds invest in infrastructure assets, such as companies in transportation, energy, and communications. *See* Aleksandar Andonov, Roman Kräussl & Joshua Rauh, *Institutional Investors and Infrastructure Investing*, 34 REV. FIN. STUDIES 3880, 3886-39 (2019).

[65] *See* Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1461 (1995).

[66] *See* Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121, 124-25, 128-29 (2009).

[67] *See id.*

[68] In a leveraged buyout, the private equity fund itself provides the equity financing for the acquisition. (If the target company is a corporation, for example, the fund will get stock in the company in exchange for the capital that it contributes toward the acquisition.) The debt financing, however, is typically provided by some combination of banks and institutional investors (directly or through funds or securitization vehicles) and may take the form of senior secured loans, high-yield bonds, mezzanine debt, and more.

improved over the holding period.)[69] As long as a portfolio company is sold at a gain, the use of leverage will further amplify the returns to the buyout fund.[70] This explains why private equity funds finance their acquisitions with a heavy proportion of debt.[71]

### 3. How the Buyout Strategy Translates to the Investment Contract

Understanding how private equity funds are formed and how they invest is crucial, because both aspects shape the contractual relationship among the investors, the fund, and the private equity sponsor. By contrast to investments such as public-company stocks, private equity investments—that is, controlling stakes in companies—are highly *illiquid*, meaning that they require significant time and transaction costs both to acquire and to sell.[72] When a buyout fund sells one of its portfolio companies, for example, the process may last longer than a year, disrupt the company's business and distract management, and generate eye-opening investment banking and legal fees.[73] Due to this illiquidity, private equity funds cannot permit investors to take their capital out of the fund at any time, unlike mutual funds or ETFs, which are required by law to invest in highly liquid assets.[74] Instead, private equity funds are typically created with a limited lifespan of ten years (or more), and investors' capital is locked in to the fund for that entire period.[75]

As discussed in Part I.A.1, because buyout funds are private investment funds, they are largely unconstrained by the federal securities laws as to their investment strategy, financing, and governance, leaving all fundamental terms of the arrangement among the sponsor and the investors to be worked out through contract.[76] Yet buyout

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[69] *See* Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121 (2009) (reviewing the various channels by which private equity funds can increase portfolio company value).

[70] *See* Edie Hotchkiss, David C. Smith & Per Strömberg, *Private Equity and the Resolution of Financial Distress*, 10 REV. CORP. FIN. STUD. 694 (2021).

[71] *See* Ulf Axelson, Tim Jenkinson, Per Strömberg, & Michael S. Weisbach, *Borrow Cheap, Buy High? The Determinants of Leverage and Pricing in Buyouts*, 68 J. FIN. 2223, 2239 (2013) (documenting that leveraged buyouts tend to be funded with 70% debt and only 30% equity); Ulf Axelson, Per Strömberg, & Michael S. Weisbach, *Why Are Buyouts Levered? The Financial Structure of Private Equity Funds*, 64 J. FIN. 1549 (2009).

[72] *See* Josh Lerner & Antoinette Schoar, *The Illiquidity Puzzle: Theory and Evidence from Private Equity*, 72 J. FIN. ECON. 3 (2004); Ann-Kristin Achleitner & Christoph Kaserer, *Private Equity Funds and Hedge Funds: A Primer* 9, 11 (Ctr. For Entrepreneurial & Fin. Studs., Working Paper 2005-03, 2005).

[73] Valentino Vasi, *Easy Money—Private Equity Firms Collecting Transaction Fees*, CARTER LEDYARD (Mar. 19, 2018), https://www.clm.com/easy-money-private-equity-firms-collecting-transaction-fees/

[74] *Investment Company Liquidity Risk Management Program Rules*, SEC (May 1, 2019), https://www.sec.gov/divisions/investment/guidance/secg-liquidity.htm

[75] More precisely, there is no right for investors to redeem their investment in the fund. In recent years, the trend has been toward allowing investors to sell their interest in the fund to another investor if they are able to find a buyer, but such "secondary" transfers remain limited and cannot be guaranteed, in the absence of a continuous market price.

[76] *See Private Equity Funds*, U.S. SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/investment-products/private-investment-funds/private-equity.

funds face few constraints under state law either. A private equity fund that is a Delaware limited partnership, for example, is subject to both Delaware's statutory provisions for limited partnerships and to the Delaware common law of limited partnerships. However, the primary feature of this law is to grant parties the right to set the terms of their own relationship by agreement among the parties.[77]

Taken together, these fundamental features of buyout funds render the contract among investors, the fund, and the sponsor of paramount importance. Given that (1) private equity investments are highly illiquid and difficult to value, (2) investors' capital is therefore locked up for at least a decade, and (3) the terms of private equity funds are almost entirely governed by contract (rather than securities regulation or state organizational law), the fund's limited partnership agreement bears the heavy burden of establishing all of the economics and governance of the fund from scratch, in addition to setting the boundaries to the sponsor's investment discretion. It must fully and correctly anticipate events and concerns that will arise over the fund's ten-year life, or provide for mechanisms to deal with unanticipated ones. Negotiated at the outset of the relationship—that is, before most investors commit their capital to the fund—the limited partnership agreement represents investors' only bite at the apple in setting the terms of their deal with the sponsor.

Accordingly, limited partnership agreements for private equity funds are lengthy documents—often exceeding one hundred pages—and cover all of the terms of the investment relationship, including: investment restrictions applicable to the fund, the sponsor's powers, obligations, and compensation, the investors' (very limited) voting rights, how profits from the fund will be split among the investors and the sponsor, the timing and manner of investors' required capital contributions to the fund, the fund's reporting and disclosure obligations to investors, the complex tax accounting for the fund, the remedies if an investor defaults on its required capital contributions to the fund, amendments, limitations on liability for the sponsor, and much more.[78]

### 4. Sponsor Compensation

A defining feature of private equity buyout funds is the compensation payable to the sponsor for selecting, managing, and exiting the portfolio companies acquired by the fund. Here again, the parties are largely left to decide the question as they see fit.

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[77] Stated differently, Delaware limited partnership law, much like Delaware limited liability company law, explicitly espouses freedom of contract and largely favors default rules over mandatory ones. *See* Debevoise & Plimpton, *supra* note 12, at 8 (noting that "Delaware's Revised Uniform Limited Partnership Act…contains significant flexibility to modify many core partnership terms by contract"). Therefore, most statutory provisions applicable to Delaware limited partnerships apply only if the parties do not provide otherwise. These "default" statutory rules can be, and almost always are, overridden by the parties in the limited partnership agreement.

[78] *See* Debevoise & Plimpton LLP, *supra* note 12, at 27-55 (describing the standard contents of limited partnership agreements for private equity funds).

Nonetheless, the market has coalesced around a particular arrangement, under which the sponsor receives both (1) a management fee, calculated as a fixed percentage per annum of the total commitments to the fund, and (2) a performance fee (or "carried interest"), calculated as a fixed percentage of the fund's profits.[79] (That is, any profits realized by the fund are split between the investors and the sponsor according to the performance fee percentage.)[80] Because the management fee is tied to the fund's size, it does not vary over time or with the fund's performance.[81] It is typically paid on a quarterly basis.[82] The performance fee, by contrast, is payable whenever the fund realizes any profits on its investments, which is typically whenever a portfolio company is sold or a dividend is received.[83] Although the specific percentages of the management fee and carried interest vary, the most common model for buyout funds is "two and twenty": a 2% management fee and a 20% carried interest.[84]

### *B. What We Know (and Don't Know) about Private Equity*

Given its profound impact on corporate governance and corporate finance, a large scholarly literature has arisen in both finance and law to study and to opine on the private equity industry and its effects.[85] The bulk of this work centers on the impact of leveraged buyouts on the target companies themselves. The first branch compares private equity-owned companies to comparable public companies on a range of performance metrics.[86] It seeks to determine, for example, which of the two governance models—ownership by a private equity fund or by public shareholders—leads to better corporate performance, as measured by (1) managerial agency costs,[87] (2) board

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[79] For a discussion of the relative weight of the management fee and performance fee, see Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD., 2303 (2010).

[80] Note that private equity sponsors may also derive compensation by charging various fees to their funds' portfolio companies. *See* Ludovic Phalippou, Christian Rauch, & Marc Umber, *Private Equity Portfolio Company Fees*, 129 J. FIN. ECON. 559 (2018).

[81] Many funds provide for a "step-down" in the management fee percentage (or the basis to which it applies) after the end of the fund's investment period, however.

[82] *See* Debevoise & Plimpton LLP, *supra* note 12, at 34.

[83] *See id.* at 27 (discussing the timing of distributions from the fund).

[84] *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3-5 (2008) (describing typical compensation scheme for private equity funds).

[85] *See generally* Steven N. Kaplan, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J. Fin. 1791 (2005); Josh Lerner, Morten Sørensen & Peter Strömberg, *Private Equity and Long-Run Investment: The Case of Innovation* (Nat'l Bur. Econ. Rsch. Working Paper 14623) (2008).

[86] For a review of this literature, see, e.g., Ludovic Phalippou & Peter Morris, *Thirty Years After Jensen's Prediction – Is Private Equity a Superior Form of Ownership?* (working paper, Nov. 29, 2019), available at https://ssrn.com/abstract=3495465.

[87] *See, e.g.*, Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986); Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 61-62.

performance,[88] (3) (net) employment,[89] (4) innovation,[90] (5) sales and operating margins,[91] and (6) productivity.[92]

A second (and often overlapping) branch of this literature focuses on the impact of buyouts on third parties. These parties would include (1) stakeholders of the company other than the private equity fund itself, such as creditors and employees,[93] (2) the government, and (3) any other potentially affected third parties, such as customers,[94] suppliers, and communities where the portfolio company operates. For example, this line of scholarship examines what proportion of private equity returns is generated by true increases in firm value versus mere transfers of wealth from creditors, employees, and the government, and whether private equity portfolio companies impose more negative externalities than other comparable companies.[95]

By definition, the common feature of both branches of the literature on LBOs is the focus on the *investments* made by private equity funds. Yet a smaller, more recent literature approaches private equity funds with an entirely different focal point: the *formation and governance* of the fund itself.[96] Here the object of study is the relationship

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[88] *See, e.g.*, Viral Acharya, Conor Kehoe & Michael Reyner, *The Voice of Experience: Public Versus Private Equity*, MCKINSEY QUARTERLY 2018, at 1-7; Francesca Cornelli & Ōguzhan Karakas, *Private Equity and Corporate Governance: Do LBOs Have More Effective Boards?*, *in* 1 THE GLOBALIZATION OF ALTERNATIVE INVESTMENTS WORKING PAPERS VOLUME 1: THE GLOBAL ECONOMIC IMPACT OF PRIVATE EQUITY REPORT 2008 65, 72 (World Econ. Forum 2008), *available at* http://www3.weforum.org/docs/WEF_IV_PrivateEquity_Report_2008.pdf.

[89] *See, e.g.*, Steven J. Davis et al., *Private Equity, Jobs, and Productivity*, 104 AMERICAN ECONOMIC REVIEW 3956 (2014).

[90] *See, e.g.*, Josh Lerner, Morten Sorensen & Per Strömberg, *Private Equity and Long-Run Investment: The Case of Innovation*, 66 J. FIN. 445, 446, 474 (2011).

[91] *See, e.g.*, Viral V. Acharya et al., *Corporate Governance and Value Creation: Evidence from Private Equity*, 26 REV. FIN. STUD. 368, 370 (2012) (examining LBO data from Western Europe, between 1991 and 2007).

[92] *See, e.g.*, Frank R. Lichtenberg & Donald Siegel, *The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior*, 27 J. FIN. ECON. 165 (1990); Steven J. Davis et al., *Private Equity, Jobs, and Productivity*, 104 AM. ECON. REV. 3956 (2014).

[93] *See, e.g.*, Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 1 (Alan J. Auerbach, ed.1988); Marie Lambert et al., *Employee Views of Leveraged Buy-Out Transactions* (working paper, Jun. 1, 2021), available at https://ssrn.com/abstract=3926300.

[94] *See, e.g.*, Atul Gupta, Sabrina T. Howell, Constantine Yannelis & Abhinav Gupta, *Does Private Equity Investment in Healthcare Benefit Patients? Evidence From Nursing Homes* (Nat'l Bureau of Econ. Rsch., Working Paper No. w28474, 2021); with Ashvin Gandhi, YoungJun Song & Prabhava Upadrashta, *Have Private Equity Owned Nursing Homes Fared Worse Under COVID-19?* (2020) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3682892; Charlie Eaton, Sabrina T. Howell& Constantine Yannelis, *When Investor Incentives and Consumer Interests Diverge: Private Equity in Higher Education*, 33 REV. FIN. STUD.4024 (2020).

[95] *See, e.g.*, Shourun Guo, Edith S. Hotchkiss & Weihong Song, *Do Buyouts (Still) Create Value?*, 66 J. FIN. 479 (2011).

[96] *See* Clayton *supra* note 23, 271–72 (2017); STEPHANIE BRESLOW & PHYLLIS SCHWARTZ, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION (Carol Benedicto ed., Practising Law Inst. 2015).

between the private equity sponsor and the investors—both the formal terms of the economic and other arrangements among them, as well as the informal and other constraints on the parties' behavior over time. For example, early work in this vein sought to explain the sponsor compensation model in private equity and venture capital as a means of optimally controlling the agency costs of the sponsor while incentivizing the sponsor to take risks and to produce high returns for investors.[97] The most recent private equity scholarship has focused specifically on these returns: while the private equity industry has long touted its market-beating returns for investors, scholars have begun testing these claims empirically and producing a wealth of new information about the nature and size of the returns to private equity investments.[98]

As part of this latter project, attention has also turned to gathering data on the sharing of returns between the sponsor and the investors, particularly through the sponsor's compensation.[99] Among other things, this literature reveals that large investors often pay less (or even significantly less) to the sponsor in "fees" than the headline "two-and-twenty" would suggest.[100] Such discounts on fees for some—but not all—fund investors raise potential concerns about disparate treatment of private equity investors within the same fund and excessive secrecy of the industry.

Indeed, this penchant for secrecy explains why this literature is so recent and why it remains relatively small: scholars, for the most part, have simply not had access

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[97] *See* Ulf Axelson, Per Strömberg & Michael S. Weisbach, *Why Are Buyouts Levered? The Financial Structure of Private Equity Funds*, 64 J. FIN. 1549 (2009); David T. Robinson & Berk A. Sensoy, *Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance*, 26 REV. FIN. STUD. 2760 (2013); Francois Degeorge, Jens Martin & Ludovic Phalippou, *On Secondary Buyouts*, 120 J. FIN. ECON. 124 (2016); Sridhar Arcot et al., *Fund Managers Under Pressure: Rationale and Determinants of Secondary Buyouts*, 115 J. FIN. ECON. 102 (2015); Hyeik Kim, *Opening the Black Box in Private Equity: When Interests Conflict Between GPs and LPs* (Dissertation, Ohio State University) (2021).

[98] *See, e.g.*, Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *How Do Private Equity Investments Perform Compared to Public Equity?*, 14 J. INV. MGMT. 14, 15 (2016); Ludovic Phalippou, *Performance of Buyout Funds Revisited?*, 18 REV. FIN. 189, 189 (2014); Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUD. 1747, 1747 (2009); Berk A. Sensoy, Yingdi Wang & Michael S. Weibach, *Limited Partner Performance and the Maturing of the Private Equity Industry*, 112 J. FIN. ECON. 320, 341-42 (2014).

[99] *See* Tim Jenkinson, Hyeik Kim & Michael S. Weisbach, *Buyouts: A Primer* 5–6 (Fisher Coll. Of Bus. Working Paper, 2021) ("Fund fees have deviated surprising[ly] little from the 2 and 20 model. . . even as buyout funds have increased dramatically in size"); *See also id.* at 15 ("[Sponsors] are often able to borrow the funds they commit to the fund, using future management fees as collateral. . . These [subscription credit lines] allow funds to potentially borrow money against the asset values of existing portfolio companies, for example to accelerate distributions or to support portfolio companies late in fund's life").

[100] "Two-and-twenty" refers to the fees paid by investors to sponsors. The "two" refers a two percent management fee paid an investor's assets invested in a fund to the sponsor that is generally used to pay overhead expenses; the "twenty" refers to a twenty percent performance fee, paid to the sponsor out of profits once the fund has achieved certain returns, typically exceeding an agreed upon benchmark. *See Two and Twenty*, INVESTOPEDIA, https://www.investopedia.com/terms/t/two_and_twenty.asp (March 3, 2021); *see also* Chris Flood, *Private Equity Clings to "2 and 20" Fee Model*, FIN. TIMES (Apr. 12, 2016), https://www.ft.com/content/f7dc242c-58a9-11e6-9f70-badealb336d4.

to the relevant documents and data necessary to track investor returns and sponsor compensation arrangements.[101] Information about investor returns is somewhat more accessible today, in light of new private subscription services. Access to the underlying documentation, by contrast, remains extremely limited.[102] Private equity investors must agree to strict confidentiality provisions when they invest,[103] meaning that there simply is no publicly available database of buyout fund agreements and ancillary documents. Thus, while the returns and compensation arrangements for mutual funds have been the subject of innumerable empirical studies,[104] studying private equity funds is vastly more difficult. Even today, we simply do not know the true extent to which investors are treated differentially, nor which of several potential channels—side letters, co-investment, separate accounts, investment in the sponsor—is used to achieve this.

Accordingly, this Article fills an important gap in the literature: there is considerable and increasing interest in the division of spoils between the sponsor and investors in private equity, and among the various types of investors, but there has thus far been little opportunity to study it. We shed light on a particular channel by which sponsors *could* alter the fund's basic deal for favored investors, if desired—one that has come to play a major role in fund negotiations and drawn considerable criticism—namely, the side letter.

### *C. The Side Letter Phenomenon*

#### 1. A Burgeoning Practice

A notable feature of private equity limited partnership agreements is that they tend to treat all investors in the fund *uniformly*.[105] Under a typical limited partnership agreement, for example, all investors' economic and voting rights are simply *pro rata* according to their capital commitments to the fund.[106] They have the same right (or lack of right) to sue; they receive the same reporting from the fund at the same times; they

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[101] Tim Jenkinson, Hyeik Kim & Michael Weisbach, *Buyouts: A Primer* at 68 (Nov. 2021, NBER Working Paper No. w29502), available at https://ssrn.com/abstract=3968725.

[102] *See* Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *How Do Private Equity Investments Perform Compared to Public Equity?*, 14 J. INV. MGMT. 14 (2016) (describing the Burgiss database and discussing the continuing difficulties of obtaining data on returns).

[103] *See* Madison Marriage & Chris Newlands, *Pension Funds Forced to Sign Non-Disclosure Agreements*, FIN. TIMES (Oct. 26, 2014).

[104] *See, e.g.*, Michael C. Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 J. Fin. 389 (1968); Burton G. Malkiel, *Returns from Investing in Equity Mutual Funds 1971 to 1991*, 50 J. Fin. 549 (1995); Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. Fin. 57 (1997); Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. Fin. 1589 (1998); Marcin Kacperczyk et al., *On the Industry Concentration of Actively Managed Equity Mutual Funds*, 60 J. Fin. 1983 (2005).

[105] *See* Clayton, *Preferential Treatment supra* note 23, at 280–82.

[106] *See* Practical Law Corp. & Sec., *Limited Partnership Agreement (LPA) for Private Equity Fund*, THOMAS REUTERS PRAC. L., W-000-5447 (2022).

make capital contributions to the fund and receive distributions at the same time; and they suffer the same penalties if they default on their capital commitment.[107]

This uniform treatment is not required by any rule or regulation; it is simply a norm for the industry. For example, limited partnership agreements could simply provide for different classes of investors, each with different rights and obligations and different economic deals. In fact, such an approach is routinely employed with mutual funds, even for retail investors—investors with large accounts are placed in an "institutional shares" class and pay *lower* management fees than do investors with small commitments.[108]

The uniform treatment of investors in the limited partnership agreement is not the end of the story, however. It is now routine for funds and sponsors to negotiate separate bilateral agreements with individual investors during the fund formation process, at the same time that the limited partnership agreement is being negotiated.[109] These agreements are referred to as "side letters." A side letter grants special rights and preferences to an individual investor in the fund, beyond those that apply to other investors in the fund under the limited partnership agreement. By definition, then, an investor who receives a side letter receives preferential treatment in some fashion.

Side letters are not unusual, one-off occurrences.[110] To the contrary, side letters have become a ubiquitous practice in the private equity industry, and are often given to many or even most investors in the fund.[111] As a result, the aggregate length of all side letters for a fund often vastly exceeds the length of the limited partnership agreement itself.[112] Although each side letter applies only to the specific investor who is the signatory, it is enforceable by that investor not only against the sponsor, but also against

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[107] *See* David T. Robinson & Berk A. Sensoy, *Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance*, 26 REV. FIN. STUD. 2760, 2761–62 (2013).

[108] *See* U.S. Securities and Exchange Commission, *Mutual Fund Classes* (https://www.investor.gov/introduction-investing/investing-basics/glossary/mutual-fund-classes#:~:text=Class%20I%20shares%20might%20have,%2C%20through%20a%20retirement%20plan) ("Class I shares might have lower overall fees than Class A, B or C shares, but they would be sold only to institutional investors making large fund share purchases.").

[109] *See* Debevoise & Plimpton LLP, *supra* note 12, at 23 (noting that "it has become increasingly common to address the specific issues of an investor via a side letter agreement between the Limited Partner and the General Partner (or the Fund)."

[110] *See* Ian Levin & Kevin Scanlan, *The Downside of Side Letters*, 7 J. INV. COMPLIANCE 43, 43 (2006) (referring to side letter practice as "fairly common and longstanding").

[111] *See* Sullivan *supra* note 1 ("[A]ttorneys for private-equity firms . . . told Insider that they're seeing a proliferation of side letters or special agreements requested by investors that fall outside the proposed contract, such as stipulations that a PE firm offer special oversight of their investments with additional financial-reporting requirements.").

[112] *See "Private Fund Side Letters: Negotiating and Drafting Key Terms, Financing and Other Concerns,"* Strafford Publications, Inc., CLE Presentation, at minute 33:30 (noting the 800-900 pages of side letter provisions for the largest private equity fund sponsors such as Blackstone and Apollo).

the fund, such that both the terms of the agreement and its contents should be relevant to the other fund investors. Nonetheless, whether any of the fund's side letters will be disclosed to the other investors is itself a matter of negotiation with the sponsor.[113]

### 2. The Academic and Policy Debate

Why has side letter practice exploded for buyout funds, and what should we make of it? Why would private equity investors simultaneously negotiate the fund's limited partnership agreement and a series of side letters that alter it? And how do these side letters tend to modify the deal that is reflected in the limited partnership agreement? Justifiable interest in these questions has prompted a recent debate among academics and policy-makers, largely divided into two main camps.

#### i. Side Letters as Unfair Deception or Exploitation

The first view holds that side letters are a potentially deceptive, unjust device to favor certain investors at the expense of less sophisticated ones. In this view, private equity sponsors collude with their most favored investors—typically, their largest investors—to give them "secret side deals."[114] Unbeknownst to them, this argument implies, smaller, less sophisticated investors are effectively being made to subsidize these preferred investors.

At first glance, this view has intuitive appeal. It is certainly the case that side letters are more likely to be given to larger investors,[115] and that smaller investors may never know the terms of these confidential side deals. Among other things, as a result of side letters, smaller investors may (1) pay more fees to the sponsor than do larger investors; (2) have fewer rights to exit their investment; (3) have less influence over the sponsor's investment decisions; and (4) receive less information about the fund and its investments. The current chair of the SEC recently summarized this concern, stating: "[I]t's not even the case that every investor gets the same deal within a particular private fund… Over the years, there's been an increasing use of differential terms to investors. Each limited partner may be negotiating its own deal. Sometimes, they get their own deal through the use of what's called side letters."[116]

In light of this perceived unfairness, Senator Elizabeth Warren has in the past even called for an outright ban on side letters and other side arrangements in private

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[113] *See infra* part II.5

[114] *See* "One-Pager" for The Stop Wall Street Looting Act of 2019 (calling for a ban on "secret side deals that privilege some investors over others.").

[115] *See* Marco Da Rin & Ludovic Phalippou, *The Importance of Size in Private Equity: Evidence From a Survey of Limited Partners*, 31 J. FIN. INTERMEDIATION 64 (2017).

[116] Gary Gensler, *Prepared Remarks at the Institutional Limited Partners Association Summit* (Nov. 10, 2021).

equity.[117] Other commenters have criticized side letter practice for these very reasons.[118] The SEC has recently proposed sweeping regulation of side letters, prohibiting certain side letter terms entirely and requiring full disclosure to prospective and current investors of all preferential treatment of any investor.[119]

### ii. Side Letters as "Efficient" Price Discrimination

The opposing view holds that side letter arrangements are neither unfair nor unique to private equity. In this view, side letters are simply one among many instances of price discrimination.[120] In economic theory, price discrimination occurs when the seller of a good or service charges consumers different prices based on their "willingness to pay"—a measure of how intensely they desire the good or service.[121] Consumers with a higher willingness to pay are charged a higher price, while those with a lower willingness to pay are charged less.

Price discrimination is rampant in practice. In some cases, sellers achieve price discrimination by offering slightly different quality products at different prices, such that consumers self-select according to their willingness to pay by buying different products.[122] Airlines, for example, are able to charge business travelers more than leisure

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[117] *See* The Stop Wall Street Looting Act of 2019, Sec. 502(c) ("The general partner of a private fund may not provide any term or benefit to any limited partner of the fund unless the general partner provides that term or benefit to all limited partners of the fund."), available at https://www.warren.senate.gov/imo/media/doc/2019.7.17%20Stop%20Wall%20Street%20Looting%20Act%20Text.pdf; "One-Pager" for The Stop Wall Street Looting Act of 2019 (seeking to "end secret side deals that privilege some investors over others"), *available at* https://www.warren.senate.gov/imo/media/doc/2019.7.17%20Stop%20Wall%20Street%20Looting%20Act%20One%20Pager.pdf. The Stop Wall Street Looting Act of 2019. *See also* Magnuson, supra note 18 at 52 (advocating for a requirement that private equity firms "grant equal treatment to all investors").

[118] *See, e.g.*, Magnuson, *supra* note 18 at 1872 (noting that side letters allow private equity funds to "treat investors differentially," for example by charging lower fees to their favored investors or by granting them a veto right over investments), 36 (stating that, through the use of side letters, "preferential treatment is often given to repeat investors or large institutional clients") and 37 ("Side letters and other arrangements for differential treatment of investors thus raise the distinct possibility that fund assets will be diverted to preferred investors at the expense of non-preferred investors.").

[119] Proposed Rules, *supra* note 21.

[120] *See* Mark Armstrong, *Recent Developments in the Economics of Price Discrimination* (Advances in Economics and Econometrics: Theory and Applications: Ninth World Congress, eds. Blundell, Newey and Persson, 2005) ("[P]rice discrimination exists when two 'similar' products with the same marginal cost are sold at different prices").

[121] "Willingness to pay, sometimes abbreviated as WTP, is the maximum price a customer is willing to pay for a product or service." Harvard Business School, *Willingness to Pay: What It Is & How to Calculate*, (Oct. 20, 2020).

[122] This form of price discrimination is referred to as "product versioning" or "second-degree price discrimination." *See* Don-Shin Jeon & Domenico Menicucci, *Optimal Second-Degree Price Discrimination and Arbitrage: On the Role of Asymmetric Information Among Buyers*, 36 RAND J. ECON. 337, 337 (2005) ("The theory of [second-degree price discrimination] studies a monopolist's optimal pricing scheme when she has incomplete information about buyers' individual preferences. According to the theory, the monopolist

travelers, on average, by charging more for roomier seats, refundable tickets, and priority boarding.[123] In other cases, however, sellers are able to charge different groups different prices *for the exact same product*.[124] Pharmaceutical companies, for example, routinely charge more for their drugs in wealthier countries than in poorer countries, and even within a given country they may charge different patients different prices based on their willingness to pay (such as by offering discounts to lower-income patients.)[125]

The same principle may be at play in the private equity industry. In his excellent article, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, Professor William Clayton makes a compelling case for why all tailored arrangements offered by private equity sponsors to individual investors in their funds (such as co-investments or separate accounts) should simply be viewed as instances of price discrimination among the investors.[126] Imagine that Investor A is willing to pay to the sponsor a 2% management fee and a 20% share of the fund's profits, while Investor B is not willing to pay more than a 1.75% management fee and a 15% profit share. If the sponsor needs both investors in order to reach an optimal fund size, but is unwilling to accept the lower compensation offered by B from all fund investors, then it is not only rational for the sponsor, but also beneficial for both investors, if the sponsor simply charges Investor A and Investor B different prices.[127]

The arguments for this view are equally compelling. On the whole, private equity investors—which are almost exclusively institutional investors—are sophisticated and well resourced, and they tend to be represented by experienced counsel.[128] It strains credulity that these investors either would be wholly unaware that differential pricing

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can maximize her profit by using a menu of options that induces each type of buyer to select the option designed for the type.").

[123] *See* Joanna Stavins, *Price Discrimination in the Airline Market: The Effect of Market Concentration*, 83 REV. ECON. & STAT. 200 (2001).

[124] This form of price discrimination is referred to as "group pricing" or "third-degree price discrimination". *See* Chien-Wei Wu, *Price Discrimination Through Group Buying*, 57 HITOTSUBASHI J. ECON. 27 (2016).

[125] *See* Patricia M. Danzon, *Price Discrimination for Pharmaceuticals: Welfare Effects in the US and the EU*, 4 INT'L J. ECON. BUS. 301 (1997).

[126] *See* Clayton *supra* note 23. In his article, Clayton focuses primarily on price discrimination through co-investment—the practice of allowing certain fund investors to allocate additional capital to a specific fund investment, by investing in the portfolio company not only pro rata through the fund (like all other fund investors), but also directly. Coinvestors often pay reduced compensation to the sponsor on the portion of their capital that is invested directly, as compared to their investment in the fund. In principle, however, the same form of price discrimination could be achieved far more simply and directly in side letters, simply by awarding investors discounts on the management fee or share of profits payable to the sponsor through the fund.

[127] *See* Debevoise & Plimpton LLP, *supra* note 12, at 39 (stating that sponsors typically announce a targeted fund size).

[128] *See* Elisabeth de Fontenay, *Agency Costs in Law-Firm Selection: Are Companies Under-Spending on Counsel?* 11 CAP. MARKETS L. J. 486 (2016).

occurs in private equity, or that they would knowingly invest in a scheme forcing them to accept below-market returns so that larger investors achieve above-market returns. If private equity investors within a given fund are treated differentially, therefore, the most plausible assumption is that all investors are at least aware of this possibility and expect to earn acceptable returns regardless.

Even if price discrimination is common in other industries, however, it is not especially surprising that critics find the practice distasteful in the private equity industry. Contrary to many other instances of price discrimination, fee discounts in private equity result in the largest and wealthiest investors paying *less* than smaller investors pay.[129] This is because, paradoxically, small investors have greater willingness-to-pay. The argument runs as follows. On the whole, sponsors prefer large investors over small investors: by definition, large investors provide more capital to a fund sponsor all at once, thereby reducing the cost and delay of finding sufficient investors to meet the sponsor's targeted fund size. Because sponsors prefer large investors, the latter will receive many more offers to participate in buyout funds than will small investors. A large investor therefore has better "outside options" when negotiating with any particular fund sponsor than does a small investor: the large investor can simply threaten to walk away and go to another fund, while the small investor may have no choice but to invest in this fund or forego the buyout asset class altogether. In order to successfully attract large investors, therefore, the sponsor may rationally offer more favorable economics (i.e., charge lower fees) to the large investor than to the small investor.[130] A massive sovereign wealth fund, for example, should expect to obtain better terms than a small charitable foundation should.

What troubles observers about this feature of buyout funds is that price discrimination in other, more familiar contexts often works the other way, with wealthier investors paying higher prices. (Returning to the airline industry, for example, business travelers pay more for their tickets than do leisure passengers in "coach" class.) Nonetheless, all are instances of price discrimination. Most importantly, this type of price discrimination, in which larger investors pay lower fees to the investment manager than do smaller investors, routinely occurs—with regulators' blessing—in investment funds that are open to retail investors.[131]

### 3. Side Letters as Contractual Modularity

An emerging literature has identified the importance that modularity plays in modern contracting and particularly in complex deals.[132] Complex M&A deals, for

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[129] *See* Flood, *supra* note 100.

[130] *See* Juliane Begenau and Emil Siriwardane, *How Do Private Equity Fees Vary Across Public Pensions? available at* https://www.hbs.edu/ris/Publication%20Files/20-073_32c98338-75e6-4174-947f-510b16236e6d.pdf.

[131] *See infra* note 218.

[132] *See supra* notes 29-30.

instance, can be viewed as what Prof. Hwang termed "unbundled bargains," reflecting a modular design[133] that allows for better precision and reduces transaction costs. Indeed, many business deals employ several ancillary documents in addition to the main deal document. This modular approach can allow attorneys to better divide tasks, to offer better customization and precision in the deal, and, therefore, to reduce negotiation costs ex ante and enforcement costs ex post.[134] Viewing the various deal documents as a modular structure has important implications for court enforcement and contract interpretation.[135]

Side letters are an example of deal modularity. More broadly, the entire process of forming a private equity fund exhibits the type of modularity and, potentially, the benefits of modularity that scholars have identified. In addition to the limited partnership agreement, the formation process also includes subscription agreements (covering the investment amount as well as other individualized information for each investor),[136] side letters, and the investment management agreement (between the fund and the management company that is formed by the sponsor to select and manage the fund's investments).[137] Side letters allow the sponsor and each investor to customize the deal agreement in a way that a single deal document cannot. They can clarify specific terms and exempt an investor from specific obligations for regulatory reasons or due to their business model and may provide additional incentives, monetary or otherwise. The MFN provision itself (defined in Part I.C.4 *infra*) is a modular structure within each side letter,[138] allowing investors to import provisions negotiated by other investors into their

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[133] "A highly modular component of a machine is one that can be manipulated without significantly affecting other parts of the machine (and the other parts of the machine, too, can be modified without affecting the module)." *See* Hwang, *Unbundled supra* note 29, at 1418.

[134] Prof. Hwang uses an employment agreement in the M&A context as an example. When a key employee of the target company is employed by the buyer, the deals team assigns that agreement—a single module of the entire deal—to a specialized employment attorney. This kind of employment agreement is very modular in the greater scheme of the entire transaction, because "changes to the details of the employment agreement generally do not need to affect other deal documents. Likewise, even big changes to the acquisition agreement. . . may not affect the employment agreement at all." Hwang, *Unbundled* at 1418.

[135] *See* Hwang & Jennejohn, *supra* note 29, at 13–14 (to determine contract drafters' intent, "courts must *first* determine if a contract is modular or integrated in structure" (emphasis in original)).

[136] *See* JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS 2-4 (2021); *see, e.g.,* ILPA Model Subscription Agreement, https://ilpa.org/model-sub-agreement/.

[137] *See* ROBERT K. DOYLE & PHYLLIS BERNSTEIN, INVESTMENT ADVISORY RELATIONSHIPS: MANAGING CLIENT EXPECTATIONS IN AN UNCERTAIN MARKET 24 (2002) ("[T]he [investment advisory] agreement is a very useful tool to help manage the advisory relationship. A typical IA agreement lays out the responsibility of both the [sponsor] and the [investor].")

[138] *See* Smith, *Modularity in Contracts*, *supra* note 29, at 1180 ("Forming a modular system involves *partially closing off* some parts of the system and allowing these encapsulated components to interconnect only in certain ways.") (emphasis in original).

deals.[139] That ability allows each investor to negotiate the side letter concurrently with the limited partnership agreement and simultaneously among most investors without the need to wait until all documents are complete, further increasing deal efficiency.

Side letters therefore have the potential to fulfill many of the virtues contract literature has identified in modular contract design.[140] They can allow for better precision through party,[141] risk,[142] and time specificity[143] and allow for the customization of terms[144] that those who view side letters as an efficient price discrimination tool have argued for.[145] On the other hand, side letters may also present some of the concerns raised regarding modularity, namely that they reflect path dependency,[146] raise concerns regarding lawyer motives,[147] and lead to differential disclosure.[148] We explore where side letters fall on this spectrum in Part III.

### 4. Common Side Letter Terms

What additional rights might investors seek in their side letters? As shown in Appendix A, the range of provisions identified in our sample—more than eighty substantively distinct terms—is quite broad. Here we provide a brief description of some of the terms that are most frequently discussed in the practitioner and policy literature: (1) the most favored nation ("MFN") clause, and its exclusions; (2) the advisory board seat; (3) fee discounts and co-investment rights; (4) assignment and withdrawal (the "liquidity" rights); (5) investment restrictions; and (6) information rights.[149]

First, if an investor successfully negotiates for an MFN provision in its side letter, the investor obtains the right to elect the benefit of terms in *other* investors' side letters. This provides some reassurance to the investor that it is obtaining at least as good a deal as other investors. However, whether the MFN right will extend to all other investors' side letters and to all provisions of such investors' side letters is a matter of further negotiation with the sponsor. Indeed, it is common for an investor's MFN right to apply only to the side letters of investors with equal or smaller commitments to the fund, and

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[139] The degree of cross references among side letters may be detrimental because they "defeat modularity, increase complexity, and create traps." *Id.* at 1199.

[140] *See* Hwang, *Unbundled supra* note 2924, at 1417.

[141] *See id.* at 1427.

[142] *See id.* at 1430.

[143] *See id.* at 1432.

[144] *See* Smith, *supra* note 29, at 1175.

[145] *See* Clayton, *Preferential Treatment supra* note 22.

[146] *See* Hwang, *Unbundled supra* note 29, at 1434.

[147] *Id.* at 1436.

[148] *Id.* at 1438.

[149] *See* William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. REG. 67, at 103-105. *See also* Debevoise & Plimpton LLP, *supra* note 12, at 23.

to exclude several terms from the MFN (such as seed investor rights, advisory board seats, coinvestment rights, and many more).[150]

Second, the "advisory board" (or "advisory committee") consists of a group of investors that are hand-picked by the sponsor—typically from among the largest investors—to represent the investor viewpoint.[151] The limited partnership agreement will determine the rights and powers of the advisory board, in particular whether its role is purely advisory or whether it has some binding authority over the sponsor or the fund (such as the ability to waive certain of the fund's investment restrictions or to approve certain of the sponsor's conflicts of interest).[152] Advisory board seats are typically awarded to specific investors in their respective side letters.

Third, large investors wanting a better deal than the economic split between investors and the sponsor provided for in the limited partnership agreement may try to negotiate either fee reductions (that is, reductions in the "two and twenty" compensation payable to the sponsor) or the right to coinvest with the sponsor at reduced rates.[153] Coinvestment refers to an investor contributing capital directly into a portfolio company alongside the fund, in addition to its (indirect) investment in the portfolio company through the fund. Coinvestment allows sponsors to offer large investors a better deal than the basic fund arrangement,[154] without necessarily having to commit to any particular fee discount in advance.[155]

Fourth, because buyout funds lock in investors' capital for at least a decade, investors may seek limited liquidity rights from the sponsor and the fund in side letters.[156] Examples would include the right to assign their interest in the fund to a willing third party at any time, or even the right to withdraw from the fund under some circumstances.

Fifth, some investors may seek to prevent the sponsor from having the fund invest in specific types of investments. Buyout funds are "blind-pool" investment funds:

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[150] *See infra* Part II.C.2 for a detailed review of our findings regarding MFN.

[151] *See* Debevoise & Plimpton, *supra* note 12, at 49-50.

[152] *See id.* at 39, 41, 47.

[153] *Id.* at 104 (noting that "co-investment rights are commonly granted to investors that are already participating in a manager's fund through those investors' side letters").

[154] *Id.* at 2020 ("Co-investments are attractive to investors because managers typically charge much lower fees on co-investments than they charge for investments in their pooled funds").

[155] There is mixed evidence, however, on whether investors actually obtain better returns on their coinvestments than their investment through the fund. *Compare* Lily Fang, Victoria Ivashina & Josh Lerner, *The Disintermediation of Financial Markets: Direct Investing in Private Equity*, 116 J. FIN. ECON. 160 (2015) (finding worse performance), *with* Reiner Braun, Tim Jenkinson & Christoph Schemmerl, *Adverse Selection and the Performance of Private Equity Co-investments*, 136 J. FIN. ECON. 44 (finding no significant difference).

[156] For recent discussions of the liquidity needs (or lack thereof) of private equity investors, see Taylor D. Nadauld, Berk A. Sensoy, Deith Vorkink & Michael S. Weisbach, *The Liquidity Cost of Private Equity Investments: Evidence From Secondary Market Transactions*, 132 J. FIN. ECON. 158 (2019) and Brian Boyer, Taylor D. Nadauld, Kieth P. Vorkink & Michael Weisbach, *Discount Rate Risk in Private Equity: Evidence from Secondary Market Transactions* (Nat'l Bureau of Econ. Rsch., Working Paper No. w28691, 2021)..

private equity investors do not get a say in what companies the fund acquires or how much they pay for them. Yet, some investors may be unable (because of regulatory constraints) or unwilling to invest in specific types of investments. To remedy that, side letters may contain a back-ended investment restriction on the fund, in which the sponsor agrees to have the fund avoid specified companies or industries entirely or to allow the investor to be excused from the fund's investment therein.

Finally, investors may request additional information rights and reporting from the sponsor in a side letter, beyond what is agreed to in the limited partnership agreement. Compared to registered investment funds such as mutual funds, or to public companies, private equity funds typically provide dramatically less information and financial reporting to their investors under the terms of the limited partnership agreement.[157] Furthermore, because such financial and other reporting results from private ordering—that is, it is a matter of pure negotiation with investors—it tends to differ substantially across funds. Investors seeking more disclosure (or more uniform disclosure) may request this in a side letter.

## II. Demystifying Side Letters: Empirical Analysis

Side letters have enjoyed an aura of mystery as private equity took center stage in the U.S. economy over the last few decades. Shrouded in secrecy, their contents and structure have rarely been the subject of academic work or policy discourse.[158] The lack of disclosure has led researchers in both law and finance to focus on areas with more readily available data, despite the private equity industry's important share of the capital markets.[159]

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[157] *See* Andrew J. Bowden, Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Address at the Private Equity International Private Fund Compliance Forum: Spreading Sunshine in Private Equity (May 6, 2014), https://www.sec.gov/news/speech/2014--spch05062014ab.html (reporting the SEC's findings through its examinations of private equity sponsors that "most limited partnership agreements do not provide limited partners with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager"); Magnuson, *supra* note 18, at 1882.

[158] *See* Sullivan, *supra* note 1 ("Some large investors include a special provision in their side letters that combats against the collection of their data. . . these special provisions say opposing counsel must segregate the investor's documents in the firm's internal file system . . . thereby preventing the law firm from referring to terms the client had previously agreed to in future negotiations."); *see also See* William W. Clayton, *High-End Bargaining Problems*, __ VAND. L. REV. __ (forthcoming, 2022), at 41 ("It is well-established that private equity managers commonly impose significant restrictions on the accessibility of private equity contract terms outside the fund. These non-disclosure restrictions prevent the public, researchers, and all other investors in the market . . . from seeing the terms granted in private equity contracts.").

[159] For a detailed discussion of the law and finance dependency on readily available data and its shortcomings see, e.g. Jens Frankenreiter, Cathy Hwang, Yaron Nili & Eric L. Talley, *Cleaning Corporate Governance,* 171 PENN L. REV. 1 (2022).

But as we detailed, the veil of secrecy over side letters has also led to the conventional wisdom regarding their contents, with many assuming that side letters must materially alter the economic deal for some investors.[160] Yet, the lack of available data has made it impossible to know how side letters really interact with the limited partnership agreement and what significance they hold, economically and otherwise.

This Part II uncloaks side letters, using a first-of-its-kind dataset of 252 side letters spanning 30 years across numerous sponsors and investors. While we describe key observations regarding the side letters in our sample below, perhaps our most important observation is what we did not find. The data we present categorically dispel the notion that side letters are the type of price-discrimination device that many assumed them to be. In fact, we find no evidence of widespread price terms in our sample of side letters, which show little differential treatment among investors as to the fund's fundamental economic deal. If certain investors are indeed receiving materially better deals than others on the basic fund economics, these arrangements—such as the right to co-invest alongside the fund with lower fees paid to the sponsor—are likely the result of informal (and unwritten) agreements between the sponsor and individual investors. This suggests that regulators' and others' attempts over time to discourage sponsors from charging different fees to different investors have, counter-productively, led to far less efficient, far more opaque, and far more costly means of price discrimination, such as co-investment and separate accounts.

What we do find is that side letters tend to include mostly benign requests from investors, many of which are better suited to being standardized and included in the limited partnership agreement or the subscription agreement. Moreover, while side letters rarely include terms of material economic importance, we show that they have ballooned over time, growing longer and more complex and generating significant negotiation and drafting costs. Below we describe our methodology, data and key findings.

### *A. Methodology*

As noted above, private equity fund agreements are often considered a black box, given that the fund documents, including side letters, are not publicly disclosed. We obtained a first-of-its-kind sample of 252 side letters from a small number of institutional investors, under a confidentiality agreement for academic research.[161] While in many cases our side letters reflect a single observation per fund, for some funds we were able to collect all of the side letters given to investors, providing us with variation across both funds and investors.

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[160] *See supra* notes 19-22 and accompanying text.

[161] Where possible, we sampled 100% of the buyout fund side letters to which the investor had been a party. In cases where it would be too burdensome for the investor to compile all such side letters, we instead requested a smaller random sample from the complete list provided by the investor. This was done to limit the possibility of selection bias in the side letters provided to us by investors.

For each side letter, we began by identifying the investor, the fund, the private equity sponsor and the date. Data on fund size was obtained from Pitchbook or, where unavailable, from the investor. We also collected descriptive data on the length of each side letter, the number of separate provisions it contained, and the type of investor to which the side letter was given.

We then read and hand-coded each side letter to identify all substantive provisions included therein. First, we identified whether the side letter contained an MFN provision, how the MFN was tiered, the exclusions (if any) from the MFN, and whether the investor would receive copies of other investors' side letters. We then coded all remaining terms in the side letter, yielding a total of 84 distinct substantive provisions.[162]

### *B. Sample Description*

Our sample consists of 252 side letters from 1991 through 2020—a span of 30 years. As shown in Tables 1a and 1b, the side letters reflect a variety of private equity sponsors and investors and draw from a wide range of fund sizes—from small and middle-market funds to some of the largest buyout funds in the world.

Table 1a: Descriptive Statistics—Unique Observations

| Variable | No. of unique observations in sample |
|---|---|
| Side letters | 252 |
| Sponsors | 48 |
| Investors (LPs) | 150 |
| Buyout funds | 96 |

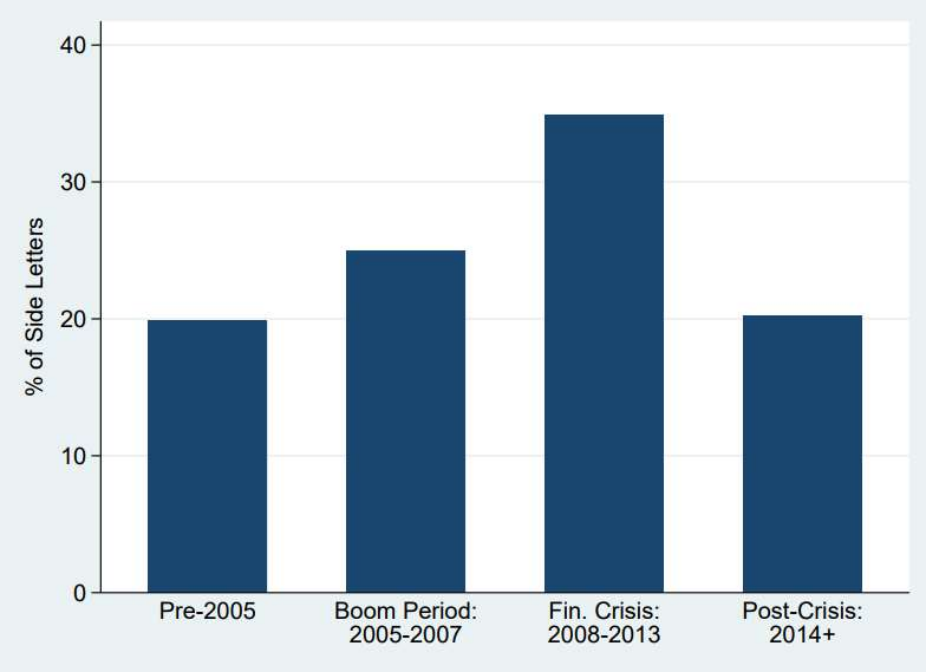
Table 1b: Descriptive Statistics—Funds in Sample by Size

| | No. of Funds | % |
|---|---|---|
| < $500 million | 49 | 51.0% |
| >= $500 million & < $1 billion | 14 | 14.6% |
| >= $1 billion & < $5 billion | 11 | 11.5% |
| >= $5 billion & < $10 billion | 7 | 7.3% |
| >= $10 billion & < $15 billion | 7 | 7.3% |
| >= $15 billion | 8 | 8.3% |
| **Total** | **96** | **100.0%** |

[162] The total consists of 7 MFN characteristics, 15 MFN exclusions, and 62 additional substantive side letter terms.

We divided our sample into four time periods, each corresponding to a distinct era of private equity buyouts:[163] (1) the pre-2005 period; (2) the private equity "boom" period (2005-2007); (3) the 2008 financial crisis and its aftermath (2008-2013); and (4) the post-crisis period (2014-2020). As Figure 1 below shows, we have a relatively balanced distribution of side letters from each era, with approximately 20 percent of side letters in the sample originating in both the pre-2005 and the post-crisis periods, 25 percent in the boom period, and 35 percent in the financial crisis era.

Figure 1: Side Letters by Era




Our sample also covers a wide range of investors and investor types. As detailed in Figure 2, eight key categories of investors appear in the sample, with the largest share of side letters given to university endowments and public pension funds. This tracks relatively well the share of investment in private equity funds more generally, except that our sample features relatively fewer sovereign wealth funds and corporate pensions.[164]

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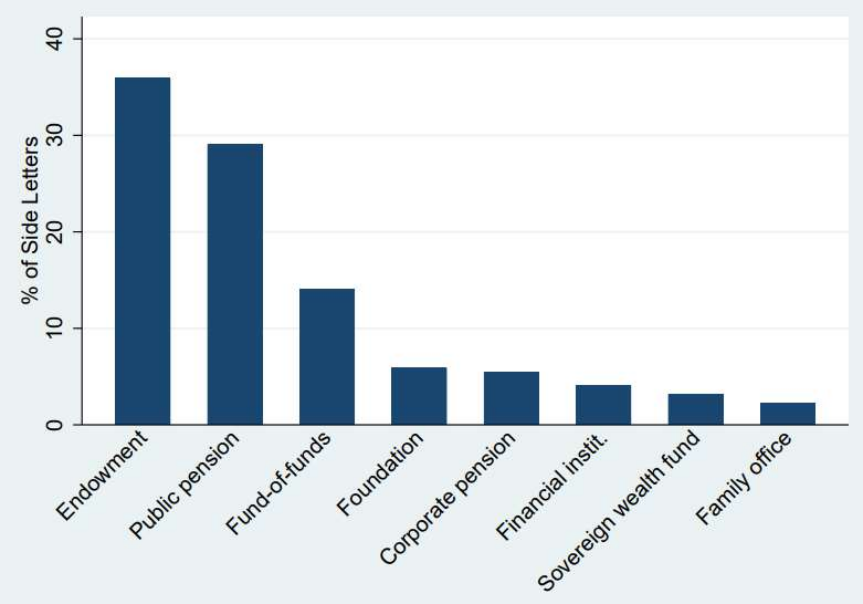
[163] *See* Tim Jenkinson, Hyeik Kim & Michael S. Weisbach, *Buyouts: A Primer* 49–52 (Fisher Coll. Of Busi. Working Paper 2021-03-018). *Private Equity & Venture Capital*, Preqin, https://www.preqin.com/academy/lesson-4-asset-class-101s/private-equity-venture-capital.

[164] Sec. & Exch. Comm'n, *Private Funds Statistics: First Calendar Quarter 2021* 18 https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2021-q1.pdf (November 1, 2021).

Figure 2: Side Letters by Investor Type




### *C. The Evolution of Side Letters*

We begin with an overview of how side letters have evolved. First, we document an overall increase in the length and number of provisions covered in side letters over the past thirty years, as well as an overall increase in the use of both MFN provisions and MFN exclusions. While the range of topics covered by side letters is broad, with more than eighty different provisions appearing in our data,[165] "price terms" in the form of fee discounts were virtually absent from our sample. We also find that regulatory and tax-related provisions predominate in side letters, though the relative share of governance and disclosure or reporting provisions has increased markedly over time. Finally, we find that side letters often contain provisions that should be, or easily could be, included in the limited partnership agreement rather than in side letters.

#### 1. Length and Complexity

Beginning with the sheer length of side letters, a clear, statistically significant[166] trend is evident. While side letters began as relatively simple and concise documents, they have morphed into lengthy agreements in recent years. The average length of side letters has increased more than sevenfold over the last 30 years with an average word count of 659 words in the pre-2005 era and 4,983 words in the post-crisis era. The page-

[165] For a full list see Appendix A.

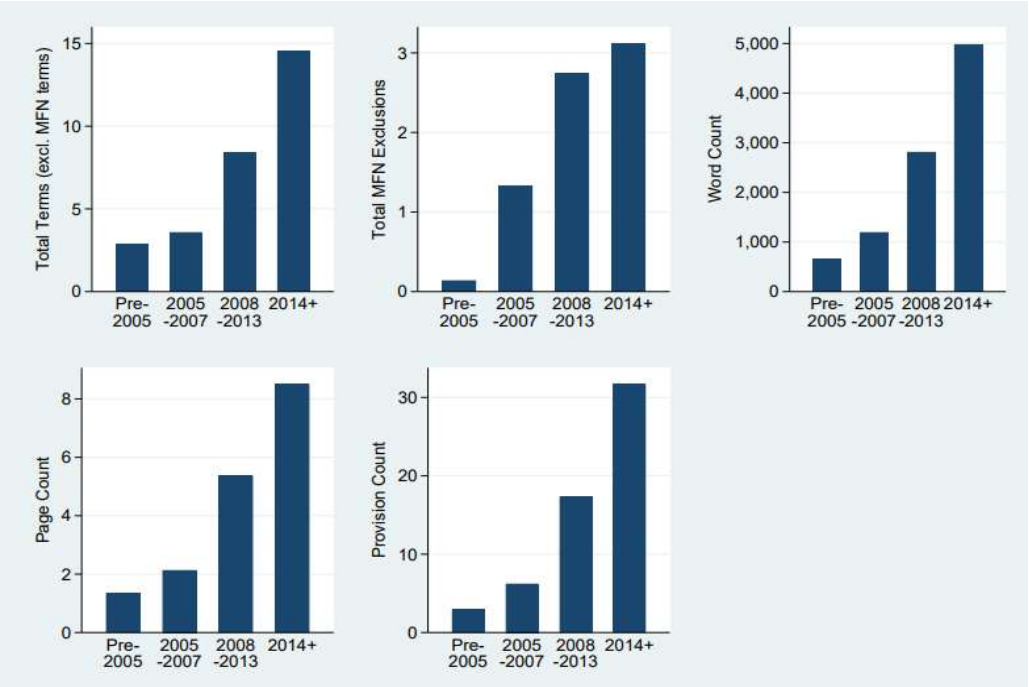
[166] Unreported regression analysis is on file with the authors.

length of each side letter has similarly ballooned from an average of 1.3 pages in the pre-2005 era to 8.5 pages in the post-crisis era.

It is not only the length of the documents that has expanded over time, but also the number of distinct substantive provisions and their complexity. While the average number of substantive side letter terms (excluding MFN-related provisions) was 2.9 in the pre-2005 era, that number increased to 14.7 in the post-crisis era. Measured by a simple count of provision headings, side letter terms increased from an average of approximately 3.0 pre-2005 to 31.7 since 2014. As a proxy for complexity, the total number of exclusions from the MFN provision jumped from an average of 0.14 pre-2005 to 3.1 post-2014.

Figure 3 shows that the length and complexity of side letters in our sample marched steadily upward in each period under all five measures employed.

Figure 3: Side Letter Length and Complexity

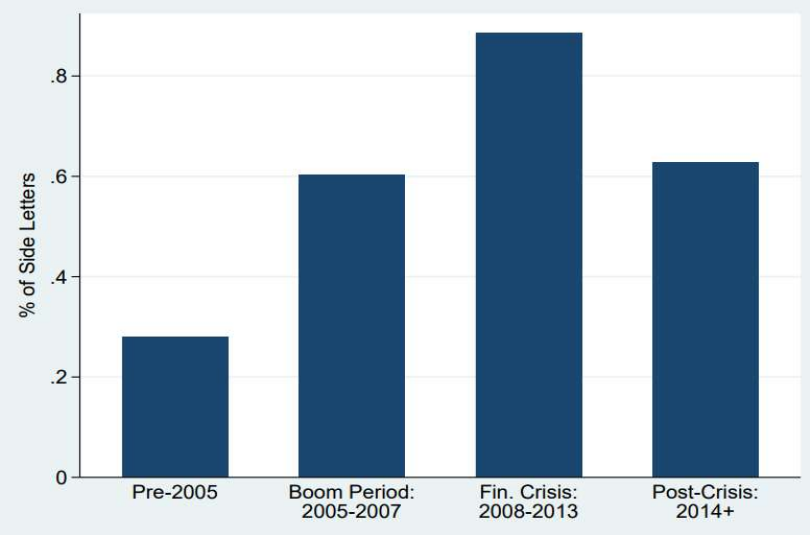



## 2. MFN

As discussed, MFN provisions are a central feature in the side letter process. We identify several important trends in MFN usage. First, as shown in Figure 4 below (and in the table in Appendix C), the presence of MFNs has increased dramatically over time, from 28 percent of side letters in the pre-2005 era to 63 percent in the post-crisis era. Even more notable, MFN provisions were granted in 89 percent of our sample during

the financial crisis—reflecting the sharp increase in the bargaining power of investors during that period, when capital-raising was especially difficult for sponsors.[167]

Figure 4:
Pct. Side Letters Containing MFN (By Era)




As the use of MFN provisions became more common, so did the complexity of what might be excluded from the purview of the MFN. For instance, MFN provisions often exclude any rights given due to specific laws or regulations applicable to some, but not all, limited partners (in 51.2 percent of our sample) and the advisory board seat (in 50.8 percent of our sample).[168] While the MFN in the pre-2005 era only rarely listed exclusions (with only 0.14 exclusions on average), by the post-crisis era an MFN was subject to an average of 3.12 exclusions.

The industry has taken note of the ballooning of MFN provisions. Interviewees commented that, in the 1990s, sponsors and investors would bargain for an MFN and an advisory board seat in a two-to-three page side letter. Today, they claimed, it takes twenty pages to end up with a merely adequate MFN.[169] According to interviewees, sponsors are increasingly unwilling to negotiate MFN provisions, because negotiating hundreds of such terms, each with slightly different reporting and notice requirements, is incredibly cumbersome.[170]

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[167] Interview with Participant 4 (Feb. 16, 2021) (commenting that side letters are the result of a "legacy of ten years ago when fundraising was difficult and [sponsors] were willing to do anything to bring in [investors].").

[168] *See* Appendix C.

[169] Interview with Participant 5 (Feb. 19, 2021).

[170] Interview with Participant 3 (Oct. 7, 2021).

### 3. Type of provision

We classified the 84 distinct substantive side letter provisions identified in our sample of side letters into six different categories: (1) governance; (2) disclosure; (3) regulatory/tax; (4) fee discounts; (5) co-investment; and (6) other financial terms. Terms in the first category aim to tackle governance issues or to curb the sponsor's agency costs. Examples include advisory board representation,[171] "key person" provisions,[172] and fiduciary duty obligations of the sponsor.[173] Terms in the second category impose various disclosure obligations on the sponsor or the fund, such as detailed reporting of fees and other financial reporting, notice of litigation or enforcement actions, defaulting partners, or a change in auditor, and annual certifications by the sponsor.[174] The third category comprises terms addressing an investor's regulatory requirements, including tax. Among such provisions are restrictions on the fund incurring UBTI,[175] covenants relating to ERISA compliance, exemptions from the confidentiality provisions in the limited partnership agreement (which are often necessary for an investor to comply with FOIA requests, for example), and acknowledgment of an investor's sovereign immunity.

The remaining three categories consist of side letter terms that could affect the investor's economic stake in the fund, whether directly or indirectly, or otherwise create potential side benefits for the investor. The fourth category ("fee discounts") includes explicit "price terms" such as agreements to charge the investor a reduced management fee or carried interest for the fund *or for co-investments*. The fifth category ("co-investment"), deals with provisions relating to co-investment,[176] such as explicit grants of co-investment rights, acknowledgments of an investor's interest in co-investing, and various limitations on co-investment. Finally, the sixth and final category ("other financial") includes all remaining terms that could affect the investor's economic stake in the fund. Examples include an investor's right to transfer its stake in the fund to a

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[171] See supra note [ ].

[172] "[A] 'key person provision' generally refers to a contractual provision that grants various rights and remedies to the investors upon the departure or disabling conduct of a specified number of 'key persons.' The 'key persons' are typically defined in the partnership agreement as the Principals or senior managers of the fund." JAMES M. SCHELL ET AL., PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 11.04[6] (2018).

[173] James J. Greenberger, *Private Equity Co-Investment Strategies*: Issues and Concerns in Structuring Co-Investment Transactions, J. PRIVATE EQUITY, Fall 2007, at 54, 56.

[174] William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. REG. 67, 105-06;

[175] Tax-exempt organizations, including "qualified" pension plans, foundations, and endowments, are still subject to tax on their "unrelated business taxable income" (UBTI) which is any gross income derived by a tax-exempt entity from an unrelated trade or business that it regularly carries on, less the deductions directly connected with that trade or business. *See Venture Capital & Private Equity Funds*, MORGAN LEWIS, (2015), https://www.morganlewis.com/-/media/files/special-topics/vcpefdeskbook/fundformation/vcpefdeskbook_accommodatingtaxexemptinvestors.pdf.

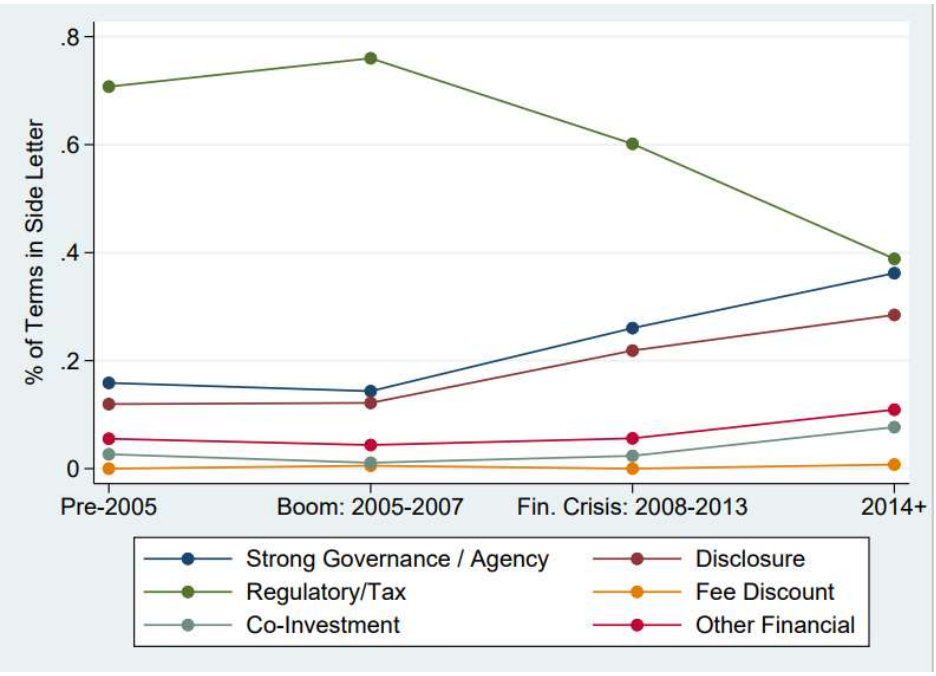
[176] *See supra* note 152.

third party (liquidity rights),[177] agreements as to how fees and expenses will be allocated, limitations on the investor's indemnification obligations, and pre-agreed economic terms to be given to the investor in a successor fund.[178]

Many provisions plausibly fall into more than one category and therefore are counted more than once. For instance, a term relating to an investor's regulatory requirements might also involve a disclosure obligation, and a disclosure obligation may be designed to improve the fund's governance (as in the case of required disclosures regarding the sponsor, which are designed to control sponsor agency costs).

First and foremost, we find that *explicit fee discounts are virtually absent from our sample in all periods*. Second, on average across our full sample, approximately 62% of terms in a given side letter relate to the investor's regulatory or tax requirements: these are by far the most common side letter provisions. Third, and notwithstanding, the relative share of regulatory provisions in side letters has declined significantly over time. Conversely, the relative share of governance and disclosure provisions in side letters have both increased markedly over our sample period. Figure 4 illustrates this graphically, while Table 3 presents the data in detail. (Recall that side letter terms often fall within more than one category, such that the totals add up to more than 100 percent.)

Figure 4: Side letter provisions by category




[177] *Private Fund Side Letters: Common Terms, Themes and Practical Considerations*, DECHERT LLP (Oct. 28, 2018), https://www.dechert.com/knowledge/onpoint/2018/9/private-fund-side-letters--common-terms--themes-and-practical-co.html.

[178] Sponsors often begin fundraising for a new fund every 2-3 years and may provide assurances to investors regarding the terms of their participation in such a future fund.

Table 3: Side letter provisions by category

| (1) Governance/ Agency Costs | | | |
|---|---|---|---|
| **Side Letter Era** | **Mean** | **Standard Deviation** | **Frequency** |
| Pre-2005 | 0.159 | 0.243 | 43 |
| Boom Period: 2005-2007 | 0.144 | 0.206 | 61 |
| Fin. Crisis: 2008-2013 | 0.260 | 0.167 | 84 |
| Post-Crisis: 2014+ | 0.362 | 0.149 | 51 |
| **Total** | **0.234** | **0.206** | **239** |
| **(2) Disclosure / Reporting** | | | |
| **Side Letter Era** | **Mean** | **Standard Deviation** | **Frequency** |
| Pre-2005 | 0.120 | 0.194 | 43 |
| Boom Period: 2005-2007 | 0.122 | 0.203 | 61 |
| Fin. Crisis: 2008-2013 | 0.219 | 0.137 | 84 |
| Post-Crisis: 2014+ | 0.285 | 0.108 | 51 |
| **Total** | **0.190** | **0.174** | **239** |
| **(3) Regulatory / Tax** | | | |
| **Side Letter Era** | **Mean** | **Standard Deviation** | **Frequency** |
| Pre-2005 | 0.707 | 0.286 | 43 |
| Boom Period: 2005-2007 | 0.760 | 0.275 | 61 |
| Fin. Crisis: 2008-2013 | 0.601 | 0.205 | 84 |
| Post-Crisis: 2014+ | 0.389 | 0.157 | 51 |
| **Total** | **0.616** | **0.267** | **239** |
| **(4) Fee Discount** | | | |
| **Side Letter Era** | **Mean** | **Standard Deviation** | **Frequency** |
| Pre-2005 | 0.000 | 0.000 | 43 |
| Boom Period: 2005-2007 | 0.005 | 0.043 | 61 |
| Fin. Crisis: 2008-2013 | 0.000 | 0.000 | 84 |
| Post-Crisis: 2014+ | 0.008 | 0.022 | 51 |
| **Total** | **0.003** | **0.024** | **239** |
| **(5) Co-investment** | | | |
| **Side Letter Era** | **Mean** | **Standard Deviation** | **Frequency** |
| Pre-2005 | 0.027 | 0.154 | 43 |
| Boom Period: 2005-2007 | 0.011 | 0.060 | 61 |
| Fin. Crisis: 2008-2013 | 0.024 | 0.058 | 84 |
| Post-Crisis: 2014+ | 0.077 | 0.070 | 51 |
| **Total** | **0.032** | **0.089** | **239** |
| **(6) Other Financial** | | | |
| **Side Letter Era** | **Mean** | **Standard Deviation** | **Frequency** |
| Pre-2005 | 0.055 | 0.134 | 43 |
| Boom Period: 2005-2007 | 0.044 | 0.135 | 61 |
| Fin. Crisis: 2008-2013 | 0.056 | 0.082 | 84 |
| Post-Crisis: 2014+ | 0.109 | 0.097 | 51 |
| **Total** | **0.064** | **0.113** | **239** |

Not only do these results challenge the notion that side letters are used for price discrimination among investors, they also put some pressure on the oft-repeated claim that buyout fund terms grow ever more favorable to sponsors over time, while investors are powerless to turn the tide. If governance and disclosure terms have grown significantly more prominent in side letters since the beginnings of the buyout industry, this suggests that, through side letters, some investors may be carving back sponsor-favorable terms in the limited partnership agreement. To be sure, this does not allow us to conclude whether, overall, sponsors or investors are coming out ahead compared to prior eras, but it does dispel the myth that sponsors have unfettered discretion in buyout funds today.

What, specifically, do side letters include? Appendix C provides a detailed list of the relative incidence of all side letter provisions that were coded in the sample, and Table 4 below lists the top ten most common provisions overall. As one might expect, the MFN is the most common provision, present in over 64 percent of the side letters in the sample. Putting aside MFN exclusions, which are also quite common, the top three most common provisions after the MFN are (1) carveouts from the confidentiality provision in the limited partnership agreement (allowing the investor to disclose certain information about the fund, often due to regulatory requirements), (2) certain tax and ERISA-related provisions, and (3) the investor's right to transfer its interest in the fund to an affiliate. Not one of these provisions—in fact, not one of the top ten most common provisions (other than, potentially, the MFN)—is a price term or other term that could have an indirect economic impact on the investor.

We also learn something from the provisions that are relatively rare in side letters, contrary to the conventional wisdom. Provisions relating to the sponsor's fiduciary duty/standard of care are virtually absent, for example, despite being thought to figure prominently in side letter requests.[179] Only 6 percent of side letters explicitly commit to granting co-investment rights to the investor.[180] Instead, side letters that address co-investment increasingly opt for a mere "acknowledgement" of the investor's interest in co-investing (in 18.7 percent of side letters). Similarly, agreements regarding (1) the economic terms of successor funds and (2) the minimum fund size are each present in only 2.4 and 2.8 percent of the sample letters, respectively. Even more notable, *only one side letter out of the 252 in our sample (0.4 percent) granted the investor a fee discount for their current fund.*

[179] *See* Clayton, *Bargaining Problems supra* note 156.
[180] *See* Appendix C for the incidence of such provisions.

Table 4: Top 10 most common side letter provisions (Full sample: 1991-2020)

| Term | % Side Letters: 1991-2020 | Rank: 1991-2020 |
|---|---|---|
| MFN | 64.3% | 1 |
| Exceptions to Confidentiality/ LP Right to Disclose | 59.1% | 2 |
| Tax & ERISA - Other reporting /notices/reps (audits, tax shelters, PFICs, withholding, etc.) | 59.1% | 2 |
| MFN Exclusion: Laws, rules and regulations applicable to some but not other LPs | 51.2% | 4 |
| MFN Exclusion: LPAC or observer seats | 50.8% | 5 |
| Transfer /Assignment to Affiliates | 46.0% | 6 |
| Tax - UBTI and/or ECI covenant not to incur (and other tax covenants) | 34.1% | 7 |
| Clarification of an interpretation of LPA provision | 31.0% | 8 |
| Reps and warranties or opinions of GP | 27.8% | 9 |
| Notice (or Rep)- Litigation/ Enforcement actions | 27.4% | 10 |

### 4. Side Letter versus the Limited Partnership Agreement

Side letters cannot be viewed in a void. They are part of a series of deal documents that form a private equity fund and that are layered on and modify the limited partnership agreement, which sets the fund terms for all investors collectively. While the sponsor is within its rights to award different terms to different limited partners through the side letter process, it is not permitted to grant rights that might alter the rights of other limited partners without their consent.[181] Therefore, *side letters may only include*

[181] *See* ESG Cap. Partners II, LP v. Passport Special Opportunities Master Fund, LP, No. CV 11053-VCL, 2015 WL 9060982 (Del. Ch. Dec. 16, 2015) (holding that a side letter's grant to one investor of preferential rights that materially and adversely affected the other investors was equivalent to a unilateral amendment of the limited partnership agreement, in violation of the agreement's majority approval requirement for amendments).

*provisions that alter the rights of the parties to the side letter*, without implicating the rights of other parties to the limited partnership agreement.

Examining the substance of side letter provisions reveals a concerning picture. First, many side letters provisions do, in fact, impact the rights of other limited partners in a way that requires their inclusion in the limited partnership agreement. Examples of such provisions are restrictions on fund size, investment restrictions imposed on the fund, and commitments not to generate certain kinds of taxable income.[182] We find that, while trending downwards, *close to a third of all side letter provisions in the post-crisis era may have an impact on other investors*, though this is a marked improvement over the 57 percent in the pre-2005 era.

Second, Table 5 also shows that, even if they do not implicate the rights of other investors, many side letters provisions are analogous to "public goods," in that once they are granted to one investor, they are virtually costless to provide to the remaining investors. Such provisions may include fund-level financial reporting, notices by the sponsor of certain events, certain representations and warranties of the sponsor, and restrictions on the formation of successor funds. One would expect such provisions to appear in the limited partnership agreement, so as to reduce the individual negotiations required for side letters. However, while more than half of all side letter provisions in the sample could be extended to all investors at negligible marginal cost, these provisions continue to reside in side letters, rather than the limited partnership agreement. Finally, as Table 5 reveals, a significant portion of side letter provisions are terms that the other investors would want to know of because they arguably affect them, even if only indirectly or only when breached by the sponsor. Examples of such provisions include a covenant by the sponsor to maintain specific auditing standards, certification of a specific interpretation of a limited partnership agreement provision, and various notices to investors pertaining to the fund or the sponsor.

Table 5
Side letter provisions that belong in the limited partnership agreement (LPA)
(Full sample period: 1991-2020)

| **Provision should be in LPA** | | |
|---|---|---|
| **Mean** | **Standard Deviation** | **Frequency** |
| **0.546** | **0.267** | **239** |
| **Provision should be in LPA because it impacts other LPs** | | |
| **Mean** | **Standard Deviation** | **Frequency** |
| **0.400** | **0.262** | **239** |
| **Provision should be in LPA because it is costless to give to other LPs** | | |
| **Mean** | **Standard Deviation** | **Frequency** |
| **0.511** | **0.265** | **239** |

[182] *Id.*

| Provision should be in LPA because LPs would want to know | | |
|---|---|---|
| **Mean** | **Standard Deviation** | **Frequency** |
| **0.539** | **0.265** | **239** |

**5. Side Letter Opacity**

As previously highlighted, private equity fund documents are not publicly disclosed and are tightly controlled with confidentiality provisions. In contrast, the investors in the fund gain full access to the limited partnership agreement (as signatories). In that sense, while outside investors, regulators, and academics are not privy to the details of the limited partnership agreement, the investors in the fund all share equal access to that document and to any mandatory disclosure stipulated in the limited partnership agreement.

But side letters present an important departure from the concept of equal access by all partners in the fund. They are not only opaque to the outside observer; they are often similarly opaque to other limited partners in the fund. Indeed, 57 percent of the side letters that we reviewed did not require the sponsor to provide any information regarding any other side letters given to other investors.

Further exacerbating the lack of disclosure of side letters is the complex structure in which they are granted to fund investors. First, many investors in a fund do not receive a side letter at all: for an investor with little leverage, the sponsor might not be willing to grant any modified rights whatsoever. Not only will that investor not receive a side letter, it also will not be able to observe what modifications other investors are getting. Even if the investor is given a side letter, side letters differ in how they deal with the disclosure of other side letters. Only 35 percent of side letters in our sample granted to the investor the right to receive the full text of the other side letters. In the rest of our sample, side letter recipients were only given a compilation of the terms granted to others. That means investors only learn *which rights* were given to other investors, but not *to whom* they were given.

Furthermore, in some cases, investors receive a compilation consisting only of the rights from which they are entitled to elect based on their MFN, rather than all rights given to investors who received side letters. This is a common practice in which investors can "check the box" to add rights to their own side letter if they were given to other investors. This is the case when the side letter includes an MFN and such rights were not excluded from the purview of the MFN. But as side letters have grown more complex, so have the exclusions to the MFN. Many MFNs nowadays are tiered, meaning that the matching rights are only applicable to investors at or below the same investment tier as the investor (based on the total size of their investment, or "capital commitment"). Therefore, a smaller investor will only see and be able to elect rights given to investors at or below its investment in the fund. In addition, as described in Part II.C.2, many MFNs exclude some of the most valuable rights from the matching option of the MFN;

those excluded rights will therefore not be identified to investors, even if within the same tier.

To sum up, side letters are a departure from the equal treatment of investors that characterizes the limited partnership agreement, not only in their substance, but also in their disclosure. Not only do side letters modify the rights given in the limited partnership agreement, they are also unequally transparent to investors in the fund. Some investors are left in the dark with respect to what others have received from the sponsor, while some enjoy greater awareness of what has been granted, and to whom.

# III. How Did We Get Here? The Side Letter Dilemma

Based on the findings discussed in Part II, the academic and policy focus on side letters would seem, at first blush, to be much ado about nothing. Side letters are almost never used to charge different prices to different investors, and they rarely result in material differences in the treatment of investors along non-price terms. For all the attention that they receive, side letters appear to achieve very little in the way of a true substantive reallocation of rights and obligations between the sponsor and the investors, or among investors themselves.

It would be a mistake to conclude that side letters are harmless, however. While side letters seem to provide few material benefits to investors, they impose very real costs. If that is the case, why has the market not corrected the problem on its own? And how did we arrive here in the first place? This Part attempts to answer these questions.

As we will see, the costs of side letter practice today appear to more than outweigh the benefits. Supplementing this analysis, the Article also relies on a series of original interviews with limited partners, counsel for sponsors and other participants in the private equity industry.[183] These interviews provided important context to understanding the rise of side letters and some of the reasons that this practice has gained so much traction, despite the real costs it generates. Indeed, in our interviews with market experts, participants were unanimous in describing side letter practice as an inefficient waste of resources and in expressing dissatisfaction with the state of play.[184]

Our discussion and findings also carry important implications for contract theory and the emerging literature on contract modularity. While the emerging scholarship has, justifiably, highlighted the benefits of modularity and thereby justified the increasing use of modularity in transactional documents,[185] the side letter

[183] *See infra* Part III.F for our methodology and Appendix B for a list of our interviews.

[184] *See, e.g.,* Interview with Participant 7 & 8 (Apr. 8, 2021) (there is a tendency to think that investor counsel "has bad incentives to run up a bill"); Interview with Participant 4 (Feb. 16, 2021) (the side letter process is "terribly inefficient in terms of time and money"); Interview with Participant 3 (Oct. 7, 2021) (there is a trend toward side letters "getting substantially lengthier and more cumbersome").

[185] *See* Hwang, *Unbundled supra* note 29, at 1417–18. However, modularity has also the potential to disrupt contractual terms. See Kastner *supra* note 30.

phenomenon also provides a cautionary tale. In the multiparty, opaque framework of private equity fund formation, side letters may lead to what we refer to as *"over-modularity."*

This Part proceeds as follows: Subpart A describes the various costs—both direct and indirect—imposed by side letters. Subparts B, C, and D then describe the incentives of private equity sponsors, investors, and their counsel, respectively, with regard to side letter practice. This survey reveals why the market is stuck with a suboptimal regime with which all parties are dissatisfied.

### *A. The Cost of Side Letters*

Side letters impose serious costs and burdens on private equity sponsors and investors. Some of these are easily measurable, out-of-pocket costs. The most obvious are the legal fees associated with negotiating and drafting side letters.[186] Typically, each investor seeking a side letter will send a draft letter containing their desired terms to the sponsor. The sponsor, faced with a battery of different form letters and terms, will then negotiate separately with each investor until an agreement is reached as to final terms. (These negotiations are primarily between sponsor counsel and investor counsel, with the investment principals at the sponsor and the investor rarely participating.)[187]

Complicating matters further, as we have seen some investors successfully negotiate for a "most favored nations" (MFN) clause in their side letter, which permits them to elect to obtain the benefit of any provision in other investors' side letters.[188] The result is that, once the buyout fund has closed, this triggers a new flurry of activity between the sponsor and investor counsel, as the terms of the various side letters that the sponsor agreed to are circulated to investors, who then determine which provisions to elect under their MFN right. This process diminishes any purported benefit of modularity, however. No longer are side letters modules that do not interact with and do not rely on other elements of the deal[189]—in this case, the private equity funding process and the limited partnership agreement. Instead, they quickly turn into a cost drain as the interdependencies of the increasingly long and complex side letters are checked against one another.[190] Reconciling these investor elections and clarifying the

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[186] The highest paid private-equity law firm "billing rates range from $1,500 an hour for partners to $500 an hour for associates, who work to hammer out the investor agreements according to a private-equity attorney. . . . And with budgetary constraints limiting how much they can spend on their own attorneys, investors hire firms that offer lower hourly rates than the private-equity firms." Sullivan, *supra* note 1.

[187] *See* Sullivan, *supra* note 1.

[188] In practice, MFN provisions are not unqualified and universal in the manner just described. There are many variations of MFN provisions and many restrictions on their applicability.

[189] *See* Part I.B, *supra*.

[190] Interview, Head of investment operations in large-size private endowment, Feb. 19, 2021. *See also* Hwang & Jennejohn, *supra* note 29 at 386–7 ("Cognitive load" measures the "amount of difficulty humans have in understanding a particular piece of language. . . . Since contingencies, enforcement uncertainty, cross-references and integrations with other agreements, document length, and linguistic complexity all

final terms applicable to each investor is a complex, labor-intensive task. It is not surprising, then, that side letter negotiations result in very large legal fees. Our interview participants confirmed that negotiation costs have spiraled upwards as side letters have become more complex. One participant equated side letters to "Frankenstein's Monster," stating that "some are 40 pages long" and that it takes approximately fourteen hours to review the fund documents and half as much in addition to negotiate the side letter.[191]

More troubling, perhaps, are the less visible and measurable costs of side letters. First and foremost are the time and attention they require. Side letter practice imposes a material delay on the private equity fundraising process.[192] Because buyout funds are private investment funds, they can typically raise capital faster than can companies going through an initial public offering, for example. Nonetheless, separate side letter negotiations with dozens or potentially hundreds of investors are necessarily time-consuming, and they materially lengthen the fundraising period before the fund can begin making investments. They are also considered a distraction by sponsors: side letter negotiations can drag sponsors away from their primary task of identifying promising investments. On the investor side, private equity investors must either specifically instruct their outside counsel on what to push for in side letter negotiations or hire their own in-house staff for that purpose.

A third, but no less important, category of costs stems from the terms of the side letters themselves. Certain side letter provisions alter the sponsor or the fund's behavior *in ways that could harm other investors in the fund*. Imagine, for example, a buyout fund investor that is a charitable foundation with a strong environmental or social mission. If the investor is large, it may successfully negotiate for a side letter provision requiring the fund not to invest in industries such as oil and gas, tobacco, and firearms. (Alternatively, the side letter may simply "excuse" the investor from participating in such fund investments, or state only that the sponsor will "consider" not causing the fund to make such investments.)[193] This side letter provision provides a real benefit to the foundation: it allows it to optimally balance its desire for high investment returns with its environmental and social mission. From the perspective of *other* investors in the fund, however, this provision—of which they may be entirely unaware—may be highly problematic. If their own goal is to maximize their investment return from the fund by whatever means, a provision that leads to the sponsor to forego potentially lucrative investments is clearly suboptimal and may, unbeknownst to them, reduce the value of their stake in the fund. Side letter provisions can thus alter the fund's operations in ways

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increase cognitive load, an overall measure of cognitive load captures a variety of inputs that can increase complexity.")

[191] Interview with Participant 10 (Dec. 16, 2021). *See also*, Sullivan, *supra* note 1, for the hourly costs incurred by lawyers to do these deals.

[192] *See* Debevoise & Plimpton, *supra* note 12, at 19 (describing the typical fundraising process for private equity funds, which lasts over a year).

[193] *Id.*, at 42-43 (describing withdrawal and excuse rights in private equity funds).

that harm other investors and that potentially reduce the value of the fund overall. These are costs that must be taken into account in judging the value of side letter practice.

To make matters worse, recent SEC enforcement actions have exposed the fact that many sponsors violate the terms of the limited partnership agreements to which they are party, unbeknownst to investors.[194] Yet side letters are even less visible, often only known to one investor, which further increases the risk of sponsors breaching their express contractual obligations with no one noticing.

More generally, the fact that side letter practice results in the sponsor's and the fund's obligations being spread across dozens of different agreements, negotiated by different parties, leads to an extraordinarily complicated contractual morass. This renders compliance difficult for the fund—even for a sponsor acting in good faith—and imposes costs and delay in the fund's operations, while the sponsor constantly confirms whether it is complying with its differing and possibly conflicting obligations.

### *B. The Sponsor's Incentives*

If side letters contain largely inconsequential terms, yet generate considerable costs and complexity, why do they not only persist, but proliferate? If side letters are only very rarely used for price discrimination among investors, what role do they serve? Sponsors in particular would seem to have a strong incentive to forego them, given the costs and delay that they impose on fundraising. Why would sponsors not simply incorporate investors' various requests into the limited partnership agreement or the subscription agreement—which apply to all investors—rather than negotiate myriad bilateral contracts with individual investors? There are two principal answers to this conundrum, both of which pose a challenge for classical contract theory.

#### 1. Maintaining a Sponsor-Favorable Limited Partnership Agreement

First, sponsors typically wish to maintain approximately the same template for the limited partnership agreement across their various funds and over time. A successful buyout sponsor does not raise and manage a single fund; rather, it will form a "successor" fund partway through the life of its existing fund, and the cycle will continue for as long as investors are willing to invest with the sponsor. When the sponsor agrees with its investors on a limited partnership agreement for Fund I, it may wish to retain roughly the same agreement for Funds II, III, IV, and so on, so long as the terms were favorable to it. Yet, market conditions, regulations, and the cast of investors can change over time, such that investors' requests in negotiations will also change. Maintaining a consistent form of limited partnership agreement over time therefore requires the sponsor to address investors' new requests in separate side letters.

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[194] *See, e.g., In the Matter of Corinthian Capital Group, LLC*, 3-19159 S.E.C. (2019) (finding that Corinthian Capital inappropriately applied certain LPA provisions, resulting in the fund's limited partners overpaying approximately $1.4 million in management fees).

The desire for a consistent form of limited partnership agreement across funds cannot be purely aesthetic. Rather, sponsors must believe that this approach provides them with a material *economic* advantage—either that it reduces the costs of contracting with investors in some manner or that it results in more favorable terms for the sponsor in its negotiations with investors. The former explanation is ruled out, because, as we have seen, side letters *increase* the costs of contracting. Therefore, sponsors must believe—rightly or wrongly—that the final terms of their agreements with investors are likely to be more favorable to them (1) under the current practice of having a limited partnership agreement that changes relatively little over time, combined with an array of side letters, than (2) under the alternative of incorporating all investor requests into the limited partnership agreement and allowing it to change materially over time.[195]

Where might this advantage stem from? The most likely candidate is the widespread belief that contract terms in the limited partnership agreement are "sticky"—that is, that such terms have an "anchoring" effect on the final bargain reached by the parties.[196] In other words, investors may agree to a particular term in the limited partnership agreement simply because they have agreed to it before, even if they would prefer a different term if they were starting from scratch. If that is indeed the case, then sponsors have an incentive to maintain a limited partnership agreement with highly sponsor-favorable terms, while relegating any investor-favorable terms to side letters. Relatedly, sponsors may believe that adopting a divide-and-conquer strategy with investors results in a more favorable outcome for them: instead of having investors potentially band together in some way to negotiate the limited partnership agreement, the sponsor faces them one at a time in separate side letter negotiations.

We should note that there is little clear evidence one way or the other for whether these beliefs are in fact justified. That is, for any given buyout fund, we do not know whether the overall package of terms is indeed more favorable for the sponsor if it combines a sponsor-friendly limited partnership agreement with many investor-friendly side letters than if all terms are combined into the single limited partnership agreement. However, the persistence of these types of beliefs among businesspeople and lawyers is a fascinating illustration of the continuing discrepancies between contract theory and the reality of contract practice. Indeed, the classical law and economics analysis of contracts begins with the premise that sophisticated parties will reach a bargain on terms that optimize their collective preferences and constraints.[197] Therefore, classical economic theory does not account for a sponsor's desire for consistency in the limited partnership

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[195] According to one interviewee, there is a historical basis for sponsors to adopt this structure: back when fundraising for private equity was difficult, sponsors were more willing to do anything to bring in limited partners. *See* Interview with Participant 4 (Feb. 16, 2021).

[196] *See* Adam D. Galinsky & Thomas Mussweiler, *First Offers as Anchors: The Role of Perspective-Taking and Negotiator Focus*, 81 J. PERSONALITY & SOC. PSYCHOL. 657, 667 (2001); Amos Tversky & Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124, 1131 (1974).

[197] *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limited of Contract Law*, 113 YALE L. J. 541, 545 (2003).

agreement, but not in side letters: it simply does not recognize that the *order* in which terms are negotiated and what *form* of document they are contained in might affect the final terms agreed to by the parties.

### 2. Going with the Flow: Why Sponsors Let Investors Seek Side Letters

A different explanation altogether for why sponsors have not put a stop to the side letter process is that they are simply conceding to the wishes of investors, or more accurately that they do not have sufficiently strong incentives to push back on side letter requests from investors.

First, although the costs of side letter negotiations are considerable, they are primarily borne by the investors in the fund, rather than the sponsor. Indeed, the sponsor's legal costs of side letter negotiations are typically treated as an "organizational expense" of the fund—that is, a cost of setting up the fund. As such, these costs are treated as a *fund* expense, such that they are ultimately charged to the investors collectively.[198] This means that, while the sponsor may prefer not to waste time on side letter negotiations, it typically does not bear any out-of-pocket expenses from doing so, and therefore does not have strong incentives to put a stop to them.

Second, if side letter terms tend not to be material, sponsors may simply be willing to tolerate them as a concession to investors. In particular, if investors *believe* that they are getting special treatment through their side letter compared to other investors (even though, as we have shown in Part II, this is rarely the case), then sponsors may view side letters as a relatively cheap way of keeping investors happy and attracting them to the fund.

## *C. The Investors' Incentives*

### 1. A Prisoner's Dilemma

The primary obstacle to shrinking and reforming side letter practice is a collective action problem among investors. Our evidence suggests that private equity investors *collectively* would be considerably better off if all terms were negotiated in the limited partnership agreement, or, at a minimum, if side letter practice were standardized and constrained to a strict minimum of regulatory provisions. And yet, investors *individually* lack the incentives to change the practice.

The explanation for this seeming paradox is that buyout fund investors face a prisoner's dilemma when it comes to side letters.[199] While investors collectively would be better off avoiding the transaction costs and other inefficiencies created by side letters, each individual investor has an incentive to "defect" from this equilibrium by trying to

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[198] Often organizational expenses are subject to a dollar cap: up to the capped amount, the expense is borne by the fund (and therefore, ultimately, by the investors), but any amount above the cap is borne by the sponsor. *See* Debevoise & Plimpton LLP, *supra* note 12, at 36.

[199] *See* Avinash Dixit & Susan Skeath, Games of Strategy 90-92 (2nd ed. 2004).

negotiate its own side letter. If Investor A knows that Investors B, C, and D could negotiate for additional rights from the sponsor in separate side letters, then A should rationally try to obtain its own side letter. Game theory suggests that we should expect precisely the outcome that we observe in practice for the private equity industry: *investors seeking ever more side letters and side letter terms over time*.

In theory, this inefficient outcome—like all prisoner's dilemmas—could be avoided by means of a binding agreement among investors *ex ante* (with sufficiently punitive consequences for a breach).[200] Such an agreement is impracticable in context, however. First, during the fundraising period prospective investors typically do not know which other investors are expecting to participate in the fund. Second, such collective bargaining by investors could potentially raise antitrust concerns. We are therefore left with a pure arms race among investors, with each one seeking to maximize the provisions that it obtains in a side letter, and continually adding new terms over time. As such, the growth in side letters over the past thirty years may have little or nothing to do with increasing regulatory complexity or other market changes that have been postulated—it may simply be the result of an inefficient competition for terms.

The problem is exacerbated by the fact that investors in buyout funds differ as to their bargaining power versus the sponsor, with larger investors better positioned to negotiate preferential terms. By definition, the provisions of a side letter apply only to the investor who signed it. Yet terms in the limited partnership agreement apply to all investors in the fund. Thus, all else equal, an investor with the power to negotiate favorable terms should prefer to have such terms appear in its own side letter than in the limited partnership agreement.[201]

Finally, even if investors were willing to cooperate with one another to negotiate uniform provisions and to move them from side letters to the limited partnership agreement, the secrecy and absence of disclosure surrounding fund formation and the side letter process would make such coordination extremely difficult.

### 2. A Battle of the Forms

The second explanation for why investors have not managed to curtail the side letter process relates to the fact that, like sponsors, private equity investors tend to be repeat players in the industry. Large sovereign wealth funds or pension funds, for example, tend to be continuously invested in the buyout strategy, meaning that they have invested in dozens or even hundreds of such funds over time. As a result, each is likely to develop a "form" of side letter request, containing all side letter terms that it expects from a sponsor, because this saves time (for the investor, rather than the sponsor), promotes consistency over time (again, for the investor, rather than the sponsor), and

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[200] *See* Dixit & Skeath, *supra* note 198 at 356-59

[201] *See* William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. REG. 67 (2020).

ensures compliance with the investor's special regulatory or tax concerns.[202] Once investors develop their own form side letters, however, the default assumption is that the fund will permit side letters and that the sponsor will negotiate different provisions with different investors, thus exacerbating the complexity and delay. As with the prisoner's dilemma described above, the proliferation of investors' bespoke "form side letters" reflects a divergence between investors' collective interest and their individual incentives.

### *D. The Lawyers' Incentives*

Up until now, the discussion has implicitly treated the parties whose economic interests are at stake (the sponsor and the investors) and the parties negotiating the limited partnership agreement and side letter terms as one and the same. This is clearly not the case: both sponsors and investors rely heavily on their respective counsel for negotiations and drafting. As agents for their clients, lawyers in this market have very particular incentives that may depart from the interests of their principals. It is therefore worth pausing to describe who these lawyers are.

Outside counsel for private equity sponsors and investors tend to draw from a very small set of elite law firms that specialize in private equity practice. While some of these law firms split their work between sponsors and investors, most tend to specialize primarily in either sponsor-side work or investor-side work. As a result, these law firms are, surprisingly, the purest repeat players in the industry: they outlive most sponsors and participate in more fund negotiations than investors do. For the lawyers, "[k]nowing what terms investors have agreed to in past deliberations can give one side an edge over the other when it comes time to negotiate a new contract."[203]

The dollars at stake are enormous. A quick search of law firm websites reveals that private equity has become the largest practice group for several of these firms. Unfortunately, neither sponsor counsel nor investor counsel has strong incentives to rein in side letter practice. To the contrary, both sides are integral to its expansion and increasing complexity.

#### 1. <u>Sponsor Counsel: Branding the Partnership Agreement "Form"</u>

Sponsor counsel refers to the small club of law firms that generate substantial business from "fund formation," the process of setting up funds for sponsors and managing the fundraising process and negotiations with prospective investors. To

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[202] *See* Debevoise & Plimpton LLP, *supra* note 12, at 23 ("Many institutional investors now have a list of personalized 'standard' side letter requests that they make in respect of each Fund investment.").

[203] Sullivan, *supra* note 1 (citing an anonymous source claiming that Kirkland & Ellis is "accruing somewhat of an unfair advantage" by advising so many private-equity-fund formations that it has effectively monopolized the market).

continue to attract business from new and repeat sponsors, these firms must demonstrate not only their expertise with the market, but also their ability to obtain favorable terms for sponsors. Both goals can be achieved by developing and maintaining a well-known "form" of limited partnership agreement that contains highly sponsor-favorable terms.[204] This is precisely what the most successful sponsor-side firms have done. Such is the prevalence of this approach to drafting that any experienced lawyer can tell within minutes of reading which of the top law firms drafted a particular limited partnership agreement for a buyout fund.

The incentives to maintain a consistent, sponsor-favorable form of limited partnership agreement are therefore even stronger for sponsor counsel than they are for sponsors themselves. Indeed, *a law firm's particular form of limited partnership agreement is a type of branding:* the more recognizable and sponsor-favorable the form, the more powerful the brand, and the more the firm will attract sponsor business.

In our interviews, sponsor counsel complained bitterly about the inefficiency of the side letter process and attributed it to investors and their counsel. Ironically, however, sponsor counsel arguably bears the larger share of the blame, through their insistence on maintaining a consistent and highly sponsor-favorable form of limited partnership agreement.

Unfortunately, this rigidity surrounding limited partnership agreement forms likely benefits sponsor counsel more than it does their clients. As discussed, these near-universal beliefs in the private equity industry about the power of forms conflict with some classical contract theory. The latter postulates that voluntary agreements are always reached on terms that maximize the parties' joint surplus.[205] If that is true, then sponsors cannot succeed in getting exceptionally favorable terms into the limited partnership agreement "for free": they must give something up in exchange. Investors will not be fooled by a sponsor-favorable limited partnership agreement into agreeing to something that they do not want. Moving investor-favorable terms to side letters or keeping them in the limited partnership agreement should not affect the final bargain. Nonetheless, most lawyers hold precisely these views, and the debate has yet to be resolved empirically.

### 2. Investor Counsel: Negotiating in Silos

Representing investors in buyout funds can also be a highly lucrative practice, albeit less so than fund formation. Due to the billing structure for this type of work, and perhaps also due to risk aversion, counsel for investors have focused on improving and expanding side letter terms for their own clients, rather than on trying to achieve the best overall outcome for the investor side of the market. Firms that specialize in investor-side work typically represent numerous institutional investors, often in the same fund and at the same time. In principle, these firms could work together to aggregate

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[204] *See id.*

[205] *See supra* note 196 and accompanying text.

and then simplify and standardize the common terms that they encounter across investors and funds, which would save their clients considerable time and money. Thus far, however, investor counsel has failed to standardize side letter practice, simply because they have no economic incentive to do so.

### *E. Contractual Over-Modularity*

The previous Subparts serve as a cautionary tale regarding modular contractual structures. To be clear, modulatory has many benefits and many deal structures benefit greatly from the use of modular contractual design. Yet not every transactional setting necessarily benefits from modularity and side letters are a perfect case study. As we detailed, strategic behavior as well as misaligned incentives have led to an arms race in the side letter space. Instead of improving efficiency and reducing costs, side letters unnecessarily move provisions from the limited partnership agreement into individually tailored agreements, thereby requiring multiple versions of the same provisions to be negotiated simultaneously. The result is a more costly and less efficient process.

Aside from the culprits we discussed in Subparts A-D above, two other factors merit highlighting. First, unlike many other forms of transactional deal-making, such as mergers and acquisitions, the side letter process is a multi-party negotiation. The allocation of various subjects to various documents is not done only between two parties (or multiple parties controlled/represented by one entity) but rather among many parties. Modularity in that setting may exacerbate the negotiation process rather than improve it. Instead of one term, similar terms are now negotiated between the sponsor and many other participants.

Second, the simultaneous, and opaque, nature of side letters may also contribute to over-modularity. Not only do multiple side letters exist, they are being negotiated at the same time as the limited partnership agreement and as other side letters are negotiated. Therefore, investors may negotiate out of fear of losing a zero-sum game, or to protect themselves from future concessions given to other investors in a way that leads to excessive fragmentation of the process.

Taken as a whole, the fund formation process of private equity funds differs significantly from that of many other business deals. That process, and the rational but inefficient incentives of investors, sponsors, and their lawyers, have led to a proliferation of side letters in ways that are excessively modular and inefficient.

### *F. Interview Methodology*

This section discussed findings from original interviews that we conducted with investment officers, in-house counsel and outside counsel for both sponsors and investors. The interviews provide further insight into the role of side letters in fund formation and shed light on the trends that we observe in our data. A table describing the interviews is set out in Appendix B. To identify interview subjects, a snowball sampling technique was employed, beginning with several participants to whom we

reached out proactively, and asking each interviewee to refer us to anyone else willing to be interviewed. The clear downside of snowball sampling is that it is difficult to obtain an unbiased sample. However, this technique helped us gain access to participants who might otherwise have been disinclined to participate. Because of the challenges associated with using snowball sampling and interviews in general, the interviews referenced in this article only provide context and support to our data and analysis.

# IV. Reconceptualizing Side Letters

On their surface, side letters are exactly the type of modular contractual tool that scholars have advocated for in other areas of transactional law.[206] Side letters allow the sponsor to differentiate between different investors and to address investors' specific regulatory or operational idiosyncrasies without burdening the limited partnership agreement with numerous carve-outs and carve-ins. They have also been widely perceived as potential tools for efficient price differentiation. Moreover, the MFN provision itself, present in many side letters, solves many of the concerns raised by the multi-party negotiation process of private equity funds by providing investors the comfort to negotiate their deals before other parties have negotiated theirs—providing a matching mechanism of sorts after the process is complete.

But our data shows that the prevailing practices and contents of side letters fall significantly short of the efficient modular document one could have envisioned. While we do not find any evidence of price differentiation that modularity might enable, we find that side letters have grown significantly longer, often accounting for the bulk of the documents in the deal. Side letters have grown more complex, requiring more effort and time to negotiate. The MFN, despite its benefits, has also grown more complex, on the one hand providing investors with an impossibly long list of options to choose from after the fund closes, but on the other hand excluding many of the most important provisions in the side letter, thereby forcing investors to negotiate them individually. Most importantly, we find that side letters often contain provisions that must or should be included in the limited partnership agreement—either because they impact other investors or because it is more efficient to include them in the limited partnership agreement.

We have also traced the side letter puzzle to several distinct forces, each raising serious concerns about the current value side letters provide to investors and sponsors alike. Lawyer incentives, investors' prisoner's dilemma, and incomplete information have all contributed to the proliferation of side letters, even when it is not in the best interests of either investors or the sponsors.

To break out of the current arms race in side letters, we argue in this Part IV for a much-needed reconceptualization of side letter practice, potentially requiring an

[206] *See* Hwang, *supra* note 29, at 1410.

intervention by regulators, investor groups, and sponsors themselves. We divide our recommendation into two parts. First, we recommend ways to reduce the complexity of the side letter process by standardizing key provisions, normalizing fee differentiation in the limited partnership agreement, and by forcing each investor to fully bear the cost of its own side letter. Second, we discuss ways to reduce the arms race by improving fund and sponsor disclosure and by shifting many side letters provisions to the limited partnership agreement. Finally, we discuss how investors, sponsors and regulators could implement these recommendations, while also highlighting how the SEC's recent proposed regulation of side letters misses some of the real issues at stake.

### *A. Reducing Side Letter Complexity*

Among transactional documents, side letters are not alone in having grown more complex over the last few decades. M&A deals, for example, have become more complex, necessitating more attention to various business, legal and regulatory issues in the underlying agreements.[207] Side letters may not fit that set of justifications, however. Unlike the limited partnership agreement that establishes most terms of the deal, side letters deal with a discrete set of issues that have not significantly changed over the last twenty years. They mostly provide additional governance and disclosure rights to investors who have been investing in the private equity space for decades. Yet, side letters have undeniably grown longer and more complex. In Part III we identified several potential drivers of this trend and of the costs that it entails. We are skeptical that the spiraling complexity currently exhibited by side letters is indeed warranted or beneficial. Below, we offer three key recommendations for curbing side letter complexity.

#### 1. <u>Legal Costs</u>

Side letters continually expand in part because the cost of negotiating them is not fully borne by each investor, and it is not borne at all by the sponsor. Currently, the sponsor's legal fees for side letter negotiations are treated as a *fund* expense and are thus borne by all fund investors collectively.[208] As a result, sponsor's counsel has little incentive to minimize negotiations, while individual investors can (partly) pass off the sponsor's costs for their own lengthy side letter negotiations to other investors, *including those who receive no side letter at all*. This cross-subsidy allows sponsor counsel to allocate significant resources to the negotiation and reduce the incentive of each investor to reach a simple and streamlined document. We recommend that the sponsor's legal costs for side letter negotiations no longer be treated as a fund expense. Rather, each investor and the sponsor should bear the cost of negotiating any side letter to which it is a party.

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[207] *See* Robert Anderson & Jeffrey Manns, *The Inefficient Evolution of Merger Agreements*, 85 GEO. WASH. L. REV. 57, 76 (2017) (documenting the increase in length of merger agreements between 1994 and 2014); John C. Coates IV, *Why Have M&A Contracts Grown? Evidence from Twenty Years of Deals* 14 (European Corp. Governance Inst. (ECGI), Working Paper No. 333, 2016), https://ssrn.com/abstract=2862019 (documenting the increase in both length and complexity in merger agreements over the same twenty-year period).

[208] *See* Clayton, *Bargaining Problems supra* note 156.

Internalizing the cost of negotiating side letters will help ensure that investors do not negotiate lengthy side letters with other investors' money, but rather focus on the key issues that are of particular importance to them.

### 2. Demystifying Side Letters.

As our interviewees have expressed,[209] part of the driving forces behind side letters is what one might refer to as the vicious cycle of side letters. Not knowing what other investors are getting until after the fund closes (under the MFN election), if at all (such as when an investor receives no side letter, no MFN, or an MFN that is applicable only to a specific set of investors or terms) has led investors to negotiate for side letters provisions out of fear of losing out. Therefore, we recommend that all side letter terms be disclosed to all investors in the fund. Our review of side letter provisions across a large sample of funds reveals no justification for keeping such provisions confidential among investors. Side letters simply do not contain anything proprietary as to either the sponsor or the investor. Disclosing side letters to all investors could help dampen investors' enthusiasm for them, given their largely immaterial contents, in addition to facilitating greater coordination among investors in negotiating collectively against the sponsor in the limited partnership agreement, rather than individually in side letters. As one interviewee, the co-founder of the private-equity practice at a top U.S. law firm, stated: "[O]ne thing that has always amazed me is how consistently horrible [investors] have been at negotiating with sponsors for the last 40 years!"[210]

### 3. The Value of Boilerplate Provisions

As we have seen, the bulk of side letter provisions for buyout funds relate to investors' regulatory and tax concerns. An investment in a private equity fund creates more regulatory and tax risk for investors than an investment in, say, a mutual fund, for several reasons. First, U.S. private equity funds are typically formed as limited partnerships or LLCs and are therefore treated as partnerships for U.S. tax purposes unless they elect otherwise. This means that, for tax purposes, any income earned by the fund flows through directly to the investors, who are treated as engaging directly in the business of the fund itself (and of any of the fund's portfolio companies that are themselves partnerships for U.S. tax purposes). This creates significant tax concerns for certain investors, such as U.S. tax-exempt investors (including pension funds, university endowments, and charitable organizations) and foreign investors. Second, buyout funds hold *controlling* stakes in their portfolio companies, as opposed to mutual funds and other

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[209] Interview with Participants 7 & 8 (Apr. 8, 2021) ("Sponsors would love to get rid of side letters" because there is a tendency "to think [investors'] outside counsel has bad incentives to run up a bill; Interview with Participant 10 (Dec. 19, 2021) (Although neither sponsors nor investors want side letters, the persistence of side letters "is coming from [sponsor] counsel").

[210] The interviewee continues, "There's an answer to that, which is that the returns were so good that they didn't care or didn't have the bargaining power. But even now that the treturns are less good, they still aren't negotiating effectively. I don't get it." Interview, May 13, 2020.

funds that hold minority stakes (and typically small ones) in public companies. Controlling stockholders can be subject to additional prohibitions, liabilities, and obligations under the securities laws, pension rules, U.S. national security laws, and many other areas of law.[211]

These special regulatory and tax burdens, which differ across investor types, would seem to justify tailoring side letters to different investors. The review and coding of all side letters in our sample suggests the opposite conclusion, however. Different categories of private equity investors undeniably face different tax and regulatory concerns from their investment in the fund. Yet these categories of investors and the tax and regulatory concerns that they face have long been identified, as have the contractual provisions that can address them. These provisions are therefore perfectly suited for standardization not only across investors of the same type within the same fund, but across the entire industry.

Currently, we observe extensively tailored regulatory and tax provisions in side letters that are nonetheless substantively identical. These provisions can be, and should be, boilerplate. The fact that different categories of investors face different concerns is no impediment whatsoever: there would simply be separate boilerplate provisions for each category of investor: U.S. high-net-worth individuals, U.S. tax-exempt investors, foreign investors, investors claiming sovereign immunity, etc. This approach is neither novel nor difficult: for example, the securities law disclaimers for foreign investors in the marketing materials for buyout funds have long been boilerplate, with each country requiring a different disclosure.[212]

Indeed, the possibilities for simplification are obvious: investors could simply check the box next to the provisions that apply to them in their subscription agreement, for example, rather than negotiate a bespoke side letter to address them.

Thus far, there has simply been a failure of collective action to bring about this change. As discussed, the largest limited partners all have their own form side letters with substantively equivalent provisions, leading to endless negotiations with sponsors as the latter seek to reconcile the different provisions. The small group of elite law firms representing sponsors and the largest investors could easily coordinate to standardize these provisions for the industry, but, lacking the incentive to reduce their clients' legal fees, they have failed to do so.

Such coordination and standardization over complex legal terms is demonstrably achievable, however. And while it could be imposed by regulatory fiat, as is the case with registered investment funds such as mutual funds, successful private ordering examples exist as well. In the early 1990s, the largest derivatives dealers coordinated to create the standardized ISDA forms for over-the-counter derivatives, thereby reining in an

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[211] *See supra* note 172.
[212] *See* Debevoise & Plimpton LLP, *supra* note 12.

extraordinarily unwieldy and complex contracting practice.[213] The National Venture Capital Association dramatically reduced the time and legal fees associated with venture financing of early-stage companies by developing and publicizing a standardized set of model documents for venture capital financing, which have been wildly influential in the industry.[214] It is past time for the private equity industry to do the same, by shedding the secrecy surrounding documentation that only benefits the lawyers.

### *B. Back to the Limited Partnership Agreement*

Side letters have not only grown more complex, they have also unsettled the modular structure of the fund formation process, by incorporating provisions that should figure instead in the limited partnership agreement. Our analysis has revealed many provisions that were either required to be included in the limited partnership agreement because of their impact on other investors, or that at the very least would be more efficiently slotted in the limited partnership agreement. Below we highlight three key areas where we believe the limited partnership agreement should take center stage rather than the side letter.

#### 1. Explicit Price Differentiation

First, contrary to those who oppose any differential treatment of private equity investors, we acknowledge that price discrimination can sometimes benefit the parties overall. We have shown, however, that the conventional wisdom that side letters are the tool through which such price discrimination is achieved, is incorrect. Instead, *most price discrimination in private equity funds today appears to occur only indirectly, and only through informal (unwritten) agreements*.[215] For example, rather than granting an explicit fee discount to an investor in a side letter, a sponsor may merely acknowledge in the side letter that the investor is interested in co-investment opportunities. Whether the investor will in fact be offered co-investment opportunities, and whether it will pay lower fees to the sponsor on such co-investments, are left open. Co-investments are a strikingly inefficient form of price discrimination, however, as they generate major transaction costs and the

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[213] *See* John Biggins, *'Targeted Touchdown' and 'Partial Liftoff': Post-Crisis Dispute Resolution in the OTC Derivatives Markets and the Challenge for ISDA*, 13 German L. J. 1297, 1310–11 (2012).

[214] *See* Troutman Pepper, *Modeling the Market: The National Venture Capital Association Revises its Model Documents*, (Sept. 16, 2020) https://www.troutman.com/insights/modeling-the-market-the-national-venture-capital-association-revises-its-model-documents.html ("[The] updated suite of model venture capital financing documents . . . reflect the current events shaping the investment climate, and for the first time, embedded analysis of market terms in the NVCA's model term sheet."); *see also* NVCA, *Model Legal Documents*, (2020) https://nvca.org/model-legal-documents/.

[215] In addition, during our interviews with market participants we learned that in some cases sponsors and investors enter into a third agreement, often termed "confirmation letters" or "diligence rights" that may contain specific beneficial treatment that is not subject to the MFN. *See, e.g.,* Interview with Participants 7 & 8 (Apr. 8, 2021) and 11 (Jan. 1, 2021).

investor has no obvious means of predicting what the investment amount, returns, and fee discounts will be in advance.

We therefore recommend that sponsors be *encouraged* to make any desired price discrimination among investors explicit in the limited partnership agreement itself. For example, limited partnership agreements could include a schedule of different management fees or carried interest rates for investors based on the size of their commitment to the fund. Our interview participants confirmed that a small set of sponsors already adopt this approach.[216]

Encouraging explicit price discrimination would lessen the incentives to discriminate inefficiently among investors (i) in side letters on the basis of *non*-price terms as a substitute for price terms or (ii) through indirect and costly approaches of price discrimination such as co-investment rights. It would also remove the uncertainty surrounding current side letter negotiations, where smaller investors are often left in the dark regarding the price terms of larger investors.[217] While some private equity sponsors have already followed this path, we believe that an explicit blessing of this approach from regulators and from the investor side could produce sufficient momentum for a substantive change. It is especially discordant that regulators and politicians have thus far discouraged price discrimination in private equity funds, when the practice is standard for investment funds (such as mutual funds) that are open to *retail* investors.[218] Why should buyout funds with large and sophisticated institutional investors not do the same?

### 2. Complying with Partnership Law

Astonishingly, we find that approximately 40 percent of the side letters in our sample are arguably unenforceable.[219] Indeed, the law effectively limits what terms side letters may include. All private equity limited partnership agreements contain provisions specifying how they may be amended. (For most partnership agreement terms, amendment requires the consent of the sponsor and a majority in interest of the investors.)[220] But what constitutes an "amendment"? Recent case law confirms what practitioners have long understood: at a minimum, a side letter provision with the

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[216] *See, e.g.,* Interview with Participants 7 & 8 (Apr. 8, 2021).

[217] *See* Securities and Exchange Commission, *supra* note 14 (noting the massive increase in private fund assets from a variety of sources, small and large).

[218] Mutual funds frequently offer different classes of shares, each with a different management fee, depending on the size of the investor's commitment. Investors with larger commitments will pay a lower management fee.

[219] We find that an average of 40.04% side letter provisions in our sample should have been included in the limited partnership agreement, because they could negatively impact other investors.

[220] *See* Debevoise & Plimpton LLP, *supra* note 12, at 43 ("Majority in interest is typical for general amendments to a Fund Agreement").

potential to negatively affect *other* investors in the fund would constitute an amendment of the limited partnership agreement requiring the appropriate parties' consent.[221]

Limited partnership agreements typically contain a provision acknowledging that the sponsor and the fund may enter into side letters with individual investors. Mere disclosure of this possibility is not sufficient to cleanse the problem, however, where the side letter term negatively affects other investors.[222] For example, a side letter provision permitting one investor to sell its interest in the fund to a third party at any time (while other investors are locked into the fund for the full term, could negatively impact the remaining fund investors.[223]

And yet, as discussed in Part II, we find that these and other provisions that can negatively affect other investors run rampant in buyout fund side letters. Why would sponsors run the risk of breaching the limited partnership agreement by agreeing to such terms? One likely answer is that the risk of being caught is very low: given that most side letter terms are secret (other than for other investors with side letters that contain MFNs), the investors who are potentially harmed do not know enough to complain. In addition, because private equity investors are repeat players, they are rationally reluctant to develop a reputation for suing sponsors; such litigation is therefore extremely rare. If the requirement not to include terms potentially affecting other investors in side letters were routinely and vigorously enforced, most obviously by the SEC, then necessarily a slew of common side letter terms today would be moved to the limited partnership agreement. (Sponsors could then decide whether to grant such rights to all investors or to differentiate explicitly among them in the limited partnership agreement.)

### 3. Moving Low Cost "Gives" to the Limited Partnership Agreement

Sponsors' strong desire to limit and control information about their respective funds has proved to be a significant obstacle to streamlining investors' side letters. Investors often seek side letter provisions requiring the sponsor to provide them with basic reporting about the fund, its investments and the sponsor. This is because the mandatory reporting provisions in buyout funds' limited partnership agreements are

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[221] *See* ESG Cap. Partners II, LP v. Passport Special Opportunities Master Fund, LP, No. CV 11053-VCL, 2015 WL 9060982 (Del. Ch. Dec. 16, 2015) (holding that a side letter's grant to one investor of preferential rights that materially and adversely affected the other investors was equivalent to a unilateral amendment of the limited partnership agreement, in violation of the agreement's majority approval requirement for amendments).

[222] *See* Debevoise & Plimpton LLP, *supra* note 12, at 23 (stating that "a side letter cannot amend the Fund Agreement with respect to the other investors").

[223] "We believe that granting preferential liquidity terms on terms that the adviser reasonably expects to have a material, negative effect on other investors in the private fund…is a sales practice that is harmful to the fund and its investors" Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Exchange Act Release Nos. IA-5955; File No. S7-03-22, 17 CFR Part 275 (Feb. 9, 2022). Proposed Rules *supra* note 21.

almost comically sparse, even for multi-billion-dollar funds.[224] For example, unless they request such disclosure in side letters, investors often will not receive any information about how the fees paid to the sponsor were calculated, the value of the fund's assets, or any new material events affecting the fund or the sponsor.[225] Sponsors have been remarkably resistant to providing such information in limited partnership agreements, perhaps out of concern that doing so would lead them down a slippery slope toward the onerous and endlessly expanding mandatory disclosure imposed on registered funds such as mutual funds and ETFs.

Yet, buyout fund investors, many of which owe duties to their own fiduciaries, increasingly require such information for their own reporting, and have therefore had to resort to requesting it in side letters. Once a sponsor commits to provide such information to one investor, however, the marginal cost of providing it to the other fund investors is close to zero. The case is therefore compelling for moving all such disclosure-type provisions to the limited partnership agreement, rather than doling out slightly different packages of information to different investors through endless side letter provisions.

### *C. Implementation*

Many of the reforms that we propose are aimed at correcting collective action problems. Happily, the private equity investor community already has an established trade organization that can be instrumental in advancing many of the remedies we highlight. The Institutional Limited Partners Association (ILPA) [226] is a collective organization of over 500 large investors that has a mission of engaging, empowering and connecting investors in private equity funds. In fact, ILPA has already taken concrete actions in mitigating such collective action problems, for example by developing an investor-friendly form of limited partnership agreement, as a counterweight to the sponsor-friendly forms in the market.[227]

ILPA could therefore direct similar attention to side letter practice and could serve as an ideal conduit for incorporating specific recommendations in its standard best

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[224] The SEC has recently proposed amendments to Form PF, a required form for certain SEC-registered investment advisers to private funds. Included in the proposed changes are a reduction in the threshold for reporting size and requiring "more information regarding private equity funds. . . to enhance the information used for risk assessment and the Commission's regulatory programs." Securities and Exchange Commission, *SEC Proposes Amendments to Enhance Private Fund Reporting*, (Jan. 26, 2022) https://www.sec.gov/news/press-release/2022-9.

[225] *See* Magnuson, supra note 18, at 1882; James C. Spindler, *How Private is Private Equity, and at What Cost?* 76 UNIV. OF CHI. L. REV. 311, at 328 (2009).

[226] *Who We Are,* INST. LTD. PARTNERS ASS'N., https://ilpa.org/about/.

[227] *See* ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interest for General and Limited Partners 5 (2019) ("The ILPA Principles were first published . . . to encourage discussion between Limited Partners . . . and General Partners . . regarding the alignment of interests in private equity fund partnerships.").

practices, thereby alleviating the concern of potential backlash against individual sponsors or investors who seek to buck the current trend. One interviewee shared exactly that sentiment, stating that "ILPA members could get whatever they want if they banded together."[228] For example, moving side letter costs out of fund expenses could be achieved through a best practice suggestion made by ILPA. Similarly, we believe that ILPA could push for better disclosure practices and for the development of boilerplate language for the regulatory and tax requirements that currently dominate side letter provisions. Importantly, ILPA is not only able to serve as an agent in mitigating collective action, but it also has access, through its members, to the deal documents, which would allow it to provide well-informed recommendations.

That said, regulatory intervention by the SEC may also be warranted. Ensuring appropriate disclosure to investors is a key function of the SEC in ensuring efficient and fair financial markets, and the secrecy of side letters is an area where regulatory intervention seems sufficiently narrow and justified. Moreover, while ILPA action is more likely in areas where investors collectively suffer from lack of data or lack of awareness—where ILPA can be effective—it is less likely when investors' incentives are misaligned. In fact, the same interviewee who indicated that ILPA members could do whatever they wanted if they acted collectively also indicated that they do not, because they cannot hold the line together.[229] If ILPA is unable or unwilling to act, regulatory action might not only be warranted but needed. Indeed, the proposed SEC rules correctly identify the need for better disclosure of side letter arrangements and more uniform disclosure practices by private equity funds.

The need for investor protection in the private equity arena is not merely a hypothetical. In a recent Risk Alert, the SEC's Division of Examinations reminded investment advisers that, under the Investment Advisers Act of 1940, they have both a duty of care and a duty of loyalty to their clients and that such obligations "require[] the investment adviser to act in the 'best interest' of its client at all times."[230] The Risk Alert goes on to note that the Division of Examinations staff has observed that certain funds have failed to accurately disclose fund-level management fees, resulting "in investors paying more in management fees than they were required to pay under the terms of the fund disclosures."[231] The limited partnership agreement would use broad language to describe the reduction in cost basis after disposing of part of an investment, but then "did not implement policies and procedures reasonably designed to apply those terms consistently when calculating management fees."[232] Another issue raised in the Risk Alert was the failure of advisers to obtain required approvals before extending the terms

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[228] Interview with Participant 1 (Mar. 16, 2021).

[229] *Id.*

[230] *See* Securities and Exchange Commission, *supra* note 14 (noting the massive increase in private fund assets from a variety of sources, small and large).

[231] *Id.*

[232] *Id.*

of private equity funds, resulting "in potentially inappropriate management fees being charged to investors."[233] Side letters are an even more opaque area of private equity, and thus regulatory oversight may be even more justified.

In pushing for greater standardization and publicity for private equity documentation, we caution that the SEC and ILPA would be forced to walk a very fine line. If the largest buyout fund investors believed that they would get a worse deal as a result—by being forced to accept the same terms as an average-sized investor—they would likely avoid the "fund" mechanism altogether. Specifically, they would opt for "funds of one" (also known as "separately managed accounts"),[234] providing them with the same access to the sponsor without the potential downsides of being lumped into a fund with other investors. This is why, in contrast to the bulk of the commentary on side letters, we have no objection to *explicit* price discrimination among investors, so long as it appears in the limited partnership agreement. Private equity documentation could be dramatically improved by removing the incentives for large investors to negotiate separately (and secretly) with the sponsor. In a sense, the proliferation of side letters and their ceaseless growth in length and complexity amounts to a private-ordering, contractual substitute for the regulation buyout funds avoid by remaining private investment funds. On this particular score, the private-ordering outcome may well be less efficient than the regulated counterfactual, and only relatively light regulation would be required.

### *D. A "Sea Change": A Critique of the SEC's Suggested Reform*

As noted, the SEC has just recently proposed a major overhaul of the regulation of private equity funds.[235] While the proposed rules cover many areas, they specifically address side letters. Broadly, the SEC suggested rules with respect to side letters can be divided into two main buckets. First, the SEC proposes to prohibit several substantive side letter terms. Among these are preferential transparency[236] and early redemption[237]. Second, the SEC requires full disclosure of any permitted side letter terms to all current and prospective investors.[238] Importantly, in an effort to prevent the concerns we highlight above regarding the exit of larger investors from pooled funds, the SEC is also suggesting prohibiting sponsors from opening "funds of one" so long as they are "substantially similar pool of assets."[239]

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[233] *Id.*

[234] For a detailed discussion of separately managed accounts and their increased popularity in private equity, see Clayton, supra note 23. See also Debevoise & Plimpton, *supra* note 12, at 17.

[235] Proposed Rules *supra* note 21.

[236] *Id.* at 166.

[237] *Id.* at 164.

[238] *Id.* at 168-169.

[239] *Id.* at 252.

The SEC proposed rules have already garnered immediate rebuke from the private equity industry and its lawyers, and the form of final rules remains in doubt.[240] While we intend to separately address the proposal more thoroughly, our findings in this project provide important data that is currently missing from the proposed rules. In some respects, our findings support the SEC concerns and proposals, while in others, they cast doubt on the necessity of some of the more severe actions.

As we discussed above, one key finding of this project is that side letters have become unnecessary long and costly and that their opacity and over-modularity are key culprits. In that respect our call for better disclosure and the move of side letter provisions that affect other investors back to the limited partnership agreement align relatively well with the proposed rules.

Yet, the proposed rules also miss the forest for the trees in some respects. First, the focus on prohibiting specific arrangements from side letters makes an assumption that these material price terms are commonly utilized in side letters. Our data does not support that. Second, the key problem with side letters that we identified is the increased costs they add to the fund formation process. The SEC reform is unlikely to reduce these costs, but rather has the potential to increase legal drafting that attempts to avoid or address the regulation and potentially increasing costs to the same investors the proposal is aimed at protecting. The proposal has not addressed the need for more standardization of provisions commonly found in side letters, encouraging explicit price differentiation, or transferring low cost gives to the limited partnership agreement. Third, while the SEC has correctly identified the concern of large investors' migration from joint funds to separate "funds-of-one," we are unsure the proposed rules actually effectively address such concern. Sponsors may decide to create "funds of four" with increased commitments, including only investors that would have received the most preferential treatment and pushing out the same investors the SEC is trying to protect. Similarly, sponsors may become more aggressive with offering "co-investment" funds of one, further fragmenting the investment in the private equity sector, and potentially allowing larger investors to transition from a pooled fund to an invest-as-you-go model.

Overall, the SEC focus on the private equity sector is warranted, but the current proposed rules continue to reflect the view that side letters are unfair due to their potential for discrimination among investors with regard to fee discounts. We have seen no evidence justifying this concern and instead urge the SEC to focus on the structural problems with the side letter process that we have highlighted in Part III.

## Conclusion

In this Article, we report the results of a multi-year effort to shed light on a unique feature in the governance of private equity funds—side letters. Side letters are

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[240] Blass et. al, *Regulatory and Enforcement Alert: "Transparency Is Not Enough"—SEC Continues Steady March Towards More Intrusive Regulation of Private Funds*, SIMPSON THACHER & BARTLETT LLP (Feb. 9, 2022) https://www.stblaw.com/docs/default-source/publications/regulatoryenforcementalert_02_09_22.pdf.

essential to the multi-party nature of private equity funds, providing useful tailoring to the needs of particular investors.

Side letters have expanded beyond that crucial role, however. Using rare, publicly unavailable data, the Article provides insight into side letter governance—showing that side letters have become inefficient, path-dependent, contractual burdens. While side letters may not contain significant price terms, they exemplify how collective action and perverse incentives can plague even the most innovative and sophisticated actors in the financial markets. By shedding light on side letter governance, our Article stresses the need to address the spiraling governance concerns of the private equity model. Our findings are only a first needed step in an effort to shed more light on the governance of private funds and merit the continued focus of academics and regulators alike into the prevailing practices of the industry. In so doing, the Article seeks to spark discourse on how best to move in that direction.

## Appendix A

List of All Side Letter Provisions Coded

**MFN Characteristics**
Notice of Other LPs' Side Letters
Notice Tiered
MFN
MFN Automatic (vs. LP needs to elect)
MFN: If LP needs to elect - # Notice Days
MFN tiered vs. universal
MFN tier type
**MFN Exclusions**
MFN Exclusion: Side letter applies to economic rights only (vs. grants same righ
MFN Exclusion: Seed investor/Founding LP rights
MFN Exclusion: LPAC or observer seats
MFN Exclusion: Co-Investment
MFN Exclusion: Laws, rules and regulations applicable to some but not other LPs
MFN Exclusion: Due to status of LP (tax exempt, ERISA or public plan)
MFN Exclusion: Special /additional reporting
MFN Exclusion: Access to information
MFN Exclusion: Transfer rights
MFN Exclusion: Fee Reductions & Economic Rights for Certain LPs (ex: Special or
MFN Exclusion: Subscription agreement reps and covenant waiver
MFN Exclusion: Representation or warranty of GP/MC/Key Person
MFN Exclusion: List of Partners
MFN Exclusion: Use of name
MFN Exclusion: Withdrawal or excuse rights
**Side Letter Provisions (other than MFN)**
Management Fee Discount
Carried Interest Discount
LPAC or observer seat
LPAC or observer seat conditioned on retaining minimum commitments
LPAC Cap on size/composition
LPAC Composition - No GP Affiliates (or Strategic Investors)
Co-investment rights - Granted
Co-investment rights - Acknowledgment of interest
Co-investment Rights – Fee Discount
Co-investment Rights - Cap on Fees
Co-investment rights - Limits
Key person provision/GP exclusivity
Transfer /Assignment to Affiliates
Transfer /Assignment to Third Parties
Notice of Secondary Interests or Assignments
Access to Information Rights /Inspection Rights
Exceptions to Confidentiality/ LP Right to Disclose
Credit facilities /Borrowing (no guaranties /liens)

| |
|---|
| Reporting - Fees & Expenses |
| Reporting - Conflicts of Interest/ Affiliated transactions |
| Reporting - Financial information |
| Reporting - Needed for LP Compliance with internal policies /statutory requirements |
| Notice - Distributions/ Recycling/ Investment Period |
| Notice - Defaulting Partners |
| Notice - Transfer of Interest in GP/MC |
| Notice (or Rep)- Litigation/ Enforcement actions |
| Notice - Change of Auditors or Accounting Standards |
| Notice - Indemnification Obligation of Fund |
| Tax - UBTI and/or ECI Covenant not to incur (and other tax covenants) |
| Tax & ERISA - Other reporting /notices/reps (audits, tax shelters, PFICs, withholding, etc.) |
| GP/MC/Key Person Covenants - Retain minimum interest /Restrictions on Transfers of MC interests |
| Successor Fund - Admission |
| Successor Fund - Economic Terms |
| Successor Fund - Restrictions on Formation |
| LP Withdrawal / Excuse or Other Waiver |
| Investment Restrictions |
| Reps and warranties or opinions of GP |
| Certifications of GP (annual) |
| Allocation of fees, organizational and operating expenses |
| Placement agent disclosures /fees |
| Limits on portfolio company fees to sponsor |
| Indemnification (Limitations and Notices) |
| Clawback rights (escrow and guarantees) |
| Fiduciary duties/ standards of care |
| Insurance requirements |
| GP settlements/ damages as GP expenses |
| Communications with other LPs |
| Legal opinions of LP's in-house counsel permitted |
| List of partners |
| Covenant - Conflict of Interests/ Affiliated transactions |
| Clarification of an Interpretation of LPA provision |
| In-kind distributions OR custodian for securities held by partnership |
| Increase to (or Reduction in) Commitment Amount |
| Accounting standards - Covenant to adopt/maintain specific one |
| 10b-5 Rep |
| '40 Act Exemption Rep |
| Maximum Fund Size |
| Minimum Fund Size |
| FCPA |
| Sovereign Immunity |
| Arbitration /Consent to Venue |
| No disclosure of MNPI |

## Appendix B

| Interview List | | |
|---|---|---|
| **Participant Number** | **Date Interviewed** | **Background** |
| 1 | March 16, 2021 | [Current position redacted to preserve anonymity]. Extensive experience in the industry. Has represented both PE funds and investors in the past |
| 2 | February 19, 2021 | Legal counsel for a large public pension fund |
| 3 | October 7, 2021 | Partner in a large law firm representing PE funds |
| 4 | February 16, 2021 | In-house for a large private endowment |
| 5 | February 19, 2021 | Head of investment operations in a large private endowment |
| 6 | February 18, 2021 | Partner in a law firm representing investors; also served in-house |
| 7 | April 8, 2021 | Partner in a law firm representing sponsors |
| 8 | April 8, 2021 | Partner in a law firm representing sponsors |
| 9 | December 21, 2021 | In-house counsel for a large public pension fund |
| 10 | December 16, 2021 | Partner at a law firm representing investors |
| 11 | January 1, 2021 | General counsel of a large endowment |

Appendix C

Table:
Pct. Side Letters Containing MFN (By Era)

| Side Letter Era | Mean | Standard Deviation | Frequency |
|---|---|---|---|
| Pre-2005 | 0.28000 | 0.45356 | 50 |
| Boom Period: 2005-2007 | 0.60317 | 0.49317 | 63 |
| Fin. Crisis: 2008-2013 | 0.88636 | 0.31919 | 88 |
| Post-Crisis: 2014+ | 0.62745 | 0.48829 | 51 |
| **Total** | **0.64285** | **0.48011** | **252** |

Appendix D
Most Common Side Letter Provisions

| | % Side Letters | Rank | | | | |
|---|---|---|---|---|---|---|
| **Term** | **Full Sample: 1991-2020** | **Full Sample: 1991-2020** | **Pre-2005** | **Boom Period: 2005-2007** | **Fin. Crisis: 2008-2013** | **Post-Crisis: 2014+** |
| MFN | 64.3% | 1 | 2 | 1 | 1 | 4 |
| Exceptions to Confidentiality/ LP Right to Disclose | 59.1% | 2 | 12 | 2 | 5 | 1 |
| Tax & ERISA - Other reporting /notices/reps (audits, tax shelters, PFICs, withholding, etc.) | 59.1% | 2 | 4 | 4 | 4 | 2 |
| MFN Exclusion: Laws, rules and regulations applicable to some but not other LPs | 51.2% | 4 | 38 | 3 | 2 | 9 |
| MFN Exclusion: LPAC or observer seats | 50.8% | 5 | 9 | 6 | 3 | 11 |
| Transfer /Assignment to Affiliates | 46.0% | 6 | 7 | 5 | 6 | 5 |
| Tax - UBTI and/or ECI covenant not to incur (and other tax covenants) | 34.1% | 7 | 12 | 7 | 7 | 27 |
| Clarification of an interpretation of LPA provision | 31.0% | 8 | 5 | 10 | 8 | 20 |
| Reps and warranties or opinions of GP | 27.8% | 9 | 5 | 19 | 9 | 16 |
| Notice (or Rep)- Litigation/ Enforcement actions | 27.4% | 10 | 16 | 13 | 11 | 11 |
| LPAC or observer seat | 25.8% | 11 | 23 | 9 | 23 | 3 |
| MFN Exclusion: Due to status of LP (tax exempt, ERISA or public plan) | 23.8% | 12 | 38 | 19 | 9 | 15 |
| Investment Restrictions | 23.4% | 13 | 1 | 12 | 14 | 33 |
| Reporting - Financial information | 22.2% | 14 | 38 | 18 | 13 | 10 |
| MFN Exclusion: Co-Investment | 19.4% | 15 | 38 | 16 | 11 | 43 |
| Co-investment rights - Acknowledgment of interest | 18.7% | 16 | 23 | 29 | 24 | 7 |
| List of partners | 18.3% | 17 | 20 | 19 | 26 | 5 |
| Reporting - Needed for LP Compliance with internal policies /statutory requirements | 17.1% | 18 | 8 | 11 | 16 | 51 |
| Legal opinions of LP's in-house counsel permitted | 17.1% | 18 | 12 | 24 | 16 | 16 |
| In-kind distributions OR custodian for securities held by partnership | 15.9% | 20 | 12 | 19 | 14 | 38 |
| LP Withdrawal / Excuse or Other Waiver | 15.5% | 21 | 3 | 14 | 30 | 43 |
| Indemnification (Limitations and Notices) | 14.7% | 22 | 11 | 24 | 16 | 33 |
| Sovereign Immunity | 14.7% | 22 | 23 | 14 | 16 | 33 |
| Notice - Transfer of Interest in GP/MC | 14.3% | 24 | 38 | 29 | 32 | 8 |
| Access to Information Rights /Inspection Rights | 13.9% | 25 | 38 | 44 | 16 | 20 |

| | % Side Letters | Rank | | | | |
|---|---|---|---|---|---|---|
| **Term** | **Full Sample: 1991-2020** | **Full Sample: 1991-2020** | **Pre-2005** | **Boom Period: 2005-2007** | **Fin. Crisis: 2008-2013** | **Post-Crisis: 2014+** |
| Notice of Secondary Interests or Assignments | 12.7% | 26 | 16 | 24 | 31 | 20 |
| Notice - Distributions/ Recycling/ Investment Period | 12.7% | 26 | 38 | 36 | 16 | 29 |
| Credit facilities /Borrowing (no guaranties /liens) | 11.5% | 28 | 38 | 36 | 32 | 13 |
| Notice - Change of Auditors or Accounting Standards | 11.5% | 28 | 23 | 44 | 26 | 20 |
| Accounting standards - Covenant to adopt/maintain specific one | 11.1% | 30 | 16 | 44 | 32 | 16 |
| LPAC or observer seat conditioned on retaining minimum commitments | 10.7% | 31 | 38 | 16 | 41 | 25 |
| Reporting - Conflicts of Interest/ Affiliated transactions | 10.7% | 31 | 23 | 29 | 43 | 14 |
| Certifications of GP (annual) | 9.9% | 33 | 38 | 29 | 16 | 53 |
| Successor Fund - Admission | 9.5% | 34 | 38 | 36 | 38 | 20 |
| Transfer /Assignment to Third Parties | 9.1% | 35 | 20 | 29 | 38 | 29 |
| Reporting - Fees & Expenses | 9.1% | 35 | 23 | 44 | 32 | 26 |
| Placement agent disclosures /fees | 9.1% | 35 | 38 | 29 | 26 | 38 |
| MFN Exclusion: Special /additional reporting | 8.7% | 38 | 38 | 44 | 43 | 16 |
| MFN Exclusion: Transfer rights | 8.7% | 38 | 38 | 36 | 32 | 27 |
| Notice - Defaulting Partners | 8.7% | 38 | 38 | 44 | 26 | 33 |
| Clawback rights (escrow and guarantees) | 7.9% | 41 | 23 | 44 | 25 | 58 |
| Limits on portfolio company fees to sponsor | 6.7% | 42 | 38 | 44 | 41 | 32 |
| MFN Exclusion: Side letter applies to economic rights only (vs. grants same rights/benefits to all LPs) | 6.3% | 43 | 38 | 8 | 54 | 71 |
| Co-investment rights - Granted | 6.0% | 44 | 23 | 44 | 54 | 29 |
| GP/MC/Key Person Covenants - Retain minimum interest /Restrictions on Transfers of MC interests | 6.0% | 44 | 23 | 44 | 48 | 33 |
| FCPA | 5.6% | 46 | 38 | 44 | 43 | 38 |
| MFN Exclusion: Seed investor/Founding LP rights | 4.8% | 47 | 38 | 19 | 65 | 47 |
| MFN Exclusion: Use of name | 4.8% | 47 | 38 | 44 | 48 | 43 |
| Co-investment rights - Limits | 4.8% | 47 | 23 | 44 | 54 | 38 |
| Covenant - Conflict of Interests/ Affiliated transactions | 4.8% | 47 | 23 | 44 | 54 | 38 |
| MFN Exclusion: Access to information | 4.4% | 51 | 38 | 44 | 50 | 43 |

| | % Side Letters | Rank | | | | |
|---|---|---|---|---|---|---|
| **Term** | **Full Sample: 1991-2020** | **Full Sample: 1991-2020** | **Pre-2005** | **Boom Period: 2005-2007** | **Fin. Crisis: 2008-2013** | **Post-Crisis: 2014+** |
| Key person provision/GP exclusivity | 4.4% | 51 | 38 | 44 | 43 | 48 |
| Notice - Indemnification Obligation of Fund | 4.4% | 51 | 38 | 44 | 38 | 53 |
| Allocation of fees, organizational and operating expenses | 4.4% | 51 | 20 | 36 | 54 | 48 |
| Arbitration /Consent to Venue | 4.4% | 51 | 23 | 36 | 32 | 63 |
| MFN Exclusion: Fee Reductions & Economic Rights for Certain LPs (ex: Special or Strategic LPs) | 3.2% | 56 | 38 | 24 | 54 | 58 |
| MFN Exclusion: Representation or warranty of GP/MC/Key Person | 3.2% | 56 | 38 | 44 | 54 | 48 |
| Co-investment Rights - Fee Discount | 2.8% | 58 | 38 | 36 | 65 | 51 |
| Insurance requirements | 2.8% | 58 | 38 | 29 | 65 | 53 |
| Minimum Fund Size | 2.8% | 58 | 9 | 44 | 65 | 71 |
| MFN Exclusion: List of Partners | 2.4% | 61 | 38 | 44 | 50 | 58 |
| Successor Fund - Economic Terms | 2.4% | 61 | 38 | 44 | 43 | 63 |
| Increase to (or Reduction in) Commitment Amount | 2.4% | 61 | 23 | 44 | 50 | 61 |
| MFN Exclusion: Subscription agreement reps and covenant waiver | 2.0% | 64 | 38 | 44 | 65 | 53 |
| Co-investment Rights - Cap on Fees | 2.0% | 64 | 38 | 44 | 65 | 53 |
| Successor Fund - Restrictions on Formation | 1.6% | 66 | 23 | 44 | 50 | 66 |
| 10b-5 Rep | 1.6% | 66 | 16 | 36 | 65 | 71 |
| MFN Exclusion: Withdrawal or excuse rights | 1.2% | 68 | 38 | 44 | 65 | 61 |
| LPAC Cap on size/composition | 1.2% | 68 | 38 | 44 | 54 | 63 |
| '40 Act Exemption Rep | 1.2% | 68 | 38 | 24 | 65 | 71 |
| LPAC Composition - No GP Affiliates (or Strategic Investors) | 0.8% | 71 | 23 | 44 | 65 | 66 |
| Fiduciary duties/ standards of care | 0.8% | 71 | 38 | 44 | 54 | 66 |
| Maximum Fund Size | 0.8% | 71 | 38 | 44 | 54 | 66 |
| Carried Interest Discount | 0.4% | 74 | 38 | 44 | 65 | 66 |
| No disclosure of MNPI | 0.4% | 74 | 38 | 44 | 54 | 71 |
| Management Fee Discount | 0.0% | 76 | 38 | 44 | 65 | 71 |
| GP settlements/ damages as GP expenses | 0.0% | 76 | 38 | 44 | 65 | 71 |
| Communications with other LPs | 0.0% | 76 | 38 | 44 | 65 | 71 |