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High-End Bargaining Problems

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HIGH-END BARGAINING PROBLEMS

William W. Clayton*
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This Article presents a novel challenge to one of the central principles of the law and economics literature. Traditional law and economics theory places great confidence in the ability of contracting parties to bargain for optimal contracts, and the law reflects this confidence in many important ways. In this Article, I question the wisdom of a formalistic faith in bargaining by uncovering significant flaws in the bargaining process at the high end of the market, where parties are sophisticated and have substantial resources to aid them in bargaining.

My analysis focuses on the private equity fund industry, which is widely regarded as one of the most elite and sophisticated contracting spaces in the market. There are few industries where parties are better-positioned to bargain for optimal outcomes, but a careful review reveals many problems. Drawing on proprietary survey data and dozens of conversations with industry participants, this Article offers an in-depth analysis of problematic bargaining practices in private equity funds.

These bargaining problems raise a difficult question for scholars and policymakers: If theory does not reflect reality in the high end of the market, what can be expected in other areas where parties are less sophisticated and have fewer resources? These findings call for greater skepticism of formalist assumptions about bargaining across the market more broadly, with important implications for contract law, the law of business organizations, and securities law.

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INTRODUCTION

One of the central principles of the law and economics literature states that if a market has enough sophisticated contracting parties in it, those parties will bargain for optimal outcomes without any need for outside intervention.[1] The legal rules governing business transactions adhere to this idea in many important ways. Contract law is built on the foundational principle that the enforcement of bargains will benefit contracting parties and society more broadly, with only limited exceptions.[2] The law of limited liability companies ("LLCs") and limited partnerships grants managers and investors almost total flexibility to contract for anything they want, including the complete elimination of fiduciary duties, and the law of corporations has taken significant strides in this direction in recent decades.[3] Federal securities law gives parties almost complete freedom to raise capital in whatever fashion they desire in the private markets.[4]

This Article presents a novel challenge to the traditional law and economics approach to bargaining. It asks: How well does bargaining actually work in real-world sophisticated settings? How effective is bargaining at the *high end* of the market, where the parties have substantial resources and expertise to aid them in bargaining effectively and efficiently? To answer these questions, I focus on the private equity fund industry. Private equity is widely regarded as one of the most elite and sophisticated sectors of the commercial marketplace, but a close examination reveals a world where many aspects of the bargaining process are messy and (by all appearances) far from optimal.

The private equity fund industry has many characteristics that theoretically should make it an ideal contracting space. First, the investors in the industry generally must satisfy investor qualification standards that are higher than the baseline standard typically required for investing in private markets.[5] As a result, this industry is dominated by institutional investors that should have sufficient

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[1] *See, e.g.*, Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 547 (2003) [hereinafter Schwartz & Scott, *Contract Theory*] (arguing for formalist interpretation of contracts between sophisticated economic actors); Benjamin E. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 J. L. ECON. & ORG. 230, 233 (1993) ("[I]f the private parties are sophisticated and are symmetrically informed at the time of contracting, then there is no benefit to the courts' mandating the terms of private contracts."); Alan Schwartz, *How Much Irrationality Does the Market Permit?*, 37 J. LEGAL STUD. 131, 131 (2008) (finding that "when enough consumers are sophisticated and the naïve have a relatively low willingness to pay for their preferred contract, exploitative contracts decline in frequency and may actually vanish"); MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 120 (1993) ("To the extent that there is a margin of informed, sophisticated, and aggressive consumers in any given market, who understand the terms of the standard form contracts on offer and who either negotiate over those terms or switch their business readily to competing suppliers offering more favourable terms, they may in effect discipline the entire market, so that inframarginal (less well informed, sophisticated, or mobile) consumers can effectively free-ride on the discipline brought to the market by the marginal consumers . . . .").

[2] *See infra* Section I.A.

[3] *See infra* Section I.B.

[4] *See infra* Section I.C.

[5] *See infra* Section II.B.1.

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resources to hire capable in-house lawyers and/or external lawyers. Second, because private equity funds are typically dissolved after about ten years and institutional investors tend to diversify their investments across managers, the in-house lawyers at many of these institutions participate in a high volume of fund investments each year, making them particularly experienced in these types of transactions.[6] Third, the limited life of private equity funds also means that there are fewer potential contingencies for the contracting parties to account for than in most operating businesses, which typically have an indefinite life when they are formed.[7] Finally, the limited life of private equity funds means that this is an industry built on repeat transactions, a factor that should give managers and investors strong reputational incentives and facilitate greater trust and reliance on the contracts entered into by the parties.[8] For all of these reasons, the parties in this industry are unusually well-positioned to bargain for optimal outcomes.

Notwithstanding these many advantages, however, a deeper analysis reveals a number of bargaining problems in this high-level environment. Perhaps most prominently, contracting in the private equity fund industry has a controversial history. For decades, private equity funds avoided regulatory scrutiny and operated almost entirely under the SEC's radar. In 2010, however, the SEC was granted authority by Congress to examine private equity funds across the industry. Their findings, announced in 2014, were shocking to most industry observers. Among many other issues, the SEC indicated that violations of law or material weaknesses in controls relating to the payment of fees and expenses were found in over 50% of the managers that they examined.[9] The SEC highlighted various deficiencies in private equity contracts that made this misconduct possible.[10] Clearly, this was a far cry from the optimal outcomes that formalist models would have predicted.

Ever since then, the SEC has maintained a special examination unit focused specifically on private investment funds, and it examines hundreds of private equity funds each year.[11] This "Private Funds Unit" effectively serves as a full-time police presence in the industry.[12] Formalist law and economics models would never anticipate that such a thing would be necessary in this high-end contracting space.

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[6] *See infra* Section II.B.2.
[7] *See infra* Section II.B.3.
[8] *See infra* Section II.B.4.
[9] *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) [hereinafter Bowden, *Spreading Sunshine in Private Equity*] ("When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.").
[10] *See infra* notes 88-90 and accompanying text.
[11] *See* "Risk Alert: Observations from Examination of Investment Advisers Managing Private Funds," SEC Office of Compliance Inspections and Examinations (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf (noting that "OCIE examines hundreds of private fund advisers each year").
[12] *See id.* ("OCIE . . . is frequently asked about its observations from examinations as well as common deficiencies and compliance issues. Many of the deficiencies discussed [in the risk alert]

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Private equity fund contracting flies in the face of formalist expectations about bargaining in other ways as well. For example, law and economics scholars theorize that sophisticated parties will bargain for optimal non-price contract terms regardless of how the balance of bargaining power is distributed between them. The basic logic—which is elegant in theory—is that sophisticated parties to any voluntary arrangement will agree to final terms that maximize the collective surplus generated by the transaction they are entering into, after which they will split that surplus through the price term.[13] However, in practice this is not how the private equity industry works at all. Across the industry, non-price terms relating to the governance of the fund vary greatly depending on the balance of bargaining power between managers and investors.[14] More generally, many scholars over the years have criticized the substance of common private equity fund terms, arguing that they are one-sided and unlikely to maximize the joint welfare of all parties involved.[15]

In addition to these problems with substantive contract terms, there are also many problems with the *process* by which private equity fund agreements are bargained. The process is unusually time-consuming and costly, with most of the time being spent on the negotiation of individual side letters outside the primary fund documents.[16] Moreover, bargaining incentives are distorted in private equity funds because fund investors typically pay nearly all of the manager's legal fees for negotiation of the fund documents (in addition to their own legal fees).[17] This makes investors particularly sensitive to legal costs associated with bargaining, and makes managers far more insensitive by comparison. Finally, information flows in the market are extremely restricted due to confidentiality provisions, which makes it difficult for investors to benchmark and compare contract terms across the market.[18]

Moreover, in addition to problems with the substance of private equity fund terms and the process by which contracts are formed, scholars have identified various ways in which private equity investors face perverse incentives. These include agency problems that arise when the interests of staff members within institutional investors deviate from the interests of the institution's beneficiaries,[19]

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may have caused investors in private funds to pay more in fees and expenses than they should have or resulted in investors not being informed of relevant conflicts of interest.").

[13] This principle is not a fringe theory, but has been referred to as a "defining feature" of law and economics scholarship on contracts. *See* Adam B. Badawi and Elisabeth de Fontenay, *Is There a First-Drafter Advantage in M&A?*, 107 CAL. L. REV. 1119, 1127 (2019) ("A corollary of the prediction that parties to a voluntary agreement will inevitably agree to efficient non-price terms is that other factors, such as bargaining power, the negotiation process, and negotiating skill, have no effect on the final non-price terms. This 'irrelevance proposition' . . . has been a defining feature of much of the study of contracts in law and economics.").

[14] *See infra* Section III.A.2.

[15] *See infra* Section III.A.3.

[16] *See infra* Section III.B.1.

[17] *See infra* Section III.B.2.

[18] *See infra* Section III.B.3.

[19] *See infra* Section III.C.1.

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coordination problems that cause investors to bargain in sub-optimal ways,[20] and perverse incentives to avoid liability under the federal securities laws.[21]

Finally, this Article also presents new survey data that reveals new problems with bargaining in private equity and also reinforces the relevance of many of the problems identified above. Because private equity funds are privately-held, much of what we know about them is based on conventional wisdom and anecdotes. Drawing on a private dataset of survey responses from 70 institutional investors,[22] this data shows that information flows are even more restricted in private equity funds than previously known,[23] that the private equity fund bargaining environment is even more fractured than has been documented in the literature,[24] and that the private equity industry deviates even more from the bargaining power irrelevance proposition than previously understood.[25]

These high-end bargaining problems raise a difficult question for scholars and policymakers: If theory does not reflect reality in the high end of the market, what can be expected in other areas of the market where parties are less sophisticated and have fewer resources? What, for example, are the implications for consumer contracts in retail settings? What about small businesses, which are typically set up as LLCs and give parties the flexibility to eliminate fiduciary duties by contract?[26] This Article's findings call for greater skepticism of formalist assumptions about how parties bargain, not just in private equity but across the broader market.

These problems also call into question the binary nature of federal securities regulation. The federal securities regime prescribes an extraordinarily detailed set of disclosures and processes that must be complied with when a business engages in a public offering, but it imposes no requirements for private offerings. This approach implicitly embraces the idea that sophisticated parties will demand appropriate levels of disclosure and appropriate processes without any intervention by policymakers. The private equity example shows that this cannot simply be assumed.

Finally, the problems identified in this Article also have important implications for the private equity industry itself. SEC Chair Gary Gensler has

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[20] *See infra* Section III.C.2 and III.C.4.
[21] *See infra* Section III.C.3.
[22] This survey was created in collaboration with the Institutional Limited Partners Association ("ILPA"), the trade association for institutional investors in the private equity asset class. It was distributed to ILPA's membership in advance of its 2020 Private Equity Legal Conference, which was held in October 2020. The survey was completed by the chief legal counsel or comparable function for 70 institutional investors. For more details on the survey, see Section IV.A.
[23] *See infra* Section IV.B.1.
[24] *See infra* Section IV.B.2.
[25] *See infra* Section IV.B.4.
[26] *See* Peter Molk, *Protecting LLC Owners While Preserving LLC Flexibility*, 51 U.C. DAVIS L. REV. 2129, 2133 (2018) ("There are no minimum standards for who can become an owner of an LLC, and a series of cases has shown the perverse consequences that can result when an entrepreneur induces other investors to sign away fundamental protections without appropriately valuing those protections—as when they undervalue these provisions' importance, do not understand what the legal terms mean, or simply do not read the documents they sign.").

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made clear in recent comments that the SEC takes problems in the private equity industry seriously, and that the SEC staff is examining whether the regulator should take additional actions to improve how the industry operates.[27] Given the massive size[28] and influence[29] of the private equity industry, and given the fact that the largest investors in private equity funds are public and private pension plans that invest on behalf of ordinary people,[30] it is not surprising that these problems have attracted the SEC's attention. I close with a discussion of possible approaches to addressing bargaining problems in the private equity industry.

This Article proceeds as follows. Part I shows how contract law, the law of business organizations, and federal securities law all embrace formalistic assumptions about bargaining. It also discusses the scholarly literature that supports this approach in these three areas. Part II identifies the characteristics of private equity funds that make it an elite bargaining space that supports careful contracting. Part III reveals the bargaining problems that exist in the private equity industry notwithstanding these advantages. Part IV builds on Part III by presenting the most salient results from a survey of 70 institutional investors in private equity funds, and discusses why these results show a bargaining environment that is much more complex and problematic than has been commonly understood. Part V concludes

[27] *See* Chair Gary Gensler, Testimony Before the Subcommittee on Financial Services and General Govt., U.S. House Appropriations Committee (May 26, 2021), https://www.sec.gov/news/testimony/gensler-2021-05-26 ("The SEC is the primary regulator of registered investment advisers to private funds. . . . Given the growth and changes in private funds, I've asked staff for recommendations for consideration of enhanced reporting and disclosure through Form ADV, Form PF, or possible other reforms.

[28] *See A New Decade for Private Markets*, MCKINSEY & COMPANY (Feb. 2020), https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/mckinsey-global-private-markets-review-2020-v4.ashx ("In 2019, private market AUM grew by 10 percent, reaching $6.5 trillion, another all-time high.").

[29] *See* Paul J. Davies, *Why Private Equity Risks Tripping on Its Own Success*, WALL ST. J. (Feb. 13, 2018) ("The industry's assets under management have tripled since the end of 2006. . . . Their decisions on whether to invest or cut costs now hold ultimate sway over millions of jobs, from shop assistants to pharmaceutical scientists."); *How Private Equity Works, and Took Over Everything*, BLOOMBERG (Oct. 8, 2019), https://www.bloomberg.com/news/features/2019-10-03/how-private-equity-works-and-took-over-everything.

[30] *See* 2018 Preqin Global Private Equity and Venture Capital Report 73 (showing that public pension plans are the largest investors in private equity funds, representing 35% of all capital in the asset class); *State Public Pension Funds Increase Use of Complex Investments*, PEW CHARITABLE TRUSTS REPORT (Apr. 12, 2017), https://www.pewtrusts.org/-/media/assets/2017/04/psrs_state_public_pension_funds_increase_use_of_complex_investments.pdf (showing that public pension plans more than doubled their allocations to "alternative" investments—including private equity funds, hedge funds, and private real estate funds—in less than a decade, from 11 percent of assets in 2006 to 25 percent of assets in 2014); Jean-Pierre Aubry, Anqi Chen & Alicia H. Munnell, *A First Look at Alternative Investments and Public Pensions*, CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE (July 2017), http://crr.bc.edu/wp-content/uploads/2017/06/slp_55.pdf (noting data showing that public pension plans' allocation to alternative investments increased from 9 percent in 2005 to 24 percent in 2015).

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with a discussion of the policy implications of these high-end bargaining problems, both within the private equity industry and across the market more broadly.

I. FAITH IN BARGAINING

Many important areas of the law maintain an extraordinary amount of faith in the ability of parties to contract for optimal outcomes. Below, I discuss three prominent examples.[31] I consider scholarship that supports a formalistic approach in each of these areas, on one hand, along with scholarship that pushes back against formalism, on the other.

A. Contract Law

Contract law is built on the foundational principle that the enforcement of private bargains will lead to beneficial outcomes for contracting parties and for society more broadly.[32] Progressive variations on traditional doctrines have evolved in different jurisdictions over the years,[33] but as a general rule contract law leaves parties free to contract for almost anything they desire[34] and avoids second-guessing the deals struck by competent adults.[35]

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[31] To be clear, my intention is not to provide an exhaustive review of the literature on bargaining, as that would be a substantial project unto itself. My purpose here is to show how formalistic views of bargaining pervade important areas of the law, and to give an overview of the some of the most important literature backing, and pushing back against, those views.

[32] *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 72 cmt. b (AM. LAW INST. 1981) ("Bargains are widely believed to be beneficial to the community in the provision of opportunities for freedom of individual action and exercise of judgment and as a means by which productive energy and product are apportioned in the economy. The enforcement of bargains rests in part on the common belief that enforcement enhances that utility.").

[33] *See, e.g.*, Masterson v. Sine, 68 Cal. 2d 222, 65 Cal. Rptr. 545, 436 P.2d 561 (1968) (setting forth a contextualist approach to the parol evidence rule in California); Teachers Insurance and Annuity Assoc. of America v. Tribune Co., 670 F. Supp. 491 (1987) (finding that an agreement to agree can bind parties to negotiate in good faith).

[34] Note that the implied contractual covenant of good faith and fair dealing cannot be waived under Delaware law. *See infra* note 179 and accompanying text.

[35] A look at the unconscionability doctrine reinforces this point. The unconscionability doctrine allows a court to refuse to enforce an unconscionable contract term or an entire contract by either modifying or voiding the contract. But it requires a showing of "procedural unconscionability" and "unfair surprise," so unless there is an unusual and unfair flaw in the bargaining process, courts generally must enforce contract terms. *See* Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665, 1690 (2012) ("The doctrine requires not only a defect in the bargaining process ('procedural unconscionability'), but also a term that is harsh or unreasonably unfavorable to the vulnerable party ('substantive unconscionability')'. While gross inequality of bargaining power is often mentioned as a factor contributing to procedural unconscionability, it is rarely sufficient on its own. Unless the imbalance amounts to duress, undue influence, or incapacity, courts typically require further defects in bargaining, especially a finding that the weaker party also lacked the opportunity to read or understand the harsh term."). The default assumption is that the vast majority of exchanges are informed and welfare-maximizing, even when the substance of the agreement would suggest otherwise. *See* 8 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS §18:15 (4th ed. Supp. 2019) ("The mere assertion

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Much of the law and economics literature on contracts supports the idea that sophisticated parties will bargain for optimal contract terms if given the freedom to do so.[36] In fact, the law and economics literature goes so far as to predict that sophisticated parties will always bargain for optimal contract terms even when there is a significant disparity in bargaining power between them, and when the balance of bargaining power between the parties shifts over time. This theory is called the bargaining power irrelevance proposition.[37] The basic logic is that sophisticated parties to any voluntary arrangement will agree to final terms that maximize the collective surplus generated by the transaction they are entering into, after which they will split that surplus through the price term. This is because all of the parties will both be better off if they choose terms that make the pie as large as possible before they bargain over how to split it. Accordingly, the irrelevance principle predicts that parties will agree on optimal non-price terms that maximize the size of the pie, after which they will use their bargaining power to negotiate price, which determines how the pie gets divided up.[38] This irrelevance principle is not a fringe theory, but rather is a defining feature of much of the study of contracts in law and economics.[39]

Interestingly, contract theory goes even further and extends this kind of contractarian confidence to markets that have a substantial number of unsophisticated parties. In high-volume contracting settings, the parties often do not negotiate, but instead the seller will prepare a form contract and buyers will "take or leave" that contract. In this environment, the quality of a contract's protections are thought to be shaped by the preferences of that market's "marginal"

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that the price was excessive has been deemed conclusory and insufficient to establish the defense of unconscionability.").

[36] *See supra* note 1 and accompanying text.

[37] There are various statements of the bargaining power irrelevance proposition in the literature. *See, e.g.*, ROBERT E. SCOTT & JODY S. KRAUS, CONTRACT LAW AND THEORY 58–60 (4th ed. 2007); Douglas G. Baird, *The Boilerplate Puzzle*, 104 MICH. L. REV. 933, 934, 938 (2006); George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1320–21 (1981); Alan Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 Va. L. Rev. 1053, 1072–74 (1977) ("Given . . . three [weak] assumptions, a firm will produce the same level of product quality regardless of whether the firm is a monopolist or a perfect competitor."); Schwartz & Scott, *Contract Theory*, *supra* note 1 at 552–54 ("Bargaining power instead is exercised in the division of the surplus, which is determined by the price term. Parties jointly choose the contract terms so as to maximize the surplus, which the price [sic] may then divide unequally."); Alan Schwartz & Louis L. Wilde, *Product Quality and Imperfect Information*, 52 REV. ECON. STUD. 251, 251–52, 258 (1985) (arguing that where consumers are imperfectly informed about product prices and quality levels offered by the various sellers, and where there are low fixed costs to providing quality, a profit-maximizing seller will offer at least the optimal quality, but at a supracompetitive price).

[38] Two versions of this "bargaining power irrelevance proposition" have been identified in the literature. First, the strong-form version stands for the proposition that bargaining power only affects price and has no effect on non-price terms. Second, in the weak-form version, bargaining power may affect non-price terms, but the parties are no more likely to agree to inefficient non-price terms under unequal, rather than equal, bargaining power.

[39] *See supra* note 13 and accompanying text.

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buyers.[40] Marginal buyers are those that care most about the contractual protections and are most likely to stop buying a product when the quality of the contractual protections goes down.[41] Accordingly, law and economics theory predicts that if the marginal buyer in a market with standard form contracts is rational and informed, a large number of uninformed and irrational investors will also be able to invest in that market without upsetting the quality of the contract's terms.[42]

Some scholars have pushed back against this formalistic faith. In form contract settings, for example, scholars have argued that, in reality, non-drafting contracting parties suffer from bounded rationality and are unlikely to pay attention to more than a limited number of terms when making contracting decisions.[43] This line of thinking supports a more liberal use of the unconscionability doctrine to invalidate one-sided contracts.[44] More recently, some scholars have focused on practical challenges that can arise in the production of contracts. These include problems relating to the loss of meaning in commercial boilerplate provisions over time[45] and coordination problems, including the failure of networks to support efficient contract formation,[46] among others. Recent law and economics scholarship on contracts has thus become more open to the possibility of process-related flaws impeding the production of optimal contracts.

B. *Law of Corporations, LLCs, and Limited Partnerships*

The law of business organizations has placed an increasing amount of faith in bargaining over the years and has embraced a steady push toward increased

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[40] This assumes that the market is competitive. *See* G. Marcus Cole, *Rational Consumer Ignorance*, 11 J.L. ECON. & POL'Y 413, 414 (2015) ("[N]onprice terms, like price terms, are 'policed' in competitive markets by the marginal consumer for each term. Competitors failing to capture the marginal consumer for such terms under competitive market conditions suffer the same fate as sellers who fail to compete on price.").

[41] *See id*. at 422 ("[T]he marginal consumer, by definition, is the party for whom a particular term means the most. . . . The marginal consumer is someone who cares so much about that particular term, that she has educated herself, researched the product terms, and its closest substitutes along the margin of that all-important dimension—whatever it happens to be.").

[42] *See supra* note 1 and accompanying text.

[43] *See, e.g.*, Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 UNIV. CHI. L. REV. 1203 (2003) ("Because buyers are boundedly rational rather than fully rational decision-makers, when making purchasing decisions they take into account only a limited number of product attributes and ignore others. While sellers have an economic incentive to provide the efficient level of quality for the attributes buyers consider ('salient' attributes), they have an incentive to make attributes buyers do not consider ('non-salient' attributes) favorable to themselves, as doing so will not affect buyers' purchasing decisions.").

[44] *See id.* at 1207 ("By recognizing purchasers' bounded rationality as the most important root cause of inefficiency in form contracts, courts can modify their use of unconscionability analysis to increase both social welfare generally and buyer welfare specifically.").

[45] *See, e.g.*, Stephen J. Choi, Mitu Gulati & Robert E. Scott, *The Black Hole Problem in Commercial Boilerplate*, 67 DUKE L.J. 1 (2017); Scott, Choi & Gulati, *Revising Boilerplate: A Comparison of Private and Public Company Transactions*, 2020 WISC. L. REV. 629 (2020).

[46] *See, e.g.*, Robert E. Scott, *The Paradox of Contracting in Markets*, 83 L. & CONT. PROBLEMS 71 (2020); Ariel Porat & Robert E. Scott, *Can Restitution Save Fragile Spiderless Networks?*, 8 HARV. BUS. L. REV. 1 (2018).

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contractual flexibility. The most obvious manifestation of this trend is the general weakening of fiduciary duties over time. Since the mid-1980s, legal developments in Delaware and other states have made it increasingly easy for owner-investors to contract out of fiduciary duties. In the corporate context, for example, after the 1985 *Smith v. Van Gorkom* decision, the Delaware legislature amended the Delaware General Corporation Law to allow corporations to eliminate directors' personal financial liability for a breach of the duty of care in their charters.[47] This is now a widely-used provision in Delaware corporate charters across the market. In addition, in 2000, the Delaware legislature again amended its statute to allow corporations to carve back the fiduciary duty of loyalty by waiving liability for corporate opportunity claims in their charters as well.[48]

Delaware law has gone even further in the alternative entity space, where the number of new formations now far outnumber new corporate formations. LLCs and limited partnerships are heavily contractarian and allow for nearly unlimited flexibility to contract around fiduciary duties. In fact, in 2004 the Delaware legislature amended both the state LLC and limited partnership statutes to explicitly state that the policy of those statutes is "to give maximum effect to the principle of freedom of contract"[49] and that fiduciary duties can be "expanded or restricted or eliminated" in operating agreements and limited partnership agreements.[50] Delaware is unabashedly contractarian when it comes to alternative entities.

Doctrinal changes in Delaware have largely tracked contractarian theoretical developments. In the mid-1970s, Jensen and Meckling re-conceptualized corporations as simply a "nexus of contracts" among various constituents.[51] Fiduciary duties thus became mere contract terms between principal shareholders and their agent managers. Early contractarian scholars like Easterbrook and Fischel framed fiduciary duties as part of an arm's-length bargain that should thus be waivable, rather than a mandatory court-imposed duty arising out of the relationship between the parties.[52]

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[47] 488 A.2d 858 (Del. 1985); DEL. GEN. CORP. L. § 102(b)(7).
[48] DEL. GEN. CORP. L. § 122(17).
[49] DEL. CODE ANN. tit. 6, § 18.1101(b) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."). *See also* DEL. CODE ANN. tit. 6, § 17.1101(c).
[50] *See, e.g.*, DEL. CODE ANN. tit. 6, § 18.1101(c) ("To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing."). *See also* DEL. CODE ANN. tit. 6, § 17.1101(d).
[51] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (stating that "most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals" and that "[t]he private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships").
[52] *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) ("The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and

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This contractarian premise has been endorsed by many prominent scholars over the years who have argued for greater contractual flexibility.[53] Some have even argued that fiduciary duties should not be default obligations in LLCs and limited partnerships, instead arguing that they should be specifically contracted for.[54] In 1993, Easterbrook and Fischel noted that contractarian thinking had become so dominant among law and economics scholars that only one of the law and economics textbooks then in print even mentioned fiduciaries in the index.[55]

Scholars have responded with a few different reactions to the contractarian movement in business organizations scholarship. "Market realists" have advanced theoretical and empirical arguments to support the idea that parties do not really bargain effectively in these settings. For example, empirical researchers have noted a significant degree of uniformity in corporate charters, suggesting that charters may not actually be subject to the robust bargaining that contractarians theorize about.[56] Others have studied real-world examples of fiduciary duty modifications and argued that the investors in LLCs do not appear to be demanding offsetting contractual protections when they waive fiduciary duties.[57] Other critics have argued that contractarian thinking focuses too narrowly on the shareholder-manager relationship in business organizations and advocated for consideration of a broader set of stakeholders.[58] Finally, others have challenged contractarianism on the grounds that law and economics is not the appropriate framework to analyze relationships in business organizations.[59] Regardless of this pushback, it has not

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opportunities that are available in a large economy. No one set of terms will be best for all; hence the 'enabling' structure of corporate law.").

[53] *See, e.g.*, Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1615 (1989) (arguing that mandatory corporate law cannot be easily justified); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1621 (1989) (stating that the "stable mandatory core of corporate law [is] . . . the institution of judicial oversight"); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425, 427 (1993) ("Fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings.").

[54] *See, e.g.*, Larry Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 210.

[55] Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425, 427 n.4 (1993) ("There is surprisingly little commentary from other scholars on the economics of fiduciary duty. With the exception of Posner's Economic Analysis of Law, none of the textbooks has an entry for 'fiduciary' in the index.").

[56] *See, e.g.*, Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U L. REV. 1559 (2002).

[57] *See, e.g.*, Peter Molk, *How Do LLC Owners Contract Around Default Statutory Protections?*, 42 J. CORP. L. 503 (2017); Michelle M. Harner & Jamie Marincic, *The Naked Fiduciary*, 54 ARIZ. L. REV. 879 (2012); Suren Gomtsian, *Contractual Mechanisms of Investor Protection in Non-Listed Limited Liability Companies*, 60 VILL. L. REV. 955 (2015); Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555 (2012); Brent Horton, Modifying Fiduciary Duties in Delaware: Observing Ten Years of Decisional Law, 40 DEL. J. CORP. L. 921 (2016).

[58] *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 248, 249, 254-5 (1999).

[59] *See* Jacob Hale Russell & Arthur B. Laby, *The Decline and Rise of Fiduciary Obligations in Business*, in FIDUCIARY OBLIGATIONS IN BUSINESS, forthcoming 2021 ("Scholars have identified and debated what unifies fiduciary obligations across disciplines, giving rise to new insights about

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changed the fact that contractarianism is generally king when it comes to the law of business organizations.

C. *Federal Securities Law*

The federal securities laws are not usually thought of as being heavily contractarian. To the contrary, businesses are obligated to comply with extraordinarily detailed public disclosure requirements and fundraising processes anytime they want to engage in a public offering. In addition, publicly-traded companies are subject to a similarly detailed set of ongoing mandatory disclosures. These prescriptive rules and regulations are intended to promote transparency, efficiency, and consistency in the public capital markets. In this sense, the federal securities laws are remarkably *non*-contractarian in many respects as they apply to public offerings and publicly-traded companies.

Publicly-traded companies, however, represent only a portion of the companies in the overall marketplace. In recent decades, the number of private companies has grown to the point where they have overshadowed publicly traded companies in many ways.[60] Unlike public offerings and publicly-traded companies, however, the federal securities laws are completely hands-off when it comes to private offerings and private companies. Instead of imposing incrementally fewer requirements on private offerings and private companies, the securities laws impose almost no requirements on the manner in which private companies raise capital.

This binary approach implicitly places great faith in the ability of private firms to raise capital through private ordering. It assumes that investors will generally demand an appropriate amount of disclosure and that issuers will generally respond by granting that level of disclosure. It also assumes that private parties will agree on efficient fundraising processes through private ordering.[61] By taking a binary approach, rather than an incremental approach that merely reduces requirements in the private markets, federal securities law embraces formalist assumptions about contracting in private markets.

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when heightened duties are warranted. Their method and approach are often at odds with proto-contractarians, and draw on a wider range of doctrine –especially trust law and equity—more than contract law. . . . Intellectually, many contributors in this field come less from a law-and-economics background and are more likely to draw on philosophy.").

[60] *See* Andrew S. Weinberg, *What to Do About the Shift From Public to Private Markets*, World Econ. Forum (Apr. 29, 2021), https://www.weforum.org/agenda/2021/04/what-to-do-about-the-shift-from-public-to-private-markets/ ("[C]oncerns have been raised that corporations and investors may be bypassing public markets in favor of raising funds via private equity, late-stage venture capital, or direct lending. Consider that the number of domestic companies listed on U.S. exchanges, which from a peak of some 7,500 in 1996 has since declined by nearly 40%.").

[61] There is a significant literature arguing that mandatory disclosure is unnecessary, though this is largely focused on publicly-traded companies. Accordingly, I will not provide a thorough discussion here. *See, e.g.*, George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964); Stephen J. Choi & Andrew T. Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 71 S. CAL. L. REV. 903 (1998).

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II. PRIVATE EQUITY AS AN ELITE CONTRACTING SPACE

The private equity fund industry is one of the most well-resourced and elite sectors of the financial marketplace. On paper, the private equity fund industry is about as close as you can get to an ideal contracting environment. Anyone who has a basic understanding of the traditional law and economics literature would naturally assume that parties bargain for optimal outcomes in this space.

A. Basic Structure of the Private Equity Industry

Private equity managers[62] raise money from investors (primarily institutional investors) and invest that money for a fee. They pool the invested capital of their various investors into a single vehicle called a fund. These "pooled" funds are typically organized as limited partnerships[63] and governed by a limited partnership agreement (an "LPA"), a document that is collectively negotiated between the manager and the fund's investors and that sets forth the terms of the fund. As discussed below,[64] it is also quite common for most of the investors in a fund to separately negotiate their own "side letter" to the LPA, which modifies the terms of the LPA as they apply to the investor that is the recipient of the side letter.[65]

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[62] To avoid unnecessary complexity, I will use the term "manager" through most of this Article, even in cases where other terms (like "sponsor" or "adviser" or "general partner") may be more technically correct. Any technical distinctions will not be important for purposes of this Article. I will also generally use the term "investor" throughout this Article, even in cases where the term "limited partner" might be more technically correct, for similar reasons.

[63] Because funds are usually structured as limited partnerships, the limited partnership architecture applies to these vehicles. Accordingly, investors are passive "limited partners," and the manager acts through a "general partner" that has broad authority to control the fund.

[64] *See infra* Section III.C.4.

[65] *See* JAMES M. SCHELL ET AL., PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 11.14 (2018) ("A side letter is an agreement between a Fund and one of its investors, which establishes a series of investment terms that supplement or modify the terms of the partnership agreement with respect to that investor.").

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PRIVATE EQUITY FUND EXAMPLE

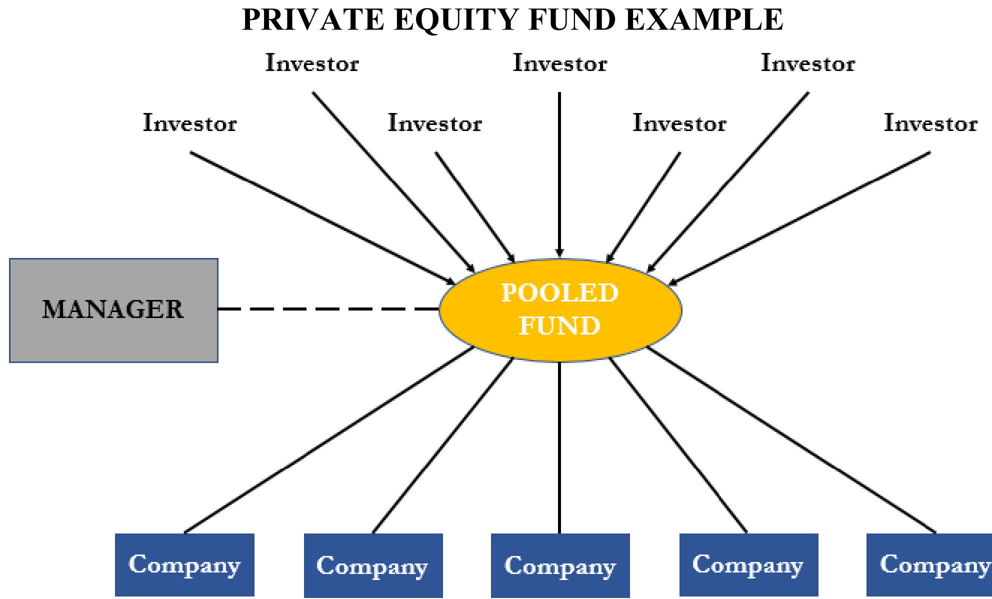

Figure A

Once a fund is formed, a manager typically has a three to five year "investment period" during which the fund is free to make investments.[66] These investments are known as "portfolio companies," and managers seek to buy companies that are undervalued or that would benefit from changes to strategy or management. During the investment period, investors contribute capital to the fund each time the manager makes a "capital call" so the fund can make investments and pay the fund's fees and other expenses. The manager will eventually seek to sell the fund's portfolio companies, hoping to make profits upon the disposition. Each fund usually has a stipulated end date (typically around ten years after the date of the fund's closing)[67] by which the manager must dispose of any remaining assets and distribute the proceeds to the fund's investors.[68]

Given the level of discretion that private equity managers have over their investors' assets, conflicts of interest naturally arise. For example, private equity managers may be incentivized to invest less time and effort than they would if they were managing their own money, or may seek to enrich themselves at the expense of their investors. Manager self-dealing could take the form of secretly charging

[66] *See* STEPHANIE BRESLOW & PHYLLIS SCHWARTZ, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION § 2:4.2 (Carol Benedicto ed., Practicing Law Inst. 2015) ("The appropriate length of the commitment period will vary depending on the investment strategy of the fund, with a time period of three to five years being typical for many strategies.").

[67] *See* Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 222 (2009) (noting that private equity funds are typically established for ten-year terms).

[68] Often, the life of a fund can be extended for successive one- or two-year periods to liquidate and wind up investments.

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excessive fees and expenses, or keeping the best investment opportunities for personal investment rather than allocating them to the fund, among various others.[69]

Often, there are also additional conflicts outside each individual fund. For example, after the investment period of one fund ends, a private equity manager commonly launches another fund following the same strategy. This means that the manager's investment professionals will have to divide their time between operating (and eventually selling) the businesses already owned in the older fund, on one hand, and searching for new investment opportunities for the newer fund to invest in.[70] In addition, private equity managers commonly manage funds simultaneously that focus on different strategies, including leveraged buyout funds, growth equity funds, venture funds, corporate debt funds, real estate funds, natural resources funds, and/or infrastructure funds, among others.[71] Sometimes, an investment opportunity can plausibly fit within the description of multiple funds, forcing the manager to make decisions about where to allocate it.

In addition, many private equity managers have also branched out and formed broker-dealer subsidiaries that engage in activities historically left to investment banks, such as advising on mergers and acquisitions and underwriting securities issues, creating another set of conflicts that must be dealt with.[72]

B. *Private Equity's Contracting Advantages*

If formalist law and economics scholars could custom build an environment for effective contracting, it would probably look like the private equity fund industry in many respects. Compared to most other contracting settings, participants in the private equity marketplace possess significant advantages when they seek to address the conflicts of interest described above through contract.

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[69] *See supra* Section II.A for a discussion of some of the conflicts that have been criticized in private equity funds.

[70] These conflicts have been exacerbated in recent years as managers have compressed the period of time between funds in response to high investor demand for private equity. *See* Elisabeth de Fontenay, *Private Equity's Governance Advantage: A Requiem*, 99 B.U. L. REV. 1095 (2019) ("[T]he extraordinarily favorable fundraising climate for private equity has meant that private equity firms are successfully compressing the time between funds from more than five years to less than three and a half.").

[71] *See id.* ("Large private equity firms now simultaneously run LBO funds, credit funds, real estate funds, alternative investments funds, and even hedge funds."); Andrew Tuch, *The Remaking of Wall Street*, 7 HARV. BUS. L. REV. 315, 340-47 (2017) (describing the expansion of private equity managers' business platforms to include credit funds, real estate funds, and hedge funds in addition to traditional corporate buyout funds).

[72] *See* Tuch, *The Remaking of Wall Street*, *supra* note 71 at 345 ("Large private equity firms have registered under the Securities Exchange Act as broker-dealers, allowing them to venture into traditional investment banking territory, including M&A advisory and capital-markets work."); Paul J. Davies, *Why Private Equity Risks Tripping on Its Own Success*, WALL ST. J. (Feb. 13, 2018) ("Today, big private-equity firms are financial conglomerates reaching into all corners of the markets. They act not only as fund managers, but also proprietary investors, traders and investment bankers. Big private-capital firms now typically encompass traditional buyout arms plus private debt, real estate, infrastructure and energy funds.").

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1. Parties Have Substantial Resources

Because federal law restricts who can and cannot invest in private equity funds, all of the investors in this industry are generally presumed to be sophisticated and/or capable of hiring competent counsel. Under the Securities Act of 1933, all of a fund's investors typically must be "accredited investors" meeting certain net worth thresholds (generally $5 million for certain entities and $1 million for individuals).[73] Furthermore, under the Investment Company Act of 1940 (the "Investment Company Act"), in most private equity funds all of the fund's investors must be "qualified purchasers" who satisfy a different set of net worth thresholds (generally $25 million for certain entities and $5 million for individuals).[74] Various other exemptions to the Investment Company Act exist, but this is the most commonly used one. Furthermore, in any private equity fund that charges investors incentive-based compensation, the investors must also meet the "qualified client" standard under the Investment Advisers Act, which currently requires both entities and natural persons to have a net worth of at least $2.1 million or an investment with the manager of at least $1 million.[75]

This makes the private equity landscape very different than, for example, a retail consumer setting, or a small business setting with unsophisticated owners. The private equity investor base is dominated by institutional investors that should have sufficient resources to hire competent in-house counsel. Even if the in-house lawyer or lawyers for a particular institutional investor are inexperienced, that investor should generally have resources to pay outside counsel to negotiate on their behalf.

2. Parties Have a High Volume of Experience

Institutional investors that participate in private equity commonly have a substantial amount of capital to deploy to the asset class, and they commonly seek to diversify their investments across managers within the industry. As a result, many institutional investors have dedicated in-house teams that oversee investments in private equity funds, and these teams often invest in a high number of private equity funds each year. This is compounded by the fact that private equity fund investments typically only last for about ten years, after which the money is returned to the institutional investor and needs to be redeployed.

For instance, of the 70 investors that completed the 2020 ILPA survey that will be discussed in Part IV,[76] more than half of them had invested in 10 or more

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[73] *See* 17 CFR 320.501(a) for the formal definition of "accredited investor."

[74] *See* Section 3(c)(7) of the Investment Company Act (which allows a fund to raise an unlimited amount of money from an unlimited number of investors if they are all "qualified purchasers"). Alternatively, the Investment Company Act of 1940 Section 3(c)(1) of the Investment Company Act allows a private fund to operate as long as it has fewer than 100 investors. *See* Section 3(c)(1) of the Investment Company Act (which imposes no sophistication requirements as long as the fund has fewer than 100 investors).

[75] *See* 17 CFR 275.205-3. In practice, virtually all private equity fund managers charge incentive-based compensation.

[76] *See infra* Section IV.A.

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private equity funds in the prior 12 months. As illustrated in Figure B below, less than 15% of responding investors, by contrast, reported that they had invested in five or fewer private equity funds during the prior 12 months. This means that in-house lawyers at large institutional investors participate in a large number of private equity fund investments each year, which can clearly be expected to accelerate their confidence and capability in contracting for this type of transaction. It also means that we can expect most lawyers in this setting to have well-developed, thoughtful views on the issues that commonly arise in this setting. In any given transaction, it is unlikely that there will be many issues that are matters of first impression for the lawyers involved.

PE Investments in Prior 12 Mths.	# of Investors
0-5	9
6-10	20
11-20	17
20+	23

Figure B[77]

3. Contracting Relationship Has a Limited Life

Most business entities have an indefinite life at the time that they are formed. If the business is successful, the parties might choose to keep it running for decades. Alternatively, the business could become an acquisition target, or it could engage in a public offering of its shares. In the meantime, the nature of the business could change, the business' capital structure could go through dramatic alterations, and the regulatory system applicable to the business might evolve. The longer the potential life of the business, and the broader the range of potential paths that the business might go down, the harder it becomes to anticipate all of the possible contingencies and account for them in the contract.

Private equity funds, by contrast, typically have a much clearer end date at the time that they are launched, and the manner in which the funds will be terminated is also very clear.[78] As noted above, the typical private equity fund has a life of about 10 years, after which it is liquidated and the proceeds are paid out to investors.[79] When the parties know that the entity will not continue past a certain date, and they know in advance how the entity is going to be wound up, there are fewer possible contingencies that they have to account for in the contract. The shorter the life of the entity, the more realistic it becomes to account for possible outcomes by contract.

[77] 69 out of 70 investors provided information about the number of private equity investments entered into during the prior 12 months.

[78] While it certainly is possible to extend the life of a fund in most private equity funds, this process is clearly laid out in the LPA. At a certain point, the investors' approval will be required to extend the fund's life.

[79] *See supra* Section II.A.

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4. *Contracting Parties Have Strong Reputational Incentives*

The limited life of private equity funds also creates another contracting advantage: if managers want to stay in business over a long time horizon, they have to raise successive funds in a serial fashion. This means that private equity managers should have unusually strong reputational incentives not to violate the letter—or the spirit—of their contractual commitments. On the other side of the table, because institutional investors are often making such a large number of investments in different private equity funds each year,[80] investors in private equity funds are also concerned about their reputations in the marketplace.

This should facilitate greater trust in the contracts entered into between managers and their investors. If there is a hole in a contract, for example, both sides have greater incentives not to take advantage of that incompleteness if it would affect their reputations in the market. This should increase the net beneficial reliance by investors on private equity fund contracts. Moreover, from an ex ante perspective, when parties have greater trust in each other it should help to facilitate a more efficient contracting process.[81]

C. *Elite Academic Expectations for Private Equity Bargaining*

Given the factors described above, it is not surprising that the private equity industry has been held up by some as a leading example of contractarianism.[82] The various contractual methods in the private equity model have been praised at times as superior alternatives to the more rigid governance approaches found in public corporations.[83] For any proponent of the traditional law and economics scholarship described above, it only seems natural to assume that bargaining in the private equity market should lead to optimal outcomes.

III. HIGH-END BARGAINING PROBLEMS IN PRIVATE EQUITY

Traditional law and economics theory would predict that bargaining in the private equity market should be effective and efficient. But a closer look shows that this high-end market is far from perfect, suggesting that reality is much more

[80] *See supra* Section II.B.2.
[81] *See generally* Robert E. Scott, *The Law and Economics of Incomplete Contracts*, 2 ANN. REV. L. SOC. SCI. 279 (2006); Oliver Hart & John Moore, *Foundations of Incomplete Contracts*, 66 REV. ECON. STDS. 115 (1999).
[82] *See, e.g.*, LARRY RIBSTEIN, THE RISE OF THE UNCORPORATION 222-26 (2010); Larry Ribstein, *Partnership Governance of Large Firms*, 76 UNIV. CHI. L. REV. 289 (2009) ("Private-equity buyout firms are a leading example of the use of partnership mechanisms in governing large firms.").
[83] *See, e.g.*, Larry Ribstein, *Partnership Governance of Large Firms*, 76 UNIV. CHI. L. REV. 289, 290 (2009) ("[Contractual mechanisms] substitute for costlier and often ineffective corporate-type monitoring devices, including the use of independent directors, owner voting, and fiduciary duties. . . . Substituting incentive devices for monitoring is a particularly efficient tradeoff in private equity firms given the high costs of constraining the discretion of expert managers.").

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complex than what the traditional law and economics framework typically accounts for.[84]

A. *Problematic Bargaining Outcomes*

1. *Private Equity's Controversial History*

In the years following the financial crisis of 2008, Congress passed legislation giving the SEC authority to examine private equity funds.[85] When the SEC reported its findings in 2014, it painted a damning picture of the private equity industry's governance environment. Perhaps most alarming of all, the SEC indicated that violations of law or material weaknesses in controls relating to the payment of fees and expenses were identified in over 50% of the managers that they examined.[86] This was made possible because, in the words of the SEC, the private equity industry was an environment where "lack of transparency and limited investor rights ha[d] been the norm . . . for a very long time."[87]

The SEC identified various problems with the contracts bargained for by private equity investors and managers. The SEC reported that LPAs commonly granted managers broad discretion to charge fees and expenses that were not

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[84] To be clear, private equity funds are not the only sophisticated space where bargaining problems have been observed. For example, sub-optimal bargaining practices have been documented in the M&A literature. *See, e.g.*, Robert Anderson & Jeffrey Manns, *The Inefficient Evolution of Merger Agreements*, 85 GEO. WASH. L. REV. 57, 66 (2017) (finding that M&A agreements derive from a broad set of different precedent forms on a random basis, and arguing that this lack of standardization is inefficient); Matthew Jennejohn, *The Architecture of Contract Innovation*, 59 B.C. L. REV. 71 (2018) (highlighting the extent to which merger agreement provisions are path-dependent); Jeffrey Manns & Robert Anderson, *The Merger Agreement Myth*, 98 CORNELL L. REV. 1143, 1154, 1186 (2013) (using an event study to show that the market does not react to the disclosure of acquisition agreements following the merger announcement).

However, there are a number of important distinctions. First, the M&A studies involve publicly-traded corporations, and there is less contractual flexibility and far more mandated transparency in the public M&A space than in private equity funds. Accordingly, compared to private equity funds, bargaining in the public M&A space is a less effective test of how sophisticated bargainers will use contractual freedom without external intervention. Second, bargaining problems in private equity raise greater normative concerns than the M&A space. In private equity fund investments, a huge percentage of the capital is being invested on behalf of ordinary people by pension plans and other institutional investors. On the other side of the transaction are some of the wealthiest and most sophisticated actors on Wall Street. If a bargaining problem in private equity consistently favors managers over investors, then it creates serious distributional concerns. Bargaining problems in the public M&A space is far less likely to raise such distributional concerns.

[85] *See* Title IV, Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (eliminating the "private adviser" exemption to registration requirements under the Investment Advisers Act of 1940, which had the effect of requiring all but a small minority of private fund managers to register with the SEC and become subject to the SEC's examination authority).

[86] *See* Bowden, *Spreading Sunshine in Private Equity*, *supra* note 9 ("When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.").

[87] *Id*.

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specifically discussed at the time the LPAs were negotiated,[88] which resulted in managers receiving large amounts in hidden payments that were never specifically disclosed and were "not reasonably contemplated by investors."[89] The SEC also criticized the light disclosure requirements set forth in LPAs and indicated investors lacked sufficient information rights to be able to monitor their investments adequately. According to the SEC, LPAs commonly had broad, imprecise language which enabled managers to be opaque in areas where investors would benefit from transparency.[90] The SEC's findings were, all in all, a sharp rebuke of common practices in the industry.

As noted above, in response to these findings, the SEC established a special unit specifically focused on examining private investment funds, and it has maintained a robust examination program covering the industry ever since.[91] The SEC's oversight activities are primarily focused on making sure that the contractual bargains struck between investors and managers are complied with. Yet, even with this oversight presence in place, the private equity industry has not transformed into a model industry with squeaky clean governance practices. As recently as June 2020, in fact, the SEC's Private Funds Unit issued an extensive "risk alert" highlighting a host of common deficiencies and compliance issues throughout the industry.[92]

All of this prompts the question: If private bargaining between investors and managers is supposed to yield optimal governance terms in private equity contracts, why would a permanent government oversight presence be necessary? Moreover, why would questionable practices continue even with that oversight presence?

2. *Private Equity's Shifting Governance Terms*

Another factor that raises questions about whether bargaining leads to optimal governance terms in private equity fund contracts is the fact that these terms appear to ebb and flow over time as bargaining power dynamics in the industry

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[88] *Id*.
[89] *Id* ("Many limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser). This has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors.").
[90] *Id.* ("[M]ost importantly, we see 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. Of course, many managers voluntarily provide important information and disclosures to their investors, but we find that broad, imprecise language in limited partnership agreements often leads to opaqueness when transparency is most needed.").
[91] *See* "Risk Alert: Observations from Examination of Investment Advisers Managing Private Funds," SEC Office of Compliance Inspections and Examinations (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf (noting that "OCIE examines hundreds of private fund advisers each year").
[92] *Id.* ("OCIE . . . is frequently asked about its observations from examinations as well as common deficiencies and compliance issues. Many of the deficiencies discussed [in the risk alert] may have caused investors in private funds to pay more in fees and expenses than they should have or resulted in investors not being informed of relevant conflicts of interest.").

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modulate. As discussed above,[93] one of the basic principles of the law and economics scholarship on contracting is the idea that sophisticated parties will bargain for optimal contract terms regardless of how the balance of bargaining power is distributed between them. If this "bargaining power irrelevance" proposition were an accurate depiction of the contracting dynamics in the private equity industry, then hands-off, formalistic approaches to the law would almost certainly lead to the best outcomes.

Anyone familiar with the industry, however, knows that governance terms actually change significantly when the bargaining power dynamics in the industry shift. Industry practitioners will tell you that governance terms shifted sharply in favor of investors in the years immediately following the financial crisis of 2008 as the industry struggled to find sources of capital in the challenging environment.[94] Likewise, as the private equity industry has experienced massive growth in more recent years in a favorable low interest rate environment, industry participants report that governance terms have moved dramatically in favor of managers.[95]

This anecdotal evidence is consistent with an important early study of the venture capital industry. In 1996, Gompers and Lerner found that in periods of high demand for private equity fund investments, private equity fund managers did not charge correspondingly higher prices as one might expect.[96] Instead, managers and investors tended to bargain for less restrictive contractual covenants in times of high market demand and more restrictive contractual covenants in times of low market demand. This dynamic is the exact opposite of what the bargaining power irrelevance proposition—a "defining feature" of the law and economics literature—would predict.[97]

3. *Academic Criticism of Private Equity Terms*

Finally, over the years various scholars have also directly questioned the substantive quality of the terms in private equity fund contracts themselves. For

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[93] *See supra* notes 37 and 38 and accompanying text.

[94] *See* Michael Suppappaloa, *At the Negotiating Table: Ts and Cs That Require Attention*, PRIVATE EQUITY INTERNATIONAL: PRIVATE FUNDS MANAGEMENT at 13 (Jan. 2016) ("The relationship between LPs and GPs has continually shifted as market conditions and the private equity industry has evolved. During the global financial crisis of 2007-2009 and subsequent recession, severe economic headwinds resulted in a very difficult fundraising environment for many GPs. During this time and for a number of years thereafter, the pendulum of negotiating leverage shifted sharply in the direction of LPs.").

[95] *See* Institutional Limited Partners Assoc., SEC Comment Letter on Proposed Commission Interpretation Regard Standard of Conduct for Investment Managers (Aug. 6, 2018), https://ilpa.org/wp-content/uploads/2018/08/ILPA-Comment-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-August-6-2018.pdf ("[A]s the market has rebounded, the legal terms have become immensely more challenging. This has been exacerbated by the current fundraising environment, which is characterized by unprecedented fund raising levels and speed, where GPs have significant leverage in negotiations, and many LPs, particularly public pensions, are forced to deploy capital under disadvantaged terms in order to achieve certain performance thresholds designed to allow them to meet their pension and other disbursement requirements.").

[96] See Section III.C.1 for a more detailed discussion of this study.

[97] *See supra* notes 37 and 38 and accompanying text.

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example, scholars have criticized private equity contracts for failing to align managers' reputational incentives with the interests of investors,[98] for failing to sufficiently align managers' and investors' economic incentives,[99] and for providing investors with insufficient information rights after the fund has commenced business operations,[100] among other critiques. Scholars have argued that these shortcomings have caused significant harm to the investors in private equity funds.[101]

Again, this is not what the formalist view of bargaining would predict. Of course, it is difficult for outside critics to claim to know what the substantive terms for every LPA *should* be. But these scholarly criticisms have aligned with the SEC's criticisms over the years, making it difficult to accept the formalist assumption that all of these terms are joint welfare maximizing provisions for managers and investors.

B. *Problematic Bargaining Processes*

A close look also reveals a number of problems in the process by which private equity contracts are bargained. While each of the following issues could individually be the subject of a lengthy discussion, I offer a high-level description below.

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[98] *See, e.g.*, William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1900 (2018) [hereinafter Magnuson, *Public Cost of Private Equity*] ("[R]eputation can only constrain a party's behavior if the party believes that others will receive information about the party's past behavior and base their decision making on that past behavior. In other words, reputation is only as good as the information that underlies it."); James C. Spindler, *How Private is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 309, 332 (2009) [hereinafter Spindler, *How Private is Private Equity*] ("There is a tendency to overstate the salutary effect of reputation; from a theoretical perspective, the gradual learning that takes place through reputation is inefficient compared to more immediate revelation through greater transparency.").

[99] *See* Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSPS. 147, 162 (2009) ("To isolate further potential conflicts between the managers of private equity buyout funds and their outside investors, I discuss a few features of buyout contracts that exacerbate conflicts of interest, rather than mitigate them. First, managers have an incentive to time cash flows in a way that will increase incentive fees. Second, certain contracts provide steep incentives for shortening investment horizons. Third, transaction fees may distort choices of buyout firms in terms of leverage, size of investment, and number of changes in capital structure.").

[100] *See, e.g.*, EILEEN APPELBAUM & ROSEMARY BATT, CTR. FOR ECON. & POLICY RESEARCH, FEES, FEES AND MORE FEES: HOW PRIVATE EQUITY ABUSES ITS LIMITED PARTNERS AND U.S. TAXPAYERS 12 (May 2016), http://cepr.net/images/stories/reports/private-equity-fees-2016-05.pdf ("Many current Limited Partnership Agreements stipulate that a portion of the transaction and monitoring fees charged to portfolio companies will be rebated to the PE fund's limited partners. But vague and confusing wording in the LPAs has meant that too often . . . these investors have not received the fee income that is owed them; instead, it has been pocketed by the PE firm. Even when LPs are reimbursed out of these fees, the LP can only receive the amount it has paid in management fees. Monitoring fees in excess of those payments are retained solely by the PE firm.").

[101] Rosemary Batt & Eileen Appelbaum, *The Agency Costs of Private Equity: Why Do Limited Partners Still Invest?*, 35 ACAD. MGMT. PERSPECTIVES 45, 52 (2021) [hereinafter Batt & Appelbaum, *Agency Costs of Private Equity*] ("A growing body of evidence has shown that the flaws in the corporate governance of the PE model have had some real consequences for the limited partners and PE fund portfolio companies.").

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1. Costly and Time-Intensive Contracting Process

The private equity negotiation process is extremely labor-intensive and costly. Instead of evolving toward industry-wide standards that reduce the time and expense associated with crafting private equity contracts, the industry has instead moved in the opposite direction.[102] The fundraising and negotiation process for a substantial-sized fund commonly takes 18 months or more, with managers and investors typically negotiating hundreds of pages of "side letters" in addition to the 150+ page fund agreement that applies to all investors. According to one prominent private funds attorney, a law firm representing a manager in a substantial fundraise will commonly spend approximately 7,000 hours negotiating contract terms with investors—a "vast amount of time" by any standard.[103] Such a process is clearly a sizeable profit-making opportunity for the law firms representing private equity managers and their investors, but it seems far from a model of efficiency.[104] According to industry participants, these costs have only increased over time.[105]

To highlight the unusual nature of this approach, a comparison to the market for syndicated credit investments provides a useful counterpoint. In a syndicated credit arrangement, a corporation issues a large amount of debt that is syndicated into smaller interests and sold to a large number of investors across the marketplace. Just like a private equity fund, there is a single issuer that ultimately collects investments from a large number of investors who depend on that issuer to provide investment returns. However, unlike a private equity fund, each of those individual investors does not negotiate a separate side letter with the debt issuer. Instead, a single "administrative agent" negotiates the contractual terms of the credit

[102] While the Institutional Limited Partners Association has produced a set of best practices that it encourages private equity investors and managers to consider when negotiating LPAs, these principles are intended as a starting point for discussion. *See ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners*, https://ilpa.org/wp-content/uploads/2019/06/ILPA-Principles-3.0_2019.pdf ("This guidance is set forth as a road map for GPs and LPs to develop the same set of expectations when entering into any partnerships, and to frame a more precise and specific dialogue between the GP and the partnership's existing and prospective investors during the fundraising process and over the life of the partnership.").

[103] Vicky Meek, *LPA Blues*, PRIVATE EQUITY FINDINGS (2020), https://www.collercapital.com/sites/default/files/Private%20Equity%20Findings%20Issue%2016_0.pdf ("[A]cting for a general partner with a 10 billion euro plus fund, for example, [Jason Glover, managing partner of Simpson Thacher's London office] estimates that on average, his team spends 7,000 hours negotiating terms with limited partners and their legal counsel. 'That's a vast amount of time, but it's pretty typical.'"). Note that this estimate does not include time spent by counsel representing investors.

[104] *Cf.* Robert Anderson & Jeffrey Manns, *The Inefficient Evolution of Merger Agreements*, 85 GEO. WASH. L. REV. 57 (2017) (finding that M&A agreements derive from a vast set of different forms and that M&A clients would obtain better outcomes if law firms would be willing to coordinate).

[105] *See* Institutional Limited Partners Assoc., SEC Comment Letter on Investment Adviser Advertisements (Feb. 10, 2020), https://www.sec.gov/comments/s7-21-19/s72119-6794358-208353.pdf ("Organizational expenses relate to establishing and organization the private equity fund. . . . Over the past decade, organizational fees for private equity funds have increased dramatically.").

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arrangement in a single, bilateral negotiation, after which that investment is syndicated into small pieces and sold to the outside investors.[106] Moreover, unlike the private equity industry, market-standard documentation is widely used across the market.[107] These different approaches dramatically increase the speed and efficiency of the process as compared with the private equity market.

2. Investors Pay the Manager's Bargaining-Related Legal Fees

Another problematic aspect of the private equity contracting process is the fact that the investors in a fund generally pay for the legal expenses incurred by the manager while the fund contracts are negotiated. This means that each investor is directly paying its own external lawyer (if it hires one) to negotiate on its behalf and is *also* paying a pro rata portion of the manager's legal expenses. While the partnership's obligation is typically capped at some percentage of the size of the overall fund (typically between .5% to 1.5%), industry participants commonly feel that increasing fund sizes have led to this cap being somewhat toothless.[108]

This has been criticized for creating a distorted set of bargaining incentives. Managers, on one hand, are relatively insensitive to the legal costs that are incurred during the bargaining process because they are not paying their attorneys' legal bills.[109] Investors, by contrast, are paying two sets of legal fees for every hour that they negotiate the fund contract, making them even *more* sensitive to legal costs. One predictable effect of this arrangement is that investors are less likely to raise

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[106] *See* Bryan L. Barreras and David B. Kobray, *Issues for Administrative Agents to Consider*, Mayer Brown Client Memorandum (Oct. 2019), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/10/issues-for-administrative-agent-to-consider.pdf ("In a typical syndicated credit facility, one of the lenders (or an affiliate of a lender) acts as administrative agent for the lender group. . . . Generally speaking, the role of the administrative agent is in many respects essentially for convenience and efficiency.").

[107] *See* Allison A. Taylor, *The LSTA and its Role in the Promotion of the Corporate Loan Asset Class*, in THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING 32-33 (Allison Taylor & Alicia Sansone eds., 2007) ("Standardized documentation is the most significant contributor to the rise in liquidity in the leveraged loan market. . . . Over the past decade, the [Loan Syndications and Trading Association] has established standard terms for nearly two dozen documents, including par and distressed trade confirms and purchase/sale agreements, as well as guidelines for processing such amendments.").

[108] It is interesting to consider why this arrangement has persisted over time. One factor, of course, is the general strength of manager bargaining power in recent years. *See supra* note 95 and accompanying text. This could also be viewed as a product of a collective action problem within private equity funds. Because the manager's legal fees are spread out across the entire partnership, each individual investor is only bearing a pro rata portion of those fees. But if one investor were to challenge the manager and seek to negotiate to eliminate the partnership's obligation to pay the manager's legal fees, that investor would likely exhaust an enormous amount of bargaining power in doing so (or be rejected from the fund entirely) while only capturing a pro rata portion of the benefit.

[109] *See* Jeffrey E. Horvitz, *Commentary: Support ILPA's Standard Fund Documents Project*, PENSIONS & INVESTMENTS (Jan. 20, 2020) ("GPs have no incentive to control the legal costs because fees are included in fund formation costs typically borne by the LPs. In other words, LPs are paying for both their own legal fees and the GP legal fees. Multiply this by the number of LPs across multiple funds and clearly a lot of investor money is being wasted.").

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issues than they otherwise would be, and managers are more likely to push back on issues raised by investors than they otherwise would be.

3. Constraints on Information Flows

In a private equity fund, it is also very common for managers to require investors to agree to non-disclosure provisions that prohibit them from sharing LPAs with third parties,[110] and also to withhold the identifying information of the other investors participating in the same fund. These kinds of restrictions make it more difficult for investors to coordinate their bargaining efforts with each other. They also make it much more difficult for investors to benchmark and compare LPAs against each other across the market,[111] which decrease efficiency and also hamper the diffusion of contracting innovations and improvements across the market-wide network of investors.[112]

As discussed in detail below, some scholars have argued that efforts like this to minimize information flows can be understood as an attempt to avoid the reach of antifraud rules under the securities laws.[113] Other commentators have accused private equity of using non-disclosure agreements primarily to prevent the public evaluating LPAs and criticizing unfair terms in them.[114] The private equity industry, in response, has argued that the terms of private equity contracts are a source of competitive advantage, and that exposing those terms to the public would impair managers' ability to generate high returns for investors.[115]

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[110] *See, e.g.*, Madison Marriage & Chris Newlands, *Pension Funds Forced to Sign Non-Disclosure Agreements*, FIN. TIMES (Oct. 26, 2014), https://www.ft.com/content/94524a60-5b96-11e4-81ac-00144feab7de ("Anger has erupted over the practice of asset managers coercing pension funds into signing non-disclosure agreements."); Gretchen Morgenson, *Behind Private Equity's Curtain*, N.Y. TIMES (Oct. 18, 2014), https://www.nytimes.com/2014/10/19/business/retirement/behind-private-equitys-curtain.html ("[I]n exchange for what they hope will be hefty returns, many pension funds have signed onto a kind of omerta, or code of silence, about the terms of the funds' investments.").

[111] Concerns in this area have even led one commentator to create a publicly-available collection of "leaked" private equity fund LPAs, including LPAs from many of the largest private equity managers in the industry. *See Private Equity Limited Partnership Agreements*, NAKED CAPITALISM, https://nakedcapitalism.net/documents.html (last visited Feb. 16, 2021); Albert J. Hudec, *Negotiating Private Equity Fund Terms: The Shifting Balance of Power*, 19 BUS. L. TODAY, May/June 2010 at 48 ("Traditional limited partnership agreements do not have expansive information rights and tricky confidentiality obligations make robust information flow difficult to come by.").

[112] *See* Lisa Bernstein, *Beyond Relational Contracts: Social Capital and Network Governance in Procurement Contracts*, 7 J. LEGAL ANALYSIS 325 (2016); Alan Schwartz & Robert E. Scott, *Third-Party Beneficiaries and Contractual Networks*, 7 J. OF LEGAL ANALYSIS 325 (2015).

[113] *See* Spindler, *How Private is Private Equity*, *supra* note 98 at 331 (arguing that, for private equity, "[s]taying below the regulatory radar is paramount").

[114] *See, e.g.*, Marriage & Newlands, *supra* note 110 ("Critics believe the non-disclosure agreements allow fund managers to overcharge some of their pension clients significantly."); Dan Primack, *Private Equity's False Argument for Confidentiality*, FORTUNE (Nov. 25, 2014), http://fortune.com/2014/11/25/private-equitys -false-argument-for-document-secrecy.

[115] *See* Steve Judge, *Confidentiality of Limited Partner-ship Agreements Is Paramount*, PE HUB NETWORK (Nov. 3, 2014), https:// www.pehub.com/2014/11/confidentiality-of-limited-partnership-agreements-is-paramount.

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Whatever the motivation for including restrictions on disclosure, limiting information access in this way can be expected to reduce the efficiency and effectiveness of the bargaining process in the private equity industry. Again, this is inconsistent with formalist assumptions about optimal contracting.

4. The Complicating Role of Investor-Level Regulation

Another process-related factor that is not addressed by the traditional law and economics literature is the fact that an enormous percentage of the investors in private equity funds are regulated institutions that are subject to their own array of regulations and requirements. In fact, the largest investors in the industry with the most bargaining power—including public pension plans and sovereign wealth funds[116]—are often the ones that are most likely to be subject to these kinds of regulations.

While it is difficult to measure the precise impact of this kind of investor-level regulation, at least two effects are clear. First, to the extent that investors are required by law or regulation to obtain certain contractual terms from managers, those terms are not actually the product of bargaining between sophisticated parties. Instead, such terms are produced by legislatures and regulatory bodies through political and administrative processes that are not accounted for in the law and economics literature.[117]

Second, investor-level regulation has helped contribute to the complex, labor-intensive, and costly negotiating dynamic observed in the private equity industry[118] by requiring bilateral bargaining between investors and managers. Since there is only one LPA for the entire fund, that document cannot by itself accommodate the various requirements that regulated investors are subject to. It is therefore necessary for regulated investors to negotiate side letters that modify and supplement the terms of the LPA as they apply to those investors.

Two levels of bargaining thus must happen simultaneously during a private equity fund raise—one at the level of the fund LPA and one at the level of the investor side letters. This creates a complex set of incentives, as will be discussed in greater detail below.[119]

C. Problematic Incentives

The conventional law and economics literature assumes that in a sophisticated environment like private equity, it will be in the parties' best interest to bargain for optimal terms. However, a closer look shows that private equity managers and investors may not always have incentives to bargain for optimal

[116] *See supra* note 30 and accompanying text.

[117] For a discussion of the benefits and challenges associated with this kind of investor-level regulation, see William W. Clayton, *Public Investors, Private Funds, and State Law*, 72 BAYLOR L. REV. 294, 332-43 (2020).

[118] *See supra* Section III.B.1.

[119] *See infra* Section III.C.4.

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contract terms, notwithstanding their sophistication and the various other contracting advantages found in private equity funds.[120]

1. Agency Problems in Institutional Investors

As noted above, in a foundational early study of the venture capital industry,[121] Gompers and Lerner documented an unusual phenomenon in private equity funds. In periods when demand for private equity investments was high, private equity fund managers did not charge correspondingly higher prices. Given that private equity fund managers are highly sophisticated profit maximizers, it was puzzling that they did not seem to take advantage of their bargaining power to demand higher fee rates.[122]

Gompers and Lerner found that instead of negotiating for higher fee rates, managers and investors instead agreed to include less restrictive covenants in private equity LPAs. Diluting covenants in this way made it easier for private equity fund managers to extract private benefits, including by, for example, enabling the manager to engage in conflicted transactions that would generate greater personal returns at the expense of investors.[123] In other words, private equity managers appeared to exercise their heightened bargaining power by seeking inefficiently weak contractual constraints on their activity rather than higher monetary compensation.

Acknowledging that the bulk of the capital invested in private equity funds comes from institutional sources, one explanation posed by Gompers and Lerner for this dynamic points to agency problems within institutional investors.[124] To

[120] *See supra* Section II.B.

[121] *See* PAUL GOMPERS AND JOSH LERNER, THE VENTURE CAPITAL CYCLE (1999).

[122] *See id.* (noting that it is "puzzling" that the adjustment to supply and demand dynamics takes place through the insertion and deletion of contractual restrictions in addition to explicit monetary compensation); Paul Gompers and Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J. L. & ECON. 463 (1996) ("If the demand for the services of experienced venture capitalists changes rapidly while the supply of those venture capitalists is fixed in the short run, the price of venture capital services should rise: venture capitalists' expected total compensation should increase.").

[123] Gompers and Lerner outline three different types of restrictive covenants commonly found in private equity contracts. First, there are covenants that restrict the manager's discretion in managing the fund as a whole, including by limiting the amount invested in any one firm, the amount of debt taken on by the fund, investments alongside other funds raised by the same investment manager, and restrictions on the manager's ability to reinvest the fund's profits. Second, there are covenants that limit the activities of the manager, including by limiting the manager's ability to invest personal funds in the fund's portfolio companies, limiting the manager's ability to sell its ownership interests in the fund, and limiting the manager's ability to raise other funds or engage in other outside activities. Lastly, there are also covenants that limit the types of assets in which the fund can invest. Paul Gompers and Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J. L. & ECON. 463, 479-84 (1996) [hereinafter Gompers & Lerner, *Analysis of Venture Agreements*]. In each case, restrictive covenants are designed to limit conflicts of interest and make it harder for the manager to do things that will benefit the manager at the investors' expense.

[124] *See* Lakonishok, Shleifer & Vishny, *The Structure and Performance of the Money Management Industry*, *BROOKINGS PAPERS ON ECONOMIC ACTIVITY, MICROECONOMICS* 339 (1992).

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illustrate, if an investment officer at a public pension plan were to agree to significant price increases for a new fund investment, those increases would be conspicuous and would have a higher probability of being noticed by the regulators and trustees overseeing that officer's investment activities. Depending on the circumstances, this attention could plausibly subject the investment officer to criticism, censure, or even career risk.[125]

Gompers and Lerner posit that this investment officer may find it more attractive to agree to dilute restrictive covenants in the fund's LPA. Doing this can provide meaningful value to a private equity manager by making it easier to extra private benefits from the fund, but because the change is buried deep within the fund's LPA, it is unlikely to be noticed by the investment officer's regulators or superiors. Diluting restrictive covenants could thus be viewed as an indirect—and inefficient—way to make price adjustments that is less likely to attract the scrutiny of an investment manager's superiors.[126] Importantly, these incentives do not go away just because investors are sophisticated.

2. *Incentives to Leverage Resource Advantages*

It has also been argued that large institutional investors in private equity funds have an incentive to bargain for unnecessarily complex, difficult-to-understand contracts.[127] This argument is based on the idea that the individuals who work at these institutions (public and private pension plans, endowments, etc.) are primarily concerned with how their institution performs *relative* to the rest of the market because that is how their personal performance is evaluated. Accordingly, even if a particular contract term will lead to a decrease in an institutional investor's performance, that investor might find the term desirable if it causes other investors to suffer a worse decline in performance by comparison.

Phalippou and Morris argue that because of this emphasis on relative performance, large institutional investors can actually be better off when private equity contracts are complex and difficult to benchmark across the marketplace. Many large institutional investors allocate billions dollars each year to private equity and employ dozens of professionals to manage the investment process. As such, as contracts become more and more complex, and as it becomes increasingly

[125] *See* Peter Morris and Ludovic Phalippou, *A New Approach to Regulating Private Equity*, 12 J. CORP. L. STDS. 59 (2012) [hereinafter Morris & Phalippou, *New Approach to Regulating Private Equity*] ("[A] rise in headline fees might . . . encourage [those with oversight authority] to take resources away from the agents, i.e., the organization's private equity department. Fewer resources might mean lower salaries and fewer jobs for the private equity department. . . . This means that private equity firms are able to raise prices, but have to do so using non-headline fees.").

[126] *See* Gompers & Lerner, *Analysis of Venture Agreements*, *supra* note 123 ("These covenants represent a less visible way to make price adjustments than explicit modifications of the split in capital gains. Deviations from the standard 80 to 20 percent division of profits are likely to attract widespread attention in the institutional investor community. The inclusion or deletion of covenants, however, is much less likely to attract notice. Investment officers responsible for choosing venture capital investments may find that concessions made in this manner attract less scrutiny from regulators or superiors.").

[127] *See* Morris & Phalippou, *New Approach to Regulating Private Equity*, *supra* note 125.

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difficult to compare terms across the market, the competitive advantage of large institutions should increase. Relative to smaller investors, large institutions should be able to use their resources to generate superior information about the true cost of contracts, which should enable them to pick better funds than other institutional investors and outperform industry benchmarks.[128]

To the extent that large investors—the ones with the greatest bargaining power—have these incentives, one would expect to find sub-optimal contract terms and bargaining processes.

3. *Incentives to Avoid the Federal Securities Antifraud Rules*

One scholar has also argued that some of the central characteristics of the private equity governance model are not actually the product of bargaining between the parties, but instead simply reflect an overriding effort to keep the fund outside the reach of the federal securities antifraud rules.[129] The basic idea is that because exposure to the antifraud rules is so costly in terms of compliance costs and exposure to litigation risk, it is in the best interests of both managers and investors to avoid having the manager become subject to those laws. According to Spindler, this helps to explain why private equity funds have such weak disclosure practices, why private equity funds give such weak control rights to investors, and why private equity funds offer investors such limited liquidity.[130] Far from an optimal arrangement, Spindler argues that the private equity governance model should actually be considered an "incubator for agency costs."[131]

At its core, this argument is more a criticism of the federal securities antifraud regime than an argument that private equity investors and managers are ineffective bargainers.[132] But to the extent that this is true, it means that the terms in private equity fund contracts are not the product of high-level bargaining at all. Accordingly, a policy approach that presumes free bargaining among the parties will miss an important part of the overall picture.

As with the problem of internal agency costs and the incentive to leverage resource advantages described above, these incentives will not disappear simply by making sure that all of the investors are sophisticated. According to Spindler, because the potential liability under the federal securities laws is so significant,

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[128] *Id.* ("[Large investors'] competitive advantage increases when private equity firms make their contracts more complex. Superior information about the true cost of contracts, past performance, etc., enables them to pick better funds than average. They will be able to outperform private equity industry benchmarks.").

[129] *See* Spindler, *How Private is Private Equity*, *supra* note 98 at 312 ("The breadth of the law's reach, and what one must do to escape it, largely defines what private equity is.").

[130] *Id.* at 313 ("[A]voiding securities law liability entails some combination of reduce or no disclosure to limited partners, limited control rights for limited partners, and minimal liquidity of limited partnership interests.").

[131] *Id.* at 333 ("One could view the typical private-equity setup as creating almost an incubator for agency costs, an incredibly hospitable environment for opportunistic managerial behavior.").

[132] *Id.* at 331 ("I question whether the private equity juggernaut has come to be because it is a technological innovation in its own right, or whether it is simply because the U.S. securities regime has become, by comparison, so bad.").

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rational investors and managers decide to adopt the private equity model *despite* the fact that it is more controversial and less efficient.[133]

4. A Commons Problem

Another critique of private equity incentives focuses on the fact that side letters are so common in the private equity industry.[134] In an earlier article,[135] I challenged the simplistic view that private equity contracts can be presumed to be optimal based on the assumption that they are "highly-negotiated."[136] I argued that because side letters make it easier for investors to bargain for individualized benefits in private equity funds compared to other settings, investors with bargaining power have a much more complex set of incentives than is commonly understood. Instead of prioritizing terms that will benefit all investors in a fund, investors have strong incentives to make individualized benefits a top negotiating priority.[137]

This describes, in effect, a commons problem in the private equity industry.[138] Just as with any large business entity, as the total number of investors increases, the cost of monitoring and negotiating for good governance terms goes up but the incentive that any single investor has to invest in monitoring and governance goes down. Because the benefits of strong governance terms in an LPA are shared with all investors in the fund, there is a natural incentive for any individual investor to under-invest in that term. This incentive is exacerbated by the fact that investors can more easily bargain for terms with individualized benefits in side letters.

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[133] *Id.* at 312 ("[M]y thesis is that securities laws have a significant and negative effect upon private equity, greatly exacerbating agency costs in the industry. . . . [H]aving bad securities laws leads to inefficiencies in both public and private markets.").

[134] *See supra* Section III.B.1.

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

[136] *See id.* at 85-86 ("In response [to criticisms of private equity LPAs], one defense frequently used by the private equity industry has been to invoke what I call the private equity negotiation myth. The myth is simple. It claims that large investors in private equity funds use their bargaining power to negotiate for robust protections in fund agreements that benefit all investors in a fund. Because fund agreements are highly negotiated, so the myth goes, concerns about the substantive quality of their terms must be unwarranted.")

[137] *See* Clayton, *The Private Equity Negotiation Myth*, *supra* note 135 at 70 ("In general, the more than an investor can use its bargaining power to negotiate for individualized benefits before it negotiates for things that will benefit all investors in the fund (like fund agreement protections), it will be a more 'efficient' use of that investor's bargaining power. This does not eliminate the negotiation of fund agreements, but, when individualized benefits are common, it is likely to have a dampening effect on the extent to which fund agreements are negotiated.").

[138] *See* Lee Anne Fennell, *Common Interest Tragedies*, 98 NW. U. L. REV. 907, 915-16 (2004), https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=8861&context=journal_articles ("The second tragic tendency associated with a commons—underinvestment—is typified by shirking on a communal farm. . . . The person who cultivates a garden . . . internalizes all of the costs but (in a setting where the produce is open to the group as a whole) does not internalize all of the benefits. Therefore, she will invest too little time and effort into cultivation, because she will not receive the benefits of her work.").

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To illustrate, imagine a large investor with two options.[139] On one hand, the investor could bargain for an LPA governance term (like, for example, a tougher restriction on the manager's ability to engage in conflict of interest transactions) that would increase the fund's profits by $10,000 and reduce the manager's profits by $10,000. However, since the investor owns only a portion of the fund, it would enjoy a fraction of that fund's increased profits—this would be $1,000, for example, if it is a 10% investor. Alternatively, that investor could negotiate for an individualized benefit in a side letter that would bring it a $10,000 benefit and (like, for example, a fee discount). Just as this investor would have a strong incentive to negotiate for the fee discount—which exhausts the same amount of the investor's bargaining power vis-à-vis the manager and brings a larger individualized benefit than the LPA term—similar incentives are likely to exist whenever large investors have the option to negotiate for individualized benefits.

Moreover, individualized benefits can also weaken large investors' incentives to "vote with their feet" by refusing to invest in funds that have suboptimal protections. Because large investors can use their bargaining power to negotiate for individualized benefits that offset the harm caused by weak LPA protections, side letters can make large investors more willing to invest in funds that they might otherwise find unacceptable if they lacked bargaining power.[140]

So long as investors cannot coordinate effectively, the incentives described above to under-value governance terms that provide a common benefit cannot be eliminated, or even mitigated, just by ensuring that investors are sophisticated.

5. *Other Problematic Incentives*

Other factors that can dissuade investors from bargaining aggressively for strong contract terms include the fact that investors are often competing with each other for access to the top-performing managers' funds. Accordingly, investors may be less likely to insist on high-quality terms when they are negotiating with successful managers out of concern that they will lose access. In addition, scholars have acknowledged that as the industry has become increasingly institutionalized, a growing list of actors has a vested interest in maintaining the existing model, even if it is not optimally efficient. Most obviously, the law firms that represent managers and engage in the actual negotiations with investors clearly have strong incentives to avoid standardization and to keep information flows restricted. Other parties that have incentives to avoid significant changes in the model include financial analysis, investment advisors and consultants, and investment banks.[141]

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[139] For a more in-depth example and discussion, see Clayton, *The Private Equity Negotiation Myth*, *supra* note 135 at 92-96.

[140] *See* Clayton, *The Private Equity Negotiation Myth*, *supra* note 135 at 97 ("A close evaluation reveals that when large investors have bargaining power, it can make them more likely to tolerate funds with weak terms than if they had no bargaining power at all.").

[141] *See* Batt & Appelbaum, *Agency Costs of Private Equity* ("The institutionalization of the PE business model . . . mean that a larger web or network of players have a stake in the survival of the model—including creditors, investment banks, PE lawyers, financial analysts, and investment advisors or consultants.").

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IV. SURVEY-BASED EVIDENCE OF BARGAINING PROBLEMS IN PRIVATE EQUITY

Because private equity funds are privately-held, much of what we know about them is based on conventional wisdom and anecdotes. This is one reason why there is typically little resistance to formalist assumptions about the optimality of bargaining outcomes in private equity. Because few empirical data points exist to show how bargaining actually works in this context, there is little to counter baseline contractarian assumptions.

To better understand how bargaining actually works in this high-end setting, I worked with the Institutional Limited Partners Association to distribute a survey to a large set of institutional investors. The questions included in the survey were targeted to elicit investor feedback on questions that have important implications for the way we think about private equity bargaining. Using survey data from actual institutional investors in private equity funds, this Part reveals new problems with bargaining in private equity and also reinforces the relevance of many of the problems identified in Part III above.

A. The Survey Data

The findings discussed below are drawn from responses to a 37 question survey.[142] The responses were provided by senior in-house lawyers at 70 institutional investors, including 29 public pension plans, nine family offices,[143] nine insurance companies, seven endowments, seven impact investors focused on global development, three private pension plans, two sovereign wealth funds, and one bank, one foundation, one investment company, and one superannuation fund. 35 of the respondents are institutions located in the United States, and 35 are located outside the United States.

[142] This survey was distributed by the Institutional Limited Partners Association to its membership in advance of its annual Private Equity Legal Conference in October 2020. The Institutional Limited Partners Association allowed me to have significant input on the questions included in the study. The survey data was compiled by Institutional Limited Partners Association in May 2020. A one-page, highly condensed summary of certain of the survey results was made available to the public here: https://ilpa.org/wp-content/uploads/2020/06/2020-ILPA-Fund-Terms-Survey-Highlights_External.pdf.
[143] A family office is a private wealth management firm serving ultra-high-net-worth individuals and families.

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Investor Types	# of Investors
Public Pension Plans	29
Family Offices	9
Insurance Companies	9
Endowments	7
Impact Investors	7
Private Pension Plans	3
Sovereign Wealth Funds	2
Banks, Foundations, Investment Companies, and Superann. Funds	4

Figure C

Most of the respondents invest in private equity funds that make investments throughout North America, Europe, and Asia. A smaller number of respondents invest in funds that make investments in emerging markets outside of Asia.

Region	# of Investors
North America	64
Europe	57
Asia including Oceania	42
Emerging Markets ex Asia	18

Figure D[144]

The survey respondents are frequent, serial investors in private equity funds. As shown in Figure B in Section II.B.2 above, at the time of the survey, one-third of the respondents had invested in more than 20 private equity funds in the prior 12 months. Over 85% of the respondents had invested in more than five private equity funds in the prior 12 months. One advantage of the serial nature of private equity is that survey respondents are not just speaking theoretically in response to questions posed to them about the private equity process. Most of them are intimately familiar with the distinctive bargaining process in this industry and have participated in it dozens of times. Similarly, most of them have likely developed thoughtful positions—and even formal policies and procedures—on the various topics raised in the questions.

The respondents also represent a wide range of sizes, as measured by the size of the maximum investment that they report making in private equity funds. The smallest investor in the sample reported that it does not make investments larger than $100,000 in any given private equity fund, while the largest investor

[144] The number of investors depicted on this table exceeds 70 because many of the respondents make investments in more than one region.

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reported that it makes investments up to $1 billion. The size of the investors in the sample is shown in greater detail in the table below:

Max. Investment Size in a Fund	# of Investors
<$50M	15
$50M-$149M	19
$150M-$300M	16
>$300M	7

Figure E[145]

B. *More Evidence of High-End Bargaining Problems*

1. *Information Flows are Even More Restricted than Previously Understood*

It is well-established that private equity managers commonly impose significant restrictions on the accessibility of private equity contract terms outside the fund.[146] These non-disclosure restrictions prevent the public, researchers, and all other investors in the market (so long as they are not participating in the same fund) from seeing the terms granted in private equity contracts. These terms have been the subject of significant criticism over the years.[147]

The survey data shows that the story does not end there. Earlier criticism has focused on the restrictions that prevent parties outside the fund from accessing private equity contract terms, but investors' responses indicate that information flows are also often severely restricted *within the fund* itself. As discussed above, it is very common for investors to negotiate side letters with the manager, and these side letters are actually the documents that investors spend most of their time and effort bargaining.[148] Accordingly, if the parties spend the bulk of their time negotiating these documents as compared with the LPA, then it seems logical to conclude that the terms in these side letters must be important and substantive. It also seems clear that these side letters create ample opportunities for conflicts of interest—both direct and indirect.[149]

The survey data shows that most of the investors in a fund will never see the side letters granted to the larger investors in a fund. According to investor

[145] When a table indicates that n is less than 70, it is because less than all of the respondents responded to the specific question.
[146] *See supra* Section III.B.3.
[147] *See supra* notes 110 and 111 and accompanying text.
[148] *See supra* Section IV.C.2.
[149] Side letters create opportunities for direct conflicts by giving investors an incentive to spend their bargaining power to negotiate for individualized benefits as opposed to benefits that are shared with all of the investors in the fund. *See supra* note 137 and accompanying text. They also create an indirect conflicts by making them less likely to walk away from funds with weak LPA terms when they can negotiate for off-setting individualized benefits that make them less sensitive to the weak LPA term. *See supra* note 140 and accompanying text.

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responses, it is extremely uncommon for managers to share side letters with all of the investors in a fund.[150] Instead, the most common approach is for only the investors with "most favored nation" ("MFN") rights to see the side letters granted to other investors. An MFN right is typically granted in an investor's side letter, and it gives that investor the right to see the side letters granted to other investors in the fund and to receive the same rights and privileges given in those side letters.

This MFN approach results in very limited diffusion of side letter terms to other investors within the same fund, for two reasons. First, managers commonly only grant MFN rights to a limited number of large investors who have greater bargaining power than other investors. Second, as shown in Figure F below, it is extremely common for this right to be subject to a "size based" qualification. In other words, having an MFN right will not give you the right to see all of the side letter terms granted to all of the other investors in the same fund. Instead, it will only give you a right to see the side letter terms granted to investors that make investments in the fund that are smaller than the investment that you made in the fund. Accordingly, the side letter terms given to the largest investor in the fund will be seen by *no other investors*, the side letter terms given to the second-largest investor in the fund will be seen by only one other investor, etc.

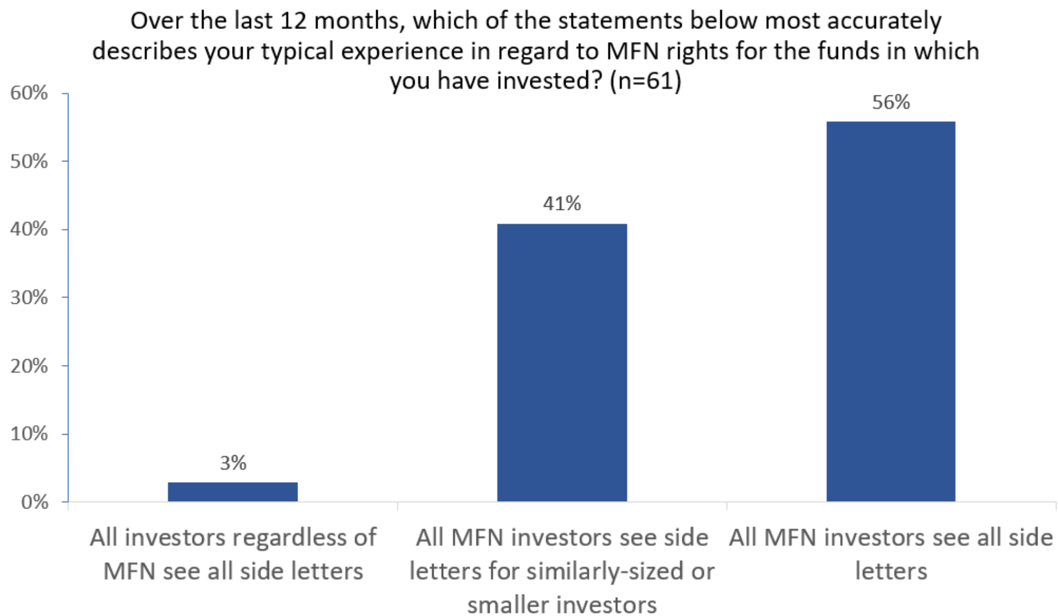

Figure F

Under the SEC's approach, if certain investors are receiving preferential treatment in a side letter that has a negative impact on other investors, there is a general obligation to disclose the possibility of such treatment so investors can take

[150] Only 3% of investor indicated that this arrangement is the most common approach they see in the market.

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that information into account when they make their investment decision.[151] But this is a very different thing than seeing the actual terms granted to actual investors. This approach also ignores the fact that the harms to other investors can be indirect. Even if a side letter benefit does not directly harm other investors in a fund, the fact that another investor can negotiate for an individualized benefit may make that investor less likely to advocate for terms that would benefit the entire fund.[152]

Various sources have criticized the private equity restrictions that limit accessibility by third parties outside the fund. If managers are also limiting the accessibility of private equity contracts not just by third parties but also by fellow-investors participating in the same fund, it further validates the concerns that have been voiced about decreased efficiency and the stifling of contract innovation.[153]

2. *Investors Spend More Time Negotiating Side Letters than LPAs*

As noted above, the process for negotiating private equity contracts is extremely time-consuming, labor-intensive, and costly.[154] One possible explanation for this is the widespread use of side letters throughout the industry.[155]

Yet there is very little to quantify just how important these side letters actually are, and how much time investors spend negotiating them. The implications are significant. As discussed above, in an earlier article I argued that investors have an incentive to prioritize using their bargaining power to negotiate for individualized benefits in side letters.[156] One negative effect of this dynamic, I argued, is that investors will tend to under-value the shared terms in private equity LPAs and that coordination between investors will be more difficult to accomplish. In other words, if investors do spend a significant portion of their time negotiating side letters, one can reasonably expect that the "commons problem" incentives described above will be a problem.[157]

The survey data confirms that side letters are more than just superfluous documents containing perfunctory boilerplate. To the contrary, the respondents confirmed that investors actually spend *more* time negotiating side letters than they spend negotiating LPAs. Whereas 37% of investors reported spending "somewhat

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[151] *See* Gardner et al., *Private Fund Side Letters: Common Terms, Themes and Practical Considerations*, Dechert Client Memorandum, https://www.dechert.com/knowledge/onpoint/2018/9/private-fund-side-letters--common-terms--themes-and-practical-co.html. The approach taken in the European Union under the Alternative Investment Fund Managers Directive ("AIFMD") is more demanding than the SEC's approach, though it stops short of requiring the disclosure of actual side letter terms. Under the AIFMD, investors must receive a "description of how the [manager] ensures a fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment, the type of investors who obtain such preferential treatment and, where relevant, their legal or economic links with the manager."

[152] *See supra* Section III.C.4.

[153] *See supra* Section III.B.3.

[154] *See supra* Section III.B.1.

[155] *See supra* Section C.4.

[156] *See* Clayton, *The Private Equity Negotiation Myth*, *supra* note 135.

[157] *See supra* Section III.C.4.

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more" or "significantly more" time negotiating side letters, only 27% of investors reported spending "somewhat more" or "significantly more" time negotiating LPAs.

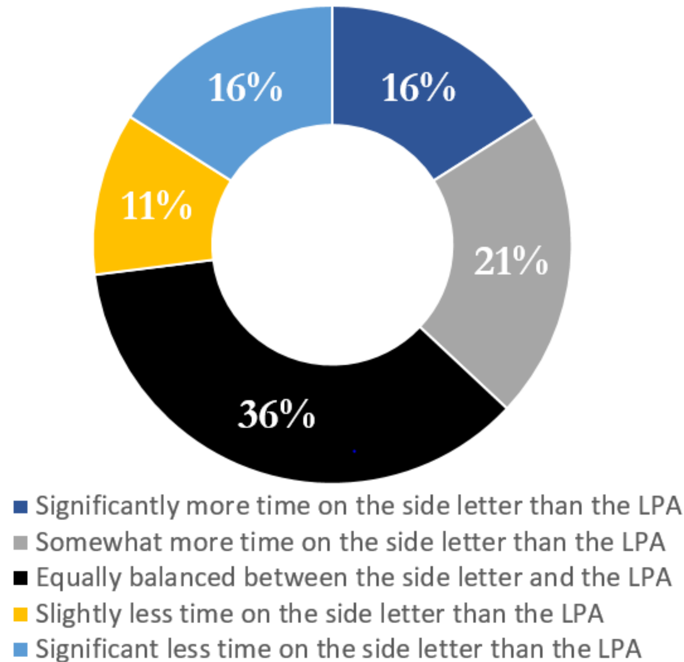

Figure G

Interestingly, this bias towards side letters was somewhat more pronounced in large investors—precisely the ones that have the greatest bargaining power and therefore the greatest capacity to negotiate for strong investor protections. As shown in the chart below, 10 out of 22 investors with maximum commitments over $100 million reported spending more time negotiating side letters than LPAs, whereas only 4 out of 22 reported spending more time negotiating LPAs than side letters. Smaller investors, by comparison, were more equal in terms of how likely they were to spend more time on LPAs versus side letters.

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Question 32 - Focus During Fund Negotiations	All LP Types (n=51) Largest Commitment Size <=100M	>100M
Significantly more time on the side letter than the LPA	5	2
Somewhat more time on the side letter than the LPA	3	8
Equally balanced between the side letter and the LPA	12	8
Slightly less time on the side letter than the LPA	4	1
Significantly less time on the side letter than the LPA	5	3
Total	29	22

Figure H

If investors are indeed spending more time negotiating side letters as opposed to LPAs, as this survey data suggests, it helps to explain why the contract production process is so labor-intensive and costly in private equity.[158] This also helps to explain why efforts to create industry-wide, standardized contract templates have had such limited traction in the past,[159] and why any forms of investor coordination—both formal and informal—are so uncommon in this industry.

Going one step further, these results also raise questions about the bargaining incentives of large private equity investors—the ones that possess the greatest bargaining power and that also appear to be *more likely* to spend a greater percentage of their time on side letters than LPAs. If large investors are spending more of their time negotiating for individualized benefits in side letters, it lends greater weight to the concern that private equity funds suffer from a commons problem, with investors under-valuing governance terms that generate shared benefits.[160]

3. *Two-Staged Bargaining is a Common Problem in Private Equity*

As noted above, Gompers and Lerner established long ago that the private equity industry defies the bargaining power irrelevance proposition.[161] Economists

[158] *See supra* Section III.B.1.
[159] *See supra* note 102 and accompanying text for a discussion of the general LPA principles that have been produced by the Institutional Limited Partners Association. In addition to these principles, the Institutional Limited Partners Association has also produced various form templates that can be referenced by investors and managers in the marketplace, including a fee disclosure template, a capital call and distribution notice template, a model subscription agreement, and a model non-disclosure agreement. These various other templates have had varying rates of adoption in the marketplace. *See, e.g.*, Testimony to the Pension Review Commission by Jennifer Choi, Institutional Limited Partners Association (July 30, 2018) (noting that approximately 22% of managers used the ILPA fee disclosure template for one or more of their investors); *Slow But Steady Wins the Race?*, PRIVATE FUNDS CFO (Apr. 2017) (quoting Institutional Limited Partners Association representative Jennifer Choi as saying that the pace of traction for adoption of the fee disclosure template was "disappointing to supporters of the template").
[160] *See supra* Section III.C.4.
[161] *See supra* Section III.C.1.

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may think that sophisticated investors *should* bargain for optimal governance terms regardless of the applicable bargaining power dynamics, and that they should instead focus their bargaining on the price term, but Gompers and Lerner found that the opposite actually happens.

As discussed above, Gompers and Lerner posited that this dynamic could possibly be explained by the presence of agency conflicts within the institutional investor organizations that invest in private equity funds. By agreeing to make concessions in the form of changes to governance terms instead of more conspicuous price terms, so the theory goes, the employees working in institutional investor organizations can avoid scrutiny and minimize career risk.[162]

The survey data, however, calls into question whether this agency problem theory is actually right. The agency problem theory assumes that institutional investors make conscious decisions to relax the non-price contractual covenants in the LPA instead of agreeing to pay higher fees. But this assumption is problematic on two levels. First, it is fairly well-known that in most institutional investor organizations, there are separate investment teams and legal teams.[163] It is customary for the investment team to make a decision about whether to invest in the fund and negotiate fees before the transaction is handed to the lawyers to work out the legal details.

Moreover, as illustrated in Figure I below, the survey data shows that communication between the investment teams and legal teams is also quite limited. As indicated in the chart below, 16% of institutional investors reported a complete split between the negotiation of commercial terms and the negotiation of legal terms, with no communication between the investment team and legal team about legal terms before the commercial terms are fully set. 38% of institutional investors reported that they only sometimes confer about critical legal terms in advance, but even then they do not have an agreed set of critical legal terms.[164] Accordingly, even if investment teams wanted to substitute more relaxed covenants instead of agreeing to pay higher fees, as the agency problem theory posits, there does not appear to be sufficient lines of communication to accomplish that in a large number of the institutional investors responding to the survey.[165]

[162] *See supra* note 126 and accompanying text.

[163] Private equity has been held out as an example of an industry in which two-staged bargaining is quite common. *See, e.g.*, Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665, 1690 (2012) ("[I]n commercial loans, private equity investments, and corporate acquisitions, many terms are agreed upon after the price is settled.").

[164] Perhaps unsurprisingly, the institutional investors that reported more advance coordination between the investment and legal teams also generally reported greater success negotiating for things like improved disclosure rights and restoration of fiduciary duties.

[165] It is, of course, possible that this problem is more serious in today's private equity industry than it was when Gompers and Lerner wrote their article, as institutional investor organizations have grown substantially and become increasingly complex.

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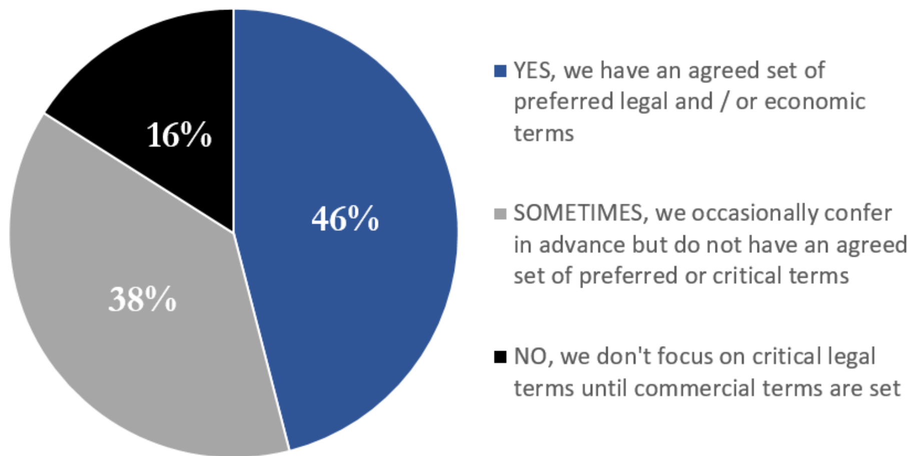

Figure I

Interestingly, two-stage bargaining has itself been identified as a possible explanation for why the bargaining power irrelevance proposition can sometimes be violated.[166] The logic is fairly intuitive. In transactions where the business principals negotiate the price and other central terms first, after which the transaction is handed over to the parties' lawyers to finalize the legal details, in practice it becomes very difficult, if not impossible, to go back and adjust the price term as the lawyers flesh out the legal issues. Importantly, however, the sub-optimality stems from a failure of communication, and not from agency problems originating with the employees working in the institutional investor organizations.

4. Investors Do Care About Fiduciary Duties After All

[166] Choi and Triantis have addressed the question of when bargaining power can influence the non-price terms in a contract. *See* Choi & Triantis, *supra* note 163. After providing a careful taxonomy of the different sources of bargaining power, they model certain cases in which bargaining power can affect governance terms. One of these cases includes transactions in which the price term is negotiated before the non-price terms (including governance terms) are negotiated. *See id.* at 1691 ("In the first stage of negotiations the parties negotiate price and key non-price provisions, often without their lawyers. This stage typically concludes with the signing of a document such as a term sheet, letter of intent, or memorandum of understanding, which is not legally binding. The parties then turn over the second stage of negotiations to their lawyers to work out the details of a definitive contract . . . . The parties would probably have an expectation of these terms when they struck a price in the first stage (perhaps what is 'market' at the time). If the second-stage terms fall outside of these expectations, the parties may be compelled to reopen the price. Although the first-stage agreement is not legally binding, there would be non-legal costs to allowing the deal to collapse after this point. This leaves lawyers with a meaningful space within which to bargain on behalf of their clients over non-price terms. This arrangement leads to a peculiar process in the second bargaining stage between the lawyers, during which the two sides cannot use the price term in their efforts to create value by logrolling.").

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Survey respondents affirmed that it is extremely common for contractual terms in private equity LPAs to dilute managers' fiduciary duties. In fact, 71% of respondents indicated that fiduciary duties were contractually modified or eliminated in at least half of the funds that they had invest in during the prior year. This means that investors and managers are regularly using the freedom granted to them by private equity law and policy to diminish and/or waive the state law fiduciary duties that would normally apply by default.

How often were fiduciary duties modified or eliminated in the past year? (n=62)				
Never	0-25% of funds	25-50% of funds	50-75% of funds	More than 75% of funds
6	10	7	16	23

Figure J

Clearly, investors and managers are making heavy use of the contractual flexibility afforded them under state law to substitute fiduciary duties for other contractual protections. The contractarian literature would presume that these changes are optimal, and that the parties are replacing fiduciary duties with more efficient and more effective contractual protections.[167] According to the contractarian approach, fiduciary duties should not matter very much to investors, as the contractual and compensation-based devices to contain management opportunism should be sufficient.[168] Moreover, the bargaining power irrelevance proposition would predict that these changes should be fairly uncontroversial, as it should be in both the investors' and the manager's interest to select optimal governance terms regardless of the balance of bargaining power between them.[169]

A closer look at the survey results, however, makes clear that many investors *do* care about fiduciary duties. The survey shows that fiduciary duties / standard of care is the second-most important negotiating priority for investors. As illustrated in the chart below, 37% of investors rate fiduciary duties / standard of care as one of their top three negotiating priorities.

[167] *See supra* note 83 and accompanying text.
[168] *See id*.
[169] *See supra* notes 37 and 38 and accompanying text.

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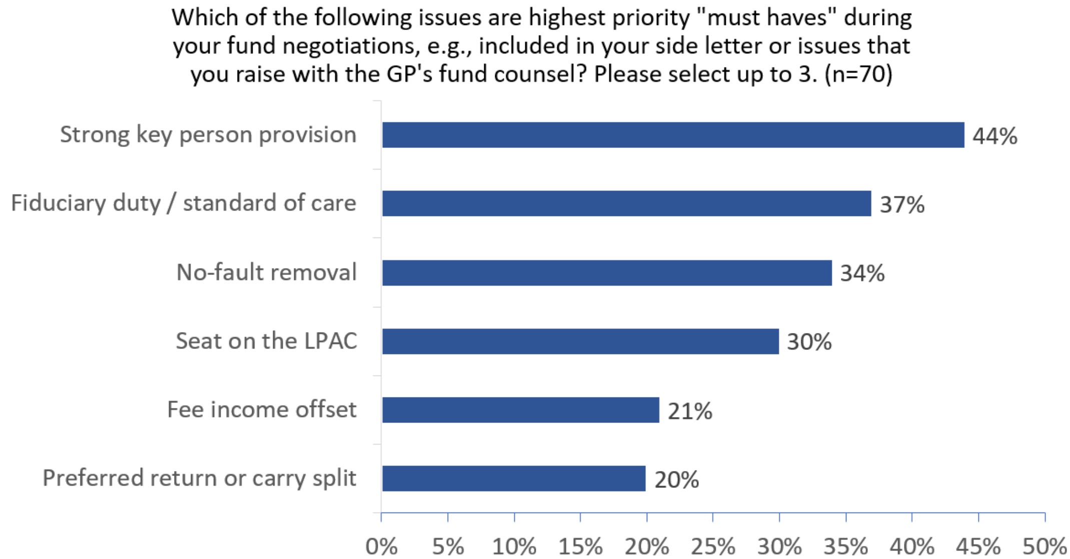

Figure K[170]

Moreover, of those investors that identified fiduciary duties / standard of care as one of their top three negotiating priorities, 25% of them had walked away from a fund due to diluted fiduciary duties in the prior 12 months.

In the past year, have you declined to invest due to fiduciary duties that could not be restored? (n=24)	
Yes	No
6	18

Figure L

This confrontational dynamic is different than what the formalist law and economics literature would predict.[171] It reflects a stark departure from the bargaining power irrelevance proposition, which predicts that sophisticated parties will bargain for optimal governance terms regardless of the distribution of bargaining power between them. It also shows that, notwithstanding the literature arguing that fiduciary duties are unimportant in the private equity context, there are many investors that actually care deeply about them.

[170] Note that this chart is limited to issues that were identified as top three, "must have" priorities for at least 20% of respondents.
[171] *See supra* Section II.B.

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V. POLICY IMPLICATIONS

The private equity fund industry provides a test case for how well bargaining actually works in an extremely high-level contracting environment. Few would disagree with the idea that the private equity setting should (at least in theory) be quite hospitable to effective bargaining. Yet, reality is far more complex—and problematic. I consider policy and theory implications below.

A. Greater Skepticism of Formalism

This Article's most important takeaway is simple. If this many bargaining problems exist in a high-end setting that appears to be extraordinarily supportive of bargaining, it calls into question how well bargaining works in settings that are less supportive. Greater skepticism of formalist assumptions about how parties bargain is warranted, not just in this industry but across the entire market.

For example, as discussed above, scholars have argued that optimal terms will persist in form contract settings even when a substantial number of participants in the market are unsophisticated.[172] This line of reasoning has been used to support policies favoring strict enforcement of contracts and a narrow use of the unconscionability doctrine.[173] Yet, while this logic may hold true under a set of stylized assumptions, it may be dangerous to apply it too broadly. This argument depends on the "marginal" investors in the market being rational and informed. But what if those investors suffer from conflicts of interest or other perverse incentives that make them unlikely to seek optimal terms? Or what if, due to constraints on information flows or other process issues,[174] those investors struggle to obtain the information they need to make informed decisions? The private equity fund market illustrates the fact that there are many factors in addition to lack of sophistication that can lead to sub-optimal contract terms and processes.

Similarly, Delaware's extremely permissive approach to contractual flexibility in alternative entities and (to a lesser extent) corporations has long found support in traditional law and economics models of bargaining.[175] But in most LLCs and limited partnerships, the parties are not subject to rigorous investor qualification standards, and they are far less likely to have as much experience.[176] Moreover, to the extent that institutional investors invest directly in LLCs and limited partnerships outside of private equity funds, they are likely to have conflicts of interest that are similar to the ones we see in private equity funds. Moreover, due in part to collective action problems[177] and other issues in widely-held companies,

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[172] *See supra* note 1 and accompanying text.
[173] *See supra* note 1 and accompanying text.
[174] *See supra* Section III.B.
[175] *See supra* Section I.B.
[176] *See supra* note 26.
[177] *See, e.g.*, ADOLF BERLE AND GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1952); Sanford J. Grossman and Oliver D. Hart, *Takeover Bids, The Free Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980); Andrei Shleifer and Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

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the corporation is typically viewed as less conducive to careful contracting than the typical private equity fund. If extensive bargaining problems exist in a high-end market like private equity funds, why should we expect anything different as we move downstream?

These questions are important not just for scholars' consideration, but for legislatures, regulators and judges as well as they consider how much stock to put in formalist theories of bargaining. General skepticism along these lines has been voiced by Delaware jurists in recent years.[178] While it is difficult to imagine the Delaware legislature changing the law's extremely permissive approach to fiduciary duty waivers in LLCs and limited partnerships anytime soon, the common law doctrine of the covenant of good faith and fair dealing has seen more action in the courts in recent years. Recent decisions suggest that there may be more room for judicial discretion to adapt this doctrine to reflect market realities in years to come.[179]

B. *The Public-Private Securities Law Divide*

These high-end bargaining problems also have important implications for securities law specifically. As discussed above, the current federal securities law regime is binary.[180] Publicly-traded companies must comply with a robust set of mandatory disclosure rules and processes when they raise capital, but if a company qualifies for an exemption to the securities laws, then their financing activity is almost entirely unregulated. Implicitly, the federal securities law system embraces the idea that if the parties to a transaction are sophisticated, they will bargain for effective terms and they will agree on effective transaction processes without assistance from a regulator.

But the private equity industry shows us that even when most of the investors in a market are sophisticated, experienced players, that market can still suffer from significant transparency[181] and process inefficiency[182] problems. In fact, not long after the SEC first uncovered these kinds of problems in the mid-2010s, state treasurers across the country actually responded by writing a jointly-signed letter to the SEC requesting that the agency use its authority to require greater disclosure of private equity fees and expenses to the public pension plans in

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[178] *See See* Leo E. Strine, Jr. and J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS (2015).

[179] *See, e.g.*, Dieckman v. Regency GP LP, 155 A.3d 358 (Del. 2017) (finding that even though a partnership agreement had waived fiduciary duties, it was implied pursuant the covenant of good faith and fair dealing that the general partner would not mislead investors in seeking investor approvals for a merger transaction); Miller v. HCP & Co., 2018 WL 656378 (Del. Ch. 2018) (finding that where an LLC operating agreement waived a manager's fiduciary duties and gave that manager sole discretion over sales of the company to unaffiliated third parties, the operating agreement did not contain any gaps that needed to be filled with respect to the issue of whether the board was required to hold an open auction before selling the company).

[180] *See supra* Section I.C.

[181] *See supra* Sections III.B.3 and IV.B.1.

[182] *See supra* Section III.B.1.

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their jurisdiction.[183] After the SEC refused to act, state legislatures responded by passing laws that dictated in detail the specific disclosures that private equity managers were required to provide public pension plans. Those state laws had a mixed impact on the market,[184] but they clearly illustrate the fact that many market participants and commentators feel that the private market was not producing sufficient disclosures on its own.[185] Many still feel that federal government intervention in the form of required disclosures and basic processes would be beneficial to the market.[186]

Interestingly, by forming the Private Funds Unit and continuing to support private fund examinations each year, it seems the SEC has effectively admitted that the binary approach does not really work. Even though private equity investors are subject to more stringent investor qualification requirements than in any other corner of the market, the industry still requires a dedicated government watchdog to sniff out fraud and other bad practices. This does not bode well for other, less sophisticated areas of the private placement marketplace.

C. *Implications for the Private Equity Industry*

The policy implications above are relevant to the entire market. But understanding problems—and potential reforms—in the private equity industry is an important area of study by itself. As noted above, public pension plans are substantial investors in this market, so bargaining problems in this market can have a substantial impact on public servants and taxpayers. Moreover, in recent years, there has also been a significant push towards making private equity available to a larger share of retail investors.[187] The prior SEC chair, Jay Clayton,[188] and

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[183] *See* Timothy W. Martin, *States, Cities to Ask SEC to Beef Up Disclosures for Private-Equity Firms*, WALL ST. J. (July 21, 2015) ("Around a dozen comptrollers and treasurers from New York to California want the SEC to demand private-equity funds make disclosures of fees and expenses more frequently than they do now, according to a copy of the letter reviewed by the Wall Street Journal.").

[184] *See generally* William W. Clayton, *Public Investors, Private Funds, and State Law*, 72 BAYLOR L. REV. 294 (2020).

[185] *See id.*

[186] *See, e.g.*, Letter from the Institutional Limited Partners Association to Chair Gary Gensler (Apr. 21, 2021), https://ilpa.org/wp-content/uploads/2021/04/2021.4.20-ILPA-Welcome-Letter-to-Chairman-Gensler-Final.pdf (noting that under current SEC regulations, investors fail to receive adequate transparency and seeking for SEC intervention to require a higher standard of care, more robust fee and expense reporting, and access to reports on compliance deficiencies identified through SEC examinations).

[187] Currently, retail investors are prohibited from investing directly in private equity funds under the federal securities laws, which impose a minimum net worth requirement. *See infra* notes 73-75 and accompanying text.

[188] *See, e.g.*, Dave Michaels, *SEC Chairman Wants to Let More Main Street Investors in on Private Deals*, WALL ST. J. (Aug. 30, 2018), https://www.wsj.com/articles/sec-chairman-wants-to-let-more-main-street-investors-in-on-private-deals-1535648208 ("Mr. Clayton said the SEC is now weighing a major overhaul of rules intended to protect mom-and-pop investors, with the goal of opening up new options for them."); Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, Remarks on Capital Formation at the Nashville 36|86 Entrepreneurship Festival (Aug. 29, 2018), https://www.sec.gov/news/speech/speech-clayton-082918.

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prominent commentators[189] have expressed desires to give ordinary investors expanded access to private investment opportunities, and steps have been taken to make that possible through indirect channels.[190] Private equity funds thus have a very public impact, notwithstanding their private status under the federal securities laws.[191] In recognition of this, the current SEC chair, Gary Gensler, has expressed concerns about practices in the private equity market and indicated that the SEC is considering whether regulatory action would help the market.[192]

Below, I consider two approaches to improving the bargaining problems identified in this Article: voluntary adjustments by private equity managers and mandatory regulation.

1. Voluntary Adjustments

One approach to improving the private equity bargaining process is simply to encourage the industry participants to adopt changes voluntarily. Scholars have previously encouraged private equity managers and investors to voluntarily adopt certain reforms that would improve the bargaining process. These proposals have largely revolved around increased transparency, coordination, and information sharing. For example, industry participants have been encouraged to work with each other to increase the standardization of LPAs so that parties can focus their bargaining on the most economically meaningful fees and covenants.[193] Scholars have also encouraged managers to work with investors to agree on standardized reporting practices and to make their disclosures publicly available through an independent third party.[194] In addition, the industry has been encouraged to invite

[189] *See, e.g.*, COMM. ON CAPITAL MKTS. REGULATION, EXPANDING OPPORTUNITIES FOR INVESTORS AND RETIREES: PRIVATE EQUITY 36 (Nov. 2018), https://www.capmktsreg.org/wp-content/uploads/2018/10/Private-Equity-Report-FINAL-1.pdf ("We find that private equity funds have a well-established performance history that justifies expanding investor access to them. We recommend three ways to do so. First, legislative reforms to expand access to direct investments in private equity funds. Second, SEC reforms to expand access to public closed-end funds that invest in private equity funds. And finally, Department of Labor reforms to facilitate the ability of 401(k) plans to invest in private equity funds.").

[190] *See, e.g.*, Edmund Lee, *401(k) Plans Move a Step Closer to Pooling With Private Equity*, N.Y. TIMES (June 3, 2020); Chris Cumming, *U.S. Labor Department Allows Private Equity in 401(k) Plans*, WALL ST. J. (June 3, 2020).

[191] *See* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337 (2013) (proposing that the rigor of public company regulatory regimes depend on the societal footprint of the company).

[192] *See supra* note 27.

[193] *See, e.g.*, Morris & Phalippou, *New Approach to Regulating Private Equity*, *supra* note 127 ("[M]arket participants could agree to use standard definitions for key items (e.g., carried interest, vintage year and leverage) and use two or three standard types of contracts. . . . There will be no significant loss of flexibility if both investors and managers participate in the process. Only the most economically meaningful fees/covenants will survive as standard options."); Magnuson, *Public Cost of Private Equity*, *supra* note 98 ("[L]arge limited partners investors could come together to coordinate investment policies, by, for example, promulgating model private equity governance terms or template limited partnership agreements.").

[194] *See, e.g.*, Morris & Phalippou, *New Approach to Regulating Private Equity*, *supra* note 127 ("We propose . . . that private equity firms work with investors to standardize reporting and agree to

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the participation of information intermediaries—like ratings agencies or third-party consultants an advisors—to supplement investor analysis by providing independent assessments of fund governance, giving investors more information to inform their bargaining activities.[195] Even though the proposals above are not new, they have gotten very limited traction, with many investors complaining that bargaining conditions have actually gotten worse in recent years due to the high-demand environment for private equity.[196]

As the industry continues its rapid expansion and as public pensions continue their embrace of the asset class, it may be in private equity managers' best long-term interest to support changes that would produce a better bargaining process. Private equity has been on the radar of many policymakers who would support increased regulation of the industry in recent years,[197] and, as noted above, it has been singled out as an area of concern by Chair Gary Gensler in the current administration.[198] Rather than simply leaving it to managers and institutional investors to organize themselves, it may be in everyone's best interests for the American Investment Council, the trade association for private equity fund managers, and the Institutional Limited Partners Association, the trade association for institutional investors in private equity funds, to formally coordinate on finding compromises that could be adopted across the market.

2. *Mandatory Regulation*

Finally, regulators could take a more heavy-handed approach and mandate certain process requirements for all managers in the market.[199] Scholars have previously proposed requiring regulatory approval of private equity contracts,[200]

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provide copies of the standardized reports to an independent third party which would make them publicly available for analysis.").

[195] *See, e.g.*, Magnuson, *Public Cost of Private Equity*, *supra* note 98 ("Independent information intermediaries, such as ratings agencies or third-party consultants and advisors, could step in to help align the interests of private equity firms and investors by staking their own reputations on successful outcomes. They could examine firm management, fund structures, and compensation incentives to provide an independent analysis of the quality of fund investments to potential limited partners. . . Just as proxy advisors today have significant influence on the investment decision of institutional investors, and thus place strong pressure on companies to adopt more investor-friendly governance practices, information intermediaries in the private equity sphere could serve as a strong force for improved governance structures.").

[196] *See supra* note 95 and accompanying text.

[197] *See, e.g.*, Stop Wall Street Looting Act of 2019, H.R. 3868, S. 2155, https://www.congress.gov/bill/116th-congress/senate-bill/2155.

[198] *See supra* note 27.

[199] One clear benefit of a mandatory approach that could not be achieved through voluntary adjustments or by process-based conditions is that true standardization across the market can be achieved. This can be valuable not only because it is useful for achieving a consistent and streamlined roll-out of the new policy, but also because any data that is generated by the requirement will be less likely to suffer from selection biases or other problems that diminish its usefulness for research purposes.

[200] *See, e.g.*, Morris & Phalippou, *New Approach to Regulating Private Equity*, *supra* note 127 ("[W]e propose that an independent third party—call it a regulator—could bring together investors, fund managers and third parties to design the equivalent of a kitemark for private equity managers.

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and also subjecting private equity managers to a standard set of mandatory disclosure obligations.[201] Various legislative efforts that would increase regulation of the private equity industry have been floated in recent years, including the Investment Adviser Alignment Act[202] and the Stop Wall Street Looting Act.[203] In addition, the Institutional Limited Partners Association has repeatedly submitted requests to the SEC to impose certain mandatory regulatory standards.[204] Public pension plan trustees and state treasurers have also voiced strong support for certain mandatory regulations.[205]

The primary concern with such proposals, of course, is that they could do more harm than good by creating costly and unnecessary red tape. That kind of

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. . . At one end of the spectrum, regulators could deny approval to managers who do not meet kitemark standards, or prevent certain kinds of investors from investing in a non-approved manager's funds.").

[201] *See, e.g.*, Morris & Phalippou, *New Approach to Regulating Private Equity*, *supra* note 127 ("Over the last 30 years, private equity managers as a group have become significant players in terms of both the companies they run and the investments they manage on behalf of millions of pensioners and taxpayers. The kind of disclosure we suggest does no more than reflect this status. 80 years ago, disclosure to the SEC helped the market for quoted securities gain depth and trust. We would like to see the same happen for private equity."); Magnuson, *Public Cost of Private Equity*, *supra* note 98 ("A Dodd-Frank for Private Equity would institute more comprehensive regulation of the financial incentives and disclosure requirements of private equity firms, and likewise include investor protection reforms intended to ensure that limited partner investors are not saddled with oppressive restrictions.").

[202] Investment Adviser Alignment Act, discussion draft available at https://financialservices.house.gov/uploadedfiles/bills-116pih-iaaa.pdf.

[203] Stop Wall Street Looting Act of 2019, H.R. 3868, S. 2155, https://www.congress.gov/bill/116th-congress/senate-bill/2155.

[204] *See, e.g.*, Institutional Limited Partners Assoc., SEC Comment Letter on SEC Proposed Fiduciary Duty Interpretation (Nov. 21, 2018), https://ilpa.org/wp-content/uploads/2018/12/ILPA-Follow-Up-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-11.21.18.pdf; Institutional Limited Partners Assoc., SEC Comment Letter on Proposed Commission Interpretation Regard Standard of Conduct for Investment Managers (Aug. 6, 2018), https://ilpa.org/wp-content/uploads/2018/08/ILPA-Comment-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-August-6-2018.pdf; Institutional Limited Partners Assoc., Letter to Subcommittee on Investor Protection Regarding SEC's Best Interest Rule (Mar. 14, 2019), https://ilpa.org/wp-content/uploads/2019/03/2019.3.14-ILPA-Letter-to-Subcommittee-on-Investor-Protection-Re-Best-Interest-Hearing.pdf.

[205] *See, e.g.*, Letter to SEC Chair Mary Jo White from treasurers and/or comptrollers from California, Nebraska, Wyoming, South Carolina, Washington D.C., Oregon, Rhode Island, New York State, New York City, Virginia, Vermont, and Missouri (July 23, 2015), https://www.sec.gov/rules/petitions/2015/petn4-688.pdf ("We (state treasurers and comptrollers) believe increased disclosure transparency will provide limited partners with a stronger negotiating positions, ultimately resulting in more efficient investment options. We have a fiduciary obligation to achieve these goals, and therefore assert that greater private equity fee disclosure standards are in the public interest."); Resolution Supporting the Investment Adviser Alignment Act (Dec. 15, 2020), National Assoc. of State Treasurers https://nast.org/wp-content/uploads/supporting-the-investment-adviser-alignment-act.pdf ("The National Association of State Treasurers urges Congress to introduce and pass the Investment Adviser Alignment Act (or substantially similar bills in subsequent Congresses) to strengthen transparency, governance and alignment of interest in the private equity marketplace, thereby providing enhanced protection of state pension and retirement systems' growing investments in the private equity asset class.").

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specific cost-benefit analysis is beyond the scope of this Article. However, this Article does seek to make an even more fundamental point. While there may be legitimate reasons to reject new efforts to regulate private equity, simply professing an unqualified, formalistic faith in the private equity bargaining process is not one of them. Proposed regulation that aims to improve the private equity bargaining process should not be categorically dismissed based on an incorrect perception that private equity is a model of effective bargaining.

VI. CONCLUSION

Law and economics theory places great confidence in the ability of contracting parties to bargain for optimal contracts, and the law embraces this confidence in many important ways. Yet a close look at one of the most elite contracting settings in the marketplace raises questions about this approach. If theory does not reflect reality in the market for private equity funds, greater skepticism of formalist assumptions about bargaining is warranted not just in the private equity fund industry, but across the market more broadly.

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