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High-End Bargaining Problems

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Many important areas of the law place great confidence in the ability of contracting parties to bargain effectively. In this Article, I question the wisdom of a formalistic faith in bargaining by identifying 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 contracting spaces in the market. Because of rigorous investor qualification laws and other distinctive features of private equity funds, this industry enjoys many advantages compared to most real-world contracting settings. A careful review, however, reveals issues. Drawing on proprietary survey data and dozens of conversations with industry

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participants, this Article offers an in-depth analysis of bargaining problems in private equity funds.

These bargaining problems raise a difficult question for scholars and policymakers: If optimal bargaining outcomes and processes are elusive in this high-end market and ongoing SEC intervention is needed, what can realistically be expected across the broader spectrum of real-world contracting settings? These findings provide a striking illustration of the fact that bargaining cannot simply be assumed to produce optimal outcomes in real-world environments. Acknowledging this reality has significant implications for securities law, the law of business organizations, and contract law.

INTRODUCTION

The legal rules governing business transactions place great confidence in the ability of contracting parties to bargain effectively. Contract law, for example, is built on the foundational principle that the enforcement of bargains will benefit contracting parties and society more broadly, with only limited exceptions.[1] The law of limited liability companies ("LLCs") and limited partnerships grants managers and investors almost total flexibility to contract for any terms they want, including the complete elimination of fiduciary duties, and the law of corporations has taken significant strides in this direction in recent decades.[2] Federal securities law has traditionally given parties almost

1. *See infra* Section I.A.
2. *See infra* Section I.B.

complete freedom to raise capital in whatever fashion they desire in the private markets.[3] Law and economics theory generally supports the idea that parties will bargain for optimal contracting outcomes under the right conditions.[4]

This Article questions how realistic it is to expect optimal bargaining outcomes in real-world contracting settings. It does so by examining how contracting works at the *high end* of the market, where the parties have substantial resources and expertise to aid them in bargaining effectively and efficiently. Specifically, I look at the private equity fund industry. The private securities markets are one of the rare contracting settings in which the law prescriptively regulates who can and cannot participate in the market based on a proxy for sophistication and access to resources, and private equity funds are subject to the very highest investor qualification standards within these markets.[5] There are few settings (if any) where contracting parties are more thoroughly vetted by legal rules to ensure sophistication.

In addition to these investor qualification requirements, the private equity fund industry also has other distinctive features that help to support private bargaining. For example, because private equity funds are typically dissolved after approximately ten years and institutional investors tend to diversify their investments across multiple 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 specific types of transactions.[6] Moreover, the limited life of private equity funds also means that there are fewer potential contingencies for contracting parties to account for than in most operating businesses, which typically have an indefinite life when they are formed.[7] For all of these reasons, the parties in this industry should be unusually well positioned to bargain for positive

3. *See infra* Section I.C.

4. *See, e.g.*, Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 547 (2003) (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." (emphasis omitted)); 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").

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

6. *See infra* Section II.B.2.a.

7. *See infra* Section II.B.2.b.

contracting outcomes, and scholars have even held up this industry as a model contractarian setting.[8]

Yet even though this is a carefully vetted contracting space, a close examination of private equity funds reveals a world where various aspects of the bargaining process are messy and, by all appearances, seem far from optimal. Perhaps most prominent, 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 various 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 fifty percent of the managers that they examined,[9] with private equity managers regularly "charging hidden fees that [were] not adequately disclosed to investors" and shifting expenses to investors "without proper disclosure that [those] costs [were] being shifted to investors."[10] The SEC highlighted various deficiencies in private equity contracts that made this misconduct possible,[11] and they have voiced similar concerns at various times since those initial observations.[12]

Ever since these early reports, the SEC has maintained a special examination unit focused specifically on private investment funds, and

8. *See infra* Section II.B.3.

9. *See* Andrew J. Bowden, Dir., Off. of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Address at the Private Equity International Private Fund Compliance Forum: Spreading Sunshine in Private Equity (May 6, 2014), https://www.sec.gov/news/speech/2014--spch05062014ab.html [https://perma.cc/QA7T-96A5] ("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 id.* It is impossible to quantify the full magnitude of these hidden fees and expenses. However, one study attempts to quantify the amount of fees paid through one particular channel that has been criticized for lacking transparency: payments made by private equity fund portfolio companies to private equity manager affiliates in the form of transaction fees, monitoring fees, and other fees. That study estimates that approximately $20 billion was paid to managers through this channel between 1990 and 2013 in a set of 592 leveraged buyouts. Ludovic Phalippou, Christian Rauch & Marc Umber, *Private Equity Portfolio Company Fees*, 129 J. FIN. ECON. 559, 568–69 (2018).

11. *See infra* notes 113–115 and accompanying text.

12. *See, e.g.*, Off. of Compliance Inspections & Examinations, *Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds*, U.S. SEC. & EXCH. COMM'N 1 (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf [https://perma.cc/6KCT-KPYN]; Div. of Examinations, *Risk Alert: Observations from Examinations of Private Fund Advisers*, U.S. SEC. & EXCH. COMM'N 1 (Jan. 27, 2022), https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf [https://perma.cc/97UF-BYT4].

it examines hundreds of private equity funds each year.[13] This Private Funds Unit[14] effectively serves as a full-time police presence in the industry,[15] and it has maintained a robust program through the Obama, Trump, and Biden Administrations. A glance at private equity's longer-term history thus makes it hard to avoid the conclusion that bargaining outcomes in this high-end space have been less than perfect over the years.

There are also other signs of bargaining problems in this space. For example, law and economics scholars have long theorized that, under the right conditions, sophisticated parties will bargain for optimal nonprice 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 that they are entering into, after which they will split that surplus through the price term.[16] However, in practice this does not appear to be how the private equity industry works at all. Across the industry, nonprice terms relating to the governance of the fund vary greatly depending on the balance of bargaining power between managers and investors.[17] In addition, many scholars over the years have criticized the substance of common private equity fund terms more generally, arguing that they are one-sided and unlikely to maximize the joint welfare of all parties involved.[18]

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13. *See* Off. of Compliance Inspections & Examinations, *supra* note 12, at 1 (noting that "OCIE examines hundreds of private fund advisers each year").

14. *See* Marc Wyatt, Acting Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Address at the Private Equity International Private Fund Compliance Forum: Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015), https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html [https://perma.cc/Y9UP-2XD5] ("OCIE has taken another step towards knowledge building and deeper specialization by creating the Private Funds Unit which is dedicated to examining advisers to private funds, including private equity advisers.").

15. *See id.*:

> OCIE . . . is frequently asked about its observations from these 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 . . . .

16. 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 & Elisabeth de Fontenay, *Is There a First-Drafter Advantage in M&A?*, 107 CALIF. 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 thus 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.

17. *See infra* Section III.A.2.

18. *See infra* Section III.A.3.

In addition to the controversial substance of private equity contract terms, the process by which private equity fund agreements are bargained also raises questions about whether contracting parties can be expected to choose optimal processes for contract formation. The private equity fund contracting 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.[19] 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).[20] This presumably makes investors particularly sensitive to legal costs associated with bargaining and makes managers more insensitive by comparison. Finally, information flows in this industry are highly restricted due to confidentiality provisions, which makes it difficult for investors to benchmark and compare contract terms across the market.[21]

Notwithstanding the substantial resources held by investors in this market, the active presence of a global trade association for institutional investors in private equity funds, and continuous examination efforts by the SEC, progress in each of these areas has been slow according to many industry participants and observers, both with respect to the substance of private equity fund contracts[22] and also the process by which they are bargained.[23] In fact, in the most

19. *See infra* Section III.B.1. As discussed below, the market for syndicated credit investments offers an interesting counterpoint. The bargaining process is far more streamlined in syndicated credit deals, notwithstanding the fact that the underlying activity—a single issuer raising financing from a large number of disparate investors—is quite similar in many respects. *See infra* Section III.B.1.

20. *See infra* Section III.B.2.

21. *See infra* Section III.B.3.

22. *See* Letter from Steve Nelson, CEO, Institutional Ltd. Partners Ass'n, to Brent Fields, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 6, 2018), https://ilpa.org/wp-content/uploads/2018/08/ILPA-Comment-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-August-6-2018.pdf [https://perma.cc/KMC7-DXAF]:

> [A]s the market has rebounded, the legal terms have becoming [sic] 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.

23. *See Key Findings ILPA Industry Intelligence Report: "What Is Market in Fund Terms?"*, ILPA (2021), https://ilpa.org/wp-content/uploads/2021/10/Key-Findings-Industry-Intelligence-Report-Fund-Terms.pdf [https://perma.cc/HM5G-3PUE] (finding that average organizational expenses associated with the formation of private equity funds has increased by 123% over the past decade); Letter from Steve Nelson, CEO, Institutional Ltd. Partners Ass'n, to Vanessa Countryman, Sec'y, U.S. Sec. & Exch. Comm'n (Feb. 10, 2020), https://www.sec.gov/comments/s7-

extraordinary development yet, the SEC dropped a bombshell in February 2022 when it introduced a proposed rule (the "February 2022 Proposal") that would dramatically increase the scope of SEC intervention in the industry.[24] If adopted, this rule would require a broad set of mandatory disclosures, prohibit certain practices that have been employed in the industry for many years, and impose various other new interventions.[25] These actions suggest that the SEC has effectively given up on the idea that parties to private equity contracts will bargain for optimal arrangements on their own.[26] They reflect, as Commissioner Hester Peirce has described it, a "sea change" in the SEC's approach to sophisticated institutional investors.[27]

Over the years, scholars have identified various explanations for suboptimal behavior by the contracting parties in private equity funds. These include agency problems that arise when the interests of staff members within institutional investors deviate from those of the institution's beneficiaries,[28] coordination problems that cause investors to bargain in suboptimal ways,[29] complex and overlapping sets of agency relationships,[30] and incentives to avoid liability under the federal securities laws,[31] among others. Some of these issues are unique to the private equity industry, but others can be expected in any setting where there are institutional contracting parties, where multiple

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21-19/s72119-6794358-208353.pdf [https://perma.cc/VV52-M6CR] ("Organizational expenses relate to establishing and organizing the private equity fund . . . . Over the past decade, organizational fees for private equity funds have increased dramatically.").

24. *See* Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Investment Advisers Act Release No. 5955 (U.S. Sec. & Exch. Comm'n proposed Feb. 9, 2022) (to be codified at 17 C.F.R. pt. 275), https://www.sec.gov/rules/proposed/2022/ia-5955.pdf [https://perma.cc/Q4AE-JZYB] [hereinafter Feb. 2022 SEC Rule Proposal].

25. *See infra* Section V.C.

26. *See* Feb. 2022 SEC Rule Proposal, *supra* note 24, at 9 (footnote omitted):

> The Commission . . . has pursued enforcement actions against private fund advisers for practices that have caused private funds to pay more in fees and expenses that they should have, which negatively affected returns for private fund investors, or resulted in investors not being informed of relevant conflicts of interest concerning the private fund adviser and the fund. Despite our examination and enforcement efforts, these activities persist.

27. *See* Hester M. Peirce, *Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking*, U.S. SEC. & EXCH. COMM'N (Feb. 9, 2022), https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922 [https://perma.cc/SCC9-UDEB] ("Today's proposal represents a sea change. It embodies a belief that many sophisticated institutions and high net worth individuals are not competent or assertive enough to obtain and analyze the information they need to make good investment decisions or to structure appropriately their relationships with private funds.").

28. *See infra* Section III.D.1.

29. *See infra* Sections III.D.2, III.D.4.

30. *See infra* Section III.D.5.

31. *See infra* Section III.D.3.

parties are negotiating collectively, or where agents are operating on behalf of others.

After discussing the issues above, this Article presents proprietary survey data that reveals new problems with bargaining in private equity and also reinforces the relevance of some of the problems identified above. Because private equity funds are privately held, much of what scholars know about them is based on conventional wisdom and anecdotes. Drawing on a private dataset of survey responses from seventy institutional investors,[32] this Article shows that information flows are even more restricted in private equity funds than was previously known,[33] that the private equity fund bargaining environment is even more fractured than has previously been documented in the literature,[34] and that fiduciary duties are more contested and controversial than contractarians would have predicted in this high-end space.[35]

These high-end bargaining problems raise a difficult question for scholars and policymakers: If optimal bargaining outcomes and processes are elusive in this high-end market and ongoing SEC intervention is required, what can realistically be expected across the broader spectrum of real-world contracting settings? What, for example, are the implications for small businesses, which are commonly set up as LLCs[36] and give parties the flexibility to eliminate fiduciary duties by contract? What about widely held corporations, which are generally less supportive of careful contracting than private equity funds due to collective action problems and other issues? If extensive bargaining problems have persisted in a high-end market like private equity funds, it may be unrealistic to expect better outcomes in less hospitable bargaining environments.

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32. 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 seventy institutional investors. For more details on the survey, see Section IV.A.

33. *See infra* Section IV.B.1.

34. *See infra* Section IV.B.2.

35. *See infra* Section IV.B.4.

36. The law does not impose sophistication requirements for who can become an owner of an LLC. *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.

These problems also raise questions about 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 has historically imposed no requirements or guidance for private offerings. This approach has implicitly embraced the idea that sophisticated parties in the private realm will demand appropriate levels of disclosure and appropriate processes. The private equity example shows that this cannot simply be assumed, echoing related concerns that have been raised by scholars in other areas of the private markets.[37]

Finally, the problems identified in this Article also have policy implications for the private equity industry specifically, and we are seeing policymakers grapple with those implications today. As noted above, the SEC's February 2022 Proposal would dramatically increase regulatory intervention in private equity funds. Given the massive size[38] and influence[39] 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,[40] it is not

37. *See, e.g.*, Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353 (2020); Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165 (2017); Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583 (2016); Matthew Wansley, *Taming Unicorns*, 97 IND. L.J. (forthcoming 2022); Verity Winship, *Private Company Fraud*, 54 U.C. DAVIS L. REV. 663 (2020).

38. *See* MCKINSEY & CO., GLOBAL PRIVATE MARKETS REVIEW 2020: A NEW DECADE FOR PRIVATE MARKETS 16 (2020), https://www.mckinsey.com [https://perma.cc/7BLY-7JXR] ("In 2019, private market AUM grew by 10 percent, reaching $6.5 trillion, another all-time high.").

39. *See* Paul J. Davies, *Why Private Equity Risks Tripping on Its Own Success*, WALL ST. J. (Feb. 13, 2018, 5:36 AM), https://www.wsj.com/articles/why-private-equity-risks-tripping-on-its-own-success-1518518193 [https://perma.cc/8XCP-UAVL] ("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."); *Everything Is Private Equity Now*, BLOOMBERG BUSINESSWEEK, https://www.bloomberg.com/news/features/2019-10-03/how-private-equity-works-and-took-over-everything (last updated Oct. 8, 2019, 3:10 PM) [https://perma.cc/2DY9-W9V9].

40. *See* PREQIN, 2018 PREQIN GLOBAL PRIVATE EQUITY AND VENTURE CAPITAL REPORT 73 (Christopher Elvin et al. eds. 2018) (showing that public pension plans are the largest investors in private equity funds, representing thirty-five percent of all capital in the asset class); PEW CHARITABLE TRS., STATE PUBLIC PENSION FUNDS INCREASE USE OF COMPLEX INVESTMENTS 15 (Apr. 2017), https://www.pewtrusts.org/-/media/assets/2017/04/psrs_state_public_pension_funds_increase_use_of_complex_investments.pdf [https://perma.cc/2CGZ-XX4W] (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 in 2014"); JEAN-PIERRE AUBRY, ANQI CHEN & ALICIA H. MUNNELL, CTR. FOR RET. RSCH. AT BOS. COLL., A FIRST LOOK AT ALTERNATIVE INVESTMENTS AND PUBLIC PENSIONS 1 (July 2017), https://crr.bc.edu/wp-content/uploads/2017/06/slp_55.pdf [https://perma.cc/XAM4-USHA] (noting data showing that public pension plans' allocation to alternative investments increased from nine percent in 2005 to twenty-four percent in 2015).

surprising that these problems have attracted the SEC's attention. However, it cannot simply be assumed that every intervention will be beneficial. As the SEC enters this uncharted territory, its regulatory activity should be calibrated to respond to the impediments to effective bargaining in private equity. Doing this requires a robust theory for what those impediments are and how they impair bargaining outcomes in private equity funds, and academic analysis of such issues has historically been quite limited.[41] Thoughtful scholarship in this area has thus never been more important.

This Article proceeds as follows. Part I shows how contract law, the law of business organizations, and federal securities law all adhere to the general idea that parties will bargain effectively when left to themselves. It also discusses the scholarly literature that supports this approach in these three areas. Part II describes the heightened qualification standards that private equity investors must satisfy and identifies other characteristics of private equity funds that make it an elite bargaining space. 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 seventy institutional investors in private equity funds and discusses why these results show a bargaining environment that is even more complex and problematic than has been commonly understood. Part V concludes with a discussion of the policy implications of these high-end bargaining problems, both in the private equity industry and across the market more broadly.

I. FAITH IN BARGAINING

Many important areas of the law maintain a remarkable amount of faith in the ability of parties to bargain effectively when left to contract freely. Below, I discuss three prominent examples.[42] I identify 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.

41. A sampling of academic work that seeks to explain bargaining problems in private equity funds can be found in Section III.D.

42. 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 some of the most important literature backing, and pushing back against, those views.

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.[43] Progressive variations on traditional doctrines have evolved in different jurisdictions over the years,[44] but as a general rule contract law leaves parties free to contract for almost anything they desire[45] and avoids second-guessing the deals struck by competent adults.[46]

The law and economics literature on contracts generally supports the idea that sophisticated parties will bargain for optimal contract terms under the right conditions.[47] In fact, the law and economics literature goes so far as to predict that sophisticated parties will 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

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43. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 72 cmt. b (AM. L. 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.

44. *See, e.g.*, Masterson v. Sine, 436 P.2d 561, 564–66 (Cal. 1968) (setting forth a contextualist approach to the parol evidence rule in California); Tchrs. Ins. & Annuity Assoc. of Am. v. Tribune Co., 670 F. Supp. 491, 499 (S.D.N.Y. 1987) (finding that an agreement to agree can bind parties to negotiate in good faith).

45. Note that the implied contractual covenant of good faith and fair dealing cannot be waived under Delaware law. *See infra* note 229 and accompanying text.

46. 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, 1728–29 (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. 2021) ("The mere assertion that the price was excessive has thus been deemed conclusory and insufficient to establish the defense of unconscionability.").

47. *See supra* note 4 and accompanying text.

called the bargaining power irrelevance proposition.[48] 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 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 jointly agree on optimal nonprice 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.[49] 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.[50]

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" buyers.[51] Marginal buyers are those that care most about the contractual

48. 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, 1074 (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, *supra* note 4, at 554 ("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 [parties] 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).

49. Two versions of this "bargaining power irrelevance proposition" have been identified in the literature. *See* Choi & Triantis, *supra* note 46, at 1668 n.4:

> First, the strong-form version stands for the proposition that bargaining power only affects price and has no effect on nonprice terms. Second, in the weak-form version, bargaining power may affect nonprice terms, but the parties are no more likely to agree to inefficient non-price terms under unequal, rather than equal, bargaining power.

50. *See supra* note 16 and accompanying text.

51. This assumes that the market is competitive. *See* G. Marcus Cole, *Rational Consumer Ignorance: When and Why Consumers Should Agree to Form Contracts Without Even Reading Them*, 11 J.L. ECON. & POL'Y 413, 414–15 (2015) ("[N]on-price 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.").

protections and are most likely to stop buying a product when the quality of the contractual protections goes down.[52] Accordingly, law and economics theory generally predicts that if the marginal buyer in a market with standard form contracts is rational and informed, a significant number of uninformed and irrational investors will also be able to invest in that market without upsetting the quality of the contract's terms.[53]

Importantly, scholars have added caveats and texture to this literature. 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.[54] This line of thinking supports a more liberal use of the unconscionability doctrine to invalidate one-sided contracts.[55] 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

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52. *See id.* at 422:

> [T]he marginal consumer, by definition, is the party for whom that 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.

53. *See* 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 . . . ;

Yonathan A. Arbel & Roy Shapira, *Theory of the Nudnik: The Future of Consumer Activism and What We Can Do to Stop It*, 73 VAND. L. REV. 929, 950 (2020) (identifying "nudnik" consumers as a source of discipline in consumer markets where most consumers remain passive); Schwartz, *supra* note 4, at 131 (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").

54. *See, e.g.*, Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1206 (2003):

> Because buyers are boundedly rational rather than fully rational decisionmakers, 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.

55. *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.").

commercial boilerplate provisions over time[56] and coordination problems, like the failure of networks to support efficient contract formation,[57] for example. Recent law and economics scholarship on contracts thus provides insight into how process-related flaws can impede the production of optimal contracts.[58]

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. 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.[59] This is now a widely used provision in Delaware corporate charters across the market.[60] 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.[61]

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

56. *See, e.g.*, Stephen J. Choi, Mitu Gulati & Robert E. Scott, *The Black Hole Problem in Commercial Boilerplate*, 67 DUKE L.J. 1, 3–4 (2017) (arguing that boilerplate terms that are reused over and over again merely because they are part of a standard-form package of terms will eventually be emptied of any meaning); Robert E. Scott, Stephen J. Choi & Mitu Gulati, *Revising Boilerplate: A Comparison of Private and Public Company Transactions*, 2020 WISC. L. REV. 629, 632–39 (finding that agency problems and coordination problems contribute to sticky contract terms in commercial contracts).

57. *See, e.g.*, Robert E. Scott, *The Paradox of Contracting in Markets*, 83 LAW & CONTEMP. PROBS. 71, 71–72 (2020) (discussing the tension between efficient production of contracts and efficient contract design in markets); Ariel Porat & Robert E. Scott, *Can Restitution Save Fragile Spiderless Networks?*, 8 HARV. BUS. L. REV. 1, 3–4 (2018) (examining whether the law can help overcome coordination problems in networks that lack a controlling party at the center of the network to facilitate network formation).

58. *See, e.g.*, Stephen J. Choi, Mitu Gulati & Robert E. Scott, *Investigating the Contract Production Process*, 16 CAP. MKTS. L.J. 414, 415 (2021).

59. 488 A.2d 858 (Del. 1985); DEL. CODE ANN. tit. 8, § 102(b)(7) (2021).

60. *See* Gabriel Rauterberg & Eric Talley, *Contracting out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1084 (2017) (noting that public companies "regularly execute" 102(b)(7) waivers).

61. DEL. CODE ANN. tit. 8, § 122(17).

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"[62] and that fiduciary duties can be "expanded or restricted or eliminated" in operating agreements and limited partnership agreements.[63] Delaware is unabashedly contractarian when it comes to alternative entities.[64]

Doctrinal changes in Delaware have largely tracked contractarian theoretical developments. In the mid-1970s, Jensen and Meckling reconceptualized corporations as simply a "nexus of contracts" among various constituents.[65] 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.[66]

This contractarian premise has been endorsed by many prominent scholars over the years who have argued for greater

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62. *Id.* 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 id.* tit. 6, § 17.1101(c) (providing the same for partnership agreements).

63. *See, e.g.*, *id.* 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 id. tit. 6, § 17.1101(d) (providing the same for partnership agreements).

64. *See, e.g.*, Cent. Mortg. Co. v. Morgan Stanley Mortg. Cap. Holdings LLC, No. 5140-CS, 2012 WL 3201139, at *26 n.211 (Del. Ch. Aug. 7, 2012) ("Delaware is a pro-contractarian state."); *In re* Cellular Tel. P'ship Litig., No. 6885-VCL, 2021 WL 4438046, at *73 (Del. Ch. Sept. 28, 2021) ("Enforcing the plain language of partnership agreements fulfills the public policy that the General Assembly has articulated.").

65. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310–11 (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").

66. *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 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.

contractual flexibility.[67] 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.[68] 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 included an entry for "fiduciary" in the index.[69]

Scholars of business organizations have responded with a few different reactions to the contractarian movement. "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.[70] 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.[71] Other critics have argued that contractarian

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67. *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.").

68. *See, e.g.*, Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 212 ("[F]iduciary duties are appropriate for relationships like those between directors and shareholders in public corporations. They do not fit relationships among parties who expect to be active, as in the typical general partnership.").

69. Easterbrook & Fischel, *supra* note 67, at 427 n.4 ("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.").

70. *See, e.g.*, Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 786 (2006) ("If the real world were consistent with the contractarian theory, we would see contractual innovation and customization reflected in a diversity of incorporation choices and corporate charter terms among public companies. It turns out, however, that diversity of this sort is minimal.").

71. *See, e.g.*, Peter Molk, *How Do LLC Owners Contract Around Default Statutory Protections?*, 42 J. CORP. L. 503, 506–07 (2017) (analyzing 283 privately owned LLC operating agreements and finding little evidence that contractual freedom is used for more efficient contractual owner protections); Michelle M. Harner & Jamie Marincic, *The Naked Fiduciary*, 54 ARIZ. L. REV. 879, 923–25 (2012) (finding that provisions modifying managers' fiduciary duties are significantly associated with provisions indemnifying managers and the absence of buy-out rights, which could be "the result of parties' lack of information or representation in the negotiations"); Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 589 (2012) ("[P]ublicly traded alternative entities appear to utilize freedom of contract as a one-way ratchet: to reduce managerial accountability without committing to meaningful contractual constraints on managerial discretion."); Brent J. Horton, *Modifying Fiduciary Duties in Delaware: Observing Ten Years of*

thinking focuses too narrowly on the shareholder-manager relationship in business organizations and advocated for consideration of a broader set of stakeholders.[72] Finally, others have challenged contractarianism on the grounds that law and economics is not the appropriate framework to analyze relationships in business organizations.[73] Regardless of this pushback, it has not 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.[74] In addition, publicly traded companies are subject to a similarly detailed set of ongoing mandatory disclosures.[75] 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.

Decisional Law, 40 DEL. J. CORP. L. 921, 923–25 (2016) (examining thirty-six written fiduciary cases in Delaware after 2004 to answer whether modification or elimination of fiduciary duties helped protect management from a claim of breach of fiduciary duty). *But see* Suren Gomtsian, *Contractual Mechanisms of Investor Protection in Non-Listed Limited Liability Companies*, 60 VILL. L. REV. 955, 957 (2015) (finding that fiduciary duty modifications in a study of nearly three hundred non-listed LLCs were not arbitrary).

72. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 249, 254–55 (1999) ("[T]he modern tendency to think of shareholders as corporate 'owners' and directors as their 'agents' glosses over several key legal doctrines distinguishing public corporations from other business forms that are difficult to reconcile with the principal-agent approach.").

73. *See* Jacob Hale Russell & Arthur B. Laby, *Introduction: The Decline and Rise of Fiduciary Obligations in Business*, *in* FIDUCIARY OBLIGATIONS IN BUSINESS 1, 9 (Arthur B. Laby & Jacob Hale Russell eds., 2021):

> Scholars have identified and debated what unifies fiduciary obligations across disciplines, giving rise to new insights about 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.

74. *See* Usha R. Rodrigues, *Embrace the SEC*, 61 WASH. U. J.L. & POL'Y 133, 138 (2020) ("Entrepreneurs must register with the SEC before going public, a lengthy and expensive process that helps ensure that investors have a sufficient quantity of information before sale.").

75. *See* *Going Public*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/smallbusiness/goingpublic (last visited Mar. 30, 2022) [https://perma.cc/UN94-3B3D].

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.[76] Unlike the federal securities laws' hands-on approach to public offerings and publicly traded companies, however, the securities laws have traditionally been 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 federal securities laws have historically imposed almost no requirements on how private companies raise capital.[77]

This binary approach implicitly places great faith in the ability of private firms to raise capital through private ordering. It assumes that investors will demand an appropriate amount of disclosure and that issuers will respond by granting that level of disclosure. It also assumes that private parties will agree on efficient fundraising processes through private ordering.[78] By taking a binary approach, rather than an incremental approach that merely reduces requirements in the private markets, federal securities law has long placed great confidence in the effectiveness of bargaining in private markets.

As noted above, however, under Chair Gensler the SEC has recently demonstrated a remarkable level of skepticism regarding this

76. *See* Andrew S. Weinberg, *What to Do About the Shift from Public to Private Markets*, WORLD ECON. F. (Apr. 29, 2021), https://www.weforum.org/agenda/2021/04/what-to-do-about-the-shift-from-public-to-private-markets/ [https://perma.cc/8G88-54LF]:

> [C]oncerns have been raised that corporations and investors may be bypassing public markets in favour of raising funds via private equity, late-stage venture capital or direct lending. Consider that the number of domestic companies listed on US exchanges, which from a peak of some 7,500 in 1996 has since declined by nearly 40% . . . .

77. *See* *Exempt Offerings*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/smallbusiness/exemptofferings (last visited Mar. 30, 2022) [https://perma.cc/L9XV-KHAC].

78. 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, 152–53 (1973) (concluding that "the disclosure requirements of the Securities Exchange Act of 1934 had no measurable positive effect on the securities traded on the NYSE"); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2373 (1998) ("There is little tangible proof of the claim that corporate information is 'underproduced' in the absence of mandatory disclosure, or that the benefits to investors from information that firms would not produce in the absence of mandatory disclosure actually outweigh their costs."); George J. Stigler, *Public Regulation of the Securities Markets*, 19 BUS. LAW. 721, 730 (1964) (arguing that "studies suggest that the S.E.C. registration requirements had no important effect on the quality of new securities sold to the public"); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 950 (1998) (reasoning that investors can obtain information on different types of companies based on the regulatory regimes that the companies choose).

traditional approach, both in the context of private investment funds[79] and also private operating companies.[80] More than ever before, federal policymakers have shown a willingness to question whether optimal outcomes are actually achieved in private settings.

II. PRIVATE EQUITY AS AN ELITE CONTRACTING SPACE

The law actively regulates who can and cannot participate in the private equity industry, with an eye toward ensuring that the industry admits only sophisticated parties with significant resources. In fact, private investment funds are subject to investor qualification standards that are significantly higher than the standards that apply to the rest of the private market, as will be discussed in greater detail below.[81]

A. Basic Structure of the Private Equity Industry

Private equity managers[82] 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 fund that is usually organized as a limited partnership.[83] The fund's governing document (called a limited partnership agreement (an "LPA")) is collectively negotiated between the manager and the fund's investors and sets forth the terms of the fund. As discussed below,[84] 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.[85]

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79. *See infra* Section V.C.

80. *See* Paul Kiernan, *SEC Pushes for More Transparency from Private Companies*, WALL ST. J., https://www.wsj.com/articles/sec-pushes-for-more-transparency-from-private-companies-11641752489 (last updated Jan. 10, 2022, 6:00 PM) [https://perma.cc/BY7U-83TR].

81. *See infra* Section II.B.1.

82. 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.

83. 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.

84. *See infra* Section III.D.4.

85. *See* JAMES M. SCHELL, KRISTINE M. KOREN & PAMELA LAWRENCE ENDRENY, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 11.14 (2021) ("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.").

Once a fund is formed, a manager typically has a three- to five-year "period" to cause the fund to make investments in assets (commonly called "portfolio companies").[86] Managers seek to buy companies that are undervalued or that can be improved through operational, financial, or other changes.[87] During this period, investors contribute capital to the fund each time the manager makes a "capital call" in order to make an investment or pay the fund's fees and other expenses.[88] The manager will eventually attempt to sell the fund's portfolio companies, hoping to make profits upon the disposition. Each fund usually has an established end date (typically around ten years after the date of the fund's closing),[89] after which the manager sells any remaining assets and distributes the proceeds to investors.[90]

Since private equity managers have discretion over how to use their investors' capital, conflicts of interest naturally arise. Private equity managers could, for example, spend less time and effort on the fund's activities than they would if they were managing their own money, or they may engage in self-dealing transactions at the expense of their investors. This could include taking the best investment opportunities for themselves or secretly charging excessive fees and expenses, among many other examples.[91]

There are other conflicts as well. For example, after the investment period of one fund ends, a private equity manager commonly launches another fund following a similar 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, on the other.[92] In addition, it is

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86. *See* STEPHANIE R. BRESLOW & PHYLLIS A. SCHWARTZ, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION § 2:4.2 (Carol Benedicto ed., 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.").

87. *See generally* Lisa Lilliott Rydin, *Private Equity, Venture Capital, and Hedge Funds*, HARV. L. SCH. LIBR., https://guides.library.harvard.edu/law/private_equity (last visited Mar. 30, 2022) [https://perma.cc/N794-ECA5].

88. *See* Prashant Mohan, *What Is a Capital Call Transaction?*, SHARESIGHT (Nov. 27, 2019), https://www.sharesight.com/blog/what-is-a-capital-call-transaction/ [https://perma.cc/EDA2-SLUP].

89. *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).

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

91. For a discussion of some of the conflicts that have been criticized in private equity funds, see *infra* Section II.A.

92. 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

common for private equity managers to simultaneously manage funds that focus on different strategies, including leveraged buyout funds, growth equity funds, venture funds, corporate debt funds, real estate funds, natural resources funds, or infrastructure funds, among others.[93] Sometimes an investment opportunity can plausibly fit within the investment mandate 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.[94]

B. Private Equity's Contracting Advantages

Participants in the private equity fund marketplace enjoy many significant advantages when they seek to address the conflicts of interest described above through contract. Most importantly, this is one of the few contracting spaces where the law restricts who can participate in the market to ensure that market participants are sophisticated bargainers.

1. Private Equity's Elite Investor Qualification Requirements

The federal securities laws restrict who can and cannot invest in private securities markets. Under the Securities Act of 1933, anyone that wants to invest in a privately held company must be an "accredited investor" meeting certain net worth thresholds. In general, this means that entities must have at least $5 million in net assets and individuals

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de Fontenay, *Private Equity's Governance Advantage: A Requiem*, 99 B.U. L. REV. 1095, 1114 (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.").

93. *See id.* at 1100 ("Large private equity firms now simultaneously run LBO funds, credit funds, real estate funds, alternative investments funds, and even hedge funds."); Andrew F. 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).

94. *See* Tuch, *supra* note 93, 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."); Davies, *supra* note 39:

> 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.

must have at least $1 million.[95] The explicit purpose of this standard is to ensure that the market is limited to sophisticated investors who can sustain the risk of loss.[96]

Investors in private investment funds (including private equity funds), however, are subject to even higher standards. 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, this means that most entities must have at least $25 million in net assets and that individuals must have at least $5 million.[97] Various other exemptions to the Investment Company Act exist, but this is the most commonly used one by far. 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 requires both entities and natural persons to have a net worth of at least $2.2 million or an investment with the manager of at least $1.1 million.[98]

The law has thus intentionally sought to ensure that the private equity contracting setting is reserved exclusively for highly sophisticated actors. This makes the private equity landscape very different than, for example, a retail consumer setting, or a small business setting with unsophisticated owners. The federal securities

95. For the formal definition of "accredited investor," see 17 C.F.R. § 230.501(a) (2021).

96. *See* COMM. ON CAP. MKTS. REGUL., EXPANDING OPPORTUNITIES FOR INVESTORS AND RETIREES: PRIVATE EQUITY 30 (Nov. 2018), https://www.capmktsreg.org/wp-content/uploads/2018/10/Private-Equity-Report-FINAL-1.pdf [https://perma.cc/34PC-SWWA] [hereinafter COMM. ON CAPITAL MKTS. REGUL. 2018 PRIVATE EQUITY REP.] ("[T]here are three distinct, but related policy concerns repeatedly highlighted by Congress and the SEC for establishing the accredited investor standard and qualified purchaser standard: (1) adequacy of disclosure, (2) investor sophistication and (3) ability to bear economic loss/higher risk of the investment."); U.S. SEC. & EXCH. COMM'N, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 2 (Dec. 2015), https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf [https://perma.cc/9AYM-PCC2] (noting that the accredited investor standard is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment . . . render the protections of the Securities Act's registration process unnecessary").

97. *See* Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(51)(A) (setting forth the requirements for "qualified purchasers"); 15 U.S.C. § 80a-3(c)(7) (allowing a fund to raise an unlimited amount of money from an unlimited number of investors if they are all "qualified purchasers"). Alternatively, section 3(c)(1) of the Investment Company Act allows a private fund to operate as long as it has fewer than one hundred investors. *See* 15 U.S.C. § 80(a)-3(c)(1) (imposing no sophistication requirements as long as the fund has fewer than one hundred investors).

98. *See* 17 C.F.R. § 275.205-3 (2021) (defining "qualified client"); Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 5756 (U.S. Sec. & Exch. Comm. June 17, 2021), https://www.sec.gov/files/ia-5756.pdf [https://perma.cc/MVG7-6DYP]. In practice, virtually all private equity fund managers charge incentive-based compensation.

laws have ensured that the private equity investor base is dominated by institutional investors and wealthy individuals 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 institution should typically have resources to pay outside counsel to bargain on their behalf.

2. Other Characteristics that Support Bargaining

The private equity fund industry also possesses certain other distinctive features that should have the effect of helping the parties bargain effectively.

a. 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.[99] 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.[100]

For instance, of the seventy investors that completed the 2020 ILPA survey discussed in Part IV,[101] more than half had invested in ten or more private equity funds in the prior twelve months. As illustrated in Figure A below, less than fifteen percent of responding investors, by contrast, reported that they had invested in five or fewer private equity funds during the prior twelve 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 most lawyers in this setting can be expected to have well-developed, thoughtful views on the issues

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99. *See* Greg Bassuk, *Solving for the Suitability Challenge in Private Equity*, WEALTHMANAGEMENT (Oct. 18, 2021), https://www.wealthmanagement.com/alternative-investments/solving-suitability-challenge-private-equity [https://perma.cc/4Q2H-B7QQ](“The fact is that many individual private equity investments do not provide the strong returns. For institutions, this is a numbers game—they diversify by investing with multiple managers—but it’s an issue for individuals with limited ability to spread their risks.”).

100. *See* Masulis & Thomas, *supra* note 89, at 222, and accompanying text.

101. *See infra* Section IV.A.

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.

FIGURE A[102]

Private Equity Investments in Prior Twelve Months	Number of Investors
0–5	9
6–10	20
11–20	17
20+	23

b. 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's 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 clear.[103] As noted above, the typical private equity fund has a life of about ten years, after which it is liquidated and the proceeds are paid out to investors.[104] 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.

102. Data comes from Author's 2020 survey of investors, discussed in detail in Part IV. Sixty-nine out of seventy investors provided information about the number of private equity investments entered into during the prior twelve months.

103. 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.

104. *See* Masulis & Thomas, *supra* note 89, at 222, and accompanying text.

3. Elite Academic Expectations for Private Equity Bargaining

Given all of the factors described above, it is not surprising that the private equity industry has been held up by scholars as a leading example of contractarianism.[105] Legal scholars have praised the various contractual methods in the private equity fund model as superior alternatives to the more rigid governance approaches found in public corporations.[106] Financial economists have held up private equity as the real-world environment that most closely approximates the world of law and economics theory.[107]

III. HIGH-END BARGAINING PROBLEMS IN PRIVATE EQUITY

The private equity fund industry enjoys many advantages that go well beyond what is found in most real-world contracting spaces. Yet a closer look casts serious doubt on the idea that parties have always bargained for optimal contracting outcomes in this market. Various data points suggest that bargaining in this high-end market is far from perfect.[108]

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105. *See, e.g.*, LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 222 (2010) [hereinafter RIBSTEIN, UNCORPORATION] ("Private equity buyouts provide a leading example of the use of partnership mechanisms in governing large firms."); Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 298 (2009) [hereinafter Ribstein, *Partnership Governance*] ("Private-equity buyout firms are a leading example of the use of partnership mechanisms in governing large firms."); Peter Morris & Ludovic Phalippou, *A New Approach to Regulating Private Equity*, 12 J. CORP. L. STUD. 59, 68 (2012) ("The generally accepted view of private equity is that it is a highly competitive market involving sophisticated players. Most observers deem it de facto efficient, such that the relationship between managers and investors requires no attention.").

106. *See, e.g.*, Ribstein, *Partnership Governance*, *supra* note 105, at 290, 299:

> [Contractual mechanisms] substitute for costlier and often ineffective corporate-type monitoring devices, including the use of independent directors, owner voting, and fiduciary duties. . . . Substituting these incentive devices for monitoring is a particularly efficient tradeoff in private-equity firms given the high costs of constraining the discretion of expert managers.

107. *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 281 (2003) ("[W]e assume that VCs are real-world entities who closely approximate the investors of theory."). The venture capital industry is a subset of the private equity industry focusing on private investment in start-up businesses. Note that the Kaplan & Strömberg study focused on contracts between private equity funds and portfolio companies (as opposed to contracts between institutional investors and private equity funds), but similar characteristics arguably apply at the fund level as well. *See also* Oliver Hart, *Financial Contracting*, 39 J. ECON. LITERATURE 1079, 1095 (2001) (employing similar assumptions in a study of financial contracting).

108. To be clear, private equity funds are not the only sophisticated space where bargaining problems have been observed. For example, suboptimal 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, 66–68 (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*

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 for the first time on an industry-wide basis.[109] 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 fifty percent of the managers that they examined,[110] with private equity managers frequently "charging hidden fees that [were] not adequately disclosed to investors" and shifting expenses to investors "without proper disclosure that [those] costs [were] being shifted to investors."[111] This was made possible because, in the words of the SEC, the private equity industry was an environment where "[l]ack of

Innovation, 59 B.C. L. REV. 71, 129–31 (2018) (highlighting the extent to which merger agreement provisions are path dependent); Jeffrey Manns & Robert Anderson IV, *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 are far less likely to raise such distributional concerns.

Similar problems have also been studied in debt contracts. *See* Albert Choi & George Triantis, *Market Conditions and Contract Design: Variation in Debt Contracting*, 88 N.Y.U. L. REV. 51 (2013). However, the explanations posited by Choi and Triantis for these problems in debt contracts (built on the adverse selection and moral hazard theories of debt covenants and collateral) do not apply in the private equity fund context.

109. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010) (codified as amended at 15 U.S.C. § 80b-3(b)) (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).

110. *See* Bowden, *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.").

111. *Id.*

transparency and limited investor rights ha[d] been the norm . . . for a very long time."[112]

The SEC identified various problems with the contracts negotiated by private equity investors and managers. For example, the SEC reported that LPAs commonly granted managers broad discretion to charge fees and expenses that were not specifically discussed at the time the LPAs were negotiated,[113] which resulted in managers receiving large amounts in hidden payments that were never specifically disclosed and were "not reasonably contemplated by investors."[114] The SEC also criticized the light disclosure requirements set forth in LPAs and indicated that investors lacked sufficient information rights to be able to monitor their investments adequately. According to the SEC, LPAs commonly had broad, imprecise language that enabled managers to be opaque in areas where investors would have benefited most from transparency.[115] The SEC's findings were, all in all, a sharp rebuke of common practices in the industry.

This low-transparency environment was particularly troubling to the SEC because of the way in which private equity investments are structured. As noted above, when a private equity fund acquires a company, it typically takes a control position. With a controlling position, the manager can unilaterally cause the companies in the fund's portfolio ("portfolio companies") to take certain actions, including activities that will benefit the manager. The SEC found that private equity fund managers were commonly using this discretion to cause portfolio companies to hire the manager's affiliates to perform services for the company and to pay expenses that should have been paid by the manager.[116] Services commonly provided by private equity managers

112. *Id.*

113. *Id.*

114. *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.

115. *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.

116. *See id.*:

> With . . . control and the relative paucity of disclosure required of privately held companies, a private equity adviser is faced with temptations and conflicts with which most other advisers do not contend. For example, the private equity adviser can instruct

included "consulting" services and "monitoring" services whereby the manager received an annual fee in exchange for providing advisory services to portfolio companies. Because the manager was the party causing the portfolio company to enter into these agreements, and because the manager's affiliates were receiving the payments, these raised obvious questions about whether the portfolio companies were receiving fair value for the fees they were paying.[117] Moreover, because these payments were made at the level of the portfolio company, and because investors had failed to bargain for portfolio company-level transparency and disclosures, it was extraordinarily difficult for investors to detect payments made at this level.[118]

One of the most controversial practices uncovered by the SEC was the "acceleration" of consulting and monitoring fee payments upon the sale or IPO of a portfolio company. For example, a manager might have had an agreement with a portfolio company whereby the manager's affiliate was entitled to receive a fee payment of $500,000 each year for consulting services over a six-year period. If that portfolio company happened to be sold to an acquirer at the end of three years, it was not uncommon for managers to cause the portfolio company to pay the manager's affiliate a lump sum of $1.5 million for the consulting services that it would have provided in years four, five, and six had the company not been acquired. This was obviously problematic, both because those consulting services *were never actually rendered* to the portfolio company and also because these payments were undetectable to the fund's investors. This practice was quite common, as evidenced by the fact that the SEC brought enforcement actions against several of

> a portfolio company it controls to hire the adviser, or an affiliate, or a preferred third party, to provide certain services and to set the terms of the engagement, including the price to be paid for the services . . . or to instruct the company to pay certain of the adviser's bills or to reimburse the adviser for certain expenses incurred in managing its investment in the company . . . or to instruct the company to add to its payroll all of the adviser's employees who manage the investment.

117. *See* Michael Wursthorn, *Private-Equity Consultants Face SEC Scrutiny*, WALL ST. J. (Oct. 8, 2014, 12:18 PM), https://online.wsj.com/articles/private-equity-consultants-face-sec-scrutiny-1412785084?st=xo6vw2ttje0d5ju&reflink=desktopwebshare_permalink [https://perma.cc/SA6W-6NTL] (discussing the controversy over consulting and monitoring services).

118. *See* Mark Maremont & Mike Spector, *Buyout Firms' Fees Come Under Review*, WALL ST. J. (July 2, 2014, 3:40 PM), https://online.wsj.com/articles/regulators-examine-buyout-firms-fees-1404330015?st=6c80vau0ivyh2pk&reflink=desktopwebshare_permalink [https://perma.cc/33ZT-DS8P] (highlighting the SEC's concern that private equity firms have not provided investors enough information about the fees they receive for participating in group-purchasing programs).

the largest managers in the industry,[119] settling for tens of millions of dollars in each of those cases.[120]

As noted above, in response to these various 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.[121] The SEC's examination activities have been primarily focused on making sure that the contractual bargains struck between investors and managers are complied with. In effect, the SEC has served as a dedicated policeman in this industry for many years, wielding the threat of enforcement actions, fines, and other deterrents.

Yet notwithstanding this significant intervention, private equity fund governance has continued to be a subject of controversy and criticism by the SEC.[122] After issuing a series of statements expressing concern about transparency issues and conflicts of interest during the early days of Chair Gensler's tenure,[123] the SEC released the February 2022 Proposal, a set of rule changes that would (if adopted) dramatically expand the scope of regulation in the industry.[124] These proposed changes make the Agency's prior interventions over the past

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119. *See, e.g.*, Apollo Mgmt. V, L.P., Investment Advisers Act Release No. 4493, 2016 WL 11467649 (Aug. 23, 2016); TPG Cap. Advisors, LLC, Investment Advisers Act Release No. 4830, 2017 WL 6554183 (Dec. 21, 2017); Blackstone Mgmt. Partners, L.L.C., Investment Advisers Act Release No. 4219, 2015 WL 5834037 (Oct. 7, 2015).

120. *See, e.g.*, Press Release, U.S. Sec. & Exch. Comm'n, Apollo Charged With Disclosure and Supervisory Failures (Aug. 23, 2016), https://www.sec.gov/news/pressrelease/2016-165.html [https://perma.cc/U3H8-CQ2S] (announcing Apollo's agreement to pay $52.7 million in disgorgement and penalties); Laura Kreutzer, *TPG to Pay Nearly $13 Million Over Accelerated Monitoring Fees*, WALL ST. J. (Dec. 21, 2017, 8:10 PM), https://www.wsj.com/articles/tpg-to-pay-nearly-13-million-over-accelerated-monitoring-fees-1513905032 [https://perma.cc/H4DZ-WNZS] (detailing a $13 million settlement between TPG and the SEC); Press Release, U.S. Sec. & Exch. Comm'n, Blackstone Charged With Disclosure Failures (Oct. 7, 2015), https://www.sec.gov/news/pressrelease/2015-235.html [https://perma.cc/3P22-783J] (announcing Blackstone's agreement to pay approximately $39 million in disgorgement and penalties).

121. *See* Off. of Compliance Inspections and Examinations, *supra* note 12, at 1.

122. *See, e.g.*, *supra* note 12 and accompanying text.

123. *See, e.g.*, *Oversight of the Securities and Exchange Commission: Putting Investors and Market Integrity: Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong. 9 (2021) (written testimony of Gary Gensler, Chair, Securities & Exchange Commission) ("The third topic [occupying the SEC's attention today] centers on private funds, and in particular the conflicts of interest their managers may have and the information they are providing investors about the fees they charge."); Gary Gensler, Chair, Sec. & Exch. Comm'n, Prepared Remarks at the Institutional Limited Partners Association Summit (Nov. 10, 2021), https://www.sec.gov/news/speech/gensler-ilpa-20211110 [https://perma.cc/9CB8-4SBX]:

> [W]hen it comes to conflicts of interest, I believe we have the opportunity to strengthen trust in the private funds market. I've asked staff how we can better mitigate the effects of conflicts of interest between general partners, their affiliates, and investors. This could include considering the need for prohibitions on certain conflicts and practices.

124. *See infra* Section V.C.

decade seem quite minor by comparison. Interestingly, in the February 2022 Proposal, the SEC specifically voiced frustration that problematic practices have persisted in the industry in spite of the Agency's examination efforts and enforcement activity over the years.[125] The Agency has, apparently, given up hope that managers and investors will remedy these issues on their own.[126]

Assuming the SEC's assessment of the industry is correct, all of this prompts the question: If private bargaining between sophisticated buyers and sellers is supposed to yield optimal governance terms, why would a permanent government oversight presence be necessary? Moreover, why would questionable practices persist 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 modulate. As discussed above,[127] the bargaining power irrelevance proposition predicts 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 a hands-off, formalistic approach to the law would almost certainly yield 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 report that governance terms shifted 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.[128] Likewise, as the private equity industry has experienced massive growth in more recent

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125. *See supra* note 26 and accompanying text.

126. *See supra* note 26 and accompanying text.

127. *See supra* notes 48–49 and accompanying text.

128. *See* Michael Suppappola, Edward Lee, Lewis Phillips & Andrew Shore, *At the Negotiating Table: Ts & Cs That Require Attention*, MODERN FUNDRAISER, Jan. 2016, at 13:

> The relationship between LPs and GPs has continually shifted as market conditions and the private equity industry have 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 . . . .

years in a favorable low interest rate environment, industry participants report that governance terms have moved dramatically in favor of managers.[129]

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.[130] 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.[131]

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 example, scholars have criticized private equity contracts for failing to align managers' reputational incentives with the interests of investors,[132] for failing to sufficiently align managers' and investors' economic incentives,[133] and for providing investors with insufficient information rights after the fund has commenced business operations,[134] among other critiques. Scholars

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129. *See supra* note 22 and accompanying text.

130. For a more detailed discussion of this study, see Section III.D.1.

131. *See supra* notes 48–49 and accompanying text.

132. *See, e.g.*, William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1900 (2018) ("[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. 311, 332 (2009) ("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.").

133. *See* Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSPS. 147, 162 (2009):

> To isolate further some 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.

134. *See, e.g.*, Spindler, *supra* note 132, at 327:

have argued that these shortcomings have caused significant harm to the investors in private equity funds.[135]

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 generally aligned with the SEC's criticisms over the years, making it harder to accept the view 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 with 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.

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 largely moved in the opposite direction.[136] The fundraising and negotiation process for a substantial fund commonly takes eighteen months or more, with managers and investors typically negotiating hundreds of pages of "side letters" in addition to the 150+ page LPA that applies to all investors. According

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> Often . . . general partners retain the right to severely limit or even eliminate disclosure on particular matters—for instance, through the general partner's discretion to keep investment information confidential. And while there is usually a requirement to deliver annual and quarterly reports, these do not require line item information about particular investments. . . . In total, the information that limited partners receive is somewhat useful in terms of keeping in check gross malfeasance by the general partners but not useful in terms of knowing what their investments are likely to be worth at any point in time or whether the general partners are doing a good job.

135. Rosemary Batt & Eileen Appelbaum, *The Agency Costs of Private Equity: Why Do Limited Partners Still Invest?*, 35 ACAD. MGMT. PERSPS. 45, 52 (2021) ("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.").

136. 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* INSTITUTIONAL LTD. PARTNERS ASS'N., ILPA PRINCIPLES 3.0: FOSTERING TRANSPARENCY, GOVERNANCE AND ALIGNMENT OF INTERESTS FOR GENERAL AND LIMITED PARTNERS 6 (2019), https://ilpa.org/wp-content/uploads/2019/06/ILPA-Principles-3.0_2019.pdf [https://perma.cc/QVC2-G9HU]:

> This guidance is put forth as a road map for GPs and LPs to develop the same set of expectations when entering into any partnership, 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.

to one prominent private funds attorney, a law firm representing a manager in a large fundraise will commonly spend approximately seven thousand hours negotiating contract terms with investors—a "vast amount of time" by any standard.[137] Such a process is clearly a sizeable profitmaking opportunity for the law firms representing private equity managers and their investors, but it seems far from a model of efficiency.[138] According to industry participants, the costs of bargaining in private equity have only increased over time.[139]

To highlight the unusual nature of this approach, 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 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 generate returns.[140] 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 arrangement in a bilateral negotiation, after which that investment is syndicated into smaller pieces and sold to the outside investors.[141] Moreover, unlike the private equity industry, market-standard documentation is widely used across the syndicated credit market.[142]

137. Vicky Meek, *LPA Blues*, PRIV. EQUITY FINDINGS, no. 16, 2020, at 24, 26:

> [A]cting for a general partner with a [10 billion euro plus] fund, for example, [Jason Glover, managing partner of Simpson Thacher & Bartlett'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," he says.

Note that this estimate does not include time spent by counsel representing investors.

138. *Cf.* Anderson & Manns, *supra* note 108, at 87–93 (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 were willing to coordinate).

139. *See supra* note 23 and accompanying text.

140. *See What Is a Syndicated Loan?*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/finance/syndicated-loan/ (last visited Mar. 30, 2022) [https://perma.cc/7RXS-TA77].

141. *See* Bryan L. Barreras & David B. Kobray, *Issues for Administrative Agent to Consider*, MAYER BROWN 1–4 (2019), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/10/issues-for-administrative-agent-to-consider.pdf [https://perma.cc/ZF3W-EAUJ] ("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 [a]dministrative [a]gent is in many respects essentially for convenience and efficiency.").

142. *See* THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING 32, 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,

These practices dramatically increase the speed and efficiency of the process as compared with the private equity market.

In the private equity market, by contrast, the Institutional Limited Partners Association, the industry trade association for institutional investors in private equity funds, has created an array of templates and model documents,[143] but these are largely viewed within the industry as aspirational documents that do not reflect market practice.[144] While these templates are often cited as reference points in private equity fund negotiations reflecting investor-favorable positions, generally they are not widely accepted tools for streamlining negotiation processes and have not achieved market-standard adoption.

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 0.5 percent to 1.5 percent), industry participants commonly feel that increasing fund sizes have led to this cap being somewhat toothless.[145]

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including par and distressed trade confirms and purchase/sale agreements, as well as guidelines for processing such amendments.

143. *See, e.g.*, *Reporting Template*, INSTITUTIONAL LTD. PARTNERS ASS'N, https://ilpa.org/reporting-template/ (last visited Feb. 1, 2022) [https://perma.cc/L3NA-ZCM9] (select the "Principles, Practices & Policy" tab, then the "Templates, Standards & Model Documents" tab to view a fee and expense reporting template, a due diligence questionnaire and diversity metrics template, a model limited partnership agreement, a model nondisclosure agreement, a model subscription agreement, portfolio company metrics template, and a capital call, distribution, and quarterly reporting template).

144. *See, e.g.*, Gus Black, Thiha Tun & Zachary Oswald, *Updated ILPA Model LPAs Continue to Miss the Mark(et)*, DECHERT LLP (Sept. 18, 2020), https://www.dechert.com/knowledge/onpoint/2020/9/updated-ilpa-model-lpas-continue-to-miss-the-mark-et-.html [https://perma.cc/5YDF-ZRCV]:

> One of the stated benefits of the Model LPA and the recent updates is to create a "baseline" to determine which terms are important and reasonable in negotiations between managers and investors. However, instead of reflecting "market" fund terms, ILPA appears to be continuing a campaign to "move" the private equity market by suggesting uncommon terms which it considers to be investor friendly.

145. 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* notes 17–23 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

This has been criticized for creating a distorted set of bargaining incentives. Managers, on one hand, are likely to be relatively insensitive to the legal costs that are incurred during the bargaining process because they are not paying their attorneys' legal bills.[146] 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 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 nondisclosure provisions that prohibit them from sharing LPAs with third parties,[147] 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,[148] which decreases efficiency and

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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.

146. *See* Jeffrey E. Horvitz, *Commentary: Support ILPA's Standard Fund Documents Project*, PENSIONS & INVS. (Jan. 20, 2020, 10:00 AM), https://www.pionline.com/industry-voices/commentary-support-ilpas-standard-fund-documents-project [https://perma.cc/VVR8-6JJG]:

> 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.

147. *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 [https://perma.cc/53WN-7D7S] ("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 [https://perma.cc/8R7G-TJ6L] ("[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.").

148. Concerns in this area 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 Mar. 30, 2022) [https://perma.cc/QY46-DGWT] (providing searchable copies of "leaked" limited partnership agreements); Albert J. Hudec, *Negotiating Private Equity Fund Terms: The Shifting Balance of Power*, BUS. L. TODAY, May/June 2010, at 45, 48 ("Traditional limited partnership agreements do

hampers the diffusion of contracting innovations and improvements across the market-wide network of investors.[149]

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.[150] Other commentators have accused private equity of using nondisclosure agreements to prevent the public from evaluating LPAs and criticizing unfair terms in them.[151] 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.[152]

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. The Institutional Limited Partners Association has, again, sought to fill this void by conducting investor surveys and providing the results to its members,[153] but these self-reported surveys can only provide investors with limited confidence and limited detail about where market terms actually stand.

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not have expansive information rights and tricky confidentiality obligations make robust information flow difficult to come by.").

149. *See* Morris & Phalippou, *supra* note 105, at 78:

> Every market needs information in order to work efficiently. It needs to be in a convenient and consistent format; comprehensive (but with the emphasis on quality rather than quantity); and available to all interested parties so that it can be independently analysed. Without this kind of information, a market cannot operate efficiently. Private equity firms already provide a lot of information to their investors, though that information fails to meet [these] conditions.

150. *See* Spindler, *supra* note 132, at 311–12 (arguing that, for private equity, "[s]taying below the regulatory radar is paramount").

151. *See, e.g.*, Marriage & Newlands, *supra* note 147 ("Critics believe the non-disclosure agreements allow fund managers to overcharge some of their pension fund clients significantly."); Dan Primack, *Private Equity's False Argument for Confidentiality*, FORTUNE (Nov. 25, 2014, 11:48 AM), http://fortune.com/2014/11/25/private-equitys-false-argument-for-document-secrecy [https://perma.cc/5V6H-2YKL] ("The real secret sauce in private equity partnership agreements are the dozens and dozens of pages about tax and fee structures. That's what firms don't want publicly disclosed.").

152. *See* Steve Judge, *Confidentiality of Limited Partnership Agreements Is Paramount*, PE HUB (Nov. 3, 2014), https://www.pehub.com/2014/11/confidentiality-of-limited-partnership-agreements-is-paramount [https://perma.cc/TA2X-86YP] ("Confidentiality is paramount for a simple reason: Private equity is one of the most competitive corners of the financial marketplace.").

153. *See, e.g.*, INSTITUTIONAL LTD. PARTNERS ASS'N, ILPA INDUSTRY INTELLIGENCE: WHAT'S MARKET IN FUND TERMS? (2021), https://ilpa.org/fundtermsurvey/ [https://perma.cc/96MF-LGLC] (setting forth fund term survey data to ILPA members).

C. A Note About Optimality

The discussion above has identified various ways in which private equity contracts may be falling short of "optimality." What exactly is meant by these references? My primary usage of this term refers to evidence that parties are not agreeing to terms that maximize the joint surplus created by private equity contracts (in other words, terms that maximize the size of the pie).[154] Process characteristics that reduce the joint surplus created by contracts, including unnecessarily costly negotiations and lack of transparency, can also be considered suboptimalities along the same lines.

But the problems discussed above can also be considered suboptimal in another respect. The bulk of the capital in private equity funds is invested by taxpayer-backed public pension plans, private pension plans investing the retirement savings of private employees, and endowments and charities investing for nonprofit causes.[155] These institutional investors operating on behalf of the public and vulnerable beneficiaries are always on the investor side of private equity fund transactions. Accordingly, any process deficiency that systematically works to the detriment of investors—and for the benefit of managers—in private equity funds will typically be socially suboptimal. This is unlike, for example, the market for M&A transactions, as these kinds of distributional concerns would not be raised if M&A sellers or buyers were systematically favored by process characteristics.[156] This lends greater weight to concerns about bargaining problems in private equity funds.

D. Scholarly Attempts to Explain These Problems

The discussion above presents a puzzle: If private equity is such a high-end bargaining space, what can explain these problems? Why have private equity investors and managers—and the well-funded industry trade associations representing them—settled on processes that, by all appearances, have failed to generate consistent surplus-maximizing outcomes over such a protracted period? Why has the SEC's ongoing examination presence been needed? Below, I discuss various theories that scholars have proposed over the years.

154. *See supra* note 48 and accompanying text.

155. *See* PREQIN, *supra* note 40, at 73 (showing that public pension plans are the largest investors in private equity funds, representing thirty-five percent of all capital in the asset class).

156. *See supra* note 108.

1. Agency Problems in Institutional Investors

As noted above, in a foundational early study of the venture capital industry,[157] 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.[158]

Gompers and Lerner found that instead of negotiating for higher fee rates, managers and investors agreed to include less restrictive nonprice covenant terms in private equity LPAs.[159] 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.[160] 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.[161] To illustrate, if an investment officer

157. *See* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE (1999).

158. *See id.* at 32 (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 & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 471 (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.").

159. *See* GOMPERS & LERNER, *supra* note 157 at 31–32, 45–47.

160. 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. Gompers & Lerner, *supra* note 158, at 479–84. 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.

161. *See* Josef Lakonishok, Andrei Shleifer & Robert W. Vishny, *The Structure and Performance of the Money Management Industry*, 1992 BROOKINGS PAPERS ON ECON. ACTIVITY:

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 career risk.[162]

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 extract 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.[163] 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.[164] 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

MICROECONOMICS 339, 341–44 (finding significant underperformance by pension plans attributable to agency problems).

162. *See* Morris & Phalippou, *supra* note 105, at 74:

> [A] rise in headline fees might . . . encourage [those with oversight authority] to take resources away from the agents, [i.e.,] the organisation'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 terms.

163. *See* Gompers & Lerner, *supra* note 158, at 472:

> 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 percent/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.

164. *See* Morris & Phalippou, *supra* note 105, at 61 ("Contracts between manager and investor appear excessively and unnecessarily complex.").

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.[165] Many large institutional investors allocate billions of dollars each year to private equity funds and employ dozens of professionals to manage the investment process. As such, as contracts become more complex, and as it becomes increasingly difficult to compare terms across the market, the competitive advantage of large institutions should increase.[166] 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.[167]

To the extent that large investors—the ones with the greatest bargaining power—have these incentives, it would not be surprising to find suboptimal 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.[168] The basic idea is that because exposure to the antifraud rules is so costly in terms of compliance 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, give such weak control rights to investors, and offer investors such limited liquidity.[169] Far

165. *See id.* at 62 ("Complexity gives a competitive advantage to those which have greater resources.").

166. *See id.* at 75.

167. *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.").

168. *See* Spindler, *supra* note 132, at 312 ("The breadth of the law's reach, and what one must do to escape it, largely defines what private equity is.").

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

from an optimal arrangement, Spindler argues that the private equity governance model should actually be considered an "incubator for agency costs."[170]

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.[171] 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 because all of the investors are sophisticated. According to Spindler, because the potential liability under the federal securities laws is so significant, rational investors and managers decide to adopt the private equity model despite the fact that it is more controversial and less efficient.[172]

4. A Commons Problem

In an earlier article,[173] I challenged the view that private equity contracts can be presumed to be optimal based solely on the assumption that they are "highly negotiated."[174] I argued that because investors can frequently bargain for individualized benefits (like co-investment opportunities) in private equity funds, investors with bargaining power have a more complex set of incentives than is commonly understood. Instead of prioritizing terms that will benefit all investors in a fund,

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170. *Id.* at 313, 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.").

171. *Id.* at 334 ("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 US securities regime has become, by comparison, so bad.").

172. *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.").

173. William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. ON REGUL. 67 (2020).

174. *See id.* at 69:

> 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.

investors may have incentives to prioritize individualized benefits.[175] This describes, in effect, a possible commons problem in the private equity industry.[176]

Importantly, as I have discussed in a different paper, managers are unlikely to use individualized contracting to systematically allocate higher-performing deals to large investors in separately managed accounts or co-investment vehicles.[177] There are, however, other forms of individualized benefits obtainable that could have the indirect dampening effect[178] on large investor bargaining described above.[179] So

175. *See id.* at 70:

> In general, the more that 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.

176. *See* Lee Anne Fennell, *Common Interest Tragedies*, 98 NW. U. L. REV. 907, 915–16 (2004):

> 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.

177. *See* William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. 249, 288–95 (2017). This early article analyzed the rise of separately managed accounts ("SMAs") and co-investments in the private equity industry and does not address side letters. Its primary contribution was to argue that managers are unlikely to allocate higher-performing deals and other resources to preferred investors through SMAs and co-investments on a sustained basis. However, this 2017 article's characterization of the rise of SMAs and co-investments as an "efficient" development—in a broad sense—for the industry was overly simplistic. That broader labeling failed to give weight to certain inefficiencies and transparency problems generated by such practices. Also, it did not speak to the dampening effect that side letter contracting and co-investments can have on large investors' ex ante incentives to negotiate LPAs. That issue is addressed in my 2020 paper, *The Private Equity Negotiation Myth*. *See* Clayton, *supra* note 173.

178. *See* Clayton, *supra* note 173, at 70 ("[W]hen individualized benefits are common, it is likely to have a dampening effect on the extent to which fund agreements are negotiated.").

179. Examples include fee discounts and seats on a fund's investment advisory committee (which provides large investors with superior access to managers and insight into a fund's operations). As another example, co-investments provide investors with various individualized benefits. Since co-investments are typically not charged a management fee, they are commonly viewed as a way for investors to "blend down" the overall fees that they pay to deploy capital in private equity strategies. Investors also commonly describe co-investments as a way to form closer relationships with managers and to gain greater insight into investment management at the portfolio company level, which can aid in the development of direct investment programs. *See* Preeti Singh, *MassPRIM: 'Co-Investment Is a Great Tool'*, PRIV. EQUITY INT'L (Dec. 11, 2019), https://www.privateequityinternational.com/massprim-co-investment-is-a-great-tool/ [https://perma.cc/STC7-9E9F] ("Limited partners are clamouring for more co-investments. The strategy has become ubiquitous, with LPs seeking to blend down fees, form closer relationships with their GPs and flex their diligence chops."). More broadly, the incentives identified in *The Private Equity Negotiation Myth* can apply anytime the parties agree to put a term in a side letter

long as investors cannot coordinate effectively, the incentives described above cannot be eliminated just by ensuring that investors are sophisticated.

5. Multiple Agency Theory and Private Equity Managers

More recently, scholars have also used multiple agency theory to shed light on the challenges observed in private equity fund contracting. Appelbaum and Batt examine the various roles played by fund managers and how those various roles generate conflicts of interest and reduce the alignment of interest between managers and investors.[180] They also point out that private equity managers are both principals and agents at the level of the private equity firm itself, as well as principals in the portfolio companies acquired by the fund and agents for the limited partners who invest in private equity funds.[181] Both managers and investors are also, moreover, managing a web of ongoing relationships with other parties, further muddying the waters.[182] This creates a complex and overlapping set of conflicts of interest that grow larger and more complex as the institutional parties get larger.

Thus, from the perspective of multiple agency theory, bargaining problems in private equity are generated not by sophistication shortcomings, but rather by complex conflicts of interest at every level of the market. Similar analysis has also been used to explain suboptimal decisionmaking regarding the timing of investment exits by venture capital fund managers.[183]

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that could otherwise go in an LPA, since it limits the number of potential contract claimants to those with side letters, as opposed to the entire fund.

180. Batt & Appelbaum, *supra* note 135, at 45 ("We argue that the PE model may be best understood as an example of multiple agency theory . . . in which there is not just one principal-agent relationship but tiered relationships among a 'web of interrelated parties.'" (citations omitted)).

181. *See id.* ("The PE general partner (GP) has multiple relationships to manage—as *principal* (partner) and *agent* (manager) in the PE firm, as *principal* (holding a small equity share) in the portfolio company that the PE fund acquires, and as *agent* for the limited partners who invest in the PE fund.").

182. *See id.* ("The limited partner investors (LPs) and GPs are also nested in a web of ongoing relationships that include banks and creditors who offer substantial loans for PE deals and financial advisors who play a key role in shaping the investment decisions of the limited partners.").

183. *See* Shyamala Sethuram, Markus Taussig & Ajai Gaur, *A Multiple Agency View of Venture Capital Investment Duration: The Roles of Institutions, Foreignness, and Alliances*, 11 GLOB. STRATEGY J. (SPECIAL ISSUE) 578, 580 (2021) (introducing a framework based on multiple agency theory to examine the factors shaping the duration of venture capital firms' investments).

6. The Complicating Role of Investor-Level Regulation

Another explanation is the fact that an extremely large percentage of the investors in private equity funds are regulated institutions that are subject to their own array of regulations and requirements.[184] In fact, the largest investors in the industry with the most bargaining power—including public pension plans and sovereign wealth funds[185]—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.[186]

Second, investor-level regulation has likely helped contribute to the complex, labor-intensive, and costly negotiating dynamic observed in the private equity industry[187] 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. Not only is this costly, but it also creates a complex set of incentives, as discussed above.[188]

7. 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

184. *See generally* William W. Clayton, *How Public Pension Plans Have Shaped Private Equity*, MD. L. REV. (forthcoming 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4009528 [https://perma.cc/9S5Z-DBF5].

185. *See supra* note 40 and accompanying text.

186. 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).

187. *See supra* Section III.B.1.

188. *See supra* Section III.B.1.

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.[189] 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 analysts, investment advisors and consultants, and investment banks.[190]

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. To better understand how bargaining 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 issues 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 identifies new problems with bargaining in private equity and reinforces the relevance of certain problems identified in Part III above.

A. The Survey Data

The findings discussed below are drawn from responses to a thirty-seven-question survey.[191] The responses were provided by senior in-house lawyers at seventy institutional investors, including twenty-nine public pension plans, nine family offices,[192] nine insurance

189. *See* Batt & Appelbaum, *supra* note 135, at 60, 63.

190. *See id.* at 60 ("The institutionalization of the PE business model . . . mean[s] that a larger web or network of players ha[s] a stake in the survival of the model—including creditors, investment banks, PE lawyers, financial analysts, and investment advisors or consultants.").

191. 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 [https://perma.cc/42BG-P4UV].

192. A family office is a private wealth management firm serving ultra-high-net-worth individuals and families. Adam Hayes, *Family Offices*, INVESTOPEDIA,

companies, seven endowments, seven impact investors focused on global development, three private pension plans, two sovereign wealth funds, one bank, one foundation, one investment company, and one superannuation fund. Thirty-five of the respondents are institutions located in the United States, and thirty-five are located outside the United States.

FIGURE B

Investor Types	Number 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 Superannuation Funds	4

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.

FIGURE C[193]

Region	Number of Investors
North America	64
Europe	57
Asia including Oceania	42
Emerging Markets excluding Asia	18

The survey respondents are frequent investors in private equity funds. As shown in Figure A in Section II.B.2.a above, at the time of the survey, one-third of the respondents had invested in more than twenty private equity funds in the prior twelve months. Over eighty-five percent of the respondents had invested in more than five private equity funds in the prior twelve 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

https://www.investopedia.com/terms/f/family-offices.asp (last updated Aug. 16, 2021) [https://perma.cc/3QLG-S92S].

193. The number of investors depicted on this table exceeds seventy because many of the respondents make investments in more than one region.

bargaining process in this industry and have participated in dozens of investment negotiations. Similarly, most of them have well-developed 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 maximum investment that they reported 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 reported that it makes investments up to $1 billion. The size of the investors in the sample is shown in greater detail in the Figure below:

FIGURE D[194]

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

B. More Evidence of High-End Bargaining Problems

1. Information Flows Are Even More Restricted than Previously Documented

It is well established that private equity managers commonly impose significant restrictions on the accessibility of private equity contract terms outside the fund.[195] These nondisclosure 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.[196]

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 noted above,[197] it is very common for investors to devote substantial time and resources to negotiating side letters with the manager. In fact, as will be discussed below,

194. When a table indicates that n is less than seventy, it is because fewer than all of the respondents responded to the specific question.

195. *See supra* Section III.B.3.

196. *See supra* notes 147–148 and accompanying text.

197. *See supra* Section III.B.1.

investors spend even more time negotiating side letters than they spend negotiating LPAs.[198]

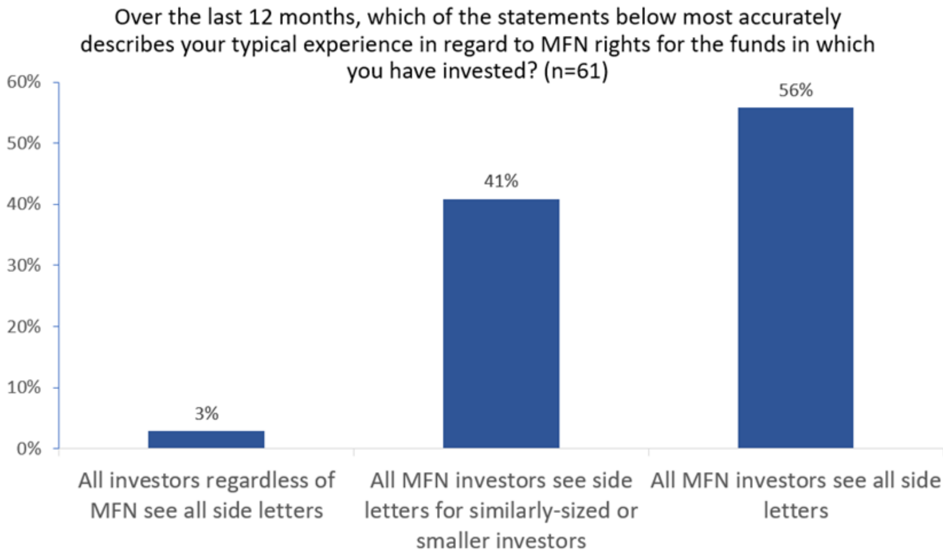
The survey data shows that most of the investors in a fund will never see the side letters granted to the larger investors in a fund. According to investor responses, it is extremely uncommon for managers to share side letters with all of the investors in a fund.[199] Instead, the most common approach is for only the investors with "most favored nation" ("MFN") rights to see the side letters issued to other investors. An MFN right is granted in an investor's side letter, and it typically gives that investor the right to both 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 that have greater bargaining power than other investors. Second, as shown in Figure E 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 always 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, when a size-based limitation applies, 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.

198. *See infra* Section IV.B.2.

199. Only three percent of investors indicated that this arrangement is the most common approach they see in the market. *See infra* Figure E.

FIGURE E



Under the SEC's historical 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 that information into account when they make their investment decision.[200] But this is a very different thing than seeing the actual terms granted to actual investors.

Various commenters have criticized the 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 raises further concerns about negative effects on efficiency and contract innovation.[201]

200. *See* Christopher Gardner, Mikhaelle Schiappacasse & Nathalie Sadler, *Private Fund Side Letters: Common Terms, Themes and Practical Considerations*, DECHERT LLP (Oct. 28, 2018), https://www.dechert.com/knowledge/onpoint/2018/9/private-fund-side-letters--common-terms--themes-and-practical-co.html [https://perma.cc/MBV9-Y52C]. Note that the SEC's February 2022 Proposal, if adopted, would require much more robust disclosure of any preferential treatment granted in side letters.

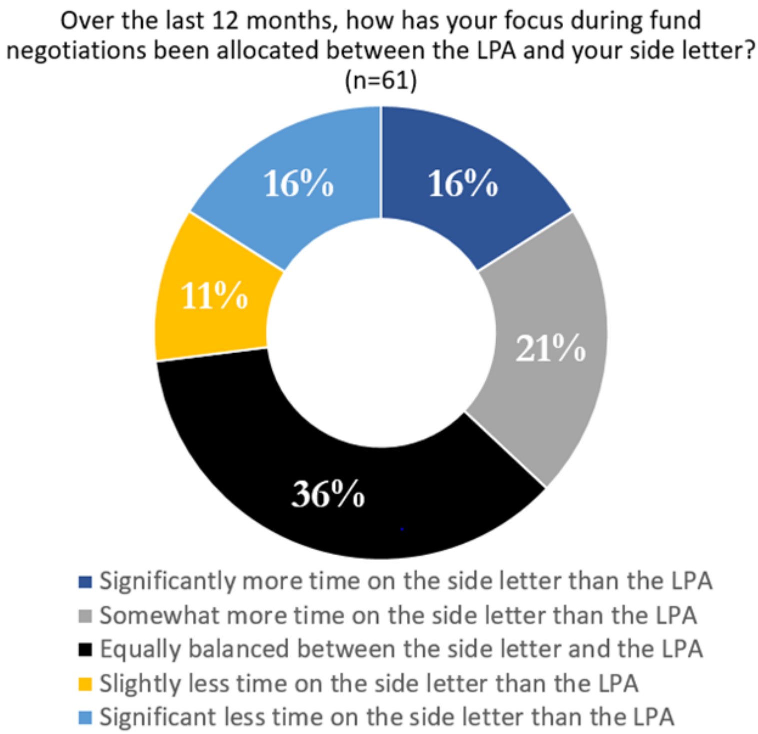
201. *See supra* Section III.B.3 (discussing problems raised by disclosure restrictions relating to LPAs).

2. Investors Spend More Time Negotiating Side Letters than LPAs

The process for negotiating private equity contracts is known to be extremely labor intensive and costly.[202] Yet there is very little information available to quantify just how much time investors spend negotiating side letters.

The survey data confirms the view that side letters do consume an enormous amount of time and attention. In fact, respondents indicated that investors spend even more time negotiating side letters than they spend negotiating LPAs. Whereas thirty-seven percent of investors reported spending "somewhat more" or "significantly more" time negotiating side letters, only twenty-seven percent of investors reported spending "somewhat more" or "significantly more" time negotiating LPAs.

FIGURE F



Interestingly, this bias towards side letters was somewhat more pronounced in large investors—precisely the ones that have the

202. *See supra* Section III.B.1.

greatest bargaining power and therefore the greatest capacity to negotiate for strong terms. As shown in the chart below, ten out of twenty-two investors with maximum commitments over $100 million reported spending more time negotiating side letters than LPAs, whereas only four out of twenty-two 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.

FIGURE G

	All LP Types (n=51)	
	Largest Commitment Size Across All Investment Strategies	
Focus During Fund Negotiations	< 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

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 costly in private equity.[203] This also helps to explain why efforts to create industry-wide, standardized contract templates have had such limited traction in the past,[204] and why any forms of investor coordination—both formal and informal—are so uncommon in the industry.

203. *See supra* Section III.B.1.

204. See *supra* note 136 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 nondisclosure agreement. These various other templates have had varying rates of adoption in the marketplace. *See, e.g.*, *Perspectives on Transparency in Public Sector Pensions: Hearing Before the Pub. Pension Mgmt. & Asset Rev. Comm'n*, 2018 Leg. 4 (Pa. 2018) (statement of Jennifer Choi, Managing Director, Institutional Limited Partners Association) (noting that approximately twenty-two percent of managers used the ILPA fee disclosure template for one or more of their investors); Anabelle Ju, *Slow But Steady Wins the Race?*, PRIV. FUNDS CFO (Apr. 13, 2017), https://www.privatefundscfo.com/slow-but-steady-wins-the-race/ [https://perma.cc/73EF-JFPC] (noting that the pace of traction for adoption of the fee disclosure template was "disappointing to supporters of the template").

3. Weak Internal Coordination Is a Common Problem in Private Equity

As noted above, Gompers and Lerner established long ago that the private equity industry appears to defy the bargaining power irrelevance proposition.[205] Theory may say that sophisticated investors *should* bargain for optimal governance terms regardless of the applicable bargaining power dynamics, and that bargaining power *should* be used to negotiate the price term, but Gompers and Lerner found that the opposite happens in the private equity context.

As discussed above, Gompers and Lerner posited that this dynamic might be explained by the presence of agency conflicts within the institutional investor organizations that invest in private equity funds.[206] By agreeing to make concessions that take 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.[207]

The survey data, however, calls into question whether this agency problem theory is right. The agency problem theory assumes that institutional investors make conscious decisions to relax the nonprice 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.[208] It is therefore not unusual for the investment team to make a decision about whether to invest in the fund before the transaction is handed to the lawyers to work out the legal details.

Moreover, as illustrated in Figure H below, the survey data shows that communication between the investment teams and legal teams is quite limited. As indicated below, sixteen percent 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. Thirty-eight percent of institutional investors reported that they only sometimes confer about critical legal terms in advance, but even then they do not

205. *See supra* Section III.D.1.

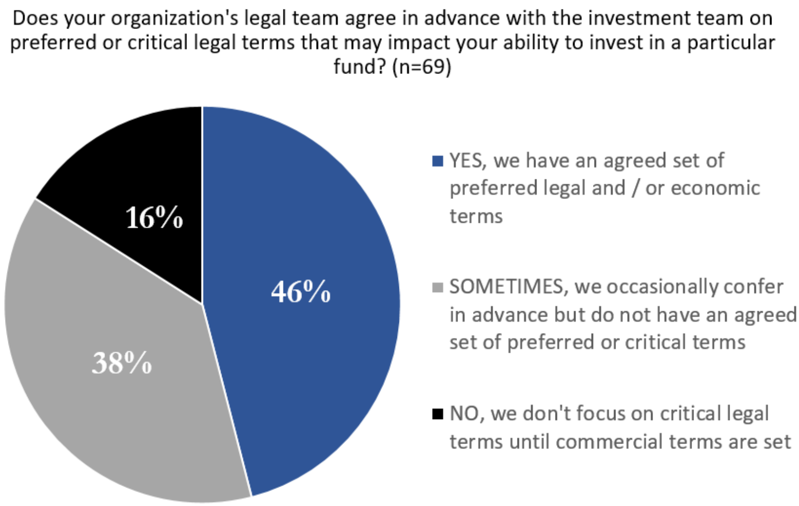
206. *See* Gompers & Lerner, *supra* note 158, at 479–84.

207. *See supra* note 163 and accompanying text.

208. Private equity has been held out as an example of an industry in which two-staged bargaining is quite common. *See, e.g.*, Choi & Triantis, *supra* note 46, at 1690 ("[I]n commercial loans, private equity investments, and corporate acquisitions, many terms are agreed upon after the price is settled.").

have an agreed upon set of critical legal terms.[209] 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 do not appear to be sufficient lines of communication to accomplish that in a large number of the institutional investors responding to the survey.[210]

FIGURE H



Interestingly, scholars have identified these kinds of communication problems as a possible explanation for why the bargaining power irrelevance proposition can sometimes be violated.[211]

209. 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.

210. 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.

211. Choi and Triantis have addressed the question of when bargaining power can influence the nonprice terms in a contract. *See* Choi & Triantis, *supra* note 46, at 1690. 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 nonprice terms (including governance terms) are negotiated. *See id.* at 1690–91:

> In the first stage of negotiations the parties negotiate price and key nonprice 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 in 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 a range of

The logic is intuitive. In transactions where the business teams negotiate the price and other central terms first, after which the transaction is handed over to the parties' lawyers to finalize the legal details, it becomes very difficult, if not impossible, to go back and adjust the price term as the lawyers flesh out the legal issues. Interestingly, if we accept this explanation, it would suggest that suboptimalities in bargaining outcomes stem from a failure of communication, and not from agency problems within the institutional investor organizations.

4. Investors Do Care About Fiduciary Duties After All

Survey respondents affirmed that it is extremely common for terms in private equity LPAs to dilute managers' fiduciary duties. In fact, seventy-one percent of respondents indicated that fiduciary duties were contractually modified or eliminated in at least half of the funds that they had invested 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.

FIGURE I

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

Clearly, investors and managers are making heavy use of the contractual flexibility afforded them under state law to modify and customize fiduciary duties. 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.[212] According to the contractarian approach, fiduciary duties should not be particularly important to investors if there are effective contractual and compensation-based devices to contain management opportunism.[213] Moreover, the bargaining power

these expectations, the parties may be compelled to reopen the price. Although the first-stage agreement is not legally binding, there would be nonlegal 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 nonprice 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.

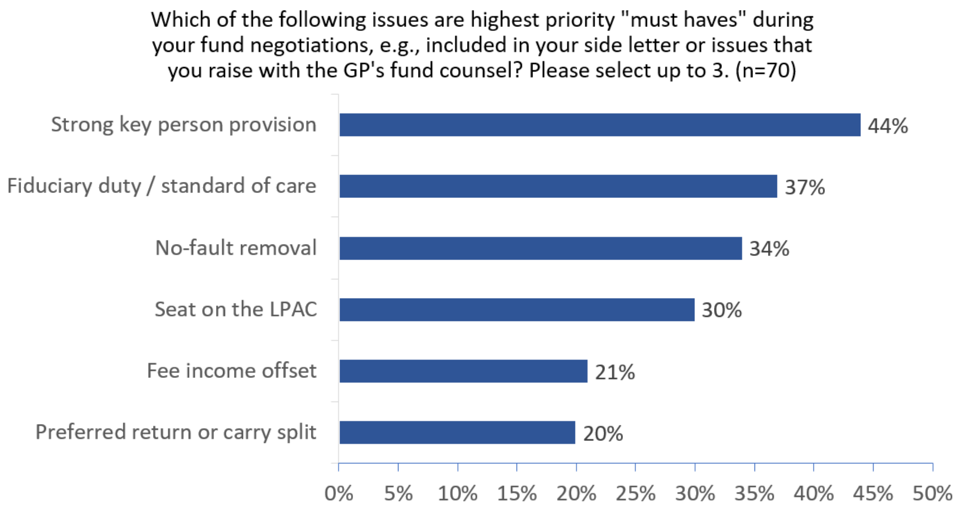
212. *See supra* note 106 and accompanying text.

213. *See* Ribstein, *Partnership Governance*, *supra* note 105, at 296.

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.[214] Indeed, the private equity industry has been painted as a leading example of this kind of contractual flexibility by scholars in the past.[215]

A closer look at the survey results, however, suggests that many investors *do* care about fiduciary duties, even if they are unable to negotiate successfully for them. The survey shows that fiduciary duties/standard of care is the second most important negotiating priority for investors. As illustrated in the chart below, thirty-seven percent of investors rate fiduciary duties/standard of care as one of their top three negotiating priorities.

FIGURE J[216]



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

214. *See supra* notes 48–50 and accompanying text.

215. *See supra* Section II.B.3.

216. Note that this chart is limited to issues that were identified as top three "must have" priorities for at least twenty percent of respondents. Other options included: fee/expense disclosures; fund borrowing terms; ESG policies and disclosures; reduced carry-on general partner removal; waterfall; consent rights on transfers; excuse rights; restrictions on general partner transfers to third parties; and co-investment rights.

FIGURE K

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

Interestingly, the survey results show that public pension plans play an important role in this fiduciary duty bargaining dynamic. Public pension influence is felt in two ways. First, compared to other investor types, the public pension plan respondents were more than two and a half times as likely to hold fiduciary duties as a top negotiating priority. Fifty-nine percent of public pension plans reported that the restoration of fiduciary duties was a top three negotiating priority, compared to only twenty-two percent of all other investor types.

FIGURE L

Fiduciary Duties/Standard of Care as a Top Three Negotiation Priority			
Investor Type	# of LPs	Total LPs	%
Public Pension	17	29	59%
All Others	9	41	22%
Total	26	70	37%

Second, not only were public pension plans far more likely to make the restoration of fiduciary duties a top negotiating priority, but they also indicate that they were far more successful at getting successful results when they did so. As shown in the chart below, half of the public pension plans that held fiduciary duties as a top negotiating priority were successful in improving or restoring fiduciary duties more than seventy-five percent of the time. All of the other investor types were far less successful, with two-thirds of them reporting negotiating success less than twenty-five percent of the time.

FIGURE M[217]

Investors Who Included Fiduciary Duties/Standard of Care as a Top Three Negotiating Priority					
How often were you able to restore or improve eroded fiduciary duties? (n=25)					
Investor Type	Never	0-25% of the time	25-50% of the time	50-75% of the time	More than 75% of the time
Public Pension	1	3	2	2	8
All Others	1	5	1	2	0
Total	2	8	3	4	8

This emphasis on fiduciary duties, and the distinctive role of public pension plans in advocating for those duties, further complicates the traditional picture of private equity as an exemplary model of contractarianism[218] and private ordering by private actors.

V. POLICY IMPLICATIONS

With elite investor qualification standards and various other advantages, few would disagree with the idea that the private equity setting enjoys many advantages compared to other real-world environments that should (at least in theory) support effective bargaining. Yet notwithstanding these many advantages, significant problems seem to persist in this market. I consider policy and theory implications below.

A. Skepticism of Formalism

This Article's most basic 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 across the broader spectrum of real-world contracting settings.

For example, as discussed above, Delaware's extremely permissive approach to contractual flexibility in alternative entities and (to a lesser extent) corporations has long found support in

217. Note that the total respondents are twenty-five and not twenty-six because one of the respondents that indicated restoring fiduciary duties as a top negotiating priority did not respond to this question.

218. *See supra* Section II.B.3.

formalistic models of bargaining.[219] But in most LLCs and limited partnerships, the parties are not subject to rigorous investor qualification standards, and they often have far less experience than institutional investors in private equity funds—particularly in small businesses and start-up environments.[220] Even when the primary investors in an LLC or limited partnership are institutional investors, one still needs to ask whether conflicts of interest are compromising the bargaining practices of those investors,[221] and whether there are constraints on information flows or other process issues[222] that are preventing them from bargaining effectively. The private equity fund market illustrates the fact that there are many issues in addition to lack of sophistication that can lead to suboptimal contract terms and processes.

The implications for widely held corporations are arguably even more problematic. Due to collective action problems[223] and other issues[224] in widely held companies, the corporation is typically viewed as less conducive to careful contracting than the typical private equity fund. Yet there has nevertheless been a steady march towards increasing contractarianism in widely held corporations over the years,[225] putting increasing pressure on the assumption that corporate shareholders are engaging in effective bargaining over charter and bylaw terms. Yet many of the same institutions that apparently have struggled to bargain for optimal terms in the private equity fund market are also large investors in publicly traded corporations. If extensive bargaining problems have persisted in a high-end market like private equity funds, why should we expect better outcomes in widely held corporations?

Moving further downstream, it only seems reasonable to conclude that if the parties in a high-end, sophisticated market like private equity struggle to achieve optimal contracting outcomes, then

219. *See supra* Section I.B.

220. *See supra* note 36 and accompanying text.

221. *See supra* Section III.D.7.

222. *See supra* Section III.B.3.

223. *See, e.g.*, ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (describing how the wide dispersal of shareholders in corporations led to collective action problems and apathy that made shareholder monitoring of managers ineffective); Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 463 (1986) (arguing that "there is too little monitoring and takeover activity" because large shareholders only internalize gains to their own shares).

224. *See, e.g.*, Albert H. Choi & Geeyoung Min, *Contractarian Theory and Unilateral Bylaw Amendments*, 104 IOWA L. REV. 1 (2018) (identifying various reasons why corporate shareholders are more vulnerable to opportunism than parties to more typical contracts).

225. *See supra* Section I.B.

there must be little hope for retail markets that are primarily filled with unsophisticated consumers. Yet this conclusion requires some important caveats. As noted above, scholars have argued that optimal terms can be accomplished in retail markets where sellers prepare standard form contracts (even when a large percentage of consumers are unsophisticated) so long as there is a minority of active, sophisticated consumers.[226] This line of reasoning has been used to support policies favoring strict enforcement of contracts and a narrow use of the unconscionability doctrine.[227] The dynamics influencing the optimality of terms in a consumer market with true standard form contracts are thus different than the dynamics in the market for private equity fund contracts. Accordingly, while it would be too sweeping to conclude that there must be problems in retail consumer markets because bargaining problems exist in private equity funds, this Article's findings do provide a striking illustration of the fact that bargaining cannot simply be assumed to produce optimal outcomes in real-world environments. Skepticism of formalist assumptions about consumer contracts, in a general sense, may be warranted.

These questions are important not just for scholars' consideration, but also for legislatures, regulators, and judges 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.[228] 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.[229]

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226. *See supra* note 53 and accompanying text.

227. *See supra* note 4 and accompanying text.

228. *See* Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11, 17 (Robert W. Hillman & Mark J. Loewenstein eds., 2015) ("[D]espite decades of effort, the corporate bar has yet to propose, much less achieve, an all-encompassing statute that obviates the need for fiduciary duties.").

229. *See, e.g.*, Dieckman v. Regency GP LP, 155 A.3d 358, 367–69 (Del. 2017) (finding that even though a partnership agreement had waived fiduciary duties, it was implied pursuant to the covenant of good faith and fair dealing that the general partner would not mislead investors in seeking investor approvals for a merger transaction).

B. The Public-Private Securities Law Divide

These high-end bargaining problems also have important implications for securities law specifically. As discussed above, the federal securities law regime has historically been a binary system.[230] Publicly traded companies are required to 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 has traditionally been almost entirely unregulated. Implicitly, federal securities law has long embraced the idea that if the parties to a transaction are sophisticated, they will bargain for effective terms and agree on effective transaction processes without assistance from a regulator.

In recent years, many scholars have argued for increased interventions in the realm of large private operating companies, on the basis that the scale and scope of these companies' operations creates significant risks that can harm a multitude of stakeholders.[231] Various scandals in the "unicorn" context in recent years have been held out as supporting evidence of this need for greater oversight.[232] The SEC has been sympathetic to these arguments and appears to be preparing new rules to require private companies to disclose more information about their finances and operations.[233]

The private equity fund industry provides additional supporting evidence for the idea that even when most of the investors in a market are sophisticated, experienced players, that market can still suffer from transparency[234] and process inefficiency[235] problems. In fact, not long after the SEC first uncovered these problems in the mid-2010s, state treasurers across the country responded by writing a jointly signed letter to the SEC requesting that the Agency use its authority to require

230. *See supra* Section I.C.

231. *See supra* note 37 and accompanying text.

232. *See, e.g.*, *Theranos and Elizabeth Holmes: History of the WSJ Investigation*, WALL ST. J. (Aug. 24, 2021, 10:25 AM), https://www.wsj.com/articles/theranos-and-elizabeth-holmes-history-of-the-wsj-investigation-11629815129 [https://perma.cc/A4G6-8C38]; Georgia Wells, *Arianna Huffington Leads Crusade to Deal with Uber's Scandals*, WALL ST. J., https://www.wsj.com/articles/arianna-huffington-leads-crusade-to-deal-with-ubers-scandals-1491384615 (last updated Apr. 5, 2017, 10:29 AM) [https://perma.cc/6ACB-FS7J]; Heather Somerville & Rolfe Winkler, *WeWork, Juul Show Downsides of Silicon Valley Success Formula*, WALL ST. J. (Sept. 27, 2019, 5:30 AM), https://www.wsj.com/articles/ceo-exits-at-juul-and-wework-show-pitfalls-of-torrid-growth-11569576601 [https://perma.cc/N3ML-2A7C].

233. *See* Kiernan, *supra* note 80.

234. *See supra* Sections III.B.3 (discussing the nondisclosure provisions that prevent fund information being shared with outside parties) and IV.B.1 (noting that side letters are generally only shared with fund investors who have MFN protections).

235. *See supra* Section III.B.1.

greater disclosure of private equity fees and expenses to the public pension plans in their jurisdiction.[236] When the SEC did not 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.[237] Those state laws had a mixed impact on the market,[238] but they clearly illustrate the fact that many market participants and commentators felt that the private market was not producing sufficient disclosures on its own. Over the years, the trade association for institutional investors in private equity funds has repeatedly argued that more federal government intervention in the form of required disclosures and basic processes would be beneficial to the market.[239]

The private equity fund industry thus contributes a remarkable chapter to the broader story of the nation's private capital markets over the past decade. Even though private equity investors are subject to more stringent investor qualification requirements than any other corner of the market, questionable industry practices led policymakers to conclude that a dedicated government watchdog was needed to sniff out fraud and other bad actions. Moreover, notwithstanding the sustained, active presence of this examination unit over the course of many years, policymakers believe that troublesome problems have nevertheless persisted in this high-end market.[240] If the SEC's assessments of the industry over the years are accurate reflections of

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236. *See* Timothy W. Martin, *States, Cities to Ask SEC to Beef up Disclosures for Private-Equity Firms*, WALL ST. J. (July 21, 2015, 7:50 PM), https://www.wsj.com/articles/states-cities-to-ask-sec-to-beef-up-disclosures-for-private-equity-firms-1437522627 [https://perma.cc/CW2P-QU7A] ("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.").

237. *See* Clayton, *supra* note 186, at 298–99.

238. *See generally* Clayton, *supra* note 186, at 330–31.

239. *See, e.g.*, Letter from Steve Nelson, Chief Exec. Officer, Institutional Ltd. Partners Ass'n, to Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n (Apr. 21, 2021), https://ilpa.org/wp-content/uploads/2021/04/2021.4.20-ILPA-Welcome-Letter-to-Chairman-Gensler-Final.pdf [https://perma.cc/MHA6-83UP] (noting that under current SEC regulations, investors fail to receive adequate transparency and seeking 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); Letter from Steve Nelson, Chief Exec. Officer, Institutional Ltd. Partners Ass'n, and Member Signatories to Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n (Oct. 26, 2021), https://ilpa.org/wp-content/uploads/2021/10/26.10.21_ILPA-Member-Letter-to-SEC-on-Fee-Transparency.pdf [https://perma.cc/7DJZ-S5MS] (similar).

240. *See* Feb. 2022 SEC Rule Proposal, *supra* note 24, at 213 ("Without Commission action, private funds and private fund advisers would have limited abilities and incentives to implement effective reform.").

market reality,[241] they serve as a cautionary tale for the rest of the private placement marketplace more broadly.

C. Implications for the Private Equity Industry

The policy implications considered above are relevant to the broader marketplace beyond private equity. But the private equity industry is also an important area of study unto itself. As noted above, public pension plans are substantial investors in this multi-trillion dollar market, so bargaining problems here can have a substantial impact on the financial well-being of public servants and taxpayers across the country.[242] Moreover, in recent years, there has also been a significant push towards making private equity available to a larger share of retail investors.[243] The SEC's Asset Management Advisory Committee,[244] former SEC chair Jay Clayton,[245] and prominent commentators[246] have expressed desires to give ordinary investors expanded access to private investment opportunities, and steps have

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241. While the SEC should be well positioned (compared to outside commenters) to observe and understand industry practices because of its examination authority, some have expressed skepticism as to the seriousness of the concerns raised by the SEC. *See, e.g.*, Matt Levine, Opinion, *SEC Finds that Blackstone Charged Too Many Fees*, BLOOMBERG (Oct. 7, 2015, 3:46 PM), https://www.bloomberg.com/opinion/articles/2015-10-07/sec-finds-that-blackstone-charged-too-many-fees [https://perma.cc/L9B9-4L6J] (questioning whether the problematic practices identified in an SEC enforcement action against Blackstone actually constituted fraud).

242. *See supra* note 184 and accompanying text.

243. 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 supra* notes 95–98 and accompanying text.

244. *See* ASSET MGMT. ADVISORY COMM., U.S. SEC. & EXCH. COMM'N, FINAL REPORT AND RECOMMENDATIONS FOR PRIVATE INVESTMENTS (Sept. 2021), https://www.sec.gov/files/final-recommendations-and-report-private-investments-subcommittee-092721.pdf [https://perma.cc/M8WT-X5HD].

245. *See, e.g.*, Dave Michaels, *SEC Chairman Wants to Let More Main Street Investors in on Private Deals*, WALL ST. J. (Aug. 30, 2018, 4:54 PM), https://www.wsj.com/articles/sec-chairman-wants-to-let-more-main-street-investors-in-on-private-deals-1535648208 [https://perma.cc/2M65-W4BN] ("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, Chair, 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 [https://perma.cc/VBR3-H2KY] (full transcript of Clayton's remarks).

246. *See, e.g.*, COMM. ON CAPITAL MKTS. REGUL, *supra* note 96, at 1:

> 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 ("DOL") reforms to facilitate the ability of 401(k) plans to invest in private equity funds.

been taken to make that possible through indirect channels.[247] Private equity funds thus have a very public impact, notwithstanding their private status under the federal securities laws.[248]

As discussed above,[249] the SEC's approach to private equity has undergone an extraordinary evolution in a short period of time. As recently as twelve years ago, private equity funds operated almost entirely off the SEC's radar, but the SEC's influence has grown as the agency has learned more about how the industry operates. The SEC is now on the brink of adopting changes that would transform the way the industry is regulated, marking a significant step towards blurring the distinctions between private and public markets.

The February 2022 Proposal would, among other things, do the following:

- Require that all registered private equity managers deliver quarterly statements setting forth detailed information about fund performance, fees, and expenses to investors;[250]
- Require that all registered private equity managers obtain an annual audit for each fund that they manage;[251]
- Prohibit private fund managers (including unregistered managers) from engaging in a list of common activities and practices that the SEC views as contrary to the public interest;[252] and
- Prohibit all private fund managers (including unregistered managers) from providing certain forms of preferential treatment.[253]

247. *See, e.g.*, Edmund Lee, *401(k) Plans Move a Step Closer to Pooling with Private Equity*, N.Y. TIMES (June 3, 2020), https://www.nytimes.com/2020/06/03/business/retirement/private-equity-regular-investors.html [https://perma.cc/6EDK-U83R]; Chris Cumming, *U.S. Labor Department Allows Private Equity in 401(k) Plans*, WALL ST. J. (June 3, 2020, 8:09 PM), https://www.wsj.com/articles/u-s-labor-department-allows-private-equity-in-401-k-plans-11591229396 [https://perma.cc/X4QE-4G87].

248. *Cf.* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 342 (2013) (proposing that the rigor of public company regulatory regimes depend on the societal footprint of the company).

249. *See supra* Section III.A.1.

250. Feb. 2022 SEC Rule Proposal, *supra* note 24 at 17-18.

251. *Id.* at 99–100.

252. *Id.* at 132–33.

253. *Id.* at 162–63.

These proposed changes have been met with criticism.[254] According to the strongest critics, including dissenting SEC Commissioner Hester Peirce, the notion of SEC intervention in this market is nonsensical because private fund investors can be assumed to use their resources and sophistication to make sound investment decisions and structure their investments effectively.[255] Commissioner Peirce's statement reflects a fundamental disagreement as to the existence of serious bargaining problems in this market. Unlike her colleagues, Commissioner Peirce seems to believe that the market is producing effective contracting outcomes, notwithstanding the industry's controversial history. Given this disagreement on basic questions about how bargaining is (and is not) working in private equity, disagreement on the proper policy approach should come as no surprise.

As the SEC steps into this uncharted territory, any future interventions should be calibrated to respond to the impediments to effective bargaining in private equity. Establishing clear theory that spells out what those impediments are and what is causing them is an important part of this exercise. Producing this theory, however, is challenging given the lack of publicly available information in this space, and Commissioner Peirce's statement shows there is disagreement on some of these fundamental facts at the highest policy level. This Article has provided a basic groundwork for thinking about the existence[256] and causes[257] of bargaining problems in private equity, but the need for continued scholarly contributions in this area has never been stronger.

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254. *See, e.g.*, Peirce, *supra* note 27; Editorial Board, *The SEC's Private Market Takeover*, WALL ST. J. (Mar. 15, 2022), https://www.wsj.com/articles/the-secs-private-market-takeover-gary-gensler-hester-peirce-11647375870?mod=opinion_lead_pos1 [https://perma.cc/GP6U-UWLL].

255. *See, e.g.*, Peirce, *supra* note 27:

> [T]he Commission judges it wise to divert resources from the protection of retail investors to safeguard these wealthy investors who are represented by sophisticated, experienced investment professionals. I disagree with both assessments; these well-heeled, well-represented investors are able to fend for themselves, and our resources are better spent on retail investor protection. . . . [T]he proposal's focus on protecting private fund investors by shaking information loose from what *we* deem to be uncommunicative private funds and shutting down practices *we* deem to be unfair is a departure from the Commission's historical view that these types of investors can fend for themselves.

256. *See supra* Sections III.A and III.B.

257. *See supra* Section III.D.

D. A Note About Net Returns

As a final note, this Article is not necessarily suggesting that institutional investors should avoid allocating significant amounts of capital to the private equity asset class. It could be the case that, notwithstanding the bargaining issues described in this Article, strong net returns from private equity have outweighed the negative effects of problematic terms and bargaining processes. There is a long-standing academic debate about the net returns to private equity investments and whether private equity outperforms public markets.[258] Regardless, given the likelihood that significant portions of the February 2022 Proposal will ultimately be adopted in the form of a final rule, the future operations of the private equity industry will almost certainly look very different than many of the historical practices described in this Article.

For this Article's purposes, it is enough to observe that private equity funds appear to have suffered from significant bargaining problems over the years, notwithstanding the various contracting advantages enjoyed by the parties in this high-end market.

CONCLUSION

Many important areas of the law place great confidence in the ability of contracting parties to bargain effectively. Yet a close look at one of the most elite contracting settings in the marketplace raises questions about whether optimal bargaining outcomes can simply be assumed in real-world settings. If optimal bargaining outcomes and processes are elusive in the private equity fund market and ongoing SEC intervention is necessary, greater skepticism of formalist assumptions about bargaining may be warranted not just within private equity, but across the market more broadly.

258. *See* MICHAEL CEMBALEST, J.P. MORGAN ASSET MGMT., FOOD FIGHT: AN UPDATE ON PRIVATE EQUITY PERFORMANCE VS PUBLIC EQUITY MARKETS 1 (June 2021), https://privatebank.jpmorgan.com/content/dam/jpm-wm-aem/global/pb/en/insights/eye-on-the-market/private-equity-food-fight.pdf [https://perma.cc/8USN-9FLC] ("[P]rivate equity is still outperforming public equity, but outperformance narrowed as all markets benefit from non-stop stimulus, and as private equity acquisition multiples rise."); Batt & Appelbaum, *supra* note 135, at 55–57 (providing an overview of various scholarly critiques of approaches to measuring performance in private equity funds).