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Navigating the Complexities of Private Equity Side Letters

How Misaligned Incentives Can Compromise Optimal Contracting

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Abstract:

Private equity contracting has always been an area of corporate contracting well hidden from the snooping eyes of the outside world, and largely overlooked by legal scholars compared to other areas of corporate law. The participants of private equity are some of the most sophisticated and resourceful when it comes to financial innovation and executing transactions. This would lead one to believe that the contracting taking place within private equity is characterized by unrivaled efficiency. This is, however, not the case, and the process is seemingly riddled with inefficiencies and risks for both investors and investment managers. A prime example, and the main focus of this thesis, are side letters – ancillary agreements whereby investors negotiate with investment managers for individual benefits deviating from the general terms granted to all investors in the constitutional agreements of a private equity fund.

This thesis sets out to examine the phenomena of side letters in private equity funds in more detail. In doing so, this thesis aims to demonstrate what exactly side letters are, the current nature and extent of their risks and inefficiencies, the contributing factors behind their inception and evolution into what they are today, as well as provide some alternatives for correcting the current market practices.

In addition to examining the legal framework and general contract law principles applicable to side letters in the U.S. and the EU, with some specific viewpoints from the Nordic and Finnish jurisdictions, the thesis analyses side letters from the perspective of some modern theories on contracting, rather than contract law. The main ones utilized here are Proactive Law, Contract Modularity and Transaction Cost Economics. Apart from a strict legal dogmatic study, this thesis takes a more practical approach by not only assessing whether side letters can, but also whether and to what extent they should, be used to achieve the goal they set out to do.

Side letters are surprisingly unique contracts, with their structure and position within a private equity deal exhibiting a form of complexity that at times creates ambiguities as to their validity, both in terms of individual terms and the side letter as a whole. Their status as modular and ancillary agreements risks resulting in uncertainties as to their interpretation or binding force. The bigger problem, perhaps, lies with the inefficiencies they create in terms of additional costs, time and resources spent to negotiate and uphold them. Together, these aspects make one question the reason behind such a seemingly problematic practice taking root in the first place.

The reason behind the current practice seems to be a set of misaligned incentives for investors and investment managers alike, upholding the current market practice despite going against the best interest of both parties and the market overall. As it turns out, the specific governance structure within private equity funds creates the perfect breeding ground for the parties to contract inefficiently. The current market environment has long been tilted towards investment managers, which has given rise to several incentives for them to uphold the status quo. Additionally, as shown in the thesis, investors are likewise subject to problematic incentives upholding the current practice. Investors collectively also currently have a hard time taking any meaningful action in correcting the unfavorable environment, due to the existence of the prisoner's dilemma deterring them from utilizing their collective power to enact change.

The thesis encourages investment managers and investors to review their own practices, look past the misaligned incentives and take action in correcting the market environment in favor of the whole industry. This can be achieved by, for example, shortening and simplifying side letters, and transferring much of their current content to the rest of a private equity fund's constitutional documents, as well as developing sound reporting and disclosure practices. The thesis also makes the case as to why a successful implementation of efficient contracting processes can create competitive advantages for the first movers adopting the various suggestions and strategies presented herein.

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Figures

Table of Cases

United States

United Kingdom

Australia

Abbreviations

Advisers Act	The Investment Advisers Act of 1940, 54 STAT. 789, 847, 15 U.S.C. § 80b-1
AIF	Alternative Investment Fund
AIFMD	Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers
AIFMR	Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision
AIMA	Alternative Investment Management Association
AUM	Assets under Management
DCFR	Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference. Outline Edition, Munich 2009
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 203, U.S. Statutes at Large 124 (2010): 1376-2223
EEA	The European Economic Area
ESMA	European Securities and Markets Authority
EU	European Union
FSA	Financial Supervisory Authority
IACCM	International Association for Contract and Commercial Management
ILPA	Institutional Limited Partners Association
IPO	Initial Public Offering
LPA	Limited Partnership Agreement
LBO	Leveraged Buyout
Member State	Member state of the European Union
MFN	Most Favored Nation clause
NCA	National Competent Authority
NDA	Non-Disclosure Agreement
PE	Private Equity
PECL	Principles of European Contract Law
PICC	UNIDROIT Principles of International Commercial Contracts
SEC	The U.S. Securities and Exchange Commission
UCITS	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and

	administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
U.S.	The United States of America

1. Introduction

1.1 Background and Purpose

When being tasked with describing the world's financial markets, more likely than not, the *public* stock exchanges quickly become the focal point of such a description. Consequently, however, the *private* markets are often disregarded, despite playing a substantial role in many major economies.[1] At the forefront of the private markets is private equity, an area of finance where highly sophisticated investors and investment managers negotiate and transact with private companies, an opportunity often not awarded to smaller and less sophisticated parties. Despite the impact private equity has globally, the precise dealings taking place between investors and investment managers have been largely kept hidden from outside eyes, shrouding the whole industry in a veil of secrecy.[2]

Its obscurity towards the mainstream world aside, the private equity industry is home to some of the most advanced financial strategies, and the parties involved are seen as seasoned veterans in the field of contracting. One would imagine such a setting resulting in a climate of unrivaled efficiency, and the value of each transaction being pushed to its limits, but despite the supposedly high level of expertise and sophistication, the area of private equity contracting is filled with apparent issues and obstacles that make the current contracting process seem messy and inefficient.[3] One such inefficiency can be attributed to side letters – ancillary agreements in the private equity contracting process wherein individual investors negotiate for individual benefits deviating from the general terms granted to all investors in the constitutional agreements of a private equity fund. Originally entered into between individual investors and an investment manager to satisfy specific regulatory or tax requirements for certain groups of investors, such as pension plans, insurance companies or sovereign wealth funds, side letters today are long and complex agreements that, apart from the above-described terms also contain much more problematic terms, both from a regulatory and efficiency standpoint.[4]

The U.S. is seen as the birthplace of private equity, along with many other financial innovations, one of them being side letters. The financial markets in the U.S. are also the largest and most advanced globally, which logically would correspond with them having the best and most

[1] See, for example, Invest Europe 2023 for an overview of the role private equity plays in Europe.
[2] de Fontenay – Nili 2023, p. 3.
[3] Clayton 2022a, p. 706–707.
[4] Clayton 2020, p. 105; Jeffers – Tucker 2022, p. 18.

efficient contracting processes.[5] This is also the reason why the U.S. market practice surrounding contracting has been adopted globally, and why much of the practice regarding private equity contracting in Finland originates from the U.S.[6] One purpose of this thesis is to display why side letters in their current form are risky and inefficient, which could lead one to question the accuracy of the statement above regarding the level of advancement of the U.S. financial innovations and the global adoption of U.S. innovations in contracting.

1.2 Main Research Questions

This thesis is focused on private equity contracting, and more specifically the many intricacies and complexities that make this area so unique, but not necessarily in a positive sense, however. The intricacies of private equity contracting have gone largely unnoticed by legal researchers due to the secrecy surrounding it.[7] This is until the U.S. SEC took a stand on its view of the issues of engaging in preferential treatment through side letters in its proposal to amend the current rules applicable to private equity in early 2022:

> *"Advisers frequently grant preferred terms to certain investors that often are not attainable for smaller institutional investors or individual investors. In some cases, these terms materially disadvantage other investors in the private fund. This lack of transparency regarding […] preferential terms causes an information imbalance between advisers and private fund investors, which, in many cases, prevents private bilateral negotiations from effectively remedying shortcomings in the private funds market."*[8]

In the EU, the legal framework applicable to alternative investment funds, to which also private equity funds belong, already set out restrictions on preferential treatment and the use of side letters.[9] Considering the current and proposed legal framework in the EU and U.S. respectively, a question arises as to what function side letters should have in private equity, and whether an essentially similar market practice regarding side letters currently in both the U.S. and the EU is the correct approach, considering the differences in regulatory regimes.

[5] Taskinen 2002, p. 10.
[6] Ibid., p. 19–20.
[7] Clayton 2022b, p. 14–15.
[8] SEC Proposed Rule 2022, p. 11.
[9] Mainly Directive 2011/61/ EU (the "AIFMD") and Regulation (EU) No 231/2013 (the "AIFMR").

A key goal of this thesis, however, is to look further than purely a regulatory analysis, such as whether side letters, in reality, *can* be used for their intended purpose and what the current constraints on their usage are. Instead, a focal point of this thesis is the question as to whether and to what extent side letters *should* be used, considering the issues associated with them and weighing such issues against their potential benefits. In achieving that end, this thesis aims to shed further light on the issue by answering the following research questions:

I. What are the scope and rules applicable to side letters in the EU and the U.S.?
II. What makes side letters and the private equity governance structure so problematic, and what are the current risks and inefficiencies present in side letters?
III. What are the reasons behind the current problems in the side letter practice, and how can they be remedied?

Together, these questions aim to provide an overarching view of most aspects regarding the complexity of side letters. As will be shown, the third question has a lot to do with a set of currently misaligned incentives for the parties active in the private equity industry, causing them to act contrary to their, as well as the collective industry's best interests at times. Currently, side letters risk causing substantial administrative burdens, legal uncertainties and misaligned incentives that could dampen the value created in the private equity industry.

Even though partially overlapping, the research questions herein are broad, which makes certain exclusions from the scope of this thesis necessary. First, so-called retail investors are excluded, as is the additional legal framework on investor protection specifically designed to protect them. Second, other legal investment structures than the limited partnership presented in Chapter 3.2.1 are excluded from the scope of this thesis, as the limited partnership, and its various national variations, is the main vehicle through which private equity operates globally, including in Finland.[10] Third, individualized investing, such as co-investing or investing through separate accounts, although themselves prone to issues, are excluded.[11] Forth, as we are mostly interested in the contractual relationship between investors and their investment manager, any dealings between a private equity fund and the companies in which it invests, so-called portfolio companies, are outside the scope of this thesis. Additional scope limitations are, to the extent necessary, made in the text below.

[10] Taskinen 2002, p. 7, 12–13.
[11] The issues regarding co-investing and separate accounts are to a large extent the same as the ones presented herein, but as they are nonetheless a different form of investing, they are excluded from the scope of this thesis. For a description on these types of investing, see generally Clayton 2020. Co-investing is to some extent discussed in this thesis, but then only as form of benefit received by an investor for investing in a private equity fund.

1.3 Methodology and Source Material

In order to properly answer the chosen research questions, the regulatory scope within which side letters can operate needs to be assessed. For that, the legal dogmatic method is used to determine the content and structure of the currently applicable regulatory framework. The legal dogmatic method, being the most frequently used method within legal research, aims to provide legal clarity to a question by interpreting and systematizing applicable law.[12] By studying the law applicable to side letters from such a *de lege lata* point of view, an outer boundary as to what is currently possible can be established. Particularly due to the new rules proposed by the SEC, but also because this thesis aims to take a practical approach to the issues with side letters, a critical *de lege ferenda* view on how the current legal framework ought to look is also utilized.

In addition to merely assessing side letters from the regulatory viewpoint of the EU or Finland, much inspiration and material is utilized from the birthplace of both private equity and side letters – the U.S. By drawing certain parallels between the regulatory frameworks in the EU and U.S., a form of comparative law analysis is utilized in search of specific similarities and differences between their legal systems.[13] Besides simply comparing the two legal frameworks against one another, a comparative law analysis can also serve as a tool to assess which one more successfully achieves its intended purpose and the more subtle differences in the reasoning behind a specific legal rule.[14] This thesis does not, however, actively compare the U.S and EU legal systems, something that is normally required for a strict comparative analysis, but rather utilizes their respective view on side letters to support the discussion as to what can be seen as reasonable from a regulatory perspective, and what could be achieved more efficiently by other means.[15] Further, as much of the discussion on side letters herein is based on a risk- and efficiency assessment, rather than a strict legal analysis, the references to the law of foreign jurisdictions, including any references to foreign court decisions, should be seen as highlighting a potential risk, and not a reference to final and applicable law.[16]

By focusing on the various contractual risks and burdens caused by side letters, rather than any particular legal rule, this thesis in many instances deals with contracts rather than contract law, and more on how contracts work in practice rather than in theory.[17] As such, this thesis has a

[12] Aarnio 1997, s. 36–37; Hirvonen 2011, p. 21–22.
[13] Bogdan 1994, p. 21.
[14] Ibid., p. 22.
[15] See Norrgård 2002, p. 29–30.
[16] Ibid., p. 30.
[17] Haapio 2013, p. 6.

practical connotation and does not explicitly intend to further any legal theory on contracts, but instead apply some available theories and put them to the test in a practical manner. By doing so, and particularly by incorporating the ideas of Proactive Law, this thesis is not only better equipped to assess the current effectiveness of side letters, but also to identify possible areas of improvement and incentives to strive for change.

Besides the rules required to assess the legal scope of side letters, legal literature is the greatest source of material for this thesis. Case law is, although very restrictively, used to emphasize specific issues, and merely intended to work as a support to the argumentation. Due to the secrecy surrounding private equity contracting, the amount of legal literature discussing the role of side letters has been severely limited, until the SEC released the proposed rules last year. Consequently, the interest in side letters has increased remarkably in the last year.[18] This is also the reason why a large portion of the literary sources herein are written from a U.S. point of view. Bearing the specific comparative component of this thesis in mind, however, this provides an ample opportunity to analyze the suitability of side letters in light of some specificities to the Finnish, and in extension the Nordic, legal systems.[19] Such an analysis can help assess whether side letters really are able to fulfill their true potential outside the U.S., considering the differences in the legal system compared to, for example, the EU and Finland.

1.4 Research Structure

The thesis is structured as follows. Chapter 2 lays out the foundation of the relevant theories on contract law. Chapter 3 seeks to explain the structure of private equity, the relevant contracts as well as the general legal frameworks applicable to side letters in the EU and the U.S. In essence, this chapter provides an answer to the first research question in regard to the regulatory scope applicable to side letters, as well as the first part of the second research question on the problematic governance structure of private equity. Chapter 4 is dedicated to highlighting many of the risks and inefficiencies currently existing in the use of side letters, while Chapter 5 takes a closer look at the reasons behind private equity's problematic governance structure and the misaligned incentives of the parties involved. Chapter 6 summarizes the main findings in this thesis and provides suggestions for further action.

[18] For example, de Fontenay – Nili 2023, Jeffers – Tucker 2022, Clayton 2022a, as well as the various comments and responses to the SEC Proposed Rule 2022.
[19] The Finnish legal system is heavily influenced by EU legislation, whereby also EU legislation is of importance.

2. The Modernization of Contract Law

2.1 The Basics of Contract Law and Contracting

In classic legal research, contracts are seen as legal instruments used by lawyers to establish rights, enforce those rights, if necessary, as well as to seek remedies for broken promises.[20] This purely legal and protective view of contracts is somewhat surprising, as one of the main objectives of contracts in practice is something completely different. Contracts today are undoubtedly one of the largest value creators, or at least value enablers, globally.[21] Contracts enable the efficient exchange of, for example, goods, services, capital and information so vital for today's free market and creating value exceeding the sum of their parts – resulting in an instance where *one plus one equals three*. This is made possible due to differences in value perception and division of labor for the parties to the exchange.[22] Take the instance of an investor for example – it does not have the same capacity and expertise to manage its capital as efficiently as a professional investment manager and is thus willing to hand over its capital to be managed by a professional. The investment manager in turn receives a fee for services rendered, resulting in a situation whereby all parties to the exchange normally are satisfied with the terms of the exchange.[23] This opportunity for mutual value creation ought to be the main objective when creating the laws and principles applicable to the creation, interpretation and enforcement of contracts, or simply, *contract law*.

The consensus on what a contract is and what general principles apply to them are fairly universal. Still, the more specific provisions of contract law are divided between two main legal systems – *civil law* and *common law*.[24] Civil law refers to a legal system based on historic roman law originating in mainland Europe and adopted in large parts of the world today.[25] A classic feature of civil law jurisprudence is the existence of a codified set of rules laying out the central components of the legal system.[26] Common law, in turn, is a legal system developed in England

[20] Haapio 2013, p. 27–28.
[21] For the sake of clarity, the term "value" here refers to monetary means of value, such as increased profits, lower costs, but also less obvious sources of value, such as a decrease in risk. This definition coincides closely with the commercial nature of this thesis. This is, however, not to say that value creation could not also refer to social or environmental goals, such as combating poverty, climate change or social inequalities.
[22] Farnsworth 2012, p. 905.
[23] The satisfaction of both parties is of course subject to the actual terms applicable and the parties' perception of their fairness, but parties willing to enter into such an exchange are usually satisfied with the terms, since they have the ability to choose whether to enter into a contract or not.
[24] See, for example Farnsworth 2012, p. 901–902, Kötz 2019, p. 907 and Zimmerman 1990, p. xi.
[25] Zimmerman 1990, p. 24–25.
[26] Kötz 2019, p. 907. In many civil law jurisdictions, this set of rules is codified in what is referred to as a *civil code*, in essence regulating all matters relating to private law.

and based largely on a set of judge-made laws laid out by the courts over time. A common law system is applied primarily in the U.S. and the major jurisdictions within the Commonwealth.[27] In Nordic legal literature, scholars have often referred to the Nordic legal system as its own, separate legal system as a variation of civil law.[28] Particularly within the area of contract law, the Nordics have developed a largely homogenous framework, however heavily influenced in particular by the German legal tradition.[29] But even as the Nordic countries, collectively and individually, exhibit certain differences from the "classic" form of civil law, they are nonetheless part of the EU/EEA and today share many similarities with the rest of the EU.[30] Indeed, especially commercial law, to which the law regarding financial markets so central to this thesis belongs, is to a large extent similar across the board within the EU.[31]

Separate from the division of various legal systems, important steps have also been taken in creating uniform, albeit non-binding, rules of contract law in Europe through the *Principles of European Contract Law* (*PECL*) and the *Draft Common Frame of Reference* (*DCFR*), as well as globally in the *UNIDROIT Principles of International Commercial Contracts* (*PICC*).[32]

Despite differences in their main source of legal rules, civil- and common law have one important thing in common when it comes to contract law – The will of the parties to a contract, and their ability to state that will, is of utmost importance, and contract law should not unnecessarily interfere with that principle. As such, much of today's contract law rules are non-mandatory, and applied in courts only when a matter is left silent by the parties. The global starting point for creating these contract rules and principles is therefore an assessment of what a rational and reasonable party to a contract would deem appropriate. This leads to general principles of contract law having a rather universally applicable nature.[33]

[27] Garner 1995, p. 177. Some of the major jurisdictions following the common law tradition today are the U.S., UK and Australia, with Canada and India applying a certain mix between the common- and civil law systems.
[28] Letto-Vanamo 2018, p. 24; Bärlund – Nybergh – Petrell 2013, p. 37. As the reliance on individual and unique legal theories between the various legal systems in this thesis is limited, and the fact that the civil and Nordic legal systems share considerable similarities, they will henceforth both be seen as included when referring to civil law, unless otherwise specifically stated.
[29] Bärlund – Nybergh – Petrell 2013, p. 38.
[30] Letto-Vanamo 2018, p. 26.
[31] Bärlund – Nybergh – Petrell 2013, p. 39–40.
[32] Even though not mandatory, they can provide valuable guidance to individual parties and courts as well as a starting point for further development within *International Contract Law*, see, for example, Kötz 2019, p. 906. Due to their non-mandatory nature, however, they will not be analyzed in further detail in this thesis.
[33] Kötz 2019, p. 904. Even though there might be instances where the specificities of contract law differ from one jurisdiction to another, especially in terms of more specific, material rules, the general principles on which this thesis focuses are to a large extent considered universally applicable.

The chapter is structured as follows: Chapter 2.2 presents some general principles of what is often called *traditional contract law*, that lays out the foundation for the possibility to contract effectively to begin with.[34] These principles of traditional contract law, however, are not on their own always sufficient to serve the parties' contracting needs in optimizing value, which is why finding new ways to view contracts has been necessary. In keeping with the spirit of the ever-evolving area of contracts, Chapters 2.3–2.5 deal with some specific theories on contracts striving towards creating better, more efficient, contracts, such as the theory of Proactive Law, Transaction Cost Economics Theory and the somewhat more practically focused idea of Contract Modularity. These ideas and theories will provide useful tools for assessing side letters and the risks and inefficiencies involved with their usage further along in the thesis.

2.2 The Traditional View on Contracts and the Road to Modernization

"[I]t is the province of the law of obligations to draw the future into the present."[35]

This one sentence, in essence, encapsulates the whole premise of a contract – establishing certain predictability surrounding promises of future performance. The parties to a contract must be able to reasonably predict the outcome of entering into a contract, in order for contracts to be able to fulfill their function as value creation tools. One way of ensuring this is to give the parties free rein to mutually agree on the terms of a contract without outside intervention, and for the law only to provide the framework to ensure that the parties' intentions and expectations as they are formulated in a contract can be legally enforced.[36] The traditional contract law adheres to this need for the parties to foresee the outcome of their contractual relations by asserting the *freedom of contract* as one of its central legal principles – a right to freely enter into contracts, or to choose not to, as well as on what terms and with whom, all with minimal outside intervention.[37] This principle is strongly linked to the idea that the parties are the ones determining the contents of the contract and thus setting out the norms applicable to them, also

[34] See note 2 in Macneil 1978, p. 855. Traditional contract law is, according to Macneil, a combination of on the one hand classical contract law, developed mainly in *The Law of Contracts* by Samuel Williston in 1920 and in the *Restatement of Contracts*, a massively important U.S. legal treatise originally from 1932 (the currently used version was adopted in 1981) by the American Law Institute, and on the other hand neoclassical contract law, building upon and modifying the classic contract law exemplified by the work of Arthur Corbin, Karl Llewellyn and the Uniform Commercial Code in the U.S. See also note 81 in Macneil 1981, p. 1050.
[35] Kohler 1914, p. 135.
[36] The legal enforcement aspect of a contract, however, should not be understated, as it is considered the single most valuable functionality of a contract and one of the main reasons why contracts have been able to develop into the value generators they are today.
[37] See, for example Peel 2015, Chapter 1 p. 5–8 or Parisi 1994, p. 213–216.

called *private ordering* or *party autonomy*.[38] The idea was, in other words, that contract law would only be concerned with the contracting process, as a fair and equitable contracting process would also lead to fair terms in the final contract.[39] Corporate law in many ways embodies this idea, in that corporate counterparties should not need to be unduly concerned with regulation, as they should be able to agree on their own law through contracts.[40]

The freedom to contract is dependent on the parties de facto being able to achieve a contract in a form acceptable to them. For this to be possible, there has to exist a sense of *bilateral power* between them when entering into a contract.[41] Traditional contract law assumes this existence of bilateral power, as it deems market actors as rational, self-interested beings, always trying to maximize their value and driving their own agenda.[42] As such, no rational party would be willing to give another party unilateral power over them without any form of reciprocation. Using the example of investors earlier, no rational investor would be willing to provide their capital to an investment manager without them having a duty to professionally manage said capital (however successfully), and conversely, no investment manager would accept to manage an investor's capital for free. Delving deeper into the principle of freedom of contract is the assumption of equal standing of the parties to a contract. This idea is enshrined, for example, in the doctrine of *caveat emptor*, translated into English roughly as "buyer beware", in essence stating that a party to a contract has no duty to disclose unfavorable information surrounding the terms of the contract. This doctrine assumes that the parties to a contract are equal, and have equal opportunities to see to their needs and in turn secure sufficient information.[43]

However, such an individualistic view of the parties' ability to provide themselves with necessary information is by no means the norm, and is in reality often the cause of great concern for achieving value maximization between the parties. First and foremost, it is easy to see why such a view of the parties' mutual relationship quickly can be questioned in instances where

[38] Parisi 1994, p. 213; Farnsworth 2012, p. 918–919.
[39] Zimmermann 1990, p. 577.
[40] Easterbrook–Fischel 1989, p. 1417–1418.
[41] Bilateral power has been described as the willingness of the parties to give up some of their *unilateral power*, the power to assert certain obligations on another party without its consent, in order to fulfill an advantageous exchange, see Macneil 1981, p. 1036. A classic example could be that of a simple contract of sale – A seller is willing to give up its property rights towards the goods in exchange for the buyer giving up its property rights to a sum of money corresponding to the sale price of the goods. Perhaps somewhat interestingly, this brief moment of exchange through bilateral power results in a contract basically giving the buyer and the seller each a unilateral power towards each other in enforcing the terms of the contract, see Macneil 1981, p. 1050–1051. Based on this idea, bilateral power need only exist at the exact moment preceding the contract entering into force, making it a rather rare phenomenon to encounter naturally.
[42]Macneil 1981, p. 1021.
[43] Weinberger 1996, p. 390.

this relationship is, in fact, unbalanced.[44] Despite the obvious imbalances created by the size and available resources of the parties, an equally contributing factor is the parties' varying access to relevant information, especially in long-term relationships built on trust and mutual cooperation. For example, the principal-agent relationship is especially problematic, as it is often characterized by a large degree of information asymmetry – the agent has substantially better access to information regarding its operations than the principal. This leads to a possibility for the agent to act opportunistically without the principal even being aware of such opportunism.[45] The relationship between an investor and its investment manager is a prime example of a situation where there exists a very real possibility for such opportunism.[46] Worth noting is that information asymmetry may very well exist between equally powerful parties, and is not only affecting the entering into of a contract itself, but is often present throughout the entirety of such a relationship.

In Nordic jurisprudence, one solution to enhance mutual value maximization and to help alleviate the potential issues regarding information asymmetry is the *principle of loyalty* (in Finnish: *lojaalisuusperiaate*). Although not codified directly in Finnish law, it is a generally accepted principle due to its presence within Finnish jurisprudence.[47] The principle is deemed to instill a duty for one party to see to the other party's interests and rights, to an extent economically reasonable, and prevents one party to a contract from pushing its own agenda at the expense of another party.[48] In essence, it lays out the way in which largely equal parties should act toward each other.[49] This makes the principle of loyalty highly present within the private equity industry, where the majority of parties involved are seen as highly sophisticated often on a largely equal footing, except for the existence of major information imbalances.[50]

Another fundamental principle in Finland, with the purpose of creating reasonable and fair contracts, is the *principle of fairness* found in Section 36 of the Finnish Contracts Act.[51] It constitutes a general clause enabling adjustments of unfair contracts.[52] It enables the setting

[44] This problem will be dealt with in more detail in Chapter 5 below.
[45] Mähönen 2000, p. 11.
[46] The situation whereby an investor provides its capital to an investment manager to manage is a typical example of a principal-agent relationship, where the investment manager, as agent, is able to relatively freely act within the mandate it is given by the investor, the principal.
[47] Sund-Norrgård 2011, p. 59–60.
[48] Ramberg – Ramberg 2010, p. 37.
[49] Sund-Norrgård 2011, p. 69.
[50] Clayton 2022a, p. 706–707. Despite the likely presence of the duty of loyalty within private equity, it is not the main focus of this thesis, and thus not conclusively assessed herein. It could, however, prove an interesting path for further research within the area from a more purely Finnish or Nordic perspective.
[51] The Finnish Contracts Act 228/1929.
[52] Husa – Karhu 2019, p. 33.

aside of any term deemed unfair or if it would lead to an unfair result and, in determining what is unfair, considers all factors relevant to the contract.[53] The principle of fairness is considered *ordre public* in Finland, preventing the application of a foreign contract law not recognizing the possibility to adjust unfair contracts, and is applied to business- and consumer dealings alike.[54]

Returning to universal contract law, another fundamental principle relates to the binding force of a contract, or the idea of *pacta sunt servanda*, as a contract is next to useless if there is uncertainty as to its validity or possibility for enforcement. Legal scholars have gone so far as to conclude that *"the only universal consequence of the legally binding promise is that of the law making the promisor pay damages if the promised event does not come to pass."*[55] The central question here is then to what extent a promise should be enforceable. An enforceable promise can be defined as a consented future act of performance with a serious intention by an able party to be bound by that promise.[56] This definition makes up much of what constitutes the principle of a contract's binding force.[57]

An interesting addition to the requirements necessary to constitute a binding contract is the inclusion of the doctrine of *consideration* within common law jurisdictions. The doctrine originates from the idea that a promise can only be seen as valid, and as such legally enforceable, if it is given in view of a counterpromise or -performance by the receiving party, forming a *quid pro quo* exchange, unless the promise is specifically given in the form of a *deed*.[58] The specific scope and content of the doctrine of consideration vary somewhat depending on the specific jurisdiction, but they generally share the same basic characteristics described above. A similar requirement does not exist within contract law of civil law countries such as Finland.[59]

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[53] See Section 36 of the Ministry of Justice, Unofficial translation of the Finnish Contracts Act, whereby, for example, "*the contents of the contract, the positions of the parties, the circumstances prevailing at and after the conclusion of the contract, and […] other factors*" play a role in determining the unfairness of a term.
[54] Husa – Karhu 2019, p. 33.
[55] Holmes 1881, p. 301.
[56] See Zimmermann 1990, p. 559–560. Most parts of this definition will not be covered in further detail in this thesis, such as the giving of consent, the existence of intention and the validity of the party to express an enforceable promise. Instead, it is assumed that they are fulfilled when the parties have entered into a contract.
[57] Farnsworth 2012, p. 909.
[58] Kötz 2019, p. 910–911; Farnsworth 2012, p. 908–911; Zimmermann 1990, p. 504–506. In essence, a deed is a written legal instrument whereby a right, interest or property may be transferred without consideration. For a deed to be valid, it needs to make clear that it is intended to constitute a deed, and signed by the promisor in the presence of a witness able to attest to the promisor's signature, see Kötz 2019, note 34. For the purpose of this thesis it is sufficient to conclude that deeds are generally more formal than other types of contracts, and need to follow certain additional requirements to make them valid and enforceable.
[59] Sund-Norrgård 2022, p. 47.

At first glance, the idea behind the doctrine of consideration seems reasonable, and fully in line with the division of bilateral and universal power in the sense that a promise without any form of reciprocity is a gift to the promisee of universal power over the promisor, which any rational party would not be willing to do unless specifically given as a gift. Upon further inspection, however, the doctrine may quickly prove problematic and result in complicated, and sometimes unforeseen, outcomes.[60] One such situation is an instance whereby the parties choose to vary the obligations of a contract for one party, while the other party retains the same obligations as before. Here, the problem stems from the fact that such one-sided modifications are considered valid in certain instances, and invalid in others, making such contracts complicated to navigate at times.[61] Situations whereby one party gets additional performance from another party without any additional performance in return well describe the practice of providing side letters, since they are deals whereby certain investors are awarded with additional rights, whilst the rights of the investment manager are usually left as they were.

Although the doctrine of consideration in its entirety is far too complex and multifaceted to be assessed at length in this thesis, its mere existence and potential to cause issues regarding the validity of a side letter without proper consideration are sufficient to warrant a brief rundown of its potential risks in Chapter 4.2.3 below. Additionally, the overall complexity caused by the uncertainty surrounding the exact scope and content of the doctrine of consideration has led some to criticize and question the doctrine altogether.[62]

The doctrine of consideration is not the only part of the traditional contract law that has gotten its fair share of criticism over the years. Traditional contract law has been criticized for being too static, seeing a contract as a simple, one-time transaction completely cut off and separated from the rest of the world around it, and between parties unaffected by any relations between them both before and after the transaction has taken place.[63] This way of looking at contracts does not work in today's economic society, where ongoing cooperation with one's partners and clients as well as good relations and reputation are of vital importance.[64] Simply put, traditional contract law fails to appropriately consider the role of contracting in business relationships.[65]

[60] Zimmermann 1990, p. 505.
[61] See generally note 282 below in Chapter 4.2.3.
[62] See Zimmermann 1990, note 169; Chen-Wishart 2010, p. 89.
[63] See, for example, Macneil 1974b, p. 693; Goldberg 1976, p. 49. This type of transaction is what is called a *discrete transaction*, since it is assumed to take place in a vacuum, without any influences of the outside world.
[64] Macneil 1974b, p. 695; Kötz 2019, p. 905. *Modern Contract Law* is characterized by a larger focus on the cooperational relation created between the parties to a contract, and the fact that all contract norms should adhere to and consider this relational aspect. See, for example, the *Relational Contract Theory* developed by Ian Macneil and discussed in, for example, Macneil 1974a, 1974b, 1975, 1978, 1981 and Campbell 2004.
[65] Nystén-Haarala 2006, p. 2

As such, scholars have started to look past the traditional view of contracts as purely legally binding promises, in an attempt to explore the various other different roles that contracts can take on. One important role is that of enforcer, as well as value creator or value enabler, but contracts are also seen as effective tools for the promotion of business success, by managing risks and preventing problems.[66] This view on contracts is embodied in *Proactive Law*.

2.3 Taking a Preventive and Proactive Approach to Contracting

As the name suggests, Preventive Law strives towards a preventive, *ex ante* approach to contracting rather than the classical *ex post* mindset of the court-centered contract law largely described above.[67] In traditional contract law, all rules and principles are ultimately created for or by the courts in contractual disputes, making the parties refrain from acting contrary to such principles purely for the reason of avoiding negative court actions directed towards them. In other words, traditional contract law may be viewed as creating rules *against* the parties instead of *for* the parties. Deemed to have been created already in the 1950s by the U.S. legal scholar and -practitioner Louis Brown, Preventive Law aims to use a lawyer's legal skills to prevent problems that could turn into disputes, instead of seeing lawyers as *fighters* – only needed in the event of a dispute and a battle in the courtrooms.[68]

This thought process goes hand in hand with what is actually happening in the real world, as studies have shown that only a small minority of business disputes in reality turn into court battles and that most disputes are settled well before that using various nonlegal remedies.[69] There exists a multitude of reasons for this, the main ones being that traditional legal remedies are costly to achieve, both in terms of their actual cost and the often lengthy process behind them, as well as the damage done to the relationship between the parties after a court battle,

[66] Haapio 2013, p. 28.
[67] Nystén-Haarala 2006, p. 1–4; Haapio 2013, p. 37–38. An ex post approach has as its main purpose to create contracts that minimizes the risk for a party of losing a dispute in court, and as such includes rules essentially only of any real use after a dispute has already arisen between the parties. Ex ante, in turn, focuses on preventing disputes from happening altogether through better planning for the future, which in theory should lessen the need for ex post contracting. This is not to say that ex ante contracting completely eliminates the need for ex post considerations, as disputes will undoubtedly arise to some extent either way, and in such instances a robust and reliable framework for handling court disputes is absolutely crucial. The idea is simply to lessen the need for ex post rules by shifting the focus towards increasing the mutual understanding of the contract between the parties and minimize the need to resort to legal enforcement actions when problems arise.
[68] Brown 1956, p. 941; Haapio 2013, p. 38; Nystén-Haarala 2006, p. 4.
[69] See generally, for example, Beale – Dugdale 1975 or Charny 1990. Nonlegal remedies here refers to settlements reached between the parties themselves, without the need for court involvement. Such remedies often include price reduction or -increases, depending on the party in a supposed breach, additional time for fulfilling the terms of a contract or other such remedies agreed upon between the parties through mutual discussions and negotiations.

where a division in winners and losers is often made by the courts.[70] It seems somewhat counterproductive to put all focus and effort into studying a small subset of contracts and contractual issues handled by courts, and in doing so largely ignore the many instances where parties have successfully navigated an issue through smart contracting or negotiations away from courts. Increased attention needs to be directed towards studying what has been done right, and simulating that, instead of focusing on what went wrong, and trying to avoid that.

The Proactive Law movement has its roots in the Nordic countries, with a lot of its pioneers being from Finland, such as Soili Nystén-Haarala, Helena Haapio and Soile Pohjonen.[71] Having grown and spread since its inception in the late 20th century, and even being discussed on a EU level,[72] its epicenter still lies in the Nordics, with legal scholars in Finland being specifically active in adopting its teachings.[73] Proactive Law also adopts the idea of preventing conflicts before they arise and adds a holistic view on contracts in that their success is dependent on all areas of contracting, and not purely the legal ones.[74] Contrary to Preventive Law, which still focuses purely on the lawyer's role in contracting, Proactive Law includes other professions crucial to a correct implementation of a contract into the mix. This shifts the focus on contracts towards reaching the parties' intended goals, maximizing the value creation and creating long-lasting and sustainable relationships. The *contractual literacy* of managers is of heightened importance, as they are the ones deciding on the most important aspects of a contract – what it is supposed to achieve, and the main factors required to reach that goal.[75]

Figure 1. Proactive Law: Shifting Focus from Prevention to Promotion.[76]

Focus not only on	Focus also on
• rules, legal tools: helping the parties to comply with the rules	• goals, managerial tools: enabling the parties to reach their objectives
• minimizing risks, problems, disputes, losses	• maximizing opportunities, desired outcomes, benefits
• preventing causes of failure and negative effects	• promoting drivers of success and positive effects
• lawyers as advisors, practicing preventive law; the law office as a preventive law laboratory	• lawyers as designers and coaches, working with clients as part of cross-professional teams

[70] Beale – Dugdale 1975, p. 47; Charny 1990, p. 405–406.
[71] Haapio – Siedel 2010, p. 656–659. See, for example, Nystén-Haarala 1998, Haapio 2013 and Pohjonen 2002. See also the Nordic School of Proactive Law (http://www.juridicum.su.se/proactivelaw/main/), a network of practitioners and researchers from the Nordics with an interest for Proactive Law.
[72] See, for example, EU 2009/C 175/05.
[73] The modern, proactive approach is actively applied in Finnish legal research. See, for example, Annola 2003, Kaave 2022, Sund-Norrgård 2011 and Sund-Norrgård 2014.
[74] Haapio 2013, p. 40–41.
[75] Haapio – Siedel 2013, p. 29–30. Contract literacy refers to an ability to understand what constitutes a contract as well as identifying their primary purpose, impact and risks, enabling managers to make informed judgements when working with contracts.
[76] Haapio 2013, p. 41, formatting modified.

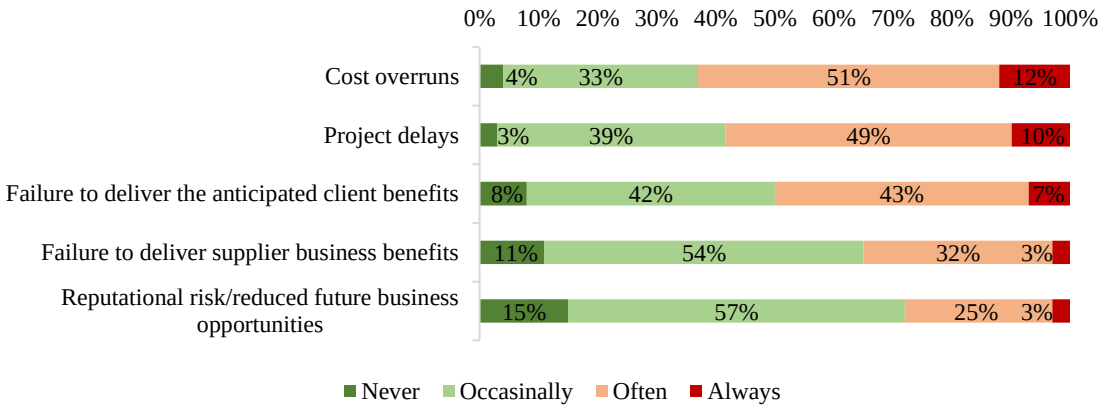
Contract literacy does not, nor does any other part of Proactive Law, require managers to delve deep into the world of legal contracting and legal jargon often prevalent in today's business contracts, but knowledge about the ways in which laws and regulations can affect business decision-making is crucial for managers to be able to mitigate legal risks or even utilize the law as a source of competitive advantage over its competitors.[77] Proactive Law does not focus purely on changing or educating managers to become better at contracting, but in many ways the other way around – making better contracts to create a real incentive for managers to actively participate in forming contracts and contractual relationships to ensure their success.[78] Evidently, the theory on Proactive Law does not fit particularly well within the standard thoughts on legal theory, creating rules and principles for the parties to follow. It instead focuses on forming a sort of best practices for parties in order for them to effectively fulfill their intended goals behind a contract. It helps the parties answer the question as to whether this is the *best and most efficient way to achieve what each of us wants*. Maybe that is exactly why another common term for Proactive Law is *Proactive Contracting*, shifting the focus away from the legal aspect of contracts and toward the concrete process of contracting.[79]

It is not uncommon for firms and their managers to delegate contract drafting almost in full to lawyers and law firms, believing that they are the ones best suited to ensure compliance with the law and the highest protection against various risks.[80] Seen from a strictly legal and risk minimization perspective this might very well be the case, but this quickly diminishes the contract to just that – an enforcement and risk mitigation tool for the parties to use against each other in case of a dispute. Proactive Law does not completely shun this idea, and recognizes its importance in balancing and mitigating strategic- and business risks with the potential value of each contract.[81] It does, however, highlight the fact that improper use of contracts, by not focusing sufficiently on reaching a mutually successful outcome for all parties and fulfilling the intended purpose of the contract, may lead to direct negative consequences for one or more parties in the form of additional costs and various delays.[82] This, in essence, might turn contracts themselves into a source of risk, creating the very thing they strive so hard to mitigate.

[77] Haapio – Siedel 2010, p. 651–652.
[78] Haapio 2013, p. 43. People today are reluctant to read contracts, and often see them as unsurmountable obstacles and too complicated to even attempt to understand, see Burnham 2003, p. 133.
[79] Rekola – Haapio 2011, p. 383. For ease of reference and to minimize confusion, the term Proactive Law will nevertheless be used throughout this thesis. It is worth noting, however, that Proactive Law is perhaps more about smart contracting than it is about influencing the existing contract law principles.
[80] Haapio 2013, p. 48.
[81] Haapio – Siedel 2013, p. 27.
[82] Haapio 2013, p. 52.

In a study focusing on contracting and the function of contracts by the *International Association for Contract & Commercial Management* (*IACCM*)[83], nearly 70 % of respondents felt that their contract negotiations do not focus on topics necessary to create a mutually successful outcome, a result that is further amplified for *larger respondents*.[84] Further, only 26 % of participants felt that their contracts are operationally useful in providing the information needed to be successfully carried out and implemented.[85] Another study by IACCM also highlighted the main problems caused by weaknesses in the contracting process, amplifying the risk of contracts themselves becoming a source of risk, as discussed above.

Figure 2. The Frequency of the Top 5 Issues in Contracting Resulting in the Following Weaknesses.[86]



Purely stating that issues exist and that measures ought to be taken is of limited use if no concrete tools to address these issues are available. This is where the idea of *Legal Design*[87] enters the picture, as it, simply put, strives to improve aspects of the legal system to be better suited for the people utilizing it.[88] Information legal design is of special importance here, as it has as its main task to simplify legal information and as such its comprehensibility and usefulness for the parties to a contract.[89] It includes considering how legal information in contracts can be made more user-friendly, through an emphasis on engaging the parties with the information and presenting it in a thought-out manner. The idea supports the use of various

[83] IACCM, having recently changed its name to World Commerce & Contracting, is a global, non-profit organization promoting and advocating for better contracts and enhanced contracting for the greater good of businesses. It seeks to do so by providing research and education on efficient contracting to everyone involved in contracting, be it lawyers, managers, project managers or salespeople. Further information is available on their website, https://www.worldcc.com/About.
[84] IACCM 2017, p. 6–7. The study covered 575 participants of different sizes, industries and regions. Larger respondents here refer to participant companies having a yearly revenue exceeding $5bn.
[85] Ibid., p. 6.
[86] IACCM 2013, p. 11, formatting modified. The study included 628 participants of varying sectors and regions.
[87] Legal Design can be described as a legal movement aimed at making the legal system more understandable and efficient to work with, by utilizing visual design ant the way we, as humans, view things.
[88] Doherty et al. 2021, p. 1.
[89] Haapio et al. 2021, p. 69.

visual aids to accompany or completely substitute the legal text, using summaries and various interactive tools regarding the contract itself and the processes surrounding it (where possible), in addition to simplifying the language and structure of the contract.[90]

Utilizing plain language in contracts by removing unnecessary language, and focusing on a contract's core objectives, brings with it important improvements besides a clearer contract that a larger group of people would be willing to read. It actively shifts contracts from being statements of rights and obligations to concrete implementation tools used to secure the performance all parties to a contract want, bringing them closer to their business use and further from purely a legal use. Followers of conventional contract language stand by the idea that standard, "battle-tested" language is to be preferred, as it has proven itself to hold up in court disputes. In the same manner that the ex-post view on contract law was criticized above, so have also this thought on preferred language been questioned, as the use of plain language might have avoided the need to go to court in the first place.[91] Both ideas undoubtedly play a role in successful contracting, but a larger focus needs to be put on when to guard against known potential disputes using conventional, tested language and when to instead use simplified, maybe even untested, language to ensure that all parties clearly understand their rights and obligations, and consequently are able to fulfill them efficiently. Putting too much focus on contracts as risk mitigation tools and protection against potential disputes, inevitably increasing their length and complexity, severely decreases the flexibility for the parties in a long-term relationship to adapt to changing circumstances, and conversely increases the risk of disputes.[92] As shown in the next chapter, efficient contracts bring additional advantages easily explained in a language all business-minded parties understand – decreased costs.

[90] Ibid., p. 69–75. Haapio et al. proposes seeing contracts as *user guides* instead of strictly legal contracts.
[91] Haapio – Siedel 2013, p. 43–44.
[92] Sund-Norrgård 2011, p. 100–101.

2.4 The Cost of Contracting Through the Lens of Transaction Cost Economics

Transaction costs permeate modern business and are present in most transactions worldwide.[93] A world without transaction costs would collide with the very essence of contracts and contracting in creating a system with the possibility for promises to be legally enforced. The mere notion of being bound by a contractual obligation is in itself a transaction cost, as, for example, a party bound to do A might very well rather do B instead, as this would be more in line with the party's interest at that moment. Doing B would constitute a breach of contract, most likely leading to costly repercussions by its counterparty or -parties. Doing A under the contract, however, would also result in a transaction cost, as choosing the sub-optimal action A over B leads to a missed opportunity and a so-called *opportunity cost*.[94] Transaction Cost Economics may play many roles in business but is ultimately concerned with the optimal organization and governance structure of economic institutions in order to maximize efficiency in the economic systems.[95] It is, however, also a theory on how to structure complex transactions, which makes it highly relevant for this thesis, as the governance structure surrounding private equity funds is far from simple, as shown further down in Chapter 3.[96]

Transaction Cost Economics recognizes that there exists a need to structure certain transactions one way and other transactions in another. There is, for instance, no use in further assessing the structure of a simple transaction such as buying groceries, as there is nothing particularly complex about it that would need addressing.[97] A complex transaction, in contrast, is one that requires additional attention and is identified by three important dimensions – asset specificity, uncertainty and frequency.[98]

Asset specificity refers to the "lock-in" effect that occurs when a transaction is supported by investments in assets specific to that transaction, creating a certain dependency of the parties

[93] Transaction costs generally refers to the costs of running the economic system or as the business equivalence of friction in physical systems, see Williamson 1985, p. 18–19. In other words, it is the additional costs incurred for doing business not directly related to production costs – the costs associated specifically with producing goods or services. Transaction costs can, similarly as within Proactive Law, be divided into ex ante and ex post transaction costs, where ex ante transaction costs refer to costs incurred by drafting, negotiating and safeguarding a contract and ex post transaction costs refers mainly to costs associated with contract maladaptation and correcting such maladaptation, see ibid., p. 20–21. Both of these components are of interest in this thesis, whereby no separation is needed and they will collectively be referred to as simply transaction costs.
[94] Goldman 1976, p. 46–47.
[95] Williamson 1985, p. 16. Transaction Cost Economics have also been seen as a theory of the firm, management and governance, due to the immense scope of transaction costs in theory. See Ketokivi et al. 2017, p. 2 (with references).
[96] Ketokivi et al. 2017, p. 2.
[97] Ibid., p. 3–4; Williamson 1979, p. 239.
[98] See Williamson 1985, p. 52–61.

on one another. A transaction lacking asset specificity quickly decreases in complexity, as an identical or nearly identical transaction can easily be made with a multitude of different parties. One's thoughts perhaps instinctively get drawn towards a situation whereby one party might be able to take advantage of this specificity, as they usually create substantial initial transaction costs, and as such a risk, for the party making the investment. Such one-sided opportunistic behavior is, however, discouraged by Transaction Cost Economics, as it is counterproductive to the long-term value maximization prospects of all parties. Instead, opportunities should be balanced so as to provide equal opportunities for the parties to prosper.[99] On the contrary, transactions involving asset specificity together with a build-up of personal trust between the parties are more resilient to adaptation and more likely to survive unforeseen events, and as such is something worth striving for.[100]

Uncertainty refers to the parties' limited ability to predict changes in the transaction environment and the behavioral uncertainty of the other parties to a transaction. The more certainty involved in a transaction, the less complex they become, as reaching a perfect understanding between the parties becomes easier, and disputes, in theory, should be next to impossible.[101] Behavioral uncertainty also ties in with the opportunism mentioned above, as the parties to an uncertain transaction have no way to ensure that all relevant information is known and whether the other party is hiding or obscuring information or its final intentions. This leads to contracts being incomplete, as no contract can possibly foresee all possible outcomes, which in turn increases the resources that need to be allocated to safeguard against these unforeseen circumstances and, especially where continuous cooperation is vital, the introduction of an efficient process to negotiate in a fair manner, should an uncertainty materialize.[102]

Frequency is perhaps the dimension most closely attributable to Modern Contract Law and Proactive Law, as it emphasizes the frequency at which transactions are conducted between the parties as a measurement of its need for complexity, bearing similarities to the idea of continuous cooperation. For example, asset specificity generally requires a certain extent of frequency in a transaction, to justify the specific transaction-related investment, but in practice, any recurring transaction relationship is worth allocating additional resources to compared to the discrete transactions mentioned above.[103]

[99] Ibid., p. 47 – 49.
[100] Williamson 1979, p. 240–241.
[101] Williamson 1979, p. 253–254.
[102] Ibid., p. 254. Note the similarities to the duty of loyalty in Finnish jurisprudence discussed in Chapter 2.2.
[103] See supra note 63.

Based on the above, and as further explored in the next chapter, contractual dealings in private equity funds should in the majority of cases be considered complex transactions in need of a more sophisticated structure. Private equity transactions are often asset specific to a certain degree, as much time and effort is needed by an investment manager to build the reputation and track record needed to attract sufficient capital, and investors conversely commit a substantial amount of capital for a specified length of time to their investment manager of choice. Further, as is often the case in the investment industry, few things are certain. A typical private equity fund includes tens, if not hundreds, of investors, many of whom might have slightly varying agreements with the investment manager through side letters, the specifics of which often unbeknownst to most other investors, let alone all uncertainty connected to the operations to the fund itself in terms of its performance and returns. Finally, private equity is an industry where frequent transactions, even though sporadic, are the norm, as private equity funds normally have a limited lifetime whereby the same investment manager creates and manages funds in succession, many of which contain many of the same investors as the previous one.[104]

As evident here, but also in the ideas of Proactive Law and Modern Contract Law overall, instances where the parties wish to foster and maintain a healthy and longstanding relationship require commitments by both parties. The relationship between investors and the investment manager in a private equity fund fits perfectly into this category and conversely, they should have every reason to act accordingly. Ensuring well-functioning cooperation built on trust alleviates one of the main shortcomings of contracts – you cannot fully prepare for uncertainty, and no contract can be equipped to deal with all situations imaginable. Efficient contracting structures should be created to match the specific transaction and its characteristics in a way that minimizes transaction costs and leads to the most economical outcome.[105] The question then becomes how this goal can be reached, and how the desired flexibility can be achieved. *Contract Modularity* might provide one solution, breaking up a complicated whole into smaller, easier to grasp, pieces.

[104] This relationship would, according to Williamson, be classified as *Trilateral Governance* – transactions of only occasional frequency and of medium to high asset specificity. Such transactions require additional attention regarding, for example, how to manage disputes and navigate uncertainties, see ibid., p. 249–250.
[105] Ibid., p. 234–235, 245, 261.

2.5 Contract Modularity – Managing Complex Contract Modules

Modern markets are becoming increasingly complex, and not just through the increasingly intricate nature of transactions and their governance structure as seen above, but the contracts themselves are also growing evermore complex.[106] Much of contract research has focused on the intricacies of individual provisions, largely ignoring the complexity made up of entire contracts or even whole deals.[107] Only fairly recently have legal scholars, predominantly within the U.S., started analyzing complex contracts as a sum of their individual parts, and the ways in which this complexity can be tackled by breaking out parts of a larger deal into smaller, nimbler modules, resulting in what can now be called the theory of Contract Modularity.[108] It can be viewed as a practical response to the call for easier, more efficient contracting advocated by Proactive Law and Transaction Cost Economics, offering real solutions to make ex ante contracting more efficient.

Contract complexity refers to the difficulties for parties to fully comprehend their rights and obligations under a contract due to vast interconnections and interactions between the terms and structure of a contract.[109] There are a number of factors resulting in a contract being considered complex, such as 1) the length of contracts, increasing the possible interactions without necessarily adding additional value, 2) the use of specific and hard-to-understand language, 3) detailed contingencies and other intricate risk management provisions combined with the first two points increasing the contract's cognitive load, making it harder for people to fully comprehend their content, and 4) structural complexity resulting from cross-references and interactions, creating a web of interconnection that becomes hard to manage.[110] The ideas of Contract Modularity focus primarily on the last point but likewise benefit from considering the others as well.

One of the primary tools of Contract Modularity are ancillary agreements, smaller agreements entered into in conjunction with the main agreement, the acquisition agreement and its various

[106] Hwang – Jennejohn 2018, p. 280–281; Hwang – Jennejohn 2019, p. 1.
[107] Macher – Richman 2008, p. 52–53.
[108] For a study on the theory and use of Contract Modularity beyond what is discussed herein, see generally Smith 2006, Triantis 2013, Hwang 2016, Hwang – Jennejohn 2018, Hwang & Jennejohn 2019 and, for a more critical view on Contract Modularity, Kastner 2022, just to name a few.
[109] It is worth noting that contract complexity differs from the transaction complexity discussed above. Transaction complexity relates to outside factors surrounding the nature of the transaction, while contract complexity refers to complexity within the contract itself, born as a result of the parties' wishes to transact. This is not to say that there is no connection between them, as complex transactions generally also leads to complex contracts, but merely that the factors to be considered when assessing complexity varies substantially from one another.
[110] Hwang – Jennejohn 2019, p. 3–10.

supporting agreements in M&A being a prime example.[111] By breaking up a complex whole into smaller parts that are both modular and precise, the parties can decrease costs both ex ante, by making contracting more efficient, and ex post, by increasing the parties', and the courts', understanding of a contract.[112] Modularity entails isolating individual modules within a complex system, where "*communications (or other interdependencies) are intense within the module but sparse and standardized across modules*".[113] In other words, modularity works best where a new, separate whole can be created from an existing system, as this often enables more effective separation of interconnections of one module from the rest. Modularity can work for both complex and simple pieces of a contract. In complex modules, the parties are able to gather most of the complexity in a certain area in one module, making it easier to both work on and understand, thus reducing the ex ante costs of drafting and the ex post costs of enforcement. Simple modules also achieve the same ex ante cost benefits, as concentrated simple and *boilerplate* modules can be completed more resource efficiently.[114]

Apart from making contracting more efficient from a legal standpoint, modularity also might make complex contracts easier to understand, by isolating the complexity to one specific subject within the system.[115] Even though Contract Modularity generally only speaks of the added value to parties through more efficient contracting by the lawyers responsible for the contract, the idea could prove useful likewise for non-lawyers. Embedding the principles of Proactive Law with those of Contract Modularity could prove an effective way of getting managers and other professions than lawyers, upon which much of a deal's success lies, more engaged in the contracting process themselves. By isolating, or at least copying, the aspects of a contract deemed most critical for the actual implementation of the deal and the parts relevant to managers and the other operative divisions into separate "performance modules", contracts could be made a practically useful tool for more than just lawyers.

Contract Modularity is, however, not a universal solution to all contracting problems, and comes with its own set of negatives, such as modules being a source of lengthier deals and increased costs, used to circumvent disclosure or cause for ambiguity in court interpretation of

[111] Hwang 2016, p. 1405. M&A stands for *mergers & acquisitions*, the practice where companies are bought and sold.
[112] Ibid., p. 1417. Even though minimizing ex post costs, such as litigation, is a clearly positive thing, the focus on this thesis is on efficiently allocating and minimizing ex ante costs, whereby they will be the ones in focus here.
[113] Smith 2006, p. 1176.
[114] Hwang 2016, p. 1418–1426; Boilerplate refers to contractual terms or modules exhibiting a high degree of standardization and self-sufficiency, able to be used in essentially the same format in several different contracts. See, for example, Smith 2006, p. 1176.
[115] Smith 2006, p. 1180.

the scope of the modules in relation to the deal as a whole, and the true intention of the parties in terms of said scope. Some of the risks and downsides of Contract Modularity will be discussed in further detail below in Chapter 4, as they provide an interesting perspective on the way we ought to look at side letters.

Side letters can be seen as a type of ancillary agreement, as they make up a small, but important, part of complex private equity deals. Scholars have gone so far as to conclude that "*[c]omplex deals, moreover, typically include a number of relatively independent agreements, such as […] side letters in a private equity […] deal*".[116] This thesis, however, generally argues that side letters are surprisingly unique contracts for which many risks and uncertainties exist, and this holds true also for the suitability of Contract Modularity on side letters. They do not conform to the general principles of independence and absence of interconnections that make modules so attractive in the first place, and do usually not allow for independent changes to them without risk of resource-intensive and costly changes cascading through the whole deal.[117]

As we will see in the next chapter, side letters are, in essence, agreements entered into with the specific purpose of modifying the main agreement, sometimes to a significant extent, which makes them highly interconnected with the rest of the provisions in the main agreement. It does not stop there either, as the various side letters in a private equity fund are heavily interconnected themselves, mainly due to so-called *Most Favored Nation* provisions.[118] This all begs the question as to what exactly side letters in private equity are, and what it is that makes them so unique. Next, the thesis examines more closely as to what exactly private equity is and its governance structure giving rise to the existence of side letters.

[116] Kastner 2022, p. 455, underlining added for emphasis.
[117] Hwang 2016, p. 1417–1418; Smith 2006, p. 1189; Jeffers – Tucker 2022, p. 4–5.
[118] See Chapter 3.2.3 below.

3. Private Equity – Governance, Structure & Regulation

3.1 A Primer to the Private Equity Industry

The global *public equity markets* are vast, with a combined value amounting to nearly $107 trillion as of the first quarter of 2023, and provide countless opportunities for investors looking to deploy their capital in the public stock markets.[119] For some, however, this isn't enough, and certain investors are turning their heads towards the *private equity markets* as well, looking to invest their capital in private companies not traded on a public exchange and thus not freely available and open to the general public. Such types of investments make up the bulk of what is generally called *private equity*. There are several reasons why one would look toward the private markets in addition to the public ones, a couple of which are supposedly better returns,[120] both on a standalone basis as well as adjusted for risk,[121] as well as better protection against general market downturns.[122] The attractiveness of the private markets, then, naturally follows the universally accepted financial principle of value maximization.[123] As such, investors have a clear incentive to also allocate capital toward the private markets.

The goal of private equity is simple – to earn a positive risk-adjusted return for investors.[124] To achieve this, the majority of investments in the private markets are made by specialized private equity firms accompanied by a number of investors, in the hopes of increasing the value of the private companies targeted and later selling them for a profit.[125] The idea is thus not to hold the investments for an indefinite period or for the foreseeable future, contrary to what can be the case with investments in the public markets, but rather to improve the companies in the mid- to short-term and then realize the created value by exiting the investment. Such an exit is usually accomplished by either selling the portfolio company to a strategic buyer looking to utilize the

[119] SIFMA Quarterly – Q1 2023, p. 4. The global public equity market refers to the combined value of all public stock exchanges globally.
[120] For example, Ljungqvist – Richardson 2003, p. 19, finding excess returns on the private equity markets of around 6–8 % on an annualized basis compared to two major stock indices, the S&P 500 and the Nasdaq Composite Index, Harris et al. 2013, p. 1863, finding excess returns of 3.4 % over the same S&P 500 index or Nesbitt 2022, claiming overperformance of 4.1 % by private equity compared to public stocks. However, some studies have emerged questioning such overperformance. See, for example, Phalippou 2014, p. 215–216 or Harris et al. 2016, p. 14.
[121] Ljungqvist – Richardson 2003, p. 29.
[122] Veronis – Esipovich 2020, concluding that investments in the private market generally has seen lesser drawdowns and historically been less risky than the public markets.
[123] For example, Brealey et al. 2017, p. 7–9. In its most simple form, the principle states that decisions that provides the highest possible return on investment at a certain risk level should be taken. As such, when two decisions are expected to provide the same returns, the one with the lesser risk attached to it should be chosen.
[124] De Fontenay – Nili 2023, p. 13.
[125] Clayton 2017, p. 258.

better performance unlocked by the private equity firm (a *trade sale*), selling it to another private equity firm for further improvement and value creation (a *secondary buyout*) or listing it on a public stock exchange (an *initial public offering*, or *IPO*).[126]

The parties on the flip side of the investment, the private companies targeted by the private equity firm that is, also have the potential to benefit from these actions. After all, running and growing a successful company is no easy task, and generally requires at least (1) a viable business idea, (2) competent personnel and management to lead and develop the company, and (3) sufficient capital to cover the costs resulting from making the idea a reality. For some companies, all of these components might be sufficiently aligned during their lifetime,[127] but the majority of them will at some point run out of steam and need a boost in terms of either outside advice or additional capital.[128] This is where private equity comes in handy, as it introduces an active governance structure specifically created to improve the management and performance of companies by, in addition to injecting capital, improving management behavior and providing valuable market expertise,[129] creating a type of win-win situation for the investors and the company itself. Helping struggling companies is, of course, not the primary goal of private equity as seen from an investor's perspective, but it's considered one aspect in which it can benefit target companies and society at large.[130]

Since private equity started becoming increasingly mainstream in the 1980s,[131] the private equity industry has grown from a niche form of alternative investment available only to a select few prominent investors to a massive industry with a total AUM in excess of $7 trillion.[132]

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[126] See, for example, Folus – Boutron 2015, p. 218–230 for a more thorough analysis on the different exit strategies available in private equity.

[127] This is, of course, largely dependent on the personal vision, ambitions and needs of a company's owner(s). In some instances, these requirements align due to perfect planning and execution, pure luck, or a combination of the two. But in other, the owner(s) of a company are completely satisfied with running a business without constantly striving towards maximizing growth and/or return. Naturally, the latter are excluded from the scope of this thesis, as they seldom have the need or willingness to try and improve their company's performance by external means.

[128] Zeisberger et al. 2017, p. 5.

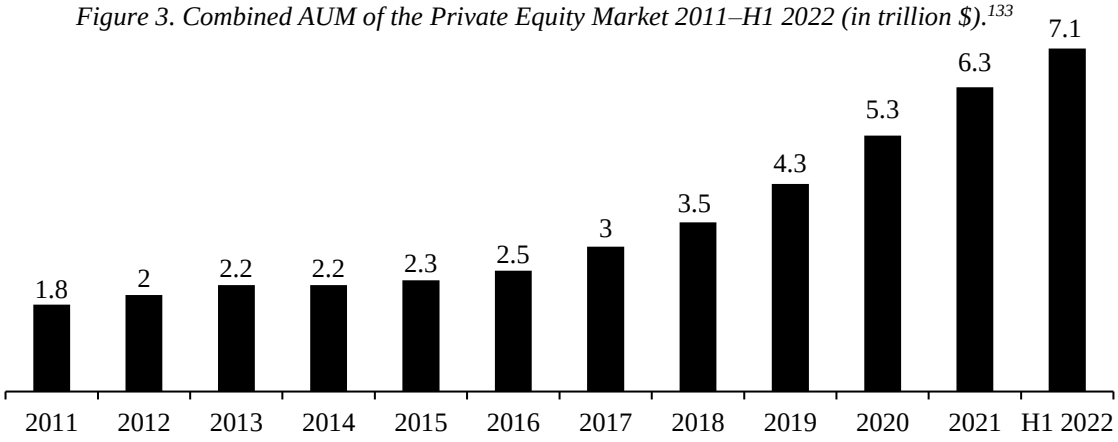
[129] Kaplan & Strömberg 2009, p. 132, highlighting the fact that private equity firms often hire professionals with specific operating and industry skills apart from only focusing on provision of capital and financial restructuring of the target companies.

[130] By, for example, improving the economic outlooks of the company and increasing its growth rate, the company will in the long-term end up paying a larger nominal monetary sum in taxes and creating more jobs as it grows.

[131] Seretakis 2013, p. 616. Private equity can be dated even further back than that, all the way to when Christopher Columbus financed his endeavor to cross the Atlantic Ocean in the end of the 15th century with an investment by the Spanish crown, in exchange for a promise of a share of the profits generated from the newly found route to India (or so he thought). See Demaria 2013, p. 11–15 for a walkthrough of the different concepts of private equity and how they can be applied to the venture Columbus undertook.

[132] McKinsey & Company, McKinsey Global Private Markets Review 2023, p. 10. When discussing AUM, certain types of alternative investments, most notably private debt, real estate and infrastructure, are excluded.

Figure 3. Combined AUM of the Private Equity Market 2011–H1 2022 (in trillion $).[133]



Based on the components of the name itself, the words *private* and *equity* that is, would lead to a simplified definition of private equity along the lines of *equity investments in private companies*.[134] Private equity, however, encompasses a much broader investment structure, both in terms of the source of the capital used and the target investments themselves. Private equity encompasses everything from acquiring a majority stake in existing and mature companies using large amounts of debt, so-called *Leveraged Buyouts* or *LBOs*,[135] to minority equity stakes in smaller, fast-growing businesses or even pure start-ups or business ideas.[136] The former generally goes by the name *Growth Equity* while the latter is called *Venture Capital*. Even though there exist many more nuanced types of private equity, they, as well as the ones briefly described here, will not be presented in any further detail, as this is not necessary for advancing the research questions set out in this thesis. In other words, the questions discussed in the coming chapters apply equally to all forms of private equity, unless otherwise expressly stated.

The rest of Chapter 3 will focus mainly on the private equity ecosystem, its legal structure and the actors involved in private equity investments, as well as the documentation relating to and governing a private equity fund. This includes a closer look at the side letter itself, including its role in private equity and the most common terms often found in it. Finally, the law applicable to private equity funds, the sponsor and its investors, or in many instances rather the lack thereof, will be presented in both the EU and the U.S.[137]

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[133] Combined AUM of Buyout, Growth Equity and Venture Capital. Source: Bain & Company 2022 and McKinsey 2023. It is worth noting that this number only reflects the size of the actual, current market. The *potential* private equity market, considering the value of all privately owned companies, is immensely higher.

[134] See, for example, the foreword to Zeisberger et al. 2017 written by Henry Kravis, co-founder and former co-Chairman of KKR, one of the largest private equity firms globally.

[135] Kaplan & Strömberg 2009, p. 121.

[136] Zeisberger et al. 2017, p. 19 and 33 for Venture Capital and Growth Equity respectively.

[137] When discussing the U.S. legal framework or market praxis, the law and practices of the State of Delaware will be used as reference, if necessary, as it is the jurisdiction of choice for the majority of private equity funds, see Debevoise & Plimpton 2022, p. 9, also stating that Delaware, the Cayman Islands and Luxembourg are the main hubs for establishing private equity funds in the form of a Limited Partnership globally.

3.2 The Private Equity Ecosystem

3.2.1 Structure and Main Actors

It makes little sense for an investor purely seeking to invest its capital to directly approach a private company asking to buy it, as this would basically make the investor a business owner instead of an investor. Instead, an investor often turns to an *investment fund* to invest its excess capital on its behalf. Investment funds are separate legal entities created for the purpose of pooling capital from investors and then investing this capital on behalf of investors.[138] Another key concept of an investment fund is the fact that they are often organized in a way as to separate the assets in the fund from an investor's other assets, thus creating a barrier of liability between the fund and its investors.[139] Even though they are created as separate legal entities, they do not manage the money and investments in and of themselves, but are instead controlled by a *management company* responsible for setting up and organizing the investment fund, gathering investors and ultimately deciding on how to manage and invest the capital.[140] An investment fund is, thus, merely a pool of capital over which the management company has been given a mandate to deploy that capital as it sees fit.

Private equity funds follow largely the same basic concepts as laid out above. A private equity firm, a company specialized in acquiring, managing and exiting private investments, sets up a private equity fund into which investors pool their capital.[141] There exists no specific legal form specifically created to facilitate this type of fund. However, the *limited partnership* or the various national variations of it is often considered the standard legal vehicle for private equity funds globally.[142] This is due to the flexible governance structure they provide as well as certain positive tax implications for investors.[143] Consequently, private equity funds are normally structured as such a limited partnership, with the private equity firm acting as the general partner (*GP*), often called the fund's *sponsor*, through a separate legal entity created for that specific

[138] Morley 2014, p. 1228; Viitala 2018, p. 528.
[139] Viitala 2018, p. 528.
[140] Morley 2014, p. 1238–1240.
[141] Kaplan & Strömberg 2009, p. 123. The term "fund" will hereinafter be used to refer explicitly to a private equity fund, unless otherwise mentioned.
[142] Ibid.; Viitala 2018, p. 530; Finnish Government Proposal 17/2015, p. 10–13, concluding that the limited partnership structure is the main legal form for private equity funds in at least Finland, Sweden, Denmark, Great-Britain, Luxembourg, France and Germany; Kaplan & Stömberg 2009, p. 123, stating that limited partnerships are the main structure used in the context of U.S. private equity funds. As such, for the purpose of this thesis, the limited partnership will be deemed to be legal entity applicable in regard to private equity funds.
[143] Viitala 2018, p. 530–533.

purpose, and the investors acting as limited partners (*LPs*).[144] The investors in these funds are often exclusively large, institutional investors with vast amounts of capital at their disposal, such as pension funds, sovereign wealth funds, banks, insurance companies, other investment funds, or wealthy companies and individuals.[145] Only allowing big and sophisticated investors to join a fund brings with it, in addition to easier and cheaper administration by having a smaller total number of investors contributing a substantial amount of capital per investor, certain regulatory advantages for the sponsor in terms of less onerous regulatory requirements.[146]

In addition to the GP and LPs, the private equity firm itself often provides various management services directly to the fund or through the GP set out in a management agreement in exchange for a separate management fee.[147] Finally, most funds include an *advisory committee* comprised of certain selected limited partners, often those with a substantial amount of capital committed to the fund. The advisory committee is, however, a contractually created entity with its decision-making capabilities limited to approval or objection to a select few operational matters.[148]

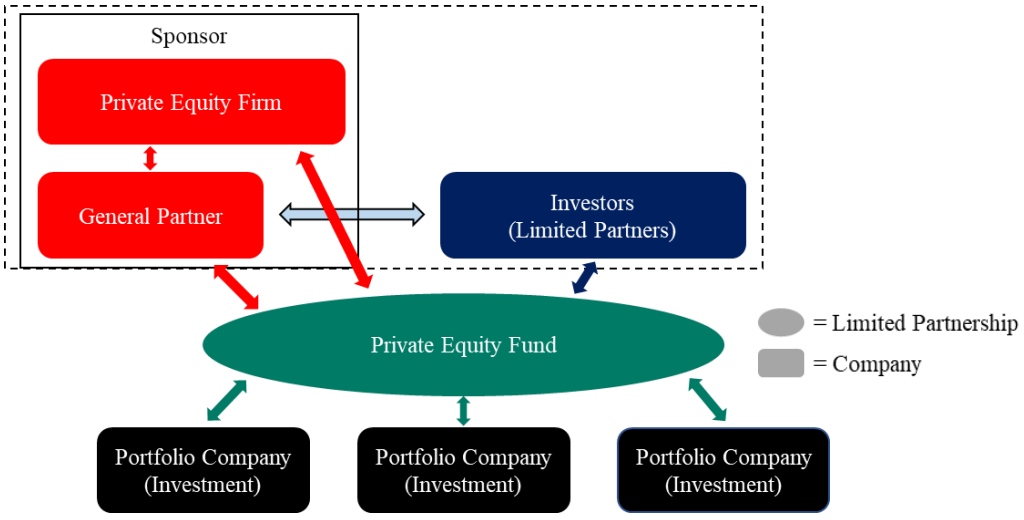
In a limited partnership, the GP is generally responsible for running the partnership itself and for all decision-making, and has unlimited liability towards the partnership, while the LPs' main task is to contribute capital to the limited partnership and are liable only to the extent of capital committed.[149] As previously stated, one advantage of the limited partnership is its flexible governance structure. This is a result of the limited partnership being largely based on the principle of freedom of contract between the parties involved, and not by vast amounts of compulsory legal rules otherwise applicable to corporations under corporate law. In the U.S., for example, limited partnerships are considered "noncorporations", and are seen as *creatures of contract* based on a far-reaching voluntary, contractual relationship between the GP and the LPs.[150] Many European jurisdictions have specific national laws in place governing the limited

[144] Ibid.; Zeisberger et al. 2017, p. 6–7, explaining the reason behind the private equity firm setting up a separate legal entity to act as GP for the fund being the separation of the legal and economic liabilities of the fund, and as such its GP, from that of the private equity firm itself, protecting it from any claims directed towards the fund. It is also done to protect any other funds for which the private equity firm is acting as GP, as a single private equity firm usually manages multiple funds simultaneously, see de Fontenay 2013, p. 121–124.
[145] Kaplan & Strömberg 2009, p. 123; Taskinen 2002, p. 16.
[146] de Fontenay – Nili 2023, p. 10–11.
[147] This fee forms part of the fee structure of private equity funds discussed below in this chapter.
[148] Debevoise & Plimpton LLP 2021, p. 66–67. Their decision-making power often includes, for instance, approving transactions or waiving certain investment restrictions of the fund.
[149] Harris 2010, p. 270–271.
[150] Manesh 2009, p. 476–477. Going forward, the terms *sponsor* and *investor* will be used instead of GP and LP respectively, in order to lessen the usage of complex terminology.

partnership.[151] The rules regarding limited partnerships are, however, also largely based on voluntary application, and are often only applied in the absence of any contrary provision in the incorporation documentation.[152] Thus, most aspects of the sponsor-investor relationship are governed by the incorporation documentation agreed upon and entered into by the parties.[153]

Once the contractual structure is in place, an investment period commences where the sponsor starts looking for potential companies to invest in and, after deeming it a suitable investment, the fund buys a stake in the company, the size of which depends on the strategy the fund follows in accordance with what was discussed above.[154] When the investment is made, the sponsor often acts as an active shareholder in the company, providing both managerial as well as technical help and expertise to the company in exchange for certain fees.[155] If the fund becomes a major, or even the sole, shareholder in the company, the sponsor usually does not hesitate to take all actions it is permitted to take in order to improve the company and make it more valuable, as its sole purpose in the end is to generate returns for itself and its investors. There are many ways in which a fund could be set up and structured, depending on the parties involved and any particular requirements regarding, for example, profit distribution or taxation, but the basic structure of a fund could look something like Figure 4 below.[156]

Figure 4. Example Structure of a Private Equity Fund.



[151] For example, the Finnish Partnership Act (389/1988), the Swedish Partnership and Non-registered Partnership Act (1980:1102), the UK Limited Partnerships Act 1907, the Luxembourg law of 10 August 1915 on commercial companies and the German Commercial Code (in German: *Handelsgesetzbuch*), just to name a few.
[152] See, for example, the Finnish Partnership Act, Chapter 7 paragraph 2.
[153] These funds are, however, not completely cut off from all regulatory requirements, but the ones applicable focuses more on the investment activities of the fund itself rather than on the sponsor-investor relationship.
[154] Clayton 2017, p. 259–260. The investment period often covers three to five years, whereafter the sponsor focuses on developing its portfolio companies.
[155] Kaplan & Strömberg 2009, p. 124.
[156] The various ways in which a fund can be structured is not relevant for the purpose of this thesis and will thus not be developed further. The most central aspect to be kept in mind here is the division between the sponsor as the decision-making entity on the one hand, and the investors, mainly as capital providers, on the other.

The focus of this thesis is on the contractual relationship between a sponsor and the investors (the entities within the dotted square in Figure 4 above), and how this relationship can be managed to maximize value and minimize contractual risks or inefficiencies for both parties. A consequence of that is that some unique parts of the private equity ecosystem will be left out and some aspects not necessarily dealt with exhaustively.[157] Having said that, there are a number of specificities that apply to private equity funds not present in many other forms of investment funds,[158] that together contribute to a governance structure susceptible to certain types of risks that could prove detrimental to the continued success of a private equity firm.[159]

First off, most private equity funds are created as *closed-ended* funds, meaning that investors cannot withdraw their capital once it has been committed, and have to wait until the fund is terminated to get their initial investment back.[160] Along the same vein, an investor's capital is usually not transferred to the fund all at once, but instead, the investor commits to provide the fund with a certain amount of capital should the sponsor call for it within a specified commitment period – through a *capital call*.[161] Most of these capital calls are made during the investment period of the fund, to enable the fund to acquire the desired target companies and start paying the fund's expenses.[162] Another major peculiarity relating to the closed-ended nature of private equity funds is their lifespan. Unlike many open-ended funds, which in theory are open and active indefinitely,[163] closed-ended funds most often have a fixed lifetime, after which all investments are exited, and the fund's capital is distributed to the investors. The lifespan of a fund is often around 10 years, but with the possibility for the sponsor to prolong this by a few years, after which the fund's assets not yet divested have to be liquidated and proceeds distributed to investors, net of any fees.[164]

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[157] The most notable part left out from the scope of this thesis is the relationship between the fund, or its sponsor, and the portfolio companies themselves. That section lacks relevance mainly because of the absence of a similar imbalance in decision-making power as is the case between the sponsor and the investors, especially considering the often substantial amount of capital the investors provide compared to the sponsor.
[158] The main examples here being mutual- or common funds, as well as hedge funds.
[159] Magnuson 2017, p. 1850–1851.
[160] Kaplan & Strömberg 2009, p. 123. In some instances, the sponsor can decide to distribute some of the profits or initial investments back to the investors prior to the termination of the fund, but that decision often lies solely with the sponsor.
[161] Chertok – Braendel 2013, p. 34. The idea behind capital calls is to not unduly store excess capital in the fund while the sponsor analyses and choses potential portfolio companies, and that actual capital is only committed once a suitable acquisition target has been found.
[162] Clayton 2017, p. 260.
[163] Payne 2011, p. 6.
[164] Kaplan & Strömberg 2009, p. 123; Clayton 2017, p. 260. About two to three years seems to be the market praxis, but it could in theory be even longer if the fund's investors so desire or allow. So-called *evergreen* funds, funds similar to those of private equity funds but with a theoretically indefinite lifespan and open for investors to exit at certain points, are not discussed in further detail in this thesis, even though many aspects applies likewise to them.

The final aspect highlighted here are the fees payable to the sponsor from the assets of a fund, which for the most part are structured according to the *two and twenty model*.[165] This model is on the one hand made up of a management fee paid to the sponsor, often around two percent annually of the fund's committed capital. This fee is fixed, and thus not tied to the performance of the fund.[166] On the other hand, the sponsor also charges a variable fee based on the performance of the fund – a *carried interest*. The carried interest is in the majority of cases twenty percent of the profits made by the fund, with some additional restrictions added to it in many cases, such as a preferred rate of return for investors before carried interest is charged.[167] Numerous other costs are also charged to the fund, such as transaction fees for acquiring the portfolio companies and monitoring fees for monitoring and developing them,[168] as well as organizational fees for setting up the fund that, for example, includes the costs of creating the fund's incorporation documents and other agreements.[169]

As private equity funds are largely based on a voluntary contractual relationship between the sponsor and the investors, the agreements governing said relationship is of utmost importance.[170] One agreement not discussed in further detail herein, although important for the purpose of investing in a fund, is the *Subscription Agreement*. It is an agreement between the sponsor and an investor laying out the terms of the actual investment, including, for example, the amount of capital committed and the terms governing the capital commitment process.[171] The next chapter will focus on the two main agreements relevant to this thesis – starting with the *Limited Partnership Agreement* (LPA), and continuing with the side letter itself.

3.2.2 The Limited Partnership Agreement

The main agreement governing the structure of a fund and the rights and obligations between the sponsor and the investors is, as previously mentioned, the LPA. It is a lengthy document with its main purposes being the conclusion of the general terms of the fund's investment activities as well as mitigating the risk of *agency costs* – conflicts of interests arising out of the fact that the sponsor is not investing on its own behalf but primarily on behalf of the fund's

[165] Magnuson 2018, p. 1866.
[166] Ibid., p. 1867; Metrick–Yasuda 2009, p. 9. This fixed annual management fee functions in largely the same way as for other investment funds.
[167] Metrick–Yasuda 2009, p. 10–13.
[168] Ibid., p. 13–14.
[169] De Fontenay – Nili 2023, p. 47; Debevoise & Plimpton LLP 2021, p. 50.
[170] De Fontenay – Nili 2023, p. 11.
[171] See, for example, Zeisberger et al. 2017, p. 218.

investors, thus creating a risk that the interests of the sponsor on the one hand and the investors on the other sometimes might not be completely aligned.[172] Instances may occur where, for example, the sponsor chooses to shift its focus toward another one of its funds that are currently raising assets or is in the middle of a major acquisition round, instead of managing the fund in question in the most efficient way possible.

It seems, however, that the LPA leaves quite a lot to be desired when it comes to tackling these agency costs, as the whole governance structure of private equity gives rise to some grave instances of imbalance in the interests between the sponsor and the investors not often effectively addressed in the LPA. These are mainly 1) the fee structure of funds as described above, resulting in a situation of *moral hazard* whereby the sponsor gets to take part in much of the upside of the fund's performance through the carried interest fee, but is simultaneously largely shielded from any losses due to the sponsor usually only investing a very small amount of its own capital in each of its funds.[173] Furthermore, 2) the investors are often severely limited in their options to take actions towards the sponsor in order to correct any misalignments or voice their opinion on important matters, as they are almost completely cut off from the active decision-making in the fund, and have no easy way of *voting with their feet* by redeeming their investment or transferring it to someone else.[174] To top it off, the information disclosed to investors by the sponsor is often kept to a minimum, thus further diminishing any real possibility of investors becoming aware and reacting to any situation where the risk of agency costs is realized.[175] Finally, and what is also the main focus of this thesis, 3) the sponsor treats investors differently depending on their size, influence and bargaining power, rendering the general provisions in the LPA somewhat arbitrary in the sense that they can still be deviated from by the sponsor and individual investors.[176]

[172] Harris 2010, p. 263; Cumming – Johan 2014, p. 39.
[173] Magnuson 2018, p. 1866–1874. The term moral hazard refers to one party's increased incentive to take excessive risks due to them being protected from potential losses from such risk-taking. As such, the sponsor is incentivized to invest in riskier companies with a high chance of a larger upside. These types of companies are, however, usually accompanied by a similarly large risk of a negative outcome, increasing the risk of the fund performing negatively more than would be the case with safer, more modest companies. The sponsor is ready to gamble like this due to the fact that the largest portion of their compensation is derived from the management fee, ensuring the sponsor certain fees no matter the performance of the fund itself; It is customary for the sponsor to also invest some of its own capital in the fund in order to have some skin in the game and hopefully mitigate some of the agency costs. It seems the customary amount to be invested is around 1 percentage of the fund's committed capital, which in the grand scheme of things hardly manifestly affect the sponsor's behavior. See, for example, Magnuson 2018, p. 1870, Kaplan & Strömberg 2009, p. 123 or Harris 2019, p. 287.
[174] This possibility is discussed in a bit more detail in Chapter 5.1 below.
[175] Magnus 2018, p. 1874–1884.
[176] Ibid., p. 1884–1889.

Consequently, it seems that the LPA has lost some of its importance in aligning the interest of the sponsor and the investors in the fund. This need not necessarily be the case, and one of the objectives of this thesis is to assess whether it makes more sense for both parties to strive toward increasing the importance of the LPA when it comes to assigning the final rights and obligations of the sponsor and the fund's investors. As will be presented in more detail below, not all provisions can be practically neglected in the LPA and instead included in separate side letters. Some of the major provisions often included in the LPA governing the relationship between the sponsor and the investors are:

Scope of Investment Decisions. These kinds of provisions set the boundaries of the decisions the sponsor is able to take in regard to managing the fund and its investments, and often include 1) restrictions on the size of one portfolio company's share of the fund compared to the total size of the fund, forcing a sponsor to diversify the fund's portfolio and conversely reduce its risk, 2) limitations on any borrowing options available to the sponsor, limiting the risk associated with using leverage, 3) potential restrictions on co-investment in a portfolio company by another fund managed by the sponsor or as a direct investment by an investor in the fund. This is done to control situations of conflict of interest whereby certain investors could be provided the opportunity to co-invest alongside or separately from the fund itself, thus circumventing the various fees the other investors pay in order for the sponsor to find and manage promising investments.[177] The LPA often also includes restrictions in terms of 4) the investment universe, such as geographical-, industry- or other limitations in terms of the portfolio companies.[178] Any provisions on 5) the advisory committee, its composition and decision-making mandate also form a part of this section.[179]

Information disclosure forms an integral part of many investors' investment decisions, both before committing capital to a fund, but also during its lifetime in order to access the performance of the investment and whether to continue the cooperation with the sponsor going forward. However, the regulatory disclosure obligations for funds are rather lacking both in the EU and the U.S., especially in terms of periodical reporting and information regarding the fund's holdings.[180] This makes it more difficult for an investor to make demands regarding information disclosure of the fund towards the sponsor, due to the variations in bargaining

[177] Cumming – Johan 2014, p. 147–148.
[178] Debevoise & Plimpton LLP 2021, p. 57.
[179] Ibid., p. 66–67.
[180] See Chapter 3.3 below.

power between the parties.[181] On the contrary, the lack of disclosure obligations leads to sponsors often choosing to keep the amount of information given to a minimum.[182]

Provisions relating to confidentiality, the liquidation of the fund and any specific liquidation rights (although seldom the case in practice), the distribution of capital and profits, the redemption procedures attached thereto, as well as information on the fees are also often included.[183] The provisions presented herein are by no means an exhaustive list of what is included in the LPA, but they are some of the most influential in controlling the agency costs related to private equity in governing the relationship between the sponsor and a fund's investors. They also are some of the more common provisions being altered by the sponsor and an individual investor through a separate agreement not necessarily available to the other investors – the side letter.

3.2.3 The Side Letter

The fact that similarly situated stakeholders in a company should be treated similarly is a universally accepted principle of corporate law.[184] The same principle can to a certain extent be said to hold true in private equity funds as well, as the provisions in the LPA generally apply equally to all investors in the fund.[185] That principle, however, is quickly cast aside with the introduction of side letters – separate agreements between the sponsor and an individual investor granting special rights and preferences deviating from, or even contradicting, the terms laid out in the LPA.[186] The use of side letters has become an increasingly widespread phenomenon, resulting in not only more sponsors utilizing side letters in their funds on an increasing amount of investors, but also in the length and complexity of these side letters.[187]

[181] The variations in bargaining power between the sponsor on the one hand and investor(s) on the other will be discussed somewhat more in depth further down in Chapter 5, as this bargaining power is one of the major contributing factors as to why the practice of utilizing side letters has become so widespread.
[182] Magnuson 2018, p. 1881.
[183] For a more complete list of common fund terms, see Debevoise & Plimpton LLP 2021, p. 37–73.
[184] Magnuson 2018, p. 1884. This should be taken with a grain of salt, as there are instances where shareholders might be treated differently, most notably as a result of multiple share classes or the existence of preferred shares.
[185] De Fontenay – Nili 2023, p. 19, stating that most provisions in the LPA assigning rights or obligations to investors are done on a simple *pro rata*-basis in accordance with their commitments to the fund.
[186] Ibid., p. 20; Magnuson 2018, p. 1885–1886; Clayton 2017, p. 263 (not specifically mentioning the use of side letters in private equity funds but rather more generally referring to *individualized investing* – an operation whereby the investing itself is the result of customized contracting between an individual investor and a sponsor).
[187] Jeffers–Tucker 2022, p. 6; de Fontenay – Nili 2023, p. 20. In large funds, the combined length of all side letters often surpasses the length of the LPA by a margin of several hundred pages.

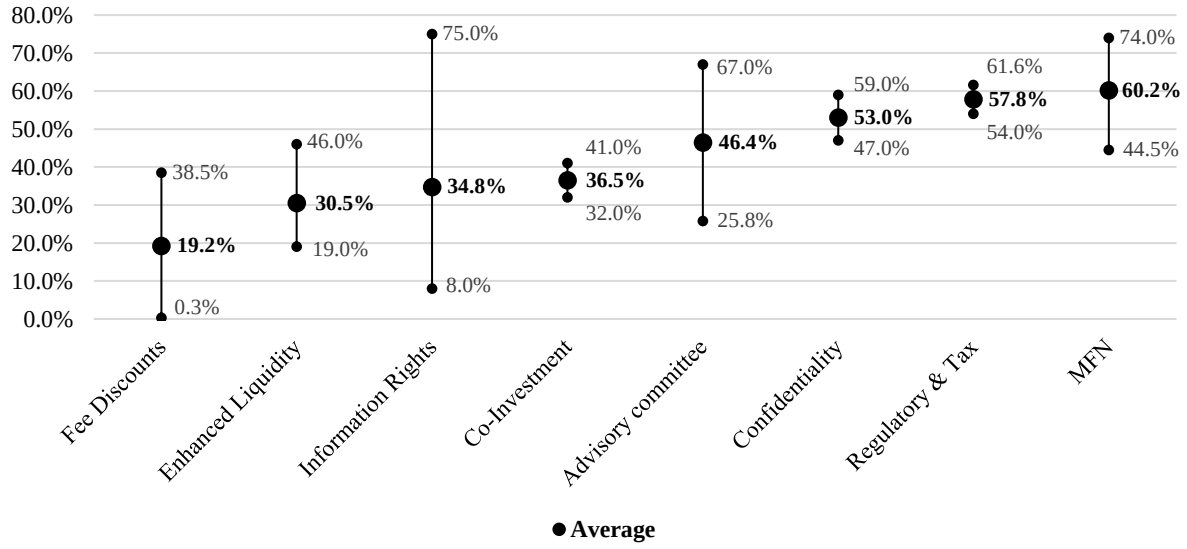
In essence, and especially concerning various fee discounts, side letters can be seen as a classic example of positive *price discrimination*, where providing certain investors with different fees or other terms might favor all investors in the long run. This is largely due to certain costs associated with managing a fund being relatively fixed no matter the size of the fund, which in the end reduces the fees a sponsor needs to charge the bigger the fund gets.[188] Even though most evident in pricing, practically any term or customization provided specifically for one investor can be seen as a form of discrimination. This may affect other investors either positively, negatively, or not at all. These instances of discrimination are not, however, purely an act of kindness towards large investors by the sponsor, as sponsors generally benefit from the large investments, despite the sweetened deal given to such investors, for example by lessening the burden of finding and negotiating with investors to reach the fund's intended size.[189]

Side letters also fill an important function in corporate transactions, especially when multiple parties are involved, since they provide valuable flexibility for the sponsor in an individual case at a relatively low cost.[190] Naturally, it is easier to leave certain terms up to bilateral negotiations between a sponsor and investors, rather than finding a suitable middle ground for all parties to the LPA. This flexibility is heightened when the LPA already has been signed, and new or existing investors would like to negotiate some of its terms afterward. It is easier to just amend certain parts of the LPA through a side letter rather than changing the whole LPA, which might cause more investors wanting to renegotiate as well. It is also an effective tool to attract capital, as a sponsor can provide concessions depending on the need for additional capital.[191] Side letters are by no means a fundamentally bad construction, and have a clear purpose both for sponsors and investors. The question, however, remains as to whether they are the best tool for providing such positive discrimination.[192] It is also questionable whether their apparent cost efficiency holds up in the long term when the number of individual side letters starts growing. A single side letter might seem effective in a vacuum, but considering the web of complexity they often end up creating in aggregation, their effectiveness in their current form is debatable.

[188] Clayton 2017, p. 256.
[189] Ibid., p. 266–267; de Fontenay – Nili 2023, p. 24. A general fee discount for an exceptionally large investor, for example, does not actively affect other investors in a negative way. In addition to the positive effects a large investor has on other investors in the fund, the sponsor itself is also better off, due to the shorter time it takes to reach the desired amount of capital and start finding profitable investments generating returns.
[190] Jeffers – Tucker 2022, p. 9.
[191] Ibid., p. 9–10.
[192] Positive discrimination refers to such differential treatment of investors that have an either completely neutral or positive effect on the rest of the investors in a fund. The opposite phenomena, *negative* discrimination, resulting in a negative impact for the other investors are to a large extent regulatorily prohibited, see Chapter 3.3.

Only in recent years have studies been conducted to assess the more specific contents of side letters, carried out by legal scholars and market participants alike, and in terms of the latter, predominantly law firms.[193] As with any comparison between multiple studies, it is worth noting that not all data is directly comparable between them, due to variations in definitions, categorization, timeframe, and many other factors. In any case, some features regarding common terms and their average frequency of inclusion in side letters can be seen, as shown in Figure 5 below, together with the minimum and maximum frequency of the included studies as well as their respective standard deviation.

Figure 5. Aggregated Occurrence of Specific Term Categories in Side Letters.[194]



	Fee Discounts	Enhanced Liquidity	Information Rights	Co-Investments	Advisory Committee	Confidentiality	Regulatory & Tax	MFN
Standard Deviation	0.14	0.11	0.25	0.05	0.21	0.06	0.04	0.11

One of the most frequently included provisions, and one prone to cause severe administrational difficulties for the sponsor, is the *Most Favored Nation* clause, also called the MFN clause. The provision gives an investor the right to see the terms of other side letters made by the sponsor,

[193] For the research-focused studies, see de Fontenay – Nili 2023, analyzing 252 side letters from 48 different sponsors and 150 different investors between 1991–2020, and Jeffers – Tucker 2022, analyzing 79 side letters from 45 different *impact fund* side letters between 1993–2019. Impact fund refers to a fund with a secondary objective alongside creating monetary value, such as positive social and environmental impact; For the studies by market participants, see Simmons & Simmons 2022, in which all side letters entered into by *hedge funds* advised by their London office during the twelve months ended 30 June 2022 were included, and Seward & Kissel 2022, using the same approach and timeframe.

[194] Based on minimum, maximum, average and standard deviation of results in studies mentioned in *supra* note 193. Note that for some categories, the data presented herein is limited to only two out of the four studies presented here, which has an impact on the following categories presented: *Co-Investment, Advisory Committee, Confidentiality* and *Regulatory & Tax*.

and the option to receive the same treatment as stated in any of those side letters. MFN rights protect an investor against another investor getting better individualized rights, but usually only apply to terms received by other investors with commitments equal to or smaller than that of the investor in question.[195] This ensures that the largest investor in a fund can be the sole recipient of the most favorable terms, and works as an incentive to drive up the commitments of investors. It is not hard to imagine the administrative nightmare that a complicated web of numerous MFN clauses spread across multiple investors of different commitment sizes and preferences may cause for a sponsor trying to ensure that it fulfills its contractual obligations towards all investors, and that everyone is given the chance to choose their preferences in terms of applicable side letter provisions.

Various regulatory and tax-related disclosure or reporting rights are also common in side letters. Certain institutional investors, such as pension plans or endowments, might need additional representations from the sponsor in order to fulfill their own regulatory duties. In keeping with the general secrecy of side letters, provisions on confidentiality are often included to hide not only the contents of the side letter itself, but in many instances the majority of information disclosed to an investor by the sponsor connected to the fund in any way.[196] Some confidentiality provisions concern the sponsor, but the majority of obligations are directed towards investors, further shrouding side letters in a veil of shadows, hidden from the outside world and in many instances even from the other investors in the fund.[197] While the LPA often sets out the mandate and function of the advisory committee, deciding on who actually sits on the committee is done in side letters.[198] A place in the committee gives investors the possibility to monitor the sponsor and its activities related to the fund to the extent agreed in the LPA, shifting some power back to investors, but only to the extent they have been given a seat at the table to begin with. This apparent problem with inclusion on the advisory committee is only strengthened by the fact that investors on the committee usually do not owe a *fiduciary duty*, a duty of loyalty and care, towards the fund or any of its investors in the same manner as the sponsor, as described below in Chapter 3.3.2. This means that investors on the advisory committee are free to maximize their own self-interest.[199]

[195] Clayton 2020, p. 94.
[196] Jeffers – Tucker 2022, p. 37–38.
[197] Ibid., p. 39.
[198] Clayton 2020, p. 105.
[199] Zeisberger et al. 2017, p. 210.

Co-investment rights, as the name suggests, grant an investor the opportunity to invest in a portfolio company alongside the fund for free, or at greatly reduced costs, and function as an opportunity for an investor to earn higher returns with lower total fees.[200] Investors might also demand greater information rights, through more frequent and detailed reporting on the ordinary operations of the fund, as this kind of reporting is, as discussed, normally kept to a minimum in the LPA as standard.[201] Various terms giving an investor enhanced liquidity, such as early redemption or transfer rights also exist, allowing an investor to redeem their investment earlier than other investors or transfer their investment in the fund to another party, respectively.[202] The perhaps most intuitive term one expects to find in a side letter, a deviation from the fee structure in the LPA that is, exists, but not to the extent one would imagine. The variation between the studies is remarkable, ranging from only being found in 0.3 % in one study to as much as 38.5 % in another.[203] Other potential terms not specifically highlighted in the studies are different opt-out rights or changes in the investment restrictions of the fund, provisions allowing an investor to either not take part in a certain type of investment with its committed capital or to prevent the fund from making certain investments overall, respectively.[204]

Based on the various provisions that can, and often are, included in these side letters, it is not hard to start imagining instances where these individual rights might work to the detriment of other investors not receiving a level of customized treatment of the same standard, if at all. Take, for instance, a situation whereby a fund without any investment restrictions in its LPA refrains to invest in a certain company due to terms in a side letter with an individual investor

[200] Clayton 2020, p. 104.
[201] de Fontenay – Nili 2023, p. 28 & 35.; *supra* note 175; Simmons & Simmons 2022, p. 7. Some common examples are notices relating to various legal action directed towards a party, key person events, change in service providers or amendments to the fund documentation.
[202] Transfer rights are often pretty severely limited, as the sponsor have a keen interest in knowing the investors of the fund in terms of their eagerness to cooperate and continuing a relationship for new funds and their financial situation. This is highlighted by the fact that the whole investment amount is not directly transferred to the fund as of making the investment, but instead given out as a capital commitment. Sponsors are thus dependent on investors' ability to provide capital in case of a capital call. This results in these transfer rights usually applying only to closely related entities to the original investor, such as affiliates. See, for example, de Fontenay – Nili 2023, p. 38.
[203] The data derived from the studies is limited and to a certain extent flawed, with the studies being based either on side letters originating from the same law firm office on the one hand, or them being provided for a study on a completely voluntary basis on the other. As such, no ultimate conclusions should be drawn based on this data alone, but it does give an indication as to the terms' overall existence and the potential terms to be included.
[204] Magnuson 2018, p. 1886; de Fontenay – Nili 2023, p. 44. Certain investors might be committed to following certain environmental, social and/or governance (ESG) objectives while the fund overall is not bound by such a mission. This may result in the investor demanding that it be left out of or that the fund does not invest in, for example, companies within the tobacco, oil or firearms industry.

stipulating that the fund cannot invest in companies within that specific sector.[205] Or when only certain investors have access to valuable information on the operations of the fund, leaving the other investors completely in the dark regarding potential risks or problems brewing in the fund. This differential and seemingly unfair treatment is, luckily for investors, not limitless, and there are certain restrictions that sponsors in both the U.S. and the EU must adhere to. Due to the secretive and opaque nature of side letters, often heavily guarded by various NDAs, effective supervision of the contents of side letters and the doings of the sponsor is often difficult to actively monitor. As a result, one study on side letters conclude that around forty percent of the sampled side letters include provisions that would make them unenforceable under applicable law.[206]

What, then, are the rules governing these funds in the EU and the U.S. respectively? And on what terms is the sponsor allowed to treat investors differently? Luckily for the smaller investors in a fund, they are not completely left at the mercy of the sponsor and a battle of negotiating power, as there are certain, albeit rather limited, rules and restrictions that apply to all sponsors running a private equity fund. Furthermore, sponsors are generally obligated to act in the best interest of a fund's investors. These aspects will be the next focus of attention.

3.3 The Law on Side Letters in Private Equity Funds

3.3.1 The EU Framework

In the EU, private equity funds are considered *alternative investment funds*, or *AIFs* – funds not falling within the scope of the strict legal framework laid out in the UCITS directive.[207] AIFs, and as such private equity funds, instead fall within the scope of the AIFMD, a legal framework aiming to harmonize the regulatory and supervisory requirements surrounding *alternative investment fund managers*, or *AIFMs*,[208] and their activities in managing AIFs within the

[205] In most instances, such a restriction will be based on the investor having certain ESG requirements and wanting to exclude companies within, for example, the oil-, tobacco- and weapon sectors. But in other instances it can be the result of an investor simply not wanting any further concentration towards a certain industry to which it is already greatly exposed to, either through other investments or its own activity.
[206] de Fontenay – Nili 2023, p. 57.
[207] AIFMD, Article 4.1.(a). Other funds considered AIFs are, for example, hedge funds, real estate funds and other specialized funds intended for institutional investors, see EU – Investment funds 2023. The UCITS directive lays out a common framework within the EU for regulating a certain type of fund. UCITS funds are open for daily subscription and redemption for retail investors, making them a highly unattractive option for private equity funds. As such, the UCITS directive is excluded from the scope of this thesis.
[208] The AIFM most often act as the GP of the private equity fund, see Payne 2011, p. 17. This coincides with the definition given to the term sponsor earlier on in the thesis and will, for ease of reference and coherence of the thesis, be used instead of the term AIFM going forward.

internal market of the EU.[209] Smaller sponsors fulfilling one of the two *de minimis* thresholds in the AIFMD are largely exempt from the scope of the AIFMD, notwithstanding certain registration and reporting requirements to their *National Competent Authority* (*NCA*).[210]

Collective action was deemed necessary on an EU level in order to ensure that sponsors, which over time have evolved into substantial players in the financial markets, and the risks related to their activities could be sufficiently managed and supervised on a harmonized level within the internal market.[211] Regulation of private equity had previously been the responsibility of the Member States themselves, resulting in vastly different approaches as to the best way to regulate the sector.[212] The entity responsible for providing guidance and assistance on matters relating to the financial markets within the EU internal market, and as such also on the entity entrusted with assessing the content and implementation of the AIFMD and its supporting acts, is the *European Securities and Markets Authority*, or *ESMA* for short.[213] The AIFMD and its supporting acts, primarily the AIFMR, sets out the requirements applicable to sponsors marketing and operating a fund within the EU, mainly regarding the authorization of the sponsor with their NCA, own capital requirements for sponsors as well as provisions regarding general sponsor conduct, remuneration, conflicts of interest, risk- and liquidity management, valuation, delegation, reporting to NCAs as well as various disclosure requirements to investors.[214] For the purpose of this thesis, the provisions on investor disclosure and the general sponsor conduct rules are the most relevant, and also the ones briefly discussed below.

Investor disclosure under the AIFMD can be divided into two primary types – an annual report as well as pre-investment and periodical information to be provided to investors. The annual report shall be made available to investors no later than six months following the end of the financial year of each AIF managed by the sponsor, and include an overview of the fund's financials, activities, remuneration and material changes made to it throughout the previous

[209] AIFMD, recital 4. The regulation covers all managers established within a Member State, non-EU managers managing an AIF established within the EU or at least marketing such AIF to investors domiciled in the EU.
[210] Sponsors managing AIFs totaling less than EUR 100 million or sponsors who manage unleveraged AIFs totaling less than EUR 500 million, and the AIFs in the latter case additionally does not provide any redemption rights for a period of five years from the initial investment period of any such AIF, see AIFMD, Article 3 2.(a)-(b). Both of these could in theory be applicable to private equity funds, whereby easier restrictions would apply. Should a sponsor, however, want to benefit from any rights given under the AIFMD, the directive becomes applicable in its entirety on that sponsor, see AIFMD Article 3.4.
[211] AIFMD, recital 2–3. See also Payne 2011, p. 11 and Gibson–Witney 2017, p. 1.
[212] Ibid., p. 1. Germany, for example, took a "hand-off" approach when it came to specific regulation regarding private equity and its managers, the regulation in the UK was minimal, and primarily focused on setting out certain guiding principles, while France opted for a more extensive framework set out to protect investors.
[213] For more information on ESMA, see, for example https://www.esma.europa.eu/about-esma. See also ESMA AIFMD Final Report 2011 and ESMA AIFMD Consultation Paper 2011.
[214] See AIFMD, Articles 12–24.

financial year.[215] The pre-investment and periodical disclosure in turn should, as the name suggests, be made available to all investors before committing to investing in a fund and periodically afterward and include, among other things, information on the following:

- the fund's investment strategy and -restrictions,
- liquidity management, including any redemption rights as well as current redemption arrangements with investors,
- all fees, charges and expenses as well as their maximums borne by investors, and
- *how the sponsor ensures fair treatment of investors, and if preferential treatment is or might be given, a description of such treatment, the type of investor eligible for preferential treatment and their economic or legal connection to the AIFM, if any*.[216]

As evident from the disclosure obligations above, sponsors within the EU have, in fact, rather far-reaching obligations in terms of the information they have to provide its investors. Most importantly, the sponsor is required to disclose to all investors the possibility to issue side letters, what terms are open for individual negotiations and included in these side letters, as well as the type of investors eligible for such negotiations.[217] This should, in theory, remove much of the secrecy surrounding side letters and what they include, even though no requirement exists as to disclosing the individual terms that are, in fact, included in the side letters, or with whom the sponsor has entered into any side letter arrangement with. Additionally, and of critical importance when it comes to the importance of this thesis, sponsors have an obligation to treat all investors fairly, and any preferential treatment provided to one or more investors shall not result in a material disadvantage to other investors in the fund.[218]

The concept of fair treatment has not been clearly defined on an EU level, as ESMA believes a definition would hinder the Member States' ability to effectively tackle problems relating to whether a sponsor is, in fact, acting fairly. It further concludes that the vast majority of Member States already have a principle of fair treatment in their legal frameworks and that an assessment of the concept of fair treatment almost always includes a subjective assessment of the facts in each individual case, which a definitive definition might threaten.[219] As such, the assessment

[215] AIFMD, Article 22.
[216] For the full list of disclosures, see AIFMD, Article 23.
[217] No explicit guidance is provided as to what exactly is meant by *type of investor*, which leads one to believe that the general division of investors in *professional*- and *retail* investors is the *type* referred to herein. See AIFMD Article 4.2 (ag) and (aj). It is possible, however, that it also refers to more specific categories of investors, such as specific investor entities or investors who invest a certain amount or before a certain date, just to name a few examples.
[218] AIFMD, Article 12.1(f) and AIFMR, Article 23 respectively.
[219] ESMA AIFMD Final Report, p. 51. See also the Finnish duties of loyalty and -fairness in Chapter 2.2.

as to what is fair and what is not is largely left up to the individual Member States, which causes certain uncertainty as to the boundaries of the concept of fair treatment.[220] One clear aspect included in the concept of fair treatment, however, is the prohibition of preferential treatment causing a material disadvantage to other investors. Unfortunately, the problem of uncertainty persists, as this principle is also not set in stone as ESMA is rather inconclusive as to what exactly might constitute a material disadvantage, and only provides a couple of examples of situations not constituting a material disadvantage to investors.[221] For example, providing investors with varying terms using different *share classes* might not constitute a material disadvantage to investors to the extent the varying terms in the different share classes are sufficiently disclosed to all investors.[222] The usage of different share classes is common practice in certain investment funds, such as hedge funds, but largely absent in private equity funds for some reason.[223] Another example highlighted by ESMA is providing *seed* investors with more favorable terms than investors joining a fund at a later stage.[224] The practice of seed investors is mainly used in other types of funds which are, in theory, open indefinitely with periodical subscription and redemption periods and as such not in private equity funds, which have a specified lifetime and does, as a rule, provide only one subscription and redemption opportunity.

As we can see from the provisions in the AIFMD and AIFMR, the rules regarding the use of side letters are fairly strict within the EU. All possible side letter terms and to whom they might be provided should be disclosed, and they may not result in a material disadvantage for other investors. This, paired with an overall concept of fair treatment of investors based on the relevant NCA's assessment, should not leave a lot of leeway when it comes to secretly treating

[220] These boundaries could prove an interesting subject for another paper, but for the purpose of this thesis it is enough to conclude that legal uncertainty presides as to what the limits for the fair treatment principle are.
[221] ESMA AIFMD Consultation Paper, p. 52–53.
[222] Share classes are used to divide a fund into several separate compartments whereby different terms apply to the different compartments, but they are still part of the same pool of capital in the fund. In the ESMA AIFMD Consultation Paper, however, ESMA only refers to variations in redemption fees, minimum investment amounts and management fees, leaving it open as to whether there might, in fact, still be terms prohibited and deemed to cause a material disadvantage to investors even when used in different share classes, see ibid., p. 52.
[223] de Fontenay – Nili 2023, p. 20, 57.
[224] So-called seed investors are investors joining a fund at an early stage, often providing crucial capital in getting the fund operational, but also taking on more risk as the track record of the investment fund is unknown and the limited amount of capital in the fund at that point puts pressure on the first investors, see, for example Klingler-Vidra 2016, p. 692–693. In this example, however, ESMA gives no indication as to what terms may be provided to seed investors that deviate from the terms given to other investors later on, leaving the situation highly uncertain, see ESMA AIFMD Consultation Paper, p. 53. I am highly skeptical towards an interpretation of ESMA's statement as in practice allowing all kinds of preferable treatment of seed investors, as there are certain terms (such as preferential redemption) that would constitute an obvious material disadvantage and unfair treatment of investors having more limited, or non-existent, redemption terms.

certain investors more favorably at the expense of other investors. However, a lot of legal uncertainty persists as to which exact terms are permitted and which are not in any given instance, resulting in a certain degree of risk in utilizing side letters as an EU sponsor, especially when they become longer and more complex.

3.3.2 The U.S. Framework

The primary piece of legislation regulating sponsors in the U.S. is the Investment Advisers Act of 1940, the *Advisers Act*.[225] However, specific regulation applicable to the private equity industry in the U.S. was pretty much non-existent until the Dodd-Frank Act was enacted in 2010, amending the Advisers Act in the aftermath of the financial crisis of 2008.[226] Similar to the AIFMD, one of the motives behind the Dodd-Frank Act was "*to promote financial stability of the United States by improving accountability and transparency in the financial system…*",[227] which was achieved by implementing wider obligations for fund managers to register as investment advisors[228] with the *U.S. Securities and Exchange Commission* (SEC), an obligation to which many sponsors had earlier been exempt from due to exceptions in the earlier version of the Advisers Act.[229]

This was followed by an obligation for sponsors above certain thresholds to adhere to more onerous disclosure obligations.[230] This obligation included maintaining certain records and reports on each fund, including information about the fund's assets and investments, valuation arrangements and most importantly for this thesis, information on any side arrangements or side letters through which certain investors get more favorable rights than other investors.[231] Of great importance here is the fact that these records and reports are only "*required to be*

[225] SEC 2013, p. 1.
[226] Seretakis 2013, p. 654 & 660.
[227] Dodd-Frank Act, preamble.
[228] As was the case with AIFMs in Europe in the previous chapter, the term *sponsor* will henceforth be used instead of the term *investment adviser*, regardless of whether an exception applies to the sponsor to not register as an investment adviser.
[229] See the original Investment Advisers Act Section 203(b). Previously, sponsors who did not publicly hold themselves out as investment advisors and during the preceding twelve month had fewer than 15 *clients*, in this instance meaning funds, were amongst the ones excepted from this registration requirement. See also Seretakis 2013, p. 661.
[230] For example, Advisers Act Section 203A, § (a)(1)(B), whereby investment advisers with AUM below $100 million should register with the state regulator instead of with the SEC or Advisers Act Section 203, § (m), whereby an investment adviser acting solely as an adviser of private funds and has AUM in the U.S. of less than $150 million is except from the registration requirement. Both might, in theory, apply to smaller sponsors. A further discussion on theses registration exceptions is not necessary here, as it is enough to conclude that a much larger part of U.S. sponsors where required to register under the new rules in the Dodd-Frank Act, but that some exceptions still remain for the smallest sponsors.
[231] Advisers Act Section 204, § (b)(3).

maintained by an investment adviser and subject to inspection by the Commission…",[232] and do as such not result in any direct disclosure obligations towards the actual investors in the fund, but rather towards the SEC. This points towards concrete private equity disclosure regulation having as its primary objective to monitor systemic risks in the financial markets rather than investor protection.

The specific provisions applicable to registered sponsors concerning a fund's investors in the Advisers Act have on purpose been left rather inconclusive, as sponsors must also adhere to a broad, non-waivable fiduciary duty of acting in the best interests of their investors.[233] This fiduciary duty is supposed to substitute a strict set of minimum regulatory requirements and ensure that the sponsor and the investors themselves are able to choose the terms under which they want to cooperate, by, for example, ensuring that the investor receives all necessary disclosure in good faith to make an informed decision as to whether to engage in a relationship with a specific sponsor or not.[234] A sponsor's fiduciary duty under the Advisers Act is comprised of on the one hand a *duty of care*, setting out the sponsor's conduct in terms of how to act on behalf of its investors, and on the other hand a *duty of loyalty*, the notion that the sponsor shall subordinate its own interests to that of its investors' interests.[235] The duty of loyalty specifically includes an obligation to make full and fair disclosures to investors of all material facts relating to the relationship.[236]

The scope of this duty, however, does not seem to automatically include disclosure of any preferential terms provided to certain investors and not to others, as the SEC has recently raised concerns about the practice of providing side letters to certain investors, and the very limited disclosures made to investors currently.[237] The result is a proposed amendment to the Advisers Act, whereby concrete disclosure obligations on a sponsor's side letters would be implemented. The proposal would, among other things, outright prohibit preferential treatment in terms of preferred liquidity- and information rights for certain investors, as well as a general prohibition

[232] Ibid.
[233] SEC 2013, p. 22; Previously, many sponsors would contractually waive any fiduciary duties, as this was possible for limited liability partnerships under Delaware law, see for example de Fontenay 2013, p. 181 or Manesh 2009, p. 476–477. Such a waiver is, however, not possible anymore since the obligation to register with the SEC and the Advisers Act became applicable to most sponsors. Any such contractual waiver is to be considered as void, see Advisers Act Section 215, § (a).
[234] SEC 2008, p. 4.
[235] SEC 2019, p. 12–21; The notion of fiduciary duty can be found in the Advisers Act Section 206, prohibiting fraudulent behavior or deceit by a sponsor.
[236] See SEC 2019, p. 21–22 as well as SEC 2008, note 148 and Instruction 2 to Part 2A of the Proposed Instruction to Form ADV.
[237] SEC Proposed Rule 2022, p. 168 & 191.

on preferential treatment unless it is sufficiently disclosed to the other investors both on a pre-investment and annual basis.[238]

Since the proposal was made public by the SEC in February 2022, affected parties have not been shy in giving their opinions on the proposed amendments, as over 350 comments have been received by the SEC from a wide array of entities, as of the date of this thesis.[239] Even though the comments of the proponents and opponents of the proposed rules are in stark contrast to each other, a common conclusion among commenters seems to be to note that the SEC is deviating from their usual approach, or even going as far as stepping out of line, by directly inferring mandatory rules onto the relationship of sophisticated parties within the space, something they have thus far avoided.[240] The former chairman of the SEC, Harvey Pitt, even questions whether this approach of "*altering the balance of negotiating power between highly sophisticated parties*" is the best use of taxpayer money by the SEC.[241]

Critics have argued that, for example, the prohibition on preferential information rights serves no actual purpose in the context of private equity and venture capital, since all investors are stuck with their investments and thus not able to act on the additional information provided to the detriment of other investors.[242] Another point made is the fact that requiring certain disclosure obligations in regard to side letters would cause additional administrative burdens, the costs of which are ultimately borne by the investors themselves and elevating the barrier for entry into the market.[243] This critique, however, can be questioned considering the scope of this thesis, as it seems to presuppose that the side letter practice would continue as before, only with added and costly requirements. On the contrary, a disclosure obligation could incentivize a sponsor to rethink their side letter arrangements and remove unnecessary terms from them, ultimately resulting in shorter, more transparent and more efficient side letters. In light of the above, the SEC ought to focus on creating a framework whereby the parties themselves would

[238] SEC Proposed Rule 2022, p. 341 and proposed rule § 275.211(h)(2)-3.
[239] The full list of comments is available at Comments on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (sec.gov) (Accessed 15.5.2023). Although not the purpose of this thesis, some comments on the SEC Proposed Rule 2022 are nonetheless worth highlighting, as the final wording of the rules will naturally have a huge impact on how sponsors' at least should treat side letters. This thesis wants to go further than purely finding the minimum requirements they all have to follow, but instead focus on finding out whether all parties could benefit from changing the way they use side letters, and thus focusing on what they *want* to do rather than what they *have* to do.
[240] See, for example, NVCA 2022, p. 7–8; Proof VC 2022, p. 10; Clayton 2022b, p. 1–2; Pitt 2022, p. 2.
[241] Pitt 2022, p. 12.
[242] NVCA 2022, p. 27; Proof VC 2022, p. 9.
[243] NVCA 2022, p. 27; Proof VC 2022, p. 9–10.

be incentivized to look over and enact necessary changes to the practice of side letters that minimizes the inherent risks and issues related to them highlighted in this thesis.

The current boundaries on the usage of side letters, however, still seem broader in the U.S. than they are in the EU, and the whole private equity regulation in the U.S. is currently seen as more lenient and "sponsor-friendly".[244] This is not to say that the current rules are free of legal uncertainty and without substantial risk, as there are already several instances where the SEC has warned sponsors, and even brought action against them, for breaching their fiduciary duties through insufficient disclosure practices.[245] The current proposal by the SEC to introduce specific regulation on the use of side letters also adds to their uncertain future, as the rules threaten to overthrow some of the current market practices surrounding them, such as their secrecy through confidentiality and some of the general terms available for inclusion. In aggregation, this creates substantial risks associated with the current practice of providing side letters in the manner currently witnessed in the industry.

3.3.3 The Legal Framework - Challenges and Opportunities

The use of side letters is generally not prohibited in its entirely, and might serve as a form of positive discrimination, lowering the overall costs each investor has to bear. This, however, requires that the sponsor complies with all regulatory provisions regarding their use, such as disclosure requirements and a prohibition on certain terms, which in certain instances could limit their current function severely.[246] It is somewhat interesting that the use of side letters is a relatively global phenomenon, despite the current regulation in at least the EU and the U.S. being of a rather varying level and clarity. As the rules on private equity are easier on sponsors in the U.S. compared to in the EU, this begs the question as to why the same practice and

[244] Seretakis 2013, p. 662.
[245] See SEC Risk Alert 2020 for an overview of some of the deficiencies found in sponsors' conduct relating to their fiduciary duty, and specifically the duty of loyalty. For action brought by the SEC see, for example, In the Matter of Blackstone Management Partners LLC., et al., Investment Advisers Act Release No. 4219 (Oct. 7, 2015) (settled action) (failure to inform investors about certain sponsor benefits on fees); In the Matter of Orinda Asset Management, LLC, Investment Advisers Act Release No. 4513 (Aug. 2016) (settled action) (failure to disclose side letter term to the SEC); In the Matter of Apollo Management V, L.P, et al., Investment Advisers Act Release No. 4493 (Aug. 2016) (settled action) (breaching its fiduciary duty in terms of investor disclosure); In the Matter of Mitchell J. Friedman, Investment Advisers Act Release No. 5338 (Sept. 4, 2019) (settled action) (failure to properly disclose material conflicts of interests); In the Matter of Global Infrastructure Management, LLC, Investment Advisers Act Release No. 5930 (Dec. 20, 2021) (settled action) (false and misleading statements to investors on how fees are charged from the fund).
[246] This is based on the fact that all terms that could be considered as causing a material disadvantage for the fund's other investors would be declared invalid. One study showed that nearly forty percent of side letters contained such a term, see *supra* note 206.

problems seem prevalent in both jurisdictions. One answer, though somewhat simplified, might be that EU sponsors are simply following the market practices laid out by sponsors in the U.S., as both private equity AUM and the practice of side letters seem heavily tilted towards the U.S.[247] The theory is plausible since the private equity industry is notorious for being reluctant to deviate from established market practices due to the risk of reputational damage attached to failure when going against the status quo.[248]

Despite their current usage, various legal risks and uncertainties surrounding side letters remain, particularly regarding what terms are prohibited due to them causing a material disadvantage for other investors. As more specific guidance is yet to be found in the regulation itself, other sources have to be utilized to assess the concept of materiality. The *Alternative Investment Management Association* (*AIMA*), a global representative for all practitioners within the alternative investment industry, published a guidance note on side letters as early as 2006, in an attempt to assist practitioners, but also EU and U.S. regulators when forming the contents of both the AIFMD and the Dodd-Frank Act.[249] In the note, AIMA defines a material term as:

> "*Any term the effect of which might reasonably be expected to be to provide an investor with more favourable treatment […] which enhances that investor's ability either (i) to redeem […] or (ii) to make a determination as to whether to redeem […], and which in either case might, therefore, reasonably be expected to put other[s] […] at a material disadvantage in connection with the exercise of their redemption rights*".[250]

Terms such as preferential redemption rights, *key man* clauses and various portfolio transparency rights are also given as examples of what could be considered a material term.[251] This corresponds rather well with the proposed new rules by the SEC, whereby preferred

[247] North America's share of the global private equity AUM was around 50 % in H1 2021, see McKinsey Global Private Markets Review 2023, p. 8; According to Simmons & Simmons 2022, p. 5, around 56 % of all investors party to a side letter was from North America, and U.S. investors were in a clear majority. For reference, only 18 % of investors were from Europe. Worth noting here is also the fact that this study only represented side letters on which a law firm office in London had worked on, which in theory should result in an overweight of European investors due to the proximity to the EU. It is reasonable to expect that the numbers would have been even further tilted towards U.S. investors, had the study been conducted in the U.S.
[248] Magnuson 2018, p. 1892–1894.
[249] See, for example, AIMA's comments to the SEC 2007.
[250] AIMA's Industry Guidance Note on Side Letters, p. 1–2.
[251] Ibid. p. 2. In private equity, a key man clause generally refers to a prohibition by the sponsor to undertake new investments in the absence of a named *key individual*. They are used to ensure that the investment have been approved by a specific individual, a skilled and knowledgeable person investors often hold in high regard.

redemption rights and certain portfolio information provisions are proposed to be prohibited altogether.[252]

This interpretation would exclude many terms frequently used in side letters, making them unenforceable by law.[253] This, together with the uncertainty remaining for other terms in the "grey area" for side letters, and side letters quickly become increasingly limited in their usage, and associated with substantial legal risks. But side letters are not only problematic from a strictly legal risk perspective, they are also practically burdensome for both sponsors and investors in relation to their negotiation, administration, time consumption and ultimately, costs. Apart from the regulatory requirements laid down in Chapter 3.3, the relationship between the sponsor and investors is to a large extent a contractual one, based on contractual principles and the result of their mutual negotiations. As a result, there are a myriad of contractual principles, "soft-law" and other, sometimes even surprising, factors in play behind structuring the aforementioned relationship. As the usage of side letters seems restricted, and at times risky at best, one might start to question whether there are more efficient options out there for sponsors to receive capital and investors to receive the rights they both so desperately desire. The next part of this thesis aims to further highlight the other risks and hurdles in the side letter practice, diminishing their usefulness as a simple solution to a somewhat complex problem, as well as to discuss the factors contributing to the development and upholding of such a seemingly problematic governance structure.

[252] SEC Proposed Rule 2022 and proposed rule § 275.211(h)(2)-3 (a).
[253] See *supra* note 206.

4. Unveiling the Side Letter Enigma

4.1 Current Side Letters are Inherently Imperfect

Actors active in the private equity industry, such as sponsors, investors and their respective agents or advisors, are currently given rather free reins in shaping their contractual relationships to their pleasing, staying within certain regulatory boundaries of course. In the eyes of many scholars, this is a natural outcome, since the parties involved are to be considered professional and sophisticated entities able to see to their own needs, and thus able to contract efficiently.[254] Direct critique has been directed towards regulating private equity, as a cause of undue costs ultimately borne by investors and unnecessity due to the previously mentioned sophistication of the parties involved.[255] Others, especially in recent years, have started to question the existence of such an efficient negotiation mechanism as described above, and instead highlight the many aspects resulting in suboptimal and at times unfair contracting between even the most sophisticated parties, particularly within the private equity industry.[256] The very idea that sophisticated parties can fend for themselves in contracting is up for debate, since the contracts they create continue to become more difficult to understand and harder to effectively fulfill.[257]

Side letters are also not as simple as they might seem at first glance, and the current practice of providing side letters is far from straightforward and hassle-free. Assuming this, the side letter enigma then becomes why such a seemingly unoptimized practice has been developed and adopted in such a sophisticated and competitive industry in the first place. To make such an analysis worthwhile, as well as to develop alternative approaches, a more thorough review of the current shortcomings of side letters is necessary, to incentivize a change towards more suitable practices. Chapter 4 aims to do just that. Even though the legal framework applicable to side letters is limited, apart from the disclosure obligations presented in Chapter 3.3, some additional grey areas exist as to their validity and interpretation. Further, many other aspects of the current practice create inefficiencies and other unnecessary burdens for the parties involved. Having done that, we take a closer look at the current misalignment of incentives that currently permeates nearly all aspects of the side letter value chain, from sponsors, investors, both individually and collectively, to the various advisors and legal counsel advising them.

[254] See, for example Payne 2011, p. 12 and Walker 2007, p. 13.
[255] Seretakis 2013, p. 659–660. See also generally the critique of the SEC Proposed Rule 2022 on *supra* p. 45.
[256] Clayton 2022a, p. 707–711. See also SEC Proposed Rule 2022, p. 132, 153 & 213–214, highlighting the problems caused by conflicts of interest and competition between investors.
[257] Kastner 2022, p. 453.

4.2 Uncertainty Regarding the Validity and Enforceability of Side Letters

4.2.1 Side Letter Validity – The Applicable Framework

Although rather few, there are certain crucial legal requirements for sponsors to fulfill in order for their potential side letters to be valid and enforceable. Firstly, all sponsors falling under the regulatory regime in the EU need to fulfill the disclosure requirements set out in the AIFMD.[258] As such, a clear disclosure needs to be made to each investor as to the possibility for the sponsor to enter into separate side letters with certain types of investors, as well as concerning what terms can be included in such side letters. Although not explicitly the case yet in the U.S., largely the same requirements might soon become applicable to U.S. sponsors under the Investment Advisers Act, depending on the final content of the proposed amendments.

In theory, this requirement is rather easily addressed by including a standardized statement in the LPA describing the situations, with whom, and on what terms side letters can be entered into between a sponsor and an individual investor. However, simple as it might seem in theory, such a broad disclosure would limit the secretive nature of side letters, as all investors would be made aware of their existence and the rough form they may take. This would require sponsors to more carefully examine their side letter practice and weigh its benefits against the risks, mainly resulting from disgruntled investors who do not succeed in negotiating their own side letter. Further, it would also limit the sponsor as to what terms can be negotiated with potential investors, since the types of potential terms need to be included in the LPA and thus known to the sponsor beforehand. This could prove specifically problematic when considering the potential of investors joining after the LPA has already entered into force. As a result, it becomes increasingly important for the sponsor to carefully consider what terms might be included in future side letters. Not properly assessing the universe of potential side letter terms can, in a worst-case scenario, lead to a sponsor having to turn down crucial investors due to the LPA not permitting the terms needed for such an investor to be able to invest.

Secondly, EU sponsors cannot include terms that cause a material disadvantage for other investors.[259] Similar prohibitions on using certain terms are currently also applicable to U.S. sponsors, as was shown in the U.S. case of *ESG Capital Partners*.[260] In the case, the Delaware

[258] AIFMD Article 2.1. As described in Chapter 3.3.1, the AIFMD applies to 1) EU AIFMs, irrespective of the AIF managed, 2) non-EU AIFMs that manage an EU AIF and 3) non-EU AIFMs marketing a AIF in the EU, irrespective of whether the AIF is an EU AIF or non-EU AIF. See also *supra* p. 39–40.
[259] AIFMR Article 23.2. See also *supra* p. 41–42.
[260] ESG Capital Partners II, LP, et al., v. Passport Special Opportunities Master Fund, LP, et al., C.A. No. 11053-VCL (Del. Ch. Dec. 16, 2015) (Hereinafter "ESG Capital Partners").

Chancery Court held that a sponsor did not have the authority to grant preferential treatment to certain investors through a side letter in a manner that would cause a detriment to other investors.[261] The case concerns a limited partnership set up with the intent of purchasing shares of Facebook prior to its IPO, by raising money from various investors, much like in a private equity fund. The LPA in this case held that any distributions would be made to all investors in a pro-rata manner in accordance with their ownership in the partnership. This provision in the LPA was, however, not adhered to, as the sponsor had entered into side letters with certain investors granting them a fixed amount of distribution depending on the sum of their investment, rather than in proportion to their overall ownership in the partnership. This led to some investors not having a side letter receiving either no distribution at all, or at least on worse terms than investors with a side letter.[262] The disfavored investors brought action against the investors who had gotten preferential distribution rights through side letters, arguing a breach of the LPA in violation of its distribution provision and the unjust enrichment of certain investors.[263]

The court held that the term in the side letters granting certain investors with distribution rights related to their investment rather than its proportion to the size of the partnership was invalid, as the sponsor lacked the authority to unilaterally grant rights that would *materially and adversely change the specifically enumerated rights or duties of a party or of a class of parties* as per the LPA. For such an addition to have been valid, the LPA would have needed to be amended, requiring the approval of a majority of investors.[264] Additionally, the court found that the side letter term in principle assigned the investors a specific number of Facebook shares as "their own", which goes against Delaware Law.[265] Interestingly, the terms of the side letter were in fact deemed invalid by the court already at an earlier stage, due to a clash with an *integration clause* in a superseding agreement, yet another risk with side letters and one we will take a closer look at in Chapter 4.3.2.[266]

Although the case concerned the specific circumstance in that an integration clause already invalidated the side letter and that the term in the side letter was practically contested both

[261] ESG Capital Partners, p. 27–29.
[262] Ibid., p. 1.
[263] Ibid., p. 6.
[264] Ibid., p. 28.
[265] Ibid., p. 25–27. See also ibid., p. 11 and the Delaware Uniform Limited Partnership Act § 17-701, stating that a limited partner does not have any interest in specific limited partnership property. Instead, a limited partner has a partnership interest in the limited partnership, giving the partner a share of the partnership's profits or losses, as well as a right of *distribution* of partnership assets, but not ownership of the property itself.
[266] An integration clause is, in essence, a confirmation by the parties to a contract that all aspects relating to the matter therein is included in the contract itself, and superseding any previous understanding.

directly in the LPA and indirectly in applicable law, there are a couple of interesting points to be made here. Even though the court did not directly assess whether certain terms are by nature invalid in side letters, it created a kind of *negative prohibition* on certain terms that are protected in the LPA by prohibiting altering terms in side letters that specifically would require amending the LPA. Thus, a standardized clause in the LPA could to a large extent make applicable substantially the same prohibition on material disadvantage for other investors as is currently the case under the AIFMR in EU law:

> *Any amendment to this [Agreement] that would materially and adversely affect the rights of any [limited partner] must be approved by a majority of the adversely affected limited partners.*[267]

Simple as it might seem in theory, and as will be discussed more in-depth in Chapter 5, there currently exist several barriers to a widespread implementation of such a clause. Both sponsors and, maybe somewhat surprisingly, investors are currently incentivized to engage in personalized negotiations. Even leaving the LPA silent as to any specific unilateral amendment prohibitions of the sponsor could leave the determination of a sponsor's authority to enter into certain terms with specific investors in the hands of a court. An accurately defined provision in the LPA removes the authority of a sponsor to amend the provision in favor of certain investors, at least to the detriment of other investors. This is the case especially when the terms of the side letter directly affect the right of investors not party to the side letter, as they are entitled to enforce the terms of the LPA as it is written from their point of view.[268] Thus, a sponsor should clearly specify its authority to grant additional rights and to unilaterally amend the LPA, which would realistically be most probable, with respect to *certain* terms for *certain* investors, without which it could risk having a court declare lacking authority to enter into side letters and thus invalidating them.[269] Although not as definitively and broadly as is the case in the AIFMD, the ESG Capital Partners case seems to at the least create an incentive for sponsors to disclose the possibility and authority for the sponsor to enter into side letters with specific investors, in order to minimize the risk of a side letter being declared invalid by a court on the grounds of lacking authority for the sponsor.

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[267] This clause is written by the author purely as an example of the main components of such a clause, and is further subject to any specific definitions given to any term therein in each individual LPA and other supporting documents.

[268] ESG Capital Partners, p. 27.

[269] The highlighted *italic* text here refers to the most likely outcome in practice, as few investors, large or small, would specifically allow a sponsor the authority to amend any part of the LPA in favor of any single investor that could cause a direct negative effect on other investors.

4.2.2 Should You Agree to an Agreement to Agree?

More than half of private equity AUM is located within North America, and the share grows even larger when considering other notable hubs for Private Equity such as Great Britain, the Cayman Islands and Australia.[270] Besides making up a large chunk of the private equity market, they all have one other important thing in common – they follow the common law system. Agreements to agree in the common law system are, as the name would suggest, an agreement between parties to agree or negotiate on a specific matter. As a matter of contract law, they should be seen as incomplete agreements and separate from the ultimate contract which the parties wish to agree upon or negotiate.[271] Conversely, agreements to agree have generally been seen as unenforceable due to the large extent of uncertainty as to the specific end result.[272]

This is not to say that they are a construct limited to the common law system, as variations exist in nearly all jurisdictions, including Finland. Here, a difference needs to be made as regards the similarly non-binding *letter of intent* (in Finnish: *aiesopimus*), and the binding *preliminary agreement* (in Finnish: *esisopimus*). The decisive factor in determining which one becomes applicable is the common intention of the parties entering into such a contract, and not the name or the objective content of such a contract.[273] Should the parties end up in a disagreement as to their common intention, a court might be forced to make a final decision on such intention between the parties. Such an endeavor is no easy task, and as outsiders to the contract, a court has to resort to interpretation to determine the common intention. This problem, together with other risks associated with interpreting side letters, warrant a separate discussion on interpretation in Chapter 4.3.1 below.

As an agreement to agree can take practically any form, and in theory include any matter imaginable, the idea behind it may also be applied to side letters in private equity funds. Recalling from Chapter 3.2.3 above, side letters are prominently used to add flexibility to the negotiation process, and likewise do agreements to agree provide enhanced flexibility by postponing the agreement of certain details into a future side letter, allowing for an easier negotiation of the LPA. However, the parties to a side letter should nonetheless ensure that the legal intention of the side letter is sufficiently clearly stated, to ensure that it is enforceable. A case specific to agreements to agree in the form of a side letter serves to illustrate this point.

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[270] Bain & Company 2022, p. 28–29.
[271] Peel 2015, Chapter 2, p. 98. Agreement to agree and agreement to negotiate are both collective terms for the principle described herein, and, for ease of reference, the term agreement to agree is the one used here.
[272] Ibid., Chapter 2, p. 99.
[273] Saarnilehto – Annola 2000, Section III, Chapter 3 on "Aiesopimus".

In the UK case of *Barbudev v Eurocom Cable Management Bulgaria EOOD*[274], Mr. Barbudev wished to sell his company to a consortium of owners. An important point for Mr. Barbudev, and one that was also made clear to the buyers, was that he was interested in reinvesting some of his proceeds into the consortium. In order to facilitate this point, a side letter was entered between the parties whereby the consortium "*offer [Mr. Barbudev] the opportunity to invest in the Purchaser on the terms to be agreed between us […] and we agree to negotiate the Investment Agreement in good faith with you"*, and even laid out the basic framework for Mr. Barbudev's investment.[275] The court arrived at the conclusion that the parties indeed intended to create legal relations, and noted that several provisions in the side letter were clearly intended to be legally enforceable.[276] Nonetheless, the court held that the side letter was no more than an agreement to agree, due to the inclusion of the terms "*to be agreed*" and "*[negotiated] in good faith*", and thus unenforceable as a valid contract.[277]

The case serves as an important reminder that side letters supposed to have legal effect should include explicit wording to this effect. Terms pointing towards additional actions are a strong indicator that the parties' common intentions were not to enter into a final and binding agreement. This is of heightened importance to consider when side letters are structured along the lines of setting out the general terms for long and prosperous cooperation between a sponsor and a specific investor, often resulting in a fuzzy description of their far-reaching intentions and goals. Co-investment rights seem to be one term often falling under this category, as one of the aforementioned studies on side letter terms found that the majority of co-investment rights were given as a mere "*acknowledgment of the investor's interest in co-investing*", leaving it up to the sponsor to provide such opportunities, or not to.[278] This should be kept in mind by investors, should they rely heavily on actually receiving co-investment opportunities, maybe in exchange for making other, explicitly legally binding and enforceable, concessions on other terms.

[274] Georgi Velichkov Barbudev v Eurocom Cable Management Bulgaria Eood & Ors [2012] EWCA Civ 548, 27 April 2012 (hereinafter "Barbudev v Eurocom").
[275] Barbudev v Eurocom, p. 1–3, 8. The side letter laid out that Mr Barbudev "*shall invest an aggregate amount of not less than €1,650,000 in consideration for a combination of shareholder debt and registered shares which shall represent ten (10) percent of the registered share capital of the Purchaser on the date of the Investment Agreement."*
[276] Ibid., p. 9. For example, the side letter included clear jurisdiction and confidentiality clauses.
[277] Ibid., p. 9.
[278] de Fontenay – Nili 2023, p. 38 & 56. The study found that only six percent of side letters provided explicit co-investment rights, whereas almost nineteen percent included an acknowledgement of the investor's interest in co-investing opportunities.

4.2.3 One-Sided Contract Modifications Under the Doctrine of Consideration

A substantial amount of side letters fall under the doctrine of consideration and thus face the risk of being nullified due to the absence of sufficient consideration.[279] This risk is increased considering that side letters commonly provide investors with additional rights, without altering the rights of the sponsor. Uncertainty arises regarding to what extent consideration should be given by an investor for the additional rights received in side letters. The general viewpoint of practicing lawyers seems to be that side letters constitute such modifications to an original agreement that requires additional consideration, or to be entered into as a deed.[280]

Somewhat interesting, however, is the fact that they a lot of times seem to take the existence of consideration for granted, either simply stating that proper consideration often exists due to the nature of the transaction, or that the benefits to both parties in the transaction are obvious, resulting in adequate consideration.[281] While this might be the case in some instances, they do not consider the fact that certain types of side letters are shrouded in considerable uncertainty when it comes to validity due to consideration. For example, without such a one-sided side letter as described above, a sponsor would be de facto better off, as sufficient terms of the investment itself are already laid out in the LPA and the Subscription Agreement, and no additional benefits are attained in the side letter. Much effort has been put into trying to logically explain the doctrine of consideration, and to develop various theories that could provide clear rules as to when consideration is needed and when it is not, as well as the extent of consideration needed in applicable instances, without much luck in establishing clear ground rules.[282] Some legal practitioners also advocate that courts look at the deal as a whole when determining the existence of consideration,[283] yet an Australian court case invalidating a side letter due to lack of consideration goes to show that consideration for a side letter cannot automatically be assumed, even when it is part of a larger transaction.

The case in question is *ACN 151 368 v Pro-Pac Packaging (Aust) Pty Limited*,[284] whereby ACN agreed to sell its business to Pro-Pac Packaging. The Parties entered into a Sale Agreement

[279] Due to the majority of side letters falling under a common law jurisdiction.
[280] See, for example, Dillon Eustace 2013, p. 2; Wade–Stafford 2011; Hollingsworths 2012; Gadens 2018; Lavan 2018.
[281] For the former claim, see, for example, Willans 2011 and Wade–Stafford 2011. For the latter claim, see Hollingsworths 2012.
[282] See, in general, Benson 2011; Chen-Wishart 1991; Chen-Wishart 2010; Hill 2015; Hillman 1982; Ilg 2020.
[283] See Willans 2011, stating that "*courts look at the entirety of a whole transaction...*".
[284] ACN 151 368 124 v Pro-Pac Packaging (Aust) Pty Limited [2017] NSWSC 913 (Hereinafter "ACN v Pro-Pac Packaging"). ACN 151 368 is hereby referred to as "ACN" and Pro-Pac Packaging (Aust) Pty Limited is hereby referred to as"Pro-Pac Packaging".

whereby ACN was entitled to a sale price of $1,2 million, subject to adjustments, 4 deferred payments of $62 500 each, split evenly over 2 years, as well as various incentive payments if certain targets were met. The parties additionally entered into a side letter whereby they reconfirmed ACNs right to the deferred payments, but now made them conditional upon the fact that Pro-Pac Packaging was able to utilize a license to occupy the business premises given by ACN in the Sale Agreement.[285] Later, a dispute arose as to the validity of the side letter. ACN claimed that the side letter had no contractual effect as it was inconsistent with the terms of the Sale Agreement or alternatively, because no additional consideration had been given to ACN. Pro-Pac Packaging held that it was not liable to pay the deferred payments under the side letter, as the conditionality provision of the deferred payments in the side letter was valid.[286]

The court held that, as the Sale Agreement already granted ACN a right to the deferred payments, the conditionality provision in the side letter was unenforceable due to lack of additional consideration and that Pro-Pac Packaging thus was liable for payment of the deferred payments.[287] This case captures the essence of the risk in entering into side letters without accounting for the need for sufficient consideration, and highlights the need to conclude a side letter as a deed in situations where there are any doubts as to the consideration requirement.

4.3 Modular Complexity in Private Equity Deals Increases Uncertainty

4.3.1 Interpretation Risks

As an outsider to an agreement, as courts often are in disputes, correctly interpreting an agreement is no easy task, especially in complex deals. Efficient contracts should clearly identify and embody the parties' intentions and the rights and obligations relating to their relationship under the contract. A failure to do so risks resulting in a dispute between the parties as to the actual content of a contract and how it should be interpreted, at times leading to courts having to assert the "correct" interpretation of a contract.[288] Disputes relating to the de facto contents of a contract often come in two forms – either the parties have differing views on the meaning of certain parts of a contract, whereby courts have to engage in *interpretation*, or the contract is silent on a topic, leading the courts to resort to filling in the gaps using

[285] ACN v Pro-Pac Packaging, p. 1–7.
[286] Ibid., p. 8.
[287] Ibid, p. 8–9.
[288] Kastner 2022, p. 466, 470–471. The intent of the parties, naturally, carry a dominant role in asserting the contents of a contract, as they are the ones best suited to determine their own intentions behind entering a specific contract under specific terms and circumstances.

supplementation.[289] This thesis focuses on the former, as a specific interpretation risk of side letters relate to their connection, or rather risk of disconnection, from the LPA and its terms.

The general approach to interpretation by courts in both common- and civil law jurisdictions, Finland included, is commonly made up of finding the common intention of the parties. This is, however, often a difficult thing to accomplish when the parties are of varying opinions as to their common intention. Thus, courts generally combine this subjective assessment with a more objective stance, in interpreting the contents of a contract as it would be understood by a reasonable person acting in good faith in a similar situation.[290] These assessments grow more difficult the more complex the situation is. The private equity governance model and contract structure both exhibit the kind of complex modularity that magnifies the risks inherent to court interpretation. For the theory of Contract Modularity to function properly, a clear set of rules is required. Without it, considerable uncertainty risks materializing as to how the interaction between the pieces of a modular contract structure interact and, conversely, should be interpreted. Such clarity, however, does not currently exist.[291]

A substantial interpretation risk associated with side letters lies in the uncertainty as to which provisions of the LPA are applicable directly to side letters in certain instances. Consider the following situation: A sponsor and a number of investors enter into an LPA, whereby any dispute relating to the investment between the sponsor and an investor should be resolved by arbitration. The sponsor then enters into a side letter with an individual investor, in which some terms in the LPA are, for the sake of this example, validly altered between the sponsor and the individual investor. The side letter is, however, silent on the possibility of arbitration. When a dispute later ensues as to a term in the side letter, is arbitration or court litigation the correct forum for the dispute? On its own, this question should not cause concern, as a court would probably resort to a form of the *one contract rule*, whereby contracts related to the same subject and executed at the same time are considered to be construed together, in the absence of an indication to the contrary.[292] Things get a lot more complicated when the side letter starts to indicate that it is to be seen as a free-standing contract, due to the incorporation of various discrete, boilerplate provisions likewise included in the LPA with substantially the same content, such as, for example, clauses on jurisdiction and choice of law, confidentiality, notices, as well as duplicates on representations, warranties and indemnifications by the parties already

[289] Kötz 2019, p. 913.
[290] Ibid., p. 914; Annola 2016, p. 15–16; Sund-Norrgård 2022, p. 84–85.
[291] Kastner 2022, p. 466–469.
[292] Ibid., p. 472.

found in the LPA.[293] Then, the question as to whether the contracts are still sufficiently and intentionally connected becomes harder to accurately answer.

Introducing yet another layer of complexity to the question is the existence of the *parole evidence rule* in common law, which prevents courts from looking at evidence and documentation of previous negotiations and agreements that could have an effect on the agreement in question if the final, written contract is to be considered the complete and final expression of the parties' intentions. The rule exists to prevent a party from reverting back to previous discussions or documentation contradicting the final contract. In other words, it protects a party's trust in the fact that the final agreement constitutes the complete expression of the parties' intentions under the agreement.[294] This has resulted in common law jurisdictions emphasizing the written contract – the *four corners of a contract* – to a larger extent than, for example, Finland and the rest of the Nordics.[295]

Indeed, Nordic jurisprudence does not accredit the same level of authority to the written agreement as the parole evidence rule sets out. Instead, it highlights the need to pay sufficient attention to all other relevant aspects surrounding a contract as well.[296] This results in the de facto purpose and content of the contract, the balance of power between the parties and their expectations having a larger impact on the interpretation of the contract.[297] In addition, the fundamental principles of loyalty and -fairness described above in Chapter 2.2 both provide an opportunity to supplement or deviate from the text in a contract, should they become applicable.[298] However, the mere existence of alternative aspects to contract interpretation does not make the wording of a contract any less important. Indeed, such additional aspects are not always utilized to their full extent in Finland nor in the rest of the Nordics, and the written content of a contract still weighs heavy in deciding the intention of the parties.[299] This is largely due to how easy it is to resort to the written agreement between the parties, as it is often the only easily available source of at least some common understanding between the parties in a dispute. Giving additional importance to the written contract is the principle that each term in

[293] de Fontenay – Nili 2023, p. 51.
[294] Farnsworth 2012, p. 920–921; Restatement (Second) of Contracts, § 213.
[295] Sund-Norrgård 2011, p. 23; Hwang – Jennejohn 2018, p. 322.
[296] Sund-Norrgård 2011, p. 22–23.
[297] See, for example, Section 36 of the Finnish Contracts Act, setting out examples of what can be considered "all relevant aspects" in the context of contracts.
[298] Such an assessment is no easy task, and is usually dependent on a multitude of factors and their combined effect on a contract. Consequently, a deeper analysis of their applicability is outside the scope of this thesis.
[299] Ramberg – Ramberg 2010, p. 149; Sund-Norrgård 2022, p. 84.

a contract should be given importance.[300] These aspects add up, and make a clearly formulated term in a contract increasingly difficult to deviate from also in Nordic jurisdictions.

No matter the jurisdiction, an increasing level of sophistication of the parties generally increases the importance of the final, written agreement. Sophisticated parties are seen as being able to contract efficiently, and able to ensure inclusion and sufficient clarity in the terms they see as necessary. In other words, should they have wished for additional factors to be taken into consideration by courts in examining their intentions, they would have explicitly stated so in their contract.[301] Such sophistication is generally found in both sponsors and investors.

The theoretical example presented above regarding the applicability of the arbitration clause shares many similarities with the U.S. case of *Rosenblum v. Travelbyus.com Ltd*,[302] where Mr. Rosenblum sold his travel-related company to Travelbyus, laid out in an acquisition agreement, conditioned on the fact that he was to continue working for the company, agreed upon in a separate employment agreement. The employment agreement included a broad arbitration clause, whereby "*…any matter in dispute under or relating to this Agreement shall be finally resolved by binding arbitration*".[303] When Travelbyus failed payment under the acquisition agreement, Mr. Rosenblum brought action before the court citing a breach of the acquisition agreement. Travelbyus responded with a motion to dismiss the case on the grounds that the arbitration clause in the employment agreement barred him from initiating court proceedings. The court in the first instance, the United States District Court for the Northern District of Illinois, granted Travelbyus' motion to dismiss, holding that the employment agreement was incorporated into the acquisition agreement through a merger clause and thus clearly meant to be part of the agreement as a whole, making the arbitration clause valid and enforceable on matters relating to the acquisition agreement as well.[304]

Interestingly, the court of appeals, the United States Court of Appeals for the Seventh Circuit, reversed the decision of the district court. Although not strictly connected to the dispute in question, the court of appeals compared the contents of both contracts and found that "*both contracts are complete on their own*", due to them sharing many of the same boilerplate provisions and, thus, that the parties must have intended for the two contracts to function

[300] Hemmo 2003, p. 618–619. A similar principle can be found in Article II.–8:105 of the DCFR.
[301] Hwang – Jennejohn 2018, p. 289.
[302] Rosenblum v Travelbyus.com Ltd., 299 F.3d 657, 662 (7th Cir. 2002) (Hereinafter "Rosenblum v Travelbyus.com Ltd").
[303] Rosenblum v Travelbyus.com Ltd, p. 660.
[304] Ibid., p. 661.

independently from each other (despite the employment being a condition precedent for the acquisition to hold and vice versa, the employment agreement lacking any real meaning without being accompanied by the acquisition agreement). The court of appeal argued that the existence of, in essence, identical provisions in separate agreements heavily favors the intent of the parties being a separation of the contracts, as otherwise "*one of these provisions [would be] wholly superfluous*".[305] The arguments for applying the arbitration clause due to its broad scope and incorporation clauses in the agreements were also not upheld by the court of appeal, concluding that the arbitration clause did not apply to disputes arising out of the acquisition agreement.[306]

In other words, contract modularity may lead to uncertainties as to how different parts of a deal are either woven together or seen as separate, and courts might have difficulties in assessing in what way the parties want the different modules to interact with each other. The excessive use of standardized and easily available boilerplate provisions in an otherwise coherent deal risks splitting the deal up into separate parts in the eyes of a court. Further complicating things, as courts cannot master every intricacy of all kinds of complex contract structures out there, they usually resort to applying familiar rules to new structures, even though they may not fully follow the same structure, causing uncertainty, especially in more complex deals.[307] Despite theoretically equipped with additional tools in assessing the scope of a contract and the parties' intentions, Finnish courts might not be in a much better spot when it comes to this risk of contract separation. After all, the written contract weighs heavy, and it is hard to imagine the intention of sophisticated parties being applicability by direct incorporation for certain boilerplate provisions and indirect incorporation per the *one contract rule* for others.

Yet another source of uncertainty is the inclusion of various clarifications on specific terms in the LPA in side letters. Asking for such an interpretation clarification is natural, as many investors are simultaneously investors in various different funds, often with slightly varying wording of the respective provisions in each LPA.[308] Investors seeking coherency in the terms of their investments want to ensure that similar-looking terms in different LPAs are in fact interpreted similarly, greatly reducing the legal costs for the investor in assessing the exact wording of each LPA it enters into. The risk occurs when many, slightly different interpretations of a clause in the LPA are simultaneously ensured in a number of side letters and, as it later turns out, only one of them is correct. This would force a sponsor to breach a side letter with at

[305] Ibid., p. 663.
[306] Ibid., 664.
[307] Kastner 2022, p. 477–478.
[308] Clayton 2022a, p. 726.

least one party, likely resulting in both monetary and reputational damage for the sponsor. Even though this practice should be most prevalent regarding simple and non-essential boilerplate provisions, which should mitigate the risk of substantial deviations from one term to another and the risk of a dispute, the risk nonetheless exists.

Side letters risk facing the same fate as in the case described above, due to them including, and even amending, boilerplate provisions found in the LPA as well.[309] The more "unnecessary" boilerplate added to a side letter that is already found in the LPA enhances the risk that they are seen as concluded with the intent of keeping them strictly separate to the extent possible. This risk of contractual disconnection is, however, presumably smaller for side letters than in the case of Rosenblum v. Travelbyus.com Ltd presented above. Side letters are pure ancillary agreements to an LPA, and thus hold a stronger connection than two agreements on entirely different topics, even though related to the same transaction, as in the case at hand. Nevertheless, side letters might still face the risk of having a court classify them as a sufficiently independent from the LPA, due to their secrecy and inherent complexity forcing a court to apply similar, more well-known methodologies of interpretation.[310] To safeguard against this risk, as much boilerplate and straightforward provisions as only possible should be transferred to or left in the LPA. In such instances, a simple reference to the term in the LPA should be sufficient to ensure their applicability in side letters as well. Apart from a reference to individual terms and their applicability in the LPA-side letter relationship, proper referencing to the inclusion of the side letter in the deal overall is crucial, and a failure to do so can prove fatal for a side letter. This is often done by utilizing an *integration clause*, the theme for the next chapter.

4.3.2 Integration Clauses Setting Aside Side Letters

Another source of risk when working with complex transactions utilizing a modular structure, such as investments in private equity funds, is determining the exact scope of the parties' understanding. Committing to investing in a fund is often a lengthy process, requiring much time and effort from both parties. Having spent much resources on negating a deal, the parties are most often keen on locking in the final scope and content of their agreement, to avoid the risk of a court resolving a dispute using outdated information. Essentially, they are looking to

[309] Jeffers – Tucker 2022, p. 4–5.
[310] See de Fontenay – Nili 2023, p. 51, stating that "*the fund formation process of private equity funds differs significantly from that of many other business deals.*"

explicitly incorporate the idea behind the parol evidence rule into their contract.[311] To achieve that end, the parties often include an *integration clause* in the final contract that explicitly states that the terms as they are laid out in the contract constitute the whole understanding between the parties on the matter therein.[312] It is a classic example of a contractual boilerplate provision, often not given much further thought in the contracting process.[313]

This nonchalance towards integration clauses might lead to some unpleasant surprises if not properly thought through. To illustrate this risk in the context of side letters specifically, we will return to the previous case of ESG Capital Partners discussed above. In this case, the sponsor and the investor entered into a subscription agreement on March 5, 2012. It included a boilerplate integration clause, whereby:

> "*[The subscription agreement] constitutes the entire understanding among the parties with respect to the subject matter hereof, and supersedes any prior understanding and/or written or oral agreement among them.*"[314]

The parties had concluded the disputed side letter on March 4, the day prior that is. As a result, the court simply held that the side letter was such a *prior agreement* as referred to in the integration clause of the subscription agreement, and thus null and void in its entirety.[315] The abrupt and concise statement by the court highlighted the robust and effective nature of integration clauses, and the power with which they may nullify any prior interactions.[316] Thus, the timeline made up of the different agreements in modular deals is crucial to keep track of and structure in a way as to clearly include all relevant parts of the deal.

This cautiousness is of increased importance with regard specifically to side letters, as they are in most instances negotiated and entered into at roughly the same time as the subscription

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[311] The parole evidence rule is only applied to the extent the parties did not intend for other parts to be incorporated into the final understanding. Thus, in a conflict regarding the intended content of an agreement, courts must assess whether other agreements, in writing or orally, have been intended to be included as part of the final agreement or not. As seen in Chaper 4.3.1, determining the parties' intention is no easy task, and comes with its own risks and issues. See, for example, Restatement (Second) of Contracts § 213 or Mitkidis – Neumann 2018, p. 190–191.

[312] Integration clauses also goes by the name of *merger clause* or *entire agreement clause*, see generally Ibid. and Rosenblum v Travelbyus.com Ltd. For ease of reference, the term integration clause is used throughout this thesis.

[313] Mitkidis – Neumann 2018, p. 190; In some instances, an integration clause gains full effect only when it is individually negotiated, such as in PECL. Article 2:105, where such an integration clause otherwise only constitutes a presumption of the parties' intentions, and able to be excluded or restricted. Such ambiguity is a very real risk in and of itself for incautious parties. However, for the purpose of this thesis, and considering the sophistication and contracting proficiency of the parties involved in private equity, it is assumed that each clause in their contracts are sufficiently negotiated to hold their ground.

[314] ESG Capital Partners, p. 24.

[315] Ibid.

[316] In the case of ESG Capital Partners, the integration clause, and in essence the whole case, was stated, reviewed and decided on less than half a page, without any additional motivations or considerations besides the explicit wording of the clause itself, pointing towards a strict textualist approach in interpreting such clauses.

agreement and/or LPA.[317] This increases the risk of them being concluded before the main agreement(s) and later nullified due to a boilerplate integration clause in the subscription agreement or LPA, especially since side letters are faster and easier to negotiate and their content likely decided long before the other agreements. To mitigate this risk, a clear view of the agreement and signature timeline should be kept and followed at all times, and the integration clause relating to the deal should explicitly include any side letters as falling within the scope of the deal. Such inclusion is best made in the LPA itself, as it is the main agreement of the deal as a whole, and for courts the most likely starting point for any dispute relating to the deal, which at the same time removes the need to include similar provisions in the side letter itself, strengthening its position as a subordinated agreement by eliminating generic boilerplate, as discussed in Chapter 4.3.1 above.

Mitigating the risks inherent to contract interpretation of modular structures and integration clauses simultaneously shortens the length of side letters, resulting in an additional advantage that both sponsors and investors understand and greatly appreciate – increased returns, here in the form of reduced costs, as well as a lesser administrative burden. These potential inefficiencies in side letters make out the theme for the next chapter.

4.4 Cost (In)efficiency

4.4.1 Direct Transaction Costs

Having thus far highlighted some risks connected to the use of side letters from a validity and enforceability standpoint, we now turn toward a number of equally important inefficiencies that are more practical in nature. First and foremost, all agreements come with transaction costs, be it directly or indirectly, as a result of negotiating and drafting a contract.[318] These costs are amplified for complex and tailored contracts, where the use of boilerplate provisions is often limited and instead replaced by highly customized provisions requiring greater amounts of resources spent on formulating them.[319] Modularity, and in extension proactive contracting, are in and of themselves also a source of increased costs, as additional time and effort are spent on streamlining the contracts and shifting the focus towards ex ante prevention instead of ex post disputes.[320] Further, the very structure of side letters is a cause of costs. Instead of all relevant

[317] de Fontenay – Nili 2023, p. 20, 51.
[318] Williamson 1985, p. 20.
[319] Jeffers – Tucker 2022, p. 7, 33, 46–47.
[320] Kastner 2022, p. 469.

provisions being included in the LPA, a sponsor enters into a multitude of individual, modular side letters with certain investors, increasing the total number and length of contracts associated with a single fund. This, in turn, results in a *contractual over-modularity* caused by multiple versions of both bespoke and substantially the same terms being negotiated simultaneously with several different investors, increasing both the time and cost spent by sponsors in the process.[321]

Yet another type of cost the parties are the victims of are opportunity costs, as more time spent by the sponsor on negotiating side letters means less time spent on actually managing the fund and earning returns for its investors.[322] Last, but far from least, the current over-modularity of side letters described above is likely to lead to substantial administrative and compliance costs resulting from the complex web of interconnections created by the aggregated mass of side letters, especially when combined with a plethora of MFNs.[323] As is evident, there are a myriad of different costs associated with side letters. But contracts should be value creators and not a source of costs, which is why each source should provide advantages that trump that of the costs associated with it. This, however, is not always the case with side letters, as many aspects of their current usage are inefficient also from a pure cost-efficiency perspective. The very source of the money used to cover said costs is also a cause for concern, and might counteract a change towards more efficient practices. These inefficiencies and their sources will be the focus of the remainder of this chapter.

In their basic form, side letters do provide some valuable benefits in terms of cost-effectiveness for both sponsors and investors. For sponsors, individually negotiating the fee terms with the most important investors ensures that a sponsor only gives out fee discounts to those investors who are in a position to demand it, and then still gets the maximum amount of fees an investor is ready to pay, without giving any "free" rebates to investors who did not specifically ask for it. For some investors, those in a position to effectively negotiate a side letter that is, benefit from demanding fee discounts to the extent they are able to set the level of fees at a lower level than in the LPA (which most investors in a position to effectively negotiate side letters are). In terms of non-fee terms in side letters, they also hold an economic value both to sponsors and investors, albeit harder to objectively assess the price of, but may be sufficient to warrant individual negotiations.

[321] de Fontenay – Nili, p. 51.
[322] Jeffers – Tucker 2022, p. 19. Higher returns for investors, in the end, means higher fees for the sponsor.
[323] Ibid., p. 13; de Fontenay – Nili 2023, p. 45.

Looking past the upside of using side letters, many aspects of the current practice are currently bringing down their effectiveness. The main culprit in terms of the legal fees associated with side letter negotiation seems to be the fact that neither the sponsor nor the individual investor is responsible in full for their fees. Instead, legal fees are seen as fund expenses and taken directly out of the assets of the fund, rising into the millions for large funds.[324] As such, the sponsor usually bears no or only a small part of the costs associated with negotiating side letters, and an investor, in practice, only pays a pro-rata portion of its committed capital compared to the total commitments of the fund. As a result, the parties to a side letter have rather weak incentives to deviate from current the market practice to begin with. This practice is in stark contrast to a cornerstone principle of the economic analysis of contracts, where sophisticated parties should be able to obtain maximum value, efficiency and balance in their contracts.[325] It is hard imagining mutual efficiency being achieved when the parties only pay a fraction of their own negotiation costs. Apart from ensuring collective alignment of investor incentives, a solution to the problem already proposed by some would be to shift the cost burden to the negotiating parties.[326] This is already sometimes the case, where a cap is set for the sponsor as a specific percentage of the size of a fund, but especially for large funds this cap is currently often seen as rather arbitrary.[327]

4.4.2 The Costs of Complying

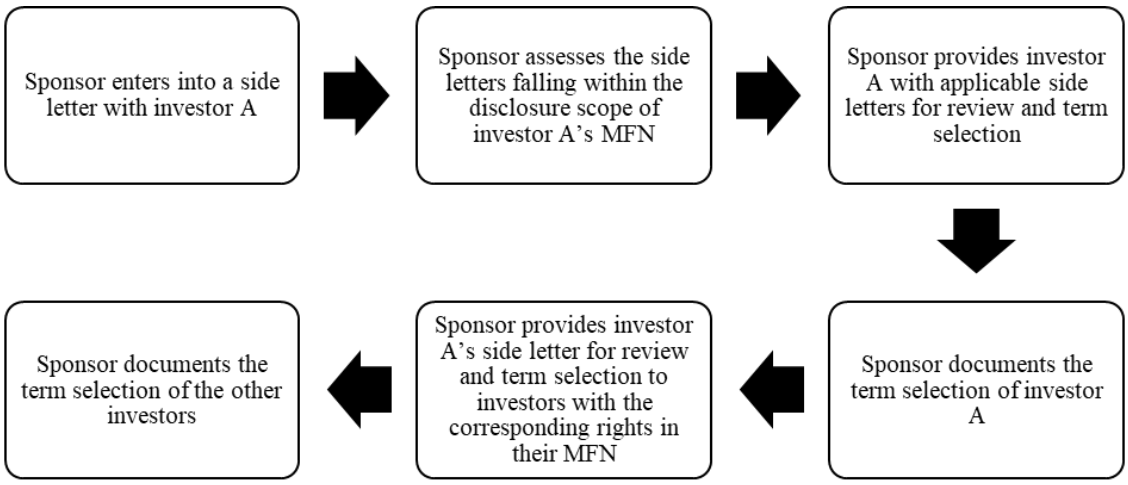
Apart from directly increasing the cost of front-end contract negotiations, which are ultimately borne by investors, side letters are not free from other types of costs either. They are a large source of *compliance costs* for sponsors due to the risks associated with continuously ensuring adherence to a complex set of interconnected terms between the LPA and all side letters.[328] Simultaneously complying with the LPA and all side letters of a fund is a daunting task for many sponsors, a source of substantial indirect costs, and presents a real business risk for sponsors in ensuring adherence to their aggregated obligations towards investors.[329] The

[324] Debevoise & Plimpton LLP 2020, p. 50–52; Clayton 2022a, p. 737–738; Jeffers – Tucker 2022, p. 18, seeing average costs of around 10 000 – 15 000 $ per side letter and reaching the millions for certain funds.
[325] Schwartz – Scott 2003, p. 544; Clayton 2022a, p. 708.; See also Chapter 2.1 above.
[326] de Fontenay – Nili 2023, p. 53–54; Jeffers – Tucker 2022, p. 45–46.
[327] Clayton 2022a, p. 737. Often set at around 0.5 to 1 % of the fund's total capital, this would still entail a "negotiation budget" of EUR 5-10 million for a sponsor of a EUR 1 billion fund.
[328] Compliance costs refers to not only to the direct costs arising out of a sponsor's need to devote time and resources to ensure that all fund agreements are adhered to, but also covers the risk that a sponsor becomes contractually liable for failing to comply with its obligations.
[329] Jeffers – Tucker 2022, p. 13.

overall, length, complexity and amount of boilerplate in side letters means that sponsors have to dedicate significant time and resources to ensure that all terms in the side letters are adhered to, many of which are almost identical in meaning to existing provisions in the LPA or another side letter. Although many provisions in side letters are *boilerplate-like* in the sense that they govern matters often concluded in standard boilerplate format, studies have shown that the boilerplate provisions themselves are often severely lacking in standardization.[330] This might be largely explained by a lack of incentives for both the parties and their negotiating lawyers to work toward standardization.[331]

A major potential source of compliance costs are MFNs, included in on average 60.2 % of all side letters in the sample, the most common and often a heavily negotiated term.[332] Following the signing of a side letter including an MFN with investor A, a sponsor must first assess which side letters already made with other investors fall within the disclosure scope of the current side letter and MFN, and provide those side letters to investor A for review and term selection.[333] After that process, the sponsor is required to determine the scope of investors entitled to review and optionally elect the terms of the side letter with investor A and provide them with it. It is a long and cumbersome process that has to be repeated for each new side letter. Increasing standardization and shortening the length of side letters would have a spill-over effect on MFNs, making them easier to manage by decreasing the amount and variation of terms to choose from.

Figure 6. The MFN Process for New Side Letters.



[330] Ibid., p. 47; de Fontenay – Nili 2023, p. 55.
[331] de Fontenay – Nili 2023, p. 7, who blame lawyers for not settling for standardized language of common side letter terms, due to lack of incentive to essentially work towards lessening their billing time and thus their fees; Clayton 2022a, p. 735–737, discussing the fact that private equity negotiations have taken an almost opposite approach to standardization, unlike many other similar structures, for example syndicated debt.
[332] See Figure 5 in Chapter 3.2.3.
[333] As discussed in Chapter 3.2.3, MFNs gives the benefactor an opportunity to view and select terms concluded with other investors instead of its own, thus giving the benefactor a possibility to receive the "best" terms available.

Easily overlooked, opportunity costs are also a very real, indirect cost of the current side letter practice. One study found that side letter negotiations can drag out for 12-18 months, severely reducing the sponsor's resources to focus on finding lucrative investment opportunities.[334] Of the terms commonly included in side letters, many grant no specific advantages to one particular investor, nor do they require bespoke and complex negotiations to formulate. Based on the data presented in Figure 5, Information Rights, present on average around 35 % of side letters, and Regulatory & Tax provisions, present in approximately 58 % of side letters, for example, require little to no further costs to provide to all investors once provided to one investor.[335]

Nevertheless, sponsors are reluctant to provide anything "for free", having cited concerns regarding smaller investors being less well-known compared to large investors, committing less capital to a fund and having fewer resources to ensure compliance with the fund agreements, for example in terms of confidentiality.[336] The result is sponsors withholding already generated reports despite them being prepared by the sponsor and therefore easily available for distribution. Indeed, 56 % of investors in a survey conducted by the *Institutional Limited Partners Association* (*ILPA*) indicated that such reporting is generally not shared with all investors.[337] In forgoing a process of standardized reporting provided to all investors, a sponsor risks having to produce several different sets of reporting to investors, increasing both negotiation and compliance costs, as well as causing dissatisfaction amongst the rest of investors not having access to any such preferential treatment.[338] By instead developing a sponsor-wide reporting standard that fulfills the most common reporting items requested by investors, and also provided to most, if not all investors in a fund, a sponsor can remain in control over its reporting framework, reducing the need to individually negotiate for customized reporting standards with individual investors. The existence of minimum reporting standards in the EU and the similarly proposed disclosure rules in the U.S. sets a good starting point for developing such standardized reporting. ILPA has gone so far as to develop its own *ILPA Reporting Template* in an effort to promote transparency and align the interests of sponsors and investors, which seems to be well received by many sponsors.[339]

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[334] Jeffers – Tucker 2022, p. 19.
[335] See data presented in Figure 5 in Chapter 3.2.3 above; Jeffers – Tucker 2022, p. 10-11; de Fontenay – Nili 2023, p. 59; ILPA Analysis 2023, p. 17.
[336] Jeffers – Tucker 2022, p. 45.
[337] ILPA Data Packet 2023, p. 25.
[338] Vance 2013, p. 24.
[339] ILPA Report 2023, p. 17; ILPA Data Packet 2023, p. 26, indicating that investors are provided with reporting in accordance with the ILPA Reporting Template more often than not in 59 % of instances; More information about the Reporting Template is available at https://ilpa.org/reporting-template/.

5. Achieving Change in the Side Letter Practice

5.1 Inflexible Contracts Introduce Unnecessary Complexity

With the many inefficiencies highlighted so far, one would think it fairly obvious that investors would be quick to demand change in many of the current side letter practices, as some of these issues should disgruntle even the biggest individual investors. To some extent even sponsors should be pushing for reform, to streamline their administrative duties and increase their possibility of earning returns for their investors, and ultimately, for themselves. But the fact that the current side letter practice is still at times inefficient shows that this is not the case, and both investors and sponsors are unable to act in ways that would diminish these inefficiencies. In fact, a survey carried out by ILPA shows that 65 % of investor respondents disagree with the statement that they have been able to efficiently negotiate contractual terms with sponsors.[340] Further, a staggering 97 % of respondents consider the starting point of the LPA as having become more sponsor-friendly in the previous three years, while 87 % think that the final version of the LPA has shifted in favor of sponsors as well.[341] Sponsors have a hard time motivating a change in market practice that has, in fact, benefitted them for a long time, and thus risk upsetting that advantage.

Despite the general discontent amongst investors regarding their negotiation abilities, they have a hard time pushing for any major change both before investing and during the lifetime of a fund. In the negotiation phase, many investors simply lack the specific information to be able to negotiate effectively, partly due to them simply not being aware of potentially harmful side letter terms with certain investors.[342] Furthermore, and especially during periods when there is competition amongst investors to invest with the best sponsors, many are reluctant to develop a reputation as problem-makers and being unruly towards sponsors.[343] Having joined a fund, however successful in negotiations, investors are faced with additional problems in driving for change. Firstly, investors cannot easily replace the sponsor of the fund should they deem that it fails to act in the interest of the investors. Often, such a decision requires substantial misconduct of the sponsor and even then usually requires as much as 80–90 % of investors to vote in favor

[340] ILPA Report 2023, p. 8; ILPA Data Packet 2023, p. 8. 33 % of respondents strongly disagreed with the statement, while 32 % disagreed. Additionally, 27 % remained neutral, leaving only 5 % agreeing and 3 % strongly agreeing with the statement.
[341] ILPA Data Packet 2023, p. 9.
[342] Ibid., p. 13, where 21 % of investors indicated that a sponsor's information advantage over investors is a cause for accepting sub-optimal contract terms.
[343] de Fontenay – Nili 2023, p. 58.

of the removal.[344] Secondly, they often cannot exit the fund, removing an effective technique to discipline sponsors by withdrawing investments, reducing the potential fees for the sponsor as well as risk damaging its reputation. For this very reason, LPAs often include a prohibition for investors to sell or transfer their interest in a fund without the prior consent of the sponsor.[345]

Giving investors an option to exit their investment through, for example, a secondary market could be one way to combat the agency costs resulting from investors being largely at the mercy of the sponsor after the inception of a fund. Apart from reducing agency costs, including an exit for investors could lead to a cost reduction in the negotiation process, as parties not as strictly bound by a contract can forego much of the detailed negotiations that make up a large part of the negotiation if they are given a way out if need be.[346] The idea is to allow the free market to incentivize the parties to a contract in creating mutual benefits and meeting each other's needs to create a prosperous business relationship built not upon the parties' respective bargaining power at the time of execution of a contract, but instead on a willingness to prosper together.

This school of thought applies exceptionally well to the sponsor-investor relationship for a couple of reasons. Firstly, a fund is usually closed-ended with a fixed lifetime of 10–12 years, during which it needs continuous access to its committed capital. As stated above, investors often cannot exit or transfer their investment in a fund prematurely without the express consent of the sponsor, leading to them having to negotiate as if they are locked into the fund for the full duration of its lifetime. Secondly, the relationship between sponsors and investors is one where the success of one party in a very direct manner benefits the other party. A sponsor performing well increases its reputation, which consequently increases the size of its funds and allows it access to bigger and better opportunities This helps a sponsor in further increasing the performance it generates for its investors and consequently, the fees it collects. An investor performing well, in turn, is able to increase the value of its assets, allowing it to invest larger sums in the future, thus generating more fees for the sponsor of the funds in which it invests.[347]

Providing an exit for investors and allowing them an opportunity to "vote with their feet", as discussed above in Chapter 3.2.2., could substantially lessen the agency costs associated with the private equity structure as well as the need for drawn-out negotiations in ensuring that an

[344] Magnuson 2018, p. 1876–1877.
[345] Ibid. 2018, p. 1879.
[346] Haapio – Siedel 2010, p. 678–679. In an example provided, the contracting parties renegotiating a 10-year, fixed agreement added a mutual termination right without cause with a notice period of 12 months, greatly reducing the amount of negotiation resulting from being bound by an agreement of a definite time of ten years.
[347] As noted earlier, the fees charged by a sponsor are often based on a percentage of the capital provided by an investor, which leads to the amount of fees growing in tandem with the fund itself.

investor is willing to be bound by its commitments to a sponsor for the entire lifetime of the fund in question. In practice, however, this solution might not be so easy to pull off, mainly due to the specific investment method of utilizing commitments so common in private equity. When first investing in a fund, an investor commonly only provides a small part of the total investment capital, while the rest is provided in capital calls made by the sponsor when that capital is needed. Due to the large amounts of uncalled capital still in the hands of investors, a sponsor is heavily reliant on each investor's ability to provide the committed capital when necessary. This makes sponsors reluctant to take the risk of allowing the transfer of an investor's investment to someone else, who might not be as capable of providing the committed capital when needed.[348]

Additionally, having investors exiting a fund preemptively could be interpreted as a bad sign of a sponsor's ability to successfully manage a fund and generate sufficient returns for its investors. There is undoubtedly untapped potential to be utilized by sponsors and investors alike, given that they both embrace the need for change and make the necessary efforts to achieve it. Given that the parties are relatively free to contract in the manner they choose to, on top of the fact that a change has not already taken place, points toward a need to change the way the parties think about side letters and the private equity negotiation process.

5.2 Misaligned Incentives Permeate the Private Equity Governance Structure

5.2.1 Alignment Issues in the Sponsor-Investor Relationship

Albeit problematic, and currently running the risk of creating substantial agency costs in private equity, the previously mentioned issues are only part of the problem. If they were the only issues, investors would soon come together to demand a change in market practice to fix these inefficiencies. This is not, however, the case, as the main issue with the current governance structure within private equity can, in essence, be summed up in a single word – *Incentives*. Misaligned incentives seem to be both the source of the current problems with side letters and the main barrier to change, present in as good as all parts of the private equity ecosystem. To begin with, sponsors currently have numerous incentives and biases working to their advantage in creating and maintaining this sponsor-favored governance structure.

[348] See generally Chapter 3.2.1 above. The prospect of introducing enhanced liquidity in funds is an important step in fixing many of the misalignments that currently exists within the industry, but is a specificity not discussed further in this paper due to scope constraints.

First, as a sponsor is the one creating a fund, it is also the one presenting the first draft of the LPA and side letter to potential investors. This creates an *anchoring effect*, whereby investors may underestimate the value of their investment and overestimate the negotiating power of the sponsor, when the first drafts set a reference by *anchoring* the terms at a certain level.[349]

Second, as the market practice in recent years clearly has favored sponsors, they have enjoyed the advantage of the *status quo bias*, whereby parties systematically favor maintaining current practices rather than trying to create alternatives.[350] As such, the more rooted the current market practice becomes, the harder it is for investors, as well as sponsors for that matter, to deviate from currently used practices and move towards improvements.

Third, following the theme of favoring current contract terms over new ones, is a form of *path dependency* having made its way into contracts and contract negotiations.[351] With time, as specific contract terms are negotiated, amended, scrutinized and maybe even litigated, they become "safer" to use and provide a certainty that new and untested terms cannot. Further, the more commonplace a term is, the higher the opportunity costs associated with renegotiating or amending such a term. Investors are to a large extent victims of exactly this type of path dependency. Considering the sum of the capital invested, the stakes are often considerable. Additionally, as funds are often closed during their lifetime of 10–12 years, investors have to ensure that their contract is robust enough to stand the test of time, which is easier to predict with tested and well-known terms. Combined with the fact that a sponsor usually does not have to worry about negotiation costs, makes such an undertaking a costly and risky endeavor for investors. Indeed, investors are generally less likely to bring up complex issues or engage in active and drawn-out negotiations when they are the ones footing the final bill for the fund's legal expenses both for their own and the sponsor's legal counsel.[352]

Fourth, a solid reputation is vital for investors and sponsors alike. When the risk of failure weighs higher than the potential for success when trying out innovative investment strategies or, for the purpose of this paper, contract structures, a party might become hesitant to try something new. This phenomenon, called *herd behavior*, stems from the idea that it is better to fail doing what everybody else is doing rather than try something new and fail, which would

[349] Zacks 2015, p. 393–394.
[350] Korobkin 1998, p. 625; Samuelson – Zeckhauser 1988, p. 8.
[351] Magnuson 2018, p. 1890–1892. Path dependency refers to the phenomena whereby a current practice is based on past decisions, with the QWERTY keyboard originally made to enhance writing functionality on typewriters constitutes a prime example, as it is the overwhelmingly most common layout used still to this day.
[352] Clayton 2022a, p. 738. See also generally Chapter 4.4.1.

have a greater impact on one's reputation.[353] The idea fits perfectly into the current issues in private equity funds, as a sponsor could face a major reputation loss if it were to try something out of the ordinary and fail. Investors, many of which are large pension funds backed by the capital of ordinary taxpayers, are likewise hesitant to put their capital at risk in a manner out of the ordinary, leaving them open to much scrutiny should it fail.[354]

Returning to the issue of the legal fees associated with negotiating the contracts, sponsors not having to foot the bill for its negotiation costs induces a lack of monetary responsibility of a sponsor towards its legal counsel. Not being responsible for the legal fees removes the incentive of a sponsor to monitor and, if necessary, regulate the time and resources its counsel spends on, at times unnecessary, negotiations. This creates an involuntary misalignment between sponsors and investors as early as the negotiation stage, as 30 % of respondents in the ILPA survey indicated that the sponsor's legal counsel defended sub-optimal terms even though the sponsor itself would have been willing to make concessions.[355]

Perhaps surprisingly, sponsors are not the only ones with incentives to at least maintain the current sponsor-friendly market practice. As much as 84 % of investor respondents in the ILPA survey have accepted unsatisfying terms when investing in a fund, clearly indicating that there are factors currently affecting investors that are tilting the scales in favor of the sponsor.[356] To a large extent, this can be explained by the current sponsor-friendly environment, as the "fear of missing out", often abbreviated *FOMO*, by being declined to invest in the best funds or by having their allocation to such funds reduced was the most cited reason for accepting sub-optimal terms, as 59 % of respondents indicated that they are willing to accept sub-optimal terms in order to not risk having their allocation reduced.

Another cause for concern is the fact that investors seem more inclined to accept worse non-price contractual terms, which we have shown de facto raises costs, instead of directly being charged higher fees.[357] By weakening the effectiveness of an investor's contractual non-price terms, a sponsor can indirectly reap additional rewards, usually making up for not gaining

[353] Scharfstein – Stein 1990, p. 465–466.
[354] Important to note here is the fact that "failure" here does not implicate that the innovative structure itself would be the cause of failure, but the effect of an "ordinary failure" due to bad investments or market conditions is amplified if there are something out of the ordinary with the fund.
[355] Ibid.
[356] ILPA Data Packet 2023, p. 15.
[357] Gompers – Lerner 1999, p. 31-32, 45-47; Clayton 2022a, p. 741.

higher fees paper.[358] The reason investors prefer this approach is largely due to agency problems within the investor itself, as they do not always act in a way to maximize the value of their ultimate beneficiaries. Many of the most prominent investors in private equity are large financial institutions such as pension plans, insurance companies, endowments or other funds, many of which include their own investment professionals. The explicit fee level is one of the most closely monitored and scrutinized terms when negotiating an investment as seen from within an investor, which gives the individual investor representatives negotiating an incentive to keep the fees down whenever possible. As such, investor representatives become more inclined to choose less direct price adjustments instead of fee adjustments, in order to avoid the scrutiny of an investor's upper management.[359]

5.2.2 The Prisoner's Dilemma

The issue regarding misalignment of incentives does not persist solely between sponsors and investors, nor purely within them either, as the collective bargaining power of investors would trump that of a sponsor. The practice of side letters rather effectively prevents investors from collective action and acting as *gatekeepers*[360] for investors' interests by providing an option for bilateral bargaining with the sponsor.[361] In other words, it creates incentives for investors to compete against each other instead of providing a united front toward the sponsor.

It is a classic example of the prisoner's dilemma. Collectively, investors would be better off if they would cooperate in their negotiations against the sponsor in setting terms that are generally favorable for all investors.[362] Individually, however, investors are better off negotiating their own terms with the sponsor, since they have a higher chance of success when the sponsor would not need to grant the terms to all investors, but only to its individual negotiation counterparty.[363] In theory, this situation is ideal for the sponsor, since it gets to split up the investors and

[358] Gompers – Lerner 1999, p, 479–484. Such benefits generally include a more extensive right to control the fund or a sponsor's ability to invest in a portfolio company personally or through another fund it manages. The common factor for most such benefits is that they provide a sponsor with the means to more easily acquire benefits at the investor's expense.
[359] Gompers – Lerner 1996, p. 472.
[360] Gatekeepers hold an important role in many contractual relationships where the parties are of varying sizes and have different opportunities to influence a relationship, as they generally negotiate for the greater good for their side of the contract, granting benefits also to smaller participants. One of the most classical examples is that of large shareholders driving the interests of all shareholders in a company, creating universal benefits for all shareholders combined. In essence, they are private actors able to prevent general counterparty misconduct in a specific instance. See, for example de Fontenay 2014, p. 136–137.
[361] Magnuson 2018, p. 1887–1888.
[362] de Fontenay – Nili 2023, p. 7; Clayton 2022b, p. 9, 13.
[363] Magnuson 2018, p. 1898; de Fontenay – Nili 2023, p. 47–48; Clayton 2020, p. 91.

approach them individually, making the most effective use of its own bargaining power at all times. Then, once investors start negotiating these individual terms in side letters and the collective bargaining power of the remaining investors starts to decay, all other investors should also seek to negotiate for individual terms, for the fear of otherwise missing out completely. Naturally, this leads to smaller investors being left largely at the mercy of the sponsor, as they have little chance of dictating the terms of the negotiation. The secrecy and confidentiality of side letters only exacerbate this issue, as most investors will never lay their eyes upon the side letters granted to investors in a fund larger than themselves.[364]

Besides creating obvious inefficiencies on a large scale, the individual bargaining between investors and the sponsor results in a perhaps more concerning issue relating to the quality of the LPA itself. When large investors are given an incentive to negotiate for the best terms on an individual basis, the need to negotiate and scrutinize the contents of the LPA becomes a second priority.[365] Seeing how important many of the common terms in side letters are to basically all investors, the corresponding terms in the LPA being left without further thought by many investors raises concerns. For the sponsor most costly, and for the investors most sought after, provisions are often negotiated on an individual basis to investors capable of demanding them, and in turn left predominantly sponsor-favored or completely left out from the LPA, lowering the overall quality of the LPA. The result is smaller investors not being able to negotiate sufficient side letters due to their limited size and influence being left with a sub-optimal LPA, slowing down or outright blocking the evolution of efficient market standards and best practices.[366] Certain large investors have argued the opposite, in that it is the very practice of side letters that enables contract innovation within the private equity industry.[367] However true that statement may be in innovating a relationship between a sponsor and an individual investor, it is questionable as to what impact hidden terms evolved out of side letters have on *market innovation* if the side letter terms are unlikely to see the light of day due to their secretive nature and often strict confidentiality restrictions. In fact, the survey conducted by ILPA shows that at least 26 % of respondents have insufficient information on what the current

[364] Clayton 2022a, p. 751.
[365] Ibid. However, highlighting the fact that LPAs are not left completely unnegotiated, but rather that the provisions in the LPA that are common also in side letters usually gets rather limited attention, expressly for the fact that they can be easily adjusted in a side letter.
[366] Ibid., p. 96–97; Jeffers – Tucker 2022, p. 10.
[367] See Lacera 2022, p. 3.

market praxis is currently, which makes it even less likely that investors are aware of new and innovative practices included in secretive side letters.[368]

In other words, the often vital role of the largest stakeholders as gatekeepers for robust terms and protection for all stakeholders, including smaller ones, is largely eliminated through individual bargaining and side letters. Large investors' duties as gatekeepers are further diminished when considering the fact that the investors receiving the most favorable side letter terms are also the ones usually receiving seats on the advisory committee, where they are further able to drive their own, personal agenda, free from any responsibility towards other investors.[369] Thus, increased bargaining power ought to be directed toward the LPA, and intensives provided to investors to minimize the threat posed by the prisoner's dilemma.

Further complicating things, the scale of bargaining power of investors on the one hand and the sponsor on the other is in reality not so two-dimensional so as to only consider size and capital invested. Apart from various indicators, such as reputation or an investor's willingness and possibility to partake in subsequent funds and strategic relationships, the actual balance of power between investors and the sponsor is greatly influenced by market cycles and the general sentiment on the financial markets.[370] The availability of excess investment capital on the markets dictates the respective party's advantage in a negotiation. Up until recently, the financial markets have for a long time generally been healthy and there has existed an abundance of capital in the markets. This has created a predominantly sponsor-friendly environment, where investors have been willing to give large concessions to their contract terms in order to secure a spot in a fund run by the sponsors with the best reputations and track records.[371] Recent market turbulence, however, might cause a power shift in favor of investors, whose capital quickly could become increasingly valuable for sponsors trying to fulfill the capital quotas of their funds. Consequently, now could prove an excellent opportunity to rewrite the practice of using side letters to the extent currently done.

[368] ILPA Data Packet 2023, p. 13. The study was conducted as part of the SEC Proposed Rule 2022, and thus only encompass U.S. investors. Worth noting is that the question mainly referred to investors' willingness to accept sub-optimal contract terms, and not specifically whether they were aware of the current market standards. Thus, realistically, that number ought to be even higher.
[369] *Supra* note 199.
[370] Jeffers – Tucker 2022, p. 28.
[371] See *supra* note 356.

5.3 Rewriting Side Letters – Contracting as a Competitive Advantage

A key focus for any business, private equity firms included, is how to maximize value for its shareholders. In a free market economy, an important stepstone is answering the question as to how a company can outperform its competitors by providing superior, long-term value to its customers, in the end having a positive effect on the value generated for shareholders.[372] Essentially, all companies should look to obtain a *competitive advantage*. Although normally seen as a business objective and something meant for management to fulfill by operational means, a proper utilization of the law, and especially contracting, can likewise create valuable competitive advantages.[373] Considering the already fierce competition within the private equity industry, its sub-optimal governance structure as well as the recent change in the economic climate, sponsors ought to focus on embracing the currently misaligned incentives and regulations, such as investor disclosure and fair treatment, as a possibility of competitive advantage instead of a temporary advantage or unnecessary burden. This chapter aims to show in what way sponsors and investors can use regulation and the inherent inefficiencies of side letters to their advantage, by turning them into a competitive advantage. A change in the legal environment, such as the proposed rules by the SEC, can provide an excellent opportunity for both sponsors and investors to create new forms of competitive advantage.[374]

Competitive advantage comprises a strategy that creates value not currently implemented by competitors and cannot easily be duplicated, at least not in the short term.[375] Law might seem like a difficult area to obtain any notable advantages in, as the same exact rules have to be applied by everyone, and their content is accessible to practically anyone. The traditional way of looking at the law from a strict compliance point of view, by focusing on staying compliant with applicable laws, but not going further than that, seldom results in any meaningful increase in business operations, let alone a competitive advantage, and usually only causes additional time and resources spent.[376] By instead going a step further and taking a proactive approach to utilize the law as part of a company's ordinary operations, while its competitors see it as a burden, can create a meaningful competitive advantage, as competitors are unlikely to copy that approach due to fundamental differences in how the law is viewed and utilized.[377]

[372] Porter 1996, p. 62–64.
[373] Haapio – Siedel 2010, p. 643.
[374] Ibid., p. 647.
[375] Barney 1991, p. 102.
[376] Haapio – Siedel 2010, p. 650.
[377] Bird 2011, p. 19.

In the legal literature, Robert C. Bird has identified three main strategies on how to achieve an advantage by utilizing the law. The first, named *prevention*, goes one step beyond pure compliance by encouraging a culture of active incorporation of legal decisions as part of the business goals and self-monitoring. It enables a company to utilize its legal resources to achieve a strategic result not otherwise achievable, often resulting in cost and time savings benefiting the company as a whole.[378] In private equity, this primarily takes the form of improving contracting and contract negotiation as described above. By working towards standardized and simplified fund documentation, cutting down the need for lengthy negotiations and limiting the use of side letters to the minimum extent necessary results in a less costly and substantially faster contracting process than the current market standard, leaving more room for a sponsor to generate returns and enables investors to manage their investments more efficiently. Undoubtedly creating an *advantage*, it is however questionable how *competitive* these mainly efficiency-based improvements are, as they are susceptible to imitation by rivals.[379] No matter the competitiveness of such an advantage, the current market practice as a whole would arguably benefit the most from the widespread adoption of this kind of competition, making it an advantage worth striving towards either way.

But, by going one step further still, a company can create truly competitive advantages by making the law an equally important part of a company's operations as any other part. The second strategy, aptly named *advantage*, sees legal problems as opportunities and legal strategy as a goal in and of itself, rather than purely a means to another end, and utilizes legal resources to capture value and market share in a way not easily replicable by competitors.[380] For the private equity industry, this entails concretely working for the mutual benefit of both the sponsor and investors by, for example, having sponsors actively listen to investor requirements and make specific investor demands or solutions available to all investors, increasing sponsor reputation and consequently improving its goodwill and attractiveness to investors and market share. Contrary to the prevention strategy, the advantage strategy is better equipped to capture the specific competitive advantage, as it results in a self-reinforcing cycle of advantages leading to increased reputation and market share, resulting in additional advantages and so on, creating a first-mover advantage and cycle not easily broken by competitors.[381]

[378] Ibid., p. 24–25.
[379] Ibid., p. 25.
[380] Ibid., p. 26.
[381] Ibid., p. 29–30.

The third and greatest strategy to achieve a competitive advantage using the law is through *transformation*. This strategy uses legal resources not only to make the most of what is seemingly out there, but also uses it as a key business objective to create value and advantages where none was thought to exist. It requires a fundamental shift in a company's culture, behaviors, beliefs, values and the way the law is looked upon, which is also what makes it sustainable in the long run, and hard for competitors to mimic.[382] To illustrate the way the transformation strategy goes beyond maximizing the value behind what the law states, Bird uses Lincoln Electric Company as an example of, having developed one of the most productive and consistent workforces in the U.S. by relinquishing its right to dismiss workers at will.[383] Such a strategy provides the most sustainable competitive advantage in the long run, as it requires a fundamental shift in mindset and commitment from everyone involved.

Seeking inspiration from the example of Lincoln Electric Company, certain parallels can be drawn to the example above in Chapter 5.1 of providing an "out" for investors in a fund by allowing them to more freely transfer or otherwise liquidate their investment in a fund.[384] Sponsors might be more inclined to collaborate and work together with investors for their mutual benefit when they have a way of exiting the fund if they are dissatisfied with the sponsor. Consequently, investors might simultaneously be more inclined to allow sponsors additional rights and freedom for the very same reason. If executed correctly, and combined with the legal strategies presented above, this could build a sense of trust and collectiveness similar to that of employees and management at Lincoln Electric Company. It could also serve to further enhance the capabilities of the private equity industry as contractual and financial innovators for which it is already so well known.

The idea of using law and contracts to establish a competitive advantage goes hand in hand with the ideas of Proactive Law presented in Chapter 2.3. It starts with managers, or in this case, sponsors, acquiring sufficient legal knowledge and contractual literacy necessary to enact a change in their perception of law and contracts. This knowledge lays the foundation for

[382] Ibid., p. 30.
[383] See ibid., p. 32–36. The massively increased job security created by forfeiting its right to dismiss employees, in addition to guaranteeing a certain amount of work regardless of economic conditions, encouraged employees to increase efficiency in the company's operations, built trust between employees and management and nurtured an acceptance of a payment system based almost entirely on the output of each employee. This, in aggregation, created one of the most loyal and efficient workforces on the market, massively outweighing the risk by not being able to dismiss employees at will and proving vital for the survival of the company in the long run.
[384] To clarify, this does not suggest that making private equity investments freely redeemable and in that sense liquid, as this could risk jeopardizing the whole fund when capital is seldom readily available for distribution once investments have been made. Instead, it should be seen as a means of providing secondary liquidity, by selling an investor allocation in a fund to another party on an open market or through an arm's length transaction.

embedding legal strategy and a proactive approach to law and contracts into the very core of their organization and a source of opportunities.[385] Organizations with the correct mindset can start using contracts as tools available to both managers and lawyers, to not only prevent disputes and allocate risks, but to achieve and implement concrete business goals, an increasingly important aspect of contracting when complexity and the need for cooperation grows. Indeed, contracts and transactions that fulfill the criteria for complex transactions, which private equity and side letter transactions by nature are,[386] requires a shift in focus from individual business transactions towards continuous business relationships built on mutual trust and benefits.[387] Seeing contracts as tools also enables an organization to more effectively implement contracts, in addition to simply creating them can enable competitive advantages by increasing the efficiency of the performance of their contracts.[388]

Simply embracing the idea of competitive advantage can bring with it several improvements both on an individual and industry level, and there are concrete steps to follow in doing just that. Removing inefficient terms and clauses from contracts that are not viable from a risk/reward point of view, saving time, costs and reputation, creates apparent advantages for sponsors and investors alike.[389] By then utilizing legal strategies to drive further change, overhauling the way law and contracts are used and generating investor goodwill makes the advantage competitive, due to the increase in reputation and the inherent *stickiness* of investors towards their favored sponsors. Seeing the problematic governance structure and misaligned incentives existing within and between the parties in a private equity deal as an opportunity for improvement, instead of accepting the status quo has the potential of creating valuable competitive advantages for the daring.

[385] Haapio – Siedel 2010, p. 666–667.
[386] Complex transactions refer to the criteria laid out by the theory on Transaction Cost Economics discussed in Chapter 2.3, and are: 1) asset specificity, 2) uncertainty and 3) frequency. The existence any of these criteria is said to increase the complexity of a transaction, which in turn requires more consideration as how to structure it in the most efficient manner possible.
[387] Haapio – Siedel 2010, p. 674–679.
[388] Ibid., p. 680–681.
[389] Ibid., p. 679.

6. Private Equity Contracting – Finding a Way Forward

Having taken a closer look at the governance structure of private equity, the regulatory and contractual complexity that are side letters, including their many risks and shortcomings, as well as the misalignment of incentives within the industry as a whole, one thing seems clear – there is room for improvement, efficiencies to be unlocked and value to be created. One of the main objectives of this thesis was to shed additional light on the problematic practice of side letters, and to present the underlying reasons as to what has enabled such a practice to take root and develop in the first place. In doing so, numerous solutions to the burden created by side letters for both sponsors and investors are available, and mainly comprise a better understanding of the inherent complexity caused by the unique contract structure of side letters, as well as embracing a practice of simplifying, shortening and depowering them in favor of the LPA. The fact that no major action has yet been taken on a market-wide level points towards the existence of substantial barriers to change and a market practice unwilling to freely change without the proper incentives.

As with many things in the cutting-edge area of finance, side letters are also largely a construction originating from the U.S. The world's financial markets being as global as they are, side letters have quickly grown to become the market standard globally, including in Finland and the rest of Europe. Simply adopting and implementing the idea of side letters from a foreign jurisdiction does not, however, come without its fair share of risks, as the legal principles governing contracts overall can vary substantially from one jurisdiction to another, let alone the specific capital market regulation. Apart from creating uncertainty in the boundaries of their scope and validity, the current practice of side letters originally designed for the U.S. market are attempting to solve problems not necessarily existing in other jurisdictions, consequently creating additional problems and inefficiencies. The current rules on preferential treatment and investor disclosure applicable in the EU already limit many of the core concepts of a side letter – to provide individual benefits unbeknownst to others. By intending to solve problems that do not exist, side letters instead end up creating unnecessary complexity and uncertainty.

Although certain regulatory differences currently exist depending on jurisdiction, many of the core issues highlighted in this thesis are of a non-regulatory nature, focusing on contractual risks, inefficiencies and a barrier to amount to any meaningful change in its current state. The proposed rules on side letters by the SEC, however, has ignited a recent spark on the regulatory

side of the side letter debate, by taking an unusually active stance in an industry previously governed largely by market forces alone. Although regulation is one way to enact change in the market practice, by limiting the scope and use of side letters by force, it is not necessarily the right, and certainly not the only, alternative. Indeed, the proposed rules have been criticized for focusing too much on specific terms and market practices, without addressing their inherent structural inefficiencies that result in additional time, resources and costs being spent on the fund formation process.[390] Further, this kind of forced incentive to refrain from acting in a certain way is not the most efficient way to enact sustainable change in a way that could benefit both sponsors and investors in the long run and may result in sponsors adopting a merely compliance-focused approach to the proposed changes. After all, it is not the law that lays out how contracts should look and act, but rather the parties to it.[391]

Thus, a compliance approach is likely to lead to additional costs for setting up and running a fund, costs that are in the end borne by a fund's investors and, perhaps equally as problematic, does little to refrain sponsors from actively trying to find loopholes in the regulation or to change the underlying incentives behind the currently flawed market practice. Instead, addressing the underlying cause for the current issues, the misaligned incentives surrounding practically all parties within the private equity ecosystem, should be the main course of action for scholars, regulators, representative organizations and industry participants alike. Several organizations, such as AIMA and ILPA, have already taken steps toward creating models, standards and guidelines for addressing many of the inefficiencies and defects in the current side letter practice. This kind of collective and standardized effort could prove increasingly valuable as more market participants start embracing the existing flaws and strive towards improving the use of side letters. A recent Risk Alert by the SEC explicitly encourages sponsors to review their current practices, increasing the relevance of this thesis.[392]

Due to the relative secrecy of the exact scope and contents of the dealings in the private equity industry compared to many other areas of business and finance, a vital first step is conducting additional research and encouraging scholarly contributions to this area, in order to lay the groundwork for adopting better practices going forward.[393] This thesis sought to make such a contribution, and to provide a stepping stone into further research as to how private equity contracting should be organized to attain maximal value creation for all parties involved.

[390] de Fontenay – Nili 2023, p. 62.
[391] Haapio 2013, p. 82.
[392] SEC Risk Alert 2022, p. 6.
[393] Clayton 2022b, p. 14–15.