TURNER:

Hello, and welcome back to Wisconsin Law in Action, a podcast where we discuss new and forthcoming scholarship with the University of Wisconsin Law School professors. I'm your host, Kris Turner, and my guest today is Professor of Law and Smith-Rowe Faculty Fellow in Business Law at the University of Wisconsin Law School, Yaron Nili.

Professor Nili is truly a prolific author of numerous well-regarded articles focused on corporate law, corporate governance and business. Today, Professor Nili is here to discuss his newest article, "Side Letter Governance," forthcoming later this year in the Washington University Law Review and co-authored with Elisabeth de Fontenay of Duke University.

Professor Nili's newest article focuses on a standard but difficult-to-study practice in private equity known as side letters. The article examines how side letters have evolved and are viewed in the industry now and what role they play in dealing with investors. The article also contributes new data and insights to the literature by collecting data on how side letters are currently employed and provides readers with recommendations for improving existing inefficient bargaining equilibriums.

Thank you for returning to the podcast today, Professor Nili. Third time is indeed the charm.

NILI:

Thank you for having me. Always a pleasure.

TURNER:

Yes, the same goes for me. I'm going to start off right at the top and say that side letters is an entirely new area for me, so I'm going to ask a lot of fundamental questions I think, but then we'll dig into some of the deeper issues that you and Professor de Fontenay discuss in the paper.

My very first question is, should listeners read or watch Barbarians at the Gate before or after they read the paper? What's the movie and book about?

NILI:

Well, either way will be good, but yeah, I always have my students... It's one of the recommended movies or readings to have. The title is a little bit, I know, barbarian, but it's basically a story about the emergence of the private equity buyout industry in the 1980s and tells the story of the purchase of RJR Nabisco, which was a giant conglomerate making both cigarettes and Oreos, but that was purchased by KKR, which is one of the most renowned private equity buyout firms in the world. It's written in a very accessible and easy to understand, and really, you can view the private equity buyout disruptors into the 1980s and that stick around.

The model of private equity overall is to purchase companies, take them private and do a bunch of changes to the way companies operate, to the management team, to wasteful spending, and then take those companies back into the market. That's the model. Obviously, management has viewed those actions as the barbarians at the gate coming for them, so to speak. That's the name for the book and the movie. Both are excellent.

TURNER:

Okay. Well, now it's at the top of my list. I'll pop some popcorn tonight or over the weekend and I'll watch it and I'll get back to you.

NILI:

It's a very well-done movie. The movie especially, it's a Hollywood production, so it gives some life to... It's an early version of Succession if you want to equate it a little bit. It's a 1990s version of what Succession did to corporate law in the 2020s.

TURNER:

Okay, well, you've got me sold. But first, let's get back to your article and begin by reviewing the basics of private equity funds and leverage buyouts, just as you and Professor de Fontenay do at the start of your piece.

NILI:

Yeah. As I just said, private equity, generally speaking, talks about those fund managers that manage private funds. The big difference between public and private funds is to the extent those are regulated, what disclosures you need to have. Those private pools of funds traditionally have been very lightly regulated by the SEC. There is currently an attempt by the SEC to maybe change that to some extent, so that's something that is a hot topic, so to speak.

But what they do, especially what we focus in the paper, private equity buyout funds, is a model where you pull investment from large institutional investors, so pension funds, the State of Wisconsin Investment Board, for instance, is one of the investors in private equity, banks, mutual funds and insurance companies, endowments all invest in a private equity fund and that fund is managed by a firm, let's say KKR, and they go and through the life cycle of that fund, which is usually 10 to 12 years. They'll go by three, four, five companies with a mixture of equity and a lot of debt, and utilize that time to make significant changes to the way the companies operate, and then sell them and that's how they make the profits.

They also brought this financial innovation in the way they compensate themselves, which is called "The 2 and 20." So the managers of the fund get 2% of the committed capital into the fund as management fee, but they also get 20% of whatever profits they make for the fund. That's very simple. There's more complications and nuances to that, but I think this is a good really kind of 30,000-feet overview of the private fund industry.

TURNER:

Yes, thank you. I needed it very much so to understand a little bit of this. That was a truly interesting paper, but I appreciated the introduction, the 30,000-foot view, for sure.

But now, how does side letters play into private equity and work with these investors?

NILI:

Yeah, so that's a very interesting phenomenon, and I can tell you one of the things that I was... It's kind of closing a full circle. So when I was an associate at a law firm in New York, one of my favorite assignments was to negotiate side letters with investors. I had a close knowledge of it when I was practicing and then always kept kind of a curious eye towards it and it was great to be able to actually write an academic paper on it.

What happens is that investors in the private equity fund have two key documents they negotiate. One is what's called the limited partnership agreement. So usually, private equity funds are organized as limited partnerships, so the investors in the fund are the limited partners and the manager of the fund is the general partner, and there's a whole agreement that needs to govern the way the fund is managed, organized, what happens at various contingencies, how the money is being divided and all of that.

But in addition to that big, lengthy document, it can be 100, 220 pages, a lot of investors also negotiate a different agreement, what is called a side letter. Basically, they're asking for specific either clarification or additions and amendments to the limited partnership agreement that cater to the specific needs, wants, desires, and so on. So, that's the practice of side letter.

And one of the difficult and interesting things with the private equity is because they're private, there's no obligation to disclose anything. So researchers are often in the dark about what those documents contain, and I think one of the biggest contributions of this project is the ability to shed light on the actual side letters. We're able to get a pretty large sample of side letters from investors and basically able to code them and look under the hood and see what they do. As I said, both Professor de Fontenay and me worked in the industry, so we had a sense anecdotally of what side letters have and don't, but we weren't exposed to that large quantity of side letters and it was really great to be able to do that.

TURNER:

Yeah, you've seen some of the trees and now you have the forest with all this data to work with. That's great.

NILI:

Yes.

TURNER:

So I think you kind of alluded to this in this answer, but how are side letters viewed in academia and in practice currently?

NILI:

Yeah, so in practice, they are omnipresent, right? So those are something almost every investor is going to try to negotiate for a side letter. The level of success they'll have will be dependent on their leverage, but they're very common, not just in private equity, but especially in the private equity context.

From an academic perspective and also from regulators and politicians, there's been kind of two key, I think, approaches to side letters. One, which seems maybe the most intuitive one and kind of rooted in maybe a fairness sense is that side letters are basically unfair. You have this big document that everybody sees, everybody signs, and then suddenly some investors get different terms, different preferences, and this is done under the dark of night, so to speak, and behind closed doors. And there's a sense, "This is not fair, this is not okay, this should be banned," and we bring some quotes from, in our paper, Elizabeth Warren was trying to open in the SEC, has a very skeptical view of side letters.

But there is also an academic view that side letters are actually providing very important aspects to private equity negotiation and is the theory of efficient price discrimination. Basically, different investors of different leverages and the private equity sponsor can basically charge different prices from different investors utilizing side letters. Instead of the main document, they're basically giving preferential treatment to some investors to encourage them to join the fund through side letters.

But both of those views really hinged on this sense that the side letters will contain significant financial provisions. If you want to discriminate or efficiently discriminate based on price, you need to have some price terms. When we went in this project, we expected to see a lot of financial provisions in the side letters. I'm going to have a spoiler alert. We found almost none. So it was very interesting for us to basically dispel both notions or both concerns from politicians and academics alike.

Side letters are not what we really think that they're going to do. They don't really provide discrimination, price discrimination. Regardless if you think it's good or bad, it just doesn't exist there. They contain much more minuscule benign-type of provisions, but also some problematic stuff that I'm sure we'll talk about in a second.

TURNER:

Yeah, so once you popped the hood, as you had mentioned earlier, you found some surprises in there like that, but like you said, one of the larger contributions of this paper is the analysis of about 250 or more side letters that you both reviewed. What was your methodology as you went through all these materials?

NILI:

This is one of the rare cases that we use no RA help for the coding because it's pretty complex, and also, we want to make sure that we are consistent. The two of us, we read all of the side letters, both of us, and we both coded them based on the metrics we created. So we started a sample, we kind of tried to look what are common types of provisions, and then started hand code, manually code all those side letters.

And then later on, once we had the whole Excel sheet with the coding, we also clustered them together into specific buckets of what types of provisions are those? Are those provisions that relate to the governance of the fund? Are those financial provisions? Are those financial? Are those regulatory compliance type of provisions? So on and so forth.

TURNER:

Wow, all that without any research assistant or student support. I'm even more impressed coming into this now with your background in side letters and now with doing all this data analysis.

And so when you and Professor de Fontenay reviewed the side letters, what did your empirical analysis reveal about the evolution of the side letters over time?

NILI:

We have a lot more data about our sample, but it ranges over roughly close to 30 years from the 1990s to 2019 when we collected those more recent documents, and really, four big eras in the private equity cycle. So pre-2005, then the gold era, the first gold era of private equity 2005-2008, then we had the financial crisis and post-financial crisis, and then the more recent private equity era.

And some things were pretty clear. Side letters became more complex, had way more provisions, words in them. They were more lengthy, and although that was a particularly important observation because as we'll talk later, we're not sure that's really a needed development in the context of private equity side letters. I think we also show side letters tend to differentiate based on the size of the investor. So most of our sellers were either endowment or public pension funds, but we had a pretty good distribution with the exception of [inaudible 00:13:01] we didn't really have. But the number of terms over time increased significantly. The complexity, the number of pages that's within, and the number of provisions, all of those traced an increase over time.

We also see much more complex MFN provisions. I'm just going to stop and explain what MFN is. That's an acronym for most favorite nation provision. One of the interesting things with side letters is that they're negotiated simultaneously with multiple parties. So different investors are negotiating side letters at the same time and the limited partnership agreement is also being negotiated at the same time. And that created interesting moral hazard issue. So if you're an investor, you would say, "Well, I want to wait and see what other people are doing before I'm going to sign my stuff."

So private equity sponsors came up with this nifty idea, which is the most favorite nation provision. Basically, a provision that tells investors, "Listen, based on the specific parameters, if somebody else gets better times than you later on, you'll be able to match it." So it prevents the need to delay your signing. You can actually negotiate what you really care about, and if anybody else ends up getting better treatment, you are promised that you're going to get that as long as you qualify. Usually, it's based on the size of your investment and some other solutions. That was the simple notion of MFN. Over time, that became a very complex provision. It can take half a page to a page with a lot of exclusions, a lot of modifications or language that restricts your ability to get those benefits. So that's another interesting development that we saw over time with funds.

TURNER:

Again, going back to your spoiler alert, what else did you find most surprising in your analysis of these side letters?

NILI:

We saw almost no financial provisions at all. Most of the provisions that we have seen were dealing with regulatory compliance, tax, and to some extent, governance provisions. But coming into it and based on regulators' sentiment and academic discourse, we were expecting to find way more in the way of specific financial benefits that are, when I say financial benefits, it could be a fee discount. So instead of paying the 2 and 20, you would pay less than that. It could be even promises, concrete promises to participate in co-investment. So one of the things that we thought that will be very, very common in side letters is concrete promises that the general partner will give to specific investors about the right to co-invest alongside the fund in specific investments.

What do I mean by that? Let's say private equity fund wants to buy a company. It could take and buy the company with the equity that it has in a debt, but it could also buy only 80% of the company with equity and debt that it has and give opportunity to other investors to contribute the rest of the equity.

Why is that beneficial? It allows the limited partners to participate in that transaction outside of the fund structure, which means that they can basically invest more but also don't have to pay the same fees that they would pay under the fund. So you don't have to pay the 20% management fee, they don't have to pay as many fees otherwise. So it could be a pretty good deal assuming you are selecting a good investment in the sense that the company that you end up buying generates good value. Investors really are keen to get those opportunities.

So we were expecting specific promises about the opportunity to participate in those type of co-investments and we basically saw none. We saw language to the extent that the general partner acknowledges the wishes of a specific investor to participate, but nothing concrete to the level where it actually gives you a right to do so. And that was, I think, very surprising to the both of us.

TURNER:

It sounds like a lot of these findings will change the viewpoints of these side letters, especially in academia and regulators and governments. How can this data be used to debunk these claims about side letter in the literature?

NILI:

Well, first of all, I just want to caution and I think like any empirical work, especially in this opaque world of private equity, our sample is limited. We did the best that we could to get a representative sample, but it's still relatively small. 250 is nothing to thousands and thousands of those. So I think one of the hopes is to encourage more research into that and encourage other people to try to supplement and contribute to that emerging literature or looking into the inner works of private equity.

And I think the second thing is to use the data that we do have to better tailor the regulatory tension. So I think what we try to highlight in this paper is that the attention to the concerns about financial discrimination may have been unwarranted, and actually, some of the regulatory effort in limiting side letters might be counterproductive. But at the same time, we do want to highlight that there are costs that are associated with private equity negotiations: the transaction costs that are being born by the negotiating of those letters by attorney fees; that are born by investors, the investors on the fund basically pay for both sides negotiations, both for the general partner and for the own negotiations.

So we are not sure the development of side letters currently is the best and efficient way to run private equity. There's a host of collective action issues and party patents that may lead us to the way we are, but we try to encourage both regulators and investors themselves to think about how we can streamline the process because it's clear to us that there are some provisions that don't necessarily need to go into side letters or meeting these provisions. A lot of them are provisions that could easily be incorporated into the larger agreements and basically reduce the cost of negotiating. There are some specific stuff that side letters may be the best venue for them, but I would venture to say that the majority isn't. And that brings questions about how can we move to a world where a lot of this language is actually moving into the limited partnership agreement and is removed from the side letters?

TURNER:

Right, yep. You've anticipated my next question. I was going to ask about limited partnership agreements and how side letters affect them, but it sounds like a lot of things that you found in side letters could actually be potentially moved to these limited partnership agreements.

NILI:

A, yes, and B, I think that's even a more concerning aspect of it is that generally speaking as part of contract law, the limited partnership agreement recognizes the fact that some parties may engage in side letters, so it's allowed by the limited partnership agreement. But generally speaking, the limited partnership agreement should be prevailing over side letters. So any language in the side letter that is basically detrimental to any party in the private equity fund needs to be approved by the limited partnership agreement.

And what we have seen in the side letters is that there are quite a few instances, but that provisions might actually be detrimental to other parties but are not cleared by the limited partnership agreement and that is something that needs to be ironed out because to the extent the side letter is modifying the limited partnership procurement in a way that is detrimental to other parties, that's something that needs to be disclosed and approved by those parties, and that is often not the case and based on the sample that we were able to decipher.

TURNER:

Another related concept that you cover in your paper is contract modularity. What is this concept? How does it come into play with side letters?

NILI:

Yeah, so the contract modularity literature basically talks about the value of slicing legal arrangement into different documents. So in a MA agreement, in an M&A transaction, you might have several different documents dealing with various different aspects of the deal. And the notion is that there is efficiencies often in passing out different types of obligations outside of the key main agreement because it might be first, faster to negotiate, it might have less detrimental implications on the larger agreement. There's all kind of reasons why you want do it and that's why we see, in complex transactions, a series of documents and not just one big agreement, so that's the module initial in the whole.

And side letters are an example of contract modularity where we basically have the limited partnership agreement and then we have a series of side letters. But what we do see in our sample is that often, that actually creates inefficiencies. So contract modularity is very valuable when you are doing it in a way that improves the overall transaction costs of generating that transaction. And what we keep on hammering in this paper is that it seems that side letters are actually an efficient way to go about negotiating side letters, and to the extent you want to discriminate based on price, side letters are also an efficient way to go about it. And we are pretty explicit in our call for those arrangements to be incorporated in the limited partnership agreement.

TURNER:

So sometimes the contract modularity can be sliced too thin and these documents are too spread out then?

NILI:

And again, some of those provisions really are boilerplate provisions that we see in any side letter and can be easily modified to be applicable to the PA, so instead of wasting the time of negotiating an extra 20 provisions, you can just do it once in one document.

We talk about it in the paper, but that is part of the cost of having multiple sides. So when you talk about M&A transactions, and this is where the contract modularity started, you have two sides negotiating. You have the seller and the buyer. Each of them has a set of lawyers. So kind of dividing which documents will contain what is easy to do. The private equity context, you have the limited partnership agreement and you have multiple sides to it and then you have multiple negotiations on each of those side letters. It's really hard to coordinate, so the efficiency of modularity here is really questionable.

TURNER:

Okay, great. Well, based on all this, why are we using side letters now? How do we get to this point?

NILI:

This is what we tried to flesh out through a series of interviews with people in the field. We talked to partners at law firms, we talk to investment side people, we talk to institutional investors and so on. And there's different stories and we try to highlight several of those in the paper. It's pretty clear that the incentives of the general partner really are to play along with side letters.

And there are, I would say, two key observations here that I want to highlight. One is that it almost costs them nothing. They don't pay for the negotiations. This is a cost that are born by the fund. So for them, it's a costless effort. And the second and equally important is that general partners are really, really wary of making changes to the limited partnership agreement. For them, this is the party dependent document. Any concession they're going to make in the limited partnership agreement, the following fund, they're going to try to raise will have to start from that starting point because the party will say, "Okay, this is what you do in fund five, now we're at five, six, we want to keep that." They want to keep that document as unchanged as they can.

So to the extent they're willing to give anything out, they'd rather do it in a side letter, which is much more opaque. It's not something that often translates from one party to the other. So they're more comfortable doing it with side letters. So that's from the sponsor side why they don't... At the very least, they don't care or they have somewhat of an incentive of having the side letters in place.

From an investor perspective, it's a classical prisoner's dilemma situation. No, I think everybody would be better off if they negotiated together to put all those agreements in limited partnership agreement, but to the extent they can't negotiate together and that's the case, then they will try. Each of them is trying to maximize their own benefit by trying to get something out of the general partner through side letters. So there's incentive to at least do it. And not only that, if you know that other parties are getting side letters, you're going to say, "Well, I want a side letter too. I want to get something too." There's a very behavioral component to chasing the side letter because the other parties are also doing it at the same time.

And then we have the lawyers, and for lawyers, this is an important component of the billable hours that they spend in forming a fund, so they don't necessarily have the incentive to try to cut it down. If you can charge significant hourly rates for negotiation letters, that's not something that you necessarily want to see go, so they don't really have an incentive to let it go.

And equally important is that lawyers want to show their clients that they're doing good by them, and if you can't really make a lot of changes to the limited partnership agreement, one of the only ways for you to show your client that you actually produce something is by showing them that you were able to achieve something in the side letters. So there's also a component of the lawyers... Basically, the key avenue for them in the negotiation of a private equity deal is to be able to generate some side letter concessions, so they have an incentive there too.

TURNER:

There's a lot of human nature underlying these side letter motivations is what I'm hearing here. There's caution, there's billable hours, there's the prisoner's dilemma, and so this is all kind of locking the parties into the side letter work here that there might be better ways to go about it, as you and Professor de Fontenay discuss.

NILI:

That's right.

TURNER:

Which is a perfect segue into my next question. What recommendations does your analysis provide for recontextualizing the views of side letters and improving these investment practices?

NILI:

For us, part of it is disclosure. Right now, side letters are not often not always disclosed to other parties and sometimes they're only going to be specific provisions that are going to be disclosed. So we think that sunlight is the best disinfector. It could help the prisoner dilemma. If other parties are seeing what other parties are getting and understanding this is not that big of a deal, it might reduce that prisoner dilemma and the race, so to speak, the race to the side letter type of phenomenon.

We think, as I already mentioned a few times, there's a lot of provisions that can go into the limited partnership agreement. They have no need to be in side letters, so moving them to the limited partnership agreement will be a key. And to the extent that we want to have price discrimination between parties, we really think this something that should be in the limited partnership agreement. There's no need to hide it, there's no need to be shy about it. This is something that sophisticated parties should acknowledge and we want to encourage both limited partners and general partners to think about incorporating in the limited partnership agreement.

TURNER:

And still through all that, the lawyers can still show their clients that they're have their best interests at heart, as you had mentioned, that they're doing good by them. Even if their billable hours might be a little bit affected, there's still the, "Look, I'm doing the good work and this is how it's going to improve."

NILI:

Correct, right. And we didn't talk about it, but institutional investors have an organization called ILPA that tries to reduce that prisoner dilemma between investors trying to coordinate to put best practices in place. So a lot of the recommendations are geared towards investors themselves pushing private equity companies to make changes. We think ILPA has a really important role in trying to alleviate some of those coordination efforts between investors, but some of it might need to be taken by regulators as well.

TURNER:

Okay, great. So there are efforts by parties underway in some ways to improve these already?

NILI:

Yes.

TURNER:

Speaking of which, there is some recently introduced SEC proposed rules that you mentioned at the top of our discussion on private equity that's focused on side letters in particular. Will they help correct some of these issues uncovered in your data?

NILI:

I think the SEC has generally correctly identified their issues with the way private equity and the private equity industry is being managed. There are some friction points that need to be addressed. We think that generally speaking, the proposals, to some extent, miss the [inaudible 00:30:15] for the trades. Really, there's an effort to prevent side letters from dealing with specific aspects that we didn't really see in side letters, so the concern about financial arrangement is not really there.

And the second thing is that the SEC proposal might actually increase the costs for side letter negotiation and for private equity arrangement, not reduce them. The drafting will need to be more careful based on the SEC current proposals and they really don't really try to address the collective action issues that we talk about. So standardization, moving things into the limited partnership agreement, this is where we think the SEC can have a really useful element and voice and one that we suggest that the focus will be there and not necessarily on forfeiting specific provisions from side letters altogether.

TURNER:

So with that, what do you most hope readers take away from your article?

NILI:

As you said, it's an interesting story about the ecosystem of legal documents and how sometimes the opaqueness level of documents allows for a somewhat peculiar and potentially inefficient system to thrive, so to speak. Right? So I think the ability to shed light on a relatively dark corner of the financial system is always super fun. I think we learned a lot from it. I think that there's a lot more to learn, but I think what we highlighted is that potentially our concerns about what's happening in side letters were misguided, but it doesn't mean that we don't need to address side letters altogether. It's just that the problems we identified are different than the ones that people have suspected they will bring about.

TURNER:

We'll link to Professor Nili's scholarship on this and everything else and your Twitter profile, of course, on our podcast page. Thank you very much again for joining the podcast today, Professor Nili. I hope to see you back again with the next paper that's coming out.

NILI:

Thank you. And don't threaten me, I will be here.

TURNER:

Okay, great. Excellent.

We've been discussing Professor Nili's forthcoming article, "Side Letter Governance," co-authored with Elizabeth de Fontenay and forthcoming later this year in the Washington University Law Review. I highly recommend reading the article in full. We've only scratched the service of the piece's groundbreaking analysis and contribution to the literature. You can find it right now on SSRN. Check out our podcast page for a link. For a complete listing of Professor Nili's published work, visit the University of Wisconsin Law School Repository.

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