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# Shadow Contracts

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# Shadow Contracts

*Jessica S. Jeffers & Anne M. Tucker*[*]

*This project explores side letters in private market funds. Side letters, separate agreements between a fund and an investor, act as an invisible amendment to the main contract. This article introduces a new use case for side letters: impact investments, where funds target social, as well as financial, returns. Using a hand-collected data set, we examine the scope and role of side letters in this growing space. Side letters as "shadow contracts" demonstrate the Easterbrook/Fischel theories in action, namely that parties "write their own tickets," tailoring agreement terms to their specific needs within the framework of corporate governance rules. Expressing preferences and constricting manager power through contracts is even more important when managers serve dual goals. However, side letters come with costs, including direct transactional fees and indirect costs such as additional complexity, slower adoption of best practices, and hidden hierarchies that advantage some parties to the detriment of others. The solution? Standardization and transparency. Common side letter provisions, such as information rights and advisory committees, should be addressed in the main agreement to reduce costs, increase transparency, and push contract innovations out of the shadows. Further, in line with recent SEC proposed rules, side letters should be disclosed.*

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## I. INTRODUCTION

Contracts are legal artifacts that represent the best expression of parties' agreement at the time that the deal is struck.[1] Written contracts guide parties' actions and courts' interpretations after the agreement is made.[2] When contract terms change through amendments, addendums, modifications, or substitutions, they are usually agreed to by all parties, attach to the original contract, and visibly alter performance obligations going forward.[3]

What happens when the mechanisms of change occur by the agreement of *some parties* and are not made visible to all parties?[4] That is exactly what can happen with side letters, also called side agreements, which are ancillary bargains struck by some, but not all, parties to the original contract.[5] Even in contracts with multiple parties, sides letters can be negotiated between a subset of

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1 *See*, *e.g.*, Eric A. Posner, *Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533, 534–35 (1998) (describing the role of written contracts as providing the best evidence of the parties' intent to create a complete contract).

2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS 225 (3d ed. 2004); *see also* John E. Murray, Jr., *The Parol Evidence Process and Standardized Agreements Under the Restatement (Second) of Contracts*, 123 U. PA. L. REV. 1342, 1387–88 (1975).

3 RESTATEMENT (SECOND) OF CONTRACTS § 279 (Am. L. Inst. 1981); *cf.* David Horton, *The Shadow Terms: Contract Procedure and Unilateral Amendments*, 57 UCLA L. REV. 605, 605 (2010) (pointing out that "many standard form consumer agreements . . . authorize drafters to revise procedural terms unilaterally").

4 William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. ON REGUL. 67, 91 (2020) (describing how in a side letter "the benefit of the negotiated bargain is not shared with all of the other investors in the fund" but only "appl[ies] to the investor that is the recipient of the side letter").

5 *Id.* The SEC recently defined side letters as "agreements among the investor, general partner, adviser, and/or the private fund that provide the investor with different or preferential terms than those set forth in the fund's governing documents." Private Fund Advisors; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,886, 16,928 (proposed Mar. 24, 2022) [hereinafter Proposed Private Fund Rules], https://perma.cc/6DPL-HSUP.

parties in secrecy to create individualized benefits reserved exclusively for the recipient of the side letter.[6] Once finalized, a side letter between *some* parties changes the deal parameters in a way that can affect *all* parties.[7] Side letter terms create both direct effects, like granting preferential liquidity rights, and indirect effects, such as when side letter provisions change manager incentives. For example, a side letter can include an excuse provision that allows the LP to sit out a particular investment. An excuse provision for one investor can change the investment landscape for all investors by leading the fund manager to avoid an otherwise attractive investment opportunity because it conflicts with the excuse provision, and as a result changes the capital pool available. Side letters thus act as a shadow contract changing the contours of the original deal on the side.

Inquiries into how contracts operate are central to larger questions of corporate law. Consider the nexus of contract theory advanced by Michael Jensen and William Meckling, positing that corporations are a network of contracting relationships.[8] Others

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6 William W. Clayton, *Public Investors, Private Funds, and State Law*, 72 BAYLOR L. REV. 294, 316 (2020); William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1886–87 (2018) ("Many of these arrangements go undisclosed to other, less-preferred investors . . . ."); *cf.* JAMES M. SCHELL ET AL., PRIVATE EQUITY FUNDS: BUSINESS STRUCTURES AND OPERATIONS § 11.14 (identifying an exception to secrecy: the most favored nations clause, which entitles the holder of these rights, usually in their own side letters, to see side letter terms equal to or more favorable than the terms granted to it).

7 Magnuson, *supra* note 6, at 1886 (discussing most favored nations provisions).

8

> The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships, and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals. While this definition of the firm has little substantive content, emphasizing the essential contractual nature of firms and other organizations focuses attention on a crucial set of questions—why particular sets of contractual relations arise for various types of organizations, what are the consequences of these contractual relationships, and how they are affected by changes exogenous to the organization?

Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976). *See also* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 18 (1996) (describing the firm as "a nexus of contracts," by which he means that the "firm is in essence the common signatory of a group of contracts" among various factors of production); Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts: A Critique of Gulati, Klein & Zolt's "Connected Contracts" Model*, 88 IOWA L. REV. 1, 18 (2002); Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 819–23 (1999); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1193 (1991).

view corporate boards of directors as mediating hierarchies tasked with balancing the interests of contract holders.[9] Further still, corporations are formed by filing articles of incorporation, which courts treat and interpret as contracts, supplemented by bylaws and other corporate contracts.[10] Thus, corporate law's most central questions are resolved using standard contract-law principles.[11]

Easterbrook and Fischel famously extended and intertwined corporate and contract law theories, arguing that enabling corporate law statutes in each state provide a loose framework within which parties can dictate their own preferences, resource allocations, and information rights through contracts.[12] They conclude that corporate law shouldn't be more robust because parties can "write their own tickets" and set the rules as they wish, via contracts governing corporate actions.[13] They offered a party-agnostic theory of *contract primacy* as a powerful explanatory framework in corporate law.[14] Thus, contracts are central to broader questions of corporate law, as well as economics. Side letters embody the open-ended nature of contracting theorized by Easterbrook and Fischel bounded only by creativity, party resources, and judicial interpretation.

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9 Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250–51 (1999).

10 *Salzberg v. Sciabacucchi*, 227 A.3d 102, 116 (Del. 2020) ("[R]ecognizing that corporate charters are contracts among a corporation's stockholders, stockholder-approved charter amendments are given great respect under our law."); *see also ESG Cap. Partners II, LP v. Passport Special Opportunities Master Fund, LP*, No. CV 11053, 2015 WL 9060982, at *13 (Del. Ch. Dec. 16, 2015) (holding a general partner lacked authority, under the partnership agreement, to subsequently grant prohibited rights to select investors).

11 *Id.*; *see also* Magnuson, *supra* note 6, at 1875 ("[I]nvestor rights are largely a creature of contract law, and not state or federal law as one finds with publicly listed companies.").

12 FRANK H. EASTERBROOK & DANIEL R. FISCHEL, ECONOMIC STRUCTURE OF CORPORATE LAW 2 (1996) [hereinafter EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE]; Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416, 1417–18 (1989) [hereinafter Easterbrook & Fischel, *Corporate Contract*].

13 Easterbrook & Fischel, *Corporate Contract*, *supra* note 12, at 1417–18.

14 The phrase *contract primacy* was used by Judge Easterbrook at the University of Chicago Symposium: The Economic Structure of Corporate Law at Thirty: A Retrospective on the Work of Easterbrook and Fischel (March 25, 2022). Contract primacy offers an alternative framework to shareholder primacy and director primacy theories advanced in the corporate law literature. *See*, *e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005) (arguing for increased shareholder power to hold managers accountable and improve corporate performance); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) (arguing for continued rules that place directors largely in control of corporations with limited shareholder voting rights).

Side letters also typify some of the inherent tensions and contradictions that are central in the contract literature. For example, by design, side letters are modular, meaning divided into standalone segments within the agreement and separate from the main Limited Partnership Agreement (LPA).[15] But, side letters are also integrated with the LPA through cross references.[16] Even though highly tailored to investor needs,[17] side letters share common themes[18] and amend boilerplate[19] in the LPA.[20] The term

[15] Henry E. Smith, *Modularity in Contracts: Boilerplate and Information Flow*, 104 MICH. L. REV. 1175, 1176, 1196 (2006); Spencer Williams, *Contracts as Systems*, 45 DEL. J. CORP. L. 219, 237–38 (2021).

[16] Smith, *supra* note 15, at 1189 (cross referencing works against modularity and instead creates interdependence); *see also* Cathy Hwang & Matthew Jennejohn, *Deal Structure*, 113 NW. U. L. REV. 279, 305 (2018) ("Integration can be understood as the opposite of modularity—an integrated system has direct connections between the various constituent units. Most often, separate components are purpose-built to work together, and a change in one part causes changes in another."). *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 3, at § 209(3) ("Where the parties reduce an agreement to a writing which in view of its completeness and specificity reasonably appears to be a complete agreement, it is taken to be an integrated agreement unless it is established by other evidence that the writing did not constitute a final expression.").

[17] *See, e.g.*, Ola Bengtsson & Dan Bernhardt, *Different Problem, Same Solution: Contract-Specialization in Venture Capital*, 23 J. ECON. & MGMT. STRAT. 396, 397 (2014) (describing findings that VCs appropriately tailored financial contracts to maximize compensation, reputation, and future fund-raising ability).

[18] Standard price, payment terms, duration, delivery terms, and many others gap fillers in the law promote standardized contract language. *See* Omri Ben-Shahar, *"Agreeing to Disagree": Filling Gaps in Deliberately Incomplete Contracts*, 2004 WIS. L. REV. 389, 394 (2004) (first citing U.C.C. § 2–204 (2002); and then citing RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 3, at § 33); Jeremy McClane, *Boilerplate Semantics: Judging Natural Language in Standard Deal Contracts*, 2020 WIS. L. REV. 595, 610–624 (2020) (describing different contract clauses like change control and *pari passu*).

[19] For a discussion of such boilerplate language, see Smith, *supra* note 15; Michelle E. Boardman, *Contra Proferentem: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105, 1107 (2006) (arguing that boilerplate terms carry less litigation uncertainty and therefore reduce transaction costs); MITU GULATI & ROBERT SCOTT, THE 3 ½ MINUTE TRANSACTION 2–3 (2012) (discussing the widespread use of a boilerplate *pari passu* term in sovereign bond contracts); Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 262 (1985) (noting that default contract terms reduce transaction costs by providing parties with standardized and generally applicable "preformulations").

[20] For example, see standard side letter language:

> In connection with the investment by the Investor in XX, an X limited partnership (the "Partnership") which is constituted pursuant to the limited partnership agreement dated X, as amended and restated on X and as further amended, restated or modified from time to time (the "Partnership Agreement") and as an inducement for investment by the Investor in the Partnership, the General Partner has agreed to provide the Investor with this letter agreement (this "Side Letter"), which grants certain rights and benefits to the Investor with respect to his investment in the Partnership. This Side Letter shall supplement the terms of the Partnership Agreement.

Side Letter Doc. 39 (on file with authors).

"contract" does not even have a singular meaning. For example, a side letter is a standalone agreement, but can only be understood as part of a "bundle" of agreements related to the investment.[21] In private market funds, the "bundle" commonly includes the LPA, investor subscription agreements, and side letters. Thus, studying side letters adds depth to current debates about contract design and contracts' role in shaping corporate theory. Further still, contracts are a useful vehicle to examine the power of private, for-profit actors to contribute solutions to existential questions of climate risk, social inequities, and sustainability.[22] In prior work, we studied impact investment contracts[23] to explore greenwashing and contracting practices that align manager incentives to serve dual goals, e.g., profit and purpose.[24] Contracts morph and change as circumstances require, and we see evidence of their changing in response to new goals with tailored provisions in side letters. Impact funds are best understood as a subset of private market funds, making our findings relevant to both literatures.[25]

In this paper, we introduce a novel data set of 79 side letters to impact investment agreements, part of a broader effort by the Impact Finance Research Consortium (IFRC) to gather legal, financial, and other information on the performance and structure of impact investing funds.[26]

This article has three main contributions. First, we shine a light on an understudied aspect of contracting: side letters. Side letters are extremely common and increasingly complex. Yet few academic articles highlight their role in shaping contractual relationships.[27] We connect our findings to broader themes in

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[21] Cathy Hwang, *Unbundled Bargains: Multi-Agreement Dealmaking in Complex Mergers and Acquisitions*, 164 U. PA. L. REV. 1403, 1418–23 (2016).

[22] *See, e.g.*, Proposed Private Fund Rules, *supra* note 5, at 16,930 (describing "excuse rights" to shield certain investors from contributing money to portfolio companies that violate the investor's "environmental, social, or governance standards").

[23] The Global Impact Investing Network defines impact investing as "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets and target a range of returns from below market to market rate, depending on investors' strategic goals." *What You Need to Know about Impact Investing*, GLOB. IMPACT INV. NETWORK, https://perma.cc/PA32-ZFLU (last visited Feb. 8, 2022).

[24] Christopher Geczy et al., *Contracts with (Social) Benefits: The Implementation of Impact Investing*, 142 J. FIN. ECON. 697 (2021).

[25] *Id.* at 697.

[26] *See* IMPACT FIN. RSCH. CONSORTIUM, https://perma.cc/8NBV-SLR2 (last visited Feb. 8, 2022).

[27] Helpful published works include Clayton, *supra* note 4; Clayton, *supra* note 6; and Magnuson, *supra* note 6. *See also* Kenneth Ayotte et al., *Bankruptcy on the Side*, 112 NW. L. REV. 255 (2017) (analyzing side agreements between creditors in bankruptcy proceedings). Professors Elisabeth DeFontenay and Yaron Nili have a to-date unpublished

contracts, impact investing, and corporate law. We argue that side letters exemplify the Easterbrook and Fischel notion that corporate parties "write their own tickets" through contracts.

Second, we present data on a case study of impact investment side letters alongside interview insights. These data show that side letters help investors document and protect preferences. For example, we find that investors negotiate for information rights and advisory committees that can help ensure their desired balance between dual goals. Confidentiality and other rights are also tailored to fit investors' mandates, such as carve-outs for public institutions who require transparency to their constituents.

Third, we demonstrate the presence of a trade-off inherent to the use of side letters and propose solutions. Side letters allow funds to promise what they are able to deliver, and for investors to demand what they value.[28] At the same time, increasingly complex and tailored contracts can generate substantial transaction costs. When terms are negotiated in the "shadows," side letters can also result in hidden hierarchies and hamper the adoption of best practices.[29] These trade-offs are heightened in settings with heterogeneous investors and emerging best practices, as is the case in impact investing. The impact investment setting compounds transaction costs by reducing the pool of capital that can be invested for impact.

One solution to the cost of side letters is to bring more of the side letter terms out of the shadows and into the main agreements. Our analysis documents variation in language and length of side letter provisions, but also demonstrates common themes in side letter negotiations around information rights, advisory committees, and confidentiality carve outs, among other terms. If most impact deals have a side letter (or more) negotiating these

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empirical study drawing on over 250 side letters in private market deals. Elisabeth de Fontenay & Yaron Nili, *Side Letter Governance*, WASH U. L. REV. (forthcoming), https://perma.cc/8B38-WSSJ.

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> Investors part with their money willingly, putting dollars in equities instead of bonds or banks or land or gold because they believe the returns of equities more attractive. . . . Firms begin small in growth. They must attract customers and investors by promising *and delivering* what those people value. [Firms] that do not do so will not survive.

EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE, *supra* note 12, at 4.

29 The SEC supported its proposed side letter disclosure rule stating that "[i]ncreased transparency would better inform investors regarding the breadth of preferential treatment, the potential for those terms to affect their investment in the private fund, and the potential costs (including compliance costs) associated with these preferential terms." Proposed Private Fund Rules, *supra* note 5, at 16,930.

terms, then the LPA and subscription agreement, not a side letter, should address them.

Our article proceeds as follows: Section II describes side letters in private market deals generally; Section III introduces our case study and data; Section IV discusses the costs and implications of side letter practices sending with recommendations; and Section V briefly concludes.

## II. SIDE LETTERS

Side letters are used in a variety of settings like collective bargaining or other employee union agreements,[30] investment banking contracts,[31] and a host of other transactions. One arena where side letters are the rule, rather than the exception, is in private equity.[32] Side letters tailor investor rights,[33] facilitate investments by governments and pensions,[34] and authorize ancillary services to funds such as lending agreements.[35]

This paper discusses side letters in impact investing, a subset of private equity in which funds target social as well as financial returns. In the section below, we describe the landscape of side letters in private equity in general and then in impact investing specifically.

### A. Private Market Side Letters

Side letters change main agreements in one of three ways: (1) clarifying terms, (2) correcting or changing existing terms, or (3)

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[30] *See, e.g.*, *Bhd. of Locomotive Eng'rs & Trainmen v. United Transp. Union*, No. 10CV1532, 2011 WL 4478495, at *4 (N.D. Ohio Sept. 26, 2011), *aff'd*, 700 F.3d 891 (6th Cir. 2012) (interpreting two side letter agreements that modified a 1996 collective bargaining agreement and effectively determined employee rank for the positions covered in the side letter).

[31] *Red Zone LLC v. Cadwalader, Wickersham & Taft LLP*, 994 N.Y.S.2d 764, 769 (N.Y. Sup. Ct. 2013) (litigating a side letter to an investment banking agreement that reduced the representation services from $10 million to $2 million if the investment bank facilitated a proxy contest rather than a tender offer).

[32] *See, e.g.*, Ian Levin & Kevin Scanlan, *The Downside of Side Letters*, 7 J. INV. COMPLIANCE 43, 43–47 (2006) (noting that common practice of side letters in private equity in 2006); Clayton, *supra* note 4, at 91 ("[I]t is extremely common for large private equity fund investors to negotiate for various forms of individualized benefits in private equity funds."). For a primer on private equity, see PRIV. EQUITY RSCH. CONSORTIUM & INST. FOR PRIV. CAP., DEBT AND LEVERAGE IN PRIVATE EQUITY: A SURVEY OF EXISTING RESULTS AND NEW FINDINGS (2021), https://perma.cc/M9QK-WEBY.

[33] Houman B. Shadab, *Hedge Fund Governance*, 19 STAN. J.L. BUS. & FIN. 141, 170 (2013); *see also* Magnuson, *supra* note 6, at 1875.

[34] Clayton, *supra* note 6, at 294, 305.

[35] Mark C. Dempsey & Kristin M. Rylko, *Developing Side Letter Issues*, MAYER BROWN (2019), https://perma.cc/AVT3-FG6J.

adding terms reflecting a new consensus between the parties.[36] In practice, side letters in private equity agreements reallocate power and refine rights that generate both efficiencies and costs. For example, increased flexibility and targeted negotiations are two efficiencies.[37] On the other hand, side letters introduce additional complexity, stall development of best practices in LPAs and usher in hidden hierarchies, as well as extract costs.[38] Before turning to the data, we first describe the landscape in which side letters emerge, and the dynamics that fueled their growth.

We start with the main appeal of side letters: low cost, flexibility,[39] and bespoke tailoring. In private equity, side letters cater to and incorporate the idiosyncratic needs of large investors.[40] For example, when a pension plan negotiates a fee discount, changes must be made to the investment agreement for the fund to secure the capital.[41] Amendments and modifications or a wholesale revision to the investment agreement would implement the change. But these approaches are costly, and it is risky to open the whole deal to renegotiation. Side letters offer a tactical advantage: lower transaction costs.[42] In theory, negotiating a limited set of deal points in a side letter involves less time and money than a formal amendment process open to more investors and renegotiations.[43]

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[36] Tae Jung Park, *The Uses and Advantages of Side Letters in the Investment Chapters in Preferential Trade Agreements*, 12 J. INT'L DISP. SETTLEMENT 84, 87 (2021); *see also* Dempsey & Rylko, *supra* note 35.

[37] *Id.*

[38] "[S]ide letters can amend, supplement, or even contradict, the terms that are provided in the limited partnership agreement. Through the negotiation of these side letters, preferential treatment is often given to repeat investors or large institutional clients." Magnuson, *supra* note 6, at 1886 (footnote omitted). On this issue, the SEC found the following:

> In granting preferential liquidity rights to a large investor, the adviser stands to benefit because its fees increase as fund assets under management increase. As noted above, the adviser attracts preferred investors to invest in the fund by offering preferential terms, such as more favorable liquidity rights. While the fund also may experience some benefits, including the ability to attract additional investors and to spread expenses over a broader investor and asset base, there are scenarios where the preferential liquidity terms harm the fund and other investors.

Proposed Private Fund Rules, *supra* note 5, at 16,929.

[39] Park, *supra* note 36, at 87–88.

[40] Clayton, *supra* note 4, at 70.

[41] Clayton, *supra* note 6, at 316.

[42] Park, *supra* note 36, at 87.

[43] *Id.*; *see also* Dempsey & Rylko, *supra* note 35.

While we later show that some side letters are bloated, within our case study, the majority of our side letters are 10 pages or less.[44]

Side letters are also flexible, reflecting last minute and after-the-fund-is-formed deal adaptations necessary to attract capital.[45] This is particularly true with large investors, those able and willing to invest cornerstone capital necessary to make a fund.[46] Large investors hold negotiation power because of their influence over whether the fund raises the minimum capital amount to form. Large investors in one fund are also potential investors in sister or subsequent funds.[47] Importantly, large investors can demand idiosyncratic terms within side letters because the capital they invest will foot the legal bill of contract negotiation.[48]

Side letters are not without their own costs, such as perpetuating poor-quality LPAs. For example, when large investors negotiate for their own private benefits, they are less sensitive to the poor quality of LPA protections that extend to *other* investors.[49] Side letters create a hidden hierarchy.[50] Suboptimal LPA terms, such as lack of information reporting or participatory governance, can be repaired in a side letter but left in the main agreement, exposing other investors to weak protections and perpetuating "best practices" that are anything but.[51] Some side letter provisions, once complied with for one investor, often cost little to extend the privilege to other investors. Take information rights for example: once a fund produces information for one investor,

44 *See* Compiled Side Letter Data File (on file with authors). Our findings are in line with the side letter lengths observed by Professors de Fontenay and Nili, who documented growth in recent side letters to an average of 8.5 pages. de Fontenay and Nili, *supra* note 27, at 33.

45 Clayton, *supra* note 4, at 88 ("[S]ome amount of flexibility and discretion was needed.").

46 *Id.* at 90 ("Large investors generally have greater bargaining power with private equity fund managers than smaller investors . . . ."). In the proposed rules, the SEC identified funds' incentives to negotiate side letters with "large" investors to induce their investment in the fund or in future funds. Proposed Private Fund Rules, *supra* note 5, at 16,928–29.

47 Qualitative Interview Session 1 (Nov. 6, 2020) (on file with author).

48 Clayton, *supra* note 4, at 109–10; *see also* Magnuson, *supra* note 6, at 1887.

49 Clayton, *supra* note 4, at 91.

50 "The very fact that [information rights] complexity is not included in the central LPA document creates the circumstances conducive to divergence. This state of affairs is clearly traced back to the GPs refusal to provide information transparency not just to the public, but even amongst their investor base. . . . [E]qual access to the enhanced level of information made available to DFIs presents a first, straightforward opportunity to simplify and standardize and therefore deliver significant time and cost savings." Qualitative Interview Session 1 Summary, *supra* note 47, at 5.

51 Clayton, *supra* note 4, at 96–97.

providing it to all other investors costs the fund nothing.[52] We address some of the reasons why parties repeatedly negotiate for such low-stakes bespoke rights below.

Who are the large investors that act as 1000-pound gorillas demanding special contract rights? In practice, a range of investors negotiate side letters, each with their own investment objectives.[53] According to a 2020 study by the law firm Seward & Kissel, the six principal investors negotiating side letters in private capital are, in order of frequency: (1) funds-of-funds (42%); (2) government plans (18%); (3) corporate pension plans (15%); (4) endowments (10%); (5) wealthy individuals/family offices (7.5%); and (6) non-profit institutions (7.5%).[54] Alternatively, Professors de Fontenay and Nili found that endowments and pension plans negotiated over 60% of the side letters in their sample, followed by foundations (14%).[55] In Section III, we discuss foundations and Development Finance Institutions (DFIs) as common investors in impact investing.[56] Pushing these investors' collective negotiation power outside of the LPA and into the side letters stagnates LPA best practice development. Strengthened LPA rights would benefit *all* investors, not just the parties to the side letters.

Common private equity side letter provisions include most-favored nation clauses (MFNs), advisory committees, information rights, separately managed accounts, and tax compliance.[57] Controversial side letter provisions include management fee and carried interest discounts, which increase an investor's potential return.[58] Large investors also negotiate co-investment rights to

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52 Funds reported a lack of trust in their non-DFI investors and "fear that information might leak into the public domain." Qualitative Interview Session 1 Summary, *supra* note 47, at 4.

53 The SEC identified a range of potential side letter parties including "seed investors, strategic investors, those with large commitments, and employees, friends, and family." Proposed Private Fund Rules, *supra* note, 5 at 16,928.

54 SEWARD & KISSELL LLP, THE SEWARD & KISSEL 2019/2020 HEDGE FUND SIDE LETTER STUDY 4 (2020), https://perma.cc/D3RU-Q7HP; *see also* Amy Whyte, *Funds-of-Funds Most Likely to Receive Preferential Hedge Fund Terms*, INST. INV. (Sept. 15, 2017), https://perma.cc/HC22-DLKB.

55 de Fontenay and Nili, *supra* note 27, at 31–32. Foundations, corporate pension plans, financial institutions, sovereign wealth funds, and family offices each accounted for 5% or less of the investors negotiating side letters. *Id.*

56 For a description of DFI investors, see *infra* note 77 and accompanying text.

57 Clayton, *supra* note 4, at 105–06.

58 Wulf A. Kaal, *Private Fund Fee Structure and Blockchain Applications*, *in* PRIVATE FUND REPORT (Lowell Milken Inst. for Bus. L. & Pol'y, UCLA Sch. of L. ed., 2017) ("It has become increasingly common in recent years for investors to negotiate fees with fund managers."); *see also* Magnuson, *supra* note 6, at 1887 ("[I]nvestors can receive significantly different returns, based on management-fee discounts and rebates."); *cf.* de Fontenay and

invest directly in portfolio companies alongside the fund, thus granting the investor double access to the portfolio company and a greater chance of returns.[59] Collectively, these side letter terms allow preferred investors to strengthen their claims to returns and relative position in the fund.[60]

Recently, the SEC weighed in on the practice, issuing guidance on investor risks associated with hidden hierarchies in side letters.[61] Private fund investment advisors fail to make adequate disclosures, and run afoul of the SEC, when they do not inform fund investors after other investors negotiate preferential liquidity terms.[62] The side letters in question fundamentally changed the risk exposure to the other investors in the fund. Failure to disclose these special terms meant that some investors were unaware of the potential harm that could be caused by select investors redeeming their investments ahead of other investors, particularly in times of market distortion where there is a greater likelihood of a financial impact.[63] In February 2022, the SEC went one step further, proposing new rules for private funds

Nili, *supra* note 27, at 38–39 (finding low occurrence of fee discounts and financial terms in their side letter study).

59 PREQIN, PREQIN SPECIAL REPORT: LP APPETITE FOR PRIVATE EQUITY CO-INVESTMENTS 3–4 (2012) (documenting the prevalence of co-investments in private equity deals and the motivations for doing so such as lower investment fees and a chance for higher returns); PREQIN, PREQIN SPECIAL REPORT: PRIVATE EQUITY CO-INVESTMENT OUTLOOK 9 (2015) [hereinafter PREQIN, PRIVATE EQUITY CO-INVESTMENT OUTLOOK] (documenting LP appetite for co-investments citing "superior returns" as motivation); PREQIN: PREQIN SPECIAL REPORT: PRIVATE EQUITY FUND MANAGER OUTLOOK 7 (2018) (citing return maximization as a main LP motivation and relationship building with investors and "access to additional capital for deals" as the main motivations for managers); *cf*. de Fontenay and Nili, *supra* note 27, at 39 (finding only 6.3% of side letters contain co-investment rights in their side letter study).

60 "[P]referential terms do not necessarily benefit the fund or other investors that are not party to the side letter agreement and, at times, we believe these terms can have a material, negative effect on other investors." Proposed Private Fund Rules, *supra* note 5, at 16,928.

61 U.S. SEC. & EXCH. COMM'N, RISK ALERT: OBSERVATIONS FROM EXAMINATION OF INVESTMENT ADVISORS MANAGING PRIVATE FUNDS 3 (June 23, 2020) [hereinafter U.S. SEC. & EXCH. COMM'N, RISK ALERT], https://perma.cc/SL63-8GA5; *see also Philip A. Falcone and Harbinger Charged with Securities Fraud*, U.S. SEC. & EXCH. COMM'N (June 27, 2012), https://perma.cc/8WPK-GLT9.

62 U.S. SEC. & EXCH. COMM'N, RISK ALERT, *supra* note 61, at 3 ("[S]ome investors were unaware of the potential harm that could be caused if the selected investors exercised the special terms granted by the side letters.").

63 *Philip Falcone and Harbinger Capital Agree to Settlement*, U.S. SEC. & EXCH. COMM'N (Aug. 19, 2013), https://perma.cc/77TP-6F39 ("Falcone and Harbinger granted favorable redemption and liquidity terms to certain large investors in HCP Fund I, and did not disclose certain of these arrangements to the fund's board of directors and the other fund investors.").

prohibiting preferential liquidity, certain information rights, and other side terms not disclosed to all investors.[64]

Further, negotiating and complying with patchwork and bespoke obligations introduces transaction costs for the fund.[65] Agreeing to and documenting side letters costs time and money. Complex terms with layers of carve-outs, developed across multiple documents, also increase compliance costs over the life of the fund. Side letters with multiple investors increase administrative costs to managers.[66] Without limits on side letter provisions or a checklist to monitor performance of all fund side letter agreements, managers can be swamped by compliance obligations.[67] The combination of complexity and divergence presents general partners (GPs) with a business risk in complying with the stipulations of one side-letter without falling afoul of another or of the LPA itself.[68]

### B. Impact Investing Side Letters

Impact investing shares much of the structure and dynamics of private equity, but the addition of a non-pecuniary goal generates its own set of pressures as well. Fund managers and investors vary in their impact goals, mandates, and motivation.[69] As a result, the need to "write your own ticket" is especially salient in impact investing, elevating the importance of side letters as a tool to document idiosyncratic investment priorities.

Due to the limited literature on side letters, we introduce a novel data set of 79 impact investment side letter agreements, as well as a set of interviews with impact investing stakeholders.[70]

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[64] Proposed Private Fund Rules, *supra* note 5, at 16,886 (proposing rules "that would prohibit all private fund advisers, including those that are not registered with the Commission, from . . . providing preferential treatment to certain investors in a private fund, unless the adviser discloses such treatment to other current and prospective investors").

[65] *See infra* notes 95–99 and accompanying text; *see also* de Fontenay and Nili, *supra* note 27, at 44–45 (outlining the negotiation costs and material delays of side letters).

[66] Qualitative Interview Session 1 Summary, *supra* note 47, at 5; *see also* Proposed Private Fund Rules, *supra* note 5, at 16,930 (citing to the compliance costs of side letters).

[67] Joseph M. Mannon & Nell M. Blatherwick, *Private Fund Side Letters–Investor Agendas, Tactics and Disclosure*, 19 INV. LAW. 1, 5 (2012); *see also* de Fontenay and Nili, *supra* note 27, at 7–8 (describing the complexity of excessive modularity resulting from multiple, simultaneous side letters).

[68] *ESG Cap. Partners II, LP v. Passport Special Opportunities Master Fund, LP*, No. CV 11053, 2015 WL 9060982, at *13 (Del. Ch. Dec. 16, 2015) (finding a side letter violated the LPA); *see also* Qualitative Interview Session 1 Summary, *supra* note 47, at 3 (discussing side letter compliance concerns).

[69] Geczy et al., *supra* note 24, at 710.

[70] Section III, *infra*, contains more details on the data collection and the interview process.

The mixed methods approach provides a 360-degree view of side letters, stakeholders, and the economic and political reality in which these shadow contracts are negotiated.

For impact investment funds, the large investors demanding special contract rights are typically foundations[71] and development finance institutions (DFIs).[72] Foundations count impact investments toward their program related investments (PRIs), defined under IRS rules as investments that further one or more of the foundation's exempt purposes.[73] PRIs cannot be intended to primarily produce income: making money can be a byproduct, but not the primary purpose.[74] PRIs are counted toward a private foundation's minimum distribution requirement of 5% per year, but many foundations invest beyond the 5% benchmark.[75] For example, one side letter includes the statement:

> The parties also acknowledge that the Foundation is purchasing the Interest as a "program-related investment" within the meaning of Section 4944(c) of the Code and are entering into this Agreement in order to allow the Foundation to determine that its investment will be used to further

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71 "Venture philanthropy (VP) is a funding model within the broader movement of impact investing in which a nonprofit or 'mission-driven' organization makes investments to advance its philanthropic mission." Esther S. Kim & Andrew W. Lo, *Venture Philanthropy: A Case Study of the Cystic Fibrosis Foundation* 1 (2019) (unpublished manuscript), https://perma.cc/MNS9-CHQH.

72 National and International Development Finance Institutions (DFIs), as defined by the OECD, "are specialized development banks or subsidiaries set up to support private sector development in developing countries. They are usually majority-owned by national governments and source their capital from national or international development funds or benefit from government guarantees." *Development Finance Institutions and Private Sector Development*, OECD, https://perma.cc/WKP8-QMSJ (last visited Feb. 9, 2022).

73 I.R.C. § 4944(c). "[A] private-foundation investment . . . will subject the foundation to jeopardy taxes under § 4944 of the Internal Revenue Code unless the investment is a PRI, and, even if so, the foundation must carefully monitor the investment to assure it is used for the intended purpose. Failure to do so may subject even a PRI to a § 4945 excise tax on taxable expenditures." Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 252 (2010) (footnote omitted). Like DFIs, foundation PRIs were first conceived of in the 1960s. "The Ford Foundation created a $10 million program it called the 'Program Related Investment Account' in 1968, and first used it that year to make loans to businesses and other entities in undercapitalized communities." Dana Brakman Reiser, *Foundation Regulation in Our Age of Impact*, 17 PITT. TAX REV. 357, 364 (2020).

74 *Program-Related Investments*, IRS, https://perma.cc/WU6Y-FPBA (last visited Feb. 10, 2022) ("A potentially high rate of return does not automatically prevent an investment from qualifying as program-related.").

75 *Impact Investing by Foundations: Key Terms in Philanthropy*, MISSION INVS. EXCH. (Aug. 2018), https://perma.cc/PY2A-NBAX.

> significantly the accomplishment of the Foundation's charitable purposes.[76]

Like foundations, DFI investments are motivated by policy.[77] DFIs are investors established and funded by governments to achieve policy and social objectives through private investments.[78] DFIs are "public" private equity vehicles. For example, the International Finance Corporation (IFC), a member of the World Bank Group, is the largest global DFI with $35 billion of committed capital for FY 2021[79] contributing to a global impact investment market estimated over $715 billion in 2020.[80]

DFIs and foundations provide important capital to impact investment funds for the same reason as any large investor in private market funds—they represent a large infusion of capital and potential investments in subsequent ventures. DFIs and foundations hold additional bargaining power in impact investing funds because they regularly accept concessionary (below-market) returns even in funds aiming for market-rate profits.[81] Foundation capital,[82] sometimes called catalytic capital, may "anchor" a project by providing stable capital with lower expected returns.[83] It

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76 Side Letter Doc. 30 (on file with authors).

77 DFIs emerged in the 1960s and have been a major player in development finance ever since. In 2017, for example, DFIs committed $87 billion in non-sovereign, private sector development financing, down from peaks over $90 billion earlier in the decade. DANIEL F. RUNDE & AARON MILNER, CTR. FOR STRATEGIC AND INT'L STUD., DEVELOPMENT FINANCE INSTITUTIONS: PLATEAUED GROWTH, INCREASING NEED 2 (2019).

78 Manuela Francisco et al., *Measuring the Performance and Achievement of Social Objectives of Development Finance Institutions* 2 (World Bank, Policy Research Working Paper No. 4506, 2008). DFIs (under one view in the source) were created under the belief that "an expansion of financial services supports economic growth" therefore DFIs can address prevailing market failures and reach underserved segments." *Id.* at 6. DFIs (again, this is the position of the social view of DFIs) were also created as an alternative to pure for-profit banks with low or no interest in serving low-income individuals, remote communities, or investing in "unprofitable projects with positive social externalities." *Id.*

79 *About IFC*, INT'L FIN. CORP., https://perma.cc/4CHB-RBBS (last visited Feb. 10, 2022).

80 GLOBAL IMPACT INVESTMENT NETWORK (GIIN), 2020 ANNUAL IMPACT INVESTOR SURVEY 40 (June 2020), https://perma.cc/53DD-Y63C.

81 Qualitative Interview Session 1 Summary, *supra* note 47, at 4–5. For examples of such funds, see *Financial Intermediary Funds (FTFs)*, WORLD BANK, https://perma.cc/RXA7-4D6Z (last visited Feb. 10, 2022).

82 U.S. foundations make grants of $60 billion and hold assets totaling $865 billion. ROCKEFELLER PHILANTHROPY ADVISORS, IMPACT INVESTING: AN INTRODUCTION 1, https://perma.cc/7YMU-7YDY (last visited Apr. 20, 2022). Only a portion of this, however, is in impact investing. "During the past two decades, less than one percent of U.S. foundations made PRIs each year." Ofer Eldar, *Designing Business Forms to Pursue Social Goals*, 106 VA. L. REV. 937, 959 (2020).

83 Qualitative Interview Session 1 Summary, *supra* note 47, at 4 (describing DFI capital as "cornerstone" and too attractive to forego).

can also give an unproven fund region or impact focus the capital necessary to build financial capacity and proof points, which will then allow the fund to attract non-foundation capital.[84] Similarly, interviewees report that DFIs also attract other government-backed investors by providing cornerstone capital, a practice referred to as "club investing".[85] DFI capital provides a strong branding advantage for wider fund-raising among individual investors more willing to invest after a DFI-stamp of approval, and for later fund raising in subsequent funds.[86]

Fund managers, whether dealing with traditional large investors, foundations, or DFIs, will negotiate special terms for important investors.[87] Manager concessions are not always obsequious, but are often driven by foundation and DFI organizational needs. Foundations require unique information to confirm the charitable purpose of the investment and document that the investment satisfies IRS regulations.[88] For example, the foundation side letter excerpt below specifically addresses GP obligations to serve the charitable purpose, prevent mission drift, report on any changes, and provide extensive information to the foundation annually.

> The General Partner shall use all reasonable efforts to measure the extent to which the MFI's are [serving the charitable mission] and shall take all customary and reasonable steps that are practicable under the circumstances to monitor its Investments for compliance with its charitable purpose and to prevent Mission Drift . . . .

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[84] Debra Schwartz, *Catalytic Capital: An Essential Foundation Tool*, MISSION INVS. EXCH. (Nov. 2017), https://perma.cc/8TJ2-N2CT (commenting on the author's role and experience leading impact investments at The John D. and Catherine T. MacArthur Foundation).

[85] "[S]ecuring one DFI is likely to result in a number of them participating, while losing one would often mean losing them all." Qualitative Interview Session 1, *supra* note 47, at 4–5.

[86] "Even where they [DFIs] are a less important component of the LP base, it was noticed that unlike private investors their willingness to invest in follow up funds in the face of disappointing performance by earlier funds make them a crucial contributor to the long-term financial viability of fund managers." *Id.*

[87] Clayton, *supra* note 4, at 89–90. "Side letters . . . grant more favorable rights and privileges to certain preferred investors . . . [a]dvisers often provide these terms for strategic reasons that benefit the adviser." Proposed Private Fund Rules, *supra* note 5, at 16,928.

[88] David Wood, *Roles Foundations Play in Shaping Impact Investing*, STAN. SOC. INNOV. REV. (July 13, 2000) (describing the Rockefeller Foundation's impact reporting requirements), https://perma.cc/SXZ6-5EL3.

> Notice . . . [a]ny change in circumstances that would cause the Interest no longer to serve the [charitable] purposes stated in Section [X] of the Partnership Agreement . . .
>
> Reporting . . . [i]n addition to financial reports to Limited Partners required under the Partnership Agreement, the Fund shall submit to the Foundation at least once a year . . . a statement signed by an authorized officer of the General Partner certifying that the Fund and the General Partner are in compliance with the terms of this Agreement.
>
> The General Partner shall provide the Foundation access to all information the Foundation deems relevant to evaluating the Fund's activities, including any and all reports produced by the General Partner, the Investment Committee, or the Investor Advisory Committee pertaining to the performance of the Fund.[89]

DFIs, as quasi-governmental actors, also have unique reporting mandates from sponsoring governments and oversight obligations including rigorous financial accounting.[90] DFIs also often require documentation that their investment dollars are serving stated policy objectives and are not being used for prohibited activities such as child labor, nuclear weapons, or money laundering.[91] One DFI side letter states: "If the General Partner has knowledge . . . that a potential investment in a Portfolio Company is a Prohibited Investment . . . the General Partner will so notify the Investor and . . . a description of the activities that it reasonably believes render such an investment a Prohibited Investment . . . ."[92] Prohibited investments are also defined in this side letter covering a range of military and civilian weapons.[93] Where

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[89] Side Letter Doc. 30 (on file with authors).

[90] "The transparency policies adopted by impact investors and DFIs to comply with their own monitoring, reporting and public disclosure framework in contrast compel them to require the ability to harvest and, in some cases, disclose information." Qualitative Interview Session 1 Summary, *supra* note 47, at 2.

[91] "[P]references and circumstances idiosyncratic to each DFI do play a role. While some DFIs have a specific focus on business integrity, others will be more concerned about money laundering issues, resulting in clauses of diverging length and complexity to be added to the side-letter." *Id.* at 3.

[92] Side Letter Doc. 22 (on file with authors).

[93] Prohibited investments include:

> (a) Manufacturing, selling or using cluster munitions whole systems or components, (b) manufacturing, selling or using landmines whole systems or components, or (c) deriving, in their most recent fiscal year, more than 10% of their revenue from (i) the manufacture or sale of firearms and small arms

each DFI has its own unique set of reporting mandates and prohibited activities, side letters are negotiated and agreed to for each, to accommodate the investor's need.[94]

In our empirical analysis in Section III, we show that side letters share common themes. For example, they frequently address information rights, advisory committees, MFNs, and compliance, among other topics. But side letters are neither uniform nor simplistic (see e.g., Figure 6). Our document analysis reveals a wide range in the length, content, and complexity of side letters.[95] We make recommendations in Section IV to better address investors' needs.

### C. Costs of Side Letters

Side letters extract real dollars from impact investment deals through increased transaction costs and complexity. Negotiating and tailoring terms in side letters increases the transactional costs of impact deals. Side letters, reported to once be twenty-page documents, now loom as large as forty-five pages according to one interviewee.[96] Side letters in our sample extend to seventy-nine pages, although the majority are under ten pages.[97] One interviewee reported legal costs of $1.5 million incurred by a single fund, the bulk of which corresponded to side letter negotiation with multiple DFIs.[98] The standard legal cost of side letters is more routinely estimated at $10–15,000 per impact investor, which again suggests significant idiosyncrasies.[99] Where impact investors, specifically DFIs, provide the bulk of the capital, they bear the full cost of negotiation as the GPs' costs are charged to

> ammunitions for civilian markets, (ii) the production or sale of conventional weapons and related systems or components, (iii) the production of chemical and/or biological weapons and related systems or components, (iv) the production of nuclear weapons and related systems or components or (v) the production of depleted uranium weapons, ammunitions and armor . . . .

*Id.*

94 Qualitative Interview Session 1 Summary, *supra* note 47, at 3.

95 *See infra* Section III.B.3.a. We see no evidence of boilerplate language; instead, each document has its own idiosyncrasies. *See also* Mannon & Blatherwick, *supra* note 67, at 7.

96 Qualitative Interview Session 1 Summary, *supra* note 47, at 3; de Fontenay and Nili, *supra* note 27, at 32–33 (finding increases in side letter lengths and provision numbers that can bloat side letters to 40 pages in length).

97 *See* Compiled Side Letter Data File (on file with authors).

98 "[A] Fund recently [spent] $1.5 million on legal costs, the bulk of which corresponded to side letters negotiation with multiple DFIs vividly illustrated the magnitude of the problem." Qualitative Interview Session 1 Summary, *supra* note 47, at 5.

99 "[T]the standard legal cost to the GP of side-letters was identified as at least $10–15,000 per DFI." *Id.*

the fund and, therefore, the investor.[100] Side letter negotiations also extract opportunity costs, with negotiations lasting between twelve to eighteen months creating a material delay.[101]

Once a targeted intervention, side letters have become a source of contention in impact investing.[102] Three factors drive the current situation. First, contract templates used by legal firms contain default terms like confidentiality provisions developed for non-impact deals (i.e., deals without public and policy objectives) that are a poor fit for the impact objectives and blend of private/public objectives.[103] Second, and perhaps more pervasive, embedded *norms* around confidentiality and proprietary investment pipelines in private market finance[104] have been imported into the impact space, even when they are not well-adapted to the needs of impact.[105] Sophisticated deals tend to have such protections, so the absence is unfamiliar, if not uncomfortable. These norms are "sticky" where lawyers for funds and investors have incentives to protect proprietary forms and charge billable hours for repetitive customization.[106] Professors de Fontenay and Nili also describe a perceived slippery slope where funds and lawyers are over-protective of LPA terms, believing any deviation lowers the negotiation bar for all future fund negotiations, whereas side letters offer less visible and less permanent modifications.[107] Third, side

[100] "[I]n the private equity world, the GPs are only temporarily and nominally bearing the legal costs of the negotiation as these are eventually charged to the fund, and therefore to the investors. Particularly where they provide the bulk of the capital, DFIs ironically therefore bear the cost of both sides of the negotiation." *Id.*

[101] *Id.*

[102] "There is full consensus around the fact that side letters constitute the main obstacle to simplification and standardization of the legal documentation framework." *Id.* at 3; *see also* Proposed Private Fund Rules, *supra* note 5, at 16,952 (proposed that required disclosures would discourage funds from "providing certain preferential terms in the interest of avoiding future negotiations with other investors").

[103] "A secondary driver of the prevalence of confidentiality clauses is associated with the various templates used by legal firms, which tend to contain confidentiality clauses regardless of the need or desire for one on the part of their clients." Qualitative Interview Session 1 Summary, *supra* note 47, at 2.

[104] Limited partnership agreements often include confidentiality provisions with sweeping restrictions on the disclosure to third parties of a wide array of information that is considered confidential, including partnership terms, the identity of other limited partners, and side arrangements with the general partner. These types of provisions prevent limited partners from discussing business matters with other limited partners, effectively prohibiting the investors from cooperating. Magnuson, *supra* note 6, at 1883 (footnote omitted).

[105] "GPs consider information on portfolio companies to represent their competitive advantage, in the absence of an investment process they can point at for differentiation purposes." Qualitative Interview Session 1 Summary, *supra* note 47, at 2.

[106] *Id.* at 2, 5 (discussing the role of legal forms and the billables earned by lawyers).

[107] de Fontenay & Nili, *supra* note 27, at 47–48.

letters are perceived as easy-to-implement solutions, particularly for DFIs and foundations adjusting to changed policy goals and program requirements.[108] Side letters may seem like an efficient vehicle to resolve bespoke information and oversight needs, but they can present concealed costs in negotiation, implementation, and oversight. These three factors create preferences and path dependencies for suboptimal LPA terms that require remediation in a side letter.

## III. IMPACT INVESTING: A CASE STUDY

The scant private markets literature notes the following common side letter provisions: management fee discounts,[109] co-investments,[110] confidentiality and information rights,[111] MFNs,[112] and advisory board seats. How often do we see these provisions, and others, in impact investment side letters? This case study adds to the literature by documenting side letter practices in impact investing. It also illustrates the Easterbrook and Fischel theory of tailoring contracts to reflect parties' preferences for risk, return, and here, impact. Our empirical analysis provides a basis for our later discussion of side letters' costs and benefits.

### A. Data & Methodology

We present contract coding data on seventy-nine side letter agreements with impact investment funds. These documents were collected as part of the Impact Finance Database (IFD), an initiative of the Impact Finance Research Consortium (IFRC).[113]

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[108] "When a DFI's government, or its governance structure, issues a new policy that affects DFI fund investments, the path of least resistance is for the legal team to write these directly into the side-letter, in the full confidence that GPs are very unlikely to push back given their need (or greed) for DFI capital." Qualitative Interview Session 2, Summary 3 (Feb. 5, 2021) (on file with authors).

[109] In the 2019–2020 study, fee discounts were the most prominent side letter provision appearing in 46% of all side letters reviewed. SEWARD & KISSELL LLP, *supra* note 54, at 3.

[110] "'Co-investing' describes arrangements where a manager invites large investors to invest alongside the pooled fund in portfolio companies the pooled fund is investing in." Clayton, *supra* note 4, at 104. Co-investments are attractive to large investors because they routinely outperform other investment opportunities on a net-of-fees basis due to reduced fees charged on co-investments. *Id.*

[111] Mannon & Blatherwick, *supra* note 67, at 2.

[112] SEWARD & KISSELL LLP, *supra* note 54, at 3.

[113] IMPACT FIN. RSCH. CONSORTIUM, *supra* note 26 ("The Impact Finance Research Consortium (IFRC) is a collaboration among the Wharton School, Harvard Business School, and the University of Chicago Booth School of Business to advance academic research on impact investing."). We obtained documents used in this case study in partnership with Eighteen East Capital, https://perma.cc/A88C-D4GR (last visited Feb. 20, 2022),

In 2019–2021, we studied side letters as a part of a private grant. Research partners on the grant approached major DFIs, multilateral development banks (MDBs), funds of funds, and foundations to request access to contracting documents pertaining to their private equity fund investments. European Development Finance Institutions (an association of European DFIs) provided further assistance in reaching out to individual DFIs. All documents collected in the project are subject to strict confidentiality and non-disclosure agreements.

To analyze the contents of the contracts, we developed a contract coding process using contract variables and coding procedures drawn from the legal and finance literatures.[114] Questions about confidentiality were developed in conjunction with grant partners and after a review of confidentiality provisions in the existing database. We hired, trained, and supervised law students to record the presence or absence of terms, record variations within provisions, and quote relevant language from the contracts. Text responses verify coding entries, control for accuracy, and extract additional information on observable trends and nuances in contract provisions.

Our sample of seventy-nine impact fund side letters spans from 1993 to 2019, with a majority of agreements entered into after 2010 (see Figure 1). The sample represents forty-five funds formed across the globe with clear concentration in North America and Africa (see Figure 2).

through a 2020 grant funded by Swedish International Development Association (SIDA), https://perma.cc/GUK4298F (last visited Feb. 20, 2022), and FinDev Canada, https://perma.cc/ACG7-QXL8 (last visited Feb. 20, 2022).
Beginning in 2015, we helped to create a database of impact investing fund contracts, first under WSII and more recently as part of the Impact Finance Database (IFD). The IFD data were originally collected by WSII's two-pronged data collection efforts: a survey about the impact investment practices, and collection of documents (legal and financial). WSII created a list of funds via primary research because there was no working directory of funds, and in partnership with organizations such as B Lab, the Emerging Markets Private Equity Association (EMPEA), and Anthos Asset Management, and by referring to lists such as ImpactBase and Impact Assets 50. Since the data collection project began in 2015, nearly 500 fund managers have been contacted resulting in a database that represents over 100 separate funds and 1300 portfolio companies.

114 Geczy et al., *supra* note 24, at 699.

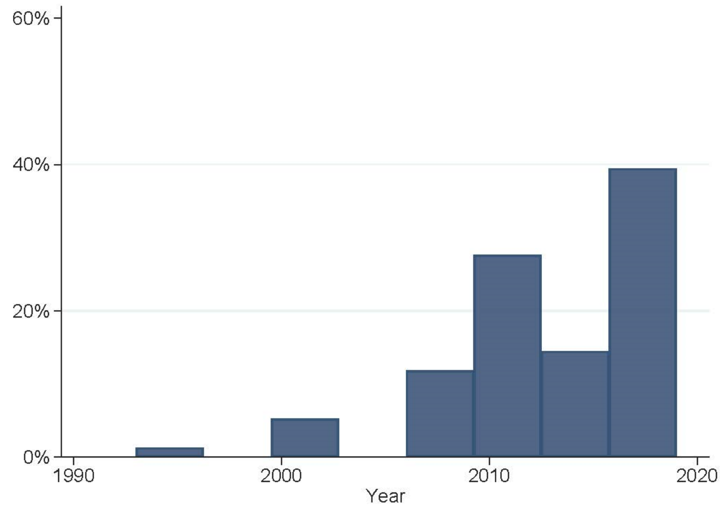


*Figure 1: Side letter execution year*

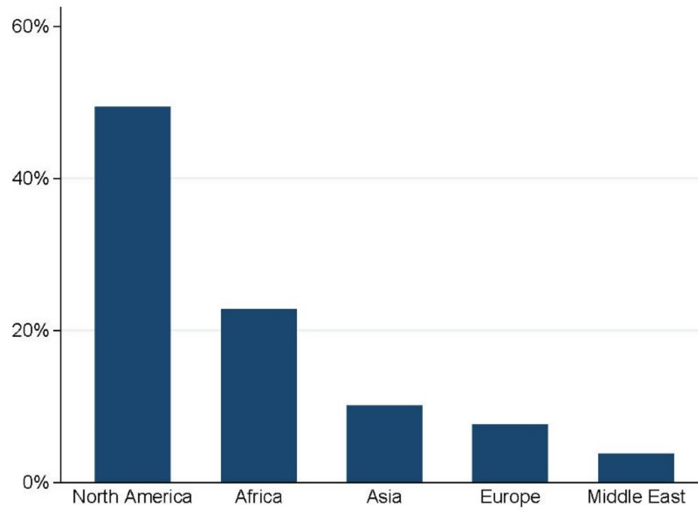


*Figure 2: Fund formation location by region*

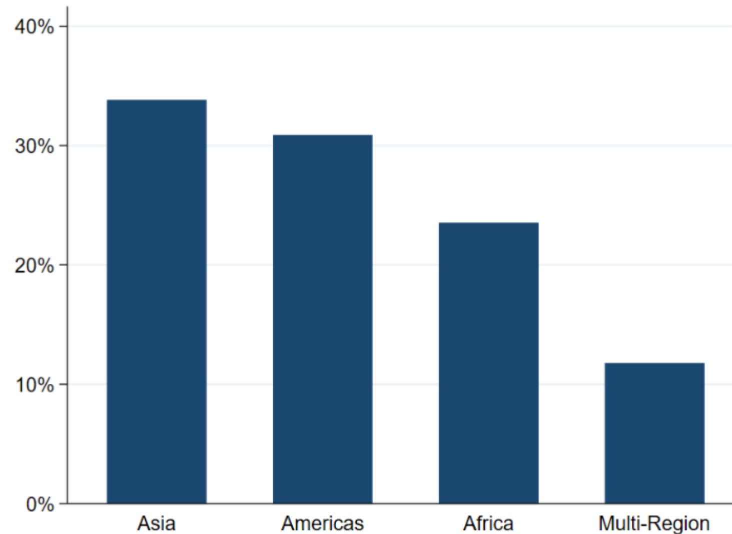


*Figure 3: Geographic investment focus*

Drawing in additional data available through Preqin,[115] we report additional data on matched funds including geographic focus (Figure 3) and industry focus (Figure 4). Funds don't always form where they invest, and Figure 3 shows a more widespread distribution of geographic focal areas. Figure 4 shows a variety of investment industries for impact funds with consumer products being the most common and a cluster of funds in raw materials, financials, manufacturing, health care, industrials, and diversified assets.[116]

[115] Preqin is an investment data company providing descriptive and financial information on private market investments. Of the 45 unique impact funds in our data sample, we were able to find 37 funds also covered in the Preqin database. We obtained data on geographic focus for 36 funds and on industry focus for 35 funds. More information on Preqin data is available at *Our Data*, PREQIN, https://perma.cc/T7CJ-9UGD (last visited Apr. 13, 2022).

[116] In Figures 3 and 4, the y axis captures the percent of fund documents belonging to a fund with the given geographic or industry focus. Funds can have multiple industry foci, so the bars in Figure 4 sum to more than 100%.

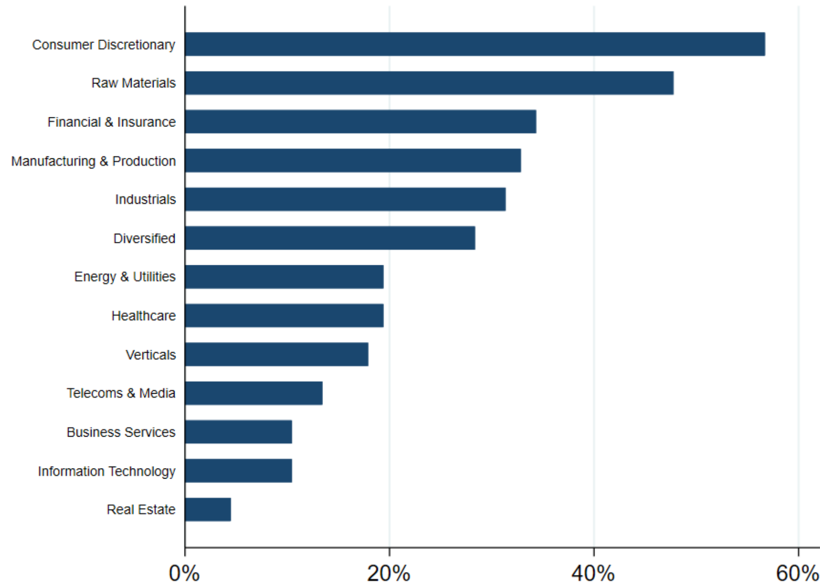


*Figure 4: Industry focus*

In addition to the direct document analysis, qualitative interview sessions were conceived to document and explain the dynamics contributing to the complexity and divergence we observed in the documents. As part of the grant, we focused in particular on the prevalence and strength of confidentiality clauses.

We conducted qualitative interviews on November 6, 2020, and February 5, 2021.[117] Both sessions were conducted under Chatham House rules. Specific inputs are not ascribed to specific individuals or specific institutions. Interview participants were selected by grant partners because of their specific area of expertise and their familiarity with the project, and willingness to participate in at least two workshop sessions. Interviewees represented key stakeholders in the investment process: four LPs, one GP, and two representatives from a major US law firm representing GPs.

117 Citations are made to interview notes on file with authors. In the first session, participants were presented with the early findings of side letters and asked to describe what they know to be the sources of and the reasons for the observed patterns. In the second session, the group discussed side letters further as well as legal documentation simplification and standardization.

Combining quantitative document analysis with qualitative interview insights affords us a more complete and nuanced view of the role played by side letters in impact investing. We organize the presentation of our analysis below primarily around our quantitative results, weaving in insights from the interviews as appropriate. We then discuss the broader implications of these empirical patterns in Section IV.

## B. Common Impact Investing Side Letter Provisions

Side letters vary widely, each negotiating a bespoke resolution tailored to the idiosyncratic and infinitely variable needs of different funds and investors. Parties are effectively writing their own corporate tickets. Figure 5 provides an overview of the main provisions in our sample.

Provisions can be grouped into several buckets. In the sections below, we distinguish between provisions pertaining to investor return protections, impact protections and compliance, and governance.

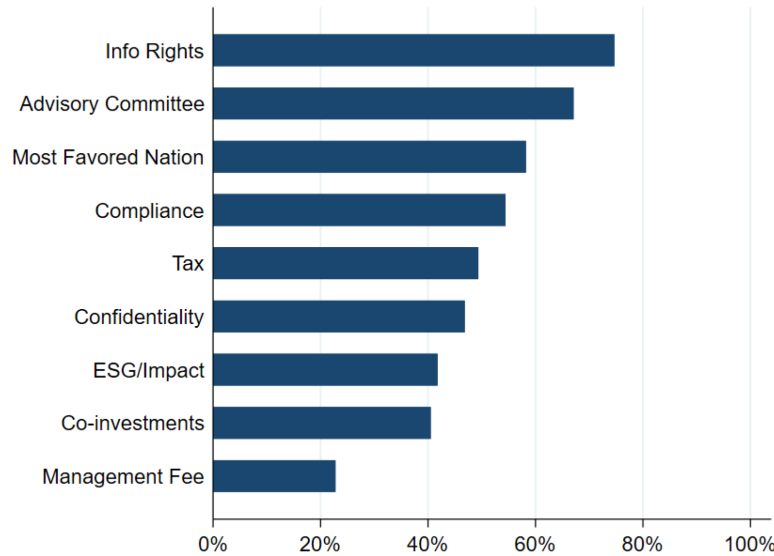


*Figure 5: Frequency of common side letter provisions*

### 1. Investor Return Protections

Contract terms establishing parties' rights, priorities, and future opportunities help investors ensure a return on the capital invested into the fund. These contract terms do not set the price of the contract, like the minimum investment or the hurdle rate,

but they frame an investor's opportunity or likelihood to make money on the initial investment. Examples of investor return protections in our side letters include MFNs, co-investment rights, and management fee waivers.

In our sample, 58% of side letters contain MFNs.[118] MFNs protect the holder of the right against another investor getting *better* individualized rights.[119] For large investors that don't see themselves as equal, but as uniquely valuable, this is especially crucial.[120] One side letter in our sample presents the MFN in the following way:

> Should any such side letter . . . have the effect of establishing rights or otherwise benefiting such Limited Partner in a manner more favorable in any respect to such Limited Partner than the rights and benefits established in favor of Investor by the Partnership Agreement and this letter agreement, the Investor shall automatically and without any need for any further action, receive all such rights and benefits unless and until it shall have given notice to the contrary to the General Partner.[121]

Other MFN variations require the fund to disclose to the investor, at the time of investment, any outstanding side letters and thereafter to provide notice of any subsequent side letters.

> The General Partner has disclosed to the Investor all side letters or similar agreements ("Side Letters") entered into by it on or prior to the date hereof with any of the Limited Partners. At any time after the date hereof should any Limited Partner receive any side letter or similar agreement from the General Partner, the Investor will be given a copy of such agreement within 30 days after the Closing Date . . . .[122]

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[118] Compare to the 44% observed in private market side letters. SEWARD & KISSELL LLP, *supra* note 54, at 3. Further, Professors de Fontenay and Nili found MFN provisions to be the most common provisions in their sample, but it fluctuated over time—starting under 30% in 2005, rising to nearly 90% in the financial crisis, and dropping to around 60% since 2014. de Fontenay and Nili, *supra* note 27, at 34.

[119] Clayton, *supra* note 4, at 94.

[120] "LP1 further remarked that DFIs do not see themselves as equal investors, and that they 'feel' they should command better terms . . . . [E]ven if all the side letters information rights they require could be transferred to the LPA, [investors] would still insist on a side letter. Particularly important to them is the 'most favored nation' ('MFN') clause that ensures they indeed cannot have more limited rights than other LPs." Qualitative Interview Session 2 Summary, *supra* note 108, at 2.

[121] Side Letter Doc. 31 (on file with authors).

[122] Side Letter Doc. 10 (on file with authors).

MFNs ensure relative bargaining positions between investors. However, MFN rights, in traditional private market deals, apply only to investors who have made investments of equal or lesser value—so those rights do not protect investors against the bargaining power of *even larger* investors.[123] We see such conditional MFNs in our sample, but less frequently.[124]

Interviewees explored one explanation for the variation in MFN rights: conflicts between multi-lateral and bi-lateral DFIs. Multi-lateral DFIs, such as the International Finance Corporation (IFC) and European Investment Bank, are private sector arms of international finance institutions with multiple private and government-backed investors.[125] Multi-lateral DFIs are more demanding than their bi-lateral counterparts, and bi-lateral DFIs would ask for whatever is granted to the multi-lateral "over and beyond what they would normally require."[126]

Several MFNs carve out exceptions such as for charitable foundation requirements[127] or fees, [128] as well as clarifications about what is included in the MFN (e.g., "This [MFN] provision applies equally to Alternative Investment Vehicle.").[129]

Co-investment terms appear in 41% of impact side letters reviewed. Co-investment provisions in our sample include language such as: "[Fund] will provide opportunities to co-invest in Portfolio Companies [and the] Investor shall be offered the opportunity to participate in any co-investment on terms no less favorable than those offered to any other potential co-investors."[130] On the substance, there is little difference between the purpose of co-investment terms in impact or private market deals—both seek to

[123] Kevin Vance, *Hedge Fund Side Letters: Conflicts of Interest and Best Practices*, 26 J. TAX'N & REGUL. FIN. INST. 23, 24 (2013). In our sample, we observe some, but infrequent language restricting MFN clauses to the highest investors. The MFN "right shall not apply to any Additional Right which is (i) provided only to investors having a Commitment to the Partnership that exceeds that of the Investor in aggregate." Side Letter Doc. 22 (on file with authors).

[124] Compiled Side Letter Data File (on file with authors).

[125] *See, e.g.*, *About IFC*, *supra* note 79.

[126] Qualitative Interview Session 2 Summary, *supra* note 108, at 3.

[127] "Notwithstanding the preceding sentence, unless separately agreed to by the General Partner and the Investor, any rights provided to accommodate specific regulatory, organizational or structural requirements of a particular investor (e.g., to address investment requirements of a charitable foundation) shall not apply to the Investor." Side Letter Doc. 33 (on file with authors).

[128] "[T]his Section . . . shall not apply to any reduction in the Management Fees and Carried Distributions payable . . . ." Side Letter Doc. 46 (on file with authors).

[129] "This [MFN] provision applies equally to Alternative Investment Vehicle." Side Letter Doc. 50 (on file with authors).

[130] Side Letter Doc. 45 (on file with authors).

help an investor earn a higher return and serve as a weak price adjustment. But our findings are harder to interpret on the frequency: some private market reviews find high rates of co-investment, and others find much lower frequency (< 10%).[131]

Management fee terms, often negotiating a discount, amending reporting obligations, or clarifying carve outs, occur in 23% of our sample.[132] Again, the substance of the provisions is the same in both impact and private market contexts, but the frequency may vary between the two. One law firm study found that discounted management fee provisions occur *more* frequently in traditional private market deals (46%) and are on the rise starting in 2018.[133] Recent academic work, however, found that true fee discounts *rarely* occur, although the study also found a recent increase in financial-related terms overall.[134] Poor performance cycles like the one caused by the onset of the global pandemic in 2020 may prompt more attention to financial terms as managers and investors alike try to massage returns in down cycles.[135]

Other examples of impact side letter provisions protecting investors' returns include investor withdrawal rights,[136] termination rights,[137] and fee clawback provisions.[138]

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[131] SEWARD & KISSELL LLP, *supra* note 54, at 3; de Fontenay & Nili, *supra* note 27, at 39.

[132] For example. one side letter contained covenants to disclose separate management fee arrangements, similar to an MFN. Side Letter Doc. 37 (on file with authors) ("The General Partner hereby covenants and agrees to disclose to the Investor if and to the extent it enters into a separate agreement to reduce the Management Fee calculated with respect to any Limited Partner."). Another side letter defined management fee obligations after a default by an investor. Side Letter Doc. 54 (on file with authors).

[133] SEWARD & KISSELL LLP, *supra* note 54, at 3.

[134] de Fontenay & Nili, *supra* note 27, at 6, 38.

[135] SEWARD & KISSELL LLP, *supra* note 54, at 3.

[136] "[I]n the event that the Fund or the General Partner violate or fail to carry out any provision of this Agreement, the Foundation may withdraw from the Fund . . . ." Side Letter Doc. 30 (on file with authors).

[137] "[T]he Investor shall be permitted to cease making payments to the Fund if:
(a) any Fund Party has materially or repeatedly breached any of the Fund Documents; (b) there is (x) a material or repeated failure by any Fund Party or any Investee Company to comply with (i) the Investment Code, (ii) any agreed E&S Action Plan or (iii) the E&S Requirements and the relevant Investee Company has failed to implement any agreed Remediation Measures to the Investor's satisfaction (acting reasonably and in good faith) or (iv) a breach of applicable anti-money laundering laws and regulations; (c) an event of bankruptcy, insolvency, dissolution, liquidation (including provisional liquidation), safeguard or any similar proceedings under applicable laws, of XX, the General Partner, the Investment Advisor, the Carried Interest Partner arises; and/or (d) any of the circumstances set out in . . . in the LPA arises." Side Letter Doc. 78 (on file with authors).

[138] "[The fund] agree[s] to provide you with details of the amount of any clawback obligation and any amounts accrued in the Escrow Account pursuant to . . . the Constitution . . . ." Side Letter Doc. 54 (on file with authors).

2. Impact Protections & Compliance

Impact side letters frequently clarify expectations, add restrictions, or impose additional obligations on funds to pursue and stay faithful to a particular impact ethos.[139] Here, we discuss provisions related directly to impact or compliance with impact-adjacent regulations, like anti-money laundering or program-related investments.[140] Forty-two percent of side letters contained additional ESG or impact obligations. Impact terms include new commitments to collect and report impact-specific data,[141] adding new social impact objectives,[142] and listing prohibited investment activities antithetical to the investor's impact ethos.[143]

Side letters also address the special tax or legal compliance needs of impact investors. Investors negotiate for compliance provisions focused on Anti-money Laundering/Know Your Client obligations in over 54% of our sample side letters. In 49% of side letters, funds also agree to notify investors of tax consequences triggered by investments or ones that would threaten the private foundation tax status of investors.[144]

Provisions excusing investors from some investments that would violate the mandates of missions of investors,[145] detailing

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[139] *See Program-Related Investments*, *supra* note 74.

[140] *See, e.g.*, Parliament and Council Directive 2018/843, 2018 O.J. (L 156) 43. Program-related investments (or PRIs) are defined by U.S. federal tax law as charitable foundation investments with a "primary purpose" of accomplishing one more charitable purposes, but not primarily to produce income. I.R.C. § 4944(c). *See also* Treas. Reg. § 53.4944–3(a)(iii).

[141] For example, one fund agreed to collect and report information on renewable energy generated, CO2 offset, and CO2 captured by fund operations. Side Letter Doc. 15 (on file with authors).

[142] For example, one side letter added a focus on gender effects and capital market development to a fund's investment objectives. Side Letter Doc. 35 (on file with authors).

[143] Impact investors frequently require confirmation that a fund is not engaging in certain, prohibited behavior. *See, e.g.*, *supra* notes 91–94.

[144] *See, e.g.*, "The GP shall transmit to the XX fund, within 90 days after the close of each fiscal year, an annual narrative report (i) evidencing compliance with the charitable purposes and covenants set forth in the partnership agreement and here in and with the employment and training agreement set forth an attachment C to the investment policies, which is attached as exhibit A to the partnership agreement, (ii) naming each portfolio company and the size and type have investment in each portfolio company . . . ." Side Letter Doc. 75 (on file with authors).

[145]

> Solely because of the Investor's status as a development finance institution, we hereby agree that the Investor shall not participate, and shall be treated as an Excused Partner . . . in respect of any proposed Investment that would cause, or reasonably be expected by the Investor to cause, harm to the Investor's reputation and/or publicity that is unwanted by, or unfavourable to, the Investor . . . .

Side Letter Doc. 78 (on file with authors).

investment policies,[146] and restricting certain investments are additional,[147] but less frequent, terms in impact side letters.

### 3. Participatory Governance

In our prior work we noted that participatory governance[148] provisions appear to play a heightened role in impact investment agreements under the theory that oversight encourages fidelity to both profit and impact.[149] Examples of participatory governance include investment approval, guaranteed seats on advisory committees, information and reporting rights, access and inspection rights, auditing rights, and access to Portfolio Companies.[150] Of these participatory governance approaches, we highlight the three most prevalent in our sample: advisory committees (67%), information rights (75%), and confidential provisions and carve outs (47%).

#### *a) Advisory Committees*

Both traditional private market and impact investment funds negotiate advisory committee rights with large investors within side letters (see Figure 6).[151] LP (investor) representatives serve on advisory boards providing both oversight of and assistance to managers.[152]

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146 In the section titled "Investment Policy", one side letter provides the following "[t]he General Partner hereby agrees that the Investor shall be permitted to cease making Capital Contributions in the event the Fund has made Portfolio Investments in material violation of the provisions set forth in the Investment Guidelines . . . ." Side Letter Doc. 38 (on file with authors).

147

> The Company shall not enter into a transaction, and [the Manager] shall not approve or enter into any transaction on behalf of the Company, that would cause the Investor to contravene the . . . Act (as amended from time to time) or any other governmental or regulatory investment restrictions with which the Investor is required to comply pursuant to 1.1 above (together the "Investment Restrictions").

Side Letter Doc. 34 (on file with authors).

148 *See* Geczy et al., *supra* note 24, at 707–08.

149 *Id.*

150 *Id.* at 704.

151 For a discussion of private market advisory committee discussions, see Clayton, *supra* note 4, at 105. *See also* Mannon & Blatherwick, *supra* note 67, at 2. Professors de Fontenay and Nili found that 15–35% of private market side letters addressed governance generally, including advisory committees. de Fontenay & Nili, *supra* note 27, at 38.

152 S*ee* Geczy et al., *supra* note 24, at 708–09.

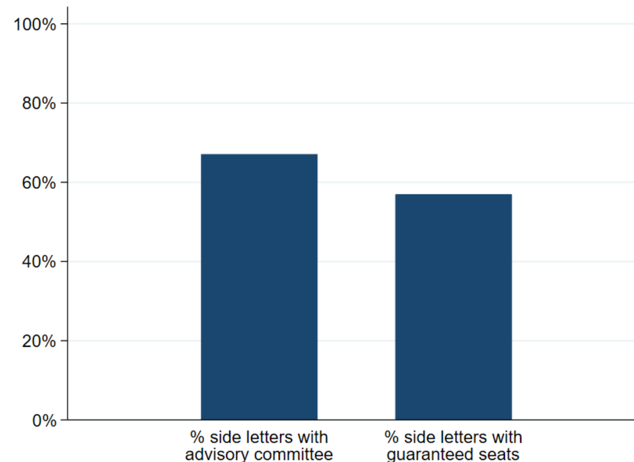


*Figure 6: Advisory committee terms in side letters*

Bargaining for advisory committee rights increases individual investors' access to a fund manager, giving them a say in fund operations to some degree, and even the power to vote on material fund decisions.[153] This is consistent with the language we see in our sample.[154] Within advisory committee provisions, the majority (representing 57% of all side letters) guarantee the investor a voting seat on the committee.[155]

Provisions like the following are common: "[T]he Investor is entitled to appoint a representative (the "Representative") to attend meetings of and serve as a voting member of [advisory committee] . . . . Such Representative will not be removed or replaced unless directed or consented to by the Investor in writing."[156]

Investors with guaranteed seats on advisory boards can vote unconstrained by fiduciary duty—investors can freely promote their self-interest when voting.[157] This concern may be lessened in the impact arena where DFIs accept concessionary returns (less incentive for selfish maneuvering) and often invest in collaboration with other DFIs, thus reducing the risk of selfish voting. The common policy objectives of DFIs and other large impact investors

[153] Clayton, *supra* note 4, at 105.

[154] *See also* Qualitative Interview Session 1 Summary, *supra* note 47, at 3.

[155] "Whilst you remain an investor in the Company and are not in default, you shall be entitled to appoint a single representative (a 'Representative') to be a member of the Advisory Board." Side Letter Doc. 4 (on file with authors).

[156] Side Letter Doc. 45 (on file with authors).

[157] Clayton, *supra* note 6, at 105. In our review, we observed several provisions specifically disclaiming any fiduciary duty owed by members of the advisory committee.

may make advisory committee access (if not advisory voting rights) an effective oversight tool.

Even though the side letter provisions coalesce around advisory committee and voting rights, variation persists in how funds address side letter provisions. For example, the length of the advisory clause among side letters with advisory committee rights ranges from 15 to 363 words, with a median of 111 words.[158] Side letters use bespoke language to address common themes, a form of rote customization, that illustrates both the lack of standardization and the increase in transaction costs when many investors get special treatment.

Beyond guaranteeing investors' voting rights, advisory committee provisions define or expand the committee's role. Figure 7 enumerates the different advisory committee roles outlined in the agreements. Note the relative low frequency overall. The most

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[158] Compare the advisory committee clause cited in *supra* note 156 with the following text:

> In consideration of the Investor's subscription for a Commitment equal to 20% of the Combined Commitments (up to a maximum Commitment of $5 million), the General Partner covenants and agrees that, so long as the Investor or one of its Affiliates remains a Limited Partner having a Commitment of at least $3 million, the Investor shall be entitled to (a) have an employee or other representative designated by the Investor (an "Investor Representative") serve on the Advisory Committee as a voting member and (b) remove and replace such Investor Representative from time to time in its sole discretion. If at any time (i) the Investor is entitled to have an Investor Representative serve as a member of the Advisory Committee and (ii) no Investor Representative is serving in such capacity, then until such time as the resulting vacancy on the Advisory Committee is filled with an Investor Representative (or the Investor ceases to be entitled to have an Investor Representative serve on the Advisory Committee), the General Partner shall provide the Investor with copies of all written materials furnished to voting members of the Advisory Committee and allow an employee of the Investor to participate as an observer at all meetings of the Advisory Committee. The General Partner agrees that so long as the Investor is entitled to have an Investor Representative serve on the Advisory Committee, the General Partner shall use commercially reasonable efforts to cause the Partnership to maintain liability insurance covering the individual members of the Advisory Committee and shall provide evidence of such insurance to the Investor upon request.
>
> (Sub-Committee) Investment Committee. In consideration of the Investor's subscription for a Commitment equal to 20% of the Combined Commitments (up to a maximum Commitment of $5 million), so long as the Investor or one of its Affiliates remains a Limited Partner having a Commitment of at least $3 million, the Investor shall be entitled to have an Investor Representative observe all meetings of the Investment Committee and to receive all written materials produced specifically for use by the Investment Committee; provided, however, that the Investment Committee shall not be required to schedule meetings to accommodate such Investor Representative's ability to participate.

Side Letter Doc. 46 (on file with authors).

common advisory committee roles include investment strategy and impact policy oversight, as well as approving investments, conflicts of interests, and annual reports. For example, one DFI side letter guaranteed the following:

> 2. The General Partner, on behalf of the Fund, will submit the Fund's E&S Management System ("ESMS") for approval to its Advisory Committee prior to its first investment;
>
> 3. The General Partner, on behalf of the Fund, will advise and consult with the Advisory Committee regarding any proposed change in the objectives or operations of the Fund, including any material environmental or social risk posed by the proposed change; and if requested by the Advisory Committee, amend the ESMS to assess and manage such additional risks in compliance with the E&S Requirements and these provisions, in a manner reasonably acceptable to the Advisory Committee.[159]

Provisions in the "other" category addressed the role of the committee if the fund or managers become involved in litigation/arbitration, or if a portfolio company materially defaults or needs remediation.

[159] Side Letter Doc. 41 (on file with authors).

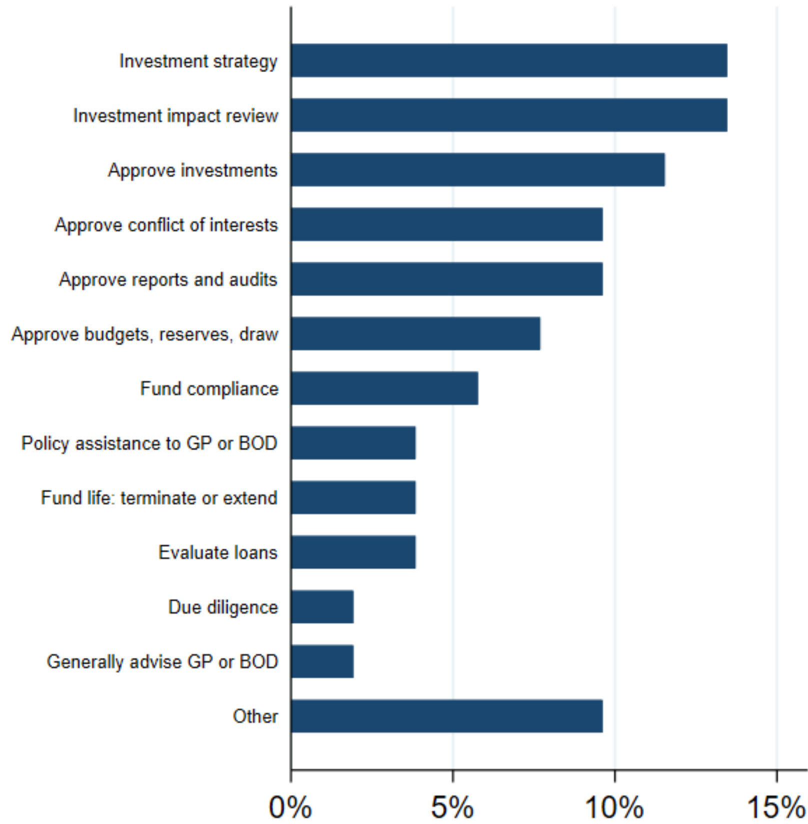


*Figure 7: Advisory committee roles*

Taken as a whole, advisory committee provisions in impact investment side letters reallocate power to limited partners. Guaranteeing a seat on an advisory committee that oversees investments, reporting, and compliance serves as an important check on manager discretion. Even in the niche world of impact investment funds, the advisory committee side letter provisions illustrate the lack of boilerplate and a high degree of tailoring.

Investor demand for advisory committees shows that in some cases, tailored, ex ante contract rights are not enough. Some investors demand the ability to engage in oversight (and potentially renegotiate) on an ongoing basis over the fixed investment life of the fund.[160] Like with private equity funds, impact LPs are locked into the investment for roughly 10 years, but unlike in private

[160] Clayton, *supra* note 4, at 76.

equity, impact managers balance dual goals.[161] Consider this side letter provision providing information to the investor and a voice two years into the fund's active investment cycle:

> Two (2) years after the Final Closing Date we shall appoint an external ESG consultant to assess the Fund's ESG performance against the ESGMS. We shall agree the terms of reference for such appointment with the LP Advisory Committee prior to such appointment. We shall consider and discuss with the LP Advisory Committee the analysis provided by the consultant and shall use commercially reasonable efforts to implement any reasonable recommendations made by such consultant which would be in the interest of the Fund.[162]

Participatory governance is an extension of the Easterbrook and Fischel notion that parties can reduce essential performance and governance terms ex ante at the time of contracting.[163] In other words, parties are writing terms specific to their preferences and deal needs. With participatory governance rights in impact funds, the parties are creating a contract mechanism to monitor future performance and ensure the spirit of the contract (both profit and purpose) is fulfilled continuously over the life of the venture.[164]

*b) Confidentiality and information rights*

Confidentiality is an important deal term in many settings, but it appears to have outsize importance in impact investment agreements. Consider the 2019/2020 private market fund study that identified manager reporting obligations as a common side letter provision and subsequent academic work finding more than half of all side letters address information or confidentiality rights.[165] Compare this with the 75% of impact investment side letters with information and report rights provisions (Figure 5). An additional 47% of side letters also address confidentiality obligations and carve outs.

Information rights facilitate participatory governance because they allow parties to observe outcomes important to achieving impact and return.[166]

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161 Geczy et al., *supra* note 24, at 699, 707–09.

162 Side Letter Doc. 26 (on file with authors).

163 EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE, *supra* note 12, at 2–4.

164 Geczy et al., *supra* note 24, at 709–10.

165 SEWARD & KISSELL LLP, *supra* note 54, at 3; de Fontenay and Nili, *supra* note 27, at 39.

166 Geczy et al., *supra* note 24, at 707–08. The final grant report concludes that:

> If (a) any member of the LP Advisory Committee [or Fund] determines that a Portfolio Company is in material breach of any of the Integrity Requirements, or otherwise poses a material Integrity Risk, . . . [the fund] shall promptly: (i) notify each of the members of the LP Advisory Committee, (ii) in consultation with the LP Advisory Committee, require the relevant Portfolio Company to undertake, within a specified timeframe, remediation measures necessary or appropriate to remedy such breach or mitigate such Integrity Risk, which shall be approved by the LP Advisory Committee, and keep the LP Advisory Committee regularly informed of the on-going implementation of those measures; . . . [or] dispose of the Fund's investment in such Portfolio Company on commercially reasonable terms, taking into account liquidity, market constraints and fiduciary responsibilities . . . .[167]

Transparency of this kind is especially important in new and evolving environments (like with impact investments), where contracting parties need to be able to rely on trust and problem solving.[168] Confidentiality, on the other hand, keeps information secret and separate. Many side letter confidentiality provisions, however, create carve outs to share information. Carve outs shift the directionality of confidentiality provisions, which are usually written as barriers to transparency, oversight, and shared knowledge.

Confidentiality provisions are a window into GP-LP dynamics. Confidentiality provisions shroud impact investments in secrecy with provisions like the following:

> The Limited Partners acknowledge and agree that all information provided to them by or on behalf of the Fund or the General Partner concerning the business of the Fund (including, without limitation, this Agreement and all amendments hereto, the Private Placement Memorandum and the

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> [c]lauses range from special notices needing to be made to DFIs, to additional transparency being granted to DFI advisory boards. DFIs are, as a result, in receipt of information beyond what would be available to LPs in a traditional private equity context, which stands to reason given that the use of public funds to support private investment vehicles is in itself a departure from the norm . . . .

Jessica Jeffers et al., *LP or Not LP: Confidentiality Clauses, Complexity, and Divergence in Emerging Market Impact Funds* 43 (March 31, 2021) (grant report on file with authors).

[167] Side Letter Doc. 30 (on file with authors).

[168] Ronald J. Gilson et al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1383 (2010).

> Subscription Agreement), . . . shall not, without the prior consent of the General Partner, be (i) disclosed . . . or (ii) used . . . .[169]

That secrecy may make sense from a traditional GP's perspective of proprietary investment due diligence processes and pipelines.[170] Secrecy, however, is at odds with promoting capital investment in impact funds. It also conflicts with transparency policies adopted by impact investors. Foundations and DFIs, in particular, have stringent information needs in order to comply with their own monitoring, reporting, and public disclosure frameworks which require the ability to harvest and, in some cases, disclose information to the public.[171] Further, deal confidentiality can exacerbate consequences for all impact investors when funds fail.[172]

Interviewees reported a growing tension between investors' need and preference for transparency and GPs' determination to maintain secrecy. This tension is highest where impact investors have lower bargaining power, such as in funds where DFIs or foundations play a less dominant role in the investor base. GPs' ability to push back is predicated on personal preferences for secrecy and the relatively lower need they have of DFI capital.[173]

Confidentiality provisions are common, but not uniform, in substance, complexity, length, or even document location within LPAs and side letters.

Preferences and information needs are also idiosyncratic to each impact investor. For example, some impact investors have a specific focus on business integrity, whereas others will be more concerned about advancing policy initiatives or complying with

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169 Side Letter Doc. 28 (on file with authors).

170

> The confidentiality clauses themselves are becoming more stringent. The grounds for this insistence on secrecy vary. Besides commercial reasons, the necessity to hide the role of individuals is often cited by GPs. This specific line of argument should cause alarm among investors concerned with political and reputational risk. GPs know DFIs are in particular subject to access to information obligations and therefore want to safeguard against information being made publicly available as a result. This phenomenon is amplified as impact investors and DFIs make additional demands for information.

Qualitative Interview Session 1 Summary, *supra* note 47, at 2.

171 *See supra* Section II.B.

172 "[B]eyond any opportunity costs linked to the resulting hinderance of fund-raising efforts, confidentiality clauses have very damaging consequences when funds fail, as they hinder the investors' effort to remedy the situation." Qualitative Interview Session 1 Summary, *supra* note 47, at 2.

173 *Id.*

money laundering issues, resulting in clauses of varying length and complexity.[174] For DFIs, information needs are shaped by the public role that they play and much of DFI-requested information is for investment monitoring and risk management. Further, DFIs may have to negotiate the inclusion of mandatory clauses and language reflecting government policy preferences.[175]

Figure 5 shows that 47% of the side letters address confidentiality. For the remainder of this section, we report detailed information about confidentiality provisions drawn from a smaller subsample (twenty-five side letters) reviewed in conjunction with the previously mentioned grant. Some letters make the agreements themselves confidential (16%) supporting the claim of secret side deals.[176] Over 90% address limited partner confidentiality obligations,[177] whereas only 32% address general partner confidentiality.[178] GPs also negotiate for the right to keep information secret from investors (48%), in other words, to withhold information (see Figure 8 below).[179]

Figure 9 shows the breakouts of withholding rights, with low frequency for expected terms like "as required by law," "non-public information about other investors," or "trade secrets." The "other" clause is the most common category, demonstrating the

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[174] *Id.* at 3.

[175]

> If so requested, the Manager shall promptly provide reasonable assistance to X in respect of: (a) questions posed to X by [relevant government bodies] as part of any enquiry by those bodies or other [relevant nation] or overseas government bodies; and (b) any investigations made by either such body, provided that any such question, enquiry or investigation relates to X's commitment to [FUND].

Side Letter Doc. 2 (on file with authors).

[176] *See, e.g.*, Side Letter Doc. 28 (on file with authors) (making the terms of the agreement, investment, and fund information confidential).

[177] *See, e.g.*, Side Letter Doc. 38 (on file with authors).

[178] "Any confidential information provided to the General Partner, the Investment Advisor or the Partnership by the Limited Partners shall be kept confidential by the General Partner, the Investment Advisor and/or the Partnership, as applicable, and shall not be disclosed to any third party . . . ." Side Letter Doc. 78 (on file with authors).

[179]

> The General Partner shall have the right to keep confidential from the Limited Partners (and their respective agents and attorneys) for such period of time as the General Partner deems reasonable, any information that the General Partner reasonably believes to be in the nature of trade secrets or other information the disclosure of which the General Partner in good faith believes is not in the best interest of the Fund or any Portfolio Company or could damage the Fund or such Portfolio Company or their respective businesses or which the Fund or such Portfolio Company is required by law or by agreement with a third party to keep confidential.

Side Letter Doc. 77 (on file with authors).

degree of tailoring that occurs in side letters. Some of the "other" provisions authorized managers to keep secret deal pipelines, negotiations, and even some financial distress cloistered from investors until the contract or default materialized.[180]

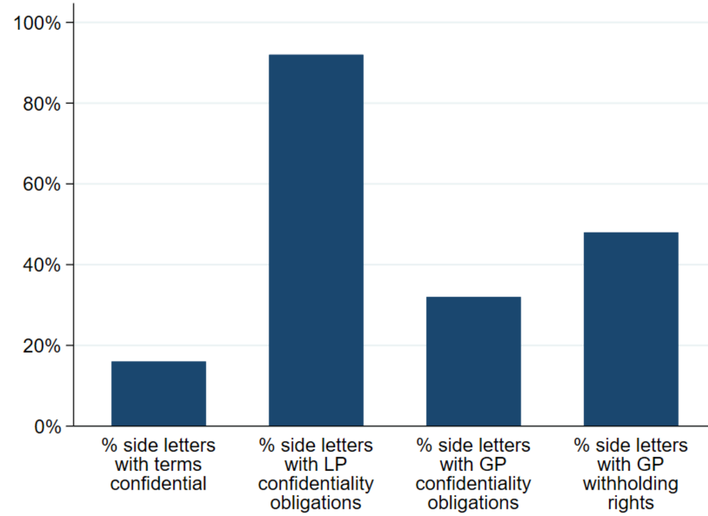


*Figure 8: Additional confidentiality provisions*

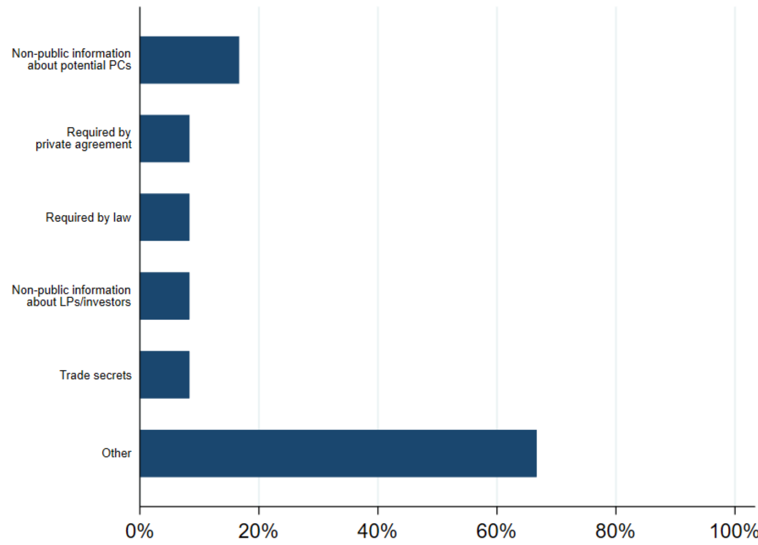


*Figure 9: GP withholding rights*

[180] *See, e.g.*, Side Letter Doc. 4 (on file with authors) (establishing that the GP can withhold "information due to applicable legal restrictions, fiduciary responsibilities or confidentiality obligations that we are unable to avoid or waive").

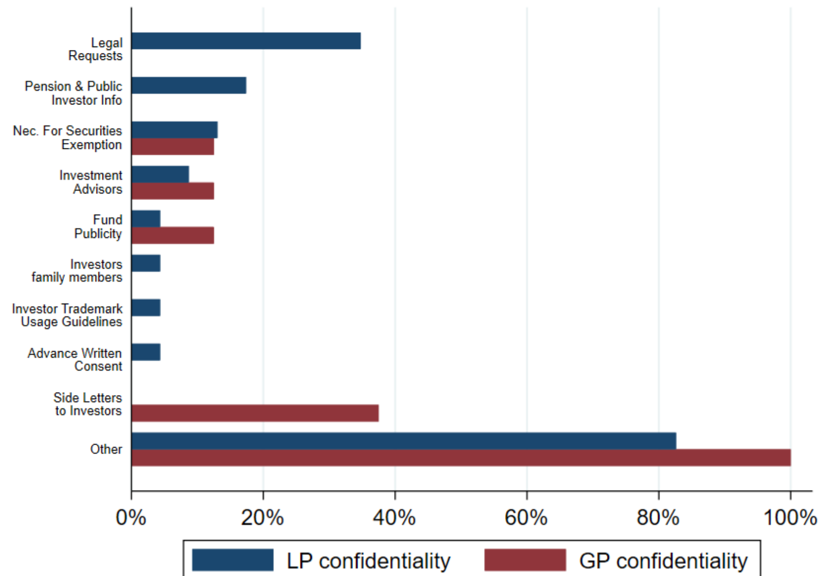


*Figure 10: LP and GP confidentiality terms*

Side letters vary in content and complexity, something we observe with the confidentiality clauses. Explicit and implicit carveouts are common for both LPs and GPs. Figure 10 plots the frequency of LP (blue) and GP (red) carve outs in the documents. Most of the recorded carveouts relate to legal compliance,[181] sharing information within the investor's network or organization,[182] and sharing requirements under *other* side letters (i.e., MFNs).[183]

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> [A]s may be required to be included in any report, statement or testimony required to be submitted to any municipal, state or national regulatory body having jurisdiction over Partnership, the General Partner or any such Affiliate, (b) as may be required in response to any summons or subpoena or in connection with any litigation or similar proceeding, or (c) to the extent necessary to comply with any law, order, regulation or rule applicable to the Partnership, the General Partner or any such Affiliate or with any provision of the Partnership Agreement or the Subscription Agreement.

Side Letter Doc. 28 (on file with authors).

182 *See, e.g.*, Side Letter Doc. 78 (on file with authors) (carving out confidentiality obligations "where the disclosure . . . is to other Partners, to Associates and advisers of the General Partner or the Investment Advisor, to the Auditors or to the Partnership's lenders").

183 *See, e.g.*, Side Letter Doc. 10 (on file with authors) (promising investor had received "all side letters or similar agreements ('Side Letters')" and promising to provide a copy of any future side letters).

Interestingly, the other category swamps the carveouts for both LPs and GPs. We interpret this as evidence against boilerplate and evidence of rote customization in side letters. While patterns emerge about provision type, each document has its own idiosyncrasies in scope, content, and language.

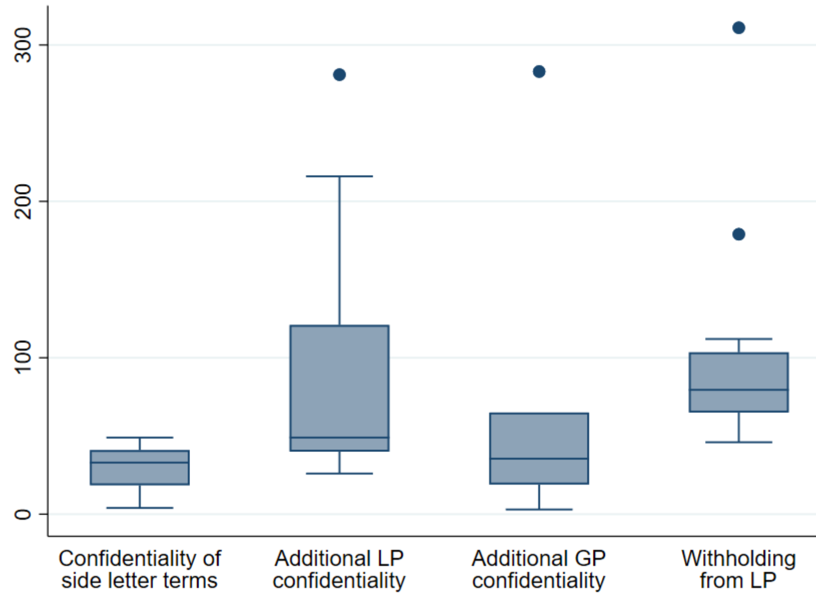


*Figure 11: Confidentiality provision length*

Last, but not least, side letter variation in length and complexity can be observed by word counts. For example, Figure 11 shows variation in the length of confidentiality clauses and illustrates the potential costs associated with highly tailored, complex contracting practices.

An important externality of confidentiality clauses, particularly in impact investing, is that they push agreements further into the shadows. This secrecy engenders costs in two ways. Secrecy in the terms of the side letters creates hidden hierarchies of investment rights, resulting in an asymmetry of information that can threaten the efficiency of private ordering.[184] The SEC cautions in its proposed side letter rules that:

[184] Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

> An adviser may agree to provide preferential information rights to a certain investor in exchange for something of benefit to the adviser. The proposed rule is designed to neutralize the potential for private fund advisers to treat portfolio holdings information as a commodity to be used to gain or maintain favor with particular investors.[185]

Secrecy in the terms of the agreements also hampers efforts to disseminate best practices that are still developing in the new space of impact investing.

## IV. Discussion

Easterbrook and Fischel present contracts as a way for corporate actors to "write their own tickets," or in other words, to promise and deliver the value that they can offer. Side letters exemplify this phenomenon: they tailor terms of existing agreements to suit the specific needs of their parties. Side letters are also ubiquitous in private market investments and, in particular, in impact investing.

### A. Side Letters as Contracts

Impact investing is a useful setting to understand the opportunities and costs of side letters as contracts because of the variety of backgrounds and mandates represented by multiple investors in this space, often within the same fund. For example, DFIs represent government policy goals, and require greater transparency and accountability commensurate with their public policy mandates.[186] DFIs frequently invest alongside high net worth individuals, whose preferences are their own, and who lack the government accountability needs (as well as back-office capacity) of DFIs. Other investors in impact investing include foundations, pension funds, and other institutional investors. Side letters are therefore critical tools to enable participants to dictate the terms of their engagement, but they can also impose unique costs in a still-developing space. In the rest of this section, we discuss these opportunities and costs in light of our results, before concluding with suggestions for a path forward.

We see evidence of "personalized contracts" in the lower frequency of co-investment rights and management fee reductions

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[185] Proposed Private Fund Rules, *supra* note 5, at 16,929.

[186] *See Development Finance Institutions and Private Sector Development*, *supra* note 72.

in impact versus non-impact side letters.[187] At the same time, impact side letters place greater emphasis on information rights and advisory committees especially compared to non-impact counterparts.[188] Side letter terms reflect investor priorities, which, in impact investing, center comparatively more on the nonpecuniary achievements of the fund. For readers interested in the development of impact investing generally, the prevalence and strength of impact-oriented provisions in the side letters attest to the overall growth and maturation of impact investing.[189]

Side letter provisions clearly answer investor needs. For example, advisory committees are governance tools responsive to the fixed investment horizon of funds (typically 10 years). Advisory committees facilitate continued oversight and engagement even after investor capital commitments are locked in. At the same time, not all investors have the desire or capacity to participate in advisory committees, and we see this manifest in the fact that advisory committees are negotiated in side letters that secure rights for *some* but not *all* investors. Moreover, we see contracts guaranteeing advisory committee seats, so advisory committee rights are not only widespread, but robust. We also do not see a single defined goal for advisory committees, but instead observe a variety of roles. In other words, advisory committee terms are not boilerplate; rather, they reflect the particular needs of specific investors.

The prevalence of information rights in impact side letters is another manifestation of tailoring provisions to specific investor needs. Information rights are the most common provision contracted for in our sample. In interviews, fund managers reported a reluctance to share the same detail of investment information with small investors compared to large investors, for a variety of reasons: small investors tend to be less well-known to fund managers due to fewer repeated interactions, and they are perceived as having lower reputational skin-in-the-game and smaller back-office compliance capabilities to ensure confidentiality is

[187] A 2019/20 study found 46% of side letters contain fee discounts. SEWARD & KISSELL LLP, *supra* note 54, at 3. A 2015 Preqin study found that 69% of GPs surveyed offered co-investment rights to certain investors. PREQIN, PRIVATE EQUITY CO-INVESTMENT OUTLOOK, *supra* note 59, at 5.

[188] *See supra* notes 77–86 and accompanying text.

[189] For further reading on impact investing, see Geczy et al., *supra* note 24; Brad Barber et al., *Impact Investing*, 139 J. FIN. ECON. 162 (2021).

maintained.[190] Many small investors also do not have the same requirement for transparency that large investors like DFIs and foundations have, due to these agencies' public regulation.

We even see side letters negotiate rights for GPs to withhold information from LPs such as deal pipelines, financial distress of a portfolio company, or information required by law. Side letter agreements make it possible for information rights to be negotiated on a case-by-case basis, in the spirit of Easterbrook and Fischel's "writing your own ticket" philosophy.[191]

### B. Costs of Side Letter Contracting

Our findings demonstrate the roles of contract tailoring via side letters, but they also reveal potential costs. First, the direct costs of side letter negotiation and execution are recouped from committed capital, meaning that increasing transaction costs reduce funds deployed for impact. Funds have little incentive to curtail a practice that appeases and lures important investors without the fund footing the bill beyond byzantine compliance obligations.

Second, side letters are shadow contracts that modify investment agreement terms, often outside of the view of all investors. They create a hidden hierarchy of investment rights,[192] a concern that has captured the attention of the SEC.[193] For example, common side letter provisions include terms that protect investors' return, such as MFNs. These provisions are only available to investors with the negotiated side letter right, yet they affect all investors in practice when invoked. The resulting hierarchy is hidden by virtue of being placed within side letters rather than within the main formation documents (e.g., the LPA). Other investors do not necessarily have rights to view these side letters.

In this way, the use of side letters and of confidentiality provisions can also hamper the sharing of best practices and evolution of best-in-class impact deal terms. It is not just that side letters remove incentives to strike the best bargain in LPAs, but additional measures of confidentiality keep contractual innovations secret. Investors do not even know to ask for certain rights or benefits that are reserved for the select few. Only insiders

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[190] Interview participants discussed the lack of trust in private investors to comply and keep information confidential. Qualitative Interview Session 1 Summary, *supra* note 47, at 4–5.

[191] Easterbrook & Fischel, *Corporate Contract*, *supra* note 12, at 1417–18.

[192] Qualitative Interview Session 1 Summary, *supra* note 47, at 5.

[193] *See* U.S. SEC. & EXCH. COMM'N, RISK ALERT, *supra* note 61.

know where they can order "off the menu," and what they may request.

Nonetheless, as we have seen, side letters serve a necessary role in spanning the gap between private market and public policy objectives. Large investors use side letters to renegotiate aspects of the investment contract and seek idiosyncratic provisions that are often tied to the goals of the backing foundation or government agency. This is most clear on the subset of confidentiality obligations where DFIs and foundations contractually embed oversight and reporting obligations as well as restrict manager discretion through prohibited investments (i.e., forced labor or outside of target regions). But shielding information from markets and the general public is counter to the public policy mandates of the government-backed investors and foundations perpetuating these practices.

Third, side letters also generate externalities from the complexity that they create. Our empirical analysis reveals a patchwork of terms with ample carve outs and little standardization that only lawyers could navigate. For example, "other" terms are the most frequent when it comes to analyzing confidentiality rights for both LPs and GPs, and the average level and variation of confidentiality clause length belies the notion of boilerplate language. Yet boilerplate not only establishes common understanding, but also reduces the need for negotiation and interpretation.[194] Lack of standardization, as we see in our sample of side letters, introduces small transaction costs that add up, from negotiation, to compliance, to interpretation in the event of a default. While side letters exhibit great variation and are used to address idiosyncratic investor needs, common themes emerge in reviewing side letters, particularly with respect to information rights, advisory committees, and confidentiality. Common side letter themes should be more robustly addressed in the LPA and leave the side letters to handle truly bespoke terms. Provisions that are crucial to documenting impact and resolving profit/purpose tensions should be negotiated and documented in the LPA to develop impact-specific best practices, and not be left in the shadows of side letters. Our case study highlights opportunities to improve the existing private ordering approaches through

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[194] Karen Eggleston et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91, 107–08, 110–12, 115–19 (2000) (discussing why contracts, in real life, are often simple and not complex because it reduces negotiation costs, increases trust and reputation, and decreases monitoring costs).

standardization.[195] In a related ongoing project, we propose a standardization menu as a starting point for negotiations to streamline the process, disrupt path dependency on out-of-date templates, and reduce the scope of negotiation.[196] Further, compliance with common laws like know-your-client, tax obligations, and PRI compliance should be addressed in standardized provisions of the subscription agreement. All remaining, truly bespoke issues can be resolved in side letters, and, consistent with the proposed SEC Rules,[197] those side letters should be disclosed to all current and future investors. Hierarchies created by contract are a natural feature of private ordering, but investors should not be subject to surprise terms that reshape investment rights or risks.[198] Additionally, moving common side provisions to the main agreements would comply with proposed SEC prohibitions on preferential information and liquidity terms in side letters.[199]

### C. Writing your own "ticket" on impact

Zooming out from the contents of our study and extending our findings to impact investing more broadly, we interpret our results as further evidence that the insertion of impact shapes private market investing in unique ways.[200] Impact objectives are evident in information and reporting goals, as well as compliance provisions. Impact goals may also motivate the heightened need for participatory governance, like provisions guaranteeing investors a seat on an advisory committee.

In studies like this one and in other work, we observe how impact seeps into the fabric of agreements and alters the networks of contract terms.[201] Impact is not bolted on as an afterthought, but it appears to be an integral negotiation point for parties.

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[195] *See* Qualitative Interview Session 2 Summary, *supra* note 108, at 2 (To generate the menu approach, we reviewed standardization efforts in private equity and related fields such as the International Swaps and Derivatives Association (ISDA) Master Agreement 2002, created in 1985 and subsequently regularly updated.); *Model Limited Partnership Agreement*, INST. P'SHIP ASS'N, https://perma.cc/UXG7-2SL4 (last visited Feb. 11, 2022) (The Institutional Limited Partners Association (ILPA) also produces a set of model private equity investment documents.).

[196] *See* Jeffers et al., *supra* note 166, at 34–41.

[197] Proposed Private Fund Rules, *supra* note 5, at 16,886.

[198] *Id.* at 167 (asserting that the rules related to information and disclosure would "curtail activity that harms investors").

[199] *Id.* at 1.

[200] Geczy et al., *supra* note 24, at 709–10.

[201] *Id.*

Several aspects of the project connect with foundational theories in corporate law, some in surprising ways. Easterbrook and Fischel noted that contracts contain endless variations because objectives, motivations, and outcomes under a contract are infinite.[202] They saw variation and tailoring as a *feature* of corporate law achieved through contracts, not as a bug. Our analysis reveals that impact investing is a particularly apt setting for tailored contracts. Lack of boilerplate and documented variation in length and complexity of side letter provisions bolster their point about the endless creative solutions that live in contracting. Easterbrook and Fischel may also interpret the side letters in the case study as clever, targeted interventions to balance power and informational needs, not as *shadow* contracts that hide important negotiations.

While Easterbrook and Fischel looked positively on contract variation, tailoring, and the role of private ordering, they did not look as favorably on corporate social responsibility as a whole.[203] They cautioned: "A manager told to serve two masters (a little for equity holders, a little for the community) has been freed of both and is answerable to neither."[204] Perhaps they viewed the transaction costs as an insurmountable obstacle: that profits would be eroded by pursuing purpose, and in contracting around it.[205] In impact investing, however, foundation and DFI money are cornerstone capital. The usual guardrails of transaction costs to curb customization soften in the face of large resources these investors have to pursue social objectives.[206]

For all their skepticism about the value of dual objectives, Easterbrook and Fischel imagined a world of infinite motivations and tailoring to parties' idiosyncratic needs. They saw contracts as a means, even, to agree on pursuing purpose over (or alongside) profit. "If a bank is formed [for] the declared purpose of giving priority to loans to minority-owned businesses or third-world nations, that is a matter for the ventures to settle among

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[202] EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE, *supra* note 12, at 2–4.

[203] "Wealthy firms provide better working conditions and clean up their outfalls; high profits produce social wealth that strengthens the demand for cleanliness. Environmental concerns are luxury goods; wealthy societies purchase much cleaner and healthier environments than do poorer nations . . . in part because they can afford to pay for it." *Id.* at 38.

[204] *Id.*

[205] "Faced with a demand from either group, the manager can appeal to the interests of the other. Agency costs rise and social wealth falls." *Id.*

[206] Clayton, *supra* note 4, at 105, 109–10.

themselves."[207] Venturers are, in fact, settling the matter for themselves. Impact agreements resolve the indeterminate nature of a stakeholder governance framework (a manager serving two masters serves neither) because the community's interests are the equity holders' interests. Further, the contract reflects the equity holder's unique preferences and priority about which community interests to serve and how to deliver on these promises. The preferences are recorded in the contract and become an enforceable term of the deal. Private ordering, not corporate *law*, enables agents to serve two masters or two goals: profit and purpose. Our only quibble is how frequently the contract of choice is the side letter and not the LPA or subscription agreement.

## V. CONCLUSION

We introduce a unique data set of side letters and impact investor interviews. These shadow contracts memorialize side deals between some, but not all investors. With our data, we document motivations for large investors to seek side letters and the most common terms of these side letters. We use our case study to identify the opportunities, like tailoring, and costs, like patchwork compliance, of side letters.

We also treat our data as a window into contract and corporate law theories. Contracts are central to promising and delivering what investors value—an emphasis that takes on new meaning as economies start to grapple with societal issues through dual purpose vehicles such as impact investing funds. Side letters are particularly useful tools to define value for large impact investors, specifically as it relates to impact monitoring and reporting. Side letters thus solve one problem specific to the investor, but they introduce other less concrete harms such as hidden hierarchies and suboptimal LPA terms. Standardizing the LPA and subscription agreement to address common side letter provisions would develop best practices in impact deals, increase transparency, and streamline side letter negotiation and compliance. Disclosure of any remaining side letters would also be consistent with proposed SEC rules on side letters in private market funds.

207 EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE, *supra* note 12, at 36.