Opting Out of Court? Reputation and Informal Norms in Private Equity

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Abstract

Private equity, an industry characterized by high-stake investments and complex contractual arrangements, operates almost entirely outside of courts. Despite the substantial financial stakes involved—billions of dollars locked in for years—and the potential for fiduciary conflicts, litigation between limited partners (LPs) and general partners (GPs) who manage the investment is exceptionally rare. In stark contrast to public markets, where shareholder litigation plays a prominent role in deterring misconduct and shaping corporate norms, the private equity world is largely defined by its absence. The puzzle, then, is this: In an industry where fiduciary breaches or misaligned incentives are not uncommon, why do LPs almost never turn to courts to enforce their rights? Drawing on proprietary documents, public records, and qualitative interviews with market players, this article provides the first account of the rarity of litigation in private equity and the ecosystem of extralegal relations and informal norms that serve as a substitute for formal legal channels.

This article makes three contributions to the literature on private equity. First, using novel data, the article provides the first empirical account of the non-litigious private equity landscape and its underlying causes. It also highlights how opting out of court is a result of reputational concerns, contractual barriers, and institutional disincentives. Second, the article investigates how private equity resolves disputes and enforces norms without recourse to courts. Based on a unique set of interviews with LPs, GPs, and legal advisors, this article sheds light on the alternative mechanisms that dominate the private equity landscape. Third, the article explores the implications of this non-litigious environment for investor protection, market efficiency, and regulatory oversight, questioning whether reliance on reputation and extralegal mechanisms is sustainable in the face of growing industry complexity.

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Introduction

In the complex world of private equity, where vast sums of money are managed through intricate partnerships, a fascinating phenomenon exists. Positioned at the heart of global finance, this $13 trillion industry[1] thrives on contracts that lock in billions of dollars over decades,[2] yet it operates in a near-litigation-free zone. In an arena where investors—the limited partners (LPs)—hand over substantial sums to general partners (GPs) and have limited say during the fund's life cycle and even fewer exit options, one would expect courts to play a pivotal role. Yet, they do not. Lawsuits against GPs are as rare as unicorns in this high-stakes world; when they do happen, they are reserved for the most egregious breaches, such as outright fraud.[3] Why and how does the private equity world operate without the judicial safety net that investors in public corporations demand?

This article seeks to offer insights into these issues. Private equity's aversion to litigation is not merely a reflection of a specific class of investors' preferences but the product of a carefully structured system of governance. Limited partnership agreements (LPAs)—the foundational documents governing private equity funds—contain a host of contractual provisions that discourage legal challenges, including sweeping indemnification clauses and safe harbor protections for GPs, mandatory arbitration provisions, and limited information rights for LPs.[4] Nonetheless, contractual barriers do not provide a complete picture. Theoretically, LPs possess the capability to negotiate for more advantageous terms, which could potentially mitigate certain barriers to litigation.

Indeed, this article shows that structural features of the private equity market itself further compound the legal hurdles. Private equity investments are dominated by institutional and accredited investors, who often have little incentive to pursue litigation against GPs.[5] Litigation not only entails high monetary costs but also demands significant time and resources, thereby distracting LPs and preventing them from focusing on managing their investments.[6] Litigation could also expose asset managers to legal risk if the litigation reveals their insufficient diligence or failure to ask critical questions.[7] Finally, and most importantly, LPs also have strong incentives to maintain a positive reputation and preserve their relationships with successful GPs in order to secure future investment opportunities. No LP wants to risk reputational harm by taking GPs to court.[8]

Nevertheless, the fact that LPs rarely use litigation to deter GPs from misconduct, does not imply a lack of enforcement of investors' rights. As this article demonstrates, the private equity sphere is a unique system where disagreements between LPs and GPs are often managed through a variety of extralegal or alternative dispute resolution mechanisms. LPs frequently negotiate directly with GPs or report concerns to public regulators, such as the Securities and Exchange Commission (SEC),

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[1] Fredrick Dahlqvist et al., *McKinsey Global Private Markets Review 2024: Private Markets in a Slower Era*, MCKINSEY & CO. (Mar. 28, 2024), https://www.mckinsey.com/industries/private-capital/our-insights/mckinseys-private-markets-annual-review ("private markets assets under management totaled $13.1 trillion as of June 30, 2023 . . . .") [hereinafter *McKinsey Global Private Markets Review 2024*]; *see also* JOHN COATES, THE PROBLEM OF TWELVE: WHEN A FEW FINANCIAL INSTITUTIONS CONTROL EVERYTHING 55–56, 65–67 (2023).

[2] *See infra* notes 37–40 and accompanying text.

[3] *See infra* Section II.A.

[4] *See infra* Sections II.B.1–2.

[5] *See infra* note 27.

[6] *See infra* Section II.B.3.

[7] *See infra* Section II.B.4.

[8] *Id.*

which can trigger public enforcement actions.[9] Additionally, and most importantly, the long-term nature of fund commitments and the heavy reliance on trust and repeat interactions between LPs and GPs create a system in which informal norms and reputational incentives replace formal legal accountability.[10]

Private equity's avoidance of litigation also reflects the broader relational dynamics of the industry: the private equity ecosystem is characterized by close, ongoing interactions between LPs and GPs.[11] GPs' dependence on LPs—not only for initial capital commitments but also for future fundraising cycles—creates an incentive to maintain positive relationships.[12] LPs, in turn, must weigh the potential benefits of legal action against the risk of alienating a GP and losing access to future investment opportunities. This dynamic generates a form of market discipline that substitutes for formal legal enforcement and that relies on reputation, trust, and repeat interactions.[13]

However, this system is not without its flaws. The rarity of litigation limits the development of judicial norms that could enhance transparency and accountability across the industry. Without court precedents to clarify fiduciary obligations or enforce disclosure standards, LPs are left to navigate a legal gray area in which their rights are defined by custom or broad contractual provisions.[14] Meanwhile, the complex structure of funds with many LPs and an additional layer of agents (those who manage the LPs' assets) makes it difficult to rule out the possibility that LPs avoid suing GPs because of internal agency costs, even when the overall expected benefits of private litigation could outweigh its costs.[15] Furthermore, the reliance on informal governance disproportionately benefits large, sophisticated LPs that have the resources, bargaining power, and access to information needed to hold GPs accountable. Smaller LPs, by contrast, often lack the tools to influence GPs or evaluate their actions effectively.[16] Finally, the concentrated power of a few dominant GPs is another factor that could limit the effectiveness of LPs' reputational threats. After all, no LP wants to be labeled a "troublemaker," which could severely undermine its ability to receive future allocations from top-performing GPs.[17]

While there is a vast literature on relational contracting as well as on the use of extra-legal norms to limit expropriation between contracting parties in close-knit communities,[18] this article is the first to explore the tendency of participants in the private equity industry to opt out of recourse to courts. This article makes three contributions to the literature on private equity. *First*, using hand-collected data, the article provides evidence of the lack of LP-GP litigation in private equity. Although GPs have been subject to increased litigation in recent years, the overwhelming majority of the lawsuits in our sample—covering lawsuits filed in the past 40 years against the top 50 private equity firms and 50 additional smaller firms—are filed by third parties. Only 4 percent of the lawsuits were brought by investors involved in private equity.[19] The article also provides a first-of-its-kind, empirical

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[9] *See infra* Section III.A.3.
[10] *See infra* Section III.B.
[11] *See infra* notes 190-200.
[12] *Id.*
[13] *See infra* Section III.B.
[14] *See infra* Section IV.B.2.
[15] *See infra* Section IV.B.1.
[16] *See infra* Section IV.B.4.
[17] *See infra* Section IV.B.3.
[18] *See infra* notes 57-66.
[19] *See infra* Section II.A.

examination of the barriers to litigation within the private equity ecosystem. Drawing on a proprietary dataset of LPAs, this analysis quantifies how litigation-related provisions are structured to insulate GPs from legal exposure. It also documents the increasing prevalence of terms that favor GPs over LPs, reflecting a power imbalance that has grown alongside the industry's expansion.[20]

Second, the article investigates how, in the absence of litigation, private equity resolves disputes and enforces norms without recourse to courts. Based on a unique set of interviews with LPs, GPs, and legal advisors, this article offers insights into some of the reasons for the lack of litigation as well as the alternative mechanisms that dominate the governance landscape—such as collaboration between LPs through Limited Partner Advisory Committees (LPACs) and industry organizations, direct settlements, reputation markets, and public enforcement by the SEC.[21]

Third, the article explores the implications of this non-litigious environment for investor protection, market efficiency, and regulatory oversight, questioning whether reliance on reputation and extralegal mechanisms is sustainable in the face of growing industry complexity.[22] Additionally, the article highlights the broader implications of private equity's governance model for other areas of financial regulation and corporate governance. As private equity continues to grow in size and influence—now managing assets that rival entire national economies—it becomes increasingly important to scrutinize the mechanisms that sustain its operations. Are informal norms and reputational incentives sufficient to deter misconduct in such a high-stakes industry? Or does the lack of litigation leave critical gaps in investor protection that could destabilize the market? These questions are particularly urgent as regulators, including the SEC, may increase individual and retail access to private funds.[23]

Through a mixed-method approach that combines qualitative insights with quantitative data, this article offers a comprehensive analysis of how private equity balances efficiency, accountability, and investor protection. The findings challenge traditional assumptions about the necessity of litigation as a cornerstone of investor protection and open new avenues for research into the evolving dynamics of corporate governance in private markets. This article's analysis is also applicable to other private funds with a similar structure, such as venture capital firms and hedge funds. Therefore, its insights and implications extend well beyond the private equity context.[24]

The article proceeds as follows: Part I provides an overview of the private equity industry and the paradox it presents with respect to litigation. Part II provides novel empirical evidence regarding the rarity of litigation between LPs and GPs. It also uses qualitative and quantitative data to highlight how the lack of litigation is driven, at least in part, by contractual barriers, institutional constraints and the value of reputation. Part III provides a detailed overview of the various alternative mechanisms LPs and GPs employ to address conflicts. Part IV discusses the normative implications.

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[20] *See infra* Sections II.B.1–2.

[21] *See infra* Section III.A.

[22] *See infra* Part IV.

[23] *See infra* note 261 and accompanying text.

[24] However, one shall bear in mind the potential differences between different private fund settings. For example, in the VC industry, additional players such as entrepreneurs can file lawsuits against the GP. *See infra* note 259 and accompanying text. The VC setting also involves more complex capital structure with common and preferred shareholders and unique conflicts that do not exist in the private equity context. Thus, any analogy to other private funds' setting should be sensitive to such differences.

I. Background

A. The Foundations of Private Equity Contracting

Private equity funds raise and pool money from investors to buy and sell entire companies, often while leveraging a significant amount of debt to finance the acquisitions.[25] Virtually all private equity funds are organized as limited partnerships and invest in portfolio companies.[26] Investors in limited partnerships—usually institutional investors and wealthy individuals—are LPs, and private equity firms, also referred to as sponsors, serve as GPs.[27]

The GP raises and manages the fund, owes fiduciary duties to the fund (unless waived), and acts as an agent of the fund vis-a-vis third parties.[28] In contrast, the LPs have only minimal rights to participate in day-to-day operations or challenge the GP's decisions.[29] Nor do they owe any duties to the fund.[30] The LPA, which is negotiated between the GPs and the LPs, governs the relationship between the investors and the fund.[31] The LPA sets the respective rights and obligations of the GPs and the LPs, and typically includes provisions on voting rights, access to information, and transfer restrictions.[32] LPAC is a key mechanism for addressing contractual issues within the LPA. Composed of LP representatives selected by the GP, its primary roles are reviewing conflicts of interest and waiving restrictions in the LPA.[33] Two key governance mechanisms in private equity funds are widely recognized for their role in aligning the interests of private equity firms and their investors. The central one is the GPs' economic incentive structure. The economic alignment primarily relies on the "Two and Twenty" compensation model, whereby GPs earn a management fee (usually 2% of the committed capital) and a 20% performance-based carried interest.[34] This structure incentivizes GPs to maximize returns, theoretically aligning their goals with those of the LPs. Nonetheless, the model has its limitations.[35] The management fee is independent of performance. Carried interest, while aligning interests by tying GP compensation to fund performance, might also encourage riskier investments than LPs would prefer, as GPs stand to gain substantially from high returns without

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[25] *See, e.g.*, Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121 (2009).

[26] *Id.*

[27] Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2304 (2009).

[28] UNIF. LTD. P'SHIP ACT § 305 (2001).

[29] Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 263–70 (2010); William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1874–78 (2018) ("Investors in private equity funds have very little say in the way that their funds are run."); William Clayton, *The Private Equity Negotiation Myth*, YALE J. ON REGUL. 37, 67, 74 (2020) ("Managers typically have extremely broad discretion to select investments"); James Spindler, *How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 328–29 (2009) ("The reason for choosing the limited partnership form is principally to limit the control rights that limited partners will have over the partnership…").

[30] UNIF. LTD. P'SHIP ACT § 302; REVISED UNIF. LTD. P'SHIP ACT §§ 302, 303(a).

[31] Harris, *supra* note 29, at 269.

[32] Magnuson, *supra* note 29, at 1850–51.

[33] Kobi Kastiel & Yaron Nili, *The Rise of Private Equity Continuation Funds,* 172 U. PA. L. REV. 1601, 1644 (2024).

[34] Magnuson, *supra* note 29, at 1866–67; Clayton, *supra* note 29, at 74–76.

[35] *See, e.g.,* Heather M. Field, *The Return-Reducing Ripple Effects of the "Carried Interest" Tax Proposals*, 13 FLA. TAX REV. 1, 35 (2012) ("[T]he GP's return is directly proportional to the return that the fund assets produce for the LPs."); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1089–90 (2003) (arguing that the fixed terms of these funds ensure bad investment decisions by a GP "will be punished through the reputation market").

bearing the full brunt of potential losses.[36] The carried interest may also lead to the GP prioritizing and shifting investments between funds to maximize the GP's potential returns to the detriment of investors.

The second key governance feature of private equity funds is their limited duration. Private equity funds typically have a lifespan of ten years, often with an option to extend the fund for one or two years upon obtaining specified approvals.[37] After investors commit capital to the funds, the GPs can access and deploy it to invest in companies with potential for improvements,[38] and the invested capital remains locked and cannot be withdrawn until the fund's investments are liquidated and the proceeds are distributed to the LPs.[39] The limited duration of private equity funds aligns GPs' and LPs' interests in two ways. First, it ensures liquidity for LPs.[40] Second, it serves as an effective tool for constraining agency costs, limiting GPs' ability to maintain underperforming portfolio companies and forcing the GPs to raise new capital every few years.[41] Yet, the limited duration also suffers from limitations. Underperformance may take time to be revealed and the time duration may be extended in various ways. Indeed, recently, private equity sponsors have found a creative way to retain assets beyond the customary ten-year fund term for up to six additional years through the use of continuation funds.[42]

Thus, while these two mechanisms—performance-based carried interest and limited duration—play a critical role in the governance of private equity, they do not perfectly align the interests of GPs and LPs. It is plausible to assume that litigation would bridge this alignment gap.

The potential role of litigation in private equity investment has gained particular importance in recent years, considering the enormous influence these funds have come to exercise in the U.S. economy. While private equity funds have existed since the 1970s, their meteoric rise began in the 2000s. During the first two decades of this century, the industry expanded from $770 billion in global assets under management to $12.1 trillion, growing four to five times faster than the U.S. economy and outpacing the growth of public markets.[43] By 2021, private equity firms managed approximately 20 percent of U.S. businesses.[44] Since then, private markets' assets have continued to grow, with the number of private equity deals increasing to 19,123 and total managed assets exceeding $13 trillion in 2024.[45] The private equity industry has also become more concentrated in recent years, with a few

[36] Harris, *supra* note 29, at 285; Magnuson, *supra* note 29, at 1871–72; Jarrod Shobe, *Misaligned Interests in Private Equity*, 5 BYU L. REV. 1437, 1457–58 (2016).

[37] PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 3–5 (1999).

[38] William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. 249, 260 (2017).

[39] *Id.*

[40] GOMPERS & LERNER, *supra* note 37, at 44; Gilson, *supra* note 35, at 1089–90; David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 2378–79. The limited duration of the fund also ensures the market will evaluate every few years whether the GP's investment decisions favored risk over expected returns and reward the GP accordingly.

[41] For a comprehensive discussion, see Andrew Schwartz, *Limited Life* (Working Paper, 2025). *See also* Magnuson, *supra* note 34, at 1859; Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 606–07, 610–11 (2017) ("This structure might well reflect recognition that, many years down the road, a general partner's skills might no longer be superior or even adequate.").

[42] For a review, see Kastiel & Nili, *supra* note 33.

[43] COATES, *supra* note 1, at 55–56, 65–67.

[44] Joe Camberato, *Why Is Private Equity Gaining Popularity?*, FORBES (May 9, 2024, 7:30 AM), https://www.forbes.com/councils/forbesfinancecouncil/2024/05/09/why-is-private-equity-gaining-popularity/.

[45] *See* PITCHBOOK, ANNUAL GLOBAL PE FIRST LOOK 2024 (2025),https://pitchbook.com/news/reports/2024-annual-global-pe-first-look. *See also McKinsey Global Private Markets Review 2024*, *supra* note 1.

large GPs dominating a significant fraction of the market. For example, the top four GPs collectively manage $2.7 trillion in assets,[46] and the top five account for 25 percent of all the capital raised within the market between June 2017 and June 2022.[47] As we will show, the concentrated power of these dominant GPs leads to fierce competition among LPs for the limited opportunities to secure allocations in these exclusive funds.[48]

B. Investment without Private Litigation: Research Agenda

A series of interviews we held with private equity market participants revealed a notable insight: Despite the anger or frustration sometimes expressed by LPs in connection with certain GP practices, our interviewees all emphatically reiterated that LPs rarely sue the GPs. Absent extreme circumstances of fraud, LPs avoid taking this route.[49]

These observations underscore a striking reality. Litigation has long been considered a vital enforcement mechanism in business settings, particularly when investors entrust their capital to another party that assumes control over those funds. In such relationships, litigation serves as a critical tool for investors to challenge, oversee, and discipline the actions of those managing their investments, typically through the framework of fiduciary duties. By means of litigation and detailed opinions, judges—especially in Delaware—set norms in the market.[50] Financial economists have also shown that strong shareholder protections, among them the ability to bring lawsuits, are essential to the development of strong capital markets.[51] The importance of litigation is also reflected by the fact that founders of public companies are generally not permitted to opt out of judicial review by, for example, requiring their companies to adopt a mandatory arbitration provision at the IPO stage.[52]

The lack of litigation becomes particularly remarkable in the context of private equity, given that a significant portion of investors in public markets—primarily institutional investors that benefit from the deterrence litigation creates—are also major players in the private equity market. The question is also intriguing due to the limited exit and voice rights of investors in private equity funds. As noted, during the commitment period, the capital invested by the fund is locked up and cannot be withdrawn until the investment is liquidated.[53] Investors are often obligated to remain with the same

[46] COATES, *supra* note 1, at 69.

[47] Nori G. Lietz & Philipp Chvanov, *Does the Case for Private Equity Still Hold?* 9 (Harv. Bus. Sch., Working Paper No. 24-066) ("Indeed, the top five firms account for 25% of all the capital raised between June 2017 and June 2022 . . . .").

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

[49] Interview with Participant 2 (Jan. 25, 2023); Interview with Participant 3 (Jan. 26, 2023); Interview with Participant 8 (Jan. 27, 2023); Interview with Participant 14 (Apr. 30, 2024); Interview with Participant 15 (May 1, 2024); Interview with Participant 16 (May 10, 2024); Interview with Participant 18 (May 20, 2024). *See also* Rob Kotecki, *Legal Special: Litigation When Unicorns Don't Fly,* PRIV. EQUITY INT'L (May 15, 2019), https://www.privateequityinternational.com/legal-special-litigation-when-unicorns-dont-fly/. This conclusion aligns with the limited existing research on the use of legal systems by private equity players. *See* Robert C. Illig, *The Dog That Didn't Bark: Private Investment Funds and Relational Contracts in the Wake of the Great Recession*, 2 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 49, 50–51 (2012) (noting that in the aftermath of the 2008 subprime mortgage crisis, many hedge fund and venture capital fund managers did not sue their counterparties despite having their contractual rights breached).

[50] *See generally* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997); Charles M. Elson, *The Duty of Care, Compensation and Stock Ownership,* 63 U. CIN. L. REV. 649 (1995).

[51] *See generally* Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) [hereinafter *Legal Determinants of External Finance*]; Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) [hereinafter *Law and Finance*].

[52] Karan S. Tyagi, *Carlyle Leaves Out Mandatory Arbitration Clause in IPO*, WOLTERS KLUWER: KLUWER ARBITRATION BLOG (Feb. 7, 2012), https://arbitrationblog.kluwerarbitration.com/2012/02/07/carlyle-leaves-out-mandatory-arbitration-clause-in-ipo/.

[53] Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2304 (2009).

GPs and have a minimal ability to replace them, even if the GPs underperform (unlike the case of directors of public companies, who often stand for election on a yearly basis or at least every three years).[54] In the presence of limited exit and voice rights, it is reasonable to assume that strong litigation rights would serve as a meaningful substitute, but this is far from reality.

Notably, despite the absence of the threat of litigation, recent evidence suggests that fraudulent activity is not common in the private equity sector. For example, the SEC has observed misconduct by about 0.05 percent of investment advisors in a 17-year period.[55] How does the private equity market operate without enforcement of investor rights in courts and without an active plaintiffs' bar that is presumed to be essential to the development of the public capital market?

This article provides the first systematic analysis of this question and seeks to accomplish four major goals. *First*, it empirically examines the presumption regarding the rarity of litigation in private equity and, most importantly, identifies barriers that limit private litigation within this sector. *Second*, it explores how the industry operates without private litigation and examines the mechanisms private equity investors utilize as alternative avenues for resolving disputes between them and GPs. *Third,* it analyzes the role played by relational contracting, repeat interactions (particularly around the sponsors' need to raise future funds), and reputational sanctions in this market, along with the limits of these extra-legal forces. *Finally*, this article assesses the implications of foregoing private litigation and provides a normative analysis of the advantages and concerns associated with the current extra-legal practices. Such an analysis is of particular relevance in light of the recent legal battle over enhancing SEC regulation in the private equity space.[56]

While there is a vast literature on relational contracting and the use of extra-legal norms to limit expropriation between contracting parties in close-knit communities, to date, there is almost no research that explores the applicability of these theories in the context of private equity investment in-depth.[57] The pioneering work of Stewart Macaulay and Ian Macneil on relational contracting theory suggests that in settings characterized by repeated interactions between contracting parties (such as manufacturers and suppliers), *reputation* significantly influences behavior as a crucial non-legal enforcement mechanism for resolving disputes and reducing transaction costs.[58] In their highly influential works, Robert Ellickson and Lisa Bernstein have focused on several specific industries, showing how informal norms and reputational mechanisms serve as effective alternatives to the formal legal system in certain close-knit communities.[59] Ellickson emphasizes the role of social norms in fostering cooperation, thereby eliminating the need for any dispute resolution system,[60] and Bernstein

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[54] Bebchuk & Kastiel, *supra* note 41, at 606–07, 610–11.

[55] Some also argue that "this small percentage significantly exaggerates the incidence of litigation because it aggregates seventeen years of enforcement activity and compares that statistic with the current population of registered advisers rather than with a comparable seventeen-year population." Joseph Grundfest, *The Most Curious Rule in Securities and Exchange Commission History*, HARV. L. SCH. F. ON CORP. GOV. (May 17, 2022), https://corpgov.law.harvard.edu/2022/05/17/the-most-curious-rule-proposal-in-securities-and-exchange-commission-history/.

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

[57] For a discussion, see *infra* Section III.B.

[58] *See id.*

[59] *See generally* ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. L. STUD. 115 (1992) [hereinafter *Extralegal Contractual Relations in the Diamond Industry*]; Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001) [hereinafter *Private Commercial Law in the Cotton Industry*].

[60] *See* ELLICKSON, *supra* note 59, at 127–36.

focuses on the extralegal mechanisms and supportive institutions that certain industries have developed to facilitate an internal conflict resolution system.[61]

Others have examined relational contracting in the contexts of venture capital, bankruptcy, and financing transactions, which are the closest to our setting. Robert C. Illig observed that although enforceable contracts were breached during the financial crisis of 2008, private investment funds were seldom involved in litigation following the crisis.[62] He focused on the question of why relational parties bother to contract in the first place, suggesting that for them, a contract must provide significant symbolic and ceremonial value. Brian Brougham shows how third-party intermediaries—such as lawyers, board members, scientists, and others—allow entrepreneurs and investors to commit to informal business norms, even though the parties may have no pre-existing business relationship.[63] Atanasov et al. focused on the reputational impact of litigation that was already initiated against general partners of venture capital firms,[64] showing how litigation penalizes GPs' opportunism *ex post* (through the loss of business opportunities and access to capital) and reduces the likelihood of opportunism *ex ante*.[65] According to them, reputation plays a key role within the relatively small industry of repeat players, and involvement in litigation signals misconduct.[66]

We approach this important topic from a different perspective, seeking first to understand why LPs refrain from filing lawsuits against GPs to begin with. We also aim to identify legal and extra-legal barriers that limit private litigation within this sector, while exploring the alternative mechanisms that private equity investors utilize for resolving disputes between them and GPs, and analyzing the role relational contracting and reputational sanctions play in this market and their limits. Closing this gap in the literature is crucial, considering the size, impact, and influence of the private equity industry on the economy as a whole and on the life savings of many Americans.[67]

II. The Rarity of Litigation in the Private Equity Ecosystem

This Part empirically examines the presumption regarding the rarity of litigation in private equity and identifies legal and extra-legal barriers that limit litigation within this sector.

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[61] *See Extralegal Contractual Relations in the Diamond Industry*, *supra* note 59, at 138–43; *Private Commercial Law in the Cotton Industry*, *supra* note 59, at 1745–54. More recently, scholars have applied relational contracting in a variety of contexts, including business ones. For example, Cathy Hwang described how non-binding agreements, such as term sheets in the mergers and acquisitions context, are used to build a "relational ecosystem" that facilitates future steps in the transaction. *See* Cathy Hwang, *Faux Contracts,* 105 VA. L. REV. 1025, 1064 (2019). Matthew Jennejohn, writing in the context of supply relationships, proposed that relational contracting, or investing in "bilateral governance" might act as a "shock absorber for disruptions in the market." Matthew Jennejohn, *The Transactional Dynamics of Market Fragility*, 85 L. & CONTEMP. PROBS. 281, 283 (2022). See also Lisa Bernstein & Brad Peterson, *Managerial Contracting: A Preliminary Study* 14 J. LEGAL ANALYSIS 176 (2022) (studying managerial contracting).

[62] Illig, *supra* note 49, at 51.

[63] Brian J. Brougham, *The Role of Relationships and Informal Norms in Entrepreneurial Finance*, COLUM. L. SCH.: THE CLS BLUE SKY BLOG (Aug. 14, 2018), https://clsbluesky.law.columbia.edu/2018/08/14/the-role-of-relationships-and-informal-norms-in-entrepreneurial-finance/.

[64] Vladimir Atanasov et al., *Does Reputation Limit Opportunistic Behavior in the VC Industry? Evidence From Litigation Against VCs*, 67 J. FIN. 2215, 2228–29 (2012) [hereinafter *Does Reputation Limit Opportunistic Behavior in the VC Industry?*].

[65] *Id.* at 2240–41 ("The resulting numbers indicate that, relative to their peers, litigated VCs invest in 430-1,840 fewer deals (investment rounds), raise 380-690 million dollars less following a lawsuit, and syndicate with 42-55 fewer partners").

[66] *Id.* at 2222.

[67] *See generally U.S. Department of Labor Issues Information Letter on Private Equity Investments*, U.S. DEP'T OF LAB. (June 3, 2020), https://www.dol.gov/newsroom/releases/ebsa/ebsa20200603-0; Martin J. Gruenberg, Chairman, Fed. Deposit Ins. Corp., Financial Stability Risks of Nonbank Financial Institutions (Sept. 20, 2023) (transcript available at https://www.fdic.gov/news/speeches/2023/spsept2023.html).

A. Evidence

As we describe in more detail in Part II.B below, we conducted 20 interviews with private equity professionals, all with significant industry experience.[68] The interviewees reported very few instances in which LPs threatened litigation against GPs, with even fewer cases ultimately proceeding to the courtroom. They emphasized that litigation is a last resort and that they prefer other means of resolving disputes with GPs whenever possible; sometimes, they opt to take no action at all. According to them, litigation is generally reserved for the most extreme cases that amount to fraud or self-dealing (while the definition of fraud is narrowly construed) and in which significant monetary compensation is expected at the end of the process.[69] They also mentioned that litigation might occur in cases where there are concerns over basic LP rights, such as incorrect fee calculations;[70] or where LPs feel a duty to recover funds for their clients, and the potential for monetary compensation is strong;[71] or where the GP's actions contravene LPs' clear instructions and warnings.[72]

We further examined these interview insights on the rarity of litigation in private equity by conducting a search of all state and federal lawsuits initiated in the past 40 years against the top and bottom 50 private equity firms, ranked by size in Private Equity International's Top 300 Private Equity list for 2024.[73] This review and comparison of results among the top and bottom 50 ranked firms were designed to ensure that our results regarding the rarity of litigation were not driven by the size of the private equity firm. A team of research assistants conducted a comprehensive search on Westlaw and Lexis databases to identify all cases in which these private equity firms were listed as defendants. A list of relevant cases with private equity defendants was compiled, highlighting those that involved investor or LP lawsuits against a private equity firm. The research assistants coded each case, noting the date of litigation, jurisdiction, and key features and creating a synopsis. Overall, our dataset consists of 153 lawsuits against these 100 private equity defendants spanning the last 40 years. The results of our investigation are described below.

First, as depicted in Figure 1, the number of cases brought each year against private equity firms has generally increased over time, with the highest number of cases—twelve—being brought in 2023. Cases brought against private equity firms involved a variety of claims, with the most common ones being breach of fiduciary duty claims (32 cases); fraud/misrepresentation (32 cases); and breach of contract/good faith obligations (29 cases).

Second, we observed substantially less litigation against small private equity firms. A total of 126 cases were brought against 34 top 50 firms, with an average of 3.76 cases brought against any firm that experienced litigation. In contrast, only 27 lawsuits were documented against 18 bottom 50 firms,

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[68] *See* Appendix I.

[69] Interview with Participant 14 (Apr. 30, 2024); Interview with Participant 15 (May 1, 2024).

[70] See also Amy Carroll, *Management Fees Cause Most LP-GP Conflict*, INFRASTRUCTURE INVESTOR (Feb. 3, 2020) ("Management fees are the biggest bone of contention for investors across the alternative asset classes").

[71] Interview with Participant 14 (Apr. 30, 2024).

[72] Interview with Participant 16 (May 10, 2024); Interview with Participant 17 (May 13, 2024) (LPs may sue GPs in cases of fee miscalculations, failure to liquidate assets timely, and disputes over key person provisions affecting fund management).

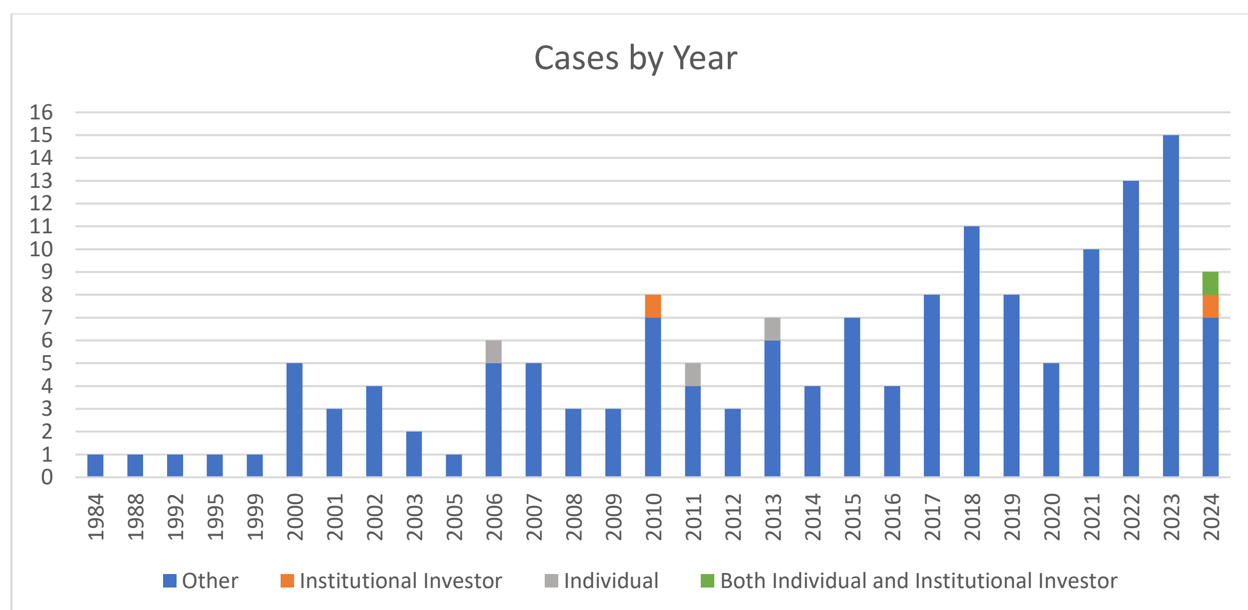
[73] *PEI 300: The World's Largest Private Equity Firms*, PRIV. EQUITY INT'L (June 3, 2024), https://www.privateequityinternational.com/pei-300/. The list was cross-referenced with other ranking platforms, confirming that the majority of the firms were consistent across sources.

with an average of 1.5 cases per firm. These results could be attributable to the fact that smaller firms engage in fewer activities or possess fewer resources from which a plaintiff can recover.[74]

Third, claims brought against private equity firms have a relatively low success rate, underscoring the inherent risks involved in pursuing such claims. Of the lawsuits brought against the top 50 firms, 61.4 percent were dismissed, as were 63 percent of the lawsuits against the bottom 50 firms when courts found insufficient grounds for claims to proceed; some of these also ended in summary judgments in favor of the defendants. In only 14 percent of the cases in our dataset were motions to dismiss denied, allowing plaintiffs to proceed with the litigation. These cases likely ended in settlements; however, public records are unclear as to the conclusions of the cases. Summary judgments for plaintiffs occurred in only 4 percent of cases.

Finally, and most importantly, the results of our investigation support the insight gleaned from the interviews that there is a stark lack of litigation involving the private equity industry. As Figure 1 shows, 96 percent of the lawsuits against private equity sponsors are filed by third parties that are not investors in the private equity firm. Only six lawsuits (4%) were brought by investors in private equity entities, and only three of them (2%) were brought by institutional investors. The other three cases were lawsuits with a plaintiff who was an individual or an investor in publicly traded entities. Lawsuits against publicly traded partnerships—such as Blackstone, KKR, and Carlyle—involve the same, routine plaintiff base as in stockholder litigation in public companies. Thus, individual shareholders with limited resources and no reputational concerns can bring them. The extremely low level of litigation involving LPs or other types of investors was even more pronounced for the bottom 50 firms, with *no* relevant cases found in this category.

Figure 1: Cases by Year and Investor Type



[74] Kobi Kastiel & Yaron Nili, *The Corporate Governance Gap*, 131 YALE L. J. 782, 820-21 (2022).

What type of claims have investors brought against private equity sponsors? In *City of Pittsburgh Comprehensive Municipal Trust Fund v. Conway*, a municipal pension trust fund sued the Carlyle Group on behalf of itself and all other similarly situated investors for breach of the obligation of good faith under the LPA. Specifically, the LP-plaintiff alleged that in Carlyle's conversion from a publicly traded partnership to a corporation, the investors made an unjustifiable payment of $344 million to the GP for its tax receivable agreement rights when those rights were economically worthless due to a lack of taxable income.[75] The case is still ongoing, but the court denied Carlyle's motion to dismiss in April of 2024, finding that the plaintiff had alleged sufficient facts that Carlyle had concealed information about the value of the rights from the fund's conflicts committee that had approved the transaction.

Another case filed by an individual plaintiff, *Gamoran v. Neuberger Berman, LLC*, involved several claims relating to investments in gambling operations, which resulted in financial losses. The court granted the private equity sponsor's motion to dismiss due to failure to comply with Delaware's demand requirement and failure to demonstrate why the special demand committee's refusal to pursue the claims due to insufficient evidence would not be protected by the business judgment rule. This case demonstrates the high threshold needed to overcome the deference given to private equity management. Similarly, two other cases were also brought by investors in publicly traded entities in the wake of the 2008 financial crisis. The plaintiffs argued that the private equity defendants failed to disclose material risks and adverse information about investments locked into the real estate market.[76]

To summarize, the interviews in our empirical investigation clearly show that there are almost no lawsuits involving LPs or other types of fund investors against private equity sponsors. Litigation in this sector is rare. Private equity sponsors have been subject to increased litigation activity in recent years, but the overwhelming majority of these lawsuits are filed not by private equity investors but by third parties. This finding applies to both large and small sponsors. Finally, the rare instances of LP litigation against GPs tend to involve publicly traded partnerships. In such cases, plaintiffs have greater access to information, and the presence of individual investors, who may be more inclined to initiate legal action, further contributes to the likelihood of any litigation.[77]

Similar to our findings, a study conducted by Atanasov et al., based on 245 lawsuits from 1975–2005, showed that LPs rarely file lawsuits against the GPs of venture capital firms (8.6 percent of the cases),[78] with many such lawsuits filed by entrepreneurs (16 percent), startup buyers (6.5 percent) or others (44.5 percent).[79] According to the authors, this trend might be explained by the fact that LPs typically have greater contractual protections compared to founders and, therefore, may have fewer grounds to pursue litigation.[80] Illig found that despite the breach of enforceable contracts during the financial crisis of 2008, private investment funds were rarely involved in litigation in the aftermath of the crisis.[81] Illig attributes the lack of litigation within the industry to the relational nature of contracts

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[75] *See* City of Pittsburgh Comprehensive Mun. Pension Tr. Fund v. Conway, No. 2022-0664-MTZ, 2024 WL 1752419, (Del. Ch. Apr. 24, 2024).

[76] In *Litwin v. Blackstone,* the Second Circuit ruled that the private equity sponsor reasonably expected downturns but omitted that information in its disclosure statement. In another case, *Charter Tp. of Clinton Police and Fire Retirement System v. KKR Financial Holdings LLC*, investors brought an action for failure to disclose material risks in a registration statement. In that case, the court granted KKR's motion to dismiss, ruling that the plaintiffs presented no evidence that KKR had knowledge that the assets were likely to drop in value.

[77] Interview with Participant 16 (May 10, 2024).

[78] *Does Reputation Limit Opportunistic Behavior in the VC Industry?*, *supra* note 64, at 2228–29.

[79] *Id.* at 2228.

[80] *Id.* at 2216-2217, 2219-2220.

[81] Illig, *supra* note 49, at 52.

and the central role of reputation among repeating players, suggesting that reliance on trust and long-term business relationships discourages investors from suing.[82] Our examination of the barriers to private litigation shows that the reality is more complex and nuanced.

B. Barriers to Private Litigation

What prevents LPs from suing private equity sponsors? We identified several legal and extra-legal obstacles and market practices that contribute to the rarity of litigation by investors in the private equity sector. These factors collectively create a landscape in which litigation is viewed as a last resort rather than as a standard procedure for resolving disputes. We divide these barriers into three main categories: contractual, organizational, and reputational. Below, we describe our methodology and address each of these categories.

1. Methodology

Private equity fund agreements are often considered a black box, given that fund documents are not publicly disclosed and that the industry's informal practices are not directly accessible to researchers. To overcome these informational limitations, we employed a mixed-method approach.

First, we obtained access to a sample of 62 limited partnership agreements (LPAs) pursuant to a confidentiality agreement for academic research.[83] These LPAs govern the relationship between LPs and GPs. For each LPA, we began by identifying the fund, the private equity sponsor, the sponsor's legal advisor, the date of the agreement, and the length of each agreement. We then read and hand-coded each LPA to identify all substantive litigation-related provisions, including mandatory arbitration, exculpation/indemnification, required books and record keeping, removal of the GP, and related party transactions and their approval provisions.[84] Such in-depth analysis of all litigation-related provisions in LPAs enables us to assess existing contractual barriers to litigation.

Second, we conducted 20 semi-structured qualitative interviews with senior investment officers at LPs and with leading legal counsels for GPs. All interview participants had first-hand experience with the interactions between GPs and LPs. The interviews thus provide important insights into the barriers to litigations and into how investors utilize alternative mechanisms for resolving disputes between them and GPs. A table describing the interviewees is presented in Appendix I. To identify interview subjects among sponsors, we approached law firms that are considered market leaders in the field. On the investor side, we contacted senior officers of asset managers who tend to invest as LPs. Interview participants were promised anonymity in order to encourage candid and detailed responses.[85] This assurance enabled us to gain access to market participants who might otherwise have been disinclined to participate.

The major shortcoming of the interview technique used is that it introduces bias into the sample selection. Arguably, participants' experiences are not necessarily representative of the industry. To mitigate potential bias in our sample, we ensured that all interview subjects had extensive experience, with a minimum of ten years. In addition, to obtain both investor and advisor perspectives, we included interview subjects from the investment side and those who advise private equity sponsors. Finally, it is important to stress that we did not rely on the interviews as our sole data source. Rather,

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[82] *Id.* at 69–75.

[83] For additional information, *see* Elisabeth de Fontenay & Yaron Nili, *Side Letter Governance*, 100 WASH. U. L. REV. 907, 941–42 (2023) [hereinafter *Side Letter Governance*].

[84] Our team of research assistants then randomly selected agreements and reviewed the coding, ensuring that no substantive provisions were missed.

[85] The authors retained copies of each interview transcript or detailed notes with personal information removed.

we supplemented the findings of the interviews with the results of recent investor surveys conducted by the Institutional Limited Partners Association (ILPA) and an extensive review of other publicly available sources. This mixed-method strategy enabled us to shed new light on the realities of dispute resolutions in the private equity sector and the role of reputation and extra-legal norms in this sector.

2. Contractual Barriers

To what extent do the contractual terms in LPAs complicate the process of filing a lawsuit against a GP? As explained above, to answer this question, we obtained access to a sample of 62 LPAs, analyzed all substantive litigation-related provisions, and corroborated our quantitative results with insights gleaned from the qualitative interviews we conducted. Our analysis below shows that LPAs' contractual provisions often set high barriers to taking action, making it cumbersome or economically unfeasible for LPs to pursue litigation.

Overview of the Agreements. The dates of the agreements ranged from 1989 to 2020, thus representing agreements from different periods. Not surprisingly, these agreements were detailed. The median length of each agreement was 58.5 pages. The vast majority of them (79.0 percent) were governed by Delaware law, despite the fact that the partnership's principal office was often located outside Delaware. New York and Massachusetts were the most common principal office locations, 25.8 percent and 19.4 percent of the sample, respectively. Only five LPAs (8 percent) were governed by a jurisdiction outside the U.S., such as the Cayman Islands.

Mandatory Arbitration. The inclusion of a clause mandating arbitration for dispute resolution is a major barrier to legal proceedings. When present, such clauses effectively close the doors of the courtroom to LPs.[86] Could the use of this provision explain the rarity of litigation between LPs and GPs?

We found that 11 of the 62 LPAs in our sample (18 percent) contained provisions mandating arbitration for all conflicts related to the LPA. This finding aligns with the observations of our interviewees, who noted that these clauses are not very common.[87] Eight additional LPAs (13 percent) required arbitration for a specific and limited purpose (valuation of securities, extension of the partnership, or removal of the GP). Overall, this evidence indicates that mandatory arbitration alone does not fully account for the infrequency of litigation between LPs and GPs.

Indemnification and exculpation provisions. Indemnification and exculpation clauses are another topic that repeatedly emerged in our interviews. As one interviewee explained, these provisions are quite common in LPAs and typically grant a highly favorable position to GPs.[88]

Indeed, all of the LPAs in our sample included similar exculpation and indemnification provisions. A typical provision stipulates that for any actions arising out of the partnership, GPs and their agents will not be liable to the partnership or the LPs and that they can be indemnified for any liabilities and expenses to which they are subject because of their role in the partnership. Reimbursement of legal expenses throughout proceedings is generally permitted, and the sponsor is obligated to repay the costs to the fund only if a *final judgment* determines that the GP is not entitled to indemnification. Only a minority of the LPAs (8 percent) did not permit expenses reimbursement if LPs brought the claim.

[86] Interview with Participant 14 (Apr. 30, 2024).
[87] Interview with Participant 15 (May 1, 2024); Interview with Participant 16 (May 10, 2024).
[88] Interview with Participant 15 (May 1, 2024).

These commonly used clauses create a situation where any compensation obtained through legal action would ultimately be paid by the partnership itself. As one interviewee noted, LPs may find themselves in the paradoxical position of having to indemnify the GPs for claims that the LPs themselves initiate and settle, which starkly discourages them from pursuing legal action.[89]

There are some limitations on the actions that can be exculpated and indemnified. Generally, the GPs' actions must be taken in good faith and with a reasonable belief that they were acting in the best interests of the partnership. Most LPAs specifically mentioned that the protections do not extend to any conduct found to be gross negligence, willful misconduct, or fraud. However, the exculpation and indemnification provisions often extended to actions taken on reliance on counsel or other experts in good faith (37 percent). This safe harbor provision, if satisfied, further protects the GP from litigation.

The recent *Carlyle* case illuminates the use of such safe harbor provisions.[90] In that case, which is the sole case of LP-GP litigation in our sample, an LP claimed that the GP breached its duty to act in good faith as stipulated in the LPA. In response, the GP invoked two primary safe harbor protections: a conclusive good faith presumption, first, when the LPAC approved the transaction,[91] and second, when the GP relied on advice from an advisor. According to the court, the provision of good faith also involved a high threshold of *subjective* good faith. Ultimately, these defenses did not prevail in the GP's favor due to the case's unique circumstances: Carlyle was a publicly traded entity, and the plaintiff successfully sought and obtained books and records, demonstrating that critical information was concealed from the members of the LPAC. Nevertheless, these safe harbor provisions serve as straightforward cleansing mechanisms, creating substantial barriers to litigation.

Limited Access to Information. Another reason our interviewees cited for their limited use of litigation is the need to gather considerable information to build a case. LPs are at an inherent informational disadvantage compared to GPs. GPs manage the investments and control the flow of information to LPs. In cases of GP failures, the way the situation is portrayed to investors can be manipulated to favor the GPs. This information gap makes it difficult for LPs even to ascertain whether the factual circumstances would provide a valid legal claim.[92]

All of the LPAs in our sample contained a standard provision mandating that the GPs maintain accurate books and records and make them available for inspection by LPs during regular business hours. These provisions, however, do not seem to provide LPs with sufficient access to information that could support a potential lawsuit against the GPs. Some agreements also contained a provision allowing GPs to keep information confidential from LPs if the GPs reasonably believe disclosure not to be in the best interest of the partnership.

One interviewee also criticized the SEC's preferential treatment rule. This rule prohibits all sponsors—whether or not they are registered with the SEC—from providing preferential treatment to an investor with respect to several rights, including access to information that the sponsor reasonably expects would have a material, adverse effect on other investors.[93] It was argued that such a rule inhibits larger, resource-rich LPs from negotiating individual information rights that would enhance investors' ability to monitor the GPs to the benefit of all other LPs.

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[89] *Id.*

[90] *See supra* note 75, at *1–2, 17.

[91] *Id. See also* Interview with Participant 16 (May 10, 2024); Interview with Participant 18 (May 20, 2024).

[92] Interview with Participant 14 (April 30, 2024); Interview with Participant 18 (May 20, 2024).

[93] *Private Fund Advisers*, U.S. SECS. & EXCH. COMM'N, https://www.sec.gov/investment/private-fund-advisers (last updated Oct. 31, 2024).

Ultimately, unlike the public market, where Delaware courts have developed extensive disclosure duties over the years and where one can request books and records in court, one interviewee explained that the private equity market lacks significant disclosure obligations. This situation places LPs at a disadvantage in terms of information compared to investors in public companies. Generally, LPs have access only to the information that the GP *chooses* to share with them.[94] This asymmetry makes it challenging for LPs to detect when a breach by the GP has occurred and to demonstrate in court that any such breaches have happened.

Related Party Transactions. Related-party transactions (RPTs) are a major trigger for litigation in public companies. In the private equity context, the extent to which LPs can prevent RPTs from occurring or substantiate a claim related to RPTs depends on the terms of the LPA.

Of the 62 LPAs analyzed, only seven agreements (11%) did not have any limitations on RPTs. Of the other 55 LPAs, the requirements for entering into RPTs varied. They generally followed four main types: blanket prohibition of RPTs with some exceptions (2 percent); blanket authorization of RPTs if they are an arm's length transaction with a fair price comparable with similar transactions (6 percent); authorization with the approval of the LPAC (45 percent); or authorization with a majority vote of the LPs (6%) or the approval of an investment banker (2 percent).

This finding leads to two main conclusions. First, in the vast majority of cases, GPs can initiate RTPs without the approval of the majority of the LPs—even over their objections. Second, LPs are likely to face significant challenges when attempting to challenge such an action in court. Many LPAs in our sample contained a safe harbor provision in the form of a conclusive good faith presumption when the LPAC approves the transaction.[95]

In the context of public companies, RPTs are subject to the deferential business judgment rule only if the transaction is approved by both a special committee of independent directors and an informed majority of the non-conflicted public shareholders.[96] However, in the private equity sector, a GP can benefit from the deferential standard of review by seeking the approval of a select group of three to five investors, whom the GP appoints to sit on the LPAC and who maintain ongoing relationships with the GP. Such a safe harbor provision effectively serves as a straightforward cleansing mechanism, creating significant barriers to litigation.[97]

GP Removal. Another important contractual provision is the removal provision, which governs investors' ability to remove the GPs. When dissatisfied with the management of their funds, investors can threaten to exercise their voting rights and vote in favor of removing GPs from their position. While this provision is not directly related to the ability to sue, an effective right to remove the GP provides investors with a better ability to enforce their other rights.

In the private equity context, where the structure typically involves a ten-year fund cycle, the option of GP removal during this period is very limited.[98] Only 12 out of 62 LPAs in our sample (19 percent) allowed LPs to remove GPs for any reason ("Removal Without Cause"), and such action required a high threshold—a 66 percent or 75 percent approval rate among LPs to issue a removal

[94] Interview with Participant 15 (May 1, 2024).

[95] *See also* Interview with Participant 16 (May 10, 2024); Interview with Participant 18 (May 20, 2024).

[96] Kahn v. M&F Worldwide Corp., 88 A.3d 635, 638 (Del. 2014).

[97] A plaintiff could rebut such presumption when showing a flaw in the LPAC approval process. In *Carlyle*, the plaintiff showed that critical information was concealed from the members of the LPAC. *See supra* notes 90–91 and accompanying text. *Carlyle*, however, involved a publicly traded entity and plaintiff was able to significant information through books and records. In the typical scenario, LPs have limited access to the information. *See supra* notes 201–76 and accompanying text.

[98] Interview with Participant 14 (Apr. 30, 2024).

notice. Our interviewees indicated that obtaining such a high percentage of LP consent for GP removal is highly unlikely to be achieved.[99]

Most LPAs in our sample included "Removal For Cause": Seventeen agreements (27 percent) allowed removal of the GP only in the event that the GP materially breached the agreement; twelve agreements (19 percent) permitted removal of the GP only upon a final court determination that the GP committed specified crimes, including fraud, embezzlement, and felonies involving the misappropriation of funds; and six agreements (10 percent) provided for GP removal in the event that the partnership was dissolved or filed for bankruptcy. Thus, the ability of LPs to remove the GP was minimal.

Provisions Favoring the GP. Our interviews also revealed that the enforcement of LPAs is markedly asymmetrical, heavily favoring GPs. For example, if LPs fail to meet capital calls (which is their primary obligation), the consequences are immediate and severe, enforced directly by GPs without any need for legal proceedings. GPs have the discretion to declare an LP in default, leading to drastic measures, such as the seizure of previous contributions or the imposition of liens on existing capital accounts.[100]

Overall, our analysis shows how litigation-related contractual terms in LPAs tend to be biased in favor of the GPs, making it difficult for LPs to sue. This conclusion, however, deserves a few additional clarifications. *First*, since many of the LPAs in our sample are not from the last decade, one could argue that the picture we portray in this Section is outdated and that more recent contractual terms provide more substantial protection to investors. This argument, however, does not align with the concerns that investors expressed in our interviews regarding the GP-bias of contractual terms in recent LPAs. It is also not in line with survey data collected by ILPA between 2020 and 2022 from a diverse group of LPs. The ILPA survey, which examines issues such as bargaining power, structuring contractual terms, and concentration in the industry,[101] found that LPs face significant challenges when negotiating with GPs. Even though LPs are typically sophisticated and knowledgeable investors, only a small fraction of them (8 percent) manage to negotiate favorable changes in the terms of the LPAs,[102] and over the last three years, 87 percent of the LPs report that final LPA terms have shifted in favor of the GPs.[103] According to the ILPA, this is mainly because of the LPA negotiation structure, in which GPs and their external counsel write the draft of the LPA, thereby allowing them to establish a GP-favorable framework.[104]

Second, it is worth asking whether the terms of the LPAs matter at all, given that trust and long-term business relationships may cause investors to refrain from suing if they had enforceable claims.[105] We believe that contractual terms matter. Not only do GP-favorable terms make it more difficult to

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[99] According to a model LPA published by the ILPA, which can be assumed to be LP-friendly, "Removal Without Cause" requires a 75% approval rate among LPs. THE ILPA MODEL LTD. P'SHIP AGREEMENT § 10.1 (INSTITUTIONAL LTD. PARTNERS ASSOC. 2020), https://ilpa.org/wp-content/uploads/2020/07/ILPA-Model-Limited-Partnership-Agreement-WOF.pdf.

[100] Interview with Participant 15 (May 1, 2024).

[101] *See* ILPA, ILPA PRIVATE FUND ADVISERS DATA PACKET 4 (2023), https://ilpa.org/wp-content/uploads/2023/03/ILPA-Private-Fund-Advisers-Data-Packet-March-2023-Final.pdf

[102] *Id.* at 8 (noting that 65% of LPs indicate that their expertise does not translate into effective negotiating power, with only 8% finding success in influencing terms positively).

[103] *Id.* at 9.

[104] *Id.* ("[t]his highlights how the structure of the LPA negotiating process itself contributes to fund terms shifting meaningfully in favor of the GP over the last decade—GP and GP external counsel write the first draft of the LPA, which serves as the contractual starting point before negotiations even begin.").

[105] Illig*, supra* note 49, at 69–75.

sue, but all non-formal interactions are conducted in the *shadow* of the contractual terms. In the presence of investor-friendly contractual terms, investors could threaten to sue or remove the GP without cause and use that leverage to receive informal benefits (even if they have no intention to take the GP to court).

Finally, it can reasonably be argued that LPs can bargain for more favorable terms that could remove some of the contractual barriers to litigation. If they avoid doing so and accept GP-friendly terms, it can be inferred that formal contractual protections are less important to LPs or that they trade them for better financial terms. We cannot rebut the argument that the LPs do not price GP-friendly terms, but our interviews and the ILPA's survey clearly indicate that litigation-related terms are important to LPs. For example, the ILPA's survey shows that in both 2020 and 2022, fiduciary duty provisions ranked as the second highest "must-have" term for LPs.[106] However, fiduciary duty has also seen the most significant shift toward GP-favorable terms at the start of LPA negotiations,[107] with many LPs reporting reduced fiduciary duties across a substantial portion of their investments.[108] LPs also relate that it has become increasingly difficult to restore or improve fiduciary duties in most of their funds,[109] even though this is a top priority in negotiations.[110] The survey indicates these difficulties arise frequently, particularly when LPs' investment amounts are lower, further limiting the leverage of smaller LPs.[111]

In the last Part of this article, we will turn to the question of why, despite these reported challenges in the negotiation process, LPs frequently choose to invest in private equity even when they are not satisfied with the LPA terms. For the purpose of this Section, however, we take the prevailing existing terms as a given and show how they limit litigation against GPs. Contractual barriers, however, do not tell the whole story, as there are also institutional and reputational barriers, which we turn to discuss now.

3. Institutional Constraints

Our interviewees also mentioned that the high costs of litigation deter them from initiating legal proceedings. Not only are the monetary costs significant, but litigation also diverts attention from managing other investments.[112] According to them, the amount at stake in the average LP-GP relationship is not large enough to justify the burden of what likely would be extremely costly litigation.[113] Moreover, our interviewees stated that many LPAs require a final judgment before any financial recovery from the GP can be made,[114] which prolongs the time and resources invested in the legal process.

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[106] ILPA, *supra* note 101, at 20 (43% of surveyed LPs said fiduciary duties is a "must-have' in negotiations in 2022, up from just 37% in 2020).

[107] *Id.* ("fiduciary duties represent the single greatest shift in terms that favor the GP as a starting point in LPA negotiations over the last three years, according to 59% of LPs").

[108] *Id.* at 42–43 (noting that 63% of LPs in 2020 reported reduced fiduciary duties in over half of their investments, and that this figure improved slightly to 48% in 2021—a still significant number).

[109] *Id.* at 38–39 (finding that only 34% of LPs in 2020 were able to restore or improve fiduciary duties in over half of their funds, and that this number dropped to 26% in 2021, with nearly 20% unable to restore and 23% unable to improve fiduciary duties).

[110] *Id.* at 39.

[111] *Id.* at 40 ("LPs making a <$100M investment are not able to restore or improve fiduciary duties in more than half their funds 75% of the time.")

[112] Interview with Participant 14 (Apr. 30, 2024); Interview with Participant 18 (May 20, 2024); Interview with Participant 20 (June 11, 2024).

[113] Interview with Participant 15 (May 1, 2024).

[114] Interview with Participant 14 (Apr. 30, 2024).

However, while many of these features are widespread across all sectors, not just private equity, public companies still experience substantial litigation. If small investors in public companies are willing to assume the risks and costs of litigation, often relying on specialized plaintiff lawyers to manage their cases, why do large, resource-rich institutional investors not do the same in private equity funds?

At least on its face, such large institutional players are usually well-equipped to handle such costly and protracted legal disputes. Moreover, since LPs often make multiple private equity investments at the same time and are pure repeat players, they have a clear interest in sending a message to the market, even if pursuing litigation through a final judgment will not be beneficial in the specific case.

Interviewees, however, explained that LPs often do not have the institutional capacity to pursue litigation, which, as mentioned above, not only takes time and resources but serves as a distraction and prevents them from managing other investments. For example, pursuing litigation entails disclosure of internal documents, depositions, and endless calls with lawyers. Due to the institutional structure of LPs, many of these actions require internal approvals and coordination, which could further complicate the process. As one interviewee summarized: "That's not what our team wants to spend their time doing."[115]

If pursuing litigation against the GP was beneficial overall, either because the expected benefits from a specific claim outweighed the costs or because of its overall positive impact on other LP investments, the LP could theoretically outsource the litigation to specialized plaintiff lawyers to pursue valuable claims. However, unlike public equity markets, where most shareholder lawsuits are class or derivative actions with hefty fees awarded, the financial benefits in the context of LP-GP litigation are not entirely clear. Moreover, the costs of time and distraction may be reduced but remain high, considering the fact that the LP may still need to provide discovery material and deal with other litigation-related tasks.

4. Reputational Constraints

Finally, and most importantly, our interviewees highlighted the desire to maintain a positive relationship with GPs as another reason why LPs infrequently engage in litigation. In fact, most interviewees identified this as *the main* reason for the lack of LP-GP litigation.[116] Investors' primary concern is the potential damage to their future allocation opportunities with GPs, particularly top-tier GPs. According to our interviewees, no LP wants the *bad reputation* of taking GPs to court.[117]

Additionally, investors know that initiating legal action may jeopardize their ability to maintain open lines of communication with GPs in the future.[118] As one of our interviewees described, litigation makes communication more guarded and defensive.[119] Preserving an unobstructed channel for dialogue and influence is often seen as more valuable than litigating disputes.

[115] Interview with Participant 20 (June 11, 2024).

[116] Interview with Participant 16 (May 10, 2024).

[117] Interview with Participant 7 (Jan. 27, 2023); Interview with Participant 8 (Jan. 27, 2023); Interview with Participant 15 (May 1, 2024); Interview with Participant 16 (May 10, 2024); Interview with Participant 17 (May 13, 2024); Interview with Participant 18 (May 20, 2024); Interview with Participant 19 (Sept. 6, 2024); Interview with Participant 20 (June 11, 2024). Similar tension exists in other commercial contexts, such as managerial contracts. *See Managerial Contracting, supra* note 61, at 187 ("[s]uppliers are often judgment proof, buyers want to avoid gaining a reputation for suing their suppliers").

[118] Interview with Participant 20 (June 11, 2024) (noting that for an LP to sue a GP, "the relationship [must] ha[ve] really gone south," meaning that the LP "probably wr[ote] down the assets to zero or close to zero").

[119] Interview with Participant 14 (Apr. 30, 2024).

Thus far, we have focused on the reputational considerations of the LPs. An additional barrier to litigation involves the reputational concerns of the *investment professionals* who manage the LPs' assets and their legal advisors. Turning to litigation could signal their own professional shortcomings, such as insufficient diligence or a failure to ask critical questions. Such messages could tarnish their professional reputation and highlight their role in the oversight that necessitated legal action. In these cases, litigation might expose asset managers to reputational risks, potentially harming their career prospects. Also, concerns over maintaining relationships with key market players may dissuade them from pursuing litigation. Instead, they may prefer to resolve issues informally to avoid the negative repercussions of public disputes.

Additionally, there is an incentive misalignment, as LP asset managers do not directly benefit from the outcomes of litigation. This agency problem further reduces their motivation to pursue legal action, as the benefits are disproportionately small compared to the effort and resources required to achieve a final judgment.

The factors above—LPs' reputational concerns and professional asset managers' personal reputational considerations—tie directly into the *composition of investors* within the private equity sector. Unlike public markets, where small investors often initiate litigation and specialized plaintiff lawyers lead litigation, private equity typically lacks small, individual investors and is dominated by institutional and accredited investors. The absence of these individual investors, who are free from reputational considerations and the need to maintain long-term relationships with the companies they invest in, may further explain the scarcity of litigation in the private equity sector.

III. Alternative Mechanisms and Extralegal Relations in Private Equity

The fact that LPs rarely use litigation to deter GPs or obtain compensation for inappropriate behavior does not imply a lack of alternative mechanisms for enforcement of their rights. Our interviewees highlighted several alternative mechanisms that LPs prefer over litigation. These include informal settlements directly negotiated with GPs, refraining from reinvesting with problematic GPs ("voting with their feet"),[120] and reporting concerns to public regulators, such as the SEC, potentially triggering public enforcement actions. Additionally, the role of reputation and the importance of repeat relationships in private equity often negate the need for formal enforcement altogether. This Part explores these alternative mechanisms.

A. Alternative Enforcement Mechanisms

Litigation is only one of many ways through which disagreements, disputes, or dissatisfaction are resolved.[121] That said, the private equity sphere provides a unique ecosystem where disagreements between LPs and GPs are often managed through extralegal or alternative means described below.

1. Private Settlements

Both GPs and LPs often prefer to resolve conflicts privately, behind closed doors, to prevent reputational damage.[122] One interviewee emphasized that when LPs perceive problematic behaviors

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[120] According to some interviewees, this is often the most practical option. *See* Interview with Participant 11 (Apr. 10, 2023); Interview with Participant 15 (May 1, 2024); Interview with Participant 19 (Sept. 6, 2024).

[121] *See infra* notes 171–55 and accompanying text.

[122] Claire C. Smith, *Are Legal Disputes Looming for Private Equity?*, PRIV. EQUITY INT'L (Apr. 1, 2020) ("Most falling out between funders or between GPs and LPs happens below the radar and is resolved behind closed doors"; "our survey shows that the majority of investors continue to handle this matter internally."), https://www.privateequityinternational.com/are-legal-disputes-looming-for-private-equity/. *See also* Interview with

by GPs, LPs can be compensated by the GPs in various ways, such as fee discounts or co-investment opportunities in future funds managed by the same GP.[123]

In public markets, tailoring arrangements for specific shareholders and providing them with preferential treatment is challenging. However, in private equity funds, GPs can grant advantages to their most important LPs. The nature of recurring relationships in the private equity sector facilitates this capability. Recent empirical research further supports the notion that GPs provide benefits to favored investors through better future allocations and fee discounts.[124] The provision of these discriminatory benefits both serves as an *ex post* mechanism for dispute resolution—compensating aggrieved investors—and creates an *ex ante* negative externality for other LPs. Essentially, this practice creates a divide between the financial and governance rights of specific large LPs, rendering them indifferent to GP behaviors that may negatively impact the remaining LPs.[125]

2. Collaboration among LPs

Collaboration among LPs offers another avenue for advancing their interests against GPs in instances of inappropriate behavior or to preemptively discourage such behavior. Specifically, mechanisms like LPACs and the ILPA exist to facilitate collective action in the private equity industry.[126] However, our interviewees indicated that these mechanisms often do not play as significant a role as might be expected.

*LPAC*s. The LPAC is a committee consisting of a small number of representatives of LPs, and its responsibilities and authority are defined in the LPA.[127] The most common functions of an LPAC involve reviewing and resolving any conflict of interest or non-arm's-length transactions in advance and waiving certain restrictions in the LPA as necessary.[128] The LPAC can also advise the GPs on any other matters brought to it by the GPs.[129] The LPAC meets regularly with the GPs and receives access to information that other investors may not receive—allowing those representatives to better understand the GPs' actions and overall performance. While regulators, such as the SEC, do not mandate the use of LPACs,[130] they have become fixtures of private equity funds, with 95 percent of funds having one.[131] Most LPACs include the largest LPs in the fund[132] or LPs with longstanding relationships with the GPs.[133]

Participant 9 (Jan. 30, 2023) (noting how GPs take LPs' dissatisfaction into account when making management decisions); Interview with Participant 11 (Apr. 10, 2023).

[123] Interview with Participant 5 (Feb. 6, 2020); Interview with Participant 14 (Apr. 30, 2024).

[124] *See* Juliane Begenau & Emil N. Siriwardane, *Fee Variation in Private Equity*, 79 J. FIN. 1199, 1206–07, 1225–32 (2024); Josh Lerner et al., *Investing Outside the Box: Evidence from Alternative Vehicles in Private Equity*, 143 J. FIN. ECON. 359, 370–75 (2022).

[125] *Side Letter Governance*, *supra* note 83, at 933–35.

[126] *See* Interview with Participant 5 (Feb. 6, 2023).

[127] Robert Seber, *LPAC by Design: Six Recommendations for GPs to Define LPAC Features During Fund Formation,* PRIV. EQUITY L. REP. (Feb. 25, 2020), https://media.velaw.com/wp-content/uploads/2020/03/02120713/PELR_LPAC-by-Design-Six-Rec.pdf.

[128] *Id.*

[129] *Id.*

[130] Claire Wilson, *The Power of the LPAC*, PRIV. FUNDS CFO (Nov. 16, 2017), https://www.privatefundscfo.com/committed-capital/.

[131] Seber, *supra* note 127.

[132] In a recent survey, most GPs admitted that they select LPs to the LPAC by the size of their allocation with more than 10% of the fund serving as a practical guarantee. *See Private Equity Fund Governance*, VISTRA (2017), https://www.acg.org/sites/files/Vistra%20Private%20Equity%20Research.pdf.

[133] Wilson, *supra* note 130.

In theory, the LPAC serves as a crucial mechanism for LPs to oversee GPs' actions and potentially preclude the need for litigation. The rationale is that appointing the largest investors to the LPAC could facilitate decision-making that benefits all LPs due to the larger LPs' significant stake in the fund's success. Larger LPs also often have their own investment groups and in-house counsel—enabling them to scrutinize and evaluate the GPs more effectively. Although some of our interviewees believe that LPACs play a significant role in overseeing GPs and described instances from their experience when LPACs effectively challenged GP decisions,[134] most of them presented a more nuanced view.

They described, for example, how major investors often sit on numerous LPACs, which limits their ability to dedicate sufficient time and resources to each LPAC vote, thereby undermining effective oversight. In this regard, our interviewees confirmed that the decision-making process within the LPAC is far less structured than in corporate boardrooms.

Additionally, because LPAC members are selected by the GPs and maintain ongoing relationships with them, they may have an inherent reluctance to challenge the GPs—a dynamic that may be suboptimal for ensuring robust governance.[135] Our interviewees also emphasized that the information presented to the LPAC is often controlled and filtered by the GPs and is frequently incomplete.[136] It is also important to note that LPAC members are not fiduciaries to the LPs; instead, they owe fiduciary duties to their own end investors and represent their own interests, which can sometimes diverge from those of other LPs.[137]

Lastly, as previously mentioned, an LPAC's approval often provides the GPs with a legal shield against court challenges to the approved actions under the terms of the LPA.[138] Given the challenges associated with LPAC approvals, there is a risk that certain GP actions involving conflicts of interest might be immunized against lawsuits, even when such immunity may not be justifiable.

ILPA. The ILPA represents the interests of institutional investors in the private equity market and advocates for improved transparency, governance, and alignment of interests between LPs and GPs.[139] Theoretically, it offers smaller LPs a platform to unite and overcome their collective action problems, thereby enhancing their bargaining power relative to GPs.

However, our interviewees noted that in practice, the ILPA primarily focuses on promoting *general policy changes* within the market rather than intervening in *specific cases* of GP breaches. This approach reflects the ILPA's broader role in shaping industry standards and practices rather than engaging directly in individual disputes between LPs and GPs.[140] This distinction highlights the limitations of the ILPA as a tool for individual LPs seeking redress in specific instances of misconduct by GPs.

While LPACs and the ILPA may not resolve individual disputes, our interviews highlight their role—as well as that of other collaborative organizations (such as the Asian American Insurance Network—AAIN)—as platforms for *exchanging information* about GPs' past and current practices,

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[134] Interview with Participant 5 (Feb. 6, 2023); Interview with Participant 14 (Apr. 30, 2024); Interview with Participant 16 (May 10, 2024).

[135] Interview with Participant 7 (Jan. 27, 2023); Interview with Participant 8 (Jan. 27, 2023).

[136] Interview with Participant 6 (Jan. 18, 2023).

[137] *See* Kastiel & Nili, *supra* note 33, at 1641–45; *see also* Interview with Participant 5 (Feb. 6, 2023); Interview with Participant 6 (Jan. 18, 2023).

[138] *See supra* notes 92–94 and accompanying text; Interview with Participant 9 (Jan. 30, 2023).

[139] INSTITUTIONAL LTD. PARTNERS ASSOC., https://ilpa.org (last visited Jan. 26, 2025).

[140] Interview with Participant 17 (May 13, 2024); *see also* Interview with Participant 5 (Feb. 6, 2023).

which enable investors to make more informed investments.[141] Also, our interviewees noted that after exchanging information among themselves, LPs sometimes approach the GPs—such as through separate phone calls—and this individual but informed approach can motivate the GPs to take corrective actions.[142] However, one interviewee highlighted a significant challenge when acting alone: a lone LP who raises concerns might be told by the GPs that "you're the only investor raising this as an issue." This situation places the LP in a weak position, especially when it is difficult to verify this claim due to limited contact with other investors.[143]

3. Public Enforcement

a. SEC Enforcement

Public enforcement serves as an external check on GPs. Our interviews indicated that anonymous whistleblowing to the SEC is an increasingly common mechanism among LPs, allowing them to trigger investigations and potential enforcement actions without exposing their identities.[144] As our interviewees described, this avenue can save LPs from direct confrontations with GPs, which could damage future allocation opportunities or tarnish the LPs' reputations in the market, leading them to be seen as "troublesome." Moreover, turning to public enforcement can mitigate the legal costs associated with litigation and overcome some of the legal barriers posed by the LPA. Our interviewees also noted that ongoing SEC proceedings against a specific GP can help LPs overcome information asymmetries regarding GPs' past problematic conduct, thus influencing GPs' investment decisions.[145] LPs consider the active involvement of regulatory bodies in the private equity market crucial.[146]

For example, in a relatively well-known enforcement action, the SEC found that KKR had not adequately disclosed to LPs its "broken deal expense" allocation practices or how the firm allocated costs associated with unsuccessful transactions. The SEC subsequently ordered KKR to disgorge over eighteen million dollars to the harmed partnership and ordered KKR to pay ten million dollars to the SEC as a civil monetary penalty.[147] In another action, which resulted in almost thirty-nine million dollars of penalties, the SEC found that Blackstone had breached its fiduciary duties to LPs through conflicts of interest. Blackston had negotiated a legal fee arrangement in which it received a heavy discount, but its funds and their LPs did not. Blackstone subsequently overcharged LPs for monitoring fees, sometimes even when Blackstone no longer provided monitoring services.[148] In the case of the Abraaj Group, once a prominent $14 billion private equity firm that collapsed in 2018, the SEC filed a civil lawsuit against the firm and its founder, alleging fraud and the misappropriation of over $230 million.[149]

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[141] Interview with Participant 14 (Apr. 30, 2024).
[142] Interview with Participant 17 (May 13, 2024).
[143] *Id.*; Interview with Participant 19 (Sept. 6, 2024).
[144] Interview with Participant 14 (Apr. 30, 2024); Interview with Participant 15 (May 1, 2024).
[145] *Id.*
[146] *But see* Interview with Participant 4 (Jan. 27, 2023) ("The [SEC] does not need to protect sophisticated players who have all the relevant representation. With all due respect, investors can protect themselves.").
[147] Kohlberg Kravis Roberts & Co., Investment Advisers Act Release No. 4131 (June 29, 2015).
[148] Blackstone Mgmt. Partners, Investment Advisers Act Release No. 4219 (Oct. 7, 2015).
[149] *See* Smith, *supra* note 122. In another example, the SEC took action against American Infrastructure Funds LLC for improperly transferring an asset from older funds to a new fund they advised without adequately disclosing conflicts

Although it is not known whether LP complaints triggered the SEC's actions, these cases illustrate how SEC interventions can protect LPs' interests by ensuring adherence to contractual duties. While anecdotal evidence about the use of SEC enforcement as a substitute for private enforcement surfaced through our qualitative work, this Section also provides hand-collected data on SEC enforcement against private equity sponsors.

In particular, we examined enforcement actions by the SEC against private equity sponsors and their affiliates from 1995 to 2024, focusing on the world's 150 largest private equity firms ("Top 150").[150] The dataset was compiled from releases issued through the SEC's Administrative Proceedings.[151] To compare these firms' regulatory violations with those of smaller private equity firms and advisors ("Other Firms"), research assistants also collected data on those other relevant SEC proceedings from 2013 to 2024 from lists compiled by the Proskauer Asset Management Litigation Team[152] and Professor Joseph Grundfest's comment letter to the SEC Secretary.[153] For each case, research assistants coded relevant details, such as the date of the release, cause of action, penalty levied, disgorgement and prejudgment interest, imposition of undertakings, and relevant statutory or regulatory violations.

Our sample consists of 74 cases—seventeen SEC enforcement actions against the Top 150 and an additional fifty-seven cases against Other Firms. Each case might be subject to multiple violations of the s Act.

A few key observations are evident from the data. *First*, amongst the Top 150, larger private equity sponsors received greater SEC attention. Only one enforcement action was initiated against firms in the bottom third of the Top 150 list. Regulators are encouraged to focus on these firms either because these cases are more likely to be the subject of news headlines, thereby providing their enforcement efforts with more exposure, or because the size of compensation expected from enforcement justifies the effort.[154]

Second, as demonstrated in Figure 2 below, most of the SEC enforcement actions in our sample focused on procedural violations, such as failure to adopt and implement written compliance policies and procedures to prevent the violation of the Investment Advisers Act of 1940 (47 cases)[155] and

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of interest, securing LP consent, or providing an opportunity for LPs to exit their investment. *See SEC Charges Private Equity Fund Advisor American Infrastructure Funds for Breaching its Duties*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/news/press-release/2023-193 (last updated Sept. 22, 2023).

[150] Information on the Top 150 was obtained from Private Equity International's annual PEI 300 ranking. *PEI 300: The world's largest private equity firms*, PRIV. EQUITY INT'L (June 3, 2024), https://www.privateequityinternational.com/pei-300/#pei-300-full-ranking.

[151] *Administrative Proceedings*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/enforcement-litigation/administrative-proceedings (last visited Sept. 22, 2024). The data was compiled using Westlaw. On the left hand side of the search bar, select "SEC Releases," then enter search term "advanced: "private equity fund" & DA(aft 05-26-2019)".

[152] Proskauer Asset Mgmt. Litig. Team, *Recent Resolutions of SEC Enforcement Actions Against Private Equity Advisors*, PROSKAUER ROSE (July 22, 2019), https://www.privateequitylitigation.com/wp-content/uploads/sites/65/2019/07/SEC-Private-Equity-Enforcement-Actions-7.22.19.pdf.

[153] Comment Letter from Joseph A. Grundfest, Professor of L. & Bus. at Stan. L. Sch, to Venessa A. Countryman, Sec'y, U.S. SEC. & EXCH. COMM'N (Apr. 22, 2022).

[154] Kastiel & Nili, *supra* note 74, at 818-20.

[155] *See, e.g.*, Platinum Equity Advisors, LLC, Investment Advisers Act Release No. 4772 (Sept. 21, 2017) (finding that "Platinum did not adopt and implement a written compliance policy or procedure governing its broken deal expense

inadequate disclosures (58 cases).[156] These procedural violations are recurring and tend to be easier to detect and prove. However, many of these violations also involved breaches of fiduciary duties stemming from conflicts of interest, or improper expense and fee allocations, all of which directly affect LPs.[157] This pattern suggests that GPs do not always self-regulate effectively based on reputational concerns. Therefore, these findings contradict the hypothesis that LPs avoid litigation only because GPs have strong reputational incentives not to engage in misconduct. *Third*, data on the Other Firms demonstrates that *individual advisors* were also named as respondents in 22 actions (out of 57 cases). In one instance, the SEC ordered an individual advisor to pay $160,000 in civil monetary penalties after it determined that he had significantly inflated the amount of assets he and his firm had under management and had lied about the amount of committed capital in certain funds he managed in order to induce investors to invest.[158] In this case—and usually when an individual is named—the SEC, along with any monetary penalties, bars the individual advisor from association with any investment advisor.[159] This type of sanction is rarely available in private enforcement.[160]

Fourth, the penalties levied on violators were nominally significant but potentially immaterial for the largest sponsors in our sample. The Top 150 firms in our sample paid an average of approximately $8.36 million in disgorgement (including prejudgment interest) to compensate the funds and their LPs that invested in private equity transactions. Additionally, these firms, on average, paid $4.56 million in civil penalties to the SEC. For all Other Firms, the average disgorgement was about $11.15 million, and the average civil penalty was around $2.53 million. We excluded from the data on small firms the Och-Ziff case, an outlier that involved a disgorgement amount of $201 million resulting from particularly egregious actions.[161] Overall, this data, and in particular the Och-Ziff case, show that smaller firms still face significant penalties, highlighting that regulatory scrutiny is applied across the industry.

Finally, since successful enforcement actions represent only a partial picture of the SEC enforcement effort, we also analyzed proprietary data on all closed SEC investigations between January 1, 2000, and July 6, 2020, from Holzman et al. (2024). They obtained the SEC investigation data through Freedom of Information Act (FOIA) requests and graciously shared that information

allocation practices"); Glob. Infrastructure Mgmt., LLC, Investment Advisers Act Release No. 5930 (Dec. 20, 2021) (finding that Global failed to adopt or implement reasonable policies and procedures to calculate the management fee offsets).

[156] *See e.g.*, JH Partners, LLC, Investment Advisers Act Release No. 4276 (Nov. 23, 2015) (finding that the respondent's failure to disclose to the advisory boards regarding conflicts of interest created by the undisclosed loans and cross-over investments resulted in negligent breaches of fiduciary duty); TPG Cap. Advisors, LLC, Investment Advisers Act Release No. 4830 (Dec. 21, 2017) (finding that "TPG failed to disclose to its funds… that it may accelerate future monitoring fees upon termination of the monitoring agreements").

[157] *See Figure 2*; Proskauer Asset Mgmt. Litig. Team, *supra* note 152.

[158] *See* Scott G. Huish, Securities Act Release No. 10694, Exchange Act Release No. 87089, Investment Advisers Act Release No. 5364, Investment Company Act Release No. 33633 (Sept. 24, 2019).

[159] *Compare* Phillip W. Conley, Exchange Act Release No. 93712, Investment Advisers Act Release No. 5917 (Dec. 2, 2021), *and* Mustafa A. Wadood, Securities Act Release No. 10912, Investment Advisers Act Release No. 5655, Investment Company Act Release No. 34148 (Dec. 22, 2020), *with* Old Ironsides Energy, LLC, Investment Advisers Act Release No. 5478 (Apr. 17, 2020); *see also* 15 U.S.C. § 80a–9.

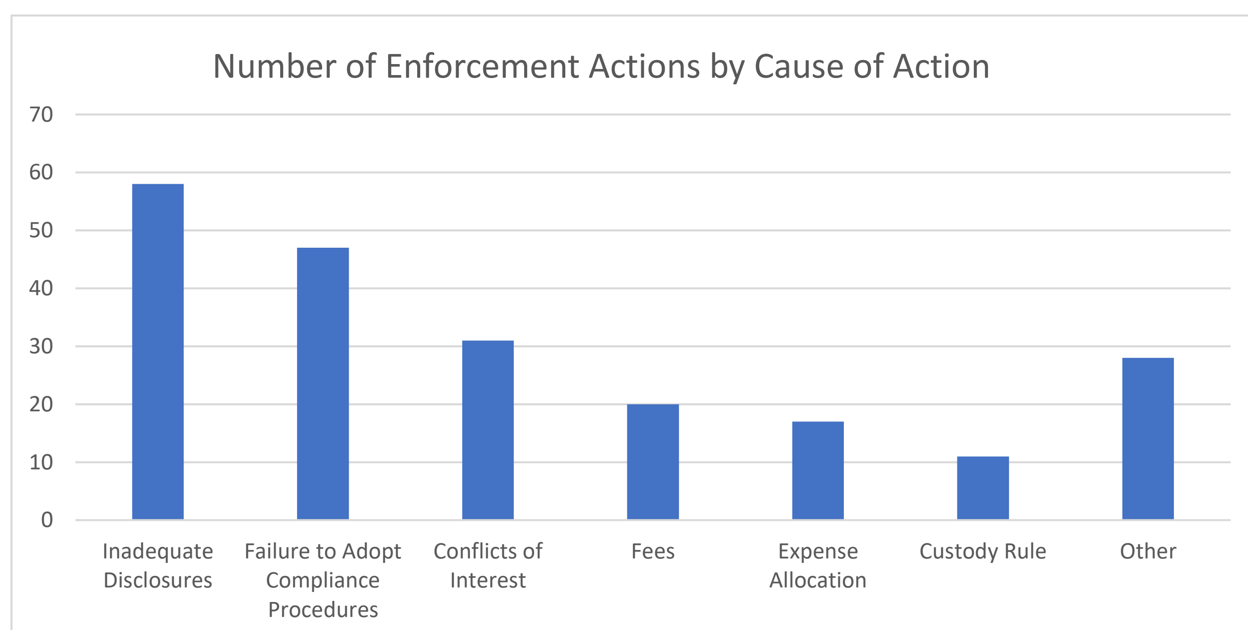
[160] *See, e.g.,* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1077 (2006) ("the scope of potential out-of-pocket liability [for outside director] is very narrow.").

[161] *See* Och-Ziff Cap. Mgmt. Grp. LLC et al., Investment Advisers Act Release No. 4540 (Sept. 29, 2016) (finding that the respondents entered into a series of transactions and investments to pay bribes through intermediaries, agents and business partners to high-ranking government officials in multiple African countries).

with us.[162] The data provided the investigation number, name of the target company, originating SEC office, opening and closing dates of the investigation, and the issue investigated.

Searching by the Top 300 private equity sponsors resulted in 109 relevant closed investigations against 33 unique sponsors. Among these, 42 investigations by 20 unique sponsors involved violations related to the Investment Advisers Act of 1940 or the Foreign Corrupt Practices Act. Large and well-known advisors conducted the overwhelming majority of these latter investigations, ranked within the top 150, such as Apollo, BlackRock, Carlyle, JP Morgan, Morgan Stanley, and their affiliates.[163] Even if an investigation did not result in an enforcement action, it still serves an important function by helping to deter *ex ante* behavior and provide information that would otherwise be opaque. As such, the threat of potential SEC investigation further amplifies the impact of public enforcement.

Figure 2: Number of Enforcement Actions by Cause of Action



b. Enforcement by State Actors

While we tend to think about the private equity world as private funds, in reality, a large proportion of the investment comes from public pension funds.[164] Even though the LPs themselves might avoid litigation, the state can step in and litigate on behalf of the underlying investors. While rare, such steps have already been taken in the case of *KKR & Co. Inc. v. Commonwealth of Kentucky* (2023). The Kentucky Attorney General challenged the constitutionality of indemnity clauses in investment contracts involving Kentucky Retirement Systems. The claim was that these clauses unfairly shielded private investment firms like KKR and others from financial liabilities, leading to a financial shortfall in the pension system. This case, still ongoing, may signal a growing willingness

[162] The data contains over 12,000 investigations across various entities, including public companies, investment advisors, broker-dealers, mutual funds, and more.

[163] For example, Morgan Stanley and its affiliates were the subject of 8 investigation; BlackRock and its affiliates had 6 investigations; JP Morgan and its affiliates faced 4 investigations; and Carlyle and Apollo had 3 investigation each.

[164] *See* Jeff Sommer, *The Risks Hidden in Public Pension Funds*, N.Y. TIMES (Aug. 4, 2023), https://www.nytimes.com/2023/08/04/business/private-equity-public-pension-funds.html.

among state actors to litigate on behalf of public investors, particularly as aggressive litigation by state attorneys general expands in other areas.[165]

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To summarize, while litigation is not an avenue that LPs pursue, they do have alternative enforcement mechanisms at their disposal. Side deals that compensate LPs for perceived wrongs, collaboration among LPs, and the threat of public enforcement all serve as substitutes, albeit incomplete at best, to private litigation.

The findings in this Section also show that the rarity of LP-GP litigation is not the result of the absence of an underlying cause of action against GP. As one commentator recently noted, "There is plainly the potential for LPs to be looking for some sort of recompense if it's available in relation to investments that may have gone wrong."[166] Indeed, this Section analyzes SEC enforcement actions against private equity firms of all sizes, with issues such as disclosures, inadequate procedures, conflicts of interest, improper expense allocations, and breaches of fiduciary duties dominating the enforcement actions. The SEC has also imposed penalties on individuals and barred them from associating with regulated financial entities.

Finally, and most importantly, active, *ex post* enforcement is just one side of the unique ecosystem of private equity governance. The following Section details how reputation and relationships may eliminate the need for enforcement altogether.

B. Reputation and Repeat Relationships in Private Equity

The lack of litigation in the private equity sector and the reliance on contractual terms governing a long-term relationship have many of the features that have been observed in other commercial areas. The literature on sectors where parties do not employ formal legal tools for norm enforcement developed around the theory of *relational contracting*. Relational theory has many applications, but we focus on norm creation and enforcement.

With respect to enforcing contracts and resolving disputes, classical and neoclassical contract theory primarily focuses on the *legal* enforceability of a contract under formal law. In contrast, relational contracting suggests that parties in long-term relationships with repeat interactions may rely on *non-legal sanctions* to deter misconduct.[167] In relational contracting theory, the primary motivation to avoid misconduct is not legal but rather social, moral, or, specifically in business contexts, *reputational*. This theory can provide significant insights to better understand how the private equity sector operates.

Since the 1960s, scholars have recognized several sectors in which the law plays a relatively minor role in long-term contractual relationships with recurring interactions. Parties in these long-

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[165] *See, e.g.*, Christopher L. Nasson et al., *Private Equity Firms Should Prepare for Increased Scrutiny as DOJ Puts False Claims Violations Under the Microscope*, K&L GATES (July 29, 2024), https://www.klgates.com/Private-Equity-Firms-Should-Prepare-for-Increased-Scrutiny-as-DOJ-Puts-False-Claims-Violations-Under-the-Microscope-7-25-2024; Jonathan Stempel, *U.S. States Sue Warburg-Owned Mariner Finance, Allege Predatory Lending*, REUTERS (Aug. 16, 2022), https://www.reuters.com/legal/us-states-sue-warburg-owned-mariner-finance-allege-predatory-lending-2022-08-16/; Fed. Trade Comm'n, Comments of Eleven Attorneys General in Response to the February 29, 2024 Request for Information on Consolidation in Healthcare Markets (June 5, 2024), https://www.regulations.gov/comment/FTC-2024-0022-2098.

[166] Smith, *supra* note 122 (also reporting that "Management fees are the biggest bone of contention for investors across the alternative asset classes").

[167] Illig, *supra* note 49, at 49, 50–51; Scott Baker & Albert Choi, *Contract's Role in Relational Contract*, 101 VA. L. REV. 559, 566 (2015).

term relationships may carry out their duties beyond the contracts' provisions and avoid pursuing legal action to enforce their rights.[168] A fundamental proposition of relational contracting theory is that every transaction is embedded in complex relations. Therefore, analyzing any transaction requires understanding all its essential elements and its broader relationships.[169] Rather than focusing on what the parties *write*, relational contracting focuses on what the parties *do* as part of the exchange.[170]

Stewart Macauley's seminal work on relational contracting proposes that contracts are not fully protected by formal sanctions but rather by informal enforcement, such as reputational costs.[171] If a party breaches a contract, other industry actors are unlikely to contract with them. Parties avoid opportunistic behavior not because they fear legal sanctions but because they fear that such behavior will lead to reputational damage that will cause them to lose future business relationships. [172] In this regard, a key objective of a relational contract is the continuation of the relationship: the parties seek to resolve any potential difficulties along the way to sustain the relationship.[173]

Ian MacNeil identified a spectrum of contract types, ranging from discrete to relational. Discrete contracts are single transactions with clear terms, typically used for simple exchanges and unlikely to be repeated. On the opposite end, relational contracts involve ongoing interactions and are foundational for long-term relationships built on mutual dependence. Behaviors and norms are highly contextual and require flexibility, often leading to incomplete terms accommodating unforeseen changes.[174]

Macaulay's and MacNeil's insights on relational contracting laid the theoretical foundation for subsequent empirical studies in various industries by scholars such as Lisa Bernstein and Robert Ellickson. While Macaulay and MacNeil emphasize the gap between the written contract and what businessmen actually do, Ellickson and Bernstein highlight the importance of community and how frequently, formal contracts are not even present.

Ellickson's research on Shasta County's cattle industry illustrates how ranchers adhere to internal and informal social norms rather than relying on formal legal rules and contracts to govern disputes.[175] Ellickson shows that persistent norm violations are addressed through reputational mechanisms, such as gossip, or by imposing practical inconveniences, like relocating trespassing animals.[176] Ellickson attributes the lack of litigation not to concerns over reputational consequences

[168] Baker & Choi, *supra* note 167, at 566-567; *see, e.g.*, David Frydlinger et al., *A New Approach to Contracts*, HARV. BUS. REV., https://hbr.org/2019/09/a-new-approach-to-contracts (last visited Jan. 26, 2025).

[169] Ian R. Macneil, *Adjustment of Long-Term Economic Relations under Classical, Neoclassical and Relational Contract Law*, 72 NW. U. L. REV. 854, 881 (1978) [hereinafter *Adjustment of Long-Term Economic Relations*].

[170] *Id.* at 879.

[171] *See generally* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study,* 28 AM. SOC. REV. 55 (1963). *See also supra* note 59 and accompanying text; Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1796–1802 (1996).

[172] *Adjustment of Long-Term Economic Relations*, *supra* note 169, at 877, 879.

[173] *Id.* at 860–90.

[174] *Id.* at 894 ("Probably the most recognized aspect of my work in contract is the use of a spectrum of contractual behavior and norms with poles, labeled relational and discrete, respectively."); Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a Rich Classificatory Apparatus*, 75 NW. U. L. REV. 1018, 1025–38 (1981); Ian R. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691, 735–805 (1974); *Adjustment of Long-Term Economic Relations*, *supra* note 169, at 859–99. Cf. *Managerial Contracting, supra* note 61, at 178 ("Gone are the days of purely informal relational governance described by Stewart Macaulay" and explaining that today important types of contractual relationships are neither fully transactional nor fully relational).

[175] ELLICKSON, *supra* note 59, at 53–54, 61, 78.

[176] *Id.* at 57–58 ("The mildest form of self-help is truthful negative gossip. This usually works because only the extreme deviants are immune from the general obsession with neighborliness.")

but rather to the efficiency and cultural pressures of the informal system. Internal norms preserve neighborly relations, reflect shared community values, operate effectively, and eliminate the need for a formal legal framework that would merely disrupt neighborly relations.[177]

Bernstein explores how relational contracting governs transactions within the diamond and cotton industries. Both sectors have replaced formal legal systems with internal norms based on repeat interactions among merchants. In the diamond industry, reputation is the key to establishing and maintaining relationships with other merchants. Trading clubs provide sophisticated mandatory arbitration systems that emphasize confidentiality and resolve disputes based on industry norms rather than legal principles while also serving as hubs for monitoring and exchanging information.[178] Deviation from informal norms, including resorting to formal legal systems, results in severe reputational consequences and, in extreme cases, exclusion.[179]

Similarly, the cotton industry has employed enforcement mechanisms based on reputation to develop norms that promote cooperation and deter opportunism.[180] The industry uses circulars, trade publications, and arbitration awards to manage reputations at an institutional level.[181] Deviations from norms result in reputational damage and exclusion.[182] By leveraging informal mechanisms and heightening the stakes of reputational consequences, both industries created an internal ecosystem that limits opportunism and functions effectively outside the formal legal system.

1. Relational Contracting in Private Equity

Is the private equity industry a realm of relational contracting? On the one hand, much like the sectors studied by Ellickson and Bernstein, the private equity market exhibits strong relational characteristics. The parties in an investment fund enter into a long-term contract that spans ten or more years,[183] with a blind pool of investments and strong dependency on the sponsor to navigate the fund throughout its life cycle. There are also recurring interactions between LPs and GPs through investments in subsequent funds managed by the same GP. Additionally, the parties also structure their relationship around a relational framework. The ongoing relationship between the GP and the LPAC serves as a key avenue for addressing contractual questions as they arise. Also, while LPs do not typically negotiate to include specific terms in the LPA, large institutional investors engage in individualized negotiations through "side letters" containing individualized benefits. This practice reflects the relational aspect of the private equity space, where each investor may be getting more tailored contractual terms that reflect their relationship with the GP.[184]

On the other hand, our interviewees indicated that LPAs are very lengthy and detailed. This characteristic might seem inconsistent with the theory of relational contracting. According to the prevailing understanding, relational contracts tend to be less detailed, relying instead on the trust

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[177] *Id.* at 60 ("[O]ne might suspect that the norms of neighborliness include a norm against the invocation of formal legal rights. And this norm is indeed entrenched.").

[178] *Extralegal Contractual Relations in the Diamond Industry*, *supra* note 59, at 120–21, 124.

[179] *Id.* at 138–39 ("When a primary social bond is sacrificed, a dealer's ability to communicate information about his reputation and obtain information about business opportunities is diminished.")

[180] *Private Commercial Law in the Cotton Industry*, *supra* note 59, at 1764 ("Because these noncooperative responses tend to reduce his future trading opportunities, the long-run cost of defection will often be greater than the short-term gain from defection.").

[181] *Id.* at 1752 ("They created formal methods for transmitting reputation information, such as circulars reporting the names of transactors who refused to arbitrate or to comply with an award rendered against them, and, in some associations, information bureau.")

[182] *Id.* ("noncooperative responses tend to reduce [the member's] future trading opportunities").

[183] Interview with Participant 19 (Sept. 6, 2024).

[184] *Side Letter Governance*, *supra* note 83, at 7.

between parties to address any issues that arise during the contractual relationship. Bernstein also shows that stakeholders rely on norms, informal mechanisms, and extralegal agreements to govern their interactions[185] and that embedded long-term relationships eliminate the need to negotiate long and detailed contracts.[186] One might ask: Why would parties, who generally avoid enforcing their contracts, draft such detailed agreements? According to Illig, private equity contracts primarily hold symbolic and ceremonial value for the parties, formalizing their relationship in an official capacity.[187]

Several other explanations emerged from our research. *First*, LPAS may be more detailed in order to protect the GPs' interests, ensuring they are safeguarded, for instance, in scenarios where an LP fails to commit funds on time. *Second*, although these contracts are not enforced through litigation, they provide a regulatory function for the relationship, serving as a continual background threat. *Third*, the lawyers drafting these contracts may create long and detailed agreements to protect themselves from any claims of negligence or omission should something go wrong.[188]

Regardless of the reasons for the highly detailed agreements, the private equity industry certainly contains significant elements of relational contracting, even if it does not entirely fit at the far end of a purely relational contract spectrum. However, despite the growing importance of the private equity markets in the United States, there is a limited academic discussion on the role that relational contracting plays in this industry, a role that is expected to be crucial given that market players in this industry generally operate outside of courts.[189]

2. What Works and What Doesn't: The Reputation Market in Private Equity

According to relational contracting theory, if a private equity fund earns a reputation for breaching duties to investors, LPs can be expected to "vote with their feet," and the GP will find it challenging to attract new investors in its next fund. This observation aligns with the findings in the venture capital sector, where involvement in litigation signals misconduct and litigated GPs face loss of business opportunities and more limited access to capital.[190]

This potential loss of investment compels GPs to align their interests with those of their LPs to maintain a favorable reputation.[191] As Professor Steve Kaplan has noted, if GPs "behave badly in one deal, they will be treated differently in the next deal."[192] For example, regarding the recent rise of continuation funds, it was argued that: "It's fair to say that there will be a degree of self-regulation preventing abuse here, because no GP can afford to alienate the same LPs to whom they will be pitching their next fund."[193]

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[185] *Extralegal Contractual Relations in the Diamond Industry*, *supra* note 59, at 155–56; *Private Commercial Law in the Cotton Industry*, *supra* note 59, 1735–36, 1744 ("[G]iven the amount of detail in the trade rules, cases involving contractual gaps are uncommon.").

[186] ELLICKSON, *supra* note 59, at 77.

[187] Illig, *supra* note 49, at 78.

[188] *Side Letter Governance*, *supra* note 83, at 966–68.

[189] Illig, *supra* note 49, at 53–55.

[190] *Does Reputation Limit Opportunistic Behavior in the VC Industry?*, *supra* note 64, at 2222, 2240–41 ("The resulting numbers indicate that, relative to their peers, litigated VCs invest in 430-1,840 fewer deals (investment rounds), raise 380-690 million dollars less following a lawsuit, and syndicate with 42-55 fewer partners.").

[191] Interview with Participant 13 (Jan. 11, 2024) ("[I]t's way more important to [sponsors] that their underlying investor puts capital into their next fund . . . [s]o[] the incentives for sponsors, as a general rule, are to ensure their LPs are happy with them overall and not to do things harmful to the relationship.").

[192] Antoine Gara, *The Private Equity Club: How Corporate Raiders Became Teams of Rivals*, FIN. TIMES (Aug. 9, 2022), https://www.ft.com/content/aec70aab-7215-4fa7-9ee3-1224d967dc28.

[193] Christophe Simon, *The Rise of GP-led Transactions (version anglaise)*, EURAZEO (Jan. 15, 2023), https://www.eurazeo.com/fr/rise-gp-led-transactions-version-anglaise.

In contrast, a positive reputation can increase future funding from existing investors and attract new investors.[194] Therefore, LPs can rely on non-legal incentives to maximize their value even when no specific contractual restrictions are in place to protect them.[195] As a lawyer specializing in private equity stated: "[I]n the small world of private equity, reputation can be everything. Litigation in this arena is very rare, simply because LPs-GP relationships are built on credibility, trust, and each side's reputation in the marketplace."[196]

Based on our interviews, the reputation market functions effectively as a non-legal enforcement mechanism in instances of underperformance or severe misconduct, such as fraud.[197] Some empirical research also supports this notion.[198] Our interviewees confirmed that in the small world of private equity, LPs often discuss GP behavior among themselves. If they hear about improper conduct, they may choose not to invest with a particular GP in the future.[199] Our interviewees also testified that in their due diligence process, they consider whether a GP has been sued by other LPs in the past. Past litigation could lead them to avoid future investments with that GP altogether.[200] However, the reputation market in private equity has limitations, as detailed below.

First, it is well known that the efficiency of reputation markets depends heavily on the quality of the information that LPs can obtain and analyze before making investment decisions.[201] In private equity, unlike public companies, the absence of mandatory disclosure requirements leads to significant information asymmetries.[202] Additionally, since private equity investments are not liquid and have a long lifespan, it may take a while until investors accumulate sufficient relevant information to assess the performance of the sponsor.[203] Empirical studies also highlight investor difficulties in collecting reliable information on previous fund performance due to the tendency of underperforming sponsors

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194 For studies indicating that top-performing funds are more likely to raise follow-on funds, *see* Paul A. Gompers & Josh Lerner, *What Drives Venture Capital Fundraising?*, 1998 BROOKINGS PAPERS ON ECON. ACTIVITY: MICROECON. 149, 188 (1998) (explaining the ability to raise new capital is also positively affected by age and size); Steve Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows,* 60 J. FIN. 1791, 1791 (2005) (showing that better performing partnerships are more likely to raise follow-on funds and larger funds); Ji-Woong Chung et al., *Pay for Performance from Future Fund Flows: The Case of Private Equity*, 25(11) REV. FIN. STUD. 3259, 3276–82 (2012) (showing that both the likelihood of raising a follow-on fund and the size of that fund are strongly positively related to current performance).

195 Some scholars, however, argue that the market for reputation may not be as effective in private equity. *See* Magnuson, *supra* note 29, at 1881–84; Clayton, *supra* note 29, at 80–81.

196 Adam Le, *The Case of the GP Threatened to Sue Over a Stapled Commitment*, SECONDARIES INVESTOR (Feb. 11, 2021), https://www.secondariesinvestor.com/the-case-of-the-gp-who-threatened-to-sue-over-a-stapled-commitment/.

197 *See, e.g.,* Interview with Participant 18 (May 20, 2024).

198 Gregory W. Brown et al., *Do Private Equity Funds Manipulate Reported Returns*?, 132 J. FIN. ECON. 267, 289 (2019) (finding that managers manipulating net asset values raised fewer funds); Feng Jiang et al., *Misconduct and Fundraising in Private Equity* (Working Paper, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4271808 (finding that the disclosure of misconduct reduces firms' ability to raise capital); Francois Degeorge et al., *On Secondary Buyouts*, 120 J. FIN. ECON. 124, 136 (2016) (indicating that investors reduce their capital allocation to firms conducting pressured secondary buyouts that typically underperform and destroy value).

199 Interview with Participant 14 (Apr. 30, 2024); Interview with Participant 16 (May 10, 2024); Interview with Participant 18 (May 20, 2024); Interview with Participant 17 (May 13, 2024).

200 Interview with Participant 14 (Apr. 30, 2024); Interview with Participant 17 (May 13, 2024).

201 Magnuson, *supra* note 29, at 1900.

202 Spindler, *supra* note 29, at 332–33 (arguing that private equity's exemption from public company-like disclosure requirements creates information asymmetries, enabling GPs to act with less accountability, and that this lack of transparency can foster opportunistic behaviors, as GPs are not subject to the immediate reputational or financial repercussions that more transparent environments would impose).

203 For recent empirical support, *see, e.g.*, Robert S. Harris et al., *Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds* (Univ. of Chicago, Fama-Miller Working Paper, 2022), https://ssrn.com/abstract=2304808.

to inflate reported returns during fundraising.[204] As a result, it can take a long time for GPs to realize the dissatisfaction of LPs.[205]

Furthermore, in contrast to the diamond and cotton industries, the private equity sector lacks strong information-sharing mechanisms, whereby GPs' misconduct can become widely known to most LPs. This gap is compounded by the fact that informal sanctions in the private equity industry are less defined and structured. While the diamond and cotton industries have institutional mechanisms that enable holding norm violators accountable, in the private equity case, there are no coordinating entities to facilitate collective action against the opportunistic behavior of GPs.[206] This gap explains why, in the startup and private equity contexts, LPs have difficulty identifying opportunistic behavior by GPs and punishing the untrustworthy ones.[207]

Second, the argument for the disciplinary effect of the reputation market assumes that private equity firms engage in fierce competition for investors' capital. This assumption, however, overlooks the power dynamics at stake, where LPs often compete to get into the most sought-after funds.[208] Our interviewees reported that the balance of power between LPs and GPs generally fluctuates; sometimes, one group competes more aggressively for the funds or allocations of the other, and at other times, the reverse is true.[209] However, they also noted that there is generally intense competition among LPs for investments with the best GPs.[210] There is an assumption that LPs have more bargaining power than they actually possess, which can misrepresent the actual dynamics at play.[211] Recent empirical evidence shows that many investors have difficulty gaining access to top-tier firms' alternative investment vehicles.[212] Top GPs involved in misconduct still find it relatively easy to attract new investors.[213] Given the competition for accessing top-tier firms' investments, some LPs may reinvest in subsequent funds with the same GP, even if they are displeased with the GP's behavior.

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[204] Brad M. Barber & Ayako Yasuda, *Interim Fund Performance and Fundraising in Private Equity*, 124 J. FIN. ECON. 172, 193–94 (2017); Rosemary Batt & Eileen Appelbaum, *The Agency Costs of Private Equity: Why Do Limited Partners Still Invest?*, 35 ACAD. OF MGMT. PERSPS. 45, 49–50 (2021).

[205] Spindler, *supra* note 29, at 332–33.

[206] Both diamond and cotton industries are well organized under institutions that establish basic industrial rules, which include norms, and effective and independent dispute resolution mechanisms. *See Extralegal Contractual Relations in the Diamond Industry*, *supra* note 59, at 119–30; *Private Commercial Law in the Cotton Industry*, *supra* note 59, at 1726–31.

[207] For empirical support, see Blake Jackson et al., *Catering and Return Manipulation in Private Equity* 5–7 (Working Paper, 2022), https://ssrn.com/abstract=4244467 (finding that LPs do not punish GPs for manipulating IRRs by refusing to commit capital to subsequent funds). In the context of VCs, although VCs involved in litigation experience declines in future business compared to their peers (*see supra* note 64, at 2221–22, 2239–42), other research finds that public pension funds are actually more likely to invest in VCs that were defendants in lawsuits, possibly due to internal agency problems. Vladimir Atanasov et al., *The Impact of Public Pension Funds and Other Limited Partners on the Governance of Venture Capital Funds* 3, 19–20 (Working Paper, 2018), https://ssrn.com/abstract=3088998.

[208] Clayton, *supra* note 29, at 97–98, 109–10; Interview with Participant 15 (May 1, 2024).

[209] Interview with Participant 14 (Apr. 30, 2024); *see also* Interview with Participant 11 (Apr. 10, 2023); Interview with Participant 13 (Jan. 11, 2024).

[210] *See* Interview with Participant 11 (Apr. 10, 2023); Interview with Participant 12 (June 28, 2023).

[211] Interview with Participant 15 (May 1, 2024); *see also* Interview with Participant 11 (Apr. 10, 2023); Interview with Participant 12 (June 28, 2023).

[212] Lerner et al., *supra* note xx, at 359–61.

[213] Yina Yang, *Private Equity Limited Partner Responses to Advisory Misconduct by General Partners* 14–15 (2022), https://ssrn.com/abstract=4223588 (showing that reputational costs for GPs are relatively low: although reports of GP misconduct, such as hidden charges or unequal treatment of LPs, are leading to increased LP departures, GPs easily find substitutes, especially GPs with more resources and GPs that engage in minor misconduct); Sharjil Haque & Anya Kleymenova, *Private Equity and Debt Contract Enforcement: Evidence from Covenant Violations* 21–26 (2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4361582 (showing that private equity firms violate loan covenants

Third, our interviews also demonstrate that different groups of LPs have different types of relationships with GPs. Large LPs are often sophisticated repeat players who sit on LPACs, and the GPs may have ongoing interactions and close relationships with them.[214] The market standard of seeking LPAC approval for conflicted transactions further empowers these large LPs and enhances their relations with the GPs.[215] For these investors, relational contracting works as the theory predicts. Their ability to align the GPs with their interests or to receive various benefits is significantly higher, thus enhancing their influence in the reputation market. For example, empirical evidence shows that some LPs consistently pay relatively lower fees across all their funds due primarily to factors such as investor size, sophistication, and negotiation skills.[216]

In contrast, smaller LPs have limited interactions with the GPs,[217] and their ability to retaliate if the GPs engage in misconduct is also limited. As a result, GPs care less about maintaining relationships with smaller LPs. Therefore, the effectiveness of non-legal sanctions and reputation in ongoing repeat relationships seems stronger for large and sophisticated investors and weaker when it comes to investors with little bargaining power.

However, even large LPs with substantial bargaining power are inherently limited in their investment. Large LPs manage significant capital, which must typically be allocated to large GPs capable of handling such substantial sums. Our interviewees highlighted a dynamic where, due to significant disparities in returns, these LPs must focus on consistently selecting managers from the top quartile to fulfill their obligations to clients and meet the expected performance standards.[218] This situation creates a dynamic where funds of large LPs predominantly flow to large GPs, effectively concentrating capital within the upper echelons of the market. As a result, while large LPs possess the ability to influence terms and conditions through their investment choices, their options for reallocating capital away from one GP in favor of another are constrained by the limited number of GPs capable of managing large-scale investments. Therefore, the ability of large LPs to leverage threats of exit as a means of utilizing the reputation market to their advantage is also limited.

Furthermore, even when large investors have the power to influence GPs through their investment choices, they may negotiate for *individual* benefits, such as fee discounts and co-investment opportunities, instead of "voting with their feet." This behavior diminishes their role as marginal investors who would typically enforce higher standards through their investment decisions.[219]

Finally, even if the GP suffers reputational harm from mistreating the LPs, such damage must be offset against the private benefits the GP derives from such behavior. When the expected loss from reputational harm is lower than the expected value from private benefits, the GP may choose to act in its own interests, even if it comes at the expense of other investors.[220]

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more often than non-PE firms, but experience smaller reductions in credit commitments due to lender leniency, influenced by repeated deals, sponsor reputation, and sponsor bargaining power).

[214] Large LPs with long-term relationships with GPs also seek specific protections through side letters. *See, e.g.,* Chris Witkowsky, *LPs Want Protections from Continuation Funds for Their 'No Fee' Co-Investments*, BUYOUTS (Sept. 6, 2023), https://www.buyoutsinsider.com/lps-want-protections-from-continuation-funds-for-their-no-fee-co-investments/.

[215] *See supra* Section III.E.1.

[216] Juliane Begenau & Emil N. Siriwardane, *Fee Variation in Private Equity*, 79 J. FIN. 1199 (2024)

[217] Fiona McNally, *Frustrated LPs Await New Guidance on GP-Led Secondaries*, PRIV. EQUITY WIRE (Apr. 29, 2022), https://www.privateequitywire.co.uk/2022/04/29/314174/frustrated-lps-await-new-guidance-gp-led-secondaries (explaining that pension plans which manage significant amounts of capital often have small teams).

[218] Interview with Participant 15 (May 1, 2024).

[219] Clayton, *supra* note 29, at 97–98, 109–10.

[220] Shobe, *supra* note 36, at 1485–86.

To summarize, the private equity sector relies heavily on norms, reputation, and informal governance. Yet, as this Section also showed, despite the reputation market's role in discouraging misconduct, it faces certain limitations, including information asymmetries, power imbalances, and the inherent delays in feedback due to the illiquid and prolonged nature of private equity investments.

IV. Implications

In this Part, we consider several implications of our study and discuss important questions for further research. We start by addressing the normative question of whether the lack of litigation in private equity is a feature that should be celebrated or a "bug" that requires intervention. We then highlight several concrete concerns associated with the non-litigious nature of the industry. Finally, we discuss several implications that our findings present to regulators, investors, and both private and public markets.

A. Investment without Litigation: An Efficient Market Outcome?

The conventional wisdom among corporate law scholars has long been that shareholder litigation plays an important part in the formation of capital markets and the enforcement and development of fiduciary duties.[221] The case of private equity we explore in this article sheds new light on that conventional wisdom. This ecosystem is fundamentally "working" even without the use of private litigation, as substantial and continuous investment flows from sophisticated investors into private equity funds, almost entirely bypassing the courts. Moreover, despite the absence of private litigation, it is not clear how common fraudulent activity is in the private equity sector. While it is possible that only a small subset of issues has been discovered, it is still noteworthy that the SEC has observed misconduct in only about 0.05% of investment advisors in a 17-year period.[222]

Those with a critical view of shareholder litigation might view the absence of litigation as a benefit. Sophisticated parties, with ongoing repeat interactions, intentionally opt out of recourse to courts and thereby reduce unnecessary costs on market activity, which is sometimes perceived as a "tax on innovation."[223] These sophisticated parties, the argument goes, favor higher returns over additional shareholder protections. They use extrajudicial mechanisms, repeat interactions, and robust incentive structures to generate market discipline instead of relying on private litigation, courts, and enforcement of fiduciary duties.

According to this optimistic view, sophisticated parties avoid litigation because the process itself is disruptive, lengthy, and costly and might have a chilling effect on the GPs, that might not feel free to make investment decisions without facing the threat of being sued. In public markets, in contrast, it is impossible to avoid litigation—even if it is excessive and costly—because of their shareholder base. There are individual, small shareholders, represented by highly incentivized plaintiff lawyers, who are willing to bring claims against company management or controlling shareholders to secure personal gains. According to this argument, lawsuits brought by small shareholders could be viewed as negative externalities on sophisticated investors who have other, more cost-effective means to discipline those who manage their investments.

[221] *See, e.g., Legal Determinants of External Finance*, *supra* note 51, at 1151 (arguing that legal protection of shareholders is essential to the development of financial markets); Edward B. Rock, *Stockholder Litigation, Fiduciary Duties, and the Officer Dilemma*, 72 BUS. L. 1211, 1213 (2017) (emphasizing the role of shareholder litigation in enforcing fiduciary duties and its doctrinal development).

[222] *See supra* note 55 and accompanying text.

[223] *See* Chen Lin et al., *Shareholder Litigation and Corporate Innovation*, 67 MGMT. SCI. 3346, 3349–50 (2021).

We, however, believe that the current situation, where private equity investors minimally use litigation to protect their interests, presents a more nuanced and complex picture. The rarity of private litigation clearly rebuts the presumption that private litigation is an important precondition for attracting investments and shaping the market. Despite this market having opted out of recourse to courts, substantial and continuous investment flows from sophisticated investors into this market. We are, however, reluctant to jump to the conclusion that opting out of courts is necessarily optimal. The rarity of private litigation could also stem from less desirable reasons, such as internal agency problems of asset managers, market concentration, and asymmetrical power relations between GPs and some LPs. It could also generate negative market-wide externalities through the lack of judicial norm-setting and the creation of obstacles to the flow of information. In the next Section, we discuss various concerns and limitations that are associated with the lack of litigation and that should be taken into account when conducting the overall cost-benefit analysis of the existing equilibrium.

B. Potential Concerns of Non-Litigious Environment

1. Internal Agency Problems

In the private equity setting, LPs are managed by investment professionals, who act as agents of the beneficial investors. This additional layer introduces a whole set of internal agency problems,[224] with studies showing how these agency conflicts lead to suboptimal behavior in private equity investments, particularly among public pension plans.[225] For example, concerns over maintaining personal relationships with private equity sponsors, who could be their future employers, may dissuade investment managers of LPs from pursuing litigation against them, preferring instead to resolve issues quietly and informally. Relatedly, investment managers at the LP level may intentionally avoid litigation that could reveal their own professional shortcomings, such as insufficient diligence or failure to ask critical questions. As noted earlier, in these cases, litigation might expose these asset managers to reputational risks, potentially harming their career prospects.

Finally, investment professionals at the LP level also do not directly benefit from the outcomes of litigation. This agency problem further reduces their motivation to pursue legal action, as the benefits are disproportionately small compared to the effort and resources required to win a case in court, as well as the potential risk to their reputation.

Taken together, this complex structure of LPs, with an additional layer of agents, makes it difficult to rule out the possibility that LPs avoid suing GPs because of internal agency costs, even though the overall expected benefits of private litigation could outweigh its costs (and thus one could expect to see more litigation).

2. Negative Market Externalities

Another possible explanation is that LPs avoid litigation because of collective action problems. While it could be efficient for each LP to avoid litigation (because of the costs associated with it), from a market-wide perspective, the lack of litigation generates systemic, negative externalities for all market players, stemming from the lack of judicial norm-setting and impediments to information flow.

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[224] Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 93, 95–104 (2017).

[225] William W. Clayton, *High-End Securities Regulation: Reflections on the SEC's 2022–23 Private Funds Rulemaking*, 14 HARV. BUS. L. REV. 71, 107–10 (2023) (describing studies identifying internal agency problems resulting in suboptimal behavior within institutions investing in private equity funds).

Lack of Judicial Norms Setting. One of the inherent benefits of litigation is its role in developing the content of fiduciary duties owed to investors.[226] Additionally, litigation helps develop and refine standards related to proper processes, including the requirements and scope of information disclosed to decision-makers and investors.[227] In the public market, where litigation remains a constant possibility following board decisions, companies are incentivized to conduct board decisions more meticulously to preempt post-decision claims about improper procedures.

One of our key findings is that the decision-making process in private equity, for example, within LPACs, is significantly less developed than in the public market. First, representatives on LPACs are not directors; they do not owe fiduciary duties to other LPs but only to their own investors.[228] However, as previously discussed, LPAC approval can provide a shield for a GP against claims of breaching its duty of good faith.[229] Yet, our interviews indicate that investors often perceive the LPAC process as inadequate because it is much less structured, comprehensive, and in-depth.[230]

Frictions in Information Flow to Investors. A significant theme that emerged from our interviews is the challenge posed by a lack of sufficient information, which hampers both legal and non-legal enforcement efforts within the private equity sector. The scarcity of information in private equity primarily stems from the absence of extensive disclosure obligations found in public markets, coupled with limited protections from LPAs. This limitation substantially hinders LPs' capacity to discern whether a failure is due to severe negligence or justifiable risk-taking, which in turn affects their ability to make informed investment decisions or initiate effective enforcement actions.

Lack of litigation could also adversely affect reputation markets. As scholars suggest, a shareholder lawsuit increases the level of information disclosed about a given company through, for example, early-stage disclosure of information vetted by objective and unbiased judges. This information often triggers negative media coverage and reputational sanctions that can play a significant role in disciplining managers and influencing public opinion.[231] Without such information, reputation markets operate less effectively.

3. Asymmetrical Power Relations

Recently, different studies have confirmed an increased concentration in the private equity industry, particularly among top-performing GPs. Lietz and Chvanov note that the Top 5 GPs account for 25% of all the capital raised between June 2017 and June 2022.[232] According to the McKinsey Annual Report of 2024, fundraising concentration has reached its peak in over a decade, as LPs continue to shift new commitments in favor of the largest GPs. The Top 25 fundraisers collectively secured 41% of aggregate commitments to closed-end funds, with the Top 5 accounting for nearly half of that.[233] In his recent book, John Coates notes that while the number of GPs has increased,

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[226] *See supra* note 50.

[227] *See supra* notes 92, 221 and accompanying text.

[228] *See supra* note 137.

[229] *See supra* note 138.

[230] *See supra* note 137 and accompanying text.

[231] Alexander Dyck & Luigi Zingales, *The Corporate Governance Role of the Media* 21 (Ctr. for Rsch. Sec. Prices, Working Paper No. 543, 2002), https://ssrn.com/abstract=335602; Roy Shapira, *A Reputational Theory of Corporate Law*, 26 STAN. L. & POL'Y REV. 1, 58 (2015). *See also Does Reputation Limit Opportunistic Behavior in the VC Industry?*, *supra* note 64.

[232] Lietz & Chvanov, *supra* note 47, at 9.

[233] *See McKinsey Global Private Markets Review 2024*, *supra* note 1MCKINSEY, GLOBAL PRIVATE MARKETS REVIEW 2024 ("The 25 most successful fundraisers collected 41 percent of aggregate commitments to closed-end funds (with the top five managers accounting for nearly half that total).").

most industry assets are still concentrated within the largest GPs.[234] This concentration is further accompanied by growing cooperation among GPs, which is reflected in practices such as club deals and secondary buyouts.[235]

The increased concentration in the private equity market leads to two major concerns. *First*, if an LP sues in court, the reputational sanctions that GPs can apply to it are more severe when there are four to five players that control a significant fraction of the market. Being labeled a "troublemaker" in such a concentrated market can severely harm an LP's ability to secure future allocations, as many LPs compete for access to top-performing GPs. This concentration also limits the effectiveness of reputational harm top-performing GPs might suffer for a breach of contract, as their dominant position in the market limits the practical impact of such measures.

Second, in this situation, LPs have limited contractual bargaining power. It is much more difficult to negotiate or come to terms with some players who dominate the market and have a relatively high market share. Based on survey data collected between 2020–2022 from a diverse group of LPs, the ILPA published a report regarding the challenges LPs face due to market concentration.[236] Despite being sophisticated stakeholders, LPs rarely manage to negotiate favorable changes in the terms of the LPA.[237] The report indicates that LPs frequently accept suboptimal terms due to high competition for access to top-performing GPs, fearing that pushing for better terms may cause them to lose their allocation.[238] Clayton highlights that LPs feel a lack of bargaining power to push back against poor legal terms.[239] For example, despite fiduciary duty and no-fault removal clauses consistently ranking as top priorities for LPs, these terms have also seen the greatest shift toward GP-favorable terms at the start of LPA negotiations.[240]

Accordingly, it is not surprising that LPs are seeing reduced fiduciary duties across a substantial portion of their investments.[241] These difficulties are frequent, particularly when investment amounts are small, as smaller LPs hold limited leverage.[242] The reliance on side letters to restore or improve fiduciary duties adds to this challenge, as such reliance provides less comprehensive protection to all LPs and requires separate negotiations.[243]

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[234] COATES, *supra* note 1, at 69 ("The four largest private equity complexes—Blackstone, KKR, Carlyle, and Apollo—report assets totaling $2.7 trillion. By contrast, the median private equity fund size is a mere $100 million.").

[235] *Id.* at 70 ("[P]rivate equity funds controlled by different advisors commonly join together to buy a single target company, in what are called club deals, and increasingly they sell their portfolio companies not to public companies, or to dispersed investors, but to each other . . . .").

[236] *See* ILPA, *supra* note 101, at 4, 12 (finding that 71% of LPs disagree with the claim that the PE industry is unconcentrated and that they have flexibility to switch GPs if they are dissatisfied with the terms offered).

[237] *Id.* at 8–9 (finding that 65% of LPs indicate that their expertise does not translate into effective negotiating power, with 97% of LPs observing favorable LPA terms for GPs at the starting point, compared to 87% after negotiations).

[238] *Id.* at 13 (highlighting that LPs indicate that fear of losing allocation, small commitment size, and an inability or unwillingness to walk away as the top reasons for accepting poor legal terms); *See* Clayton, *supra* note 225, at 115 ("[I]nvestors are concerned they will be cut out of a manager's current or future funds if they bargain too hard.").

[239] *See* Clayton, *supra* note 225, at 116 ("[M]ost common responses similarly reflect a sense among investors that they lack bargaining power—both individually and collectively—to push back on poor legal terms.").

[240] ILPA, *supra* note 101, at 20 (indicating that in both 2020 and 2022, fiduciary duty ranked as the second highest "must-have" term for LPs, while No-Fault Removal clauses were the fourth. However, both terms have seen large shifts toward GP-favorable terms at the start of LPA negotiations).

[241] *Id.*, at 42–43 (In 2020, 63% of LPs reported reduced fiduciary duties in over half of their investments).

[242] *Id.* at 40 (75% of LPs investing under $100M struggle were unable to make improvements in most funds. Even LPs investing over $150M investments face challenges, with 36% unable to improve duties in most funds).

[243] *Id.* at 41 (noting that only 19% of LPs successfully restored fiduciary duties in the LPA, while 37% had to rely on side letters).

This issue is compounded by the fact that GPs are working with a small, consolidated group of external counsels, which leads to standard-form LPAs. As we have shown, LPA terms highly favor GPs, both at the drafting stage and after negotiations, because the draft written by the external counsel allows GPs to establish a GP-favorable foundation. Additionally, unlike GPs and their external counsel, LPs do not have access to information regarding the negotiation positions of other LPs, which creates an information gap that significantly reduces their bargaining power.[244] Consequently, the concentration limits the flexibility of LPs to switch GPs when they are dissatisfied with terms. Their options are restricted to a relatively small pool of top-performing GPs, which use a standard-form LPA made by the same group of external counsel.[245]

Whether the private equity market is perceived as concentrated is controversial. A month after the ILPA released its report, the Committee on Capital Markets Regulation (CMMR) published its own report about the competitiveness of the U.S. private equity market. The CMMR's report finds that the concentration is quite low in the public equity industry as HHIs (Herfindahl-Hirschman Index indicators—a standard concentration indicator) are below concentration thresholds, the largest GPs hold a relatively small market share, and an increase of new entrants indicates low entry barriers.[246] Beyond these empirical findings, the CCMR's report criticizes the ILPA report's methodology, particularly the ILPA's reliance on vague surveys to promote market concentration,[247] the lack of robust data, and its disregard of the role of sophisticated legal counsel for LPs and recent improvements in transparency.[248]

Thus, the level of concentration in the private equity market remains a crucial open question that warrants further research. Most importantly for our purposes, the answer to this question could make a significant contribution to the ongoing debate regarding the effectiveness of the reputation market or the necessity for additional regulatory intervention in the private equity market.

4. Limited Protections to Small Investors

Another primary conclusion from our research is that the current enforcement of LP rights in private equity, which relies primarily on informal mechanisms, tends to function more effectively for larger and more sophisticated LPs with stronger relationships with GPs and less so for smaller investors with weaker ties. This disparity is evident in several aspects, including the likelihood of sitting on an LPAC (which is reserved mainly for large LPs with strong ties to the GP), the potential to receive side benefits from the GPs, such as better allocations and fee discounts as a form of compensation (which is, again, mostly reserved to large LPs), and the extent to which reputation markets effectively incentivize optimal enforcement mechanisms. As noted earlier, smaller LPs have limited interactions with the GPs, and their ability to respond if GPs engage in misconduct is also limited.[249] As a result, sponsors care less about maintaining relationships with them. Therefore, the

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[244] *See* ILPA, ILPA PRIVATE FUND ADVISERS ANALYSIS 9 (2023) ("LPs negotiate without knowing other LPs' concerns, while GPs hold full information, creating asymmetry and leading to collective action problems.").

[245] *Id.* at 10 (GPs use consolidated external counsel, leading to standardized form agreements). For additional information on GPs' counsel incentives to create standard forms of LPA, see *Side Letter Governance, supra* note 83, at 967–68.

[246] CCMR, A COMPETITIVE ANALYSIS OF THE U.S. PRIVATE EQUITY FUND MARKET 6–14 (2023).

[247] *Id.* at 31–32 ("presenting an opinion survey of buyers of a service as evidence of a lack of competitiveness, as the ILPA Report does, is a fatally flawed methodology.")

[248] The report further notes that the ILPA report lacks robust data and misrepresents "suboptimal" terms as signs of market failure and ignores the role of sophisticated legal counsel for LPs and recent improvements in transparency. *Id.* at 31–34.

[249] *See supra* note 217 and accompanying text.

effectiveness of non-legal sanctions and reputation in ongoing repeat relationships seems weaker when it comes to investors with little bargaining power.

Of course, it is arguable that if LPs perceive private equity investments as less favorable due to a lack of efficient enforcement mechanisms, they can allocate more capital to other investments, such as public markets, which have better enforcement and active shareholder litigation. This ability to reallocate their capital, the argument goes, gives LPs leverage to influence the private equity market, encourages GPs to meet their demands, and protects LPs from potential misconduct or breach of contracts through the exercise of their exit rights.

Nevertheless, the notion that LPs can easily stop investing in private equity if the GP acts in a way that has substantial adverse effects on LPs overlooks several considerations. As fiduciaries, institutional investors must act in their beneficiaries' best interests, which includes maintaining a diversified investment portfolio to manage risks effectively. Private equity investments allow institutional investors to diversify their portfolios and mitigate public market risks. This need for diversification gives GPs significant room to benefit themselves at the expense of LPs before LPs consider reducing their allocations to private equity. However, the persistent investments in private equity cannot be attributed solely to diversification benefits.[250]

As noted earlier, investment professionals of LPs face all sorts of agency problems that could lead to suboptimal behavior in private equity investments, particularly among public pension plans.[251] For example, the investment industry encourages institutional investors to invest in private equity. At the same time, incomplete and missing data can lead institutional investors to draw false conclusions regarding the desirability of such investments.[252] In this regard, individuals working for LPs may possess information about the private equity industry's flaws but are incentivized to continue investing in private equity to secure their jobs.[253] Moreover, for investment managers, investing in well-known, large private equity firms often represents a safe strategy to shield themselves from claims regarding their investment decisions.[254] Essentially, managers invest in major private equity entities; they are unlikely to face criticism or liability for those investment choices, as these firms are generally accepted as solid options within the financial industry.

Given these considerations, LPs' ability to deter GP opportunism is inherently constrained. While outright failures may eventually compel LPs to cease investments, if some opacity remains in private equity operations and the returns from continuing investments outweigh the costs of disengagement, LPs are likely to continue investing in these funds despite potential misalignments.

Interestingly, the potential concerns of a non-litigious environment stem from the unique characteristics of the private equity industry, which differs in three major dimensions from other well-known close-knit communities explored in the literature, such as the diamond and cotton industries studied by Bernstein. *First*, her settings do not involve an internal agency problem, as no representative holds the right to initiate litigation on behalf of the stakeholder groups she examines. *Second*, Bernstein

[250] Francesco Franzoni et al., *Private Equity Performance and Liquidity Risk*, 67 J. FIN. 2341, 2349–50, 2358–65 (2012) (suggesting that diversification benefits may be lower than anticipated as private equity suffers from significant exposure to the same liquidity risk factor as public equity and other alternative asset classes).

[251] *See supra* Sections II.B.4, IV.B.1.

[252] Ludovic Phalippou, *An Inconvenient Fact: Private Equity Returns & The Billionaire Factory*, 30 J. INVESTING 11, 12–13 (2020) (asserting that the belief that private equity consistently outperforms public markets is perpetuated by industry professionals, and that the use of misleading performance metrics, selective benchmarking, and incomplete public data all further contribute to the illusion of superior private equity performance); Batt & Appelbaum, *supra* note 204, at 49.

[253] Phalippou, *supra* note 252, at 12–13.

[254] *See* Interview with Participant 15 (May 1, 2024).

describes the diamond and cotton industries as well-organized under the auspices of institutions that establish basic industrial rules, which include effective and independent dispute resolution mechanisms. Such mechanisms are absent in the context of private equity. *Third*, Bernstein does not identify asymmetrical power relations as factors contributing to the lack of litigation within the diamond and cotton industries. Instead, the lack of litigation stems from the reliance on internal norms and mechanisms that encourage resolving conflicts within the community rather than being a circumstantial outcome of unequal power dynamics. Such differences highlight the uniqueness of the private equity case.

C. Going Forward

1. The Importance of Public Enforcement

Our analysis shows that public enforcement plays an important role in the private equity industry. While private litigation is scarce in the private equity sector, the sector is not a no-man's land, and public enforcement provides a partial substitute for private litigation. This type of enforcement requires appropriate governmental resources, and budget cuts by the new U.S. administration could reduce enforcement resources, undermine the existing equilibrium, and enhance the need for more effective private enforcement.[255]

Public enforcement also comes in different forms. Federal supervision could be in the form of *ex post* public enforcement via the SEC enforcement division, as well as *ex ante* regulation that enhances the disclosure of information in the marketplace and restricts certain activities. *Ex post* public enforcement and *ex ante* regulation are parallel forces, and when one weakens, there is a need to enhance the other. For example, enhancing mandatory disclosure in the marketplace could enable LPs to make informed decisions. With the improved flow of information, reputational channels will also operate more effectively. In this regard, the recent decision of the Fifth Circuit to vacate the new private fund rules (Private Fund Rules) adopted by the SEC in August 2023 stresses the need for effective SEC *ex post* enforcement.[256] The Private Fund Rules made fundamental changes to the operations of private fund advisors by restricting certain activities and enhancing quarterly reporting and audits. According to the SEC, the rule was intended to prevent fraudulent, deceptive, or manipulative practices, including charging monitoring and other similar fees to portfolio companies without disclosing the fees to investors.[257] In the absence of such protections, effective *ex post* SEC enforcement would be required to maintain investors' confidence in the private equity sector.

2. Enhancing LPs' Collaboration, Information Sharing, and Group Sanctioning

Building on the central theme of information asymmetry in private equity, our interviews highlighted the role of information exchange among LPs regarding the behaviors and practices of GPs. Such an exchange of information is crucial for the operation of extra-legal norms, making reputational sanctions more effective. Our research reveals that in the setting of private equity, which is characterized by recurring interactions and a strong reliance on reputation, LPACs and the ILPA foster a collaborative environment regarding LPs' *information sharing*. This regular exchange may

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[255] *See, e.g.,* John C. Coffee, Jr. & Joel Seligman, *About Face: How Much of the Current SEC Policy Will the Trump Administration Reverse?*, COLUM. L. SCH.: THE CLS BLUE SKY BLOG (Dec. 3, 2024), https://clsbluesky.law.columbia.edu/2024/12/03/about-face-how-much-of-current-sec-policy-will-the-trump-administration-reverse/.

[256] *See, e.g.,* Daniel Levisohn et al., *Private Fund Advisers, Breathe Easier: Fifth Circuit Vacates Private Fund Rules*, HOLLAND & KNIGHT (June 17, 2024), https://www.hklaw.com/en/insights/publications/2024/06/private-fund-advisers-breathe-easier-fifth-circuit-vacates.

[257] *Id.*

influence LPs' future investment decisions and thus serves as a *soft* mechanism for leveraging reputation as a non-legal enforcement tool.

However, collaborative platforms, such as LPACs and the ILPA, do not typically lead to collective action initiatives against undesirable GP conduct, such as the removal of GPs. Market players in the diamond and cotton industries discussed above employ clear reputational sanctions, such as removal from trade, for those who deviate from the internal norms.[258] In contrast, in the private equity context examined here, when a misbehaving GP is willing to compensate an LP (by providing fee discounts or co-investment opportunities), it is often done behind closed doors. Such private settlements between a GP and an individual LP make the sanction *non-transparent*. Thus, reputational forces in the private equity section could operate more effectively if coordination among investors is increased and if there were organized channels for information sharing and sanctioning.

3. Implications for Private Funds

The article's analysis and insights have broader implications that extend beyond the private equity context and could be applicable to other private funds with a similar structure, such as venture capital (VC) firms and hedge funds. First, like private equity, VC funds also involve reputational, relational, and repeat interactions between the fund's manager and its investors. Yet, these funds also involve direct relationships with start-up founders, and litigation is more prevalent because of that additional friction.[259] While some studies have already documented the litigation in the VC sphere, no existing studies have thoroughly examined the specific dynamics that influence litigation decisions between managers of a VC fund and its investors, the underlying reasons for its frequency, or the normative implications of this phenomenon.[260] Our article provides a first step in that direction.

Second, there are increasing calls to open the private markets to retail investors.[261] How such a move, if adopted, is going to impact the lack of litigation in the private equity context is still to be seen. However, if regulators are considering opening the private markets to retail investors, they should also account for the higher tendency of these investors to resort to litigation and how this may affect the private market dynamics.

4. Implications for Public Markets

Private litigation has long been considered a vital enforcement mechanism in public companies and a critical tool for investors to discipline corporate managers, typically through the framework of fiduciary duties. By means of litigation and detailed opinions, judges—especially in Delaware—set norms in the market.[262] The importance of litigation is also reflected by the fact that founders of public companies are generally not permitted to opt out of the legal system and require their companies to adopt, for example, a mandatory arbitration provision at the IPO stage.[263]

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[258] *See supra* notes 178-182.

[259] *See Does Reputation Limit Opportunistic Behavior in the VC Industry?*, *supra* note 64, at 2226 (arguing that lawsuits against VCs are often filed by "aggrieved" founders).

[260] For instance, while Atanasov et al. conducted an extensive study on the reputational consequences of litigation for VC firms, they did not explore the role and dynamics of LPs in these disputes or examine the broader consequences and implications for LPs when they become involved in litigation against GPs. *Id.*

[261] Christina P. Skinner, *Private Equity for the People*, 171 U. PA. L. REV. 2059, 2064–67 (2023); Hal S. Scott & John Gulliver, *Expanding Opportunities for Investors and Retirees: Private Equity,* HARV. L. SCH. F CORP. GOVERNANCE (Sept. 21, 2020) https://corpgov.law.harvard.edu/2020/09/21/expanding-opportunities-for-investors-and-retirees-private-equity/.

[262] *See supra* note 50.

[263] *See supra* note 52.

The public markets are filled with small, individual shareholders who are willing to bring claims against company management in order to secure personal gains. Are these lawsuits being filed against the will of institutional investors who hold the majority ownership interest in most public companies, or are they being filed with the (secret) blessing of institutional investors who avoid doing it themselves in order to maintain good relationships with corporate managers? Our study does not provide a clear answer to this question. While we show that large investors avoid suing the GP when investing in private markets—a phenomenon that is consistent with institutional investors' overwhelming support for adopting provisions that exculpate managers and directors from due care violation in the public company context[264]—we cannot rule out the possibility that LPs avoid litigation due to internal agency problems.

In addition, there are significant differences between public companies and private equity investments that must be addressed before drawing any inferences from our study of extra-legal norms in the private equity sector to public markets. First, private equity funds typically last ten years.[265] Due to this unique structure, private equity sponsors need to raise new funds every few years. These recurring interactions align, at least partially, GPs' interests with those of their LPs.[266] While some public companies raise additional funds after the IPO, many avoid doing it on a regular basis.

However, during the past two decades, institutional investors in public companies have become more active, employing alternative disciplinary mechanisms, including the annual election of directors and a majority voting standard.[267] Such mechanisms could enhance directors' awareness of their reputation while providing public investors with the ability to retaliate if managers engage in misconduct, similar to what LPs could do in the private equity context.

While a comprehensive discussion of the desirable level of shareholder litigation in public companies is beyond the scope of this article, we are optimistic that our analysis will open the door to a new research agenda related to this timely topic.

Conclusion

The private equity industry, as a multi-trillion-dollar force in global finance, exemplifies the intricate balance between formal legal frameworks and informal governance mechanisms. In this study, we shed light on the rarity of litigation in the private equity sphere, highlighting the role of contractual, institutional, and reputational barriers that dissuade LPs from seeking redress through courts. Instead, the industry relies on extralegal norms, reputation-based enforcement, and alternative dispute resolution mechanisms to navigate conflicts. This unique ecosystem underscores a governance model that prioritizes relational contracting over judicial intervention.

The absence of litigation in private equity is not evidence of a lack of disputes but rather a reflection of how industry-specific dynamics shape conflict resolution. While these governance structures offer efficiency and flexibility, they are not without limitations. Smaller LPs, with limited resources and less access to information, often face disproportionate challenges in holding GPs accountable. The reliance on reputational mechanisms, while effective in some contexts, is undermined by information asymmetries and the absence of robust industry-wide mechanisms for

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[264] *Delaware Amends its General Corporation Law to Authorize Exclusive Forum Provisions and Prohibit Fee-Shifting Provisions* 2, MAYER BROWN (June 25, 2015), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2015/06/delaware-amends-its-general-corporation-law-to-aut/files/get-the-full-report/fileattachment/150625-update-cs.pdf.

[265] Harris, *supra* note 29, at 279.

[266] *See supra* note 192.

[267] *See, e.g.,* Kastiel & Nili, *supra* note 74, at 792-99.

information sharing. Furthermore, the lack of judicial precedents limits the development of standardized fiduciary norms, potentially leaving critical gaps in investor protection and market transparency.

As the industry expands its reach, including efforts to attract retail investors, the adequacy of current enforcement mechanisms comes under scrutiny. The absence of litigation, combined with the limitations of informal governance, may expose investors to greater risks, particularly as regulatory oversight struggles to keep pace with the industry's growth.

Future research should explore whether the private equity model—characterized by its reliance on informal norms and relational contracting—can effectively adapt to the evolving financial landscape. Comparative analyses with similar private markets, such as venture capital and hedge funds, could provide valuable insights into the broader applicability of extralegal governance. Moreover, empirical studies on the effectiveness of recent regulatory initiatives, including those by the SEC, could offer insights into how public enforcement complements private governance.

The private equity industry's reliance on extralegal mechanisms represents both an innovation and a challenge. By forgoing traditional litigation, the sector has fostered a system that emphasizes efficiency and trust. However, as the industry continues to grow in scale and complexity, addressing its inherent disparities and vulnerabilities will be crucial to ensuring equitable and sustainable governance for all stakeholders.

APPENDIX A

Interview List		
Participant Number	**Date Interviewed**	**Background**
1	January 9, 2023	A partner at a leading law firm, specializing in representing GPs in continuation fund transactions
2	January 25, 2023	A partner at a leading law firm, specializing in representing GPs in continuation fund transactions
3	January 26, 2023	A partner at a leading law firm, specializing in representing GPs in continuation fund transactions
4	January 27, 2023	A partner at a leading law firm, specializing in representing GPs in continuation fund transactions
5	February 6, 2023	A partner at a leading law firm, specializing in representing GPs and LPs in continuation fund transactions
6	January 18, 2023	A director in an investment management company that invests as an LP
7	January 27, 2023	An officer in an investment management company that invests as an LP
8	January 27, 2023	An officer in an investment management company that invests as an LP
9	January 30, 2023	An officer in an investment management company that invests as an LP
10	January 30, 2023	A partner at a mid-size law firm, specializing in representing LPs
11	April 10, 2023	Two officers in a trade association for LPs
12	June 28, 2023	A partner at a leading law firm, specializing in representing GPs in continuation fund transactions

13	January 11, 2024	An advisor in a financial advisory firm, specializing in advising GPs in continuation fund transactions
14	April 30, 2024	A partner at a leading law firm, specializing in representing GPs and LPs
15	May 1, 2024	An officer in an investment management company that invests as an LP
16	May 10, 2024	A partner at a leading law firm, specializing in representing GPs
17	May 13, 2024	An officer in an investment management company that invests as an LP
18	May 20, 2024	An officer in an investment management company that invests as an LP
19	September 6, 2024	An officer in an investment management company that invests as an LP
20	June 11, 2024	An officer in an investment management company that invests as an LP