YALE CASE AUGUST 6, 2023

A Reference Guide on European Search Funds

European search funds should incorporate tested legal concepts and adopt established processes

Jürgen Rilling[1]
Simon Webster[2]
Peter Bransden[3]
A. J. Wasserstein[4]

First developed in 1984, the search fund model was the brainchild of Irving Grousbeck, Adjunct Professor of Management at the Graduate School of Business at Stanford University. In the almost four decades since then, search funds have become an established and accepted means to unleash entrepreneurial potential, realize lifelong dreams, and drive economic value creation. What began as one person's idea has evolved into an entire industry within the United States, with specialized individual investors, institutional funds, lawyers, and consultants contributing to the professionalization and standardization of the sector.

Relatively recently, new players have started to adapt the model to different geographic markets and legal jurisdictions around the world. This international expansion has presented numerous challenges, as processes to establish a search fund and complete an acquisition are complex and time consuming. In the U.S., the decades-long evolution of the search fund sector (and, in particular, the presence of only a handful legal firms advising the ecosystem) has led to the existence of somewhat normalized language, terms and conditions, and economics within private placement memoranda (PPM), subscription agreements, shareholder agreements, and purchase and sale agreements. In contrast, the flood of entrepreneurs and investors into the nascent European search fund community has washed up against a wide range of legal services providers. As a result, fewer norms and practices exist in local deal terms, structures, and documents. We suspect that the lack of standardization is due to the relatively low number of search funds in each specific European country to date, combined with a lack of long-term experience in investing in search funds among many of the investors. Furthermore, while the U.S. search fund ecosystem evolved slowly over almost 40 years, in the European version, the community has exploded rapidly, without the opportunity to deal with the ensuing growing pains.

This note – a reference guide on European search fund concepts, norms, and structures – is our attempt to shed some light on some of these complicated processes. It is not our goal to provide a comprehensive analysis of all deal terms and legal nuances; rather, we seek to simply introduce the most pertinent ones at a high level. Our aim is to help facilitate search fund activity for searchers and investors in Europe. While we do not seek to establish standardized market terms – all market participants can structure transactions in any way they see fit – we caution searchers from deviating from established norms, as it can be off-putting to investors, can cause unnecessary friction, and may lead to unforeseen consequences.

In the remainder of this note, we summarize the major elements of search fund legal documents in the approximate order in which they generally appear in the transaction life cycle and highlight some common errors experienced in European search fund documents. As we do so, we comment on some basic particularities and standard practices not necessarily found in the legal documents.

While it should go without saying, we wish to emphasize that this note is not a substitute for the specialized legal and accounting advice that every searcher and investor should seek from the relevant professionals in these fields. Instead, it is intended to provide interpretation and give some guidance to searchers, who are often young and, while frequently in possession of excellent business acumen, may not always have a legal background or extensive knowledge of search fund practices. Equally, we hope this note will be a useful tool for *new* investors in search funds. Although we frame this case note in the context of a first-time CEO, we think the information we offer here is also helpful for veteran CEOs and investors too. **Figure 1** lists fifteen elements of establishing a search fund legal structure which we will examine. (Please note, this document has as a companion piece, an Excel table that presents the information in a different format. It is accessible here.

Figure 1: Fifteen elements of establishing a search fund legal structure

01 Trust, but codify: The need for a solid legal foundation
02 Obtaining solid advice and expertise
03 Limiting liability
04 Search and acquisition capital
05 Establishing a board of directors
06 Search budget and searcher salary
07 Searcher equity – when and how it is vested
08 The denominator problem
09 Governance and notice periods
10 Employee options
11 Leaver provisions
12 Transfer rights
13 Drag-along and tag-along provisions
14 Non-compete and confidentiality provisions
15 Waterfall and liquidity preferences

01 Trust, but codify: The need for a solid legal foundation

The idea of a search fund may appear strange at first. A group of investors wire hundreds of thousands of euros to a young, unpolished professional (or a team of two such individuals) to search for a loosely defined business in an unknown industry. Then, the investors provide *even more* money (often millions of euros) to purchase such a firm before letting this same inexperienced entrepreneur run the newly acquired company as CEO. At first blush, this might not sound like an obvious foundation for generating superior economic returns.

As bizarre a concept as this may be, a generation of searchers, CEOs, and investors have now proven that behind this construct lies a powerful value-creation model. The search fund formula's success owes much to its main ingredients: outstanding talent that is keen to learn; rigorous selection of targets; mentorship to supplement youth with experience; and a strong, collaborative community.

One key element is the steadfast belief that investors have in the searcher's competence – despite the lack of any significant management experience and their often-limited knowledge of the industry they are about to enter. Consequently, the investors are willing to empower the searcher with the time, trust, and guidance to reach their full potential.

On that trust basis, the searcher-turned-CEO has an extraordinarily powerful position in this model. The searcher will always be the boss and leader, heading a group of multiple investors each with a small investment, heterogeneous, widely dispersed group of investors. In the words of investor Bill Egan, "The searcher starts the search with no ownership in a future company and, if all goes as planned, will become the largest shareholder. It is a truly transformational experience for anyone."

Trust and inspiration notwithstanding, this strange but marvelous concept is still a professional undertaking, and a balanced framework and formal structure must be established to guide and protect all parties involved. Legal documents codify the relationship between the searcher and investors, create a common understanding of the project, and shield all parties against both confusion and misconduct. In allocating significant funds to the venture – which is an implicit bet on the searcher-CEO – investors require that the project has a workable governance structure to provide a counterweight to the CEO's strong position. Equally, the searcher is betting a significant number of professional working years on this project; they need to know that their investors have their back and will not withdraw support at the first sign of a challenge. These concerns manifest into a firm, lasting, written commitment from the searcher and their investors to the project and to one another.

The legal documents used throughout the search fund life cycle do not just organize this searcher–investor relationship, their annexes also contain an immense amount of detailed information about the search fund, the acquired company, and all the parties involved. Within the documents relating to the initial search phase, investors will be listed, along with their number of units, total investment amount, and the stepped-up value at which the original investment will be rolled into a transaction. Upon acquisition, a cap table lists investors, key contacts, investment amounts and types (instruments), and shareholding (in euros and in percentages; see previously mentioned Excel file, item A43/A44). Shareholdings are usually given on a fully diluted basis, including the full vesting of searcher equity and the effect of the employee stock option pool. Reference is also made to the PPM, either by attaching it completely or by highlighting the search criteria (A45). An example of the waterfall mechanism and vesting scenarios is also a helpful addition to the acquisition legal documents.

Searchers or their lawyers may be tempted to introduce innovations or tweaks to the more generally accepted legal structures and terms. We caution against this for two reasons. First, when the model is already working well, it is best to try not to break it. Second, gaining acceptance for such diversions among ten to twenty investors is fraught with difficulty. At best, it creates an unnecessary opportunity for delay, and at worst, it can sow seeds of doubt regarding the searcher's intentions at a critical moment in the acquisition.

Serial search fund investors tend to be well intentioned and truly want a searcher to succeed professionally, personally, and financially. Although legal documents are a framework and define basic rules, not everything can be codified in such a manner, despite the best intentions of searchers and investors. If a need to amend these rules surfaces during an ongoing search fund venture, changes are agreed upon by common sense and consensual discussion, first among the entrepreneur and the board and then among the wider investor base. A norm that has worked well for search funds in the past is that it is up to the board to moderate such discussions and to find solutions that are palatable for the searcher and investors alike.

02 Obtaining solid advice and expertise

The process of setting up legal documents can be complex and time consuming. Although search fund deal documents borrow many straightforward clauses from private equity, there are some unique terms that need to be incorporated. Searchers tend to think that "the legal stuff is for the lawyers" and that it can be can fully delegated accordingly. However, while being knowledgeable in their own field, lawyers may lack business or finance expertise. It is therefore up to the searcher to exercise control over the content of their fund's governing documents (with deference to the norms and established practices), and they should not underestimate the value of employing an attorney who has experience in search funds. Lawyers new to the search fund industry may ignore the fact that, in addition to being an agent for the searcher or for their investor, they also play an important role in helping to nurture a long-term partnership between these two parties.

In developing the documents relating to both the search fund itself and any acquisition it may pursue, it is good practice to collaborate with two to three lead investors and get their sign-off before sending the documents to the rest of the investor group. Some search funds choose to pre-agree on a term sheet before formalizing the entire shareholders' agreement. Such term sheets, which state the major terms of the transaction, can be helpful to achieve general alignment of all parties before diving into some of the finer details.

In some countries, where several search funds have already launched, a few law firms have developed a specialty in these transactions and as a result have become popular with multiple searchers. Using such firms can be both cost effective for the searcher and provide investors with a degree of confidence that the general provisions of the documents are robust. In the ideal situation, the searcher or the lawyer can simply highlight changes from the standard document that has been used in prior searches, making it easy for the investor to assess diversions from the norm.

Similarly, it is recommended to have one or two investors advise on the share purchase agreement. The searcher is generally inexperienced in acquisitions, yet finds themselves having to translate the results of complex due diligence, seller negotiations, and bank financing into a sensible legal agreement. While the document may not necessarily contain provisions specific to a search fund, advice from a couple of seasoned investors at this point is invaluable for the searcher.

03 Limiting liability

To protect investors and searchers, certain legal entities are set up to limit the liability of shareholders, namely, a search fund and subsequently an acquisition vehicle (A41). Although limitation of liability to the amount invested may already be given by nature of the legal entity, this protection – along with the stipulation that liability is several and not joint – should be explicitly confirmed in the legal documents to give comfort to any international investors unfamiliar with the domestic law.

04 Search and acquisition capital

Given that search capital (A2/A3) is at high risk, it comes at a price. This premium includes both an option (right of refusal) to invest pro rata in any acquisition (A4) and a step-up on the initial capital. A 50% step-up remains the standard, and while some searchers have proposed to grant the step-up only on the capital consumed, investors have largely been successful in rebutting this on the premise that the entirety of their committed funds are at full risk during this time.

To fund the acquisition, searchers are generally in need of further equity capital in addition to any debt financing they have secured. While most investors usually participate in both the search and the acquisition phases, there are often some who opt not to invest in the latter. Although it is left unstated in the search legal documents, non-participating investors and searchers may decide on a buy-out at the stepped-up value, an agreement that is codified separately from the transaction documents. If additional capital beyond that which the remaining investors are willing to provide is required to complete the acquisition, further investors may be added to the project even if they were not part of the initial search.

In Europe, search budgets generally vary between €300,000 and €700,000 based on the geography and type of searcher (i.e., a solo or team search). Unit (share) sizes purchased by investors fluctuate from €25,000 to €40,000, and while there has previously been a tendency toward larger units, some investors have begun to invest in fractional units (1/2 unit or even smaller) to balance resources committed across ventures and to diversify their positions. On the other hand, the globalization of the search fund model introduces a different issue. The excellent returns evidenced by the search fund model have naturally attracted large, institutional investors who desire several units at a time. While some search funds have agreed to such demands, many searchers and investors feel this could change certain relationship dynamics within the venture.

Searchers may be tempted to add investors indiscriminately to accelerate fundraising, but this can complicate things later on. Aligning a heterogeneous group of investors in times of stress and urgency will prove to be a difficult task, particularly when there are newcomers to the search model involved. A cap table with a high proportion of experienced, serial search fund investors is helpful to produce a successful outcome. Equally, combining investors from several countries has proven to be a value-add to many search funds but naturally requires well-thought-out structures to be successful.

Carve-out provisions

Of course, if, upon acquisition, the searcher proposes that for the good of the project they intend to deviate from agreed terms, they will usually find a receptive audience in their investors. Traditionally, investors have agreed to offer some equity to an external industry expert board member (a special allocation or a carve-out). Some searchers have recently proposed to reserve special allocations and carve-outs upon acquisition. This effectively limits the right of investors to subscribe both to their pro rata share of the acquisition equity and to any unsubscribed equity. In anticipation of such a strategy, investors may propose that search-phase legal documents include high-approval hurdles: the consent of the searcher and 75%–80% of the participating units (i.e., investors) and up to a maximum of, for example, €200,000 or 5% of the total equity.

Searchers should carefully assess the benefit of carve-out provisions. In negating normal shareholder rights, they can have undesired effects and create unhelpful tension at the time of acquisition to the ultimate detriment of the searcher themself.

Rolling over search capital into acquisition capital

As discussed above, all search capital enjoys the right to roll into the acquisition of a business at a stepped-up value as if invested in cash upon acquisition. Both stepped-up search capital and acquisition capital enjoy the same preferential rights and may bear interest or accumulate a dividend. The vast majority of investors hold their share of the firm (which is collectively 70% or 75% of the firm's overall equity, assuming full vesting by the searcher) in equity-like instruments such as preferred equity or shareholder loans. The exact mechanism by which the roll-in is implemented depends on geography, local law, and structural specifics (i.e., whether the existing search entity is kept or is replaced by a new legal entity). The search fund's lawyer will carry out the important role of ensuring that the step-up works within the relevant jurisdiction.

The Bill Egan clause

There are instances, however, when another clause may override the roll-in (A6). This is the so-called "Bill Egan Clause," named after William P. Egan, a long-time serial search fund investor. This clause requires the company (not the other investors) to buy out an investor at a stepped-up value if the following criteria are met:

- more than 50% of the acquisition equity comes from new outside investors;
- the investor does not participate in the acquisition financing; and
- the investor asks to exercise this right to be bought out.

The logic behind this clause is that the project must have changed substantially if over half of the initial investors do not wish to invest. It is therefore fair to allow the entrepreneur to continue with their project but to require their fund to buy out the investors who do not wish to continue to participate.

Recently, some searchers have proposed that the new company should have a call option to buy out any investor who does not participate in the acquisition, irrespective of the threshold in the Bill Egan clause described above. In such a case, it would be reasonable for investors to insist on a reciprocal put option to force the company to buy out any investor who requests it at the stepped-up value (again, irrespective of the threshold in the Bill Egan clause). However, a searcher might find this not to be in their best interest: it would force them to raise additional capital at the time of acquisition to close the transaction.

Obtaining additional capital

Post acquisition, additional capital may be required for a variety of purposes, including future acquisitions. Some deal agreements have included a call option for additional capital (A42). This has not become standard practice, and we believe it only makes sense in those cases where the additional capital requirement is an integral part of the overall project. For example, it may be sensible in a programmatic acquisition strategy or where a specific second acquisition is pending. In the absence of such a clause, investors are generally happy to discuss such forward-looking initiatives as and when they arise.

05 Establishing a board of directors

Apart from finding a great business, one of the objectives of the searcher during the search is to establish relationships with their investors. On the one hand, close ties with a diverse cap table provides the searcher with a broad base of knowledge and contacts. On the other, frequent communications with the searcher helps investors to mitigate a material risk that they face: that of the unknown CEO.

Many European searchers have found it useful to establish a search board of two or three investors. This is a group of mentors who provide regular guidance and feedback to the searcher during the search phase (A33). While some searchers fear that focusing on only a few mentors' input could lead to undesired biases, we believe this to be misguided. An informal search board is not intended to build a wall between the searcher and their *other* investors; rather, it is a supplementary mentoring platform. It should never prevent a searcher from communicating with all investors directly or vice versa.

Unlike the search board, which is neither obligatory nor has a controlling function, a formal board of directors is always established upon acquisition (A34). There has been a lot of discussion among investors and searchers about the ideal size and composition of boards. To ensure efficiency and avoid unnecessary cost, our view is that boards should contain no less than three members but not exceed five (in both cases, not including the searcher).

Formally, board members are usually appointed by investors. However, the board is an integral part of the searcher's investment offering. It is therefore good practice for searchers to choose their board members and propose them to investors in advance of the acquisition. Recently, a few investors have started to push for board seats for themselves, which may strain goodwill and trust with searchers and co-investors.

Board members take on a special responsibility. They are prepared to commit to the project, be constantly available to contribute valuable insight to the CEO, travel multiple times per year for board meetings, and expose themselves to the inherent liability in doing so. Board members should therefore be paid meaningful fees that, like the CEO's salary, increase over time as profitability improves. Some searchers have proposed to renumerate board members per meeting; however, this fails to reflect the reality of good board work, where the actual appointment represents but a small part of the overall job.

Board members tend to be sourced from the investor base, and seasoned search fund investor board members should form the majority. Non-executive board members should be experienced, knowledgeable, and complementary to each other. Searchers should not underestimate the benefit of having a board that is both trusted among *all* shareholders and knows how search fund projects are run. If sector expertise is desired, industry professionals can also be brought in separately (i.e., as consultants or non-voting board advisors).

Particularly when seller financing exists, it is not uncommon for the seller to require a board seat. This has worked well in many cases but bears the risk of ending problematically; it is hard to prune the tree if the person who planted it is still around. Where a seller joins the board, it is best practice to establish a clear process for removal should conflicts arise.

06 Search budget and searcher salary

Before launching their fund, each entrepreneur should develop a budget specific to their search strategy. While certain elements appear in most search budgets (including the searcher's salary, interns, office space, marketing spend, travel expenses, and due diligence costs), these will vary in size for every fund. Generally, investors should want searchers to be equipped with the resources necessary to conduct a thorough yet efficient search. Still, searching is an unusual pursuit, and search money is at high risk of being written off (one in three searches winds up without closing a deal). When developing the budget, the searcher should bear in mind that search capital is relatively expensive money and that the size of budget may later narrow the number of attractive targets and acquisition opportunities. The searcher should make sure there is enough in the budget to realistically cover costs but not go overboard. Above all, sound management of this budget demonstrates to investors the searcher's ability to control costs and may influence which investors back them for the long haul.

A key line item in the search budget is the searcher's salary. It is both a relatively large expense and of personal importance to the searcher (A1). It is essential to understand that the salary should not be considered a function of the searcher's past professional experiences or previous salary. Although some searchers may argue that their background is deserving of a high salary, this is largely irrelevant – all searchers have impressive CVs. Instead, the salary should be principally determined by the personal situation of the searcher. Investors will understand and support a higher salary for a searcher who is a parent of three school-aged children, has a student loan to pay, and is searching in a country with high living expenses than they will for a searcher who is single with low overhead in a country with a lower cost of living. A searcher's focus should be fully and freely on the search; they should not have to worry about daily living expenses for themselves and their family. That said, search capital should not serve to provide searchers with a source of savings, to fund expensive vacations, or to buy second homes.

At the time of writing this note, there is no transparent benchmarking or compensation information available for European searcher-CEOs. Data from the Stanford Graduate School of Business Search Fund Study is not transferable as it focuses on U.S. salaries, which tend to be higher. Research from IESE Business School on international search funds is limited but confirms lower compensation levels in Europe.

Upon acquisition, the new CEO will receive a fair salary, which will increase over time in line with the success of the company. However, the searcher's focus should not be on their salary but rather on their equity in the new venture. This is where their primary compensation lies – earning a significant share of ownership in a business they did not start and in which they invested little or no capital.

07 Searcher equity – when and how it is vested

A searcher earns equity (often referred to as carry) according to a vesting structure designed to align the interests of the entrepreneur and their investors by incentivizing a long-term commitment to their venture, with sustained, excellent performance. Typically, single searchers can earn up to 25% of the venture's common equity (which rises to 30% for partnered searches; A7). This equity typically vests in three even tranches:

- The first third is vested upon the successful acquisition of a target company (A9). The second third vests over a period of four to five years (A10). These shares vest over monthly, quarterly, or annual periods, with investors generally preferring lengthier intervals to incentivize a longer-term commitment by the searcher. Of course, for partnered search funds, a longer vesting period benefits both the investor group and the other search partner.
- If a sale of the company occurs before all of a searcher's time-based shares have vested, an accelerated vesting of this second tranche is possible (A11) and ensures that the searcher is not penalized for taking advantage of an attractive offer to sell. Under accelerated vesting, the unvested shares are usually added to the performance vesting schedule, which then determines the vesting of those time-based shares accordingly.
- The third tranche of earnable equity is based on performance according to the pre-tax internal rate of return (IRR) to investors (A12). The standard for calculating this metric is by using the cash-on-cash return based on all cash investments made

by investors (during both the search and acquisition) and all returns to investors over the life of the investment (A13). Subject to this IRR exceeding a pre-defined hurdle rate (usually 20%), these performance shares then vest on a sliding scale along a vesting range (which generally extends to 35%; A14). For example, if the IRR is 27.5%, the searcher(s) will earn half of any available performance shares.[*]

There is also an implicit time vesting element involved in this third tranche, as performance vesting can only be earned upon a concrete vesting event (or series thereof), that is, when cash is returned to investors in an exit or through dividends. A prerequisite to performance vesting is that the searcher remains as the driving force and principal (CEO) in the project through the vesting event.

Recently, some searchers have proposed provisions to change the performance vesting schedule five years after acquisition (A15) to one based on the multiple of invested capital (MOIC). This is not standard practice in North America or Europe, and we recommend against it. While search funds are typically projects lasting four to seven years, it is very possible that searchers and their investors may choose to continue the venture beyond this period – even indefinitely. Equally, an attractive opportunity to exit the venture may arise prior to the fifth year. In these scenarios, instead of imposing a rigid time-horizon at the outset, we suggest searchers and investors agree on a "business plan 2.0" that includes redesigned incentives based on the opportunity and risk at that particular time. This approach has been observed to work well in the past for both searchers and investors.

One frequently applied alternative vesting structure that may be appropriate in specific circumstances, however, is that of a reverse vesting scheme (A16). Here, searchers formally receive and hold their full common equity share upon acquisition, while investors and the company are given a call option to buy back any unvested portions of equity (i.e., time-based, or performance-based shares) at a nominal price at exit. Such reverse vesting is typically used due to the requirements of certain jurisdictions and tax codes, and the economic impact is intended to mirror the traditional vesting scheme. It is important to note that reverse vesting necessitates specific adaption of certain legal terms. In addition, there are a few undesirable side effects of this structure (such as those related to the so-called denominator problem and governance, both of which are explained below) that must be addressed in the legal documents.

08 The denominator problem

The denominator problem occurs in a reverse vesting model when part of the searcher's vesting equity is not vested. Unvested shares reduce the calculation basis for company ownership and voting rights, which unintentionally also dilutes investors' rights (A17).

For example, let's assume a partnered search that allows for a total of 30,000 shares in an acquired company to be earned by the two searchers (30%), with 70,000 shares for investors (70%). Let us also assume that the searchers have so far vested just two thirds of their allocated share package. Logic would dictate that the searchers ought to have 20% of the shareholding (2/3 of 30%) and thus enjoy 20% of the voting and economic rights to the business. However, the 10% shares remaining unvested poses a problem when calculating the searcher's ownership percentage – namely, that these 10,000 shares are not included in the denominator (the total shares). Thus, the searcher's resulting shareholding is 22.2% (20,000/90,000) instead of 20% (20,000/100,000). The resulting percentage is neither what was intended nor fair.

[*] For a detailed explanation of performance equity calculations, please see our case note Exploring Search Fund Entrepreneur Economics.

The preferred, practical procedure to correct for the unintended denominator effect is for the company to buy back unvested shares. The issue can also be solved using a call option in favor of investors; however, this method is normally considered an alternative approach. In the case of partnered searchers, such call options should provide for a buyback of both searchers' shares (A18). If, for any reason, shares are to be called from only one search partner, it is still necessary to provide for calling enough shares from the remaining search partner to fully correct the denominator problem (leaving both the remaining search partner and the investors with their correct ownership percentage).

Regarding voting rights, a different approach applies. Without an adjustment, the voting position of a searcher unfairly shifts the balance of power towards the searcher and away from the investors. Therefore, in search fund legal documents, approval rights are often granted to investors, and investor majority approvals are required for major decisions. As an alternative to investor majorities, some searchers have proposed to define shareholder majorities that indirectly ensure that decisions can only be taken by searchers *plus* a majority of investors. However, this can easily confer undesired blocking powers on a few investors or the searcher, and so we view it as preferrable for all parties to establish approval rights requiring simple investor majorities.

09 Governance and notice periods

Prior to any acquisition, the power that the searcher has to run their search operation is largely unlimited. Once the searcher becomes the CEO of an acquired firm, however, this changes. The searcher is likely to be new to both the industry and the role of CEO, and investors trust them with the safekeeping of a multi-million-euro equity investment. Therefore, the CEO will find that certain key matters – as provided in the legal documents – must be discussed and approved by the company's board and shareholders (A35).

Besides approval rights, investors also have information rights that enable them to follow the status and development of the venture (A36). During both the search and the operational phase of the business, the searcher-CEO should provide investors with quarterly updates within 30 days and an annual report within 60 days (90 days if audited). These updates and reports give an overview of the project's general development and the important financial information of the company. Post-acquisition reports include financial accounts of the business, monthly profit and loss, balance sheet, and cashflow in addition to a brief summary of the business and key performance indicators. In addition, there is an obligation to deliver updates, including financials, to the board on a monthly basis, following a format as defined by the board itself.

Notice periods for shareholder votes or responses are defined in various parts of the legal documents. Searchers tend to prefer very short notice periods with the intention of getting things done quickly (A37); however, it is important to allow enough time for all shareholders to consider and respond to any proposals. Indeed, it is a matter of trust and good business conduct to establish reasonable notice periods. In reality, decision processes frequently follow different paths to the ones codified in legal documents, and such rules are rarely applied. Instead, the CEO often makes a proposal, and then the board and the shareholders converse until they reach a consensus. The formally designed, official processes in the legal documents might be better described as the decision-making process of last resort. If it becomes necessary to apply that last resort, it is likely due to some kind of conflict, at which point the searcher and their investors will be glad to have established longer notice periods that allow all stakeholders appropriate time to carefully assess the issues at stake. In general, formal notice periods should always be defined as a minimum of 10 business days This also relates to the duty to deliver comprehensive information that was mentioned earlier. For example, asking for an acquisition commitment (i.e., pre-emptive rights notice, discussed below) or, in the case of a proposed transfer of shares, providing related comprehensive information should be defined as a prerequisite for a notice period to start.

10 Employee options

The introduction of an employee option program (typically up to 5% of equity) is always considered in search fund deals (A21), although we find that the exact mechanisms used to execute these are often undefined (i.e., common shares, virtual shares, share strike price, etc.). Details of the plan are normally developed by the CEO and the board post-acquisition and then approved by an investor majority. Both searchers and investors experience pro rata dilution from an employee incentive program with the expectation that incentive programs create overall economic value.

11 Leaver provisions

The importance of the searcher as the project's principal and of their enduring, full-time commitment is clear. An early departure by the searcher is obviously detrimental to the venture and needs to be addressed through what are called leaver provisions.

In the "good leaver" scenario – typically when a CEO chooses to leave the search project prior to a liquidity event – the searcher loses all unvested shares, including unvested time-based shares and all performance vesting shares. The searcher will keep their vested shares and remain as a shareholder, but investors will have the right to call such unvested shares at a pre-defined minimal value (A19).

In a "bad leaver" scenario – when a searcher is removed from their CEO position – the searcher loses all their shares, both vested *and* unvested (A20). A call option should allow such shares to be called at a minimal value. A definition of what kind of removal or incident triggers such a bad leaver provision is included in the agreements.

As indicated above, it is often observed that the company, rather than the investors, calls and buys the searcher's shares in both cases. If this is the case, a correction mechanism must be established in order to avoid the denominator problem.

12 Transfer rights

Transfers of shares are normally subject to major restrictions to avoid the entry of new, undesired shareholders and to prevent searchers from selling their shares while leaving investors without any liquidity. Some direct transfers of shareholdings are permitted if they do not affect the company and are required by investors, so a list of permitted transfers is established (A22). These are often made within the same world of a specific investor (i.e., a member of the same group of companies, a company under the same management, or relatives).

A transfer of shares should be specifically classified as a permitted transfer or otherwise constrained by major restrictions. One such restriction is a pre-emptive right, which ensures that in every transfer or sale of shares, the company or the investors have a right of first refusal (A26). Generally, the company has preference over investors for pre-emptive rights. In order to avoid misuse, all proposed transfers have to be comprehensive, meaning complete, binding, and with proof of financing. Every sale of shares should require investor or board approval in order to avoid misuse and an undesired sale to a third party (A24/A25).

Some searchers have introduced restrictions on *indirect* transfers of shares. This may include the sale of shares in vehicles that hold shares in the company. This can make sense if a special purpose vehicle (SPV) is involved, as SPVs allow for easy bypassing of transfer restrictions. However, serial search fund investors often use their own established, multi-investment vehicles. Restricting the indirect transfer of shares limits the investor's freedom to take actions with their investment vehicles, which is neither reasonable nor relevant for the acquired company, given the minor relevance of a particular search fund investment within a serial search fund investor's overall portfolio (A23). A change in ownership of an investor's holding company is independent of the particular search fund investment and simply means there is a new indirect shareholder in the search fund or company. Thus, investors should be free to effect changes at the level of their investment holdings.

Recently, some searchers have decided to establish their own SPVs within which to hold their shareholdings[†] (A27). Given the importance of the searcher in the search project and the fact that the company is the dominant asset in the searcher SPV, these require special treatment. Any indirect transfer or sale should always be forbidden for a searcher and their SPV unless approved by the investors. The violation of such a rule would lead to a major sanction, such as classifying the searcher as a bad leaver, resulting in a loss of unvested and vested shares at minimal value.

13 Drag-along and tag-along provisions

Drag-along and tag-along provisions are established to protect shareholder rights. In practice, the entrepreneur normally leads any sale process that would trigger a drag-along or tag-along. A drag-along provision provides for the case in which a majority of investors intend to sell the company (A28). In such a case, all other shareholders are obliged to sell their shares pro rata and on the same terms. Thus, a minority cannot block an exit.

The tag-along provision grants each shareholder the right to sell their shares in a proposed transaction pro rata and on the same terms as the party selling the shares (A29). Thus, minorities are protected from being left in the project while others liquidate.

14 Non-compete and confidentiality provisions

Investors devote a significant amount of money to the search fund project and to the searcher. Because of this, the searcher commits to being fully dedicated to the company for the life of the investment and may not engage in another business (A38). Over time, however, it can become acceptable, or even in the interest of the company, to allow for external activities, subject to investor or board approval. In addition, non-compete provisions require the searcher-CEO to follow certain restrictions on their activities for a certain period beyond the termination of their employment.

In contrast to searchers, investors do not have any limitation regarding outside business activities, a freedom which should be explicitly confirmed in search fund documents (A39). It is the investor's daily business to evaluate opportunities and invest. Any restriction would limit the investor's freedom to act in their core business activity and would not be acceptable. While the impact of the searcher engaging with a competing business would be threatening and should be prevented, the risk arising from investors doing so is negligible. By nature, individual investors have a marginal shareholding in each search fund investment

[†] Searchers establish SPVs as this can be more tax efficient in some jurisdictions.

and, therefore, have reduced influence and insights. In addition, group dynamics give additional protection as most investors are co-invested with other serial search fund investors in a multitude of search funds and search-fund-originated deals. This provides the best protection to ensure that a particular investor does not act against the interest of the company, the searcher-CEO, or the co-investors in a particular project.

In search fund documents, lawyers tend to introduce relatively harsh confidentiality obligations (A40). Although such confidentiality paragraphs are standard in private equity, where they tend to be forgotten and never applied once agreed upon, they should be adapted to reflect the reality of search funds. One of the strengths of the search fund model is the collaborative and open community of searchers, investors, and practitioners within the search fund ecosystem. Communication about search funds and investments should be allowed to a certain extent, while business secrets and relevant confidential matters should be protected.

15 Waterfall and liquidity preferences

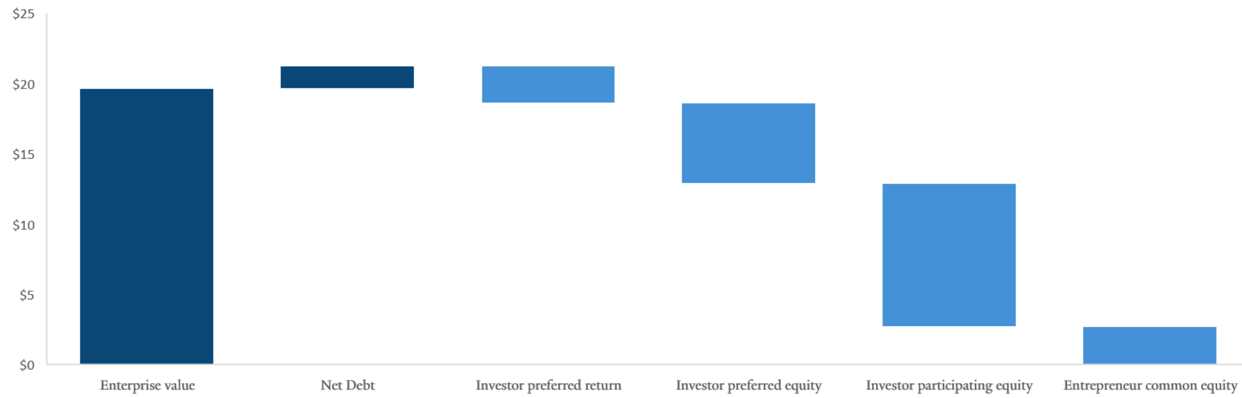
In the event of a distribution of proceeds, usually at an exit, the proceeds should not be distributed simply according to the shareholdings but according to a waterfall, a methodically defined distribution scheme. Before proceeds are shared between all shareholders, investor capital enjoys a liquidation preference and must be paid back in full (including interest). Even in a partial sale, the liquidity preference has to be serviced completely first (A30). While in venture capital deals a lot of creativity can exist regarding liquidation preferences (like an x-times or a non-participating liquidation preference), in search funds a participating 1x liquidation preference is the standard. First, investors get their money back (including the step-up and any accrued interest); second, all shareholders receive proceeds according to their share in the common equity.

Sometimes, an agreement is made to pay a catch-up to the searcher (A32) this is only relevant when the net investor IRR is greater than the investor preferred return. The catch-up is designed to offset the interest payments made to investors. The maximum catch-up payment is equal to the interest payments to investors, multiplied by the searcher's percentage shareholding, and divided by the investors' percentage shareholding. For example, in a scenario where searcher equity fully vests, the searcher would have the right to receive as catch-up a sum equivalent to 25/75 of all interest paid to investors (partnered searchers would get 30/70). Following the return of investor capital with interest and any catch-up payment, the distribution is then allocated according to each individual's common shareholding. **Figure 2** depicts an illustrative waterfall.

Waterfall steps:

- Pay-back of investor capital (including the step-up) plus interest (A31), if any;
- Catch-up, if any;
- Distribution according to common or ordinary shareholdings

Figure 2: An illustrative ETA waterfall



Conclusion

The continued success of search funds relies on a deep level of trust between searchers and their investors. However, a clear framework is needed to define the rules and protect all parties. A balance of power has to be established between the searcher, whose role confers the informal power, and the investors, who require their formal power to be codified. Contractual features and terms are largely standard, but all parties ought to review them carefully, as these details matter.

In this note, we have provided a basic overview of the formal framework and legal documentation required throughout the search fund life cycle. We hope it will help clear the sometimes-muddy waters that first-time and international searchers and investors may feel they are entering when they embark upon their search fund journey.

We wish you the best of luck in your search fund endeavors!

Endnotes

[1] Jürgen Rilling is the founder and managing director of Mirablau GmbH. He is a former searcher and co-CEO of Grundig Business Systems and is currently a board member of the Search Fund Center at IESE Business School in Barcelona.

[2] Simon Webster is Guest Lecturer, London Business School and Judge Business School, University of Cambridge and Entrepreneur in Residence, INSEAD.

[3] Peter Bransden is an MBA candidate at the Yale School of Management.

[4] A. J. Wasserstein is the Eugene F. Williams, Jr. Lecturer in the Practice of Management at the Yale School of Management.