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Exploring and Understanding the Various Legal Documents in a Search Fund Project

Search fund entrepreneurs do not need to be lawyers, but they should know what the legal documents mean

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Once a search fund entrepreneur decides to launch a fund, they are quickly thrust into a world of complex legal documents and arcane language. There are fund formation documents, private placement memorandums, subscription agreements, and more. This amplifies and exacerbates when the entrepreneur locates a deal and is marching through the actual acquisition process. Words like covenants, warranties, escrows, baskets, caps, and intercreditor agreements pop up. Truthfully, the tidal wave can be quite confusing and overwhelming.

The good news is, in an entrepreneurship through acquisition (ETA) journey, entrepreneurs do not need to pretend they are Wall Street mergers and acquisitions lawyers fencing with their counterparty. That would be foolish and would likely lead to an inferior set of documents. Instead, ETA entrepreneurs have a sherpa serving them during the climb in their hired-gun attorney. See our note on selecting a lawyer for a search fund: Exploring How to Partner with a Law Firm for a Search Fund Project. The entrepreneur should own the deal terms and the underpinning pillars of economics and risk, but the lawyer will gracefully guide the entrepreneur through the document maze.

This, however, does not relieve the entrepreneur of their obligation to fully understand the nature of the documents, the role each document serves, and what they should be angling for in each form. The searcher need not be an expert, but they must be an informed user. After all, while the lawyer will be a critical partner in the expedition, neither their name nor their signature will appear anywhere in the document set. In contrast, the entrepreneur's name and signature will blanket the files repeatedly. The lawyer's name will only appear on the invoices. In other words, while the lawyer works for the entrepreneur, the end product is ultimately the entrepreneur's responsibility.

Nobody needs to be a lawyer to be a triumphant ETA CEO, but they do need to be well-versed in all things legal that pertain to that role. Understanding how the documents interact is not that hard, but to the uninitiated, it is a whole new language in which to gain fluency and understanding. Comprehending the legal document set in an ETA foray will help CEOs close deals more successfully and communicate with their seasoned investors with improved grasp and confidence.

In this case note, we will introduce all of the common legal documents a search entrepreneur will likely encounter and use in their odyssey. We will identify the three phases of the voyage containing the documents (**Figure 1**) and then pinpoint the assorted forms in each bucket. We will articulate why each document exists, the purpose it serves, and its critical elements. When appropriate, we will provide some hints on what an entrepreneur should seek and avoid in each document.

This is a primer and will not supplant a law school course on contracts or years of corporate acquisition work as a partner at a top-tier law firm. We aim to provide our readers with enough information so they understand the basics, know how the puzzle pieces fit together, and can formulate what intelligent questions they might need to ask.

Figure 1: Three phases in the ETA voyage requiring multiple legal documents

01 **Fund formation**
02 **Acquisition**
03 **Financing**

Fund formation documents

Once legal counsel is engaged, a searcher can expect drafts of (or comments on) a standard suite of fund formation paperwork from their counsel. These documents will eventually be circulated to investors who want to participate in the offering. Aside from the investment- and searcher-specific details set forth in the private placement memorandum, the form and substance of fund formation documents should not vary significantly across search funds. This section serves to orient a searcher on the basic terms of the fund formation documents (**Figure 2**) and the legal reasoning behind them.

Figure 2: An overview of the fund formation documents

01 **The private placement memorandum**
02 **Formation documents**
03 **Subscription documents**
04 **Amended and restated LLC agreement**
05 **Investor side letter**

01 *The private placement memorandum*

The preparation and distribution of a private placement memorandum (PPM) is often the first step for searchers looking to raise capital from investors. The PPM provides a roadmap of the investment opportunity and the securities to be sold as part of this opportunity. A well-drafted PPM highlights the unique background of the searcher, the investment thesis of the search fund, and the overall strengths of the search fund model while also complying with the requirements of applicable securities laws. From a legal perspective, the PPM serves as a disclosure document that outlines the material facts surrounding the investment opportunity, flags the inherent risks associated with a search fund investment, describes the securities being sold in the offering, and puts prospective investors in a position to make an informed decision about the potential investment. Most searchers will choose to use a template PPM, in which case, it is highly recommended that legal counsel review its terms prior to distribution to investors. Any changes, including modifications to the boilerplate terms (e.g., risk factors, recitation of the search fund model, basic terms of the investment both at the time of search and the time of acquisition, the subscription terms, and exit strategy), should be reviewed by legal counsel ahead of distribution.

02 *Formation documents*

Certificate of formation

This may sound overly reductive, but a search fund cannot exist as a matter of law without a validly formed entity. Most search funds in the United States are formed as Delaware limited liability companies and come into existence by filing what is called a certificate of formation with the Delaware Secretary of State.[*] A certificate of formation contains the most basic information about a search fund and often includes only two provisions: (i) the legal name of the search fund and (ii) the identity and address of a registered agent in the State of Delaware. Delaware law requires the appointment of a registered agent with a physical mailing address in Delaware to allow for what is known as service of process – or official means to deliver court documents to the search fund if a third party initiates a lawsuit or other legal action against it. Most search funds do not have a physical address in Delaware, so they are required to engage a third-party service provider to serve as their registered agent. It is important to note that the third-party service provider's address that is listed in the certificate of formation is not the mailing address of the search fund and should only be used as the method to receive service of process. In other words, a different address (e.g., a virtual corporate office, a co-working space, or the searcher's residential address where the search will be based) should be used by the search fund as its primary mailing address for any other business applications or communications.

Initial LLC agreement

An LLC agreement (sometimes referred to as an operating agreement) is the primary document governing the management and affairs of a limited liability company and its equity holders. A search fund will often need to put in place an initial short-form limited liability company agreement that will be in effect from the date of formation of the search fund through the date of funding by outside investors. Frequently, banks will require search funds to supply an initial LLC agreement to satisfy their know your customer (KYC) requirements and open a bank account. The initial LLC agreement is typically only a few pages in length and sets forth basic information about the search fund, including (i) the appointment of a searcher as the initial member and manager of the search fund and (ii) boilerplate terms that limit the liability of the search fund's members and managers as a function of Delaware law. Notably, the initial LLC agreement is in effect

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[*] Delaware corporate law is widely considered one of the more business-friendly and predictable legal frameworks in the country, which is why Delaware has become the preeminent jurisdiction for most entity formations and mergers and acquisitions activity. The benefits of Delaware law include, among other things, a statutory framework that maximize flexibility for structuring an entity, a well-established court system with predictable legal doctrines, strong liability protections for board members and investors alike, and expediency in processing filings with state authorities. Based on this, Delaware entities are used for substantially all U.S. search funds and are familiar to and expected by most search fund investors.

for a short period of time. It will be replaced by an amended and restated LLC agreement (described below) once investors fund their capital contributions.

Other formation actions

For a search fund to be fully up and running, other formation actions must be undertaken by a searcher. For example, a search fund cannot open a bank account or set up payroll without first obtaining a federal employer identification number (EIN), which is done by completing and submitting a form SS-4 with the U.S. Internal Revenue Service. In addition, the recently enacted Corporate Transparency Act requires newly formed entities to provide information about some of their owners and other people with authority in the company by submitting a beneficial ownership information report (BOIR) to a non-public database maintained by the Department of Treasury's Financial Crimes Enforcement Network. These forms can be filled out online, and a search fund's counsel or other advisors should be able to help with them if needed.

03 *Subscription documents*

Subscription agreement

Each investor will be asked to sign a subscription form agreeing to purchase units of the search fund in exchange for cash. Subscription agreements contain several standard provisions, including (i) listing the number of units, price per unit, and specific funding amount to be wired by the investor; (ii) representations and warranties of the investor regarding its authority to sign the subscription documents; (iii) representations and warranties of the search fund regarding its legal existence and ability to offer units on terms set forth in the PPM; (iv) acknowledgments from the investor regarding its qualifications, accredited investor status, and ability to assume the risk of the investment in the search fund; and (v) covenants to keep the terms of the search confidential.

Accredited investor questionnaire

Each participating investor will also be required to fill out an accredited investor questionnaire. This document verifies that each investor meets the suitability requirements of Regulation D of the Securities Act of 1933, which, in turn, will keep the search fund from having to register the offering with the Securities and Exchange Commission. So long as each participating investor can appropriately check the box of one of the listed accredited investor criteria, then the search fund can satisfy its due diligence requirements and proceed with an unregistered offering of securities. A searcher should consult legal counsel to determine whether any federal or state notice filings will be required in connection with any registration exemptions claimed by the search fund.

04 Amended and restated LLC agreement

The search fund, the searcher, and each investor will also be required to sign an amended and restated LLC agreement that will take effect once all initial funds from investors have been received. The amended and restated LLC agreement replaces the initial LLC agreement and sets forth the governance and economic terms that will be in effect during the search phase, as well as the other rights and obligations of the searcher and the investors, all of which are briefly summarized below.

- *Governance*. The amended and restated LLC agreement appoints the searcher to the board of directors of the search fund and authorizes the board to delegate duties to one or more officers (in most cases, only the searcher(s) is named as an officer of the search fund). It also includes a robust suite of covenants that requires each searcher to dedicate all working hours to running the search, to bring all investment opportunities to the search fund, and to refrain from competing with the search fund.

- *Economics*. This LLC agreement attaches a capitalization table setting forth all of the investors' invested capital and allows for an investor's initial capital contribution to convert on a stepped-up basis (i.e., 150% of an investor's actual invested capital) into preferred equity of the search fund at the time of an acquisition. It also includes terms that entitle the investors to fund their pro rata portion of any additional equity financings (including, in particular, any acquisition financing), as well as terms regarding the distributions of funds during the term of the agreement or upon liquidation. Search funds generally only spend money during the search phase, so these distribution provisions typically do not come into play at this point in the process.

- *Other rights and obligations*. The amended and restated LLC agreement also sets forth provisions outlining the information that investors will receive during the term of the search (e.g., annual financial statements, quarterly management discussions, and information to enable timely tax filings), standard accounting and tax terms regarding the maintenance of capital accounts, tax distributions and withholding obligations, restrictions on transfer (and permitted transfers) of an investor's holding of units, and amendments to the LLC agreement.

- *Miscellaneous.* There are a number of boilerplate clauses embedded in the amended and restated LLC agreement that are a by-product of Delaware law. These include terms that limit the liability of the investors and provide mandatory indemnification by the search fund in the unlikely event that an investor is sued by a third party during the term of the investment.

05 Investor side letter

Finally, a searcher will distribute a two-page side letter to participating investors alongside the other fund formation documentation described above. This side letter is a nonbinding indication of certain core details expected to be included in the LLC agreement that will take effect at the time of an acquisition. The investor letter typically contains details as to the terms of the common units that will be issued to a searcher at the time of acquisition (including time-based and performance-based vesting criteria), the economic terms of the preferred equity issued to investors, an outline of the distribution waterfall, and a quick summary of the other rights and obligations expected to apply to participating investors. Importantly, the investor letter is not a contractual commitment on the search fund or its investors, but rather, it merely serves to orient an investor regarding a searcher's expectations once an acquisition target has been identified. All terms, including those set forth in this side letter, will be subject to discussion and negotiation at the time of acquisition.

The acquisition process

The pinnacle of any searcher's ETA journey is when they have finally closed the acquisition on which they have been working with a particular target and business owner for months. However, well before pen ever touches paper and the keys to the business switch hands, the searcher inevitably finds themselves face-to-face with a myriad of legal documents. Hiring interns or advisors, sending letters indicating interest in a potential target, and signing non-disclosure agreements with prospective target companies are all small steps on the complex path leading to a successful acquisition.

A highly effective lawyer-partner not only shepherds the searcher (and future CEO) with the tactical leadership and guidance necessary to bring a deal from letter of intent (LOI) to close, but also provides the legal tools that allow the future CEO to go into the wild and hunt for themselves.

This section will tackle a quartet of concepts (**Figure 3**). First, we will outline the legal documents that come into play after the fund formation documents but before the actual deal closing. Then, we will explore legal diligence and structuring considerations and the form and function of the various documents that facilitate the purchase and sale of a business. Finally, we will conclude with various other miscellaneous documents the searcher will need along the journey from search fund inception to deal closing.

Figure 3: Four themes we will explore in the acquisition process section

- **01 Documents in play before the acquisition**
- **02 Diligence and deal structure**
- **03 Purchase and sale agreement**
- **04 Ancillaries and other supporting documents**

01 *Documents in play before the acquisition*

There are several legal documents employed before the culmination of an acquisition. While these prelude forms are certainly not the main event, they lay the groundwork and foundation for the acquisition. We will discuss these sundry documents in loose chronological order of their appearance, although there is no hard order.

Offer letters to interns and associates

Utilizing interns and associates is a widely seen and accepted practice in the search fund world. Baked into the budget outlined in a searcher's PPM, interns and associates provide much-needed support to the searcher at a relatively low cost, with the symbiotic advantage of sowing the seeds of the next generation of searchers. Intern engagement paperwork should include non-circumvention language, making it clear that the intern's work product belongs to the search fund.

Advisory agreements

Some searchers choose to engage third-party advisors, commonly known as "finders," to aid in the search for a target business. These engagements can be broadly or narrowly drawn depending on the unique needs of the searcher and the preferences of investors. It is important to note that search fund investors may have mixed feelings about the use of finders in the search fund context. An investor might believe that they are paying the searcher to do the sourcing. These agreements set forth the governing terms of the relationship between the search fund entity and the finder. Providing a form document in this context is by no means meant to act as an encouragement to the searcher to engage in such agreements; instead, it gives the already decided searcher a more favorable form document than the likely over-broad, one-sided agreement that is sure to come from a finder or broker.

Non-disclosure agreements

Once a searcher has their eyes on a target company, they are likely eager to dive into the business's books. But these businesses are not likely to share much – if anything – without some protections in place. This is where a non-disclosure agreement (NDA), sometimes referred to as a confidentiality agreement, comes in. Included in the searcher's toolkit is a form NDA for them to use when engaging with a potential target to determine the attractiveness of a deal. Utilizing an NDA is an essential aspect of gaining access to the books and records of a possible target. Most of the time, these NDAs contain standard terms; however, it is important to avoid agreeing to terms that go beyond confidentiality and begin to create restrictive covenants on a searcher.

Indication of interest letter

These personalized letters are intended to summarize the current intentions of the search fund with respect to the potential acquisition of a particular business. Although not used in every potential deal, these forms are carefully crafted to include the critical information most business owners want to see when someone is offering to buy their company – the price tag. These letters set out a valuation range of the business, sometimes based on a predetermined EBITDA[†] multiple, that the search fund would consider paying in an acquisition. The primary purpose of these letters is to initiate more formal discussions between the two parties and kick-start the signing of a non-disclosure agreement should the business owner express a mutual interest. It can also save a searcher a significant amount of time if their offer is not within a range that the seller would consider.

Letter of intent

Getting a signed LOI is the first significant legal step toward a successful acquisition. An LOI is a written instrument that outlines the preliminary understandings of the parties prior to entering into formal transaction negotiations. Generally, in a nonbinding agreement, except for certain provisions such as confidentiality and exclusivity, the LOI typically includes key negotiation items such as purchase price and structuring and often sets the guideposts for later negotiations on other detailed legal terms of the definitive purchase agreement. Using an LOI has some key advantages: (i) it can keep the negotiations between the parties exclusive and prevent a potential bidding war; (ii) it can prevent misunderstandings later on in the deal by making sure the parties are aware of each other's position on key issues well before significant third-party fees have been generated; (iii) most of the time an ETA buyer will need to do more detailed work to confirm valuation and purchase price, and getting to do that with the exclusivity protection is critical; and (iv) getting some of the easier terms on paper builds morale and momentum for future negotiations.

Investor equity support letters

Even after receiving a letter indicating a search fund's interest, signing an NDA, and spending hours reviewing documents and records, some business owners might still be unsure as to the seriousness of the searcher – or their financial capacity for buying the business. To overcome this final issue gatekeeping the

[†] Earnings before interest, taxes, depreciation, and amortization.

acquisition process, searchers are provided with a form letter, filled out by or on behalf of a lead investor, verifying that the searcher will have sufficient financial backing necessary to bring a deal across the finish line.

02 *Diligence and deal structure*

Before moving to the following few sections, it is important to note a critical step that occurs between signing the LOI and negotiating the deal documents: due diligence. Please see our note On the Nature of Due Diligence in a Search Fund Acquisition for a more complete examination of the diligence process. It is typically more cost-effective and efficient for the searcher to review the financials of the target business and other employment- and customer-related diligence (searching for any potential deal-killers) before the lawyers get fully involved. Financial diligence, typically culminating with the quality of earnings (QofE) report produced by an accounting firm, is paramount to understanding the financial stability of a target company and whether further negotiations should even continue. Generally speaking, once a satisfactory QofE has been provided, the lawyers get the green light to pick up their pencils and start the timers on their gold-plated pocket watches.

Legal diligence

The legal due diligence process in a transaction is indispensable and expensive (for good reason). If business diligence did not uncover any issues worthy of killing the deal, legal diligence is the process that verifies there are no skeletons hidden in the target's closets. The basic function of legal diligence is to evaluate the potential risks of the intended transaction through an investigation of all aspects of the past, present, and predictable future of the business that the searcher hopes to acquire. Some of the key areas that lawyers investigate during this process are intellectual property, labor and employment, employee benefits, real property and environmental, data privacy, and tax (although actual tax diligence is usually left to the accounting firms). Reviewing tremendous amounts of documents in search of any potential issues or discrepancies can be a mountainous task that demands the meticulous eyes of sagacious associates. Leveraging a law firm that can be trusted and relied upon is imperative for the searcher to alleviate as much worry as possible. Specific deals, such as those involving healthcare, software, or other regulated industries, require specific deal-type diligence not mentioned above.

Deal structure

Typically, transactions structured as asset acquisitions are preferred for an ETA buyer because they can shield the buyer from the historical liabilities of the business. An alternative structure is a transaction structured as an equity purchase. In an equity purchase, the buyer becomes the owner of the equity of the target company such that the target retains all of the target's liabilities. Equity deals, however, are not without their perks and are often preferred by the seller. From an ease of execution standpoint, using an equity purchase to consummate the transaction often makes the transition easier by reducing the number of contract assignments that must occur, eliminating the need to terminate and rehire employees, and, for the seller, transferring all unknown liability to the buyer. There are also tax differences between an asset transaction and an equity transaction. A searcher and their lawyer will discuss in detail the advantages and disadvantages of asset purchases and equity purchases. This note does not explore all of the various considerations.

03 *Purchase and sale agreement*

After that long trek through those murky marshes of legal mumbo-jumbo and initial business diligence and structuring, searchers finally arrive at the heart of the conversation: the deal documents. Deal documents are at least fun for mergers and acquisitions (M&A) lawyers, but for search fund CEOs and gritty entrepreneurs, they may be no more than a means to an end. Whether searchers find these legal documents exciting or not, a surface-level understanding of what they are and how they operate and work together is essential.

The critical documents searchers ought to be aware of are (i) the definitive purchase and sale agreement and (ii) the supporting disclosure schedules incorporated into the purchase and sale agreement. Most, if not all, deals will also include numerous other supporting agreements (commonly known as ancillary agreements), which are incorporated by reference within the purchase agreement. All of the documents mentioned above work in harmony to effectuate the transfer of the business, purchase price, structure, post-closing covenants, and much more. A skilled legal technician leading this process is paramount to the success of a search fund and necessary to mitigate the risk the search fund entity may be exposed to throughout the process and following the closing. The subparts below provide additional color to each of these fundamental documents.

Purchase and sale agreement

The definitive purchase and sale agreement is the proverbial meat and potatoes of every M&A deal. This document is the centerpiece of the transaction, although negotiations over terms begin as early as the LOI. The purchase and sale agreement sets forth the structure of the deal, the purchase price of the target, how payment of the purchase price will be made, tax treatment of the transaction, allocation of risk and liability for breaches, closing conditions and deliveries, and the various requirements remaining after the closing. Navigating the immeasurable number of nuances and particulars that are found within any given deal is a task far outside of the scope of what this note seeks to achieve. However, certain key provisions demand further attention (**Figure 4**).

Figure 4: The key elements of the purchase and sale agreement

01 **Representations and warranties**
02 **Disclosure schedules**
03 **Indemnification**
04 **Post-closing covenants**

- *Representations and warranties*. The representations and warranties section of a definitive agreement sets forth detailed statements about the legal and financial condition of the target, the assets or equity of the target being conveyed, the ability of the parties to consummate the transaction, and other matters regarding the target's business, such as intellectual property, compliance, and other key areas. The final purchase price reflects the due diligence done by the buyer, and the representations and warranties made by a seller confirm to a buyer that such due diligence is correct and complete.

Negotiating the scope and substance of the seller's representations and warranties is a critical path to allocating risk between the parties. On the one hand, broadly defined, expansive terms expose the seller to the higher risk of being on the hook for post-closing indemnification. That is a buyer's preference. On the other hand, narrow and limited representations and warranties of the seller expose the buyer to a higher risk that the target business will have more risks than initially anticipated. Thus, a great deal of the negotiations will center around the scope and breadth of the seller's representations and warranties.

- *Disclosure schedules*. The disclosure schedules associated with the definitive purchase agreement are integral to the representations and warranties provisions of the agreement. Together, the definitive purchase agreement and the disclosure schedules create the four corners of a contract that can be legally enforced by a buyer or a seller. Some disclosure schedules act as item lists, such as "Schedule X lists all contracts of the business" or "Schedule Y lists all intellectual property of the business." These informational schedules help a buyer to confirm its due diligence review of the business.

  Other schedules act as exceptions to representations and warranties. For example, "Except as set forth in Section Z of the Disclosure Schedules, the target company is not a party to any litigation or proceedings." These exception schedules allow a seller to disclose applicable known items to a buyer. If a seller fails to disclose a list accurately or fails to disclose a required exception on an applicable disclosure schedule, then the seller would be considered in breach of the representation and warranty under the purchase agreement. In such a case, the buyer would have the contractual, legal right to seek damages resulting from such breach by making an indemnification claim pursuant to the purchase agreement. However, if a seller discloses an undesirable item to a buyer, it does not automatically become the buyer's problem. Instead, a buyer can propose that a seller specifically indemnify the buyer for any such item. As a general matter, a seller will want to make broad, sweeping disclosures that will tend to shift the burden of broadly disclosed matters to a buyer. A buyer prefers that the seller's disclosure schedules be narrowly drafted such that they can fully understand the business that they are buying and the associated risks.

- *Indemnification*. The indemnification section of any definitive purchase agreement is almost always a major point of negotiation. Indemnification provisions in the acquisition transaction outline the circumstances under which a buyer can claim damages (or seek other remedial relief) in the event that the seller breaches a representation or warranty or otherwise fails to abide by its covenants. Indemnification helps supplement the general legal rights of both parties by providing further specificity about the kinds and amounts of recovery available in the event of a breach. It is common for buyers to permit sellers to rein in this exposure by including limitations on indemnification, such as caps, baskets, and survival periods. Consulting with your lawyer regarding market terms for such limitations is a critical step.

- *Post-closing covenants*. For most search fund deals, signing the definitive agreement, closing the deal, and funding the transaction occur simultaneously. Outside of the search fund context, in traditional middle market private equity transactions and public company transactions, many times, the execution of a definitive agreement is separate from the closing and funding of the transaction, but for various reasons, a bifurcated construct is unusual in the ETA realm. In addition to the representations and warranties regarding a business prior to the closing and actions that are required contemporaneously with the closing, following the closing of the transaction, there are certain actions the buyer and the seller will each want the other party to take. The post-closing covenants set forth the obligations of each party with respect to their conduct during a defined time period following the closing. A notable example of a post-closing covenant is the seller restrictive covenant, which provides that all direct and indirect equity holder-sellers agree not to compete with the business and not to solicit customers or employees of the business for a period of (typically) five years following the closing. The last thing any bright-eyed and bushy-tailed search fund buyer wants is to pay millions of dollars to a seasoned industry veteran seller, just to have that seller turn around and start a new competing business.

04 ***Ancillaries and other supporting documents***

Apart from the definitive purchase and sale agreement, there are numerous additional agreements and supporting documents that may be required in connection with the purchase or sale of a business. Some of these agreements, most of which an aspiring searcher can expect to see at some time in the future, are detailed below.

Seller note

Buyers may look to defer payment of part of the cash portion of the purchase price at the closing. Such a portion of the purchase price is paid through what is effectively a promise to pay at a later date by the buyer or operating company in favor of the seller of the business. This is commonly referred to as a seller note, as most such deferred payments are typically documented in a standalone promissory note, but the seller note terms can equally be incorporated directly into the acquisition agreement itself. The seller note terms will outline payment terms, including a maturity date, interest rate, and principal and interest repayment schedule. A buyer may want to pay interest only or have a full payment holiday for the first year or two following the closing with a more typical amortization schedule after that. A seller will typically prefer to be paid as much cash as possible as soon as possible.

The seller note terms will also contain language stating that it is subordinated to any acquisition financing or other traditional institutional bank lending that a buyer has. A seller might request a security interest or other protections against a default by the search fund buyer, and while some of these protections may be acceptable in certain circumstances, a search fund buyer will typically want to retain as much flexibility as possible with respect to its own future financing needs and will therefore likely try to resist seller protective provisions to the maximum extent possible.

Occasionally, referring to a future payment as a deferred payment instead of a note leads to a good result for a searcher because the seller thinks of it as a simple additional (but delayed) payment of the purchase price. While this is uncommon, when it happens, the transaction is streamlined, and terms typical in a lending relationship (e.g., seniority, interest rate, default remedies) are not needed. It is advisable to give this strategy a try in the first draft of the LOI by referring to any future non-contingent payments as deferred payments as opposed to seller notes.

Employment agreements

In many deals, there will be some need for employment agreements, consulting agreements, or other means of retaining the target company's workforce. Employment arrangements with the seller of a business can be short-term, part-time arrangements to assist with transition matters, but they can also be longer-term arrangements involving full-time employment by the seller of the business. There are many business points surrounding employment agreements and terms, but the key legal terms include whether to treat the individual as an employee or a consultant and what to do in the event of termination, whether for cause, not for cause, or via an employee resignation. In addition to transition terms related to the cessation of employment at the business level, it is important to understand how the cessation of employment would implicate a terminated employee's equity holdings, if any. It is essential to get ahead of issues related to employment arrangements for a seller, key employees, and family members of a seller because these arrangements can have emotional implications in addition to legal and business terms.

Escrow agreement

Buyers and sellers have competing interests when it comes to the purchase and sale of a business. Sellers, on the one hand, want to get paid and be on the next flight to Aruba without having to worry about their beach vacation being interrupted by the buyer demanding some portion of their money back. Buyers, on the other hand, want a portion of the purchase price to sit in a holding cell for a year or two following the closing, ready and available to cover any unknown liabilities that may arise post-closing.

Lawyers can often balance these competing interests through the use of a third-party escrow arrangement. Typically, a well-known bank will serve as the third-party escrow agent. The bank will have a form of escrow agreement to which a buyer and seller would agree. A portion of the purchase price – many times approximately ten percent of the purchase price – would be placed in this escrow account at the closing, and that cash, subject to various rules regarding the release of funds, would cover future indemnification claims, working capital adjustments, or other anticipated purchase price adjustments.

Financing documents

After the lawyers are fully engaged in a transaction, the first areas of focus are legal due diligence and the preparation of a draft of the purchase and sale agreement. Once the purchase and sale agreement is in the hands of the seller and their counsel, there is typically a period of at least a week (and frequently two or more weeks) while they digest that draft and prepare comments or issues lists in response. During that window, the buyer and their lawyers are typically focused on arranging and documenting the debt and equity financing needed to close the transaction. This section will focus on the documents and processes involved in that work stream (**Figure 5**). Usually, the equity financing process and documentation are led, on the legal side, by the same lawyer who is working on the purchase and sale agreement, but the debt financing is typically led by a lawyer who is an expert on debt capital markets.

Figure 5: A trio of financing documents

01 **Equity documents**

02 **Senior creditor loan documents**

03 **Additional loan documents**

01 Equity documents

Preemptive rights notice

As discussed above, all of the search phase investors are party to the search vehicle's LLC agreement, which grants them the right to purchase their pro rata share of all of the securities offered by the search entity for purposes of funding the transaction – we refer to that right as a preemptive right. This LLC agreement sets forth the rules and procedures to be followed with respect to this right, which, most importantly, include a requirement that a formal notice be sent to each search phase investor and that each investor be allowed a period of time (usually 15 days) to consider investing in the deal. For that notice to be effective, it must contain information about the transaction, the terms of the preferred units being offered to the investors, and the terms of the equity to be issued to the searcher upon closing the acquisition. Therefore, the searcher must negotiate the key terms with at least some of the investors before sending the notice. This information appears in summary format in the preemptive rights notice (PRN) and is accompanied by an election form to be filled out by the investor indicating their desired investment level. While the search-phase LLC agreement requires that the offer be open for a specified time, searchers frequently endeavor to collect all of the PRNs on an expedited basis to avoid unnecessary delay. It is fairly typical for searchers to have spoken to all of their investors about the transaction and their interest level well in advance of the circulation of the PRN. Doing so tends to accelerate the timing of the collection of PRNs (as well as being the right way to work with investors more generally).

Subscription agreements

The subscription agreement signed at the time of the acquisition is a fairly straightforward document whereby the investors actually purchase the securities offered by the search vehicle. It is similar to the document signed by investors at the search phase. Importantly, the search vehicle does not make promises (representations and warranties) to the investors about the status of the to-be-acquired business. As a result, if there are issues relating to the company that the seller did not disclose, it is a dispute between the search entity and the seller and not between the search vehicle and its investors.

Rollover agreements

In transactions where a seller is going to continue as an equity holder following the closing, there is a rollover or contribution agreement. This is also a simple form where the rollover seller makes simple representations about their ownership of the equity and accepts securities of the search vehicle in exchange for interests in the existing company. Note that in some transactions, where a tax-deferred rollover is not possible but post-closing ownership by a seller is part of the transaction, the seller may sign a subscription agreement (as described above).

LLC agreement

The acquisition-stage LLC agreement (a second amended and restated LLC agreement of the original search fund entity) controls the search fund entity following the closing of the target's acquisition. It is used as a holding company for the equity of the target business. Of the suite of equity financing documents, the LLC agreement is the most involved and the most important. It sets forth the governance and economic terms for the searcher and investors. The governance provisions include voting rights for investors, the board, and the decision-making authority of the CEO, as well as requirements regarding the composition of the board. Searchers should pay particular attention to the section that lays out what the company cannot do without either consent of the board or consent of a majority of investors. Also included are provisions providing rights and obligations of the investors, such as preemptive rights to purchase future equity, rights of first refusal, tag-along rights, and drag-along obligations.

In addition to governance and investor rights, the economics of preferred and common equity holders are set forth. The investors hold a preferred security, typically with a preferred return, and a searcher will hold a common security that is considered a profits interest and, therefore, subject to favorable tax treatment. Terms regarding vesting of the searcher's common equity, typically 1/3 vested at close, 1/3 vested based on time, and 1/3 vested based on performance hurdles for traditional search fund deals, and terms regarding catch-ups and repurchase rights would be included in this second LLC agreement – usually at the end of the document on a schedule. A seller's rollover equity may also be part of the equity-holding structure in this acquisition-phase LLC agreement, so it is a critical document with many moving parts.

02 Senior creditor loan documents

Having invested considerable time in fund formation, deal sourcing, due diligence, and acquisition documentation, searchers (and readers of this note alike) may well find themselves somewhat "lawyered out" by the time the debt documentation comes along and inclined to focus principally on the economic terms of the loan rather than the broader requirements of the loan documentation. This is an urge that searchers should work to resist. The economic terms of loan documentation represent only a small portion of the terms of a debt facility. A comparatively substantial portion of the loan documents focus on the ongoing compliance and other obligations owed to the lender (e.g., financial reporting) and the various negative controls that the lender is granted over the business (e.g., restrictions on the business taking on other debts or selling assets) – all of which searchers will have to live with for years to come. It is, therefore, important that searchers develop the same basic facility with their debt agreements that they do their acquisition documentation. We will now explore several documents that make up the senior creditor loan package.

Term sheet

Much the same way an LOI precedes more fulsome acquisition documentation, the creditor term sheet is the first significant legal step toward a successful debt financing. This document will outline the bulk of the economic terms of the loan, such as principal amount, interest rate, fees, and so forth, as well as those ongoing compliance terms the lender views as fundamental, such as financial reporting cadence and a high-level summary of the expected financial covenant package. At the same time, term sheets are frequently more general on other key ongoing compliance items, either referencing concepts generally with specifics to be agreed or often simply alluding to the definitive documentation, including those representations, warranties, covenants, and defaults as are customary or found in similar deals. While the approach of deferring nuance and detail to the documentation stage is certainly common enough, searchers should be mindful of insisting that references to customary or similar terms speak to deals in general and not to customary terms for similar deals *of that specific lender*. This will better enable their lawyers to push for market terms from the lender in instances where the lender may otherwise push for a less favorable standard (even where they could truthfully argue that they always get that term, market notwithstanding).

The loan and general security agreements

The primary loan documents for any senior secured lender, which may be combined into a single agreement, are (i) the loan agreement itself and (ii) the general all-assets security agreement. Together, these agreements will, in addition to stating the economic terms of the loan, set out a broader regime of rights and obligations that will apply during the life of the loan. Compared to the acquisition documentation, which is principally focused on a one-day transaction (or a short executory period), loan documentation is designed to establish a years-long relationship. Given that, when considering whether to oblige lender requests, the question searchers should continue to come back to is, "Can I agree to live by these terms, without fail, over the medium-to-long term?" rather than "Can I live with this term today?"

Key areas of focus for searchers in debt negotiations include the applicable representations and warranties, covenant packages (including affirmative covenants, negative covenants, and financial covenants), and lender enforcement triggers and rights.

The representations and warranties in debt financing agreements not only are made at the initial loan closing but also are often re-made over the life of the loan in connection with certain discretionary events, notably when borrowing funds after the closing date. Fortunately, compared to acquisition agreement representations and warranties, the representations and warranties in loan documents are typically far more permissive, including many materiality (if not material adverse effect) qualifiers and setting exception and disclosure thresholds at much higher levels. Searchers should take the time to familiarize themselves with these terms so they can feel confident in their business's ability to make these representations and warranties on an ongoing basis (or, where applicable, in their rights to update the lenders as to any relevant exceptions that may arise).

Covenants under loan agreements come in three different varieties – affirmative, negative, and financial.

- The affirmative covenants set out the business's ongoing compliance requirements in favor of the lender. They will notably include the financial reporting that will be owed to the lender and will also contain other areas of required ongoing compliance that searchers should be mindful of, including insurance requirements, cash management restrictions, obligations in respect to certain types of collateral acquired or developed following closing, and certain minimum internal compliance standards for the business. The business will be expected to live up to these standards, largely without fail, on an ongoing basis during the life of the loan.

- The negative covenants establish a series of corporate actions (including, among others, taking on additional debt or liens, disposing of assets, making equity or debt investments in subsidiaries or other businesses, and paying dividends or subordinated debt) that are presumptively prohibited without lender approval. The documents will then go on to include a series of whitelisted exceptions to those rules, many of which are ordinary course and market, but some of which will be specific to the particular business being acquired. Searchers should work with their counsel (and ideally the seller) to get an understanding of what is being restricted by these covenants and what exceptions will be required to allow the business to operate in the ordinary course. The end goal of the negotiations here, for both borrower and lender, is to reach a point where the documents prohibit risky, frivolous, or non-ordinary course actions while at the same time offering sufficient flexibility for the business to be operated without having to pepper the lender with "Mother, may I?" requests on a regular basis.

- The financial covenants establish a series of financial tests and test levels that the business must maintain over the life of the loan. These covenants come in many varieties, but the most common covenants for search fund financings are (i) leverage covenants, testing the amount of bank debt or all debt of the business compared to the business' EBITDA (or, in rarer cases, its recurring revenues); (ii) liquidity tests, which require that the company maintain a certain amount of dry powder at all times, either in the form of cash or undrawn loan amounts from the loan facility; and (iii) fixed charge (or debt service) coverage tests, which broadly measure the business's cash flow compared to certain recurring expenses and charges. Of these three, the terms of coverage tests most often vary from deal to deal, so searchers should work with their investors and advisors to understand the specific components and terms their lender is proposing for that test.

A final key area of the loan and security documentation is the lender's enforcement triggers and their rights once those triggers are met. A key distinction to understand here is the difference between a default (sometimes called a simple default or pending default) and an event of default. A default is a lower-level deviation from the terms of the loan agreement that is capable of being cured or remedied within a certain time period. An event of default results either from a default persisting beyond its grace period or from a material deviation for which no cure period applies. Broadly speaking, a loan agreement will become more onerous to live under during a default, but lenders can only take active enforcement action against the business during an event of default. It is important, therefore, to be informed about the materiality thresholds and cure periods, if any, that distinguish these two kinds of non-compliance with the loan documents to stay out of the doghouse, as it were, with the lending group.

03 Additional loan documents

The primary loan documents will be accompanied by a number of other agreements and related deliverables. Many of these can be left to the borrower's and lender's legal teams to sort out, such as security interest filings to be made on behalf of the lender with the United States Patent and Trademark Office or U.S. Copyright Office in respect to registered intellectual property, but others will require business input. Borrowers should also ask a few questions of their legal teams in connection with ancillary documents.

The first among those questions is whether the lender requests make sense. For example, most lenders will request that borrowers pursue landlord access agreements, whereby the landlord recognizes the lender's senior lien position and agrees to facilitate the lender's access to the location in an event-of-default situation. However, for a business without material equipment or inventory (e.g., a services business) operating with records that are stored in the cloud (rather than a file cabinet the lenders can come in and wheel away), there really is not a lot of value to be had in pursuing these. If a borrower does agree to pursue them, it makes sense to only agree to using commercial realty efforts to try to get the landlord to play ball, versus committing to getting the landlord on board no matter what.

An additional question to ask is when documents should be required to be delivered. Many documents are readily capable of being delivered at closing without issue, but some do take time. Insurance policy endorsements, for example, typically take 30–45 days for a carrier to implement. Similarly, an agreement with the business's deposit bank is required to give a lender customary rights to take control over a business's bank accounts during an event of default, and banks have no real incentive to implement those quickly, so they, too, often lag from 60 to 90 days, or even longer. Deciding which deliverables it makes sense to push to post-closing is, therefore, crucial to ensuring that the searcher can meet both its investors' and the seller's expectations of a timely close.

Junior loan documents

The capital stack of a search fund business often includes one or more forms of junior debt, most commonly either from the seller in the form of the seller note or from a third-party creditor providing a second layer of debt that sits behind the senior secured creditor. True third-party creditors will typically (and fairly) insist on having a documentation package that largely mirrors that of the senior creditor. There is value in that for the borrower as well, both in terms of costs, as the time and money spent in developing the senior loan documents is leveraged for savings in developing the junior ones, and in terms of compliance, as the borrower will generally owe both lenders the same things at the same time rather than be subject to two sets of non-overlapping rules. As noted earlier, sellers may well look to have rights similar to those of the senior creditor, but unless there is a compelling business-specific reason, those requests should be resisted. While seller note holders technically hold debt in the business, their debt position is not the same as that of a true third-party creditor; it exists primarily as a waterfall mechanic to ensure their claim takes precedence over those of the equity holders.

Intercreditor agreement

When a business has both a senior secured credit facility and one or more forms of junior debt, the senior lender will insist on an intercreditor (or subordination) agreement between themselves and the junior holders. The purpose of this document is to establish a written record that the junior debt-holder acknowledges the senior lender's position and also to establish their relative rights in the event of a business deterioration or foreclosure. Agreements between seller noteholders and senior lenders are generally straightforward, requiring that the seller noteholder agree to effectively stand down and go along for the ride with the senior lender's decisions until the senior debt is paid in full. Intercreditor agreements among two third-party lenders, conversely, can often be subject to heavy negotiation, much of which the borrower will not be able to influence as it is not in a position to give to one lender what that lender is not getting from the other. When dealing with two third-party lenders, therefore, it is best to try to confirm that they have a prior history of successful intercreditor negotiations, or if not, have agreed to a certain precedent document to start from to best position the deal to reach closing smoothly and on time.

Conclusion

Search fund entrepreneurs must navigate a jungle of legal documents and issues before closing a deal and ascending to the CEO role. While this legal maze can absolutely be intimidating to the uninitiated, their lawyers will gracefully guide the searcher to the finish line. Entrepreneurs cannot fully delegate the legal morass to their lawyers, but they can engage counsel as a partner in the trek. This does not absolve the searcher's responsibility and obligation to understand and own all of the legal forms – they do – and if something goes awry, they will be called to account by their investors.

Entrepreneurs should familiarize themselves with the slew of legal concepts and documents highlighted in this note. While expertise is not required, a general understanding is. Comprehending how all of the legal forms underpin the process will make searchers more confident and better equipped to focus on the most impactful issues and not sweat the minor details. There is no need to pretend to be a lawyer; instead, the searcher should focus on being an exceptional entrepreneur and CEO and owning the commercial and economic terms of the transaction.

We hope that after reading this note, you are better versed in all things legal in the search fund acquisition process. Additionally, we wish you good fortune and outrageous success in your quest, and we hope your legal angles are smooth and uneventful.

Have fun!

Endnotes

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