

# **Overview of Principal Search Fund Documents**

## **Fund Formation and Search Phases**

**September 17, 2009**

### **Search Fund Formation Phase**

#### **1. Private Placement Memorandum**

The Private Placement Memorandum (PPM) is an offering document which is drafted primarily by the Fund founder or Manager and distributed to potential investors in the Search Fund. The PPM is designed to help potential investors decide whether to invest in the Fund by providing information concerning the investment proposal and the Manager. In recent years, the format of the PPM has become relatively standardized, with the Fund Manager providing detail on his or her background and résumé, the contemplated term of the Fund (typically 24 – 30 months), the Fund's search strategy, the estimated size of the Fund, the Fund's budget, the anticipated terms of the equity interests to be issued by the Search Fund (e.g., right of first refusal, 50% step-up, etc.), and other Fund-specific information, as well as information about search funds generally, including their history and historical investment returns.

In order to comply with federal and state securities laws, the Fund Manager should be careful to avoid a "public distribution" of the PPM by restricting delivery to a limited number of investors, each of whom should be an "accredited investor". Generally speaking, accredited investors include institutional investors and individuals with a net worth of over \$1 million and/or income exceeding \$200,000 in each of the two most recent years and a reasonable expectation of the same income level in the current year.

#### **2. Certificate of Formation of Limited Liability Company – Search Fund**

The Certificate of Formation is a standard form document used to form a limited liability company in the state in which it is desired to be organized. Funds are typically organized in Delaware because of its well-developed and business-oriented limited liability company statute and case law.

#### **3. Limited Liability Company Agreement – Search Fund**

Search Funds are almost always organized as limited liability companies (LLCs). The Delaware LLC statute gives the equity holders of the LLC (called "members") broad discretion to contract as to how the LLC will be managed, what rights and restrictions its membership or equity interests will have, and how profits and losses will be allocated, among other provisions. The LLC is treated as a partnership for federal income tax purposes, which means that, unlike a traditional corporation, the LLC itself pays no federal income taxes. Instead, the profits and losses of the LLC pass through the LLC to its members, as provided in the LLC agreement, and

the members pay federal income tax on their individual share of any profits. During the formation and search phases, a Search Fund typically has very little in the way of profits since the Fund's income is generally limited to the interest it earns on its investors' subscription amounts. Thus, the members of the Fund typically have no tax liability with respect to the Fund during these periods, but are entitled to deduct their proportionate share of LLC expenses or losses on an annual basis.

A typical Search Fund LLC agreement provides that the LLC will be managed by the Fund Manager who is the Search Fund founder. The LLC Agreement gives the Manager broad authority to operate the Fund on a day-to-day basis, subject to Member approval for certain material actions, such as amending the LLC Agreement in a way that adversely affects the Members, appointing or removing the Manager, entering into any contract with the Manager, making any distributions on the membership interests and admitting additional members after the initial subscription period.

Members are typically restricted from transferring their membership interest (other than for estate planning purposes) without the Manager's approval, and cannot withdraw their membership interest after they have subscribed for it. Typically, the LLC is dissolved if the Manager ceases to be the manager of the LLC, unless the Members vote to continue the LLC.

Once the LLC is operational, the Fund Manager should be careful to conduct business only through the LLC in order to minimize any risk of personal liability for the Fund Manager. For example, the Fund Manager should establish separate bank accounts for the LLC in its name and use only those accounts to pay expenses; correspond using appropriate LLC letterhead and e-mail addresses; and ensure that the Fund – not the Fund Manager or some other person – is the party to any contract relating to the business of the Fund.

#### **4. Investor Subscription Agreement**

When it invests in the Fund, the investor executes an Investor Subscription Agreement, acknowledging the terms of its membership interest; that the purchase of the interest is an extremely risky investment which may become worthless; that the investor has had the opportunity to review the PPM and LLC Agreement and acquire additional information about the Fund; and that the interests are restricted and thus cannot be freely transferred. In addition, the investor makes certain representations and warranties to the Fund (including that he or she is an accredited investor), and agrees to keep confidential financial and other information about the Fund.

The Subscription Agreement also sets forth the minimum investment amount required to be invested by all investors in the Fund in order to close the first investment round. In addition, the Subscription Agreement describes the investors' right of first refusal to purchase the equity securities issued in connection with the ultimate acquisition and details the step-up in value of the investment upon the rollover of the investors' interest in the Search Fund into the equity issued in connection with the acquisition.

Some Search Funds attach a non-binding term sheet to the Investor Subscription Agreement describing the anticipated terms of the equity interests which will be issued in connection with the ultimate acquisition, i.e., type of preferred equity, including a description of liquidation and distribution preferences. Some Funds decide not to attach such a term sheet given the relatively long duration and uncertainty of the search phase and the fact that the details of the equity issued in connection with the acquisition are often influenced by the economics of the business being acquired.

## **5. Accredited Investor Questionnaire**

In order to help ensure that the offering of and investment in membership interests of the Fund comply with applicable federal and state securities laws, each Investor is required to complete an Accredited Investor Questionnaire, certifying that the investor meets one or more criteria that allows him or her to be considered an accredited investor.

## **Search Phase**

### **6. Confidentiality Agreement**

Prior to a potential target company's disclosure of any sensitive information to the Fund, the target will typically ask the Fund to sign a confidentiality agreement. The provided form is constructed such that it is delivered by the Fund to the potential target, but it is often the case that the potential target will provide the form of confidentiality agreement to the Fund. The provided form is fairly standard and not particularly buyer or seller-friendly. It contains a customary definition of confidential information (including standard exceptions to the definition), confidentiality and use restrictions, an acknowledgement by the Fund that any rights to the confidential information remain exclusively with the potential target, a covenant regarding the return or destruction of confidential information, the term of the agreement, and certain other customary provisions.

### **7 & 8. Letters of Intent – Asset Purchase and Stock Purchase**

If the Fund is satisfied with its preliminary due diligence regarding a target and determines that it wishes to pursue a purchase of the target more seriously, the Fund, after several in-person meetings with representatives of the target, will usually deliver a letter of intent (LOI) concerning the proposed transaction. The economic and other transaction terms contained in the LOI are typically not binding on the parties but serve the important purpose of allowing the parties to determine if there is agreement on material business terms. The LOI is typically binding only for purposes of ensuring the confidentiality of the parties' discussions, acknowledging that each party is responsible for its own expenses, and restricting the target from negotiating with any other potential buyer for a period following the execution of the LOI, e.g., generally from 60 to 120 days, and certain other customary provisions.

The substantive difference between the asset and stock purchase forms of letter of intent lies in the nature of the transaction. Asset purchases are generally favored by buyers because the structure typically limits the buyer's liability for pre-closing matters and gives the buyer a

“stepped-up” basis in the target’s assets. An asset purchase is typically structured such that the Fund, or more typically a new entity organized by the Fund, purchases substantially all of the assets of the target and assumes only certain of the target’s ordinary course liabilities. Other liabilities of the target, e.g., taxes, material litigation and undisclosed liabilities remain the target’s responsibility after the closing. Because of the buyer’s ability to “cherry pick” the target’s liabilities in an asset deal, the scope of the liabilities assumed by the buyer is often among the most negotiated points in an asset transaction. In a stock purchase transaction, the buyer acquires all of the target’s assets, rights and liabilities (including undisclosed liabilities) as a matter of law, however, there are often negotiations concerning which liabilities the seller will be required to pay off immediately prior to the closing. In both the asset and stock purchase letters of intent, it is often customary to provide for a working capital adjustment to ensure that the business continues to be operated in the ordinary course prior to closing and in some cases to ensure that there is a minimum level of current assets to operate the target business following the closing.

In addition to shielding themselves from target’s pre-closing liabilities, buyers also tend to favor asset purchases because they receive a “cost” basis in the target’s assets. This means that the buyer acquires a basis in the acquired assets equal to the sum of the purchase price, assumed liabilities and certain other items. In a stock purchase transaction, the basis in the target company’s assets generally remains unchanged. Buyer’s cost basis in the acquired assets is often greater than the target’s basis in those assets, which means that buyer will be able to take greater depreciation and amortization deductions than it would have been able to take in a stock deal, and there may be less taxable gain or income when Buyer sells the assets in the future.

## Choate Hall & Stewart

Choate, Hall & Stewart has been one of the nation's leading law firms for over a century. Choate has organized over 60 search funds and has closed on over 35 acquisitions for its search fund clients. Choate is considered the leading law firm for search fund representation and, David Brown, a partner in the firm's Business and Technology Group, is a regular presenter and panelist on search fund topics at Harvard Business School, The MIT Sloan School, the Tuck School of Business at Dartmouth and the Yale School of Management. In addition to search funds, Choate's clients include leading private equity and venture capital firms, technology startups, Fortune 100 companies and prominent financial institutions. Our practice areas are focused on the legal areas that matter most to our clients, including fund formation, mergers and acquisitions, intellectual property, labor, litigation and tax, and our lawyers are internationally recognized by *Chambers USA*, *Best Lawyers in America*, *The Legal 500*, *Superlawyers* and *Expert Guides*, among others. A transaction powerhouse, we have organized thousands of emerging companies and completed M&A transactions with proceeds over \$39 billion, public company securities offerings with proceeds over \$16 billion (since 2000), as well as over \$30 billion in buyout and investment transactions in the last 5 years.