

## Exploring Bilateral Conflicts of Interest Between Entrepreneurs and Investors in Search Fund Projects

Search funds are a wonderful opportunity for aspiring entrepreneurs and capital providers, but there are many inherent conflicts of interest

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Search funds and entrepreneurship through acquisition (ETA) provide a successful model that propels post-MBA aspiring entrepreneurs onto the CEO throne as first-time executives. As entrepreneurs, investors, and academics, we are unabashed, enthusiastic supporters of this model and cannot think of a more compelling opportunity for our students who want to enter the entrepreneurship arena. ETA provides a codified, structured pathway to accessing capital, receiving mentorship, becoming a CEO, and potentially achieving life-changing wealth. It is a marvelous deal.

While ETA offers many compelling features, one that is especially attractive is its focus on aligning the interests of talent (the entrepreneur) and capital (the investors). Entrepreneurs make money in the waterfall when investors profit, and investors are incentivized to support CEOs because their precious capital is at risk. Entrepreneurs are forgoing the steady paycheck and well-paved pathways of banking, consulting, or private equity to acquire and operate a parking lot striping company in Topeka; they are all in. Investors live and die by their reputations in the search fund jungle and are motivated to be fair and on good behavior because there are no secrets, and a bad reputation spreads quickly in the market. Overall, the system generally keeps entrepreneurs and investors aligned and in check—except when it does not.

Search funds are collaborative projects between investors and entrepreneurs. They are carefully designed to align the interests of these two parties most of the time. However, there are moments in the process when the alliance attenuates, and interests may diverge, leading to various conflicts. These tensions are inherent to the search fund model and warrant careful examination.

In this note, we discuss five potential conflicts of interest from the perspectives of both the investor and the entrepreneur. This is not groundbreaking research, and these are all open secrets among ETA insiders. While industry veterans are familiar with these dynamics, newbie entrepreneurs and novel investors might not be. We are especially writing this note for starry-eyed students in MBA classrooms who aspire to be ETA impresarios. Of course, we absolutely want them to embark on an ETA expedition, but we want them to do so with complete knowledge and eyes wide open, not just seeing stars.

Our goal is not to provide solutions to eliminate these potential pitfalls; we believe that is impossible. We expect they will persist, and ETA participants will need to navigate them gingerly. Instead, we aim to clarify the issues so that entrepreneurs and investors can discuss

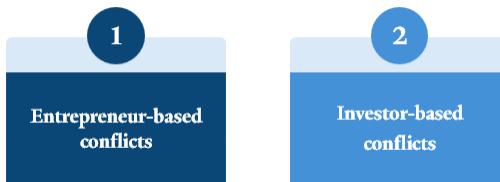
them rationally and dispassionately, ideally before they become problems, and, at a minimum, be aware that they exist in the ETA tournament.

In the context of ETA, we define a conflict of interest as a situation in which a party has a legal, fiduciary, or moral duty to prioritize the interests of the other party but fails to do so, giving precedence to their personal interests. Simply put, it occurs when circumstances arise that cause the entrepreneur and investors to no longer share matching objectives. This can happen even when both parties adhere to the governing documents but have different objectives. To clarify, a conflict of interest entails far more than inconsiderate or unkind behavior, such as taking a week to return a phone call. It is more in the category of actions or situations that prompt a need to call a lawyer or reread the operating agreement. When genuine conflicts of interest occur, at least one party usually feels pretty lousy and wonders why things went off the rails.

To reiterate, we are ETA super fans. We cannot think of a more compelling post-MBA career arc and are thrilled that this opportunity exists for our students. Still, no avenue is perfect, and participants should be aware of what hazards, including potential conflicts of interest, might arise and when.

In this note, we discuss a pentad of bilateral conflicts of interest between search fund entrepreneurs and ETA capital providers (**Figure 1**). We do not claim that these are the only conflicts that might exist; there may be more, but we believe these are the most frequent and most likely to bedevil entrepreneurs and investors alike. We hope that reading this note will help students, entrepreneurs, and capital providers better understand these inherent dynamics of the search fund adventure. Let's dive in!

**Figure 1: The roadmap for this note**



### Entrepreneur-based conflicts

When we began to socialize the concept of this note with ETA players and colleagues, their thoughts immediately turned to the conflicts that investors can create for entrepreneurs, and there are plenty of those. However, entrepreneurs are not angelic, and there are many situations in which they can slip into bad actor mode and display behaviors that are clearly not aligned with, or in the best interests of, their investor partners. Unfortunately, we understand. There are times when entrepreneurs prioritize their own needs because it is their life that is being most strongly affected. Additionally, periodically, entrepreneurs find themselves backed into a corner and make inappropriate shortcuts they believe are in the long-term interest of investors, but the short-term actions are questionable at best. We are fundamentally optimists and do not believe that entrepreneurs intentionally seek or plan to engage in conflicts. However, when things get sticky and bumpy, they can unintentionally slip into the gray zone.

Being an ETA entrepreneur and CEO is challenging. We are often worried that we and our academic colleagues make it seem glamorous or easy, which does a disservice to our students. ETA is incredibly tough on many levels. One of those is the CEO's responsibility to skillfully balance the needs of multiple stakeholders simultaneously. Sometimes, when CEOs are juggling all of these demands, a ball gets dropped,

leading to a conflict of interest. Some of these conflicts are structural and will never change, while others are situational, where the CEO might blink and temporarily make a selfish or poor decision. Both types of conflicts are predictable in the ETA race.

We will now discuss a quintet of common conflicts that entrepreneur-cum-CEOs might exhibit in their relationships with their investor partners (**Figure 2**).

**Figure 2: How entrepreneurs can catalyze conflicts of interest**

- 01 Entrepreneurs are fundamentally optionees
- 02 Entrepreneurs might not really want to be operating CEOs
- 03 Entrepreneurs might want to sell too early or hold on too long
- 04 Entrepreneurs may mislead investors with an information asymmetry advantage
- 05 Entrepreneurs may play in a gray zone with capital allocation

### 01 *Entrepreneurs are fundamentally optionees*

In the search fund labyrinth, entrepreneurs put no capital at risk and enjoy a share of the project's winnings if things go well, while they bear no financial loss if things go badly. This is the classic definition of an optionee—"heads I win, tails you lose." Yes, there are opportunity costs and reputational risks, but entrepreneurs are essentially optionees. This means that when the searcher is nearing the end of the search period, they have every incentive to buy something—anything that gets them in the game. It is widely accepted wisdom that no deal is better than a bad deal, but no deal guarantees no upside. Some deal, any deal, keeps the option alive. When a potential deal looks like a jump ball, optionees might lean in—and it benefits them to do so. Some ETA commentators might say they could get stuck in a bad deal, but if the deal starts to go sideways, the CEO can always quit. While we neither condone nor advocate for this behavior, CEOs can exit; they are not indentured. That will mean burning bridges and abandoning the investor group, of course, but it is the CEO's choice. Either way, entrepreneurs are highly motivated to close a deal, which can undermine and conflict with investors' interests.

This optionee mindset persists throughout the operating phase of the search fund trek. Since the only way CEOs garner lucre is to get a share of the upside, they are highly motivated to constantly push for manufacturing ways to generate it. This might manifest through aggressive leverage use, chasing hyper sales growth, or pursuing add-on acquisitions with unbridled zeal. Some of these strategies may be based on solid commercial logic, but they can also be rooted in a gambler's mentality.

The core conflict here is that entrepreneurs are never rewarded for not closing a bad deal or for avoiding hypergrowth that leads to poor outcomes. The prize comes from closing a deal and hitting a home run. This reality shapes entrepreneurs' behaviors, often resulting in near-conflicts. We see this as an unavoidable structural issue and a potential source of tension.

*02 Entrepreneurs might not really want to be operating CEOs*

In the wake of the proliferation of ETA content, academic courses, and conferences, aspiring fundraisers know precisely what to say to potential investors to secure their investment capital, even if it is disingenuous. Many search fund hopefuls seem to be climbing a ladder toward an investment role and career rather than an operating position. For this breed, serving as an ETA CEO is just a stepping stone toward building an institutional capital pool and becoming a capital provider. While there is nothing inherently wrong with this, entrepreneurs may not be fully honest with prospective financial partners about their true objectives.

We understand that being a CEO is a 24/7 commitment and extremely demanding. We often describe it as an endless marathon at a sprinter's pace. However, that is exactly what ETA wannabes are signing up for. If the truth is that the entrepreneur does not genuinely want to be a CEO, this could lead the CEO to seek a quick exit, not because the investment thesis has changed or because it is the right financial decision, but because they want to notch the win and move on to the next phase of being an ETA investor. By the way, entrepreneurs often think of being an investor as a kind of nirvana, but it is not. It is certainly different but equally challenging.

This is inherently a conflict of interest with the investor group. Standing up an acquisition involves lots of startup costs in funds and time. If that business finds a groove, investors would likely prefer to keep the compounding machine humming rather than jettison the golden goose just so the CEO can move on to a new role.

*03 Entrepreneurs might want to sell too early or hold on too long*

ETA CEOs typically launch their ventures in their early 30s and have little net worth immediately after completing tuition-heavy business school. This places them in a wobbly financial position and can influence their perceptions of holding periods, even if it conflicts with those of other shareholders. When CEOs see themselves with a lot of untapped, illiquid wealth, they often become antsy. They are tired of driving their MBA car and living in a graduate school-like apartment. In other words, they want some liquidity, which may prematurely trigger an exit process—even when it is not in the investors' best interest. The investment thesis might still be strong, and everything might still be moving along swimmingly, but the system could shut down because of the CEO's personal financial needs or desires. Investors might be hesitant to address the illiquidity internally through a loan or equity transaction and might sheepishly go along with a sale. A possible mitigating strategy for a sale is to crystallize the CEO's equity and allow them to bring in a new shareholder in a purchase transaction.

Taking the opposite approach, CEOs might choose to hold on to a flagging asset for too long when it would be wiser to sell. This often occurs when a CEO realizes that they will not receive any performance-based equity upon an exit transaction. In such cases, the company might simply drift, failing to thrive or create sufficient equity value and returns. In such situations, CEOs may prefer to remain in their roles, especially if they earn approximately \$250,000 per year and their location and family needs are met. They downshift into coast mode. This is not in the best interest of investors and creates a conflict of interest. In these cases, searchers and investors can agree to new or updated equity vesting terms, but such negotiations are cumbersome and fraught with painful conversations.

In either case, entrepreneurs can significantly influence the timing of an exit, often based on personal rather than corporate needs. While we understand these motivations and feelings, they can sometimes lead to problematic conflicts of interest. The CEO is essentially placing their personal needs above their shareholders' interests, even though they have a fiduciary and moral responsibility to consider their partners' perspectives.

*04 Entrepreneurs may mislead investors with an information asymmetry advantage*

Entrepreneurs are the gatekeepers of all information during their search and within the operating company after an acquisition. Investors are entirely dependent on what the entrepreneur chooses to share and when. There is a huge information asymmetry advantage favoring the entrepreneur. This places the CEO in a powerful position because they control the narrative that investors receive.

During the search phase, the entrepreneur can conveniently choose not to report on the fantasy acquisition prospect that checks every target economic characteristic and can be had for an attractive price, but is in a fourth-tier market that might be a hardship posting. This can be especially true when a searcher's spouse squashes a deal based on geography. Similarly, when an actionable deal is nearing completion, entrepreneurs may not fully disclose the precariousness of the situation to avoid losing investor attention and support. Seller jitters, diligence bumps, and creditor queasiness always loom. Better to sell sunshine than gloom, even if it is a bit hyperbolic.

The information edge exacerbates post-acquisition when financial stakes are higher. The CEO has all the key indicators that foretell future financial results. Instead of revealing bad news all at once, the CEO might dribble out the glum facts to avoid overwhelming investors. Additionally, CEOs could conceal grim tidings to prevent antagonizing investors and the possibility that investors might lose confidence in the leader.

Entrepreneurs can better control the dialogue and story than investors. The breakout event is always just around the corner, and bad news is not really that painful or, worse than being minimized, it is swept under the rug. This creates a conflict because the CEO might be manipulating short-term facts and information flows to preserve their power, stature, and status. This could directly conflict with what investors should and need to know. This lack of transparency and honesty could prevent investors from taking swift and necessary actions regarding the company or even the CEO. Furthermore, hoarding unpleasant information prevents investors and board members from intervening to help the situation and the CEO.

*05 Entrepreneurs may play in a gray zone with capital allocation*

Once an acquisition closes, entrepreneurs gain *de facto* control over the most powerful lever in the system: capital allocation. This includes both capital expenditures and ongoing operating expenses decisions. While formal governance mechanisms exist, in practice, the entrepreneur exercises broad discretion over how capital is deployed day-to-day, creating a subtle but persistent conflict of interest between entrepreneurs and investors.

From the entrepreneur's perspective, capital allocation decisions are often framed as investments in infrastructure, talent, and essential operating overhead. Many of these expenditures are defensible on their

own merits. However, they may simultaneously improve the entrepreneur's lived experience in ways only loosely tied to incremental equity value for investors.

Entrepreneurs may favor operating investments that lessen personal workload, stress, or skill gaps—such as hiring industry experts or senior functional leaders, outsourcing core tasks, or adding professional services—rather than developing these capabilities themselves. This is especially true when the entrepreneur replaces an owner who has built unique and valuable skills through years of experience. While these choices can strengthen the organization or boost managerial comfort in the short run, they may also prevent the entrepreneur from developing essential operating skills crucial for long-term value creation.

Operating expense decisions can also generate conflicts when they provide non-financial private benefits to the entrepreneur. ETA CEOs typically control the selection of vendors, professional advisors, and service providers who may offer intangible incentives, such as invitations to industry conferences and hosted events, premium access, social capital, or inclusion in desirable professional networks. While these benefits are rarely explicit or improper, they can significantly improve the entrepreneur's personal experience, visibility, and long-term career prospects. Such dynamics can subtly influence decision-making by favoring providers based on relationship rather than performance. The resulting arrangement might satisfy the entrepreneur's personal utility but could lead to higher ongoing costs, reduced execution quality, or diminished scalability for the organization.

Capital expenditures can also reflect the entrepreneur's role as a de facto option holder. Entrepreneurs might rationally prefer capital investments that increase variance rather than expected value. Large, growth-focused capital expenditures, such as aggressive capacity expansions, market entry initiatives, systems built for scale, or front-loaded commercial investments, can significantly boost the chance of an outsized outcome, even if they also raise the risk of capital impairment. If the growth initiative succeeds, the entrepreneur benefits disproportionately through equity appreciation and career signaling. If it fails, the entrepreneur's financial loss is limited chiefly to missed upside, while investors absorb the bulk of the capital loss. This asymmetry can make high-variance capital deployment seem rational to the operator, even when the investment's expected value is negative.

Importantly, this conflict rarely manifests as direct disagreement. Investors often hesitate to second-guess operational decisions unless there is obvious underperformance, and entrepreneurs seldom present these choices as self-interested. Instead, the conflict remains subtle: Entrepreneurs rationally allocate capital to enhance their experience, reputation, or perceived professionalism, while investors absorb the opportunity cost of missed distributions, slower margin growth, or deferred exits.

### **Investor-based conflicts**

Entrepreneurs are not the only ones who take actions that can be perceived as stemming from conflicts of interest; investors also have plenty of opportunities. Additionally, with more experience in the match and greater power in the relationship, investors can flex their muscles in ways that might make entrepreneurs bristle at perceived tensions. Moreover, investors are understandably laser-focused on returns and somewhat less aware of the personal or qualitative dynamics that might be more important to the ETA CEO. This can create a clearer boundary for behavior compared to that of entrepreneurs. Investors might be less emotionally involved and more focused on the big picture, while entrepreneurs are personally

committed and concentrated on the granular mechanics of the business. However, investors live by their reputations and generally avoid actions that could jeopardize future deal flow.

Although investor-based conflicts are numerous, we do not observe investors engaging in conflict indiscriminately. They tend to act only when something material is at stake and the investor believes it is truly necessary to assert their position. We will now discuss a fivesome of possible investor-based conflicts (**Figure 3**).

**Figure 3: Ways that investors can prompt conflicts of interest**

- 01 Investors can fire CEOs and CEOs cannot fire investors
- 02 Investors might invest in and sit on competitor company boards
- 03 Investors will ask CEOs to roll equity when a PE firm is the next buyer
- 04 Investors might organize the cap table and advisory team for their advantage
- 05 Investors will optimize their portfolio, not each investment

### 01 *Investors can fire CEOs and CEOs cannot fire investors*

Once entrepreneurs invite investors into their tent, the investors gain the power to fire the CEO, while the CEO remains permanently attached to the investors. This unilateral relationship is understandable but complicated. When a company performs poorly, the CEO risks being fired. However, if the CEO becomes frustrated with investors, there is little they can do. Investors provide capital, and with that comes governance authority. Most CEOs probably believe they are doing a great job and should never be fired, even when the company struggles, yet clearly there are circumstances when the CEO should be replaced. However, in this relationship dynamic, termination rights are a one-way street. Furthermore, even when the CEO warrants being dropped, investors act in their own interest, and the consequential fallout for the CEO is a secondary concern. Finally, when a CEO is jettisoned, the board might seek to have the CEO sell or forgo their equity to create a fresh equity incentive package for the subsequent CEO.

The CEO's information power further amplifies these dynamics. CEOs often believe they are performing well and that the business is on track. If investors begin raising concerns about the search CEO needing support, the search CEO might be tempted to withhold bad news rather than seek help from the board or keep the board fully informed. Poor performance could lead to for-cause termination if the search CEO misleads the board or a lender about financial covenant compliance, among other issues. It can get messy when things start to go sideways, and everyone retreats to their corners, hunkers down, and reads the operating agreement.

We view this as an endemic and structural conflict that cannot be eliminated. When investors provide capital, they must retain governance rights over who the CEO is. Accordingly, investors can always fire CEOs, and entrepreneurs cannot fire investors. That is simply how the game is played. CEOs need to be aware of this and to plan and behave accordingly.

*02 Investors might invest in and sit on competitor company boards*

Investors have broad and complex portfolios, often holding hundreds of searchers and assets. This can lead an investor to support multiple searchers competing for the same target company to acquire or invest in, or to support companies battling for the same customers or other acquisition targets. This presents thorny conflicts of interest. These situations raise tough questions about what information CEOs should share with investors and which CEOs investors will fully back when they have stakes in multiple opposing companies. Additionally, investors with conflicts involving rivaling portfolio companies also face conflicts with co-investors who do not share those conflicts, since their loyalty and views are focused on a single investment rather than multiple ones. It is a complicated situation.

This dynamic is further exacerbated when a capital provider is not only an investor in various jousting projects but also a board member of antagonist firms. Capital providers obviously need to retain the ability to invest in scores of ETA projects to build broadly diversified portfolios. Furthermore, when an investor backs a searcher (without a deal attached), they do not know how the investment story will unfold. Institutional ETA investors with a mandate to deploy capital seek to invest funds wherever compelling returns might be found. That mission is difficult enough without constraints related to competing enterprises or conflicting directorships.

This is a tricky situation, fraught with conflicts and unpredictability, with repercussions for the entrepreneur. CEOs often report frustration and emotional distress when they become entangled in investor conflicts involving other portfolio assets.

*03 Investors will ask CEOs to roll equity when a PE firm is the next buyer*

It is common for private equity (PE) buyers to require that selling ETA CEOs roll equity into a recapitalized deal. This means CEOs will not receive full liquidity in a sale, while investors probably will. Investors aim to maximize their returns and will subtly push CEOs to do whatever is necessary to support the trading equity value. This implicitly suggests that CEOs' equity carries additional encumbrances beyond investors' preferred returns and superior liquidation rights. CEOs are often caught off guard by this in the emotionally charged exit process and do not know where to turn or what to do since their advisors (the board) are in opposition to the CEO's interests. Additionally, legal counsel represents the corporation, not the CEO. This presents a thorny conflict of interest since there is a divergence in goals and expectations at exit time. CEOs might care most about the opportunity for the greatest amount of cash flowing to their pockets (regardless of valuation), while investors will likely prioritize total valuation because their cash will probably be fully realized at closing. This predicament puts CEOs and investors at odds and creates a conflict between them.

In addition, the ETA CEO will almost always have to agree to burdensome non-compete and restrictive covenant commitments, while professional investors are not required to make the same commitments at exit. Although this is a practical reality, it can feel unfair or be uncomfortable for an unwitting CEO.

Furthermore, when exiting, representation and warranty insurance should be used to cover indemnity claims by the selling group; however, the ETA CEO may face additional exposure for claims outside of the policy, such as fraud. The ETA CEO's rollover equity might also be targeted as a recovery option for the buying entity. Once again, these circumstances create conflicts because the principal parties (CEO and investors) have very different needs, goals, and risk profiles.

*04 Investors might organize the cap table and advisory team for their advantage*

Entrepreneurs often seek advice from investors on how to find additional sources of capital when raising search funds. Although this request may seem harmless, it can lead to creating a cap table that is less diverse or independent than they realize. Some CEOs claim they have a broad cap table with twenty investors, but it often functions as a single unified voice because the investors act as a cohesive group. So much for diverse opinions or investors supporting the CEO when other investors criticize.

Investors typically collaborate on multiple deals over their careers; these relationships serve as ongoing sources of deal flow and are highly important. In contrast, entrepreneurs may have only a single, one-time relationship with investors. This can create tension and a conflict of interest in how investors behave toward CEOs, since their co-investors are valuable, ongoing relationships. As a result, investors might prioritize their co-investors' needs over those of the CEO.

Similarly, investors often recommend that entrepreneurs collaborate with service providers, such as lawyers, accountants, and due diligence professionals, who have a deep understanding of the search fund model and its intricacies. Entrepreneurs may seek advice from their investors during this selection process. However, they should be aware that this can create a pseudo-channel partnership dynamic, where the service provider, out of loyalty, subtly favors the investor's interests over the entrepreneur's—especially when those interests conflict—since investors are viewed as sources of ongoing referrals and business. Technically, service providers such as attorneys represent the search fund itself, not the entrepreneur personally or the investors. Still, this relationship can become unclear, and service providers might lean toward the party that promises more future work. All of this can lead to muted conflicts of interest among investors, entrepreneurs, and service providers.

*05 Investors will optimize their portfolio, not each investment*

Institutional investors operate a business that serves both general partners (GPs) and limited partners (LPs); these are the customers, and that is where their fiduciary interests and duties lie. They optimize their firm and their portfolio, rather than individual assets in which they invest. Usually, this does not create misalignment, but sometimes it can cause interests to go off course. For example, a large institutional investor might pressure an entrepreneur to prematurely exit to highlight favorable news alongside a major fundraising effort. That is about managing the portfolio, not optimizing individual assets. Additionally, they might squelch a growth initiative in a company because they are nearing the end of the fund's investment period and are no longer making new investments. Similarly, a large investor might decline a desirable deal opportunity perceived as too small because they need to write larger checks. Actions like these constitute potential conflicts of interest in which the investor prioritizes their interests over those of the CEO or the company.

Furthermore, the economic incentives of fund management may conflict with the traditional, legacy role of a skilled search investor. Before the professionalization and institutionalization of the search investment niche, individuals acting as principals made direct investments and played a highly active role in guiding and mentoring the search entrepreneurs. As the asset class has grown significantly, LP capital has entered the space in large amounts, rewarding experienced investors with bigger pools of funds to manage. They have willingly taken on additional investment assets because these assets also offer greater economic benefits, but this has stretched them too thin. Many now sit on several boards, and anecdotally, the time

they devote to each entrepreneur has decreased considerably. A nascent searcher may develop a relationship with the head of a large institutional investor on campus or during fundraising, only to discover that the only capacity to support the CEO during operations is the firm's newest hire, who lacks operating experience or is joining their first board. This situation can present a nuanced layer of conflict between investors and entrepreneurs.

## Conclusion

ETA is a terrific post-MBA career pathway. We cannot think of a more compelling opportunity for our students and aspiring entrepreneurs. However, ETA is not a perfect course for either investors or entrepreneurs. There are several areas in which conflicts of interest are likely to arise and are inevitable. Despite this, ETA remains a compelling model, and the inherent conflicts are likely not significant enough to prompt someone to eschew the avenue entirely. Nevertheless, we want talent and capital to be clear-eyed about these conflicts and to approach them rationally.

Perhaps the best way to manage potential conflicts is for entrepreneurs and capital providers to treat their counterparty as they would like to be treated—to step into each other's shoes and try to understand what the other person needs and how best to help them achieve their goals while also accomplishing their own objectives. This is not always easy or even possible, but it is an excellent way to approach the dance.

We wish entrepreneurs and investors continued good luck and success as they play in the ETA pond. We enjoy watching your dramas unfold and are cheering for you from the sidelines. We hope that no conflicts of interest are on your horizon, but we also hope that this note highlights some of the pitfalls that might lie ahead.

Best wishes for your odyssey, and we fully expect it to be smooth, conflict-free, and filled with emotional, intellectual, and financial riches!

This case has been developed for pedagogical purposes. The case is not intended to furnish primary data, serve as an endorsement of the organization in question, or illustrate either effective or ineffective management techniques or strategies.

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## Endnotes

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