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The Importance of Well-Crafted Corporate Opportunity Waivers in Private Equity and Venture Capital Investments

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A recent Delaware Supreme Court order affirming the Court of Chancery's ruling in *Alarm.com Holdings, Inc. v. ABS Capital Partners, Inc.* provides important guidance for private equity and venture capital firms that seek to invest in competing businesses. Among other things, the decision stresses the importance of adopting provisions in governing investment documents, including the target's certificate of incorporation, that permit the PE or VC firms to invest in competing businesses. The decision also cautions that broad corporate opportunity waivers may not be enforceable and that these waivers should be carefully drafted to avoid being declared invalid. Other notable takeaways from the decision are discussed below.

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Background

In 2009, ABS Capital Partners, Inc. acquired a controlling interest in Alarm.com, Inc. through two funds that it managed. ABS appointed three directors to Alarm's board of directors, including one of its partners, Ralph Terkowitz.

In addition to the other documents governing ABS's investment, such as the nondisclosure agreement and stockholder agreements, Alarm's amended and restated certificate of incorporation (charter) contained a provision pursuant to section 122(17) of the Delaware General Corporation Law (DGCL) eliminating any obligation of Alarm's stockholders, including ABS, to refrain from pursuing corporate opportunities that might belong to Alarm.

In September 2017, ABS acquired a significant ownership interest in Resolution Products, Inc., a venture that competes directly with Alarm. ABS did not nominate Terkowtiz to Resolution's board of directors. Rather, ABS appointed one of its other partners, Phil Clough.

Court's Analysis

Shortly after ABS's investment in Resolution, Alarm filed suit, alleging that ABS and its two funds misappropriated Alarm's trade secrets and confidential information by investing in its competitor, Resolution. ABS and its funds moved to dismiss for failure to state a claim.

The court granted ABS and its funds' motion, finding that Alarm's claim failed because the documents governing ABS's investment in Alarm, such as Alarm's charter, included corporate opportunity waiver provisions that authorized ABS to invest in competing businesses.

The effect of the provisions, the court held, was "to waive any claim [by Alarm against its stockholders, including ABS] based on either usurpation of a corporate opportunity or anticompetitive activity." Thus, the court concluded that the parties specifically "contemplated that ABS could do precisely what it did" — invest in a competing company. Accordingly, the court dismissed Alarm's claims.

The court made clear in a footnote, however, that it was not deciding (because the parties did not argue) whether or not broad corporate opportunity waivers, such as the one in Alarm's charter, are enforceable. The court stated that "[n]o one has challenged the

scope of the waiver, and this decision provides no opportunity to opine on the validity of a broad and general renunciation of corporate opportunities, as contrasted with a more tailored provision addressing a specified business opportunity or a well-defined class or category of business opportunities."

Takeaways

To lessen the risk that a PE or VC firm will be held liable for investing in a competing business, firms should heed the following takeaways from the court's decision:

- **Adopt Corporate Opportunity Waivers.** PE and VC firms should be sure to include well-crafted corporate opportunity waivers in the transaction documents governing their investments, including nondisclosure agreements, stockholder agreements and, most importantly, the target's certificate of incorporation.

  Notably, corporate opportunity waivers in certificates of incorporation must be carefully drafted to avoid being declared invalid. Section 122(17) of the DGCL permits a corporation to "[r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, *specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders."* The Court of Chancery made clear in its decision that it did not resolve whether broad corporate opportunity waivers are enforceable, or whether those provisions must address specific business opportunities or a defined class or category of opportunities, as specified in the DGCL.

  PE and VC firms could instead consider using limited liability companies as investment vehicles and adopting broad corporate opportunity waivers in the applicable limited liability company agreement due to the absence of a section 122(17) equivalent in the Delaware Limited Liability Company Act and the flexible, contract-based nature of limited liability companies.

- **Confidentiality Carve-Outs.** To ensure that board designees may properly communicate with the fund about its investment, PE and VC firms should ensure that any confidentiality obligations in governing transaction documents permit disclosure of company information to the fund, its partners, agents and other affiliates.

- **Avoid the Dual-Fiduciary Problem.** To help avoid a finding or pleading-stage inference of misappropriation, PE and VC firms should designate different representatives to the boards of competing businesses. A PE or VC firm should not, for instance, designate the same representative to the boards of two competing businesses in which it has invested.

- **Prevent Prohibited Disclosures**. Finally, when investing in competing companies, PE and VC firms should implement screens intended to prevent the disclosure of one company's confidential business information to a competitor in which the PE or VC firm has also invested.

By taking these steps, PE and VC firms can help stave off lawsuits asserted against the firms and their representatives arising out of investments in potentially competing businesses.