Find the middle ground

The corporate opportunity doctrine when your investors are competitors

INTERVIEWED BY JAYNE GEST

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Consider this scenario: A startup in the artificial intelligence (AI) space develops a unique algorithm. A larger AI firm is interested in this algorithm but isn't sure it'll work. The larger company doesn't want to buy the startup, but it wants a foot in the door on the new technology and is willing to invest. The startup needs funds but is concerned about the competitive issues created by giving the larger company a board seat and waiving the corporate opportunity doctrine.

"A smaller company is under pressure — in this scenario or others like it — to waive the corporate opportunity doctrine," says Sara M. Antol, shareholder at Babst Calland. "Before you do that, stop and think about what this will mean. You need to determine whether there's room to compromise with tailored language that serves the purposes of both the company and the investor."

Smart Business spoke with Antol and Christian A. Farmakis, shareholder and chairman of the board at Babst Calland, about the corporate opportunity doctrine.

What is the corporate opportunity doctrine?

The corporate opportunity doctrine is part of the duty of loyalty imposed upon corporate fiduciaries. It's not uncommon for a business owner or entity to invest in another company. If the investment is significant, the investor may demand a board seat to help influence the policies and operations of the company. If this person finds out about an opportunity as a board member, the corporate opportunity doctrine stops that director or officer from personally benefitting from an opportunity that would belong to the corporation, if it meets a four-pronged test:

- If the corporation is financially able to exploit the opportunity.
- If the opportunity is within the corporation's line of business.
- If the corporation has an interest or expectation relating to the opportunity.
- If by taking the opportunity, the officer or director is placed in a position adverse or in conflict with the corporation.

How did it become commonplace for this doctrine to be waived?

As private investment increased, investors saw the potential conflict created by the duty of loyalty if they acted to maximize their interests while serving on a board. In 2000, Delaware amended its general corporation law to allow companies to expressly waive that duty in their certificate of incorporation. Since then, other states have adopted similar provisions, such as Pennsylvania's limited liability company law in 2016.

Today, it's common for companies to waive the corporate opportunity doctrine. Form investment documents, especially with private equity, often include this language.

Why would a company invest in a competitor and how does it create conflict?

A bigger company looking for the next big thing might invest in startups within its market space. Then, it can leverage the product or technology when the opportunity matures. Frequently, these startups are searching for capital and willing to agree to investment from a larger competitor.

The conflict arises when the larger company wants a waiver of the corporate opportunity doctrine in the investment documents. This allows the larger company to operate in its market space, which is shared by both companies, without restriction. The smaller company, though, may justifiably have concerns about future competition from the larger company.

How can companies find a compromise?

The waiver language can be tailored to address the areas and issues where the two companies might most likely compete. For example, if the larger company ends up competing with the smaller company under the waiver, the investor could lose some investor rights — investor rights that you wouldn't want a competitor to have, like a board seat, monthly financial information or information about customer opportunities. Instead, perhaps the board seat converts to observer rights and the investor is limited to only receiving annual financial information.

There's room to negotiate and countless scenarios could be proposed, so founders need to think carefully and assess the situation before agreeing to waive the corporate opportunity doctrine. At the very least they'll have their eyes open to the risks and know what they're giving up by agreeing to this waiver. ●

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