Caution to Private Equity Firms Acquiring Competing Portfolio Companies

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A common investment strategy for a private equity firm is to acquire a portfolio company in a certain industry as a platform investment, and then for the portfolio company to acquire a competitor as an "add-on". But what if the private equity firm instead decides to directly acquire a competitor of a platform investment? A private equity firm may be surprised to learn that, if such possibility has not been contemplated and addressed before the private equity firm acquires the platform investment, the private equity firm could be exposed to potentially successful claims of wrongdoing from the existing portfolio company or the existing portfolio company's other equity owners. This article describes how a private equity firm can preserve its right to change investment strategies and protect itself from claims of wrongdoing under Delaware law.

How Can a Private Equity Firm Preserve its Ability to Change Investment Strategies?

All agreements between a private equity firm and its portfolio company, including any non-disclosure, management and stockholder agreements, should expressly provide the private equity firm with the right to directly acquire competitors of the portfolio company. The following are examples:

> *"The [private equity firm] deal[s] with many companies, some of which may pursue similar or competitive paths. Nothing in this letter agreement will prevent [the private equity firm] from evaluating a possible investment in and/or collaboration with, or entering into any transaction with (including any investment in), a company whose business is similar or competitive with the business of the company."*

> *"The [private equity firm] has no duty (contractual or otherwise) not to, directly or indirectly, engage in the same or similar business activities or lines of businesses as the [portfolio company]."*

> *"The parties expressly acknowledge and agree that the [private equity firm, as a stockholder] shall have the right to, and shall have no duty not to (contractual or otherwise) engage in business ventures with companies that are competitive."*

In addition, the portfolio company's corporate charter should include a provision under Delaware General Corporation Law Section 122(17) that exempts stockholders and certain directors from any duty not to pursue corporate opportunities that otherwise might belong to the portfolio company. Such a provision in the corporate charter will have the effect of waiving any potential claims for breach of the duty of loyalty against the private equity firm or its representatives serving on the board of the portfolio company based on either usurpation of a corporate opportunity or anticompetitive activity.

Additional Steps That Should Be Taken to Protect Against Claims

Even if all the applicable agreements and the corporate charter properly preserve the private equity firm's rights, the private equity firm may still face claims of wrongdoing if, in the context of investing directly in a competitor of a portfolio company, it does not comply with all applicable trade secret laws and confidentiality obligations. While Delaware courts will not allow a plaintiff to circumvent the private equity firm's proper preservation of its rights by bringing a misappropriation of trade secrets claim as a "fiduciary substitute", it is important to note that a court may find misappropriation of trade secrets with only circumstantial (versus direct) evidence.

Accordingly, the private equity firm would be wise to appoint different representatives to the boards of directors of its portfolio companies within the same industry. In addition, the private equity firm should implement policies to ensure compliance with applicable trade secrets laws and confidentiality obligations, including how portfolio company information is controlled and shared (and NOT shared) within the private equity firm and with other portfolio companies.

Conclusion

Private equity firms sometimes, after acquiring a portfolio company that is intended to be a platform investment within a certain industry, decide to directly acquire a competitor of the platform investment. Private equity firms should properly plan for this possibility before acquiring the platform investment to preserve their right to change investment strategies and to protect themselves from claims of wrongdoing.

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