UNDERSTANDING CONFIDENTIALITY AGREEMENTS

By Harry R. Beaudry

A binding confidentiality agreement is often the very first document negotiated in a significant business transaction. Whether you are selling your company, exploring a joint venture or other commercial relationship, or inviting potential investors to come in and "kick the tires," you must make sure that important information about your business is adequately safeguarded before you share it with outsiders. A well-drafted confidentiality agreement can give you peace of mind that, whether the deal happens or not, information critical to your business will be protected.

Confidentiality agreements (sometimes called "non-disclosure agreements") come in various shapes and sizes. The most effective confidentiality agreements are tailored to the type of transaction being considered and the specific nature of the business and information that will be evaluated. Be extremely wary of anyone who insists that his or her form of confidentiality agreement is "standard" or "customary" and therefore non-negotiable; these agreements are almost always negotiated. The following takes a look at some of the key provisions in confidentiality agreements and explains why they are the subject of frequent, and sometimes intense, negotiation.

What Information Is Confidential?

A confidentiality agreement serves two fundamental purposes: (1) to prevent *disclosure* of confidential information to unauthorized persons; and (2) to prevent *misuse* of confidential information by the recipient. To achieve these objectives, you will need to make sure that the definition of "confidential information" in your agreement captures all of the critical business information that you want to protect.

If you are the party that will be sharing information, you will want a broad definition that captures all the kinds of information that might be shared with the party receiving the information, including all written, electronic, and oral information, as well as any notes, reports, analyses, or other works prepared by the recipient that were derived from information you provided. The recipient party, however, will want to define "confidential information" narrowly to avoid an accidental breach of the agreement and limit its exposure. For instance, the recipient party may propose a definition that captures only information relevant to the proposed transaction, or request that confidential information only consist of information that is marked "CONFIDENTIAL." There may be some back-and-forth as the parties negotiate and refine the definition.

IF A TRADE SECRET OR OTHER HIGHLY SENSITIVE INFORMATION IS INVOLVED,

it is appropriate to ask for an extended term only for that particular information, not for confidential information generally.

There are some customary carve-outs from the definition of confidential information:

- information that is generally available to the public;
- information that was already in the recipient's possession or was already known by the recipient;
- information that is disclosed to the recipient by a third party that is not subject to a confidentiality obligation; and
- information that the recipient develops independently without using confidential information.

Although the parties may negotiate the exact wording of these carve-outs, the disclosing party in most cases will agree to them.

Who Can Access Confidential Information?

Confidentiality agreements are ordinarily entered into by two parties: the disclosing party and the receiving party. The receiving party often will need to share the confidential information with its representatives. In the acquisition of a business, for example, the acquiring company will want to share confidential information about the target company with its outside legal counsel, financial advisors, bankers, and financing sources. When negotiating a confidentiality agreement, the disclosing party will need to consider a couple of questions: (1) which representatives should have access to confidential information? and (2) who should be liable for any unauthorized disclosure or misuse of the information by these representatives?

The party that receives confidential information will want to allow disclosure to persons that are not a party to the confidentiality agreement. It is customary for confidential information to be shared with the receiving party's officers, directors, and employees. Depending on the type of transaction being considered, it may be necessary for the receiving party to disclose confidential information to its lawyers, financial advisors, creditors, consultants, and other third parties. The disclosing party will want to limit disclosure to only those parties that are essential to the process. If the disclosing party is unsure whether disclosure to a certain representative is necessary, then the disclosing party should ask the receiving party to explain why those representatives will need access to confidential information.

Because the representatives of the recipient rarely are a party to the confidentiality agreement, the disclosing party will want some protection against unauthorized use or disclosure by those representatives. In this regard, the disclosing party may insist on one or more of the following provisions:

- the receiving party will make its representatives aware of the obligations of confidentiality, perhaps by written notice;
- the receiving party will be liable for any unauthorized use or disclosure of confidential information by its representatives;

- the receiving party will indemnify the disclosing party for any breach of confidentiality or misuse by its representatives; and/or
- the receiving party will agree to enter into confidentiality agreements with each of its representatives to protect the confidential information.

Asking the receiving party's representatives to enter into the confidentiality agreement between the recipient and the disclosing party is not customary, and it is highly unlikely that any financial advisor, law firm, or consultant would agree to do so.

What About Employees, Customers, and Other Relationships?

During the course of due diligence, the receiving party is likely to come into contact with the disclosing party's key employees and examine the company's relationship with its vendors, customers, and other key participants in the business. The disclosing party will need some level of protection against interference with these relationships and should insist on some form of non-solicitation clause. A typical non-solicitation provision prohibits the recipient (and its representatives) from soliciting or otherwise inducing the disclosing party's employees to terminate their employment in order to work for the receiving party. The provision can be expanded to prohibit poaching of customers and vendors. The disclosing party will also want to limit the ability of the recipient to communicate with its employees and may require a strict prohibition against communications with customers, vendors, and creditors. The level of protection needed will depend on the nature of both the business and the proposed transaction.

The non-solicitation clause is often the subject of intense negotiation. In many cases, the receiving party will insist on some carve-outs. For example, the recipient may insist that the non-solicitation clause apply only to those employees, customers, and vendors that were identified to the recipient in writing. The recipient will also want to carve out disclosing-party employees who are hired by the recipient through a general (i.e., not targeted) advertising or solicitation process. The term of the non-solicitation provision also is frequently negotiated, generally lasting anywhere between six months and two years.

How Long Should the Agreement Continue?

The disclosing party should insist on some continuing period of confidentiality after the parties end discussions and go their separate ways. The length of the confidentiality agreement's term will vary, depending on the type of information being shared and the nature of the transaction being proposed. Most confidentiality agreements function for one or two years, extending from either the date the agreement is signed or the date that one party or the other terminates discussions (by written notice). Certain information may require a much longer period of confidentiality. If your business is substantially dependent on a trade secret, you will want to protect that information for a much longer period of time. If a trade secret or other highly sensitive information is involved, it is appropriate to ask for an extended term only for that particular information, not for confidential information generally.

If discussions between the parties result in a deal, they will enter into a new definitive transaction document. Often that new agreement will include its own confidentiality provisions or state that the obligations under the existing confidentiality agreement will continue until closing. But what happens when the parties fail to reach an agreement and decide to walk away? Confidentiality agreements must address this situation. In many cases, the receiving party will be required to return or otherwise destroy all confidential information (including notes, reports, analyses, and other work prepared by the recipient using confidential information). It is reasonable for the disclosing party to require the receiving party to certify in writing that the receiving party has destroyed all confidential information. Keep in mind that the recipient may be required by law or regulation to retain some documentation. If that is the case, a carve-out to the "return or destroy" provision is appropriate.

Conclusion

The most effective confidentiality agreements protect vital business information and relationships while creating an environment for effective due diligence and information gathering. Many confidentiality agreements strike this balance, but usually only after a period of informed and effective negotiation. N

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