9 Clauses to Include in Every NDA

Introduction

NDAs have become so commonplace in middle market transactions, that many deal professionals have begun overlooking their importance.

However, proper management of and behavior during the NDA can be an early indicator of what the entire negotiation process will be like. Additionally, any cavalier treatment of the NDA could result in legal headaches down the road. To bring the focus back on this critical legal document, we are launching a guide that explores the NDA and...

- Types and uses of NDAs
- Strategies in NDA negotiation
- 9 clauses that should be included
- Insights from lawyers and deal professionals

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GETTING STARTED

Before diving into the specifics of the NDA, it is important to understand the overall value of the NDA and when it should be used:

NDA 101

A Non Disclosure Agreement (NDA) is a legal document that protects any confidential information, and the nature of the discussions, from being disclosed to a third party. As Eric H. Wang of DLA Piper defined, "The agreement is designed to protect the confidentiality of information exchanged in connection with the consideration and negotiation of the transaction and information exchanged in the course of a party's due diligence review of the other."

While some deal professionals have mixed feelings about the document, most transactions begin with an NDA. If there is any question of confidentiality or the importance of the information being shared, it is advisable to use an NDA -- and seek a lawyer's help in its construction and negotiation.

In most transactions, the disclosing party is the business seeking capital or investment and the receiving party is the investor.

Types of NDAs

NDAs are typically structured in one of two formats: one-way or mutual.

In a one-way NDA, also known as a unilateral NDA, only one party is disclosing information and the receiving party of the confidential information is bound to protect that information. For example, in most transactions with financial sponsors, the investor signs a one-way NDA protecting any confidential information revealed by the target company during the due diligence process. However, any information shared by the financial sponsor is not covered by the contract. Most often, the disclosing party (the seller) prepares the one-way NDA.

By contrast, in mutual NDAs, also known as bilateral NDAs, both parties disclose confidential information and both are held accountable for that confidential information. These types of agreements are more appropriate for joint ventures or strategic investments. For example, if a competitor approaches an industry peer at a trade show, they may insist on a mutual NDA to prevent their confidential information from being leaked. In this case, any confidential information that is disclosed by either party is protected by the NDA.

Note on Negotiations

Every transaction is different -- and as a result, every NDA should be different. Most importantly, the negotiating parties can be very different and, as a result, it is important to be open to negotiation and discussion for a specific NDA. “From a bidder’s perspective, it is important to keep in mind that a first draft of a confidentiality agreement is generally negotiable, notwithstanding any claims by [the seller] that the draft is a ‘standard form’ or that every bidder is being asked to sign the same,” said Igor Kirman in his book M&A and Private Equity Confidentiality Agreements Line by Line.

Inflexibility can also scare away potential investors. “We will not move past the first stage of a deal if the banker or broker is not willing to accept changes to an NDA that is otherwise one-sided and not market-based,” said Lee Miklovic of Opus Capital Partners. “The unwillingness to incorporate edits and changes ultimately reduces the number of higher quality, prospective buyers and ultimately hurts the client. Private equity firms that are in the business of reviewing deals on a recurring basis will have certain minimum standards.”

As it turns out, Miklovic has historically “passed on 25% of deals because of the language in the NDA, the rigidity to changes, or time required to make such changes.” Behavior during the NDA can be an early indicator of what the entire negotiation process will be like -- while it is not advisable to include unfair clauses in the NDA, it creates a challenging environment to be too rigid.

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9 CLAUSES TO INCLUDE

To understand the importance of the NDA, and why you should be focusing on this critical document, below are 9 elements that should be included in every single NDA:

1) Definition of Confidential Information

The definition of 'confidential information' can and should vary based on the specific transaction. As such, it is critical for every NDA to first and foremost clearly define the materials that should (and should not) be considered confidential. Materials include, but are not limited to, oral conversations, written notes, analysis, and documents produced with the use of the confidential information. Special mention should be made for any materials that are considered to include 'trade secrets'.

Generally, the "disclosing party will likely prefer a broad definition and should resist the need to mark or otherwise identify information as being confidential," explained Andrew Lord and Ted Maduri of Davis LLC. By casting the widest possible net for confidentiality, the disclosing party receives the greatest benefit of the contract.

For the same reason, the "receiving party will likely prefer a narrower definition as to what would constitute confidential information," remarked Lord and Maduri. Many receiving parties will narrow the scope of the contract to only very specific items -- like information relating to products, services, markets, customers, research, software, developments, inventions, designs, drawings, financials -- and request that all confidential material be marked confidential.

If there is a dispute over the definition of confidentiality, the 1991 case of *Pharand Ski Corp. v. Alberta* has helped establish a precedent of considerations for confidentiality:

1. the extent to which the information is known outside the owner's business
2. the extent to which it is known by employees and others involved in the owner's business
3. the extent of measures taken by him to guard the secrecy of the information
4. the value of the information to him and his competitors
5. the amount of money or effort expended by him in developing the information
6. the ease or difficulty with which the information could be properly acquired or duplicated by others

It is equally as important to define what is not confidential. For many transactions, some information cannot reasonably be expected to remain confidential, given certain circumstances, and must be outlined in the agreement.

In addition to defining what is confidential, it is equally as important to define what is not confidential. For many transactions, some information cannot reasonably be expected to remain confidential, given certain circumstances, and must be outlined in the agreement.

Examples of information that are often excluded from an NDA include, but are not limited to, publicly available information, information lawfully known prior to receiving it from the disclosing party, information lawfully received from a third party on a non-confidential basis, and compelled disclosure (further discussed below).

2) Term of Confidentiality

In addition to defining confidentiality, all NDAs should also clearly define a time limit for the agreement. The term can be one year, two years, five years, or for an indefinite term. Whatever the choice term, it is critical to clearly define it.

For most sellers, the longer the term of the NDA, the better -- especially if 'trade secrets' are being disclosed. Depending on the nature of the disclosing party's business, the 'trade secret' may be just as critical in 25 years as it is today. As such, they will seek to protect and secure confidentiality for that information for as long as possible.

However, few financial sponsors or receiving parties will sign an indefinite or very long-term NDA; it can leave them legally vulnerable or limit their ability to make investments after the close of their due diligence process. "Most potential buyers prefer a time period of 18 months, but no more than two years," explained Miklovic.

3) Disclosure / Representatives

The next item to include in any NDA is the disclosures / representatives clause. In this clause, the NDA should define with whom the confidential information may be disclosed.

This clause is particularly important for financial transactions. Typically, financial sponsors will have a variety of employees, attorneys, accountants, consultants, financing sources, and other portfolio companies review the disclosed information. Ensuring access to the confidential information for these parties is critical for comfortable due diligence and analysis.

To create an appropriate representative clause, the types of representatives with which the recipient intends to share the confidential information should be outlined. While it may be tempting to cast a very wide net of included representatives, being vague in this clause can leave significant areas of interpretation -- and create tension with the discloser, who generally prefers to have a smaller group of representatives.

Regardless of the specific parties named in the clause, most NDAs typically require, "that the potential buyer inform all recipients [and representatives] of the terms and conditions of the non-disclosure agreement," explained Schmelter, Klein, and Springer of Venable. "In some cases, there is an explicit requirement that the representatives agree to be bound by the terms of the non-disclosure agreement prior to receiving any confidential information." In other words, all representatives must know the information is confidential and the clauses to which they are bound.

4) Use of Confidential Information

One of the trickiest clauses in the NDA is the "Use of Confidential Information" clause. This section is meant to provide clarity around the intended use of the confidential information. For most standard M&A NDAs, the confidential information is limited only for evaluation and negotiation of the potential transaction.

While the clause may seem simple enough, the problem arises with the 'doctrine of inevitable disclosure.' Stephen O. Meredith of Edwards & Angell, LLP explains, "The theory is that, despite the best of intentions the executive's head is so filled with confidential information about the prior [firm] that it would be literally

impossible not to disclose (even unintentionally) or misuse that information."

Inevitable disclosure, while not appropriate for all instances, has been successfully used in few recent court cases -- including *Goodrich Capital LLC v. Vector Capital Corporation*, *Martin Marietta Materials, Inc. v. Vulcan Materials*, and *RAA Management, LLC v. Savage Sports Holdings, Inc.*

For the recipient of the disclosed information, the best strategy is to have no limitations on the use of the confidential information. However, few business owners would feel comfortable with that much openness built into the contract. Instead, some recipients prefer using a shorter term for the NDA to help mitigate the issue.

5) Compelled Disclosure / Legal Obligation to Disclose

While an NDA is signed to prevent the disclosure of confidential information to third parties, such an event is occasionally unavoidable. Necessary exceptions to the NDA must apply when disclosure is mandated by administrative or legal proceedings. For example, if a financial sponsor is being investigated by the SEC, it may have no choice but to share the confidential documents.

"Although a recipient can do much to protect the confidentiality of the discloser's confidential information, there isn't much it can do if the government steps in to demand disclosure."

As Pendulum Legal explained, "Although a recipient can do much to protect the confidentiality of the discloser's confidential information, there isn't much it can do if the government steps in to demand disclosure. The demand for disclosure may come from the government directly, or it may come from a private party compelling a response to a subpoena or discovery request. Either way, the recipient will have no choice but to comply."

While compelled disclosure occurs infrequently, the clause helps protect both the discloser and the recipient in these difficult moments. Typically the clause states that the recipient should only disclose that which is required and present a written notice to discloser if required to disclose any confidential information. This written notice allows the discloser to take appropriate action to ensure the confidential material stays confidential, and is not made publicly available during the legal proceedings.

6) Return / Destruction of Confidential Information

It is important to include a clause that defines how all of the disclosed confidential information should be handled. Traditionally, the return/destruction of the material must occur at the end of the negotiations or within a certain time frame. The strategy and timeframe of handling the confidential information largely depends on the nature of the shared information, but usually matches the duration of the NDA.

This clause also typically requires the recipient, at the request of the discloser, to confirm the return or destruction of all confidential information.

The effective return of all confidential materials has become increasingly difficult with technology. Between hard drives, e-mails, thumb drives, cloud-based storage, and other forms of virtual storage, it is difficult to fully destroy or return all confidential information. As a result, more and more NDAs are allowing the recipients to retain some of the information for ‘document retention’ -- but not accessible in the course of daily business.

7) Remedies

In the event of a breach of the NDA, the disclosing party is entitled to either monetary damage or injunctive relief. While monetary damage is first considered, the presence of a Remedies clause represents mutual agreement between both parties that the cost of a breach is difficult to assess or prove -- or the monetary damage is viewed insufficient -- and the discloser is allowed to pursue an injunction as an alternative remedy for the breach.

Lord and Maduri outlined three key qualities a well-drafted remedies clause should include:

1. address the consequences of a breach of confidentiality, which may vary depending on whether the breach was intentional, negligent or without fault of the party in breach;
2. expressly preserve the right of the disclosing party to seek equitable remedies by acknowledging that a breach can cause irreparable harm that cannot adequately be compensated with damages; and
3. include indemnification for any loss or damage (including third party claims) arising from the breach.

However, be on the watch for too many remedies in a single contract. One of the biggest red flags in an NDA for Miklovic is a provision within the Remedies clause in which “the prevailing party in a disagreement is awarded attorney fees and other punitive damages.” While it is favorable for the discloser, Miklovic feels that “the agreement is one-sided and the protected party has minimal or no downside to bring suit against the prospective buyer.”

8) Interaction with Employees

In the early stages of a deal, many business owners are concerned that news of the transaction will spill to employees and third parties. To prevent such information leaks, many disclosers require the NDA to limit interaction with employees, especially in regards to solicitation or hiring.

In regards to conversations with employees, NDAs should clearly define which employees, if any, are available for questioning or for information requests. Most often, business owners and disclosers will seek the fewest points of contacts, and opt for just one point of contact -- often their business broker or intermediary. According to Miklovic, some bankers and brokers include “provisions regarding the inability to have discussions with owners, management, and employees.”

This funnel, however, can cause challenges for the recipient. Not only is this clause logistically difficult since many private equity firms like to speak with employees and managers before signing an LOI, the clause can also become particularly problematic if there is a falling out between the banker/broker and the client.

While most recipients will prefer no limits on contacts, the best middle ground typically involves senior-level executives or a sampling of select employees for the duration of the NDA.

NDAs should also include a clause that addresses employee solicitation. This clause can sometimes be the most heavily negotiated clauses in the entire NDA. As Schmelter, Klein, and Springer of Venable explained, “The non-solicitation provision prohibits the potential buyer (and sometimes its representatives) from soliciting or otherwise inducing target company employees to terminate their employment in order to work for the potential buyer (and its representatives).”

“What if, and I know this sounds kooky, we communicated with the employees.”

Disclosing parties generally ask for expansive non-solicit and non-hire language in the NDA, which encompasses all employees in the business. Since this significantly limits

the receiving party, the clause usually includes carve outs for non-senior-level employees or for general solicitation.

9) No Binding Agreement for Transaction

NDAs should also include a clause that clearly states that neither party is under legal obligation to continue negotiations. The NDA does not indicate any formal relationship or partnership and either party can terminate discussions at any point.