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Confidentiality and Nondisclosure Agreements

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I. [10.1] INTRODUCTION

Selling a business is a daunting task. Allowing potential purchasers (most likely competitors) access to business operations and records is harrowing and disruptive, particularly for smaller businesses. Sensitive information can be protected during this process, however, through a confidentiality agreement, also known as a nondisclosure agreement.

In essence, a confidentiality agreement protects the secrecy of the disclosing party's information while allowing the recipient to review nonpublic information necessary to complete a transaction. As explained in this chapter, these agreements are much more than legal boilerplate. Both parties have an interest in the agreement, the seller for obvious reasons and the prospective purchaser for protection from what can become time-consuming and costly litigation over the alleged misuse of disclosed confidential information. *See, e.g., General Foam Fabricators, Inc. v. Tenneco Chemicals, Inc.*, 695 F.2d 281 (7th Cir. 1982) (detailing long and difficult litigation involving claims of breach of alleged oral confidentiality agreement). A well-drafted and thoughtful confidentiality agreement eases tensions while providing peace of mind that a legal remedy is available in the event of a breach. *See, e.g., Master Tech Products, Inc. v. Prism Enterprises, Inc.*, 2002-1 Trade Cas. (CCH) ¶73,637 (N.D.Ill. 2002) (denying defendant's motion for summary judgment on breach of confidentiality agreement claim when defendant-competitor allegedly used confidential information to bring competing product to market).

Furthermore, appropriateness aside, a confidentiality agreement also may be used as a litmus test for the ultimate success of the transaction. Parties may need to reconsider the prospects of consummating a deal if they cannot negotiate past a confidentiality or nondisclosure agreement.

II. [10.2] NECESSITY

Acquisitions tend to be lengthy and frequently involve competitors working together. In these circumstances, there is an increased chance that confidential information may be misused by potential purchasers, particularly if a deal is not consummated. *See, e.g., Master Tech Products, Inc. v. Prism Enterprises, Inc.*, 2002-1 Trade Cas. (CCH) ¶73,637 (N.D.Ill. 2002) (claiming defendant-competitor misused confidential information gained during failed acquisition discussions in bringing competing product to market); *Venango River Corp. v. Nipsco Industries, Inc.*, No. 92 C 2412, 1994 U.S. Dist. LEXIS 17898 (N.D.Ill. Dec. 8, 1994) (claiming defendant-competitor engaged in acquisition discussions knowing that it would use confidential information to plaintiff's detriment after discussions failed).

However, not all information related to a company's business is recognized as confidential under the law. When exploring possible acquisitions, therefore, parties should be concerned with maintaining the confidentiality of otherwise unprotected business information. Parties may also be concerned with keeping the transaction itself confidential, including the status of negotiations and the identities of the parties.

Confidentiality or nondisclosure agreements are designed to prevent the misuse of nonpublic information throughout the acquisition process, which could jeopardize the transaction, result in a

competitive disadvantage, or increase exposure to a hostile takeover. To avoid complicated, time-consuming, and expensive disputes, a nondisclosure agreement should be negotiated and executed prior to the exchange of confidential information, often before the parties are prepared to draft a term sheet and move toward a deal. *See, e.g., General Foam Fabricators, Inc. v. Tenneco Chemicals, Inc.*, 695 F.2d 281 (7th Cir. 1982) (detailing long and difficult litigation involving claims of breach of alleged oral confidentiality agreement). As such, a confidentiality or nondisclosure agreement may be the first legal agreement used in the sales process.

III. ESSENTIAL TERMS

A. [10.3] Generally

In the context of an acquisition, confidentiality or nondisclosure agreements are useful tools when utilized appropriately. They can be designed to protect the confidential information of only one party (referred to as a “unilateral agreement”) or both parties (referred to as a “bilateral agreement”).

All confidentiality and nondisclosure agreements should contain certain key elements. Initially, a confidentiality or nondisclosure agreement should carefully identify the parties to the agreement. Furthermore, the agreement should describe the proposed transaction and define the purpose of the agreement, including why the information is being shared.

Generally, an agreement will provide that information is being disclosed for purposes of evaluating the possibility of a negotiated transaction and for no other reason. The word “negotiated” is important to indicate that the information is intended for deals conducted with the company’s consent, not hostile bids. Furthermore, the word “possibility” is also important when describing the transaction in the agreement to avoid any implication that either the seller or the prospective purchaser is obligating itself to consummate the deal. For the sake of clarity, however, elsewhere in the agreement, the parties may consider expressly disclaiming any obligation on the part of either party to consummate the proposed transaction absent definitive transaction documents.

B. [10.4] Information Covered

When exploring a potential acquisition, a seller must make material available to potential buyers that the seller wishes to keep secret. There are various ways to define “confidential information” in a confidentiality or nondisclosure agreement depending on the facts and circumstances of the transaction. For example, the parties may define the confidential information covered by the agreement broadly followed by exclusions. This is typically desired by the seller. In these circumstances, it would not be unusual to see “confidential information” defined as

nonpublic, confidential, or proprietary information given in any medium, including confidential technical and scientific information and confidential internal projections and other financial data about the company, as well as any material prepared by recipient and its representatives that contains or reflects such information.

This definition includes oral or written disclosures and electronic communications. A prospective purchaser, however, may object to such a broad definition. Alternatively, an agreement could be drafted to protect only information marked by the provider as “confidential.” In these circumstances, oral information is protected if its confidentiality is confirmed in writing. This approach tends to avoid conflict, but it also puts the seller at risk of an inadvertent failure to protect information deemed confidential.

A confidentiality or nondisclosure agreement also may apply to disclosure of the fact that a transaction is being considered. Confidentiality in this respect becomes important if the seller does not want competitors, suppliers, and customers to be aware of a potential sale. This obligation should be mutual, applying both to the seller and the potential purchaser alike. A public company, however, may be prevented from entering into such an agreement given certain disclosures required by law.

C. [10.5] Exclusions

A potential purchaser in acquisition negotiations should attempt to limit the information subject to confidentiality through exclusions. Exclusions generally are based on the understanding that, if an exception exists, the information was not really confidential in the first instance.

Typically, exception is made for publicly available and already known information, including information that becomes available to the public through no fault of the prospective purchaser. Exception may also be made for independent work, that is, information gained through independent efforts and without access to the confidential material. Disputes may arise, however, over what, in fact, was “independently developed.” To lessen the prospect of lengthy and complicated litigation, the agreement should place the burden on the prospective purchaser to prove that the information was independently developed.

D. [10.6] Term

The term of a confidentiality or nondisclosure agreement will vary depending on the facts and circumstances. An agreement should last long enough to protect the seller until the disclosed information becomes “stale” but should be short enough to prevent difficulty in compliance by the prospective purchaser. Generally, this term is a relatively short one to three years. However, the term may be in perpetuity if a corporation intends to share trade secret information. In either case, a party should be wary of executing any agreement containing obligations beyond or unrelated to maintaining confidentiality.

E. [10.7] No License

For clarity and to prevent future disputes, the seller should consider including a provision in a confidentiality or nondisclosure agreement such as the following:

No License. No license to the Receiving Party under any trademark, patent, or copyright, or application for such protection, which is now or thereafter may be obtained by the Disclosing Party, is either granted or implied by the conveying of Confidential Information to the Receiving Party.

A provision such as this will assist in preserving claims for breach of the confidentiality agreement should litigation become necessary. See *Gail Green Licensing & Design Ltd. v. Accord, Inc.*, 2006-2 Trade Cas. (CCH) ¶75,458 (N.D.Ill. 2006) (refusing to dismiss claim for breach of confidentiality agreement, finding claim not barred by federal copyright statute).

F. [10.8] Upon Whom Binding

The binding effect of confidentiality or nondisclosure agreements can be tricky. Without delineated exceptions, the company agreeing to secrecy may find itself liable if any person to whom the agreement applies breaches its terms, even those whose actions cannot be directly controlled. This generally occurs when the agreement attempts to regulate professional advisors or unrelated affiliates. Issues also may occur when individual employees are required to sign the agreement. Thus, language setting forth the binding nature of the agreement should be carefully drafted based on the facts and circumstances of each transaction with a full understanding of on whom the agreement is intended to be binding.

Prospective purchasers should also determine whether they want to share confidential information with agents and advisors and negotiate appropriate exceptions to the binding nature of the agreement. In these circumstances, the provision may require that, if confidential information is shared with agents or advisors, the prospective purchaser is responsible for conveying the terms of the agreement and enforcing it as to them. A seller may go as far as to require the prospective purchaser to obtain a separate agreement from its agent and advisors.

G. [10.9] Standard of Confidentiality

In a confidentiality or nondisclosure agreement, parties should set forth the standard of confidentiality for protected information. That is, the agreement should delineate whether a party is required to hold the information strictly confidential or whether the party should (1) take reasonable precautions to hold the information in confidence, (2) hold the information according to its established procedures for confidentiality, (3) hold the information according to standards prevailing in the industry, or (4) use best efforts to hold the information in confidence. Of course, the party releasing the information will want the receiving party to maintain strict confidentiality. The receiving party should understand, however, that strict confidentiality can be interpreted to mean strict liability, regardless of fault.

H. [10.10] Disposition

Parties should consider how and when they will dispose of confidential information. For example, the confidentiality or nondisclosure agreement may contain a term that allows the disclosing party to demand the return of all confidential information at any time, or requires that the receiving party return confidential information should negotiations terminate without demand, or both. The receiving party may attempt to limit its obligation to return confidential information to circumstances only upon demand. This decreases the chance of a dispute over when the return process is initiated.

Practically speaking, when the disclosed information is maintained electronically, it may be difficult to return. In these circumstances, the agreement may require that all confidential information be deleted from the recipient's computers/servers and that an executive officer certify the destruction. Parties should consider, however, that even deletion may be difficult for a company that regularly conducts data backups. When the agreement allows for certification of destruction rather than the physical return of disclosed information, the company providing the information may require a list of all documents destroyed by the receiving party.

The agreement may contain a provision that allows the receiving party to maintain one copy of the confidential information while also maintaining continued confidentiality. A receiving party frequently requires such a provision should it become necessary to defend against a claim for breach of the confidentiality or nondisclosure agreement. Otherwise, it would be difficult for the recipient to establish what information was provided under the promise of confidentiality.

I. [10.11] When Disclosure Allowed

There are circumstances in which information protected by a confidentiality or nondisclosure agreement will have to be revealed. Thus, to avoid disputes, specific situations should be delineated within the agreement. For example, the parties should allow for disclosure within the agreement if, on the advice of counsel, such disclosure is required by law.

If a subpoena is issued for information protected by the agreement, it is not unusual to see a provision requiring that the party receiving the subpoena give notice to the party who initially provided the information (unless providing notice is unlawful), along with an opportunity to obtain a protective order before the information is disclosed. The agreement also may require the party releasing confidential information to make reasonable efforts to obtain promises of confidentiality in exchange.

In circumstances in which disclosure is not required by law, the parties may also choose to include a provision that allows disclosure if the other party grants permission.

J. [10.12] Enforcement

Money damages may be insufficient to compensate for breach of confidentiality or difficult to prove. A confidentiality or nondisclosure agreement, therefore, should expressly allow an injured party to seek equitable relief, including an injunction. An agreement should also include a choice-of-law and choice-of-forum clause should litigation ensue. The parties may also want to consider a fee-shifting provision under which the prevailing party is compensated for fees and costs. Also, a liquidated damages provision should be contemplated.

K. [10.13] Disclaimers

A confidentiality or nondisclosure agreement may disclaim express or implied warranties as to the accuracy or completeness of the confidential information, except to the extent a warranty is included in definitive transaction documentation. Parties should be careful, however, not to draft

the disclaimer in such a way as to exclude liability for known misstatements. The purpose of a disclaimer is to prevent liability only for inadvertent errors or omissions that may be made early in the transaction. Thus, an express exception for knowing misstatements should be included in the language of the disclaimer.

IV. ACCESS TO THE TARGET COMPANY'S EMPLOYEES

A. [10.14] Gatekeepers

To evaluate a potential acquisition, the prospective purchaser likely will seek access to the seller's employees. In these circumstances, a "gatekeeper" provision in a confidentiality or nondisclosure agreement protects against unauthorized disclosures of information. It provides that all communications with employees of the company must be approved by a company contact in advance, such as the general counsel. That way, the employee can be properly informed about confidentiality prior to any interview. This approach also limits operational disruptions during the acquisition process.

B. [10.15] Nonsolicitation of Employees

A confidentiality or nondisclosure agreement typically will contain a provision prohibiting the receiving party from soliciting the disclosing party's employees. This type of provision prevents the recipient of information from hiring the information provider's high-level employees discovered when visiting the target company to evaluate a potential acquisition. Nonsolicitation provisions are necessary since employees have less loyalty to a company they know might be sold. This is particularly true when the recipient of confidential information is generally a competitor in the same business as the seller, but in better financial condition.

The nonsolicitation provision may be the most heavily negotiated portion of the agreement. From the potential purchaser's perspective, it should not apply to all hiring of employees. Rather, it should prohibit only active solicitation. In other words, for the purchaser, a nonsolicitation provision should not prohibit a company from hiring individuals who, by their own volition, seek employment. Furthermore, for the purchaser, the provision should be limited to executive, managerial, and other key employees of the target company. For clarity, a list of employees who are off limits may be delineated in the agreement, and the provision can be drafted to preclude hiring, regardless of who solicits whom.

V. SPECIAL CONCERNS

A. [10.16] Trade Secrets

Even in the absence of a confidentiality or nondisclosure agreement, trade secret information may be protected under the Illinois Trade Secrets Act (ITSA), 765 ILCS 1065/1, *et seq.* See John F. Kennedy and Suzanne L. Sias, Ch. 7, *Employee Contracts Involving Restrictive Covenants and Trade Secrets*, ILLINOIS BUSINESS LAW SERIES VOL. III: MISCELLANEOUS

OPERATING ISSUES (IICLE, 2005, Supp. 2008). Although beyond the scope of this chapter, to ensure complete protection for a disclosing party, a confidentiality or nondisclosure agreement should be used in conjunction with the ITSA. Done properly, the agreement may be used to expand state law protection of trade secrets to confidential information, clarify each party's obligations, and allow the company to demonstrate the efforts taken to protect its information, should the need arise. Parties should be aware, however, that the ITSA preempts many state law claims based on the misappropriation of trade secret information, other than breach of a confidentiality agreement. *See Master Tech Products, Inc. v. Prism Enterprises, Inc.*, 2002-1 Trade Cas. (CCH) ¶73,637 (N.D.Ill. 2002) (finding ITSA preempted common-law claim for fraud as well as claims under Illinois Consumer Fraud and Deceptive Business Practices Act and Illinois Antitrust Act when all claims were founded in misappropriation of trade secrets and parties executed confidentiality agreement); *Venango River Corp. v. Nipsco Industries, Inc.*, No. 92 C 2412, 1994 U.S. Dist. LEXIS 17898 (N.D.Ill. Dec. 8, 1994) (finding that disclosure of confidential information governed by confidentiality agreement creates fiduciary relationship, but further holding breach of fiduciary duty claim preempted by ITSA).

B. [10.17] Antitrust Issues

Although antitrust law is beyond the scope of this chapter, if an acquisition involves a potential competitor, a party disclosing confidential information should be careful when disclosing pricing or other competitively sensitive information. This information could be used against the disclosing party if the acquisition is not completed and an antitrust claim is asserted thereafter. Information should be disclosed only when absolutely necessary. Furthermore, access to the information should be limited to the employees of a buyer who are not in a position to use it in a manner that violates antitrust laws. Alternatively, disclosure of competitively sensitive information could be delayed until as late as possible in the transaction. For a discussion of antitrust issues in the context of acquisition negotiations, *see Terrific Promotions, Inc. v. Dollar Tree Stores, Inc.*, 947 F.Supp. 1243 (N.D.Ill. 1996).

C. [10.18] Noncompete Agreements

Although beyond the scope of this chapter, a confidentiality or nondisclosure agreement may also contain a provision preventing a prospective purchaser from competing with the target corporation for a period of time. See John F. Kennedy and Suzanne L. Sias, Ch. 7, *Employee Contracts Involving Restrictive Covenants and Trade Secrets*, ILLINOIS BUSINESS LAW SERIES VOL. III: MISCELLANEOUS OPERATING ISSUES (IICLE, 2005, Supp. 2008). This generally occurs when a prospective purchaser would find it difficult to enter the target corporation's line of business without the disclosure of confidential information it received.

