When and How to use Non-Disclosure Agreements

By Jay Hollander

Many businesses often need to reveal some of their confidential information to new employees, independent contractors, venture capitalists or bankers. But they want to make sure the information stays relatively secret. This article explains how non-disclosure agreements allow confidential information to be revealed without fear.

The author of this article, Jay Hollander, is a member of the GigaLaw.com Editorial Board and practices computer and Internet law with his own law firm in New York City, Hollander and Company LLC. He concentrates his practice on computer software and Internet issues.

He is licensed to practice law in the state of New York. E-mail: jh@hollanderco.com.

1. Introduction

Most growing businesses face a peculiar problem when it comes to their trade secrets. On the one hand, they have a particular ace up their sleeve that they believe will give them a leg up on their competition, or even a brand new idea that will revolutionize the market. On the other hand, they don't have the financial or intellectual capital to go it alone. They must, therefore, reveal these trade secrets to new employees or independent contractors, joint venturers, venture capitalists, bankers, etc.

This is where confidentiality agreements, also known as non-disclosure agreements or NDAs, come in. Simply, NDAs are agreements by which one or more parties, standing in a confidential relationship to each other, promises to keep secret certain information acknowledged by the parties to be confidential or trade secrets. These agreements are entered into with the tacit, if not explicitly stated, understanding that dissemination of the confidential information to the public or to competitors would cause harm to the disclosing party.

2. Unilateral versus Mutual Agreements

NDAs are used in a variety of situations to protect many different types of information: financial matters, secret formulas, marketing plans, source code, methods of business operations, and so on.

NDAs, however, are not generic, and this is where many growing businesses make mistakes. The truth is, just as the types of confidential information that are the subject of NDAs are varied, so are the types of NDAs used to deal with them.

For example, NDAs can be "unilateral" or "multilateral." Let's say your company is pursuing financing from a venture capitalist or a financial joint venturer. The venturer doesn't really have

any secrets to give to you. It primarily has money. On the other hand, to persuade the venturer to invest in your company, the odds are that you'll have to disclose sensitive company information, some or all of which may be considered trade secret material.

Naturally, you want to make sure that your trade secrets aren't disclosed to your competitors, since it's very possible that the venturer you approach may also come into contact with them. Even if this weren't true, you wouldn't want the venturer to steal your idea and put it into practice with its own money.

In either case, a unilateral, or one-way, NDA obliges the financier to keep your confidential information secret and not to use it for its own benefit or disclose it, except under certain conditions, outlined in more detail later in this article.

While it is true that, in some circles today, you are considered a novice if you request an NDA from an established VC firm (which presumably has a sufficient reputation to assure you of its integrity) it's still a good idea to consider the NDA if you have any doubts.

Let's take another situation. In today's business world, where so many companies grow through acquisition, you may decide to enter into a strategic combination with another company, where both companies have trade secrets they wish to protect.

In this case, you would want to use a bilaterial, or two-way, NDA, where there are mutual obligations between the companies to keep each other's confidential information secret.

Then, there's the employee/independent contractor scenario, where you disclose confidential information, like source code or patent-pending business methods to workers, in order for them to do their job. Here, you will likely wish to have a combo plan, entering into both an NDA and a non-competition agreement.

3. Differences in Tone and Obligation

Because of the differences in emphasis between these different types of agreements, there are often corresponding differences in their language and tone as well.

For instance, in a one-way agreement, since only one party is at risk of losing confidential information, it's common for the disclosing party to insist upon the other's "best efforts" (efforts above and beyond what might be considered commercially reasonable) to ensure protection of the confidential information.

By contrast, in a two-way agreement, since the obligations imposed upon one side will likely be identical to the obligations imposed on the other, there is often a tendency to create some more "outs," knowing that each side could potentially benefit from them.

With employment related combination agreements, there are also special considerations since the law of non-competition and non-disclosure with respect to employees and contractors differs somewhat from state to state and over time. Over and above considerations applicable to all NDAs, as discussed below, companies entering into combination NDA and non-competition agreements will want to emphasize provisions allowing for severance or splitting of any provisions found to be unenforceable. Such agreements will also try to beef up so called "non-waiver"

provisions, which help insulate companies from unintentionally waiving the protections set forth in the agreement by the conduct of some of their staff.

4. The Basic Elements of an NDA

So, as you can see, there are different flavors of NDAs for different situations. Despite their differences, though, all NDAs contain certain basic provisions required to be effective.

First, you should list all the parties who will have contact with the confidential information, by category and, where possible, by name. This is not necessarily as simple as it sounds, since many companies, themselves, have subsidiaries or strategic alliances with which they share information. Also, your NDA should include appropriate language both restricting the types of people or entities with whom the other side can share the information and requiring the other side to obtain similar NDAs from employees, principals or agents of theirs who will come into contact with the information.

Second, there must be a recitation of confidential relationship between the disclosing party (the one allowing access to its confidential information) and the non-disclosing party (the one getting access to the confidential information). Additionally, there must be a recitation of the confidential materials themselves. In other words, the types of information that is expected to be kept confidential must be stated. You don't have to name every document, but it is wise to name the types of information by category or with even more specificity if the circumstances allow. Parties to a good NDA usually articulate how confidential materials will be recognized. Sometimes, it is agreed that all confidential materials must be stamped "Confidential!" in bold letters. Other times, particularly for companies that haven't had a history of diligent trade secret classification stamping, the parties will simply say that *any* information disclosed concerning certain types of information will be deemed confidential. To avoid disputes and potentially costly litigation, it's usually wise to figure out a way to earmark what will be considered confidential so as to minimize the possibility of accidental disclosure.

Third, As important as it is to define what materials will be confidential and how the other side will recognize them, it's just as important to include a straightforward statement of when it will be okay to disclose confidential information. The most common examples here concern being free to disclose information that somehow becomes public knowledge without wrongful disclosure, and freedom to release information when compelled by subpoena or other judicial or governmental process.

Fourth, NDAs are usually good only for a specified term or length of time, even though non-disclosure provisions may continue for some time after the end of the agreement. This simply recognizes that many of today's trade secrets may lose their value over time and, also, that the purpose of the disclosure may come to an end at some point, say if a proposed deal doesn't go through.

Fifth, there should be an indemnification provision, protecting the disclosing party against impermissible disclosure by the receiving party.

5. The Consequences of Wrongful Disclosure

But, what if a party *does* wrongfully disclose confidences? What then? Unfortunately, this is not an easy question to answer. Yes, there is the potential for money damages and, often, by virtue of the language of the agreement -- or the facts -- even injunctive relief may be possible. But, usually, once the cat's out of the bag, injunctions aren't too much help. And proving exact money damages flowing from the disclosure can be a challenge as well. Still, these remedies are the best we have and, usually, the credible threat of their use is a sufficient incentive on the part of the party being given access to trade secrets All of this is why one of the biggest rules of the NDA process is to investigate and develop some confidence in the party to which the information will be disclosed, as well as to draft an agreement that is clear and easy to abide by. Reduced to a pithy phrase, *investigate* and *negotiate,* so you won't have to *litigate.*

6. Protect Your Own Secrets, Too

The most important thing about NDAs doesn't concern the actual agreement itself. Instead, the most important consideration for companies with confidential information lies in how the company protects its own secrets across the board.

The number one defense to a claimed violation of an NDA is that the allegedly secret information wasn't so secret and was, in fact, disclosed to others by the company, however inadvertently or occasionally.

In the end, an NDA is only part -- albeit an important one -- of a more comprehensive trade secret program. Companies wishing to protect their trade secrets must act like they, themselves, protect their trade secrets. They must have a policy for identifying, tracking and policing their trade secrets internally, so they can credibly expect and require strong preventative measures to be taken by parties with which they enter into NDAs.

Only in this way can parties maximize their chances of getting what they expect from NDAs and protecting what might be their most valuable assets from dangerous and unauthorized disclosure.