



THE MORGAN LEWIS M&A ACADEMY

M&A Academy - Q&A For September 20, 2016 Session

Beginning a Deal: Nondisclosure Agreements and Letters of Intent

Residuals Clauses

Q: Can you comment on "residuals" clauses in confidentiality agreements --- provisions regarding exception for matters contained in the unaided memory of the recipient.

A: There are many forms of these residuals clauses. Here is one example:

The Discloser acknowledges that the Recipient and/or its affiliates and its and their Representatives [to be defined] may from time to time use Residuals, as defined below, [for any purpose, including without limitation, in the development, manufacture promotion, sale and maintenance of any products or services.] The term “Residuals” means any Confidential Information [to be defined] retained in the [unaided] memories of any of Recipient, its affiliates, or Recipient’s or its affiliates’ Representatives who had access to Confidential Information pursuant to the terms of this agreement. [One’s memory is unaided if one has not intentionally memorized the relevant Confidential Information with the intention of retaining and subsequently using or disclosing it for purposes unrelated to the proposed transaction.] However, this clause shall not be deemed to grant to the receiving party a license under the disclosing party’s copyrights or patents [or trade secrets].

In general, we see confidentiality agreements with residuals clauses more often when dealing with larger companies (for example, Fortune 500) that are receiving confidential information. Negotiating to remove these clauses can be difficult, and often just depends on the parties’ respective negotiating leverage and desire/eagerness to get the NDA completed and move forward with the transaction.

If a company that is disclosing information has agreed to the inclusion of a residuals clause, it can try to minimize the impact of the residuals clause in several ways: narrowing the clause by having it only apply to certain types of information (for example, general information and not trade secrets); providing that the clause only covers information limited to an “unaided” memory, and recipient’s employees can’t “intentionally” memorize information; limiting the permitted uses of the residual information; and providing that it does not constitute a grant of a license. More importantly, if a disclosing party has particularly sensitive information, the disclosing company could also manage the due diligence process in a way to limit the risk with respect to sensitive information, including: disclosing certain key information later in in the process, when there is greater comfort that the parties will sign definitive documents for the transaction; limiting the personnel of the receiving party who have access to and/or can use the information; and use of a “clean room” process so that only outside advisors (and maybe an identified set of recipient personnel) can see the material.

Disclosure of Long-Term Agreements

- Q: Confidentiality Agreements typically have a term of 2-5 years. How do you address the situation where an agreement being disclosed (and meeting the "Confidential Information" definition) has a term lasting longer than the term of the confidentiality agreement?
- A: Good question. I think this risk is addressed principally by requiring the recipient of confidential information to return or destroy all confidential information (subject to an exception for keeping a single archived copy for limited purposes). However, for particularly sensitive contracts this may not provide sufficient comfort, and the disclosing party should consider alternatives such as limiting disclosure to certain recipient personnel or only providing a written summary of the contract. One other issue to look out for is any agreement proposed to be disclosed that permits the disclosure of the contract to third parties, but only if the third party signs a confidentiality agreement. In this case, you will need to determine whether signing a confidentiality agreement with a term shorter than the underlying agreement satisfies this requirement.

Liquidated Damages

- Q: In mainland Europe there is a trend to specify a per day liquidated damage in case of unauthorized disclosure - is this something you see in the US?
- A: I have not seen this in the U.S. and would view it as an unusual request for a U.S. deal.

Trade Secrets and Duration of Confidentiality Obligation

- Q: The "Other Party" wants to include language that confidentiality and non-use obligations last as long as they consider it a trade secret, separate from the term and nonuse obligations of the CDA; that is an onerous obligation to be subject to.
- A: This is not an unusual request, particularly for a disclosing company that has significant trade secrets. The concern is that, if a trade secret is disclosed under a confidentiality agreement with a limited term, the protection afforded to that trade secret under the applicable state law will be lost. Sometimes parties will address this issue by having two different durations in the confidentiality agreement -- a specified term (for example, 3 years) for information that is not a trade secret, and with respect to trade secrets, until the information is no longer a trade secret. Whether or not to include an indefinite term for trade secrets will depend on the parties' negotiating leverage and, for the disclosing party, the extent and importance of trade secrets. For recipients this indefinite duration can be difficult to manage, and one way to handle this is to require the disclosing party to identify the trade secrets that are subject to this longer term. For a disclosing party, if the confidentiality agreement only has a specific term (3 years), another way to handle this is to run the due diligence process in a way that limits the disclosure of any key trade secrets.

Sale of Family Business to Managers

- Q: In a management buyout (say a family business to non family managers) is the letter of intent or confidentiality much different?
- A: Generally, I would not expect the confidentiality agreement or any letter of intent to be much different, with a few exceptions. With respect to the confidentiality agreement, the typical exception from the definition of "Confidential Information" for information already in the possession of the recipient would need to be reviewed and either deleted or narrowed to make it clear that this exception does not apply to information these non-family managers have as a result of already managing the business. In addition, any description in a letter of intent regarding disclosure of information or the due diligence process should be revised to reflect that the non-family managers in all likelihood already have the typical due diligence information normally provided to buyers.

Standalone NDA v. Part of Broader Agreement

- Q: If a client is willing to sign a non disclosure clause inside another agreement for procedural economy, should I encourage him to do it as a NDA as a better way?
- A: If the proposed broader agreement will contain non-disclosure and non-use provisions, and any related provisions, in a way that adequately addresses these issues, I can't think of a compelling reason it must be in a standalone agreement. One caution on timing -- if it will take more than a few days to negotiate and finalize the larger agreement, make sure that the client does not disclose confidential information before that other agreement is signed up.