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M&A Confidential: The Role of Nondisclosure Agreements

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As part of the mergers and acquisition process, confidentiality agreements (also known as nondisclosure agreements and NDAs) are used to ensure confidential, proprietary or non-public information disclosed by the seller will be kept secret and only used to evaluate whether the buyer wants to close the deal. A crucial element of these agreements is that the buyer agrees that the mere existence of the discussions and the agreement itself, the exchange of information, and the fact that the seller is contemplating a transaction, will also be kept confidential.

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"Disclosing confidential information in the M&A process is unavoidable. Not protecting yourself is inexcusable," write Lawrence M. Braun (right), a partner, and Justin S. Yslas, an associate, in the corporate practice group in the Los Angeles office of Sheppard, Mullin, Richter & Hampton. They advise on the use of nondisclosure agreements to limit the risks of leaking confidential information during merger negotiations.

When, Where, What, How and Why

The type of information that is typically disclosed in the M&A process covers many categories, including financial information and information related to intellectual property, trade secrets, employees, customers and suppliers. It is important to keep in mind that confidentiality agreements can only protect against the disclosure of non-public information that is confidential or proprietary in nature. Disclosure of information that is generally available to the public, even if not widely known, cannot be protected.

Entering into confidentiality agreements at the outset of the M&A process is important for a variety of reasons. Requiring interested parties to enter into confidentiality agreements sets a tone of sophistication and professionalism. It also creates legal and moral obligations so that the interested parties will protect your confidential information.

The reality is that people take things more seriously if they are in writing, especially if they have to sign a document and if there are legal consequences if they breach the agreement. The likelihood that an interested party will disclose your confidential information is greatly reduced by having them enter into a confidentiality agreement.

Confidentiality agreements can also be used to prevent an interested party from soliciting your employees. It is common for a seller to introduce its employees to interested parties during the M&A process and to tout its management and workforce. The last thing you want is to have an interested party, especially if it is a competitor, try to steal your employees.

Competitors

Confidentiality agreements are even more important in dealing with your competitors. After all, your competitors are the ones who can use your information to take business away from you. To protect yourself, there may be certain categories of information, such as who your customers and vendors are or your gross margins on particular products, that you should not give to the buyer or that you should defer giving until much later in the process when you know you have a deal. The fact that you have entered into a confidentiality agreement does not obligate you to disclose everything at once, nor does it give an interested party the right to full access. It is common to disclose more sensitive information as the parties move further along in the process of trying to get a deal done. In addition, there may be antitrust issues to consider with respect to such disclosures and their timing.

Mutuality

In general, confidentiality agreements in the M&A process are one-sided, meaning that only the seller discloses confidential information and only the prospective buyer has an obligation to protect it. Some

interested parties, including competitors, may want the obligations in the confidentiality agreement to be mutual, just in case they need to disclose confidential information to you. As a seller, you should resist this because you want to avoid becoming "pregnant" with their information, which would then impact your ability to compete in the future. In other words, since your competitors' information most likely will relate to your industry, you do not want to have the burden of protecting their confidential information because it may impact the operation of your business (assuming, of course, you decide not to do a deal with them).

'Houston, We Have a Problem'

You will be pleased to learn that confidentiality agreements are not breached very often. However, it does happen. Breaches can occur in a variety of ways. In some cases it is just because a nosey person becomes aware of the process. In others it's because a buyer uses people within their organization to assist them with the due diligence process and that person leaks information despite the fact that a confidentiality agreement exists.

The key is to be prepared. A breach can cause damage to your business. You need to have a plan in place in order to minimize the impact. For example, if a key employee walks in your door and confronts you about a potential transaction, there are many ways of handling that situation from denying it to indicating that interested parties often contact the business. Planning responses to deal with vendors and customers is also important. Legal remedies provided by a confidentiality agreement do not truly provide a remedy; rather containment is the best way to minimize any harm.

Seller . . . Beware

You need to carefully consider whom you allow into the M&A process. You know your industry and the key players. You need to consider their reputation and your prior dealings with them. Also, seek the guidance of your advisors, including investment bankers, lawyers and accountants.

Ideally, you want to disclose your confidential information to parties you trust, regardless of whether or not a confidentiality agreement is in place. Obviously, you will not have perfect information so you will need to do a risk/reward analysis when determining which parties to deal with. You do this all the time in other business contexts so this should not be new to you. For example, you may not trust your competitor, so the risk is high. At the same time, however, you may feel that there is a strong likelihood of getting a deal done with them at the highest value possible, so the reward is great. You can mitigate your risk in some instances by holding back very sensitive information until disclosure is absolutely necessary.

Take the Leap . . . But Be Careful

Disclosing confidential information in the M&A process is unavoidable. Not protecting yourself is inexcusable. At the end of the day, confidentiality agreements are more about creating accountability than enforceability. Although they are rarely breached, at least materially, the consequences associated with breaches can be severe and irreversible, especially when dealing with competitors. This is why it is always advisable to deal with those you trust. And if you can't trust them, consider ways to limit your risks by the timing and method of your disclosures.

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