Should VC Firms Sign Nondisclosure Agreements?

Introduction to Key Issues and Considerations

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Introduction

- Venture Capital (VC) firms traditionally have refused to sign nondisclosure and limited use agreements (NDAs) when asked to do so by prospective portfolio companies (PCs)
- Recently, this has begun to change
- Because they're new to the game, many VC firms have difficulty:
  - Determining when it's appropriate to sign an NDA, and
  - Negotiating appropriate terms when they do decide to sign

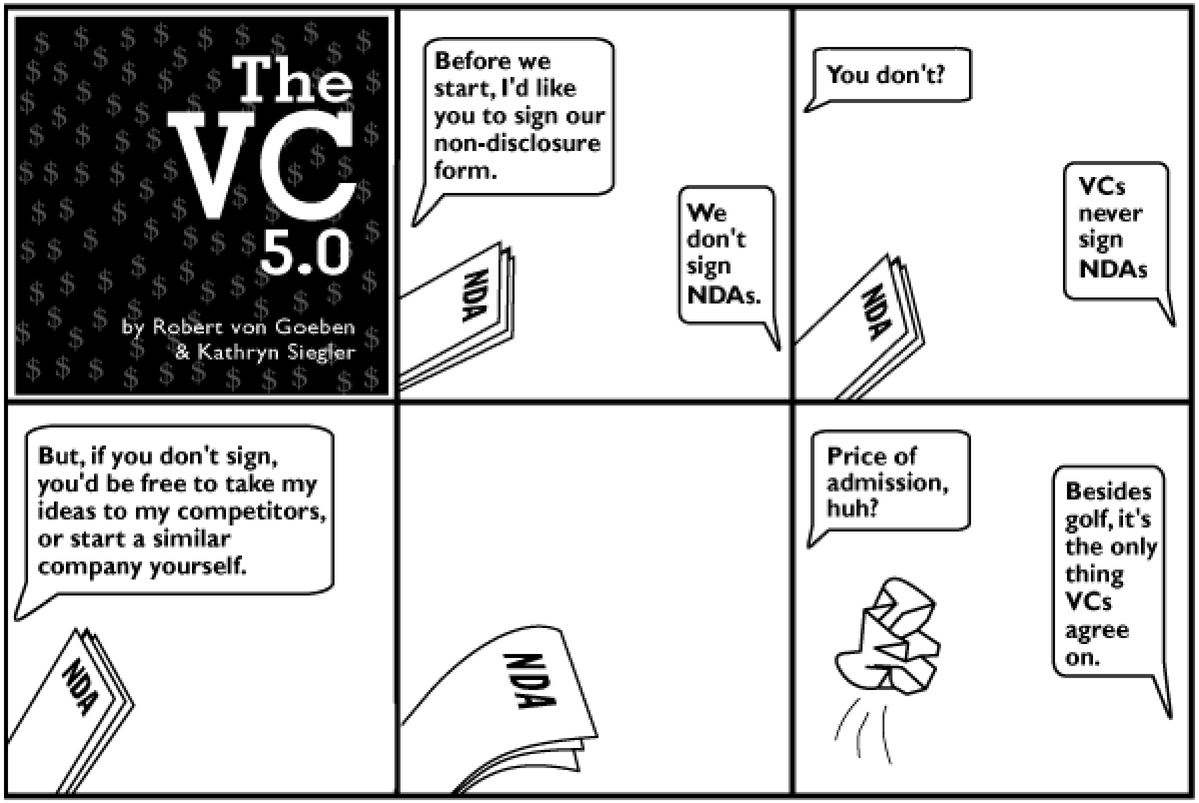
Introduction (cont.)

- This presentation is focused upon:
  - Why VC firms traditionally have refused to sign NDAs
  - What has changed
  - When signing an NDA may be appropriate
  - Key NDA terms and conditions to include/avoid
- Sample WSGR-form NDA is included in “General Materials” binder
- Note that this presentation is focused upon the concerns of VC firms
  - PCs often have an opposite perspective
  - The WSGR-form NDA seeks a balanced approach, but circumstances will dictate which details are appropriate for a specific NDA

Background: What is an NDA?

- Typically, an NDA is a set of promises:
  - To treat specific information as “confidential”
  - Not to disclose confidential information to third parties
  - Not to use confidential information other than for approved purposes (e.g., evaluating or helping the PC)
- An NDA need not be a stand-alone agreement
  - It can be part of another document, such as a binding term sheet, stock purchase agreement or shareholders agreement
  - It can be implied by a course of dealing or by informal/sloppy communications (e.g., e-mails or website)
    - “Feel free to send your business plan. We don’t sign NDAs, but we always treat business plans as confidential.”
    - “Please send business plans to the address listed below. We will respond within 10 days and hold them in the utmost confidence.”

The Traditional Approach



Reasons for Traditional Approach

- There are many reasons why VC firms traditionally have refused to sign NDAs requested by PCs. These include:
  - Special characteristics of the classic start-up company seeking VC backing
    - The “classic” PC is a “naked start-up” consisting of nothing more than a few individuals, unproven technology, and a business plan to change the world
    - Compared to a mature company in a mature industry, the classic PC has virtually no confidential information other than ideas, approaches, concepts and potentially fundamental technologies
      - Often, the “confidentiality” of such information is open to question. For many new technologies, business approaches, etc., the key concepts are “in the air” and many different start-up groups are seeking ways to exploit them.
      - NDAs covering such information may not provide the PC with much real protection against competitors, but they may enable claims against VCs who have signed

Reasons for Traditional Approach (cont.)

  - Unlike confidential information typical of a mature company (e.g., specific computer code, detailed financial statements, terms of key contracts, etc.), the “confidential information” of a classic PC tends to vaguely cover a broad swath of the business opportunity landscape
    - NDAs covering such information could “taint” the VC firm with regard to an entire new industry
    - From a risk/benefit perspective, the VC firm must consider the high likelihood that it will decline to invest in any particular PC. Signing an NDA may eliminate a huge number of investment opportunities, solely for the benefit of examining a single PC in which the VC firm is unlikely to invest.

- The classic PC typically evolves or “morphs” in fundamental, yet unpredictable, ways during the course of its development
  - Today’s financial services company could evolve into a bio-informatics company tomorrow
  - PCs that initially appear quite different often morph into competitors
  - Such evolution/morphing makes it difficult for a VC firm to assess the potential consequences of signing an NDA because the actual scope of the NDA can be radically uncertain

Reasons for Traditional Approach (cont.)

- As early stage, private companies, classic PCs generally don't need to worry that public disclosure of minor details will upset the stock market or attract SEC scrutiny
- Most PCs ultimately fail
  - A breach-of-NDA claim against a VC firm (even if frivolous) may turn out to be their most valuable asset

Reasons for Traditional Approach (cont.)

- Special characteristics of VC firms
  - VC firms are in the business of sharing information with their portfolio companies
    - Often, individual members of the firm have a fiduciary duty to disclose information in their capacity as portfolio company directors
    - An NDA could place firm members “between a rock and a hard place” (i.e., conflicting duties to disclose and not to disclose)
  - VC firms often invest at the cutting edge of technology development, where speed is critical
    - Difficult to take the time to carefully assess the risks/rewards of a particular NDA
  - VC firms often are viewed as “deep pockets”
    - This makes them attractive targets for NDA-based litigation
  - Most VC firms are small and lack a robust staff dedicated to monitoring compliance with NDAs, maintaining “clean-rooms,” etc.
    - Inadvertent breach much more likely
  - Most VC firms lack an in-house legal staff to handle NDA-related litigation
    - Even frivolous claims can be highly disruptive for a firm’s investment professionals

Reasons for Traditional Approach (cont.)

- Special characteristics of the venture capital industry
  - Widely held belief that PC management teams matter more than PC technology
    - This helps support arguments that PCs don't really need NDAs from VC firms
    - It also helps support VC firm views that NDA-related litigation is more likely to be a vehicle for blackmail than a legitimate claim for damages
  - VC firms must protect their reputations
    - VC firms that are believed to treat entrepreneurs unfairly will have a more difficult time attracting high-quality PCs
    - This helps support arguments that NDAs are redundant
  - PCs often lack the negotiating leverage to demand NDAs
    - This, of course, varies with venture capital industry cycles

What has Changed?

- Many VC firms are investing in later-stage PCs. These PCs may:
  - Have more mature, detailed types of confidential information that are legitimately within the scope of an NDA
  - Possess in-house legal personnel who make a practice of obtaining NDAs from a variety of parties
  - Hold greater negotiating leverage
  - Simultaneously attract interest from private equity/buy-out firms that traditionally have been more willing to sign NDAs
- Many VC firms are investing in foreign countries where cultural acceptance of the traditional approach is less ingrained
- General growth of the venture capital industry has reduced the power of traditional club-style business methods

Current Status

- Many VC firms now sign NDAs on an *ad hoc* basis, with no clear policies on what should be included in, or excluded from, an NDA
- Many NDAs are drafted by PC counsel, based on forms initially designed for corporate joint ventures and other types of commercial transactions that don't map well onto venture capital investments

Key NDA Goals for VC Firms

- Continue to avoid signing NDAs where possible
  - Particularly with regard to classic, start-up PCs
- Minimize risk of industry-wide “taint”
  - Define “confidential information” narrowly to contain only detailed, specific information
  - Exclude information that consists of broad ideas, approaches, concepts and fundamental technologies
  - Include express language permitting the VC firm to invest in any company, notwithstanding that possession of confidential information may influence investment decision
- Avoid “rock and hard place” trap
  - Include express language allowing VC firm to engage in traditional venture capital-style director and mentoring activities on behalf of its portfolio companies
  - Consider general exemption from nondisclosure for “residual information” (i.e., information retained in the unaided memories of VC firm members)

Key NDA Goals for VC Firms (cont.)

- Facilitate compliance by requiring that confidential information be marked as such by the PC
  - Generally require that information can be treated as confidential only if provided in writing
- Specify the time frame within which information is treated as confidential
  - Include a sunset provision (e.g., 1 – 2 years) for confidentiality obligation
  - Provide that information delivered by PC after a certain period of time (e.g., 6 months after NDA is signed) won’t be treated as confidential unless NDA is formally extended
  - Allow VC firm to tell PC to stop providing confidential information at any time
- Exclude information that isn’t truly or appropriately “confidential”
  - Information obtained or available from other sources
  - Information developed independently by the VC firm
  - Information made available to other parties by the PC without NDA protection
  - Information not relating to the VC firm’s assessment of the proposed investment

Key NDA Goals for VC Firms (cont.)

- Establish a realistic standard of care for the protection of confidential information by the VC firm
  - Example: Same degree of care as the VC firm applies to its own confidential information
  - Avoid strict liability and unmodified “best efforts” obligations
- Avoid obligation to “return” information that has been incorporated into internal VC firm documents and records
  - Such documents and records may contain additional information that cannot appropriately be delivered to the PC
  - An NDA should not be a vehicle for granting the PC ownership of the VC firm’s internal assessments and analyses
- Avoid obligation to “destroy” copies of information contained in back-up tapes or other electronic archival systems
  - Costs of compliance may be excessive

Key NDA Goals for VC Firms (cont.)

- Avoid provisions better suited to NDAs governing commercial transactions among mature corporations
  - “Clean rooms” for confidential information
  - Automatic confidential treatment for, or PC ownership of, “products” incorporating or based upon confidential information
  - Excessive recordkeeping and reporting obligations
- Avoid implied promise to conduct additional investigation/evaluation of PC or to ultimately make an investment
  - NDA should contain an express disclaimer on these points
- Avoid imposing obligations on other portfolio companies or other funds managed by the VC firm
  - Be particularly careful about provisions that seek to bind “affiliates” of the VC firm
- Avoid restrictions that would prevent standard reporting to limited partners following an investment
  - Consider providing that NDA terminates upon investment

Key NDA Goals for VC Firms (cont.)

- Minimize extraneous obligations
  - PC counsel often will “throw in” additional obligations such as non-solicitation of employees, customers, etc.
  - Many of these obligations are easy to violate and often are not truly relevant to the “real” confidential information being disclosed by the PC
  - Often, PC counsel will have copied these provisions from NDAs relating to proposed transactions among mature corporations where “stealing” employees, customers, etc. is a legitimate/greater concern
- Provide that disputes shall be settled via arbitration in a specified jurisdiction
  - Avoid getting dragged into court in a jurisdiction known for outsized damage awards
- Avoid poorly defined/implied NDAs via sloppy drafting in e-mails/websites
  - Websites should include an express NDA disclaimer*
- Make sure that NDAs built into stock purchase agreements and other documents contain all the protections of a properly drafted, free-standing NDA

*See WSGR memorandum to clients titled “Website Tips and Suggestions”

Examples of Information NOT Appropriately Subject to Confidential Treatment

- Ideas, concepts, general plans, and similar matters
  - “We propose to create a company that will allow users to view video created by other users”
  - “We propose to identify, manufacture and market proteins produced by operation of the xxy35 gene”
  - “We propose to develop software that will radically simplify the whatsit procedure in the widget manufacturing process”
  - “We have developed, and intend to exploit, a process for turning lead into gold”

Examples of Information that may Appropriately be Subject to Confidential Treatment

- Specific, detailed data on technology, as well as business operations and dealings
  - "Our EBITDA for Q2/2007 was $3,142,738"
  - "Based upon our cash burn of $23 million per quarter, absent additional financing, we will be insolvent starting January 1, 2008"
  - "In 30 days, we will announce our joint venture with General Electric"
  - "The secret ingredient for our new syrup is fluorine gas"
  - "The uncompiled code for our software kernel is as follows . . . ."
  - "The key to turning lead into gold is to manipulate the . . . ."

Additional Considerations

- In many circumstances, a two-step process will be appropriate, even where an NDA will be signed:
  - Step 1: PC provides general information, without NDA, sufficient to allow VC firm to determine whether detailed due diligence on prospective investment is appropriate
  - Step 2: If appropriate, VC firm and PC negotiate and draft a customized, definitive NDA so that PC will provide additional information necessary for detailed due diligence
- A different type of two-step process utilizes a third-party consultant
  - Step 1: Consultant, under NDA, reviews PC confidential information
  - Step 2: Consultant delivers a less confidential summary to VC firm without the need for NDA

Additional Considerations (cont.)

- This presentation generally has focused upon free-standing VC firms
  - VC firms that are contained within, or sponsored by, mature corporations may face greater insistence on NDAs from PCs, who may be reasonably concerned that a parent corporation will enter into investment negotiations for the purpose of extracting and exploiting confidential information
  - Fortunately, mature corporations that operate/sponsor VC firms generally have significant internal resources to negotiate and comply with NDAs
  - In general, confidential information should be disclosed solely within a particular subsidiary or department of the corporation to avoid “tainting” or limiting the activities of the entire corporation

Conclusions

- Traditionally, VC firms have refused to sign NDAs requested by prospective portfolio companies
- That is changing, and many VC firms now sign NDAs on an *ad hoc* basis
- A poorly drafted NDA can expose a VC firm to costly claims and fundamentally impair its ability to conduct standard venture capital investment, mentoring and harvesting activities
- A well-drafted NDA can provide assurance to a PC that its confidential information will not be materially misused, without exposing the VC firm to undue risk
  - Even so, VC firms generally should seek to avoid signing NDAs whenever possible, particularly with classic, start-up PCs
- Many NDAs circulating in the industry have their basis in complex agreements among mature corporations, and therefore contain many inappropriate provisions
- Implied, informal NDAs should be avoided, and disclaimed whenever possible
- NDAs contained in other documents, such as stock purchase and shareholders agreements, should be subject to the same degree of care and scrutiny as free-standing NDAs
- To minimize both costs and risks, each VC firm should maintain a standard-form NDA that it uses as the basis for negotiated NDAs whenever possible

This presentation is intended only as a general discussion and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.

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