practice tips

By David L. Hoffman and Robert J. Lauson

Tailoring Nondisclosure Agreements to Client Needs

In the high-tech industry, NDAs can protect inventors and investors

Nondisclosure agreements, also known as NDAs or confidentiality agreements, are vital to the exchange of technological and business ideas. As recently reported by the *Wall Street Journal,*[1] Silicon Valley conversations—even at cocktail parties—often begin with a request: "Sign this form, please." Without NDAs, however, inventors or other creators of new business methods would be unable to disclose their ideas or information to potential investors, coinventors, executives, buyers, consultants, or developers. This is especially true in the computer world, where ideas can be appropriated very quickly.

Software wizards are not the only ones using NDAs. People who need to exchange confidential information employ the NDA as a prelude to a business deal, settlement, employment, or other transaction. Although NDAs have been in use for some time, many attorneys use them without considering what their terms mean and what protection they do and do not provide. The increased use of NDAs as a result of the boom in the Internet economy underscores the importance of taking a close look at NDAs.

When an inventor with an idea—for example, a computer engineer with a business method and new software to implement it—wants to discuss business with a potential investor, business partner, supplier, customer, equipment manufacturer, or consultant, he or she will have little practical recourse without an NDA. Patent laws offer protection, but a patent application takes time to prepare and usually takes at least 18 months to issue. In any fast-moving business field, it is not desirable to wait for patent protection before starting the business. Additionally, the mere filing of a patent application does not provide rights. Until a patent issues, therefore, an NDA may be the only way an inventor can safely solicit help. NDAs bridge the gap between a concept and patent protection.

David L. Hoffman and Robert J. Lauson are members of Cislo & Thomas LLP in Santa Monica, which handles intellectual property prosecution and litigation.

Like inventors, owners of confidential information (trade secrets, customer lists, etc.) need NDAs. If the information is disclosed wrongfully, the breach of the NDA contract may be easier to prove than, for example, the tort of misappropriation of a trade secret. With an NDA, a breach of contract claim may not require proof of the trade secret status of the information. An NDA can also provide that attorney's fees will go to the victim of a breach.

A plethora of provisions, however, do not improve an NDA. Its typical use is by nonlawyers initiating discussions among parties considering new ventures, so it should be as simply worded as possible. An onerous, densely worded NDA is not likely to be signed by someone who has no relationship with the inventor. (By contrast, an NDA that is not in writing is too informal to be worthy of consideration.) Ideally, an NDA should fit on one page and feature simple, straightforward language, so that the receiving party feels confident about not having the NDA reviewed by an attorney. If the receiving party does ask an attorney to review a simple NDA, it should quickly pass muster. The purpose of an NDA is to allow the parties to explore a business relationship, not to inhibit such exploration. With this goal in mind, NDAs are frequently crafted to suit the particulars of different types of negotiations.

For example, one type of NDA binds two parties who want to disclose confidential information to each other. Under this scenario, the NDA's terms clearly indicate that each party is obligated not to disclose the confidential information received from the other. This scenario usually arises when two businesses are considering a joint venture or merger. NDAs may also be used when trade secrets and other know-how are disclosed to a licensee. In hiring, the NDA may form a separate document incorporated into the employment or consultant contract, or the NDA may be a clause or section in the agreement.

Many consultant or employment agreements contain noncompetition clauses. Typically, it is difficult to prove that a former employee made a wrongful disclosure after starting a new job with a competitor. Therefore, a blanket prohibition against an employee's competing or working for the competition can be an effective way of preventing wrongful disclosure. California law, however, generally prohibits noncompete clauses.[2] (See "Unholy Covenants" on page 40 for a discussion of noncompete clauses in California.) Even when allowed, covenants not to compete are usually subject to strict limitations in terms of scope, geography, and the length of time of the prohibition. Courts generally treat noncompete clauses less favorably than NDAs, viewing noncompetes as restraints of trade. Covenants not to compete restrict an employee's freedom of movement among employers, but NDAs only restrict disclosure of information.[3]

For these reasons, NDAs should not be viewed as a subset of covenants not to compete. For example, many NDAs contain a time limit (often five years) on the nondisclosure.[4] This time limit apparently evolved from agreements that included noncompete clauses. A time limit on an NDA, however, is undesirable. A true trade secret should be kept forever. The formula for Coca-Cola is a trade secret that has been kept since its creator brewed his first batch in his three-legged brass keg in his yard in the 1880s.[5]

While the formula for Coca-Cola is still in use, some types of proprietary information may not rise to the level of trade secret status.[6] The common five-year limit may arise out of a belief that most proprietary information has little value after five years and that it may be difficult to get someone to sign—or a court to enforce—an agreement that extends beyond five years. Furthermore, the typical useful life for computer programs is considered to be five years. Nevertheless, practitioners representing the disclosing party should avoid including a five-year or other time limit in an NDA.

Typical Elements of NDAs

An NDA serves two important legal purposes. One is to define the confidential information, and the other is to set forth the limitations on its use. Additionally, NDAs normally feature exceptions to confidentiality and termination provisions.[7]

NDAs typically define the confidential subject matter in general terms. For example, an inventor has the idea that online sales could be structured so that a shopper could buy books with a single click and believes that an online retailer could gain a competitive advantage with such an easy-to-use system. The inventor then designs software to implement the idea. Clearly, the inventor should not explain the details to the retailer if the retailer has not signed the NDA. If the inventor believes that the concept of one-click shopping is critical, then the NDA should not mention it. Instead, the NDA could describe the idea as a simplified method for purchasing books or other products online. The retailer, in turn, will not want to expose itself to liability by signing an NDA that is so broad that nearly any innovation, even one under development in-house, could be covered by the NDA. The art of writing a good NDA lies in being specific enough to arouse curiosity and allay fears without being so specific that the inventor gives away the idea before the agreement is signed.

When considering the appropriate level of specificity and the protection of the inventor, a review of documentation is important. If the inventor has a patent application on file with the U.S. Patent Office, adequate documentation of the invention exists. If the inventor has little documentation, the attorney probably should develop documentation or at least counsel the client to document the idea before disclosing it. In the event that the receiving party claims that it already had the confidential information and that the disclosing party disclosed some other idea, solid documentation will afford the disclosing party some proof that it had the information on a particular date before the disclosure.

Another consideration when defining the confidential information in the NDA is the nature of the deal that is being sought. If a business is discussing an alliance, partnership, or joint venture with another business, for example, a simple statement that "all business, technical, and financial information disclosed" is confidential may be in order. This broad definition, however, may make it difficult to prove the specifics of what was discussed. The attorney should therefore advise the client to list what is disclosed in a meeting and to send a brief letter or memorandum to the receiving party that defines each packet of information that was discussed. For example, the letter could say, "Today we discussed sales. All sales figures from 1995 to the present were disclosed. This information is confidential, pursuant to the agreement you signed on [date]."

The definition of confidential information may also be established graphically. This approach has the advantage of certainty and the disadvantage of being cumbersome to administer. Using this approach, the client-inventor marks (with, for example, the legend "confidential") all tangible information; further, the disclosing party should document that all intangible information shared with the receiving party within a set period is also confidential. Graphical definition creates some practical problems for the client. The client must be careful to document everything disclosed or face being unable to prove that any confidential information was disclosed. The approach is nevertheless desirable—at least for the inventor—because it clarifies exactly what is confidential, at least with respect to tangible items. Attorneys should therefore recommend to clients who are disclosing information that they mark anything tangible as confidential and confirm oral disclosures in writing.

Once the boundaries of confidentiality have been set, attorneys may turn to consideration of what restrictions should be included in clients' NDAs. One common NDA restriction is a blanket prohibition on use of the idea or invention other than for the particular purpose for which it was disclosed; that is, for the parties to consider a further relationship. As part of this prohibition or as a separate term, NDAs often state, "This is not a license" or use similar wording. If the NDA is part of an existing business relationship, the limitations on use may set forth the specific business purpose of the disclosure. For example, if the inventor of the one-click system is hiring a consultant to write software, the NDA may state that its information is being disclosed solely for the benefit of the inventor.

In another restriction, the inventor may impose standards or specific duties for maintaining confidentiality upon the recipient. A typical clause indicates that, in keeping the inventor's ideas confidential, the recipient will make efforts comparable to what the recipient uses to maintain the recipient's own confidential information. However, this clause does not offer much protection if the recipient either does not have confidential information or does not have policies for maintaining confidentiality. In this case, the NDA may include such specifics as:

- The information will be disclosed to employees only on a need-to-know basis.
- The information will not be disclosed to a third party without prior written consent.
- The information will not be disclosed to a third party unless that party signs an NDA.
- The information will be marked as confidential.
- The number of copies that can be made is limited to a specific number.
- The information will be kept in a secure location, such as a locked filing cabinet, when not in use.

Some or all of these provisions may be difficult to impose on the receiving party, but if the confidential material is quite valuable, they may be required.

The receiving party may also be expressly enjoined from exporting the confidential information if to do so violates U.S. export laws. This provision alerts the recipient that the material may not be legal to export and shows that the disclosing party is taking reasonable precautions to stay within the law.

Concerns of Recipients

In writing and negotiating NDAs, the attorney should keep in mind that the main concern of most recipients of confidential information is that they may have already developed the information themselves or that it may be available from third parties. The recipient does not want to be bound by confidentiality while the rest of the world can use the information freely. In the example of the one-click invention, a recipient would be placed at a competitive disadvantage by signing an NDA on a technique that had appeared in a published article two years previously. Accordingly, to accommodate recipients, NDAs typically exempt information that is in the public domain prior to the date of the disclosure or that enters the public domain through no fault of the recipients.

Information already in the possession of the recipient is often excluded as well. As one would expect, however, the disclosing party typically requires that the recipient show that the recipient had possession of the material by written evidence dated prior to the date of the disclosure. For a complex invention, this provision may not be necessary because it is hard to believe that someone could invent something complex without creating any written evidence. However, for a simple or easy-to-implement idea—such as the one-click system—written evidence could be a pivotal requirement for the inventor.

The inventor's NDA also typically grants the recipient an exclusion for information that comes into the possession of the recipient through a third party with no duty of confidentiality. It is important to include within this exception the duty of confidentiality; otherwise, one recipient of the inventor's idea could share the idea with another recipient.

Finally, the concern of some recipients—that, prior or subsequent to the disclosure, they may develop the inventor's idea independently—needs to be addressed with an express exclusion in the NDA. However, the NDA should place the burden of proof of prior development on the recipient. If the recipient is a small company, it may be safe to assume that the invention could not be independently developed subsequent to the disclosure. If the company is large, proof of independent development may be easier, even after the date of disclosure. For example, a disclosure to the New York office of a company and the subsequent independent development by the Tokyo office is a reasonable possibility. Still, the burden of proof should be placed on the recipient to show that the confidential information did not reach the Tokyo office before the alleged independent invention.

Exclusions may ask for too much from the inventor. Some NDAs, for example, include a residuals clause, which essentially allows the recipient to use some residual portion of the inventor's idea that the recipient retains in his or her memory. Ostensibly, the residuals clause protects the recipient from inadvertently using some small part of the confidential information later, after the recipient has forgotten where the information was obtained. These clauses can render the NDA worthless, and the disclosing party should avoid them.

Attorneys can help disclosing clients by formulating a plan for the end of a business relationship. If the disclosed confidential information is in document form, computer disks, or other tangible property, it is important for controlling the trade secret that the NDA provide for the immediate return, upon demand or termination, of the tangible confidential information. The recipient may want to keep an archival copy for purposes of showing what was disclosed in the event of a later dispute. The disclosing party may decide to allow this, provided that the copy is left under the control of a person such as outside legal counsel, in-house nontechnical counsel, or other trustworthy third party. Under all circumstances, however, it is imperative that the recipient's duties of confidentiality continue even after return of confidential information, termination, or cessation of the business relationship.

Enforcement

Another rainy-day measure that a discloser's counsel should consider is enforcement. An NDA, like any contract, is generally enforceable in all 50 states as long as the normal elements necessary for enforcement of a contract are present. Under California law, even NDAs covering information in the public domain may be enforceable.[8] Further, even when a patent and its related know-how are licensed together, the obligation to pay royalties on the know-how does not necessarily expire when the patent does.[9] Accordingly, the enforcement of NDAs should be taken seriously.

If a dispute gives rise to enforcement measures, attorneys usually seek some type of preliminary equitable relief, such as an injunction. Damages from wrongful disclosure or misuse of information are difficult to measure because it is nearly impossible to determine what an idea is worth before its use in the marketplace, and the value of an unproven idea is generally zero. Furthermore, it takes so much time to recover damages that clients may consider a lawsuit to be counterproductive. Inventors and start-up businesses have little money to pay lawyers to enforce rights of uncertain value. The NDA may therefore include liquidated damages provisions, but they must be justified and not a penalty.[10]

In view of these circumstances, NDAs should include an express acknowledgment that monetary relief is inadequate (with the reasons why) and a call for equitable relief. The NDA can even include an appropriate injunctive order—for example, a call for all recipients of the confidential information to return it and make no further use of it.

Although NDAs should include a general description of the idea under consideration, the limitations on its use, confidentiality exceptions, and termination provisions, too many provisions do not improve an NDA. Standard contract provisions, including integration clauses, forum selection clauses, and lawyer review by the nondrafting party, are not typically included in NDAs. However, standard clauses may help with enforcement.

NDAs, like other contracts, frequently involve parties with unequal bargaining strength. If one party has little or no bargaining power and signs the other party's NDA without lawyer review, and if the NDA is unfair to the point of being grossly one-sided, arguments can be made against its

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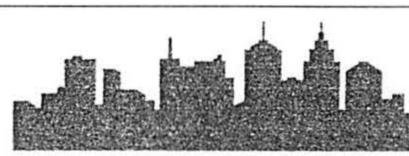

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enforcement because it amounts to a contract of adhesion.[11]

Celeritas Technologies v. *Rockwell International* is a notable NDA enforcement case in which a jury returned a large verdict for wrongful disclosure of confidential information.[12] In the mid-1990s, Celeritas Technologies developed an apparatus for increasing the rate of data transmission over analog cellular telephone networks, which were limited by the need to maintain the fidelity of voice communications. Celeritas discovered a way to overcome the problem of distortion of the data transmission and was granted a patent in 1995 for what became known as de-emphasis technology.

In 1993, Celeritas met with representatives from Rockwell to demonstrate the de-emphasis technology. The parties entered into an NDA that covered the subject matter of the meeting. The NDA stated that Rockwell would not disclose or make any use of the information except for the purpose of evaluating prospective business arrangements. The agreement further included standard confidentiality exceptions: at the time of signing, any information in the public domain, or that entered the public domain other than through the negligence of Rockwell, would not be considered proprietary. The agreement also acknowledged that because damages would be difficult to ascertain, the non-breaching party would be entitled to equitable relief (with any bond requirement waived) in addition to any other relief.

In March 1994, a third party, AT&T, began selling a modem that incorporated de-emphasis technology. That same month, Rockwell indicated that it would not be licensing the technology from Celeritas and concurrently began a development project. Rockwell assigned the same engineers who had received Celeritas's disclosure to the project. When Rockwell's sales commenced, Celeritas brought suit for breach of contract, misappropriation of trade secrets, and patent infringement. The jury returned a verdict for nearly $58 million on the breach of contract and patent infringement claims.

On appeal, the federal court disallowed the patent infringement claim. Regarding the breach of contract, Rockwell argued that de-emphasis technology was in the public domain at the time of the disclosure and that before Rockwell began sales any competent engineer could have reverse-engineered the AT&T modem. The court found California law unsettled as to whether a trade secret enters the public domain when "readily ascertainable" or when the technology is "actually ascertained by the public."[13] The court, however, ruled that the jury award was supportable under either standard.

Regarding damages for breach of the NDA, Rockwell argued 1) the contract excluded damages, 2) the breach was unrelated to any harm, and 3) liability ended once the information entered the public domain. The appellate court held that the statements in the agreement about damages being difficult to calculate did not preclude a damages award. Holding that Celeritas was clearly harmed because it is in the business of licensing de-emphasis technology, the court accepted the jury's damages award as a lump sum license fee that Rockwell would have paid had it not breached the agreement. Lastly, the court held that, in contrast with California law regarding misappropriation of trade secrets, *Celeritas* involved a written contract, so damages were not limited to the head start (the period lasting from disclosure until the information became public).[14]

Inventors and start-up companies of limited means may complain that NDAs are a victim of their enforcement success. A smaller entity often has difficulty obtaining a signature on an NDA from a more established business because the larger concern may fear that it could already be developing something similar to the smaller entity's idea. If the established business signs, it risks a lawsuit if the disclosing party is dissatisfied with an explanation or even documentary proof that the disclosed information was already known to the recipient.

One way to avoid this standoff is for each party to disclose its information to a trustworthy and knowledgeable third party, perhaps a patent attorney with experience in the field to which the proprietary information pertains. The patent attorney may review the technologies of both parties and confirm that no significant overlap exists prior to disclosure. The patent attorney would be akin to an escrow agent for intellectual property.

In some areas of business, it is hardly an exaggeration to say that NDAs are passed out like business cards at the beginning of a meeting. The information age has heightened the need for NDAs, and their importance should not be overlooked. As common as NDAs are becoming, the attorney who uses an NDA without fully considering its terms risks losing the protections that the client seeks, or preventing a sought-after transaction from taking place. ■

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1 Peter Waldman, WALL STREET J., Nov. 3, 1999, at 1.

2 *See* BUS. & PROF. CODE §§16600 *et seq.*

3 *See* Revere Transducers, Inc v. Deere & Co., 595 N.W. 2d 751 (Ia. 1999).

4 *See* <http://execpccom/~mhallign/form1.html>, among other locations on the Web, for examples of short form NDAs.

5 Coca-Cola Bottling Co. of Shreveport, Inc. et al. v. The Coca-Cola Co. et al., 568 F. Supp. 1122 (D. Del. 1983). Coca-Cola is a registered trademark of the Coca-Cola Company.

6 For a discussion of nondisclosure of trade secrets, nondisclosure of mere proprietary information, and noncompetition, *see* Mark Grossman, *Spread the Word: Protect Trade Secrets,* MIAMI DAILY BUS. REV., May 2, 2000, at A1.

7 For a discussion of the elements of nondisclosure agreements, *see* Michael L. Tavies, *Playing "I've Got a Secret" in the Information Age,* THE COMPUTER LAWYER, Dec. 1998, at 1.

8 Droger v. Welsh Sporting Goods Corp., 541 F. 2d 790, 794 (9th Cir. 1976) (anticipation of concept in prior art does not necessarily preclude classification as a trade secret).

9 Chromalloy American Corp. v. Fischmann et al., 716 F. 2d 683, 685 (9th Cir. 1983) (in hybrid patent-know-how license, if distinction is made between patent and nonpatent rights, know-how royalty payments can be enforced after patent expires).

10 California's validity standards for liquidated damages provisions may be found at CIV. CODE §1671 and associated case law.

11 Cubic Corp. v. Marty, 185 Cal. App. 3d 438, 449-50, 229 Cal. Rptr. 828, 833-34 (1986).

12 Celeritas Technologies, Ltd. v. Rockwell Int'l Corp., 150 F. 3d 1354 (Fed. Cir. 1998), *cert. denied,* 525 U.S. 1106 (1999) ($58 million jury verdict).

13 *Id.* at 1358. The technology was held to be readily ascertainable from the AT&T modem.

14 CIV. CODE §3426.3(b) limits unprovable damages "to a reasonable royalty for no longer than the period of time the use could have been prohibited."

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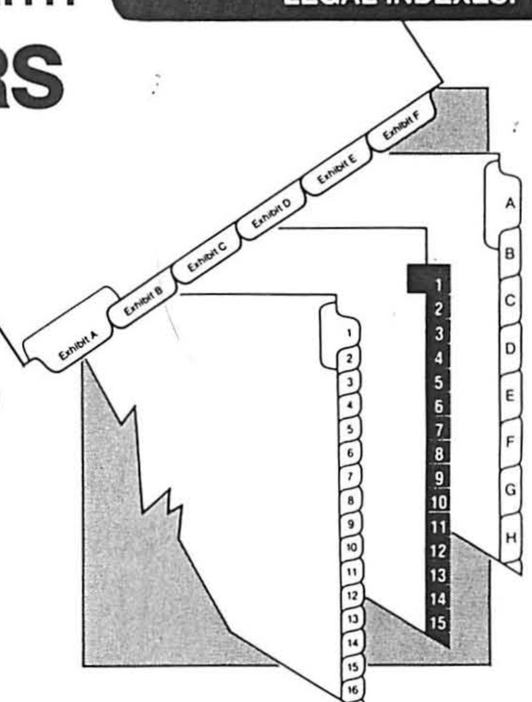

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