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VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Should Venture Capital Firms Sign NDAs?

Venture capital firms are frequently asked to sign nondisclosure agreements (NDAs) by prospective portfolio companies. Traditionally, venture capital firms have refused to sign these NDAs for the reasons described below. More recently, venture capital firms have agreed to sign NDAs in limited circumstances. In such circumstances, venture capital firms should exercise great care to ensure that NDAs are only signed when appropriate and that the terms of the NDAs are reasonable in scope to protect the interests of the firm.

How to Spot an NDA

An NDA restricts access to certain information that parties to the agreement wish to share with one another for a specific purpose but also wish to keep confidential. Be aware that an NDA can be a standalone document or can be incorporated into a term sheet or other agreement, so the venture capital firm should take care not to inadvertently impose confidentiality obligations on itself. In addition, the obligations of confidentiality may be imposed as a result of statements made in communications between the venture capital firm and the prospective portfolio company. For example, a statement in an email that the venture capital firm always keeps business plans confidential could impose a confidentiality obligation with respect to all information contained in that business plan. Such statements should be avoided.

Why Venture Capital Firms Don’t Sign NDAs

Venture capital firms have traditionally refused to sign NDAs for a number of reasons, including a desire to avoid restricting their ability to seek out and evaluate potential investments and a desire to continue acting in an advisory capacity for their portfolio companies.

Harm to a Venture Capital Firm’s Reputation

An older argument against signing NDAs is that a venture capital firm relies heavily on its reputation when seeking out prospective portfolio companies and would not risk that reputation by disclosing a company’s confidential information. This argument has become less successful on a standalone basis in part as a result of the increasing number of venture capital firms.

Inadvertent Disclosure of Confidential Information

Venture capital firms often do not have the internal resources to adequately monitor compliance with NDAs, and the cost of implementing such resources would be onerous. The venture capital firm could be setting itself up for breach of contract. Further, it is possible the firm could inadvertently breach the NDA by disclosing information learned from a prospective portfolio company because of a lack of clarity in the

NDA or miscommunication between the parties as to the scope of disclosed information that was contemplated as being kept confidential.

Restricting Investments in an Industry Sector

If the information the venture capital firm must protect under an NDA is general in nature, a prohibition on disclosing such information to third parties, or using such information with any party other than the prospective portfolio company, could effectively prevent the firm from making investments in a particular industry. This is particularly problematic if the venture capital firm ultimately decides not to invest in the prospective portfolio company with which it signed the NDA. The venture capital firm does not want to unintentionally cut off an industry segment, particularly a new one. Because new companies often evolve in the early stages, it is possible the type of information the venture capital firm has to keep confidential turns out to be different than the information initially contemplated when signing the NDA, leading to unintentional restrictions on the firm's ability to make investments.

Being Exposed to Frivolous Litigation

Regarding very-early-stage portfolio companies, it can be unclear whether such a company actually has any confidential information, or simply has a business plan and some enthusiastic people. By signing an NDA, a venture capital firm could unintentionally agree that all information disclosed by the prospective portfolio company is confidential, and therefore subject to nondisclosure obligations. Given that a high percentage of early-stage portfolio companies ultimately fail, a venture capital firm may become the target of litigation (possibly frivolous) for breach of confidentiality because the possible proceeds from that claim may become the company's largest asset.

Conflicts of Interests

Finally, the principals in venture capital firms often have advisory roles or are on the boards of directors of their portfolio companies. In such capacity, those principals may have a fiduciary duty to disclose information and opportunities to these portfolio companies, but be prohibited by the NDA from disclosing such information to other portfolio companies. Such a conflict of interest should be avoided.

What Has Caused Venture Capital Firms to Start Signing NDAs?

Even with the above-mentioned concerns, venture capital firms have started to sign NDAs for a number of reasons, including changes to the venture capital environment and competition for portfolio companies.

Increased Number of Venture Capital Firms

With the larger number of venture capital firms in existence today, firms are no longer afraid to break rank with their peers in the industry and sign an NDA. In addition, newer venture capital firms do not rely on their reputation as much as established firms and are more willing and open to sign an NDA. Those venture capital firms that wish to not sign an NDA find it more difficult to argue, "That's just the way it is."

Increased Investment in Later-Stage Portfolio Companies

In recent years, venture capital firms have been investing in later-stage portfolio companies that may have developed detailed trade secrets that are reasonably subject to confidentiality obligations. Such companies are often more sensitive to disclosures of their information, and may not proceed with talks prior to execution of an NDA.

Competition for Portfolio Companies

The increased number of venture capital firms has increased the competition for portfolio companies, and firms will sign an NDA to gain an advantage in competing against other firms for the company.

Reasonable Terms of an NDA If One Must Be Signed

In general, venture capital firms should avoid signing NDAs for the reasons described above. However, if one must be signed, the comments below apply to any document entered into between a venture capital firm and a prospective portfolio company that contains confidentiality obligations.

No NDA Before Initial Meeting

At a minimum, no confidentiality obligations should be undertaken prior to the initial meeting with a prospective portfolio company, as it is unlikely that truly confidential information will be shared during the initial discussions.

Define Confidential Information Narrowly

Any NDA entered into by a venture capital firm should be narrowly tailored for a potential venture capital investment, and should not be a broad nondisclosure agreement more suited to a joint venture or commercial transaction. Note that most nondisclosure agreements prepared by a prospective portfolio company will be overly broad from the venture capital firm’s perspective.

As a starting point, “confidential information” should be narrowly defined. This can be done by, among other things, specifically identifying the type of information that will be shared, requiring the confidential information to be shared in writing, and requiring information to be marked as confidential in order to be subject to a confidentiality obligation. The term “confidential information” should not capture vague ideas or broad descriptions of technology.

Further, the NDA should contain typical exclusions for information that is publicly available, that is required by law for regulatory filings or a court order, and that the venture capital firm may receive from sources other than the potential portfolio company, as well as information that is independently developed.

Limit the Affiliate Obligations Regarding the Confidential Information

An NDA should not broadly capture any affiliates of the venture capital firm, or the portfolio companies of the firm may be accidentally captured by the NDA’s confidentiality obligations. In addition, the NDA should expressly allow the venture capital firm to continue to mentor and advise its current and future portfolio companies, including participation on the boards of directors of those companies.

Standard of Reasonable Measures to Protect Confidential Information

The parties’ obligation to protect the confidentiality of the information disclosed should be limited to reasonable measures; it should not impose a best-efforts obligation or strict liability.

Limit the Capture Period and Term of Confidentiality

The NDA should set forth both a limited capture period and a limited term of confidentiality. The capture period is the time during which disclosures will fall within the scope of the NDA. That is, only information disclosed by one party to the other during the capture period will be subject to the confidentiality obligations of the NDA. This period should be fairly short, and ideally not extend beyond a few months (the capture period can be extended by the parties at a later time if desired).

The term of confidentiality in an NDA sets forth how long the parties must keep as confidential the information disclosed during the capture period. Ideally, the parties' confidentiality obligations should continue for only a year or less. In no event should the NDA have a perpetual confidentiality obligation. If the negotiated term of confidentiality is longer, consider adding a clause that would permit the venture capital firm to use information retained in the unaided memories of the firm's personnel even if that information would otherwise still be considered confidential.

Limit Responsibilities to Return and Destroy Confidential Information

Once the term of confidentiality expires, the NDA should not include obligations to return information that is incorporated into the venture capital firm's documents, such as reports and analysis of the prospective portfolio company, as the firm may not want to share such information with the company. Also, an obligation to destroy should be avoided as it may be unreasonably burdensome to attempt to destroy all copies of reports and evaluations, and all copies of electronic communications that may be made by backup systems. The obligation to destroy should, at a minimum, be limited to reasonable efforts to destroy confidential information and allow for the parties to not destroy information that they are required by law to maintain.

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For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

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Morgan Lewis has one of the nation's largest private investment fund practices and is ranked as "#1 Most Active Law Firm" in the U.S. based on the number of funds worked on for general and limited partners by *Dow Jones Private Equity Analyst* (2011).

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