

NON-DISCLOSURE AGREEMENTS IN VENTURE CAPITAL TRANSACTIONS

Occasionally a venture fund will receive a request from a potential portfolio company for the venture fund to sign a non-disclosure agreement prior to commencement of due diligence. The proposed non-disclosure agreement would commit the venture fund to maintaining the confidentiality of the company's information disclosed to the venture fund in the course of the due diligence investigation. Entering into non-disclosure agreements could restrict the future investing and disclosing activities of the venture fund or its principals.

Industry Custom

It is well established that for an initial meeting with a venture fund, a company seeking funding should not make any request for the venture fund to sign a non-disclosure agreement. Requesting a non-disclosure agreement for these meetings indicates that the company's technology is very weakly protected and that the company's field has low barriers to entry. In addition, the company's business plan should delineate what the company's technology does, not "how" the technology does what it does. The "how" should be protectable and may be the subject of a non-disclosure agreement at some later stage with the venture fund.

For later meetings with the full partnership of the venture fund and for most venture fund due diligence investigations, the custom in the venture capital industry has been, similarly, not to ask a venture fund to sign a non-disclosure agreement. In return, a potential portfolio company would rely on the reputation of the venture fund and its principals that they have not in the past breached confidences of companies that they investigated. This custom is still the norm for virtually all initial meetings and presentations to venture funds. The rationale for this custom is three-fold.

First, venture fund principals serve on corporate boards of many companies, and these principals have fiduciary duties as directors to these companies. If a venture capitalist, through his exposure to a new company's business plan or other disclosures, learns something material that is likely to affect a company on which he serves as a director, he would have a duty as a director to so inform his company, although he may choose not to reveal the source of the information. He naturally would not want to be conflicted because of a non-disclosure agreement to a company in which his venture fund has no investment.

Second, the mere funding by the venture fund of a company competing with the prospective portfolio company could be perceived by the prospective portfolio company as a breach of a non-disclosure agreement in that it may appear that the venture fund used the market information revealed in due diligence to evaluate another investment. Usually, non-disclosure agreements require that the recipient of the information use it only for evaluation of a business transaction with the company disclosing the information, not for evaluating another investment. Thus, the venture fund could be perceived as using the information for an impermissible purpose.

Third, venture funds and their principals have disclosure duties to their limited partners. That disclosure may involve information about a company or a market that was gleaned during a due dili-

gence investigation. Some, but not all, of those disclosures to limited partners are themselves governed by a confidentiality agreement between the fund and the limited partners, but certain legal or regulatory duties may require the limited partners to disclose certain information they receive from the venture fund, and that could include information provided by a prospective or current portfolio company. Accordingly, the venture fund does not want to be restricted in its fundamental business by being bound by a variety of non-disclosure agreements.

Historically, though, there were certain exceptions to this custom. One exception was that carefully tailored non-disclosure agreements have been used with corporate venture capital funds where the corporation sponsoring the venture fund could be a competitor of the prospective portfolio company. Another exception was that, on occasion, a company could be restricted from disclosing a material contract because that contract requires that anyone reviewing that contract be subject to a non-disclosure agreement. Thus, a venture fund might sign a non-disclosure agreement in order to have access to that material agreement. A third exception was the "strong deal" exception. In a "strong deal," typically involving a veteran team of entrepreneurs, or a later-stage transaction with multiple interested investors, the venture fund after concluding preliminary due diligence and obtaining partner approval for the transaction, might agree to the non-disclosure agreement in order to finalize its due diligence prior to making the investment. In some instances, the company and the venture fund might agree that a third-party consultant hired by the venture fund would evaluate the sensitive technology or intellectual property (and this third-party would sign a non-disclosure agreement with the company), and the consultant would merely report summary information to the venture fund or merely confirm information that had already been provided to the venture fund not under a non-disclosure agreement.

Best Practices

No non-disclosure agreements should be needed for the initial meeting with the venture fund or for the review of the business plan. Consistent with this practice, the disclosing company should be careful about putting too much of how the technology works in the business plan. If a non-disclosure agreement is required to move the transaction forward after the initial meetings, then to insure that the venture fund has freedom to operate, the venture fund should insist on a limited non-disclosure agreement; that is, a non-disclosure agreement limited to a specific list of documents or information. This list should be comprised of only those documents and information that the potential portfolio company is required by law or by contract to keep confidential. This list of documents and information would be attached to the non-disclosure agreement.

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