

# Confidential Information and Nondisclosure Agreements

Intellectual Property & Technology

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# Confidential Information and Nondisclosure Agreements by George Wowk

Nondisclosure agreements, sometimes called confidentiality agreements, can be used to protect valuable information. Typically, nondisclosure agreements are used in circumstances where one party wishes to disclose valuable information to another party while at the same time, wishes to protect the information from unauthorised use by or disclosure to others. The information being protected is sometimes called confidential information or trade secrets. A couple of well-known examples of confidential information include the recipes for KFC chicken and Coca-Cola.

## **Protecting the KFC Recipe**

Colonel Harland Sanders handwrote the original KFC chicken recipe on a piece of paper. That original piece of paper has been stored at KFC's headquarters for many decades. The recipe is considered by the company to be so important that only two company executives at any time will have access to it. In order to produce the coating for the chicken, KFC uses multiple suppliers, each of whom will only manufacture and blend a part of the coating mix. The various outputs from each supplier are then brought together and blended by yet another company, which does not know what each supplier is providing.

The piece of paper containing the KFC recipe has been stored in a filing cabinet equipped with two combination locks. The filing cabinet itself is located in a vault equipped with three locks.

In September 2008, KFC decided that this security arrangement was not adequate and required upgrading. For the upgrade, the recipe had to be removed from the vault. To do this, the recipe was placed in a lock box that was handcuffed to a security expert, who was then transported in an armoured car with an escort of off-duty police officers to an undisclosed location. KFC President Roger Eaton stated at the time "I don't want to be the president who loses the recipe... Imagine how terrifying that would be."

## **Stealing the Coca-Cola Recipe**

The Coca-Cola recipe is equally important to Coca-Cola. In July 2006 the FBI arrested three people who were trying to sell the Coca-Cola recipe and other information to Pepsi for \$1.5 million. A secretary that worked in the executive offices at Coca-Cola stole the recipe. The FBI set up an undercover sting operation to catch the culprit, who was sentenced to eight years in prison.

# Confidential Information

While recipes for famous products are obvious examples of confidential information, many organizations will have other types of confidential information including:

- future products plans
- patentable inventions
- product designs
- business opportunities
- customer information
- pricing information
- manufacturing techniques
- marketing plans
- various types of raw data
- and, source code.

## Protecting Confidential Information

The most obvious way to protect confidential information is through electronic and physical security measures. However, when confidential information needs to be disclosed to third parties the confidential information is generally protected through agreements. Confidential information may need to be disclosed to third parties in a number of circumstances. For example, if one party is interested in purchasing the business or assets of another party, the prospective purchaser may need to have access to confidential information in order to assess the business. To further complicate matters, these parties are often competitors so protecting the confidential information can be essential in the event the purchase falls through.

As well, confidential information may need to be disclosed to service providers. In the KFC example, even though no supplier has access to the whole recipe, KFC will want to ensure that all of the suppliers do not get together and piece their respective information together. Therefore, KFC will require each supplier sign an agreement to keep all information relating to the recipe secret.

Another example arises when an employee of a company needs to be given access to information that is important to the company. This information can be protected through a nondisclosure agreement.

## Do You Really Need to Disclose?

Before running headlong into negotiating and signing a nondisclosure agreement, a company should consider whether or not it really needs to disclose confidential information at all. Oftentimes the same result can be achieved through other means. For example, if a party is interested in buying KFC and wants to do some due diligence, the potential purchaser may want to have a look at the recipe, as this is one of the major assets. The parties should consider the objectives to be achieved through this disclosure. Likely, the purchaser wants to ensure that the recipe has value, in other words, the recipe is a good one. However, this assessment can be made by simply tasting the chicken made with the recipe in question.

## Do You Really Want to Receive?

The party that is to receive confidential information, in this case the purchaser, should give some thought as to whether it really needs access to the confidential information. Recall the old proverb which states “curiosity killed the cat”. The purchaser should assess the value of having access to the confidential information against the risks associated with its receipt.

The risks of receiving confidential information include the possibility that the nondisclosure agreement may contain provisions that may restrict the purchaser’s ability to freely operate in the future. This may arise, for example, if the vendor discloses information previously known to the purchaser. In particular, if the agreement states that the purchaser cannot use information received from the vendor, it is no defence for the purchaser to claim that it already had the same information prior to its disclosure by the vendor.

As well, there are risks of unnecessary litigation. As an example, if the confidential information relates to a secret manufacturing process and there is no way to determine if the secret manufacturing process is being used through inspection of the finished product, the vendor may simply claim the company is making unauthorised use of the secret manufacturing process simply because it has no other way of finding out. As another example of the risk of unnecessary litigation, the vendor may claim that it disclosed confidential information to the purchaser when, in fact, it did not. This could arise simply because the parties remember the events differently.

These risks of litigation may require significant time, energy and expense. As well, the relationship between the parties will deteriorate if litigation is commenced.



## Negotiating Nondisclosure Agreements

Once the parties decide that a nondisclosure agreement is appropriate, the parties then need to negotiate and draft the agreement.

Nondisclosure agreements are not generally lengthy, typically ranging from 1 to 5 pages in length. However, negotiating nondisclosure agreements can be difficult. The use of one's confidential information by others may not be readily apparent and because of this, the parties tend to be suspicious of one another.

Another problem with negotiating nondisclosure agreements is that neither party knows exactly what confidential information the other has in its possession. As such, it can be difficult to contemplate all of the risks associated with the receipt of confidential information and this can lead to some uneasiness between the parties.

## One-way and Two-way Agreements

Nondisclosure agreements can be either one-way or two-way agreements. They are called one-way agreements when confidential information is only flowing in one direction and two-way if each party is disclosing confidential information to the other.

## Describing the Confidential Information

One issue that arises with the exchange of confidential information is that the parties may, at a later date, dispute what confidential information was, in fact, disclosed. This can be a problem if one party is accusing the other of unauthorised use of its confidential information. To prove a breach of an obligation of confidence, a party will have to prove that it, in fact, disclosed the particular confidential information to the other party. What if the confidential information was not, in fact, disclosed but the other party is nevertheless claiming that it disclosed the confidential information? How can one defend against this type of an allegation if it independently developed this same information?

To avoid such difficulties, most nondisclosure agreement will describe the type of confidential information that is to be disclosed. The agreement will often provide a reason for the disclosure, which helps to provide a context for the disclosure. If a dispute arises, the wording of the agreement may help prove what confidential information was actually disclosed between the parties.

To avoid this problem, one might ask, "Why not just simply set out the actual information to be disclosed in the agreement itself?" While this will reduce the risk of the parties disputing what information was actually disclosed, there is a risk that the other party, learning the confidential information by reading the agreement prior to signing it, might simply decide to not sign it. It will not then be bound by the provisions set out in the agreement and cannot be forced to sign the agreement.

Further, the parties may not know exactly what confidential information will eventually be disclosed. In particular, as information is being disclosed, additional questions may be raised, which leads to the disclosure of additional information.

Another issue that should be considered is whether or not one party will have an obligation to disclose some specific confidential information. Oftentimes a nondisclosure agreement is put in place just in case confidential information is disclosed. Whether or not confidential information is disclosed may depend on how events unfold. Alternatively, the parties may agree upfront that some specific information is to be disclosed by one party to the other. Whether or not there is an obligation to disclose some specific confidential information will depend on the circumstances.

## **The Restrictions are Key**

A crucial part of a nondisclosure agreement is the restrictions contained in the agreement. The restrictions typically set out what the other party can and cannot do with the confidential information. The specific restrictions will depend on the particular circumstances. For example, a nondisclosure agreement may prohibit the suppliers of the KFC coating mix from selling any product containing the coating mix to a third party.

A nondisclosure agreement will typically set out to whom the confidential information can be disclosed. As an example, the agreement may prohibit the suppliers of the KFC coating mix from disclosing to its employees that the product is being manufactured for KFC.

## **Tailoring the Restrictions**

There is a risk that the restrictions contained in a nondisclosure agreement may have unintended consequences. For example, what if the party that is to receive the confidential information already has that information. As mentioned above, if the agreement does not contemplate this possibility, the party receiving the confidential information may be prevented from using their own information for business purposes even though they had previously independently developed this information.

This circumstance is not as rare as one might think. Often parties that enter into nondisclosure agreements are in the same industry and they may be developing similar products. As an example, if both parties are developing a new formulation for rubber for use in car tires and the agreement does not take this possibility into account, the terms of the nondisclosure agreement may inadvertently prevent one party from using this new formulation for their products even though each party independently developed the same formulation.

To further complicate this matter, neither party will know if this will be problem until after they start exchanging information. At that point it may be too late, as they will have already signed the nondisclosure agreement.

## **The Disclosure Itself**

Depending on the circumstances, the nondisclosure agreement may set out the details of how and when the confidential information will be disclosed. The agreement may provide for specific precautions to be followed. For example, “the information is to be placed in a lock box and handcuffed to a security expert, who will then be transported in an armoured car with an escort of off-duty police officers”.



## Form of Disclosure

The provisions in a nondisclosure agreement may be different depending on whether the confidential information will be disclosed in written documents, electronically or orally during the course of discussions. As an example, if the information is disclosed in a document, the party receiving the document may have specific obligations regarding its protection as well as restrictions on the party's ability to make copies of the document.

## Specific Protection Obligations

The parties should also consider whether or not the receiving party is to take any specific precautions once it has received the confidential information. This will depend on the circumstances and the nature and value of the confidential information. For example, "the confidential information is to be placed in a vault with two combination locks, where one person knows one of the combinations and another person knows the other combination."

## **Legal Obligations to Disclose to Third Parties**

Sometimes a party that has received confidential information may become legally compelled to disclose that confidential information. As an example, one of the parties may become involved in litigation and as part of the litigation, the court may issue a court order requiring the party to disclose all information relating to a particular matter. If the confidential information relates to that matter, the party would be required to disclose the confidential information in order to comply with the court order. This can be particularly problematic as documents disclosed as part of the litigation process are generally open to the public.

This circumstance puts the party who received the confidential information in a difficult situation. On the one hand, the party is subject to a court order that requires it to disclose the confidential information and, on the other hand, it is bound by a nondisclosure agreement which prohibits it from disclosing the confidential information.

As well, if the information is disclosed in the course of litigation, the information would then become public information and anyone would be free to use it as he or she saw fit.

It is helpful if the nondisclosure agreement anticipates these possibilities.

## **Termination of the Obligations**

All good things must come to an end. Well, that is the theory. From the perspective of a party that receives confidential information it will want to know that at some point it will be free of its obligations of confidence. From the perspective of the party that is disclosing the confidential information, it will want to know that it is fully protected. In the KFC example, KFC will want to know that any party that receives any information relating to the secret recipe will be bound by obligations of confidence forever.

The period of time until the obligations of confidence terminate will depend on the circumstances. The general guide is that the party receiving the confidential information should be bound by obligations of confidence for as long as the information needs to be protected. Therefore, for example, if the confidential information relates to a product that will be released into the market within a year, there would be no need to bind and no value in binding the party that received the information to obligations of confidence that extend beyond the launch date, when the information is no longer confidential.

## **Summary**

At first blush, nondisclosure agreements seem to be fairly straightforward. However, as many problems can arise if the agreements are not drafted carefully, parties are well advised to spend adequate time considering the risks and weighing the appropriateness of various clauses for their optimum protection.

# BD&P Intellectual Property & Technology Team

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### E-Business and the Internet

All areas of online business and e-commerce, including:

Agreements with respect to website and software development, linking and collaborative relationships, ISP, hosting, co-hosting, co-location, subscribers and members, and distribution arrangements

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Domain name purchases

Trade-mark protection and infringement  
Licensing of software and digital content

Advice on online contests and promotions

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Confidentiality, non-disclosure and technology ownership and assignment agreements

IT outsourcing

Publishing contracts

# Who We Are



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Brian is a partner at BD&P with over 27 years experience and his focus is on mergers and acquisitions and acting for technology companies. Brian acts as counsel to software & technology developers and service providers concerning product development, marketing and distribution; as counsel in

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