

Pitfalls To Avoid When Drafting And Enforcing NDAs

By **Sonia Baldia and Alexander Borovsky** (June 4, 2021)

Although seemingly commonplace, nondisclosure agreements have been subject to increasing litigation in recent years.

Businesses often default to using boilerplate NDAs without careful consideration of the specific business purpose or the transaction risk at hand, which can lead to challenges in court and detrimental outcomes, including loss of protection for valuable information or undue restrictions on the recipient's ability to pursue business interests.

The majority of litigation has centered around technology, where there is considerable value in protecting ideas and innovations.

While an NDA is meant to protect valuable or sensitive information from unauthorized disclosure or use, parties to an NDA consistently run into enforceability issues in the courts when relying upon boilerplate language or using nonconformed templates, undermining the fundamental utility of an NDA.

Therefore, when drafting an NDA, it is critical to review and assess each provision to determine if it adequately reflects and anticipates the business purpose for which it is being used and to make sure it appropriately identifies and defines the confidential information that is the subject of protection under the NDA as contemplated by the parties.

This article highlights some of the main trends inferred from current U.S. case law concerning the types of issues in NDAs that are frequently litigated and interpreted by the courts and offers some practical guidance on drafting NDAs in an effort to mitigate challenges in court and avoid unexpected or detrimental outcomes.

Relying on boilerplate may jeopardize your confidential information.

Pursuant to the general principles of contract interpretation, if the wording of an NDA is clear and unambiguous, courts give NDAs their plain and ordinary meaning.

Therefore, provisions such as the definition of confidential information, its exclusions, the length of the term and disclosure of confidential information are often taken literally, which can result in negative consequences when relying on boilerplate language.

For example, in 2020, in *Capricorn Management Systems Inc. v. Government Employees Insurance Co.*, the U.S. District Court for the Eastern District of New York noted that confidential information was defined in the NDA as "confidential and proprietary information, including without limitation information related to [each] party's ... operations, technology or systems."

The plaintiff took the position that under the NDA, all of its operations, technology or systems were confidential.

However, the court held that information was not protected under the NDA as, by its terms,



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such operations, technology and systems needed to be confidential and proprietary in the first instance to be protected as confidential information, and it was not being treated by the company as such in prior business dealings with the defendant.

The overly broad definition of the confidential information without correlation to the specific transaction ended up defeating the very purpose of the NDA, to the disclosing party's detriment.

When drafting an NDA, you may want to avoid the temptation of including a catch-all clause, but instead describe the exact nature of the confidential information implicated in the agreement.

Further, depending on the nature of disclosures, you may also want to include a mechanism to periodically update the inventory of confidential information to track and record any new information that may be disclosed to the other party during the term of the NDA.

Carefully defining exclusions to confidential information is equally important.

Often, parties tend to gloss over the exclusions language in the NDA without closely scrutinizing its potential impact on the scope of the confidential information.

It is equally important to consider and define what is not deemed confidential information under an NDA and make sure the exclusions do not conflict with the intended scope of the confidential information.

This is because, if the contract language is deemed ambiguous or conflicting, the courts look to the intentions of the parties, and the specific contractual provisions control over the general provisions.

For example, in 2019, in *Herdguard LLC v. NXT Generation Pet Inc.*, the U.S. District Court for the Eastern District of Kentucky was deciding whether the identity of certain third-party manufacturers and suppliers was confidential under the parties' NDA and whether the defendant had violated the noncircumvention clause in the mutual NDA by doing business directly with the plaintiff's supplier.

The NDA generally stated the identity of these manufacturers and suppliers fell within the definition of confidential information, but, significantly, the NDA expressly excluded any information that was previously known to a party from the definition of confidential information.

The court ruled in favor of the defendant, which demonstrated it knew the identity of certain manufacturers through an internet search before entering into the NDA, and that the identity of these manufacturers and suppliers were not confidential despite the general inclusion within the definition of confidential information.

Therefore, to avoid inadvertent loss of confidentiality treatment, when drafting an NDA it is not only important to address the specific information that you want to protect, but it is equally important to carefully consider any exclusions to such information.

Courts may protect ancillary business information — to the recipient's detriment.

Generally speaking, courts have been lenient in protecting certain nonproprietary confidential information under an NDA, such as ancillary business information.

For instance, in February, the U.S. District Court for the Western District of Virginia heard *Gallo v. DiversiTech Corp.*

Among other arguments, the defendant asserted that the plaintiff's proposed product developments and marketing plan were too commonsense to qualify for protection as confidential information under the parties' NDA, as such plans were neither unique nor protectable, and the commonsense product improvements were readily understood and publicly known based on the expired patents.

However, the plaintiff argued that its marketing and business strategy and the product improvements were based on its industry knowledge and research, and that the plaintiff had kept them secret and did not reveal it to anyone absent the use of an NDA.

Accepting the plaintiff's argument, the district court determined that the plaintiff's marketing and business strategies and product developments qualified as confidential information under the NDA irrespective of whether such information may be readily ascertainable in the public domain.

While this outcome favored the disclosing party, the recipient was practically precluded from pursuing business activities related to certain products in the market.

When considering what information may be protected under an NDA, a disclosing party may want to include ancillary business information related to its new products or developments within their confidential information. But the recipient must closely scrutinize such inclusions to assess impact on its ability to pursue market opportunities and negotiate the NDA terms accordingly.

Courts strictly enforce stated uses of confidential information.

Courts tend to interpret and strictly enforce the unambiguous contract language regarding the stated purposes for which confidential information is to be used under an NDA, irrespective of the parties' subjective intent.

For example, in 2019's *Dickinson Frozen Foods Inc. v. J.R. Simplot Co.*, the parties agreed in the NDA to use confidential information solely for the purpose of engaging in discussions related to a possible or potential vendor relationship.

The Supreme Court of Idaho stated that once a deal was entered into, the NDA was no longer applicable to additional disclosures because the parties would no longer be negotiating a possible or potential relationship.

The court further opined that since the NDA called for "a" possible vendor relationship, it did not contemplate multiple business relationships, and that if the parties intended for the NDA to apply to established relationships, multiple relationships or future relationships, it could have stated that in the plain language.

Consequently, the court affirmed that the defendant did not breach the NDA when it disclosed the plaintiff's confidential audit information that was subsequently shared with the defendant after the business relationship was entered into.

Accordingly, it is important to carefully consider and expressly state the exact purposes for which the confidential information is shared and its permitted uses in an NDA. The

disclosing party must be vigilant in not having too narrow of a purpose, or its information may not be protected under the NDA.

Proving breach may be easy, but recovering damages may be difficult.

Proving that a party has breached an NDA is only half the task. The plaintiff must thereafter prove that damages were caused by the breach and also prove the specific quantum of such damages.

The purpose of monetary damages is to restore the parties to the respective states they would have been in had the NDA been properly performed.

Such damages are usually measured in terms of the harm done to the injured party, such as the cost to resecure the lost secrets, or future lost profits, to name a few. Proof of actual harm and its cause must be established.

This is further complicated by the fact that NDAs customarily provide for the recovery of both direct and consequential damages in the event of a breach.

While courts have been somewhat liberal in holding that a party has breached an NDA, it is not always clear how damages will be measured, and if and to what extent the plaintiff may be able to recover any damages whatsoever despite the breach verdict.

The courts may apply different theories to measure damages.

For example, in 2020, the U.S. Court of Appeals for the Federal Circuit noted in *SiOnyx LLC v. Hamamatsu Photonics KK* that the jury was presented with multiple damage theories at trial — including a \$1 million upfront license fee, a 7% royalty on sales of the accused products and over \$2 million from a lost partnership — but the jury's ultimate award of \$794,469 matched none of those theories.

To avoid litigation and uncertainty, some parties attempt to stipulate liquidated damages in NDAs.

Such clauses are enforceable only if the specified amount is a reasonable forecast of anticipated business losses arising from the NDA breach (and not be arbitrary, speculative or punitive in nature), and the computation of damages is so difficult that the parties are justified to include such a clause in the NDA.

Historically, such clauses have been hotly contested in courts, defeating the very purpose of including such a clause.

Further, courts may not grant an injunction if there is a liquidated damages clause as it may negate the ability to prove that there is no adequate remedy at law since the NDA sets the level of damages — a key requirement in many jurisdictions for injunctive relief.

Therefore, each party must very carefully evaluate and analyze whether to include a liquidated damages clause in the NDA.

One breach, multiple claims.

When an NDA is violated, a plaintiff may plead a variety of claims in addition to a breach of contract claim, depending on the type of the confidential information.

For instance, in *ExpertConnect LLC v. Fowler*, a 2019 decision from the U.S. District Court for the Southern District of New York, the plaintiff brought several claims against the defendant, including:

- Trade secret misappropriation;
- Breach of fiduciary duty;
- Breach of contract and the duty of good faith and fair dealing;
- Civil conspiracy;
- Tortious interference;
- Unfair competition; and
- Unjust enrichment.

Such causes of actions are typically subject to many defenses, including estoppel, waiver, impossibility of performance, lack of consideration, lack of privity, statute of limitations and unconscionability.

When drafting and enforcing an NDA, it is important to determine the many different types of potential claims and defenses available to the parties and accordingly strategize the best way to proceed given the complexities and specific facts at hand.

Courts may reject agency theories.

Courts have not accepted agency theories to hold other entities who are not parties to an NDA liable for its obligations.

For example, in 2020's *Five Star Gourmet Foods Inc. v. Fresh Express Inc.*, the plaintiff did not execute an NDA with the defendant, but the plaintiff argued that the defendant signed the agreement under an agency theory as the individuals who signed the NDA did so as part of their job duties with the defendant.

However, the agreement provided it was personal to those who signed it, was nonassignable by them and made no express reference to the defendant.

Thus, the U.S. District Court for the Northern District of California rejected this agency theory and the plaintiff's breach of NDA claim.

This underscores the importance of clearly identifying the correct contracting parties in the NDA and any third parties that are intended to be direct beneficiaries under the NDA, in addition to ensuring the party who is executing the NDA has the requisite corporate authority to do so.

Courts are likely to reject overly restrictive clauses.

NDAs often include noncompete, noncircumvention or nonsolicitation clauses. If such clauses are unreasonable or overly restrictive, courts may declare the entire NDA invalid or strike down clauses that are too onerous.

An example of unreasonable behavior might include preventing an employee from obtaining employment with a competing company or in a particular field of work by an overly restrictive noncompete in the NDA in an effort to gag the employee.

Another example could be demanding that confidentiality be preserved indefinitely when the disclosed information doesn't warrant it.

In 2009, in *Lasership Inc. v. Watson*, the Fairfax County Circuit Court in Virginia invalidated an NDA, ruling that the prohibition was "not narrowly tailored to protect the legitimate business interests" of the employer as it attempted to preclude an employee from disclosing any information concerning the business of the employer to any person.

The court further held that the prohibition was "unreasonably lengthy" because it extended for the rest of the employee's life.

Including a properly crafted residuals clause may mitigate an overly broad noncompete clause, but such a residuals clause can be easily abused as well, so its inclusion must be carefully assessed based on the specific facts involved.

Similarly, courts may strike down nonsolicitation clauses as a restraint on trade if they are overly broad or lack adequate consideration. Courts in some states may invalidate the entire NDA while others may make blue pencil modifications to the restrictive clauses to avoid invalidating in toto.

Conclusion

NDAs can be deceptively complex, and the process of drafting and enforcing these agreements can be rife with risks and traps. Considerable skill, thought and care is required when drafting or tailoring an NDA to safeguard confidential information and prevent disclosure in a particular circumstance.

As protecting valuable company information has never been more important, there has been an increase in NDA litigation in recent years. Therefore, it would be prudent to consider the above trends and lessons and stay on top of developments in this area when drafting an NDA in order to minimize potential challenges and maximize legal enforceability to avoid costly litigation and unexpected outcomes.

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