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Confidentiality Agreements

Key Legal and Business Considerations for Hedge Fund Managers in Drafting and Negotiating Confidentiality Agreements (Part One of Three)

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Hedge fund managers frequently have occasion to enter into confidentiality agreements or nondisclosure agreements (collectively, NDAs). For example, distressed debt hedge fund managers often enter into NDAs before obtaining borrower financial statements and sales projections; managers that take control positions in companies often enter into NDAs before taking a "deep dive" into target company data; and managers that invest in real estate often enter into NDAs before obtaining tenant, property and related information. These are just three of the many instances in which NDAs come into play in day-to-day investment analysis by hedge fund managers. NDAs are ubiquitous, but typically receive surprisingly little attention from investment and even legal staff at managers. NDAs are viewed as a bothersome chore – a box to be checked – rather than a fundamental aspect of the investment process.

But that view is dangerously mistaken. NDAs can have powerful legal and practical consequences. Drafting or monitoring missteps can, among other things, significantly constrain the ways in which information can be used, can put a manager at risk of insider trading violations and can limit investment exit opportunities. This article – the first in a three-part series – sheds light on the NDA process, a critical but underappreciated aspect of the hedge fund business. Specifically, this article starts by identifying six discrete rationales for the importance of NDAs in the hedge fund context, then goes on to discuss: the "market" for duration provisions; events that trigger expiration of confidentiality obligations; four key elements of the definition of confidential information; and four typical carve-outs from the definition of confidential information. The second article in this series will discuss: the scope of permitted disclosure of confidential information; return and destruction of documents; and required disclosure. And the third article in this series will discuss remedies, damages and liability, and non-confidentiality restrictions in NDAs.

Relevance of NDAs in the Hedge Fund Context

In the hedge fund context, NDAs are often perceived by investment professionals as little more than an administrative hassle – a ministerial impediment to getting the deal or investment done. However, NDAs can have powerful legal and practical consequences. They can, for example, significantly limit the ways in which information can be used and even the recruitment activities

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of the manager. In particular, hedge fund managers should pay careful attention to the drafting, negotiation and monitoring of NDAs for at least the following six reasons.

First, entering into an NDA typically imposes legal and contractual restrictions on use by the manager of information obtained pursuant to the NDA. On the legal side, information obtained pursuant to an NDA often constitutes material nonpublic information, and insider trading law prohibits trading on the basis of material nonpublic information. See "Key Legal and Operational Considerations for Hedge Fund Managers in Establishing, Maintaining and Enforcing Effective Personal Trading Policies and Procedures (Part Three of Three)," Hedge Fund Law Report, Vol. 5, No. 6 (Feb. 9, 2012). On the contractual side, the name of an entity covered by an NDA – for example, an investment or acquisition target – is typically added to the restricted list or watch list maintained by a hedge fund manager. Generally, securities of issuers on the restricted list may not be traded by the manager's funds or in the personal brokerage accounts of manager personnel, and names on a watch list are monitored for developments that may require prohibiting trading. See "Use by Hedge Fund Managers of Restricted Lists, Watch Lists and Ethical Walls to Prevent Insider Trading Violations," Hedge Fund Law Report, Vol. 4, No. 37 (Oct. 21, 2011).

Adding a name to a restricted list triggers both downside and upside monitoring obligations on the part of the hedge fund manager, in particular, in most cases, on the part of the manager's chief compliance officer. With respect to downside monitoring, a manager must scrupulously prohibit trading of names on the restricted list both to prevent insider trading violations and to act consistently with internal policy. (Acting inconsistently with internal policy is a frequently cited deficiency in examinations of hedge fund managers. See "SEC Exams of Hedge Fund Advisers: Focus Areas and Common Deficiencies in Compliance Policies and Procedures," Hedge Fund Law Report, Vol. 4, No. 38 (Oct. 27, 2011).) With respect to upside monitoring, if a name stays on a restricted list longer than necessary – which in this context means after the obligations in the NDA expire or after relevant information becomes immaterial or public, whichever is later – the tardiness of removal may inhibit the manager's trading strategy.

Second, an NDA may limit not only the manner in which the manager can use information obtained pursuant to the NDA, but also the extent to which the manager can provide such information to third parties – and a manager may want to provide information to third parties in various contexts. A manager may wish to provide information to analysts or consultants retained specifically for the purpose of evaluating the investment that is the subject of the NDA. See, on this sort of arrangement, "Recently-Filed SEC Action Demonstrates the Potential Risks of Insider Trading by Investment Consultants Hired by Private Fund Managers," Hedge Fund Law Report, Vol. 5, No. 13 (Mar. 29, 2012). Similarly, a manager may wish to provide information to banks or other financing sources. Also, a manager may wish to provide information to subsequent purchasers of the asset that is the subject of the NDA – so-called "downstream" purchasers. Typically, hedge fund managers seek to provide information to consultants, banks or purchasers under NDAs containing terms at least as onerous as the NDA between the manager and the target or intermediary. These are known as "back-to-back" NDA arrangements because the confidentiality provisions are largely symmetrical. However, some NDAs prohibit the subsequent dissemination of information covered by the NDA – even under the terms of a back-to-back NDA. Hedge fund managers should be cognizant of such draconian prohibitions because they can, among other things, impair the manager's ability to sell an asset – in effect, such prohibitions can create illiquidity by contract for an asset that is economically liquid. Such prohibitions can also limit financing options and constrict the range of expertise that a manager may bring to bear on an investment situation. For example, on the expertise point, the form NDA of one major U.S. bank prohibits recipients from retaining financial advisers or consultants that are in direct competition with the bank in the relevant market, without the bank's prior consent.
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Along similar lines, some significant hedge fund investors are agreeing to invest in commingled funds as opposed to investor-specific vehicles (such as managed accounts or single investor hedge funds) in exchange for, among other things, the right to evaluate investments on a deal-by-deal basis. Such deal-specific evaluation rights may be embodied in a side letter. Managers that grant such rights to investors need the ability to provide investors with information that is typically within the scope of an NDA. But if the NDA broadly prohibits the manager from sharing information with third parties, the manager may not be able to satisfy its obligation to share information with investors. Therefore, managers that grant deal-specific evaluation rights to investors should also provide in the NDA for the ability to share relevant information with investors.

Third, the disclosing party under an NDA – typically, the seller – will often try to negotiate "standstill" or "lock-up" provisions into NDAs. Generally, with respect to a given entity, a standstill provision prohibits the recipient of confidential information from purchasing or offering to purchase any securities, assets, debt, obligations, claims or other interests in that entity; and a lock-up provision imposes similar prohibitions with respect to sales (as opposed to purchases). Hedge fund managers should try to negotiate for the elimination of standstill or lock-up provisions, or to limit such provisions in scope or duration. Managers may argue, with considerable justification, that the insider trading laws speak for themselves. Further, any effort by the disclosing party to limit trading by the recipient beyond what the law prohibits arguably may inhibit trading by the recipient while providing no justifiable offsetting advantage to the disclosing party.

Fourth, an NDA will sometimes include an exclusivity provision, which in this context may come in either of two varieties: explicit exclusivity or implied exclusivity. An explicit exclusivity provision in an NDA requires the recipient of information to deal only with or through the disclosing party with respect to a particular transaction or asset. Explicit exclusivity provisions are relatively uncommon and easy to spot. Typically, explicit exclusivity provisions appear in NDAs prepared by brokers or intermediaries who are concerned about protecting their right to a commission. In fact, explicit exclusivity provisions in broker-generated NDAs are sometimes accompanied by a provision requiring the recipient to indemnify the broker for the amount of its anticipated commission in the event of a breach by the recipient. Hedge fund managers should push back on any such indemnification provision.

Implied exclusivity provisions typically take the form of a requirement that the recipient use any confidential information obtained under the NDA exclusively in connection with the transaction. Accordingly, the strength of an implied exclusivity provision turns on the definitions of "confidential information" and "transaction" contained in the NDA. From the hedge fund manager perspective, the definition of transaction should include any transaction in connection with the relevant investment or asset, including transactions with counterparties other than the disclosing party. (However, managers should be careful not to include too capacious a definition of transaction if the NDA contains trading or other restrictions with respect to the defined transaction. The better negotiating approach here would be to use different defined terms for different restrictions.) Similarly, managers should negotiate for the right to obtain confidential information – including the confidential information that is the subject of the NDA – from other sources. This would enable the hedge fund manager recipient to obtain confidential information from another source and enter into a transaction with the other source, even in the presence of an implied exclusivity provision in the NDA with the first source. This right to receive confidential information from other sources is particularly important in more liquid markets where substantially the same asset may be available from multiple sellers or through multiple brokers.

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Fifth, some NDAs prohibit contact with the target of the relevant transaction or its related parties. For example, if the NDA relates to a purchase of debt, such a no-contact provision likely would prohibit the recipient from contacting the borrower or its advisers and agents. Notably, a prior version of the standard Loan Market Association (LMA) Confidentiality Undertaking obligated the recipient of confidential information "not to make enquiries of any member of the [borrower] Group or any of their officers, directors, employees or professional advisers relating directly or indirectly to the Facilities and/or the Transaction." This restriction has been removed in the current form of LMA Confidentiality Undertaking. See generally "The Impact of Asymmetric Information, Trade Documentation, Form of Transfer and Additional Terms of Trade on Hedge Funds' Trade Risk in European Secondary Loans (Part Two of Two)," Hedge Fund Law Report, Vol. 4, No. 38 (Oct. 27, 2011). Similarly, in NDAs relating to the transfer of debt secured by real property, it is common to find a prohibition on contact with the property owner, managing agent, tenants and other lenders. At a minimum, such no-contact provisions should be limited in time and scope, and should expire with the expiration of the NDA itself. Also, a manager should recognize that a broadly drafted no-contact provision can impede its due diligence in unrelated transactions and can impair the marketability of assets unrelated to the assets that are the subject of the NDA.

Sixth, particularly in the context of private equity or private company acquisitions, NDAs typically include provisions prohibiting the recipient from hiring or soliciting employees of the target company. While the motivation for including such provisions may be justifiable from a business perspective, the default language of such provisions is typically overbroad, and hedge fund managers are encouraged to negotiate and narrow this language. For more on the appropriate scope of non-solicitation provisions in the hedge fund context, see "Schulte Roth & Zabel Partners Discuss Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Hedge Fund Manager Employment Agreements," Hedge Fund Law Report, Vol. 4, No. 42 (Nov. 23, 2011).

Duration

Generally, there are two triggers for the expiration of obligations under an NDA: lapse of time and the occurrence of designated events. In other words, NDAs typically expire upon the earlier of occurrence of a designated event or lapse of a designated period.

Designated events typically include the execution of a definitive agreement or the closing of the relevant transaction. For example, in the context of syndicated loan transactions, the parties (for example, distressed debt or credit hedge funds) may provide for termination upon closing or settlement by assignment, participation or sub-participation.

The "market" for time-based expiration typically ranges from 12 months to 24 months. Generally, confidentiality obligations included in loan trading documents, such as the LMA and Loan Syndications and Trading Association forms, expire after 12 months, while confidentiality obligations included in private equity or similar transaction documents expire after 24 months. See "Should Hedge Funds Include Automatic Termination as a Term of Bank Debt Trades on the New Loan Market Association Forms?," Hedge Fund Law Report, Vol. 3, No. 10 (Mar. 11, 2010). On rare occasions, confidentiality obligations with respect to particularly sensitive commercial information may last 36 months. But, as a practical matter, such lengthy confidentiality obligations are likely to be superseded by intervening transactions or new information (e.g., new earnings figures, orders or sales forecasts).

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Definition of Confidential Information

NDAs in the hedge fund context typically define "confidential information" broadly to include all information disclosed to the recipient regarding a specific asset, entity or transaction. Also, NDAs sometimes define confidential information to include the existence and terms of the NDA itself.

From the hedge fund manager perspective, such a broad definition of confidential information is typically acceptable as long as: (1) the definition is limited with respect to source, timing, form and notes; and (2) the four typical carve-outs (for information that is public, previously known, learned from third parties or independently developed) are present and appropriately drafted.

Source

Managers should limit the definition of confidential information to information disclosed to the manager by the disclosing party or its affiliates, agents or representatives. Confidential information should not include – and should affirmatively exclude – information received by the manager from other sources.

Timing

Confidential information should only include information disclosed to the manager after execution of the NDA.

Form

While an NDA may contemplate the provision of information to a hedge fund manager in various formats – written, oral, electronic, etc. – managers should negotiate for a definition of confidential information that is limited to written information, whether in hard copy or electronic form. Information provided in written form should be identified as confidential and oral disclosure of confidential information should be confirmed in writing. Disclosing parties sometimes seek to provide in an NDA that confidential information includes information obtained through observation during site visits to the investment target's offices. Managers should resist this provision because it invites disputes regarding the scope of covered information.

Notes

NDAs typically define confidential information to include secondary or derivative materials that contain or reflect primary confidential information – for example, notes, extracts, memoranda, or spreadsheets prepared using confidential information. Including derivative materials in the definition of confidential information is typically acceptable and accepted. However, a hedge fund manager should negotiate for the related right to retain such derivative materials for the purpose of satisfying its obligation, if any, to return or destroy confidential information.

Four Typical Carve-Outs

As indicated, NDAs typically provide that information is not confidential information if it is public, previously known, learned from third parties or independently developed. These

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provisions are customary and noncontroversial. If they are not present in an NDA received by a hedge fund manager, the manager should negotiate to include them and the request generally should be accepted. A bit more on each:

The exception for public information typically includes any information that is generally known to the public or information that becomes generally known to the public after execution of the NDA, providing, in the latter case, that the recipient did not cause or permit such information to become public in breach of its obligations under the NDA.

The negotiating point that hedge fund managers should be aware of with respect to previously known information is the following: some disclosing parties request that previously known information be limited to information obtained by the manager on a non-confidential basis. However, in the majority of cases, much of the information possessed by a manager was obtained on a confidential basis. Therefore, hedge fund managers should resist efforts to limit previously known information to information obtained by the manager on a non-confidential basis. Rather, previously known information should include all information possessed by the manager prior to execution of the NDA, whether obtained on a confidential or non-confidential basis.

Similarly, information lawfully obtained from third parties is typically excluded from the definition of confidential information, and hedge fund managers should seek to define information lawfully obtained from third parties as all such information, not only information obtained on a non-confidential basis. Doing so will allow the manager to obtain confidential information from more than one source, which in turn will enable the manager to avoid any implied exclusivity with respect to the counterparty on the first NDA.

The exception for independently developed information is typically more significant where the confidential information relates to proprietary technology, and less significant where confidential information relates to financial data. In the normal course, proprietary technology plausibly may be independently developed, while financial data – the books and records of a business, its contracts, projections and the like – are unlikely to be developed autonomously.

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