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Avoiding Pitfalls of “Use” Clauses in NDAs

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Non-disclosure agreements, or NDAs, are essential components of public and private merger and acquisition sale processes, as they facilitate the flow of commercial information from the target to the acquirer for due diligence purposes while protecting the target’s proprietary and competitively sensitive information. Particularly in circumstances where the potential acquirer and target operate in the same industry, the target may be concerned that the information provided to the acquirer for due diligence could be used for another, potentially improper, purpose. Thus, a key provision in almost every NDA is a “use” clause, which limits the ways in which the party receiving confidential information may use that information.

Notwithstanding the fact that NDAs are commonplace in M&A transactions, breaches of NDAs are rarely litigated. Parties may be reluctant to make the dispute public and damages for breach of an NDA can be difficult to prove. Nonetheless, as the following cases demonstrate, “use” clauses can have collateral consequences if litigation does arise depending on other provisions in the NDA and how the transaction develops. Such consequences include exposing a party to potential liability for transaction fees or operating as a “standstill” that precludes the receiving party from pursuing an acquisition of the target.

Cases Addressing “Use” Clauses

In *Goodrich Capital, LLC v. Vector Capital Corporation*, a broadly drafted “use” clause triggered a separate “non-circumvention” fee payment clause, and exposed a party to potential damages of \$3.5 million in advisory fees. 2012 WL 4123401 (S.D.N.Y. June 26, 2012).

Goodrich arose from the desire of Treasurer, a cash management business, to acquire a smart safe company. Treasurer hired Goodrich as its financial advisor, and Vector, a private equity firm, agreed to finance the deal. The three parties entered into an NDA, which contained a “use” clause prohibiting Vector from using confidential information for any purpose other than the “contemplated business arrangement,” which the court interpreted to mean a transaction relating to cash handling services that involved all three parties. The NDA also contained a “non-circumvention” clause prohibiting Vector from avoiding the payment of Goodrich’s advisory fees at the closing of any such deal.

Goodrich identified potential target companies for Treasurer and Vector to pursue, and Treasurer unsuccessfully attempted to acquire one such target. Goodrich then proposed that Treasurer and Vector attempt to acquire the smart safe business line of another potential target, Tidel. Vector, however, decided to acquire Tidel on its own, without involving Treasurer or Goodrich.

Goodrich sued Vector for breach of the NDA, alleging that Vector used Goodrich’s confidential information (the list of potential targets) for a prohibited purpose (one other than exploring a transaction involving Goodrich and Treasurer). Goodrich argued that it was deprived of a \$3.5 million advisory fee for its services. In denying Vector’s motion to dismiss, Judge Rakoff held that Goodrich plausibly alleged that Vector breached the NDA’s “use” clause. The court also found Goodrich plausibly alleged that Vector’s actions were an attempt to avoid having to pay Goodrich its fee, in violation of the “non-circumvention” clause, thereby exposing Vector to damages in the amount of the advisory fee. The parties settled the case shortly after the decision.

In *Martin Marietta Materials, Inc. v. Vulcan Materials Company*, the Delaware Court of Chancery interpreted the parties' "use" clause to have the same effect as a standstill. 56 A.3d 1072 (Del. Ch.), *aff'd*, 45 A.3d 148 (Del. 2012). In that case, Martin Marietta and Vulcan entered into an NDA to explore a potential merger. When merger discussions broke down, Martin Marietta launched both a hostile bid for Vulcan and a proxy contest to replace Vulcan's directors. Vulcan filed suit, claiming that Martin Marietta breached the NDA by improperly using Vulcan's confidential information in connection with its hostile bid. Then-Chancellor Strine agreed with Vulcan and enjoined Martin Marietta's hostile bid, and the Delaware Supreme Court affirmed.

In reaching its decision, the lower court analyzed the NDA's "use" clause, which specified that Martin Marietta could use confidential information only for the purpose of evaluating a "Transaction," defined as "a possible business combination transaction" between Martin Marietta and Vulcan. The court held that the definition of "Transaction" applied only to a negotiated transaction between the parties and did not include a hostile takeover. Although the NDA did not include an express "standstill" provision, the court remedied Martin Marietta's breach of the NDA by enjoining Martin Marietta from "taking steps to acquire control of Vulcan shares or assets" for four months—the period left in the NDA at the time of the breach—and from running its slate of directors in the proxy contest. In effect, the "use" clause operated as a backdoor standstill provision, which the parties had not negotiated in the NDA.

Depomed Inc., v. Horizon Pharma, PLC serves as an even broader example of a "use" clause acting as a backdoor standstill. 2015 WL 7433326 (Cal.Super. Nov. 19, 2015). In that case, Horizon was launched a hostile bid to acquire Depomed after Depomed purchased the rights to a drug from Janssen. Horizon had previously entered into an NDA with Janssen relating to that same drug. Depomed argued that it had inherited the rights of the NDA between Horizon and Janssen when it acquired the drug, and that Horizon was improperly using confidential information in violation of that NDA in its hostile bid. The court agreed with Depomed and preliminarily enjoined Horizon's bid.

The extraordinary relief granted in the *Martin Marietta* and *Depomed* cases serves as a reminder that NDAs drafted at the very beginning of a potential deal can have broad implications on the parties well after circumstances have changed. If the parties had addressed whether a "standstill" was an appropriate remedy for a breach of the "use" clause, litigation may have been avoided or the relief awarded may have been different.

While these decisions serve as cautionary tales, case law also supports the notion that parties may pursue business opportunities directly related to their prior diligence of a company so long as the record is clear they did not improperly use confidential information. In *Cardiovascular Support Perfusion Reliance Network, LLC v. SpecialtyCare, Incorporation*, the court found that an NDA with a restrictive "use" clause did not prohibit SpecialtyCare from pursuing a separate contract that had previously been awarded to Cardiovascular Support. 629 F. App'x 673 (6th Cir. 2015).

There, Cardiovascular Support planned to sell its perfusion business to SpecialtyCare. The parties signed an NDA agreeing that SpecialtyCare would use Cardiovascular Support's confidential information solely in connection with that potential transaction. During the parties' negotiations, Cardiovascular Support disclosed that its contract with Baylor University Medical Center was set to expire. When the contract expired, Baylor declined to renew it and instead contracted with SpecialtyCare. Cardiovascular Support sued SpecialtyCare for breach of the NDA, alleging that SpecialtyCare's M&A team had passed confidential information about Cardiovascular Support's relationship with Baylor to the SpecialtyCare sales team, and that the sales team used that information to secure the contract with Baylor.

The district court granted summary judgment in SpecialtyCare's favor, and the Sixth Circuit affirmed, rejecting Cardiovascular Support's theory that SpecialtyCare had improperly used confidential information. The court found that Cardiovascular Support failed to present sufficient evidence that SpecialtyCare breached the "use" clause of the NDA, relying on the fact that SpecialtyCare's sales team had testified that they did not receive any information regarding Cardiovascular Support from SpecialtyCare's M&A team. While Cardiovascular Support pointed to emails from SpecialtyCare's sales team to the M&A team about Cardiovascular Support's known clients, the court found that such emails did not affirmatively show that information flowed in the other direction, from the M&A team to the sales team.

Best Practices

Case law provides a useful roadmap for drafting “use” clauses to avoid collateral consequences. Cases such as *Goodrich* and *Martin Marietta* illustrate that the unexpected and potentially consequential interaction between the “use” clause and other provisions in an NDA can create significant exposure, including for monetary damages or broad equitable relief. Lawyers negotiating NDAs should also consider precisely defining the consequences for violations of the “use” provision to avoid unintended consequences.

Case law also provides useful guidance for protecting against potential liability once an NDA containing a “use” clause is signed. Transaction participants should consider having protocols in place to identify potential conflicts with respect to an NDA counterparty. If potential conflicts are identified, a party may wish to take steps to segregate confidential information and restrict access to it. For instance, members of a deal team should be instructed not to share confidential information with colleagues outside the deal team, absent approval. In addition, if parties wish to engage in activities that may touch on the subject of the NDA, they should consider using a “clean team” of employees who did not previously have access to the counterparty’s confidential information. These steps may minimize the risk that a party would potentially be found liable for running afoul of a “use” clause.