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JUNE 2008

Keeping Secrets Secret: Confidentiality in the Sale of a Business

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In selling a business, maintaining confidentiality of both company information and transaction details is critical. A company's trade secrets and other sensitive information can be among its most valuable assets, and the release of that information at the wrong time or to the wrong people can not only wreck a sale, but also cause permanent damage to the business. Careful upfront attention to confidentiality will help safeguard important information and avoid disaster down the road.

Overview of Confidentiality Agreements

Potential buyers of a business need to review extensive information in their due diligence. In turn, a seller will be anxious about disclosing proprietary and sensitive information, particularly where a strategic purchaser might use the information for its own benefit if the sale is not closed. For this reason, a seller will typically require prospective buyers to enter into a written confidentiality agreement at the start of the sale process.

Most confidentiality agreements include the same basic points. Potential buyers and their advisors must use the confidential information only to evaluate the transaction, must not disclose the information to any other parties (unless a court or government agency demands it), and must return or destroy the information if the transaction is abandoned. Within this framework, specific terms are often negotiated between the seller (or its investment banker) and interested buyers. In most cases, the parties reach agreement quickly and no one ever has occasion to pick up the document again. However, sellers sometimes fail to give proper advance attention to issues that later become big problems.

Keeping It Quiet

Maintaining the secrecy of the transaction itself can be one of the most challenging tasks in the sale process. A seller will not want its competitors or customers to learn that a sale is being discussed. Also, a seller will not want multiple potential buyers in an auction to share information, including the identity of other bidders. Therefore, a seller will need to ensure that its confidentiality agreement clearly prohibits each potential buyer from disclosing any information regarding the transaction, including the fact that the parties are considering a transaction. Although this provision is common in confidentiality agreements, not all forms include it; and without it, a seller may have no remedy against a prospective purchaser that leaks information about the deal.

Internally, a seller will need procedures ensuring that information about the transaction is limited to employees who need to know. Senior management should emphasize the need for confidentiality to all involved employees. External advisors such as attorneys and investment banks typically have policies for safeguarding client confidentiality, but a careful seller will remind all team members of the need for secrecy. Maintaining the confidentiality of the transaction requires management's constant effort. If rumors of a sale become a distraction to employees, management sometimes decides to tell all employees (subject to disclosure requirements under the federal securities laws, in the case of public companies), in order to minimize uncertainty and gossip.

Guarding Employees

During the due diligence process, a prospective buyer will usually conduct extensive interviews with management, and may also want to discuss certain matters with other employees. A seller will ordinarily be concerned about the level of interaction between its employees and a prospective buyer, because of the risk that the buyer might try to hire them (or that employees may decide on their own to go to work for the buyer) if the transaction is terminated. Obviously, this concern is greater if the potential purchaser is, or by hiring certain employees could become, a competitor of the seller.

Confidentiality agreements often include provisions dealing with this risk, but such provisions are not universal and, even if included, must be carefully tailored to address a seller's concerns. A seller will want to prohibit a potential buyer from initiating contact with any employees outside the formal diligence process, so that management is aware of the exact nature and extent of all interaction. A seller will also want to prohibit the buyer from soliciting its employees for employment, and may also want to prohibit the buyer from hiring any of its employees even if the employee approaches the buyer first. Prospective buyers frequently object to a restriction on hiring employees on a non-solicited basis, such as in response to a general advertisement not specifically directed to the seller's employees. Buyers may also seek to establish a time limit on any hiring restrictions, and may also seek to limit such restrictions to a list of key employees.

Sharing Sensitive Information

As noted above, a seller will have extra concerns about confidentiality where a prospective buyer is a current or potential competitor. The misuse of sensitive information by a competitor, even if legally wrongful, could be catastrophic. In addition, federal antitrust laws limit the sharing of certain detailed information, such as pricing information and marketing plans, prior to completion of a sale. A seller will want to disclose only information that is absolutely necessary for the potential buyer to complete its diligence. Whenever there are competitive concerns, a seller should retain experienced antitrust counsel promptly to help identify specific information where disclosure is not appropriate, or appropriate only with special procedures designed to protect against misuse. Where sensitive information can be disclosed, such procedural safeguards might include the following:

- "Staggering" or deferring disclosure of competitive information until late in the process;
- Limiting access to the information only to individuals with a clear need to know;
- Adopting more formal processes for delivery of the information, such as designating a single point person or team to coordinate information flow; and
- Requiring independent consultants to review and summarize the information for the purchaser, instead of permitting the purchaser to have direct access.

Avoiding Waiver of Privilege

In due diligence, a potential buyer will want to know about company litigation. Sellers must often balance the buyer's need for this information against the risk that disclosure will waive the attorney-client privilege, which protects communications between an attorney and client, and other similar legal privileges. If the attorney-client privilege is found to have been waived, the law will allow the seller's litigation adversary to obtain the information through discovery, an unintended but potentially devastating result.

However, under the doctrine of common interest, a holder of privileged information can disclose it to a party that has a common legal interest with the holder without waiving the attorney-client privilege. Depending on the structure of the transaction and the applicable state law, a potential buyer in a sale transaction might be a party of common interest. However, determining whether the common interest doctrine applies in the sale of a business is often complex, and a seller should consult counsel in any case where information about company litigation might be revealed. A seller should also be aware that delivery of privileged information to business advisors such as investment bankers, rather than directly to a prospective buyer, will probably result in a waiver of privilege.

Finally, many confidentiality agreements state that the parties have a common legal interest and that disclosure will not constitute a waiver of privilege. Such provisions, although potentially helpful, will not guarantee the benefit of the common interest doctrine.

Conclusion

Protecting the secrecy of confidential information, and the details of a potential sale, can be among the most critical tasks in selling a business. By giving careful thought to the various issues outlined in this article, a seller can help safeguard its most important assets and avoid potentially disastrous business and legal problems.

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