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M&A Newsletter Series

Part 1: Confidentiality agreements in M&A share deal transactions

The purpose of this Baker McKenzie M&A Newsletter Series is to give an insight to prospective sellers or purchasers into some key legal documents and/or provisions they will most likely be confronted with when entering into any sale or acquisition process concerning a Luxembourg commercial company.

Part 1: Confidentiality agreements in M&A share deal transactions

This first newsletter deals with confidentiality agreements, which are usually the first legal document to be negotiated and executed in any such transaction.

A confidentiality agreement, also known as a nondisclosure agreement, is generally the very first legal document to be drafted, negotiated and executed when starting the process of selling or buying a company.

Prima facie, the purpose of a confidentiality agreement seems rather self-explanatory. It seeks to ensure that information to be disclosed by the seller (and/or the target company) to one or several prospective purchasers in connection with a contemplated transaction remains confidential, i.e., is not disclosed to anyone else.

However, some prospective sellers forget, for example, to further ensure that their confidentially agreement also prevents the recipient from using it for any purpose other than assessing the merits of the contemplated transaction. Such oversight could lead occasionally to some (more or less) serious setbacks, e.g., when the recipient is a competitor of the discloser.

Given its purpose, a confidentiality agreement is almost always drafted by the seller, as the seller is the party that most frequently relies on it, but also is frequently the most less experimented party in an M&A transaction.

However, sometimes a confidentiality agreement may form a (binding) part of a letter of intent or term sheet prepared by the prospective purchaser.

It may take the form of a contract or a unilateral undertaking (to which we will refer to hereinafter generically as confidentiality agreement(s)), executed prior to giving access to confidential information to any recipient.

OFTEN PERCEIVED BY SELLERS OR PURCHASERS AS A STANDARDIZED AND/OR SIMPLE DOCUMENT, CONFIDENTIALITY AGREEMENTS ARE IN REALITY RATHER SOPHISTICATED DOCUMENTS THAT PRESENT DIFFERENT PITFALLS.

Often perceived by sellers or purchasers as a standardized and/or simple document that merely needs to be signed as a habit before a prospective purchaser may start its due diligence process, confidentiality agreements are in reality rather sophisticated documents that present different pitfalls.

The key points of attention when drafting and negotiating a confidentiality agreement usually are (the following list is not exhaustive):

- (a) the identification of the parties thereto;
- (b) the definition of confidential information and its carve-outs;
- (c) the nature and extent of the confidentiality obligations;
- (d) the permitted use and/or disclosure of confidential information;
- (e) the return and/or destruction of the confidential information;
- (f) the additional non-solicitation or standstill obligations in certain particular types of transactions;
- (g) the duration of the confidentiality obligations; and
- (h) the remedies available to the discloser in case of breach of the confidentiality obligations.

Below we will debate these key points of attention to highlight some pitfalls they may conceal.

(a) Parties to confidentiality agreements

Focusing on the parties to a confidentially agreement may seem excessive at first, as the seller and purchaser appear to be the perfect usual suspects in this respect.

However, any prospective purchaser should always carefully consider whether the target company should be made a party to the confidentiality agreement or at least be designated as a third party beneficiary thereunder.

Indeed, in an auction process sale, for example, where there are several prospective purchasers entering into confidentiality agreements, the final purchaser may need, post completion, to rely on such confidentiality agreements to protect its brand new investment against disappointed competitors. Such a goal could, alternatively, be achieved by other legal means, such as a provision in the confidentiality agreement permitting the final purchaser to oblige the discloser to enforce its confidentiality arrangements against other bidders or assignment provisions of the rights of the discloser in the confidentiality arrangements to the final purchaser in case of completion of the transaction.

(b) Definition of confidential information

The definition of confidential information is also crucial.

It is not surprising that the discloser will push for the most extensive definition thereof. It will consider making (or not) the fact that the parties are contemplating entering into the contemplated transaction as confidential information. For its part, the recipient will be well advised to ask for customary carve-outs to the definition of confidential information, such as: (a) information that is in the public domain; (b) information that the recipient would be required to disclosed pursuant to any mandatory laws or regulations; (c) information that the recipient already had in its possession at the time of disclosure by the discloser; (d) information disclosed by the recipient with the prior consent of the discloser; and (e) any information that the recipient may demonstrate was generated by it independently of the confidential information.

Any time when the definition of confidential information includes the reports and analysis by the recipient and advisers established on the basis of the confidential information, the recipient will be particularly careful that it should be in a position to comply with its obligations to return/destroy such reports and analysis.[1]

In the same manner, if the confidential information includes the mere existence of the negotiation on the contemplated transaction, the recipient should consider if it will be prepared to return or destroy any internal emails, reports and documents simply mentioning the existence of the contemplated transaction.

[1] As they may not necessarily be in a position to do so for different reasons.

(c) Nature and extent of the confidentiality obligations

The nature and extent of the confidentiality obligations is also a key matter to be negotiated (hopefully with some common sense) between the parties. For example, are the obligations regarding the storage and security of the confidential information or the use of the confidential information after it has been disclosed to the recipient realistic? If they are for the recipient itself, are they also realistic for its so-called authorized recipients (see below)? Will these obligations force the recipient and/or its authorized recipients to adopt additional storage or security measures?

(d) Permitted use and/or disclosure of confidential information

Disclosure to so-called authorized recipients is another fundamental topic to be discussed and agreed upon.

THE PARTIES WILL NEED TO FURTHER AGREE ON THE LIABILITY ALLOCATION IN CASE OF A BREACH OF CONFIDENTIALITY OBLIGATIONS BY ANY SUCH AUTHORIZED RECIPIENTS

No confidentiality agreement should prevent a recipient from reasonably using the confidential information for the permitted use thereof, which almost always requires in any transaction the absolute need for such a recipient to be able to share it with some specific persons (the so-called authorized recipients), such as its managements bodies, its key officers, its key employees and/or agents, members of its investment committee (if any), its prospective co-investor(s) (if any), its prospective financiers and its professional advisers.

Then, when that the authorized recipients are agreed upon, the parties will need to further agree on the liability allocation in case of a breach of confidentiality obligations by any such authorized recipients. The discloser will push for liability for any such breach of confidentiality obligations to lie fully with the recipient (usually via a porte-fort clause).

Conversely, the recipient will push for each authorized recipient to enter into direct contractual relations with the discloser[2] and not be liable for them. In between, the recipient, for example, may remain liable only where one of its authorized recipients failed to sign a direct confidentiality agreement with the discloser.

Compulsory disclosure obligation in certain circumstances to some public authority, regulator or other authority (e.g., stock exchange) should also need to be addressed properly. While the discloser may usually not be in a position to prevent such a compulsory disclosure, it may at least try to submit it to some reasonable restraints and other obligations (e.g., prior notification).

(e) Return and destruction of the confidential information

It is also important not to forget the return or destruction of the confidential information when the transaction does not proceed. Different problems may occur in this respect. First, the recipient should ensure that it would not be forced to return or destroy any information it would be required to retain by law or regulation.

[2] With or without amendments to the confidentiality obligations agreed under the "main confidentiality agreement."

RECIPIENT SHOULD BE CAREFUL ABOUT ITS MATERIAL ABILITY TO TOTALLY DESTROY ELECTRONICALLY STORED INFORMATION, AS THIS MAY PROVE EXTREMELY COMPLEX AND COSTLY

Then, the recipient should be careful about, for example, (a) the timing of the return and destruction, [3] (b) its material ability to totally destroy electronically stored information, as this may prove extremely complex and costly, and (c) the documents that the recipient or its authorized recipient may be required to keep pursuant to the law, regulation and internal group policies.

(f) Additional non-solicitation or standstill obligations

It is also important not to forget the return or destruction of the confidential information when the transaction does not proceed. Different problems may occur in this respect. First, the recipient should ensure that it would not be forced to return or destroy any information it would be required to retain by law or regulation.

(g) Duration of the confidentiality obligations

All parties to a confidentiality agreement should consider that confidential information often loses its confidential nature over time or ceases to be commercially sensitive. Therefore, no confidentiality agreement should ever be entered into for an indefinite duration, also because this could enable any party thereto to terminate it unilaterally with a reasonable period. No confidentiality agreement should reasonably continue to bind the "final purchaser" after completion of any contemplated transaction concerning 100% of the company's target.

Using common sense, parties should try to agree on a specific and reasonable term in line with market practice (which may vary from one business to another), which is usually between two and five years.

(h) Remedies available to the discloser in case of breach of the confidentiality obligations

Finally, parties to a confidentiality agreement will need to agree on the sanctions in the event of a breach of confidentiality obligations. The discloser will usually try to negotiate a so-called "indemnity" in the confidentiality agreement, as damages resulting from breach of confidentiality may be hard to evidence in court. The recipient is likely to resist this demand (especially, for example, if it is a private equity fund) and stay on the basis of common law. If an "indemnity" is to be discussed, the recipient must ensure that any alleged breach/damage must be recognized by a court prior to any payment being due, and the discloser has a reinforced obligation to mitigate its loss and definition of loss is limited to the one as defined under the Luxembourg Civil Code.

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[3] For example, it will not always be obvious to determine when a transaction "does not proceed"; therefore, any time there is a deadline to proceed with return or destruction of the confidential information, it should only start as from the moment the discloser expressly requires such return or destruction.