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Don't Forget NDA Clauses Can Cover More Than Trade Secrets

By **Matthew Whitley and Parth Gejji** (December 22, 2020, 3:33 PM EST)

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Anyone who deals with contracts is accustomed to seeing confidentiality clauses.

It seems as though some form of confidentiality or nondisclosure agreement is present in almost every commercial contract, whether one is needed or not.

As NDAs become more common, it is human nature to gloss over them, just like we often do with other boilerplate contract language.

Failure to pay attention to details, though, can have major consequences, for the scope and enforceability of NDAs often turns on their precise wording.

Many people assume that NDAs merely protect trade secrets.

That belief was reinforced when the California Court of Appeal for the Fourth Appellate District vacated an arbitration award in Brown v. TGS Management Co. LLC in October, holding that a broad NDA between an employer and a former employee violated California public policy because it operated as a de facto noncompete provision.[1]

That decision generated much commentary in legal circles.[2] It also served as a reminder that the enforceability of NDAs depends on numerous factors, including their scope, their commercial context and the governing jurisdiction.

Indeed, while courts in many states would follow California's strict approach to NDAs in the employment context, they are more likely to give parties in an arm's-length transaction the freedom to bargain for contractual restrictions that are stricter or looser than those imposed by tort law.

In negotiating or litigating confidentiality clauses, therefore, it is essential that clients and counsel read the fine print.

Contracts Can Protect More Than Trade Secrets

NDAs have traditionally played an important role in trade-secret litigation. For example, NDAs are often used as evidence of precautions taken to maintain the secrecy of information.[3]

Such agreements are an important factor in establishing trade secret status.[4] NDAs can also establish the duty of confidence necessary to prove trade secret misappropriation.[5] Thus, it is well-settled that NDAs that protect trade secrets, and nothing more, are routinely enforced in breach of contract claims.[6]

But NDAs can reach more broadly than just trade secret information.

Indeed, courts have expressed a willingness to enforce broad confidentiality provisions without regard to whether or not the information at issue is publicly available or is otherwise protectable as a trade secret.[7]

As various scholars, like Raymond Nimmer, have recognized, contracts can validly protect information that extends beyond trade secrets, including information in the public domain:

Some have argued, however, that a contract cannot create enforceable rights (or obligations) in material already in the public domain. That statement supposedly draws support from common law principles that deny enforcement to promises that unreasonably restrain trade.

The blanket statement misstates the case. Courts routinely enforce royalty obligations related to trade secrets even after the previously secret information enters [the] public domain. In addition, a variety of clearly enforceable contract interests arise in public domain information based on an analysis of the importance of enforcing agreements voluntarily entered. These are frequently enforced by courts.[8]

The real question, therefore, is not whether NDAs can protect more than trade secret information. They can. Rather, the real inquiry involves three different considerations:

- How are such NDAs limited by other law — including federal intellectual property law and state law regarding restraints of trade?

- What can counsel and parties do to strike a proper bargain?

- What considerations should counsel and parties keep in mind when litigating NDAs?

Limitations Placed on NDAs by Law

The case law reveals two ways in which litigants have sought to limit the reach of NDAs that protect more than trade secret information: through (1) preemption arguments based on federal intellectual property law, and (2) anti-competition arguments based on state law regarding restraints of trade.

Preemption arguments based on federal intellectual property law have not fared well in the courts. Most courts find that, since private agreements affect only the rights of the contracting parties, they do not raise any preemption concerns.

So long as an NDA does not restrict the rights of the public at large to use publicly available information, courts generally hold that a private contract limiting the rights of a specific party to use otherwise publicly available materials does not run into the preemptive force of federal intellectual property law.[9]

In Aronson v. Quick Point Pencil Co., for example, the U.S. Supreme Court in 1979 acknowledged the role of state contract law with regard to patent preemption:

Commercial agreements traditionally are the domain of state law. State law is not displaced merely because the contract relates to intellectual property which may or may not be patentable; the states are free to regulate the use of such intellectual property in any manner not inconsistent with federal law.[10]

Thus, a licensing agreement that granted a royalty to the inventor into perpetuity was enforceable, even though the invention was not patented and eventually became public as a result of being on the market.[11] Federal patent law did not prevent the enforcement of contractual duties "freely undertaken in arm's-length negotiation," even when those obligations restricted use of information in the public domain.[12]

Numerous other courts have agreed that parties to a contract are free to limit their right to take action with regard to publicly available information[13] and to bargain for benefits beyond what the law itself can provide.[14]

Similarly, copyright preemption does not ordinarily prevent the enforcement of a valid contract between two private parties that restricts the use of information in the public domain.[15] As a practical matter, therefore, the preemption doctrine has had little impact on the enforceability of broad NDAs.

With regard to limitations on NDAs placed by state law barring unreasonable restraints of trade, the landscape is more varied. Some states are averse to NDAs in the first instance.

While the Restatement of the Law (Third) of Unfair Competition argues against imposing such limitations on NDAs,[16] some states nevertheless impose durational and geographic limitations to NDAs that are more traditionally applied to covenants not to compete.[17] Other states view broad NDAs as restrictive covenants and therefore require some showing that the information is confidential and has been subject to efforts of protection.[18]

But not all state law harbors the same aversion of broad NDAs.[19] Many courts have expressed a willingness to enforce NDAs that protect public information, and these courts have held that such provisions do not amount to a noncompete provision.[20]

Thus, NDAs that protect more than trade secret information are not outliers, and courts are generally willing to enforce such bargains in a commercial context. "Where the express terms of a commercial contract go beyond the language of protecting trade secrecy ... the broad pattern is toward enforcement."[21]

4 Considerations to Keep in Mind When Negotiating and Litigating NDAs

Given this reality, counsel and parties should keep these considerations in mind when negotiating and litigating broad NDAs:

1. The most important consideration is how the NDA defines confidential information.

After all, the scope of contractual protection depends on the contractual language.[22]

Thus, consider whether the definition merely tracks the relevant state law definition of trade secrets, or whether it incorporates more.

If the definition is broad, consider whether the definition encompasses information that is in (or may one day enter) the public domain. Whether you want a broad or narrow definition, of course, depends on the nature of the specific transaction, the relationship of the parties, and your client's interests.

2. Consider the context of the relationship.

Courts are more deferential to contract terms in an arm's-length transaction.

They are far less forgiving when the NDA appears in an employer-employee context, where courts understand the employee often has little-to-no bargaining power.[23] The Restatement, for example, has a specific section about trade secret misappropriation in the employer-employee context.[24] As the Restatement recognizes, courts are protective of the freedom and mobility of employees,[25] which usually leads to narrow enforcement of NDAs.

Thus, one should expect a court to consider the context of the relationship in judging a broad NDA's enforceability. A broad NDA covering otherwise publicly available information may be easy to justify in a commercial transaction, whereas the same restriction in an employer-employee relationship will likely be viewed with more suspicion.

3. Consider the industry involved and the information at issue.

Innovations in certain industries might have an easier time achieving trade secret status than innovations in other industries.

For example, a chemical compound with a secret formula will have an easier time achieving trade secret status than a simple mechanical device that is unknown to the market, but could be easily understood upon first viewing.[26] In the latter situation, an NDA that protects more than just trade secrets may be crucial, and the party needing that protection may want to insert language specifying the necessity for a broad NDA given the uniqueness and simplicity of the invention.

4. Finally, consider whether there are other avenues of competing in the same industry.

Courts holding that NDAs covering more than just trade secrets are unreasonable restraints on trade often do so to protect competition.[27] But if there are other ways of competing in the same marketplace without use of the information protected by the NDA, courts are more likely to enforce a broader restriction.

Thus, in negotiating the NDA, consider whether the parties should acknowledge, or deny, in writing that there are other ways of competing in the marketplace that do not depend upon the restricted information. Similarly, in litigating an NDA, consider whether an expert could identify feasible ways of competing in the marketplace that do not depend on use of the protected information.

Conclusion

NDAs that protect more than trade secret information are here to stay.

It is critical, therefore, that parties and counsel read the fine print instead of glossing over the details of a confidentiality provision.

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[1] Brown v. TGS Mgmt. Co., LLC, 2020 WL 6634990, at *10-11 (Cal. Ct. App. Nov. 12, 2020).

[2] See, e.g., https://www.law360.com/articles/1335375/it-s-time-for-california-employers-to-reexamine-their-ndas.

[3] Restatement (Third) of Unfair Competition § 39 cmt. g (1995) ("Precautions to maintain secrecy may take many forms, including . . . measures that emphasize to recipients the confidential nature of the information such as nondisclosure agreements . . . .").

[4] Id.; see also Unif. Trade Secrets Act § 1(4)(ii) (amended 1985) (defining "trade secret" to mean information that inter alia "is the subject of efforts that are reasonable under the circumstances to maintain its secrecy").

[5] Restatement (Third) of Unfair Competition § 41(a) (1995) (noting that a person owes a duty of confidence to the owner of a trade secret if "the person made an express promise of confidentiality prior to the disclosure of the trade secret").

[6] Restatement (Third) of Unfair Competition § 41 cmt. d (1995) ("If the information qualifies for protection under the rule stated in § 39, a contract prohibiting its use or disclosure is generally enforceable according to its terms.").

[7] See, e.g., Tendeka, Inc. v. Glover, No. H-13-1764, 2015 WL 2212601, at *14 (S.D. Tex. May 11, 2015) (noting that for trade secret claims, "[t]he scope of what is protected is determined by statutory and common-law requirements defining a trade secret," whereas for breach-of-contract claims, "the scope of protection depends on the parties' intent, as expressed in their contract").

[8] Raymond T. Nimmer et al., Information Law § 5:10, Westlaw (database updated November 2020) (footnotes omitted).

[9] As scholars explain:

> Enforcing a contractual term does not conflict with provisions of property law even if the terms of the contract by agreement place restrictions on the parties with respect to uses or information that would be left unrestricted under property rights law. The contract, itself, creates rights between the two parties and, unlike, property law does not set out rights good against the world. The agreement controls only as to assenting parties.

Raymond T. Nimmer et al., Information Law § 2:31, Westlaw (database updated November 2020).

[10] Aronson v. Quick Point Pencil Co., 440 U.S. 257, 262 (1979).

[11] Id. at 259-60, 262-66.

[12] Id. at 266.

[13] Universal Gym Equip., Inc. v. ERWA Exercise Equip. Ltd., 827 F.2d 1542, 1550 (Fed. Cir. 1987).

[14] Luv N' Care, Ltd. v. Groupo Rimar, 844 F.3d 442, 448 (5th Cir. 2016).

[15] See, e.g., ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1454 (7th Cir. 1996); see also Forest Park Pictures v. Universal Television Network, Inc., 683 F.3d 424, 429-33 (2d Cir. 2012).

[16] Restatement (Third) of Unfair Competition § 41 cmt. d (1995).

[17] Id.

[18] For example, Illinois law takes a stricter approach than most other states when it comes to enforcing NDAs. See Tax Track Sys. Corp. v. New Investor World, Inc., 478 F.3d 783, 787 (7th Cir. 2007) (citations omitted). Similarly, California law takes a stricter approach and treats broad NDAs as "de facto noncompete provision[s]." Brown , 2020 WL 6634990, at *10-11.

[19] For example, Texas law treats NDAs differently than traditional non-compete agreements. See, e.g., Zep Mfg. Co. v. Harthcock, 824 S.W.2d 654, 662 (Tex. App.—Dallas 1992, no writ). Texas courts have determined that NDAs do not restrain choice of employment or prevent competition. Id. Thus, in Texas, NDAs should be enforceable without the need for restraint-of-trade or non-compete reasonableness analysis. Id. at 661-62.

[20] Universal Gym Equip., Inc. v. Atl. Health & Fitness Prods., No. B-80-446, 1985 WL 72675, at *17-19 (D. Md. Oct. 24, 1985), aff'd in part, vacated in part sub nom. Universal Gym Equip., Inc. v. ERWA Exercise Equip. Ltd., 827 F.2d 1542 (Fed. Cir. 1987).

[21] Raymond T. Nimmer et al., Information Law § 5:10, Westlaw (database updated November 2020).

[22] Tendeka, 2015 WL 2212601, at *14 (noting that for trade secret claims, "[t]he scope of what is protected is determined by statutory and common-law requirements defining a trade secret," whereas for breach-of-contract claims, "the scope of protection depends on the parties' intent, as expressed in their contract").

[23] See, e.g., Brown, 2020 WL 6634990, at *8 (emphasizing California's "settled legislative policy in favor of open competition and employee mobility" (cleaned up)).

[24] Compare Restatement (Third) of Unfair Competition §§ 40-41 (1995), with id. § 42.

[25] Restatement (Third) of Unfair Competition § 42 cmt. b (1995) ("Application of the rules protecting trade secrets in cases involving competition by former employees requires a careful balancing of interests. There is a strong public interest in preserving the freedom of employees to market their talents and experience in order to earn a livelihood.").

[26] Indeed, the Supreme Court's seminal patent preemption case in the contract context involved such a mechanical device. In Aronson, the Supreme Court had the following to say about the innovation at issue: "Although ingenious, the design was so simple that it readily could be copied unless it was protected by patent." Aronson, 440 U.S. at 259. "The device which is the subject of this contract ceased to have any secrecy as soon as it was first marketed . . . ." Id. at 266.

[27] Restatement (Third) of Unfair Competition § 41 cmt. d (1995); see also Brown, 2020 WL 6634990, at *9 (noting that the NDA at issue would have prevented the former employee from competing not just in the statistical arbitrage sector, but "in the securities industry at large.").