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LEGAL AND PRIVACY

Takeover and investment talks are fraught with peril

September 1, 2020

Bankrupt U.S. fashion rental company sued Urban Outfitters for allegedly stealing confidential information during M&A discussions and then later launching its own rival Nuuly rental service. Image credit: Le Tote

By Milton Springut

Your company has grown and prospered, and is now seeking either an investment in or to be acquired by a larger entity so the business can expand to the next level.

You enter negotiations with a larger investor or potential acquirer. After extensive talks, the other side tells you it is no longer interested.

Then, some time later, you discover that this same party is now entering the same space in direct competition with you, using what you believe are your company's ideas, and undercutting your market share.

This scenario continues to be reported.

Copy that

A recent *Wall Street Journal* article, *Amazon Met With Startups About Investing, Then Launched Competing Products* (July 23, 2020) reports the same scenario taking place between small startups and Amazon's venture capital fund, who enter into investment/acquisition negotiations, only to see their ideas exploited by a competing Amazon company.

Even the world of fashion and luxury goods is not a stranger to this scenario.

In 2017, haircare product company Olaplex obtained a $66 million award against cosmetics giant L'Oreal for trade secret misappropriation.

Olaplex alleged that during merger discussions L'Oreal obtained confidential information, and then used it to manufacture competing products.

More recently, similar allegations were alleged by clothing rental company Le Tote against Urban Outfitters, and by beauty company Seed Ventures, a company which claims it is responsible for "creating, developing, manufacturing, storing, selling, and distributing" the products of the billion-dollar beauty ventures of Kim Kardashian and Kylie

Jenner.

Investment and acquisition negotiations are an undertaking in this regard that is fraught with peril.

On the one hand, the company wants to make the best impression to the potential investor/acquirer, and show off its business and valuable developments.

On the other hand, the company has to be concerned that if the deal is not consummated and falls through, its disclosure might then be used to undercut its business.

And, in most of these situations, the investor/acquirer has greater negotiation leverage than the company seeking the investment or being potentially acquired, limiting what protection the company can get.

What steps should a company take to try to protect itself in this situation?

The NDA: The traditional protection
The most commonly used protection is a Non-Disclosure Agreement, or NDA.

At its most basic level, an NDA is a legally enforceable contract that creates a contractual relationship between a person who holds some kind of confidential information or trade secret (the disclosing party) and a person to whom the secret will be disclosed (the receiving party).

By signing an NDA, participants promise not to divulge or release information shared with them by the people on the other side. If the information is leaked, the injured person can claim breach of contract and misappropriation of trade secrets.

Courts generally enforce NDAs, but only so long as they protect legitimately confidential information.

Courts often refuse to enforce NDAs that merely inhibit competition or preclude use of publicly available information.

Ideally, in an acquisition or investment situation, an NDA might also preclude the other party from entering that market space for a limited time.

However, since in the majority of cases the investor/acquirer side generally has greater negotiation leverage, they will often not agree to such terms, but only agree not to be precluded from using confidential information.

NDAs should cover at least three areas: defining what is covered by and excluded from confidential information, obligations of the parties, and temporal duration.

Most important is to spell out the categories or types of information covered by the agreement. This defines those *types* of information that must be kept confidential, without actually releasing the precise information.

For example, an NDA for an exclusive designer's clothing boutique might include a statement such as this: "[c]onfidential information includes customer lists and purchase history, credit and financial information, innovative processes, inventory and sales figures."

Other possible confidential information might include certain technologies, formulas and processes, and pending legal issues.

By the same token, NDAs often exclude certain types of information from protection, such as information already considered common knowledge or data collected before the agreement was signed.

Second, NDAs should spell out the confidentiality obligations of the parties. This might preclude not only direct use of the confidential information, but encouraging others to use that information, or allowing others access to the confidential information.

In an acquisition or investment situation, the NDA will generally permit the receiving party to use the confidential information to evaluate the company, determine the value of its business and technology, and whether the investment or merger makes sense to its business position.

Third, NDAs generally define a time period during which the receiving party is required to maintain the confidentiality. This will vary depending on the industry and, again, the relative negotiating power of the parties.

As in any contract, clarity is the goal, rather than murkiness, the latter of which tends to create disputes and then expensive litigation.

For example, in the NDA entered into between Le Tote and Urban Outfitters, the NDA provided that the parties were prohibited from using the confidential information to "impair either party's right to make, use, procure or market any products or services, now or in the future, which may be competitive with those offered or contemplated by the other party." This kind of open-ended language will be interpreted by each side differently, and likely lead to conflict.

Limits of trade secret law

At bottom, NDAs only stretch as far as the information covered is truly a trade secret. Trade secret law can be very powerful, but it has significant limits.

First, the trade secret owner has to take "reasonable measures" to keep the information secret. This includes not only NDAs with potential investors, but confidentiality agreements with employees and vendors, and cybersecurity.

Second, trade secrets only protect the information obtained through improper means, such as breach of a duty of confidentiality. This typically involves an employee who jumps ship to a competitor and steals valuable trade secrets, but it could also involve a potential acquirer or investor that obtained information subject to an NDA and then used it to set up a competing business.

But trade secret law does *not* protect use of information gained from public sources, from independent research and development, or from "reverse engineering" *i.e.*, buying a product off-the-shelf, and then analyzing it so as to copy it.

So once a company goes public with its product, competitors are free to take anything they can learn from the company's promotional efforts and products.

Trade secret law sometimes still has a role to play in this situation timing.

Before a company releases its product, it can still maintain much of the pertinent information as confidential.

Even if trade secret protection is largely lost once the product goes public, the lead time to market may be very valuable to the company, both in having exclusivity for a limited time, and developing brand loyalty.

Other forms of intellectual property

Companies should also consider other forms of intellectual property protection.

Patents, unlike trade secrets, protect against *any* use of the patented design or process, regardless of how the using party obtained the information.

Even if the competitor developed the same invention independently, or learned it through legitimate reverse engineering, a patent will protect against unauthorized use of the patented invention.

On the other hand, patents take time until they are issued, and sometimes involve a lengthy application process with the patent office.

Copyright and trademarks are other example of rights that might, in some cases, be useful in protecting a company's position.

Each form of intellectual property has its own rules and limitations, and may not apply in every situation. But it is important to consider the possibilities in advance, generally in consultation with counsel.

Waiting until the company's information is pirated is not a strategy, which at best leaves the company scrambling to protect itself and, at worst, leads to loss of what might have been valuable rights.

Navigating between a rock and a hard place

The acquisition/investment scenario presents a true dilemma to a company.

On the one hand, if the company is trying to attract an investor or buyer, then it wants to put its best foot forward, and appear to have significant value. That generally requires disclosure of the inner workings and foundations of the business.

On the other hand, the company wants to avoid having the investment/acquisition negotiations become a vehicle for someone else to steal its business.

And, the often-uneven negotiation leverage in such situations makes protecting the company even harder.

THERE IS NO legal magic bullet that will resolve this dilemma in every situation.

Most important is to be aware of the issues, and possible solutions.

Creative use of NDAs and other forms of intellectual property minimize the risks to a small company, while still allowing it to seek investment funds.

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