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Assessing the Locked Box Approach to Purchase Price Adjustments

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"Certainty? In this world nothing is certain except death and taxes"—Benjamin Franklin, circa 1789

If the First American were alive today, he might as well have added the locked box.

Long popular with private equity dealmakers and spreading across Europe like the Enlightenment, the locked box mechanism is an alternative to the more popular "completion accounts" purchase price adjustment for preserving value in M&A transactions. Whether the locked box achieves critical mass in the U.S. is yet to be determined, but evidence suggests that its use has spread beyond private equity participants to include strategic purchasers and sellers as well.

The attraction of the locked box is clear enough. It typically "locks in" the final purchase price for a deal as of the signing date of the definitive purchase agreement. This creates value certainty for both purchasers and sellers and avoids the forced march toward post-closing purchase price adjustment disputes that so frequently plague the completion accounts method. Nevertheless, in practice the locked box mechanism is as beguilingly complex as it is simple, and the transaction parties are often simply replacing one set of challenges with another.

To understand the locked box approach and the nuances of its pros and cons, we briefly summarize the completion accounts approach and then contrast it with the locked box approach.

Typical Completion Accounts Purchase Price Approach

- Parties agree on headline price assuming cash free/debt free closing balance sheet with benchmark/normal level of working capital
- Purchase agreement requires buyer to pay purchase price equal to (1) headline price plus (2) working capital over the benchmark or minus working capital below the benchmark plus (3) cash and minus (4) debt
- Buyer makes payment at closing based on estimate of purchase price
- There is a post-closing process for determining the actual purchase price
- If actual purchase price exceeds closing estimate, buyer pays seller the difference; if it is less than estimate, seller pays buyer the difference

What is the "Completion Accounts Approach"?

In most U.S. private M&A transactions, the purchase price agreed at signing is subject to a post-closing adjustment based on the closing date amount of certain financial

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metrics, such as net working capital, net assets, cash and/or debt. According to a recent U.S. study, 82% of the private acquisitions reviewed had a purchase price adjustment based on completion accounts.[1] Buyers and sellers use the completion accounts method to more accurately capture changes in the target's valuation between the initial valuation, or reference, date and the closing date. The reference date is frequently a pre-signing date for which reliable target balance sheet and other core financial information is presented, typically the most recent annual or quarterly date before signing. When the metric used to measure valuation change fluctuates based on seasonal or other factors not inherently tied to economic performance, which is frequently the case when working capital is used as the valuation metric, an arbitrary, "normalized" benchmark number is agreed to pre-signing.

What is the "Locked Box Approach"?

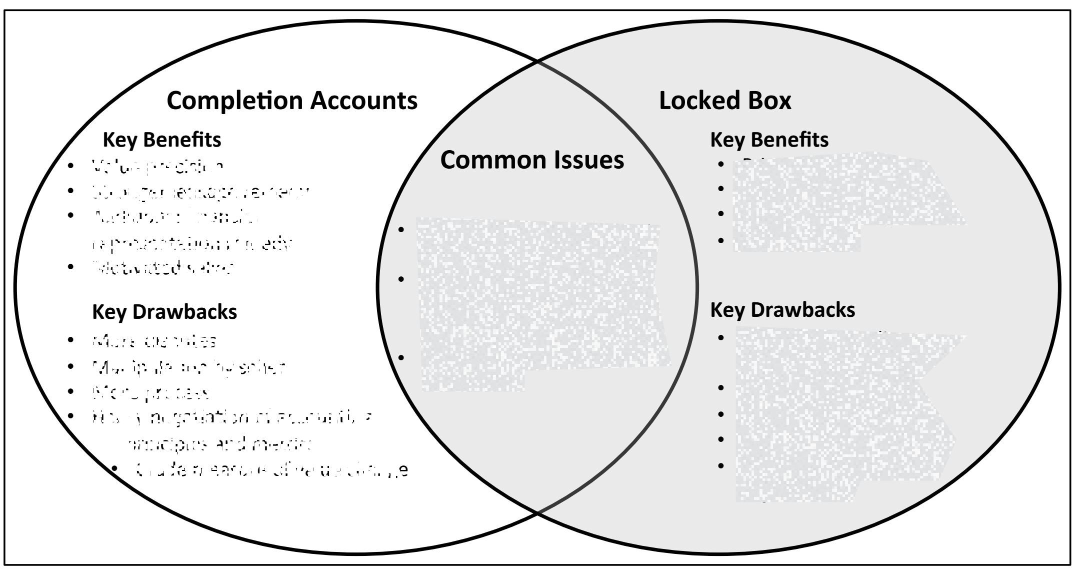
Under the classic locked box approach, there are no adjustments to the purchase price agreed to at the time of signing. Instead, in negotiating the purchase price, the parties take into account all the balance sheet items as of a reference date prior to signing as well as the projections for those amounts as of the targeted closing date.

The representations, warranties and covenants buyers rely on in a locked box approach to preserve the value of the target prior to closing are generally similar to those typical in the completion accounts approach. However, they are often stricter and carve out typical materiality, basket and cap qualifiers. Such anti-leakage protection might include prohibiting all cash distributions, other dividends, asset transfers and management fees or other related party payments, and requiring ordinary course of operation. Under the completion accounts approach, often the seller has more flexibility to take cash out of the target business or move other assets or liabilities in or out of the "box" because the metric will take into account such movements as part of the true-up adjustment as of the closing date.

Typical Locked Box Purchase Price Approach

- [illegible]
- Purchase agreement requires buyer to pay agreed equity value price
- [illegible]
- There is no post-closing adjustment

Key Benefits and Drawbacks of the Locked Box Approach



Price Certainty and Fewer Disputes—The primary appeal of the locked box approach for the parties is that there is greater purchase price certainty at the time of signing and there is less to dispute about post-closing.[2] In competitive bid situations, this certainty can be particularly appealing to sellers and

[1] American Bar Association 2011 Private Target Mergers & Acquisitions Deal Points Study released January 17, 2012.

[2] The Shareholder Representative Services 2011 M&A Post-Closing Claims Study Summary found that there was an adjustment claimed in 62% of the transactions reviewed having a net working capital adjustment provision. According to the J.P. Morgan 2011 M&A Holdback Escrow Report, purchase price adjustment disputes are the most common type of escrow claim, accounting for 44% of all escrow claims in the reviewed transactions closing between July 2008 and July 2010.

buyers. Sellers will be comparing the relative value of competing bids before the detailed negotiation of the purchase price adjustment mechanism, which typically comes after the "winner" is identified. Accordingly, using the locked box approach, the seller does not have to guess at the value erosion attributable to the purchase price adjustment negotiation process and related post-closing disputes for each respective bidder. Upfront certainty will also be at a premium for a seller because it will drive bidders to commit to a definitive purchase price earlier in the process, when the seller still maintains an asymmetric informational advantage and the seller's leverage is at its peak. From the buyer's perspective, this approach is appealing if the buyer has "maxed out" on its bid range and wants certainty that the final purchase price will not bust its budget.

Price certainty also enhances deployment of proceeds by sellers. Private equity sellers are frequently organized as limited partnerships. They can distribute more, and more quickly, sale proceeds to their limited partners when there is no post-closing adjustment, thereby typically limiting any post-closing reserves to only those needed to address indemnification claims under a capped escrow arrangement. Strategic sellers can find the locked box approach appealing when they have a time sensitive need for a definitive amount of net proceeds, such as repayment of debt, dividend payments or follow-on acquisition funding.

Under the locked box approach, with certainty comes peace. This is anything but the case under the completion accounts approach. Most of these deals will in fact result in a proposed adjustment by one party or the other, and unsurprisingly these often result in disputes. The purchase agreement typically sets forth a special process for resolving these disputes. Often there is an escrow providing a ready source of funds for the buyer to shoot at in resolving these disputes. After the signing of the purchase agreement, "deal fever" will have typically subsided and along with it the centrifugal force to concede issues to get the deal done. Either the seller or the buyer often has some remorse about the deal terms and will look at the adjustment process as an opportunity to cut some of its losses. Taken together, these create a conflict dynamic difficult to avoid.

Less Granular Negotiation—The completion accounts approach often requires that the parties spend considerable time and resources negotiating the complex accounting principles, formulas and metrics used to adjust the agreed upon headline price. In even the most basic working capital adjustment, the parties will spend enormous time negotiating which assets and liabilities count under the metric and how they are to be counted. For example, how is float calculated under the cash item? When are reserves taken and adjusted? How are deferred revenues and deferred tax assets and liabilities treated? What are the inventory valuation procedures?

Shorthand methods of computing the appropriate metric, such as U.S. GAAP or International Financial Reporting Standards (IFRS), often are not acceptable to one party or the other. These customary standards can contain multiple methods for reporting results. Even when there is reporting consistency, the applicable convention may not be acceptable in the purchase price adjustment setting, whether due to materiality thresholds of reporting items, intra-period adjustments or otherwise. In addition, the customary standards may be inconsistent in various ways with how the target's books have actually been accounted for.

As a result, the parties will often have to fall back on a shadow set of accounting conventions, so-called "special accounting principles," which apply to the purchase price adjustment. Sellers will argue that it is only in this way that "apples to apples" accounting is achieved, so that economic changes in the target's operations can be accurately measured and not distorted by GAAP. For their part, buyers will often try to push back on the complete adoption of these special principles because of their opaqueness and inconsistency with GAAP. In addition, they will often want to use the purchase price adjustment process as an additional remedy to recover for any deficiencies in the target's application of GAAP. Remedies for breaches of typical representations regarding the target's compliance with GAAP in the purchase agreement are commonly subject to more difficult proof, survival and materiality, basket and cap qualifiers.[3]

The locked box approach ostensibly avoids this morass. The parties need only agree on one number—the fixed price buyer will pay. It is true that the parties must still negotiate an agreed upon price, and, implicitly, each party will have to make determinations about the components that underlie that price. But the parties need not negotiate any or all of those components as long as they agree on the resulting total price.

[3] Of course, well advised sellers insist that the remedy for a financial statements breach exclude amounts recovered for the same issue through the purchase price adjustment mechanism so there is no double dip.

Less Process—Because there is a post-closing adjustment with the completion accounts approach, there must be a process for adjustment. Typically the buyer has up to 60-90 days to prepare a proposed closing balance sheet and resulting adjustment; the seller then has up to 30-60 days to review and dispute the proposal; the parties must then take up to 30 days to try to resolve the dispute; and then the dispute will be submitted to an arbiter, often an independent accounting firm, for final resolution that could take 30 days or more. Key accounting personnel, and often outside accounting advisors and legal counsel, are involved throughout the process. With the locked box approach, in contrast, there is no purchase price adjustment so there is none of this time and resource consuming process.

Less Precise; Reliance on Projections—Although the locked box approach provides greater certainty as to the final purchase price at closing, there will be less certainty as to whether that purchase price will reflect the precise amount of assets and liabilities of the target as of the closing date because there is no accounting as of the closing date. Instead, the parties have to project what the value of the target business will be at closing and embed those projections in the purchase price agreed to at signing. This may present particularly knotty problems for a buyer given the inherent informational advantage the seller has and the seller's control of the target business prior to the closing date.

For example, how much cash will be consumed by expenditures versus generated from sales? Will customers defect and sales decline post-announcement? The date of the closing may be difficult to forecast due to unpredictable regulatory or other hurdles and the target business may be seasonal or otherwise subject to large swings. The target may be generating losses or its performance may be declining in the short term. All things being equal, for a conservative buyer the locked box approach works best when the target business is stable and the interim between signing and closing is short.

On the other hand, critics of the completion accounts method point out that it often creates a false sense of precision because the typical metric, working capital or net assets, provides only a crude measure of changes in target economic performance. Buyers often value target businesses based on a multiple of projected earnings, and a change in pre-closing balance sheet items is not necessarily indicative of a change in long-term earnings potential. In other situations, the lack of precision in measuring balance sheet value in either approach may be unimportant to both buyers and sellers given the relative magnitude of other aspects of value (*e.g.*, the target's new blockbuster pharmaceutical).

More Diligence; Is There an Audit?—With a fixed price at signing and no later post-closing true-up as is the case under the locked box approach, there is increased pressure to get the valuation exercise right prior to signing. The parties, and particularly the buyer, must spend more time and resources prior to signing to fully understand and vet the target's reference balance sheet and likely results of operations. The buyer often seeks an audit of the reference date financials by the target's independent auditors. This is particularly important to buyers where the target is a carve-out from a larger enterprise. Of course, sellers may resist obtaining any special purpose audit because of the time and expense involved. If the reference balance sheet is unaudited, the buyer's review is even more important and often approaches an audit. This may not work for a target that does not have the necessary type of detailed information, at the ready, for an interim period or for a buyer or seller that needs to quickly sign up the deal.

Perverse Incentives—One consequence of the completion accounts approach is that the seller may be able to manipulate the closing date amount of the metric. For example, depending on the metric employed by the parties, the seller could have the target increase cash via borrowings, defer marketing, capital improvements or other necessary expenditures, accelerate collection of receivables, increase sales by lowering prices or compromising on other terms, or reverse reserves. Although buyers use representations, warranties and covenants to protect themselves from this kind of manipulation of the balance sheet, these protections require the buyer to prove a breach with respect to operating decisions that are often subtle to detect or difficult to connect to the contractual language establishing a breach. Furthermore, remedies for breach of such operating covenants are often subject to negotiated materiality, basket and cap qualifiers.

The locked box approach addresses this issue but creates an adverse incentive problem. Because the seller does not benefit from the operations of the target from the reference date through the closing date, it may not be fully motivated to operate the target to maximize its profits during that period. The buyer's typical remedy for a decline in the target's performance is to assert that a material adverse effect or change has occurred under a representation or closing condition and refuse to close. However, the judiciary has set an exceedingly high bar for the successful invocation of a material adverse effect or change provision.[4] To address this, buyers may seek closing conditions tied to specific measurements of target performance prior to closing. These conditions require negotiating time and create closing uncertainty, which undercuts some of the value of the locked box approach.

Weaker Remedies—Both approaches rely on representations, warranties and covenants to protect the buyer against value leakage and perverse incentives. These protections are largely a fallback in the completion accounts approach because, if the adjustment definitions and formulas are done well, the measurement at closing and subsequent adjustment process provides an objective test and meaningful remedy. In the locked box approach, in contrast, these protections are the only line of defense. If the seller breaches any of these anti-leakage protections, the buyer's only remedy is to make a claim, which inevitably involves subjective business judgments and is potentially limited by whatever materiality, basket and cap qualifiers have been negotiated.[5] It is for this reason that under the locked box approach there is usually a heavier focus on the level of "flex" in the seller's ability to move assets into and out of the target box.

Frequently Need Other Adjustments; Completion Accounts "Creep"—A key benefit of the locked box approach is simplicity. But often, complexity ineluctably creeps into the locked box mechanism until the overall approach is something more akin to a hybrid of the locked box and completion accounts approaches. This sometimes happens because a buyer will seek additional protection for its exposure during the period from the reference date through the closing date. For example, to backstop the leakage covenants, the buyer might seek to define acceptable uses of cash (perhaps tied to the target's budget) and request a post-closing adjustment to the extent the target has expenditures during the period that are outside the pre-defined category. Or, a seller may insist that the target be allowed to continue to incur debt to fund operations in the ordinary course. Some buyers are not comfortable with that exception even if other leakage protections keep the target from funneling cash to the seller and may negotiate for a more precise debt cap and an adjustment for any excess target closing debt not put to acceptable uses.

Under the locked box approach, sellers can claim that they are effectively delivering the economic benefits of the target business to the buyer as of the reference date. Therefore, they should be entitled to an interest or finance charge for the time value of the purchase price between the reference date and the closing date when they receive the purchase price. Some sellers will even seek at least a share of the profits generated by the target during this time period.

Both buyers and sellers contemplating use of the locked box need to realistically assess these factors and ultimately decide whether they can live with the inherent imprecision of the approach. If they cannot, and there is a push in the negotiations to more and more of the hybrid approach, the benefits of the locked box approach quickly dissipate and the "locked box" becomes more of a fancy deal synecdoche than a genuine alternative to the completion accounts approach.

Summary: Some Practical Tips for When—and How—to Use the Locked Box Approach

In light of these benefits and drawbacks, the locked box approach is often better suited for certain scenarios than others. These include:

When to Consider Using the Locked Box Approach	Sellers	Buyers
Certainty of final price is a priority (e.g., clearing price is at top/bottom of acceptable range)	✓	✓
Comparability of competing bids is a priority (e.g., auctions)	✓	
Additional data or high quality information is available to vet reference balance sheet		✓

4 See *In Re: IBP, Inc. Shareholders Litigation, 789 A.2d. 14 (Del. Ch. 2001); Frontier Oil Corp. v. Holly Corp., C.A. No. 20502 (Del. Ch. Apr. 29, 2005); Hexion Specialty Chemicals v. Huntsman Corp., 2008 WL 4457544 (Del. Ch. Sept. 29, 2008); and Genesco Inc. v. The Finish Line, Inc., Case No. 07-2137-II(III) (Tenn. Ch. 2007).*

5 Although it is common for materiality, basket and cap qualifiers to apply to claims for breach of the absence of changes representation in a transaction using the completion accounts approach, buyers should insist on an exception to these qualifiers when the representation is being used to provide leakage protection in a transaction using the locked box approach.

When to Consider Using the Locked Box Approach	Sellers	Buyers
Pre-closing time and resources are sufficient to vet reference balance sheet	✓	✓
High quality information and pre-closing time and resources are sufficient to generate reliable projections	✓	✓
Post-transaction announcement effects on target performance are likely to be minimal		✓
Target accounting is complex, making it difficult to determine an appropriate completion accounts benchmark	✓	✓
Target results of operations and/or financial position are susceptible to seasonality or other large intra-period swings and the closing date is unpredictable, making it difficult to determine an appropriate completion accounts benchmark	✓	✓
Time between reference balance sheet date and closing date is likely to be relatively short and predictable	✓	✓
Speed to signing is a priority	✓	✓
Post-closing time and resources are limited	✓	✓
Seller will not need complicated leakage exceptions that will necessitate post-closing adjustments anyway (*e.g.*, target is a carve-out)	✓	✓
Target does not have committed capital expenditure needs for which buyer will want to make post-closing adjustments anyway	✓	✓
Precision in measuring balance sheet value is unimportant given the relative magnitude of other aspects of value	✓	✓

Additionally, giving careful attention to certain key issues (many of which are not typical focal points in the completion accounts approach) can help ensure the successful implementation of the locked box approach. These include:

How to Use the Locked Box Approach	Sellers	Buyers
Obtain audited reference date financials or conduct mini audit-like due diligence (there is no available audit/audit might consider pro forma areas in the case of a carve-out)		✓
Obtain projections for changes to the reference date financials through operations from the reference date through a range of possible closing dates	✓	✓
Drive bidders to commit to a price earlier in the process when the seller has the informational advantage	✓	
Negotiate for a hybrid approach that provides for a post-closing adjustment for key metrics such as unbudgeted expenditures, especially if the target is permitted to incur additional debt		✓
Negotiate for an interest or finance charge or share of the profits for the time between the reference date and the closing date or include projection of this value in the purchase price	✓	
If interest/finance charge is accepted, negotiate for a stepped rate or reverse ticking fee to encourage a prompt closing		✓
Budget enough time and resources to vet reference date financials and projections	✓	✓
Financial statements representation should cover the reference date financial statements (both balance sheet and income statement due to interconnectedness and importance for evaluating projections)		✓

How to Use the Locked Box Approach	Sellers	Buyers
Understand how any interim period exceptions to the financial statements [illegible] apply to the reference date financials		✓
Include specific representations for any critical elements of the reference date valuation information		✓
Make sure the absence of changes representation covers a period as far back as the reference balance sheet date		✓
Include comprehensive interim operating covenants to prevent leakage transactions such as dividends and related party transactions like management fees, asset transfers and waivers of debts		✓
Include reporting and access covenants to allow monitoring of compliance with operating covenants		✓
Make exceptions to the materiality qualifiers, basket, minimum claim threshold, cap and escrow exclusive remedy provisions for the leakage protection representations, warranties and covenants		✓
Negotiate closing conditions tied to specific measurements of target performance prior to closing rather than relying on general material adverse effect condition		✓
Be prepared to fund, in addition to the purchase price, any shortfall in net working capital and any required debt payoff, since these amounts will not be subtracted from the purchase price paid at closing		✓

Just Enough To Be Dangerous: An Overview of M&A Tax Basics

***By John Jenkins, a Partner of Calfee, Halter & Griswold LLP*[1]**

M&A is in many respects the last refuge of the generalist. While an M&A lawyer may be a subject matter expert in one or more relevant areas, the lawyer's ability to spot and address important issues in areas outside of his or her core competencies is one of the keys to success in an M&A practice. For many deal lawyers, including the author, tax law is just such an area.

Tax law is intricate, arcane and, for many of us, just not a lot of fun. Thankfully, we have colleagues who either think tax law is fun or have made really bad career decisions. While non-experts would be crazy to try to navigate their way through a deal without their expertise, we are all sometimes called upon to address preliminary structural issues or navigate our way through a conference call or two without the input of tax experts. This article represents an attempt to provide you with enough basic information to handle these situations, and generally to keep your deal moving forward until your tax colleagues can come to the rescue.

In keeping with that objective, this article provides an overview of the basics of common tax-free and taxable acquisition structures. There are all sorts of nuances, exceptions, and elaborations on these concepts that are not addressed. Keep in mind that the title of this article means what it says—my goal is not to make you an expert, just to give you enough to be dangerous.

Tax "Free" Reorganizations

Dealmakers often speak in terms of a deal being "tax free," but the reality is that there is no such thing as a tax free transaction. A tax will be paid by the shareholder eventually; the only question is when. In a taxable deal, the shareholder will recognize gain right away (*i.e.*, in the year he or she receives payment for the shares). In a tax-free deal, the shareholder will not pay tax right away, but only when he or she disposes of the shares acquired in the deal.

In a taxable deal, when a shareholder pays the tax on the consideration received, his or her basis in the property is increased to the fair market value of the property on which he or she paid the tax. In contrast, a taxpayer in a tax free reorganization will carry-over the existing basis in the shares disposed of to the shares acquired. So, when the taxpayer disposes of the shares, he or she will recognize gain in amount that not only equals any increase in value subsequent to the receipt of the shares, but any increase in value of the target company shares "embedded" in the purchase price paid for those shares.

Types of Tax-Free Reorganizations—Section 354(a)(1) of the Internal Revenue Code provides tax-free treatment to shareholders that exchange stock or securities of one corporation for stock or securities of another corporation if both corporations are parties to a reorganization under Section 368 of the Code. Section 361 of the Code provides tax-free treatment to the transferor corporation in a reorganization within the meaning of Section 368. So, if the requirements of Section 368 are met, the participants in a reorganization avoid tax at the corporate level and at the shareholder level.

Section 368(a) contemplates a variety of acquisitive transactions that may qualify as tax-free reorganizations. These include statutory mergers or consolidations, certain stock-for-stock exchanges, certain stock-for assets transactions, and forward and reverse triangular mergers.

Requirements That Apply to All Tax-Free Reorganizations—Before we dive into the specific requirements of each type of Section 368(a) reorganization, it is important to note that there are other requirements that every type of reorganization must satisfy in order to qualify for tax free treatment. These are the "continuity of interest," the "continuity of business enterprise" and the "business purpose" requirements.

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[1] The opinions expressed in this article are the author's own and not those of his firm or any of its clients.

Continuity of Interest. There must be continuity of the target's pre-deal shareholders' proprietary interest in the corporation in order for a deal to qualify as a reorganization.[2] Under applicable IRS regulations, in order for the parties to have the required "continuity of interest," at least 40% of the total consideration must consist of stock of the acquiring corporation or its parent, as the case may be.[3]

Until 2000, if the target's shareholders had a plan or intention to dispose of acquiror stock in the transaction, that stock was treated as non-stock consideration for purposes of this 40% requirement.[4] In applying the continuity of interest test now, so long as the target shareholders get a sufficient amount of the buyer's stock and do not transfer that stock back to the buyer or a related party, post-closing dispositions will not generally jeopardize tax free treatment.[5]

Note that this 40% rule applies to the aggregate consideration received by the target's shareholders *as a group*, and *not* on a shareholder by shareholder basis.[6] This is important because it allows for cash election mergers, where acquirers permit shareholders to choose between receiving cash and stock, subject to an agreement that at least X% (more than 40%) of the total consideration will be paid in stock.

Continuity of Business Enterprise. This requires the buyer to continue a "significant" historic business of the target or to continue to use a "significant" portion of the target's historic business assets after the acquisition.[7] The regulations implementing this requirement indicate that a significant portion could be as little as one-third of the target's historic assets.[8]

Business Purpose. In order to qualify for tax free treatment, the reorganization must have been undertaken for a business purpose aside from the recognition of tax benefits.[9]

Tax Consequences of Tax Free Reorganizations—A target corporation generally recognizes no gain or loss in a tax free reorganization, and the basis of its assets are carried over to the acquiring corporation. Other tax attributes, like net operating losses, are also carried over to the acquirer, but their use may be limited.[10] While a target's shareholders will not recognize gain on the stock they receive in a tax free reorganization, if they receive cash or other property in addition to the stock, then this "boot" is taxable to the extent that a shareholder has any realized gain on the disposition of his stock.[11]

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[2] Treas. Reg. § 1.368-1(e)(1)(i).

[3] Treas. Reg. § 1.368-1(e)(1). Tax lawyers often have some discomfort with continuity of interest around the 40% level, and want to see a greater level of stock ownership. The regulations themselves do not specify a continuity of interest percentage lower than 50%; however, authority for the 40% number comes from a variety of sources, including examples provided in various IRS temporary and proposed regulations. See Former Temp. Reg. § 1.368-1(e)(2)(v), ex. 1; Prop. Reg. § 1.368-1(e)(2)(v), ex. 1; Notice 2010-25, 2010-14 I.R.B. 527; Preamble to T.D. 9225 (September 16, 2005).

[4] New continuity of interest regulations were issued by the IRS in 2000. See T.D. 8898, 2000-2 C.B. 271. Prior to the adoption of those new regulations, Revenue Procedure 77-37, 1977-2 C.B. 568, required a corporation seeking a private letter ruling on a tax-free reorganization to represent that the target shareholders had no "plan or intention" to dispose of a significant amount of that stock. Decisions by federal courts had also held that post-reorganization stock sales could adversely affect a reorganization's tax-free status. McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

[5] See Treas. Reg § 1.368-1(e)(1)(i) and (e)(3).

[6] See Rev. Ruling 66-224,1966-2 C.B. 114.

[7] See Treas. Reg § 1.368-1(d)(1)(i)

[8] *Id*. at ex. 1.

[9] See Treas. Reg. § 1.368-1(c). "A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization."

[10] Under Section 382 and Section 383 of the Internal Revenue Code, tax losses and credit carryforwards that arise before a change in control can be used only to a limited extent afterwards. Generally, after a change in control, only an amount of annual income equal to a long-term tax-exempt bond rate multiplied by the value of the target's stock at the time of the acquisition can be offset by those carry-over losses. Additional restrictions are imposed by Section 384 of the Internal Revenue Code and the consolidated return rules.

[11] The gain recognized by shareholders is generally capital gain, but may be recharacterized as a dividend if the receipt of boot has the effect of a dividend. See Section 356 of the Internal Revenue Code.

Specific Requirements for Each Acquisitive Reorganization—In addition to the continuity of interest, continuity of business enterprise, and business purpose requirements applicable to all transactions intending to qualify as a "reorganization" under Section 368, there are additional requirements that apply to different transaction structures.

Statutory Merger or Consolidation. Section 368(a)(1)(A) provides that a statutory merger or consolidation of two corporations (an "A Reorg") may qualify as a reorganization if the target shareholders receive at least 50% of their consideration in stock of the acquiring company. The remainder of the consideration may be paid in cash or in other forms of "boot."[12] Any class of acquirer stock may be used as consideration in an A Reorg - the buyer is not limited to the use of voting stock.

Stock for Stock Exchange. Section 368(a)(1)(B) provides that a stock-for-stock exchange may qualify as a reorganization if the target's stock is acquired solely in exchange for the buyer's voting stock (a "B Reorg"). The requirements of a B Reorg are demanding. For instance, a B Reorg has to be completed solely for voting stock of the acquirer or its parent—no other type of stock and no boot is allowed in these transactions at all.[13] While that doesn't sound like a huge impediment, things like shareholders' deal expenses and prior acquisitions of stock for cash can be regarded as "boot" for purposes of a B Reorg.[14] The acquirer must also be in "control" of the target within the meaning of Section 368(c) of the Internal Revenue Code at the conclusion of the transaction.[15]

Stock for Assets Exchange. Section 368(a)(1)(C) provides that an acquisition of substantially all of the target corporation's assets in exchange for voting stock and up to 20% other consideration, together with the assumption of the target's liabilities may qualify as a reorganization (a "C Reorg"). In a C Reorg, the acquirer buys substantially all of the assets of the target in exchange for the acquirer's voting stock. While the term "substantially all" is a notoriously squishy concept in corporate law, here it is fairly well defined: "substantially all" of the assets means 90% of the net assets and 70% of the gross assets of the target.[16] At least 80% of the consideration must be in the form of the acquirer's voting stock (or its parent's voting stock); the balance can be in cash or other property, but the amount of boot, together with the amount of assumed liabilities, cannot exceed 20% of the total consideration. The target generally has to be liquidated at the conclusion of the transaction, but unlike a taxable asset transaction, no corporate level gain is recognized.

Forward Triangular Merger. Section 368(a)(2)(D) provides that a forward triangular merger in which a target corporation merges into an acquirer's newly organized subsidiary ("Newco") in exchange for stock of the parent corporation that controls Newco may qualify as a reorganization. Like a C Reorg, substantially all of the assets of the target must be acquired. While none of Newco's stock may be used as consideration in the transaction, any class of parent stock (voting or non-voting) may be used. Like an A Reorg, an (a)(2)(D) Reorg allows as much as 50%—60% of the consideration to be in the form of something other than stock.

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[12] While, as noted in the discussion of the continuity of interest requirement above, there is IRS authority for a 40% minimum when it comes to the amount of stock consideration, for purposes of receiving an advance ruling from the IRS, at least 50% of the consideration must consist of stock. Rev. Proc. 77-37 1977-2 C.B. 1568; Rev. Proc. §6-42, 1986-2 C.B. 722. Interestingly, the case law has held that stock consideration at levels below 40% may still be sufficient to satisfy the continuity of interest requirement in an A Reorg. See *John A. Nelson Co. v Helvering,* 296 US 374 (1935) (38%); *Miller v Comm'r,* 84 F2d 415 (6th Cir. 1936) (25%).

[13] See Chapman v. Comm'r, 618 F.2d 856 (1st Cir. 1980).

[14] Under the judicially created "step transaction" doctrine, if a target company is acquired for stock in a transaction structured as a B Reorg, and the target is subsequently liquidated and has its assets and liabilities transferred to the buyer as part of a plan, the liquidation will be deemed to be part of the overall transaction, and it will not qualify for tax free treatment unless it satisfies the criteria applicable to a C Reorg. See Rev. Ruling 67-274, 1967-2 C.B. 141. The step transaction doctrine can be applied in other circumstances as well, and can result in the re-characterization of what the participants contend is a discrete transaction into a component of a larger transaction, with potentially unfavorable tax consequences. For a detailed discussion of the step transaction doctrine, see Yoram Keinan, *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*, 22 Akron Tax J. 45 (2007)

[15] Section 368(c) of the Internal Revenue Code defines the term "control" to mean "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

[16] Rev. Ruling 57-518, 1957-2 C.B. 253.

Reverse Triangular Merger. Section 368(a)(2)(E) also allows a triangular merger that goes in the opposite direction—one in which Newco merges into the target, with the target surviving—to qualify as a reorganization. Despite the similarities in structure between forward and reverse mergers, the criteria that must be satisfied for a reverse merger to qualify for tax-free treatment are more demanding. As with a forward triangular merger, no subsidiary stock may be used as consideration, and Section 368(c)'s 80% control requirement must be satisfied, and as a result, the amount of "boot" that can be paid in the transaction is limited to 20% of the deal's value.

Other Tax Free Transaction Structures: Double Mergers and Double Dummy Mergers

There are other structures that have been used to effect transactions on a tax-deferred basis beyond those specified in Section 368. For example, in 2001, the IRS issued a revenue ruling that allows companies to avoid the 20% limitation on boot applicable to reverse triangular mergers by engaging in a "double merger."[17] This transaction structure involves a reverse subsidiary merger, followed by a second merger in which the target is merged into the acquiror or another sub. Transactions structured in this fashion (and otherwise meeting the requirements of Revenue Ruling 2001-46) will be collapsed together and given the tax treatment accorded to A Reorgs or (a)(2)(D) Reorgs. The double merger can provide important non-tax advantages to buyers. That is because reverse triangular mergers tend to trigger fewer consent requirements than forward mergers, and this structure gives those dealmakers who want the ability to offer a significant cash component to target shareholders the ability to close a deal on that basis through a reverse subsidiary merger, and "clean up" the consents at a later date prior to completing the second merger.

The so-called "double dummy" merger structure avoids compliance with Section 368(a)'s requirements altogether through creative use of Section 351 of the Internal Revenue Code. Section 351 provides tax-free treatment to incorporation transactions.[18] The double dummy structure involves the acquiror's formation of a new holding company to serve as the parent of the acquiror and the target upon completion of the transaction ("Parent"). Two new Parent subsidiaries are also formed as part of the transaction, and one of the new subsidiaries merges with the target, while the other merges with the acquiror. As a result, upon completion of the transaction, the two entities that result from these mergers become wholly owned subsidiaries of the Parent.

Under Section 351, shareholders of the acquiror and the target receive tax-free treatment to the extent that they receive the Parent's stock in the transaction, so long as at closing they satisfy Section 368(c)'s 80% "control" requirement with respect to the Parent. The big difference in this structure is that unlike a reorganization under Section 368(a), there is no limit to the amount of cash that can be used in the deal.

Taxable Acquisitions

Despite the advantages provided to tax-free reorganizations, taxable deals get done every day—in fact, most of the deals that get done are taxable. When it comes to taxation of these transactions, perhaps the most important thing for a deal lawyer to know is that the IRS doesn't look at taxable acquisitions the way that the corporate laws do. The IRS doesn't care if you've structured your deal as a merger, they think of it as either a "stock purchase" or an "asset purchase"—and that characterization isn't always dependent on whether you actually buy stock or assets, but whether the IRS thinks you should be deemed to have acquired one thing or the other for tax purposes.

Stock Purchase v. Asset Purchase—In a transaction regarded as a stock purchase, the tax basis of the underlying assets of the target corporation is carried over for corporate tax purposes, no corporate level tax would be paid on the transaction, and the shareholders of the target would recognize gain or loss on

[17] Rev. Ruling 2001-46, 2001-2 C.B. 321.

[18] The double dummy structure has become increasingly popular for reasons in addition to the flexibility it provides from a tax standpoint. For example, the double dummy structure may allow acquirers to avoid a shareholder vote by taking advantage of provisions in state corporate statutes permitting the creation of a holding company structure without shareholder approval, which can be a significant advantage. For a detailed discussion of the double dummy structure, see Igor Kirman and David M. Alderstein, "Not for Dummies: Navigating the 'Double Dummy' Merger Structure," 12 *The M&A Lawyer* 8 (Sept. 2008).

the sale of their stock. In a transaction regarded as an asset purchase, there is a corporate level tax to be paid on the gain recognized by the corporation on the sale of those assets, and the basis in those assets is stepped-up to fair market value. The shareholders are also taxed on any gain on the after-tax proceeds that they receive in connection with the liquidation of the corporation.[19] The buyer receives a step-up in the basis of the assets purchased to reflect the tax paid on them.

Section 338(h)(10) Elections—In stock purchase transactions involving a corporation that is being acquired from an affiliated group or a target that is an S corporation, the parties may sometimes decide to make a Section 338(h)(10) election, which has the effect of treating the stock sale as if it were an asset sale for tax purposes. Section 338(h)(10) allows the seller to elect to recognize the built-in gain in the target's underlying assets at the corporate level instead of recognizing gain on the sale of the stock. If the purchase price is greater than target corporation's basis in its assets, then the purchaser is able to step up the corporation's basis in those assets to the purchase price, which allows it to claim higher depreciation deductions.

Structuring Taxable Mergers: A Trap for the Unwary—As previously noted, the IRS does not classify transactions in the way that state corporate laws do. The IRS is not concerned about whether a deal is a "merger" or not for corporate law purposes. Instead, it is interested in whether that "merger" looks like a sale of stock, or a sale of assets. Lawyers need to keep this in mind when deciding how to structure a taxable merger transaction. That's because, although a reverse subsidiary merger will be regarded as a *stock purchase* (no corporate level tax), for more than 40 years the IRS has taken the position that both a forward merger (in which the seller merges directly into the buyer), and a forward triangular merger may be regarded as an asset purchase subject to a corporate level tax.[20]

Conclusion

The tax aspects of an acquisition are often of central importance. Tax issues arise early and often in a deal, and any M&A lawyer needs to be able to identify significant issues that may affect the way the transaction is structured. While there is no substitute for the input of tax experts, a non-tax expert deal lawyer can arm himself or herself with enough information about the basics of M&A taxation to not only be dangerous, but more importantly, to help clients continue to move the transaction forward by making sure those issues are addressed before they become an impediment to completing the deal.

[19] This discussion of the tax consequences of an asset purchase assumes that the seller is a C corporation. If the seller is a partnership, limited liability company or S corporation, no corporate level tax will be paid in connection with the asset transaction. Income arising out of gain on the transaction for these pass through entities is taxed directly to their owners.

[20] Rev. Ruling 69-6, 1969-1 C.B. 104.

Shareholder Approval of Small Private Acquisitions: Has *Omnicare* Been Rendered a Farce?

By Ed Batts, a Partner of DLA Piper

Perceived Delaware requirements for stockholder solicitation to approve an acquisition agreement have become increasingly opaque due to first the 2003 *Omnicare* decision and then the subsequent erosion thereof. The result is the casting of a cloud of both uncertainty and inefficiency, the twin root evils of effective corporate jurisprudence.

In *Omnicare Inc. vs. NCS Healthcare Inc.,* 818 A.2d 914 (Del. 2003), the Supreme Court of Delaware invalidated a merger agreement where an insolvent company had been given 24 hours by a potential acquirer to agree to (1) no fiduciary out (the ability by a target company to terminate the agreement, subject to a break-up fee, in the event a third company offers a superior proposal for the target company) and (2) requiring voting agreements from two stockholders, who also represented one half the board, which had the effect of contractually guaranteeing the required stockholder vote prior to the company actually submitting the deal for approval to the stockholders as a whole.

Prior to *Omnicare*, private company acquisitions were relatively straightforward affairs. Provided that a transaction's value fell below the threshold requiring a Hart-Scott-Rodino ("HSR") antitrust notification filing (currently about US$66 million), and that consents from customers or suppliers could be acquired prior to signing, often a buyer could insist on a simultaneous signing and closing whereby stockholder consents were delivered concurrent with execution of the merger agreement. In venture capital funded companies with a concentration of share ownership in a select few VC firms and perhaps a founder or two, smaller stockholders were routinely ignored in the initial pre-execution solicitation, though they retained the dissenters' rights accorded them by statute. While this may seem procedurally high handed, it did nothing to substantively change the outcome of any merger vote.

A simultaneous sign/close was beneficial, however, in that it allowed certain verbose, contentious provisions to be omitted from a merger agreement—for instance, interim operating covenants for the target company between signing and closing, a termination section, fiduciary outs and break-up fees. Omitting such provisions increased deal certainty and reduced transactional (that is, lawyer) costs. Even when HSR filings or contractual consents were necessary, the immediate delivery of stockholder approval at signing eliminated the buyer's fear of a deal break-up from topping interference.

The decision in *Omnicare* limited the ability to lock up a deal prior to its submission to stockholders following execution of an agreement. For public company transactions, it meant that voting agreements could no longer make a deal a forgone conclusion. And, indeed, it meant the same for private company transactions—but with the added wrinkle that a period between signing and closing became mandatory, not optional. Thus came the advent of interim operating covenants and termination provisions in private company agreements, even where no HSR filing or contractual consents were required.

Following *Omnicare*, some involved in smaller transactions quite conveniently chose to ignore the decision—and in such cases many continue to do so. Some cannot be bothered to worry about the purportedly hypothetical risk of merger contract judicial invalidation; others voice their claim by asserting that the specific facts of *Omnicare* are not analogous to a concurrent sign/close situation.

The oracles of the Delaware Bar, however, have generally taken a dim view of both perspectives. The risk of stockholder litigation in a closely held private company may be remote, but many are concerned about even the faint chance that a cranky shareholder might turn up in a Delaware court to upset a merger. And while the facts of *Omnicare* are extreme (an insolvent corporation backed into a financial pickle) the underlying holdings are pretty clear cut—at least on their own. Further, if a law firm is asked to give a legal opinion on enforceability of a merger contract that does not comply with the basic tenets of *Omnicare*, ignoring the case is a difficult proposition.

From a public policy standpoint, the roots of *Omnicare* may well be grounded in laudable goals. In *Omnicare*, the target company (NCS Healthcare) was jammed. It was given less than 24 hours to deliver a stockholder vote for deal that threw a lifeline of value to an enterprise precariously perched on the precipice of financial apocalypse. One could reasonably posit that stockholders should have a fair period of time in which to review a detailed solicitation statement. The majority opinion in *Omnicare* noted there is an inherent balance under Delaware law between the board and the stockholders. Restoring some period of reasonable review would seem equitable in allowing stockholders to offset the specter of unfettered board edicts. Public companies already in reality enjoyed such benefits as federal securities laws have long mandated that a proxy statement for a publicly-traded company must be in the mail no later than 20 business days prior to a stockholder vote, giving stockholders a whopping month to mull over a deal's merits.

Omnicare, however, has been muzzled by subsequent erosion. Nothing in either that decision or in Delaware law prescribes an actual bright-line time period for stockholder review of the terms of a proposed merger. In practice, many deals now involve execution of the merger agreement followed by an immediate "solicitation" that constitutes an e-mail from the target's counsel to stockholders, followed by the seemingly magical submission of stockholder consents from large stockholders representing the required vote. Such consents in reality often are sought and pushed forward by the target's counsel prior to the execution of the merger agreement and held by such counsel in mythical "escrow" pending signing. This process perfects the triumph of form over substance.

It therefore was inevitable that some clever lawyer would impose a post-signing deadline for a stockholder vote. Such a deadline was included in a merger agreement that became the subject of a 2008 Delaware Chancery case, *Miami v. WCI Steel, Inc.*, C.A. No. 3833-VCL (Del. Ch. June 27, 2008), in which a 24-hour deadline to return consents was included in the merger contract; the failure to meet such condition gave the buyer a right to terminate. Upholding this condition, Vice Chancellor Stephen Lamb reaffirmed that Delaware law does not require "any particular period of time between a board's authorization of a merger agreement and the necessary stockholder vote." *WCI Steel* thus seems to appear to substantially undermine *Omnicare's* applicability to private company mergers.

Indeed, following *WCI Steel*, many smaller private company agreements now contain a 24-hour (or shorter) deadline, whereby the buyer can terminate the agreement if the stockholder vote has not been received. The result is farcical. Frantically prepared solicitation statements are transmitted in a post-signing e-mail flurry, only to be promptly superseded by prepared consents, freshly released from "escrow" and pouring in. However, lawyers must still negotiate pre-closing operating covenants, and termination provisions all of which are an arguably superfluous chore if no HSR or contractual consents are needed for closing; the provisions themselves remain operative only during the briefly open window between signing of the merger agreement and the return of stockholder approvals just hours later. One could hypothetically assert that *WCI Steel* allows for a return to the old days of near-simultaneous signing/closing, but it is not clear that it does. And lack of clarity causes customarily risk-averse lawyers to assume that the worst (a court action to invalidate) can still occur. For a transaction of modest size, this imposes both needless angst and an indirect tax (of lawyer's fees) on stockholders of both sides of the transaction.

The unadorned beauty of Delaware as the jurisdiction of choice for American corporate law is its large body of rulings on the subject, its speedy opportunity for judicial review, its customer-service oriented filing process (the utility of which is not to be underestimated) and the (usual) clarity of its judicial guidance. A few larger technology darlings have recently conducted long-awaited IPOs which have garnered much publicity. However, such deals are numerically dwarfed by the volume of pre-public acquisitions. Well established, large technology companies rely on Silicon Valley and its various geographic siblings as incubators for ideas that are enshrined in an ever-changing constellation of startups. The ability to efficiently and quickly acquire such idea-based entrepreneurial gems strips away development cost. And even startups (and their VC backers) rely on the ability to quickly combine such very entities in order to re-jigger organizations, tweak development and evolve ideas.

Accordingly, Delaware, whether through one of its august judiciary or legislative bodies, would do well to proactively address the present conundrum. If Delaware decides, through statute or a bright-line Supreme Court holding, to require a minimum period of time for stockholder review, then so be it—but a public policy determination of such importance would need teeth. One would think a period of 72 hours reasonable to digest and discuss the contents of a thorough solicitation statement (which Delaware also ought to consider mandating be written in "plain English"). In larger transactions with publicly traded buyers, even though there likely would be a required HSR filing, 72 hours would seem a reasonable period, since such buyers may need to file the terms of a definitive agreement on a Form 8-K with the Securities and Exchange Commission. Such a filing publicizes the commercial terms of the deal, thereby essentially inviting topping offers, permissible absent stockholder approval ending a fiduciary out period, which such buyers are understandably loathe to do. What we do not need is the current de facto standard, in all its ambiguity and ridiculous brevity.

On the other hand, if Delaware decides that no prescribed period is necessary, and the power of stockholders to withhold their vote (or signature on a consent) is sufficient leverage in the balance of the board and the stockholders with which Delaware should not further interfere, so be it. Such a clarification would allow the charmingly simplistic simultaneous sign/close model to re-emerge.

With either approach, however, at least transactional lawyers in small private deals could abandon their perennial head-scratching question: "But what about *Omnicare*?"

Boilerplate Matters: Giving Notice

By William Greason and Zaid Mohiuddin, a Partner and Associate of Chadbourne & Parke LLP

By the time most people get to the last article in a contract the inclination is often to think that it is just the "boilerplate" and therefore there is no reason to read it closely, if it gets read at all. Unfortunately for that reader, the boilerplate can have a real impact on how the contract will be interpreted and how the parties operate after signing.

Given that every party to an agreement has its own objectives, and the circumstances surrounding each agreement are different, it is not realistic to say that there is a correct approach to take for the boilerplate provisions. However, there are some common situations of which the reader should be conscious.

Notice provisions appear in nearly all contracts and are a staple of contract boilerplate. Despite their prevalence, notice clauses are often offered a fleeting glance and lawyers tend to groan when prompted to negotiate their terms. Nonetheless, the form, content, timing or even delivery method for notice can determine whether, for instance, a party properly declared a default, exercised an option, or claimed a force majeure event. As such, the importance of a properly given notice demonstrates the need for a discussion on this provision—not to mention the odd and all-too-common references to telex (when was the last time you sent or received a telex?).

Towards this end, this article will focus on providing practical advice on drafting notice provisions and will conclude with a checklist of items to consider when drafting such provisions.

Why do agreements contain notice provisions? Generally speaking, notice provisions perform two key functions. First, they govern the mechanics of how parties to an agreement communicate with one another. Second, they set a standard to determine whether notice was effectively and timely given.

Most contracts contain two kinds of notice provisions, sometimes called "generic" and "specific." A generic notice provision usually appears in the boilerplate section of a contract and describes the mechanics of giving notice under the contract. Generic notice sets forth the general procedures that govern all communication made pursuant to the agreement.

In contrast, "specific" notice provisions are generally scattered throughout a contract and relate to giving notice in connection with agreement-specific matters. For instance, a specific notice provision can (i) require a party to deliver quarterly financial statements according to a recurring deadline, (ii) permit a party to notify the other of an event of default or (iii) extend the term of an agreement by giving notice within a certain number of days prior to the expiry of the agreement.

The generic notice provision should be drafted broadly to ensure that it covers all possible communication under the agreement (*i.e.,* the provision should cover requests, demands or other communications made under the agreement). Moreover, the generic notice provision should require notices to be in writing and should create an obligation for the parties to comply with this requirement. A writing serves two purposes; first, it demonstrates the authenticity of the message and second, it provides evidence that a message was communicated.

As a drafting point, drafting the generic provision as a covenant (*i.e.,* "each party shall give any notice or other communication under this agreement in writing") is preferable to stating that "all notices under this agreement shall be in writing." The latter approach may leave open the question of whether the parties are obligated to send notices in writing or whether the writing serves as a condition precedent to effectiveness. The former approach, however, unambiguously requires the sender to give notice in writing, and also permits the recipient to sue for breach if the sender fails to comply.

In addition, notice provisions should enumerate the various permitted methods of delivery and state that each of these constitutes a "writing." This, for instance, may avoid any debate about whether e-mail or other means of electronic communication is considered a writing under the agreement.

One of the most important functions of a generic notice provision is to set forth when a notice is deemed effective. Historically, notice provisions operated with a presumption of delivery and thus allocated the risk of non-delivery to the recipient (*i.e.,* the "mailbox rule," you may recall, permitted an offeree, after receiving an offer in the mail, to form a contract simply by depositing an acceptance in the mail). However, in modern generic notice provisions, the effectiveness of notice often hinges on receipt.

Parties should expressly state how effectiveness of notice can be determined for each of the enumerated methods of delivery. Most agreements contain language to this effect; however, inconsistencies sometimes exist between the permitted types of delivery and the language describing when notices are deemed effective. For example, an agreement may provide that all notices shall be delivered by hand, certified mail or overnight carrier (without any mention of e-mail or fax) and then go on to state that notice is deemed effective when confirmation of e-mail or fax is received by the sender. This discrepancy raises the question whether notice delivered by e-mail or fax is indeed valid under the agreement.

Consider also who should receive the notice. Did you really intend that notices be sent to "John Smith" or were you intending that the notices go to "Chief Financial Officer" (which was the officer position John Smith was holding at the time the contract was prepared). The difference can be important. You can easily have a situation where John Smith has left the company but his e-mail address is still active but not being closely monitored and the counterparty sends a time-sensitive notice to this address. One possible way to deal with the departing contact person and e-mail issue is to provide a group e-mail address for notices under the agreement. For example, an address could be established as ProjectAlpha@xyz.com that provides for multiple persons at the company to receive the e-mail when sent to that address.

In addition, it is imperative that specific notice provisions work in conjunction with a contract's generic notice provision to ensure there is no conflict or confusion as to the mechanics on providing notice. For example, a specific notice provision may hinge on the "sending" of notice whereas the generic notice provision focuses on when notice is deemed "received" by a party. This distinction can be of critical importance—imagine you seek to exercise a warrant on the last day of the exercise period, would you be comfortable dropping your exercise form in the mail on that last day based on the concept of "sending" when the generic notice provision deems notice effective when received?

The following is a list of items that you may consider when reviewing notice provisions in a contract:

- Is notice defined broadly to include all of the methods of communication that the parties intend to permit under the agreement?
- Are addresses provided for each permitted method of delivery of notice (i.e., mailing address, courier address, e-mail address, fax number, etc.)?
- Is there a standard to determine the effectiveness of notice delivered under each of these methods of delivery?
- Under each of these methods of delivery, is notice deemed effective upon sending, receipt, or some other formulation (e.g., X days after being sent)?
- When is notice deemed effective if sent after business hours via e-mail or fax?
- Do the specific notice provisions work in tandem with the generic notice provision?
- Who is receiving the Notice—a specific person or a position?

Given the substantial risk that may accompany the failure to give proper notice, as well as the common pitfalls that to this day plague notice provisions, wise attorneys will pay close attention to such provisions.

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