In addition, California courts generally will not enforce a non-competition agreement governed by the laws of another state unless the non-competition agreement would be enforceable under California law.

If a former employee against whom an out-of-state company seeks to enforce a non-competition agreement is a resident of California at the time enforcement is sought, this limitation can preclude enforcement in California of an otherwise valid non-competition agreement entered into when the employee resided in another state, even if the parties' contract expressly provided that the law of that state governed. Some California courts, however, have shown a willingness to enforce the parties' choice of law provision when it appeared that the former employee had moved to California in an effort to avoid his or her contractual obligations.

Stock Options

If any California residents are to receive options or other equity incentives, then the stock option or other equity incentive plan must comply with California law. For example, an option must be exercisable (to the extent vested) for at least six months following termination of employment due to death or permanent and total disability and, unless the optionee is terminated for cause, for at least 30 days following termination of employment for any other reason.

If a company does not wish to extend these rights to all plan participants, it can use a separate form of agreement containing the required provisions for California participants. California option and equity incentive plan requirements do not apply to a public company to the extent that it registers option shares with the SEC on a Form S-8.

Alternatives to Traditional Working Capital True-Ups: The Locked Box Mechanism

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In many private company M&A transactions where the purchase price has been negotiated on the assumption that a particular financial position (such as working capital) will be delivered at completion/closing, this assumption is often confirmed by producing "completion accounts" (in the UK parlance) or "closing accounts" (in US parlance), with the purchase price being adjusted if the completion/closing accounts show a departure from the assumed position. Colloquially, completion/closing accounts and associated adjustments are often referred to as a "true-up."

Completion/closing accounts are intended to value a target company (and therefore derive a purchase price) based on its financial position as of the closing date. They can take a variety of forms, depending on which aspect of the financial position of the target they are designed to measure—for example, a full profit and loss account and balance sheet, a balance sheet alone, a net assets or working capital statement, a statement of cash/debt, or a combination of the foregoing.

The locked box mechanism presents an alternative approach to the true-up mechanism. At its most basic level, a locked box transaction is a "fixed price" deal, where the purchase price is determined based on a pre-signing "locked box date". The locked box mechanism is more prevalent in European transactions than in US deals, although it is often seen in cross-border transactions—*i.e.*, where there is a European entity (such as a private equity firm) selling a US target.

Below we provide an overview of a traditional "true up" and locked-box mechanisms, and highlight the benefits and detriments to buyers and sellers of these two different valuation mechanisms.

Traditional True-Up Mechanism

Overview. In a traditional US private company M&A deal, the parties usually agree to a "cash-free, debt-free" transaction, with the purchase price being increased or decreased, respectively, to the extent there is any "excess" working capital, or a "shortfall" in closing date working capital.

Under this framework, the selling shareholders and the buyer agree on the target level of working capital that the target company must have at closing (which target amount is usually based on a "normalized" level of working capital over a pre-determined period preceding closing). At closing, the seller then provides an estimate of closing date working capital and to the extent the estimated closing date working capital is greater than the target working capital, there is an increase in the purchase price at closing.

Similarly, to the extent the estimated closing date working capital is less than the target working capital, there is a downward adjustment to the purchase price at closing. This estimated closing date working capital is then trued-up to actual closing date working capital following the closing. A similar estimate/true-up mechanism is often used for indebtedness and transaction expenses.

Effect. The effect of this "true-up" mechanism is that the selling shareholders get the benefit of any increases in the value of the target business from the signing date through the closing date. Conversely, this mechanism also results in the selling shareholders bearing the burden of any decreases in the value of the target business from the signing date through the closing date.

Taxes. Under the true-up model, the selling shareholders are typically responsible for any taxes of the target company relating to the pre-closing period, with the buyer being responsible for post-closing taxes of the target company.

Negotiation; Potential for Purchase Price Swings. This purchase price adjustment provision is often one of the most highly negotiated components of a private company M&A transaction because it directly impacts the purchase price. In certain circumstances, particularly with target companies that operate with high levels of working capital (such as industrial companies), this process can be complex and can result in substantial swings in the purchase price. For example, the recent Chicago Bridge & Iron/Westinghouse transaction involved an approximate $2.5 billion purchase price adjustment dispute between the parties.

The Locked Box Mechanism

Overview. Under the locked box mechanism, the purchase price is fixed at signing, based on a balance sheet that precedes signing (*i.e.*, the "locked box date"). The purchase price is not subject to any post-closing adjustment. The locked box date may be the end of a fiscal period for which financial statements have been prepared by the target, or may be based on a balance sheet prepared for the purpose of the transaction.

Effect. The effect of the locked box mechanism is that the buyer gets the benefit of any increases in the value of the target business after the locked box date. Conversely, the locked box mechanism also results in the buyer bearing the burden of any decreases in the value of the target business after the locked box date.

Taxes. Under the locked box mechanism, the selling shareholders are typically responsible for any taxes of the target company relating to the pre-locked box date period, with the buyer being responsible for taxes of the target company following the locked box date.

"Leakage". For a locked box mechanism to work, it is important to ensure that the box is "fully locked", such that no value is "leaked" from the target business to the selling shareholders after the locked box date. Typical examples of unpermitted leakage include dividends, management fees, waivers of liabilities and undervalued transfers of assets.

The selling shareholders and buyer may agree that certain value extractions constitute permitted leakage, some of which may be treated as reductions to purchase price. For example, dividends paid to the seller following the locked box date could be treated as permitted leakage but such dividends would be deductions to the purchase price. By contrast, ordinary course salary payments could be treated as permitted leakage but would likely not be deductions to the purchase price.

Indemnity. How do buyers ensure that there has been no such "leakage"? The selling shareholders make representations and warranties and agree to certain covenants in the purchase agreement regarding unpermitted leakage that are backstopped by an indemnity.

This indemnity typically provides for a "first dollar" recovery from the selling shareholders for unpermitted leakage, and indemnity claims for unpermitted leakage typically fall outside of the de minimis and basket for indemnity claims under the purchase agreement (often there is no absolute cap on liability for unpermitted leakage although this varies). In our experience, however, it is relatively uncommon for leakage indemnity claims to be made.

Also note that if the buyer intends to purchase a "representation and warranty" insurance policy, the insurance policy will likely not cover the leakage representations and warranties in the purchase agreement.

Opportunity Cost & Interest Rate. One final wrinkle on the locked box mechanism is that because the purchase price is set at signing but the seller does not receive payment until closing, the selling shareholders will often insist on being paid for their "lost opportunity cost." To compensate the selling shareholders for this lost opportunity cost, the buyer will often agree to pay the selling shareholders interest on the purchase price between the locked box date and the closing date.

Benefits & Detriments to Locked Box Mechanisms

Although locked boxes are generally regarded as "seller-friendly", and are particularly common (arguably market standard) in seller-driven UK auction sales, the locked box mechanism is not a purely seller-favorable mechanism and involves benefits and detriments to both parties. The benefits and detriments of a locked box mechanism are summarized below.

Buyer	Seller
Benefits	*Benefits*
- Price certainty	- Price certainty
- Simplicity – no working capital true-up	- Simplicity – no working capital true-up
- No disruption to business post-closing with focus on true-up mechanics	- Incentive for buyer to agree on balance sheet on which purchase price is based
- Incentive for seller to agree on balance sheet on which purchase price is based	- Increased control over process
	- Apples-to-apples comparison of bids in an auction
Detriments	*Detriment*
- No ability to exploit true-up	- Difficult to apply in a carve-out transaction
- Committing to price before exclusivity	- Possibility of under-payment if interest charge is too low
- Business deteriorating post-locked box date	
- Handle price adjustments earlier (through definition of permitted leakage), with limited access to the business	
- Possibility of over-payment at closing	
- Seller has control over the preparation of the balance sheet and has an information advantage	
- Difficult to ensure a completely locked box	
- If planning on using a rep and warranty insurance policy, leakage reps will not be covered	

Price Certainty & Simplicity. As discussed above, the most obvious benefit for both the buyer and the seller from using a locked box mechanism is price certainty at signing.

Reduced Risks of Post-Closing Disputes. Because the locked box model obviates the need for any post-closing purchase price adjustment, it also reduces the risk of post-closing purchase price disputes.

This can be particularly valuable where the selling shareholders will continue to be employees of the acquired business, as no buyer wants to be involved in financial disputes with employees that are running the newly acquired business. Moreover, because there is no post-closing true-up, the buyer and the target company employees can remain focused on running the acquired business, without any potential distraction associated with a purchase price true-up process.

Apples-to-Apples Comparison of Auction Bids. In an auction process, most bidders will not specify the target working capital amount contemplated by their proposed purchase price. This can make it difficult for the seller to make an "apples-to-apples" comparison of the various bids it may receive.

Changes in Values of the Business; No Value Increasing Incentives. The locked box mechanism results in the buyer getting the benefit of any increases in the value of the target business after the locked box date, and also bearing the burden of any decreases in the value of the target business after the locked box date.

Because the selling shareholders do not benefit from any increase in value in the business after the locked box date, and also do not bear the burden of any decrease in the value of the business after the locked box date, from an economic perspective the selling shareholders have little incentive to run the business with an eye toward maximizing value during the period between signing and closing.