

HOW TO SANDBAG YOUR OPPONENT IN THE UNSUSPECTING WORLD OF HIGH STAKES ACQUISITIONS

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I. INTRODUCTION

The term “sandbagging” originates from the 19th century where gang members would fill socks full of sand to use as weapons against unsuspecting opponents.¹ While at first glance, the socks were seemingly harmless, when used to their full potential they became very effective and would inflict substantial damage on a “sandbagged” victim.² Over time, the term “sandbag” has taken meaning in many facets of daily life, but equally in each, the term has developed a negative connotation. As a verb, the term is defined broadly to mean to misrepresent or conceal one’s true intent, position, or potential in order to take advantage of an opponent.³ The term has taken significance as a modern sporting term, specifically, in golf signifying a golfer who pretends to play worse than he or she actually is to gain advantage and sympathy over an unsuspecting opponent.⁴ The term has also developed in the context of a business deal. A “sandbagging” buyer refers to the situation where a buyer is or becomes aware that a specific representation and warranty made by the seller is false, yet instead of alerting the seller to this fact, the buyer consummates the transaction, despite its knowledge of the breach, and seeks post-closing damages against the seller for the breach.⁵

The phrase “sandbag” evokes an inference of wrongful intent and malfeasance, yet the reasons a modern buyer might sandbag its seller vary and do not always involve morally questionable intentions.⁶ The initiation of negotiations by either party over a sandbagging provision can instantly cause wary behavior, but as the parties properly allocate

1. Glenn D. West & Kim M. Shah, *Debunking The Myth of the Sandbagging Buyer: When Sellers Ask Buyers to Agree to Anti-Sandbagging Clauses, Who is Sandbagging Whom?*, 11 M & A LAW. 3 (2007).

2. *Id.*

3. MERRIAM-WEBSTER’S DICTIONARY, <http://www.merriam-webster.com/dictionary/sandbag> (last visited April 20, 2013).

4. West & Shah, *supra* note 1.

5. Kevin M. Torney, *Targeting the Right Investment: Choices and Challenges in Private Equity Transactions*, in UNDERSTANDING LEGAL TRENDS IN THE PRIVATE EQUITY AND VENTURE CAPITAL MARKET 71 (2013).

6. Luke P. Iovine III, *Sandbagging In M&A Deals: Silence May Not Be Golden*, 16 M & A LAW. 10 (2012).

risks associated with the deal, scholars have begun to question who really sandbags whom?⁷ Whether sandbagging really is an issue of fundamental fairness that imputes bad motives to buyers?⁸ Or whether the buyer is in as much need of protection as the seller?⁹

This paper will analyze the real meaning and effect behind the use of a sandbagging provision in deal transactions. First, this paper will introduce how pro-sandbagging and anti-sandbagging provisions operate in the deal setting. Then, this paper will analyze the motives behind each party in negotiating for or against a sandbagging right, in determining who really “sandbags” who in this high-stakes game of allocating risk. Next, this paper will examine the trends in sandbagging. And finally, this paper will conclude by scrutinizing the ethical and moral implications faced by both sides in the “sandbagging” battle.

II. HOW TO SANDBAG YOUR OPPONENT

A provision creating or restricting a party's ability to sandbag may appear innocuous or boilerplate, yet understanding the potential effect and carefully crafting the provision to prevent unwanted risks is critical to both a buyer and seller. One consideration to note prior to delving into the full discussion of sandbagging is that in the United States, the current trend remains in favor of pro-sandbagging rights. The following provides an example of a common scenario where a sandbagging provision (or lack thereof) may come into play and control the actions taken by both buyer and seller.

In a typical scenario where a sandbagging provision (or lack thereof) may come into play, before the purchase agreement is signed, buyer is informed of a potential material liability uncovered during its teams due diligence investigation. Buyer immediately faces a choice: bring this liability to the attention of seller and attempt to negotiate around it or back out of the deal itself.¹⁰ The risk of re-negotiating the deal could easily lead a seller to back out, or scare the buyer's own lenders based on new liabilities now surfacing.¹¹ As buyer becomes cautious of its options, its lawyer informs it that the liability would constitute a breach of seller's representations and warranties. Buyer starts to wonder if it has a third option: may buyer proceed to closing without raising the issue and seek a post-closing claim for seller's

7. West & Shah, *supra* note 1.

8. Iovine, *supra* note 6.

9. Robert F. Quaintance, Jr., *Can You Sandbag? When a Buyer Knows Seller's Reps and Warranties Are Untrue*, 5 M & A LAW. 8 (2002).

10. Broc Romanek, Rick Climan, Wilson Chu, & Steve Glover, *Negotiating Public-Private Mergers*, 6 M & A LAW. 1 (2002).

11. *Id.*

breach? An acquisition agreement between buyer and seller may deal with this issue in three ways: (i) expressly permitting buyer to engage in sandbagging even if buyer has previous knowledge of the falsity of seller's representations and warranties; (ii) expressly preventing buyer the right to indemnification for a breach of seller's representations or warranties if buyer had prior knowledge of its inaccuracy; (iii) or remaining silent on the issue.¹²

A. PRO-SANDBAGGING PROVISIONS

1. *The Pro-Sandbagging Right and Seller's Attack Against Its Use.*

A pro-sandbagging right, or "knowledge savings" clause, is a specific provision within the purchase agreement reinforcing the benefit to a buyer of the representations and warranties it bargained-for from seller notwithstanding any knowledge or awareness buyer may have of their truth when made by seller.¹³ A sandbagging right may be included as a representation, covenant, drafted as part of the indemnity provision or placed separately in the miscellaneous section of the agreement. A common example of such a provision is as follows:

Seller has agreed that Buyer's rights to indemnification for the express representations and warranties set forth herein are part of the basis of the bargain contemplated by this Agreement; and Buyer's rights to indemnification shall not be affected or waived by virtue of (and Buyer shall be deemed to have relied upon the express representations and warranties set forth herein notwithstanding) any knowledge on the part of Buyer of any untruth of any such representation or warranty of Seller expressly set forth in this Agreement, regardless of whether such knowledge was obtained through Buyer's own investigation or through disclosure by Seller or another person, and regardless of whether such knowledge was obtained before or after the execution and delivery of this Agreement.¹⁴

If a seller is forced to accept a pro-sandbagging provision, there are numerous negotiating tactics it may employ to limit the buyer's ability to sandbag it after closing. First, the seller should negotiate the ability to update its disclosure schedules, setting forth exceptions

12. *Id.*

13. Irwin A. Kishner, *Market Trends, Legal Developments, and Their Effect on M&A Documentation*, in *MERGERS AND ACQUISITIONS LAW 2013: TOP LAWYERS ON TRENDS AND KEY STRATEGIES FOR THE UPCOMING YEAR*, 27 (2013); *See also* John F. Clifford, Freek Jonkhart, Jessica Pearlman, *What's The Market For That Cross-Border Deal? The European, US and Canadian Private Target M&A Deal Point Studies*, 12 *BUS. L. INT'L* 139, 148 (2011).

14. West & Shah, *supra* note 1.

to its representations and warranties, between signing and closing.¹⁵ With this right, if a material adverse change does occur, affecting the truth of the seller's representations and warranties, buyer will be barred post-closing for indemnification for the disclosed issue.¹⁶ Further, when approached by a buyer requesting a pro-sandbagging right, a seller should review its indemnification obligations, and the scope of damages such obligations cover, to narrow their post-closing application to breaches of seller's representations and warranties.¹⁷ When reviewing buyer's indemnification rights, seller can narrow the damages by expressly excluding consequential or punitive damages; or by obligating buyer to "act in good faith and in a commercially reasonable manner to mitigate damages."¹⁸ However, no matter what compromises each of the buyer and seller are able to settle on, there are costs to each party associated with including a pro-sandbagging right.

2. *The Costs of A Pro-Sandbagging Rule*

The purpose of a written agreement fully negotiated between sophisticated parties is to specifically allocate risks between buyer and seller.¹⁹ If the default standard is in favor of pro-sandbagging, then even buyers who do not value the right and choose silence over negotiating for the express right to sandbag, will be subjected to a pro-sandbagging standard.²⁰ With this default standard all sellers treat each buyer as a potential sandbagger.²¹ This in turn transfers at the forefront of the negotiations to all buyers the incremental costs of the risks of sandbagging that are faced by each seller, creating an uphill battle for buyer.²² These incremental costs may be created through fewer or more limited representations and warranties provided by seller.²³ The costs may also be seen through strict restrictions placed on seller's obligations to indemnify buyer, either through more narrowly drafted obligations, higher deductibles, lower caps, or shorter survival periods.²⁴ Therefore, rather than a buyer purchasing the right to sandbag,²⁵ as is commonly argued, each buyer, even those

15. Quaintance, Jr., *supra* note 9.

16. *Id.*

17. Kishner, *supra* note 11, at 11.

18. *Id.*

19. West & Shah, *supra* note 1.

20. Charles K. Whitehead, *Sandbagging: Default Rules And Acquisition Agreements*, 36 DEL. J. CORP. L. 1081, 1088 (2011).

21. *Id.*

22. *Id.* at 1104.

23. *Id.*

24. *Id.*

25. *Id.* at 1102.

who remain silent, bear a higher proportional total cost in acquiring seller from the start.²⁶

Additionally, if a seller is unable to differentiate between buyers, the seller itself may fail to allocate its resources properly when diligently stipulating its representations and warranties to buyers who are feared to be potential sandbaggers.²⁷ A seller uses its representations and warranties as insurance to a buyer that what it is purchasing has value and is not a lemon. Communicating the value through representations and warranties is usually a cost-effective substitute to buyer over a costly due diligence period. Providing sound representations and warranties thus indirectly increases the purchase price and reduces buyer's pre-closing costs.²⁸ Without a pro-sandbagging default, sellers will place more emphasis on their representations and warranties to safeguard the increased purchase price and provide proper assurances to a buyer who particularly values a seller's assessment of the business as provided in its warranties, without worrying about being side-lined by a pro-sandbagging right.²⁹

So why has an anti-sandbagging default rule not become the standard if pro-sandbagging clearly holds such high costs? A pro-sandbagging default rule holds within it a basic concept that embodies all fair deals; that the buyer should be able to rely on what the seller has warranted.³⁰ Regardless of buyer's knowledge at closing, there is an appeal to this stance. However, a pro-sandbagging rule still influences the risk-bearing decisions of each party, in a way that an anti-sandbagging default standard would not.³¹

B. ANTI-SANDBAGGING PROVISIONS

1. *The Anti-Sandbagging Right*

To mitigate any potential culpability in light of uncertain liabilities, the seller may take the upper hand and demand an anti-sandbagging provision, cutting off buyer's ability to sneak attack an unsuspecting seller.³² An anti-sandbagging provision limits seller's liability for losses arising from a breach of a representation or warranty if buyer had knowledge of the breach prior to closing the transac-

26. *Id.* at 1104-05.

27. *Id.* at 1104-05.

28. *Id.*

29. *Id.* at 1104-05.

30. Romanek, et al., *supra* note 10.

31. *Id.*

32. Vladimir R. Rossman & Morton Moskin, *COMMERCIAL CONTRACTS: STRATEGIES FOR DRAFTING AND NEGOTIATING* § 2.03 (2d ed. 2013), *See also* Clifford et al., *supra* note 13.

tion.³³ An example of a common anti-sandbagging provision is as follows:

Notwithstanding anything contained herein to the contrary, Seller shall not have (a) any liability for any breach of or inaccuracy in any representation or warranty made by Seller to the extent that Buyer, any of its Affiliates or any of its or their respective officers, employees, counsel or other representatives (i) had knowledge at or before the Closing of the facts as a result of which such representation or warranty was breached or inaccurate or (ii) was provided access to, at or before the Closing, a document disclosing such facts; or (b) any liability after the Closing for any breach of or failure to perform before the Closing any covenant or obligation of Seller to the extent that Buyer, of its Affiliates or any of its or their respective officers, employees, counsel or other representatives (i) had knowledge at or before the Closing of such breach of failure of (ii) was provided access to, at or before the Closing, a document disclosing such breach or failure.³⁴

Such provision can be designed by a seller to achieve seller's goal of conditioning buyer's ability to benefit from the bargained-for representations and warranties.³⁵ Often called a "no prior disclosure" provision a seller can use such clause to disallow a buyer's ability to seek post-closing remedies against seller.³⁶ A seller may be inclined to request the provision because of suspicions raised by the buyer's request to include specific indemnification rights or broadly drawn representations and warranties.³⁷ The inclusion of such a provision attempts to narrow buyer's broadly negotiated rights and provide seller a defense to every claim by buyer for indemnification, allowing the seller to always argue buyer had knowledge. However, like a pro-sandbagging default, an anti-sandbagging rule comes with both pros and cons to its application.

2. *Pros Of An Anti-Sandbagging Default*

Sellers argue that an anti-sandbagging provision is simply intended to be used as a shield against a callous buyer, "protecting the seller from liability for breaches that the buyer is in a better position" to discover through its own due diligence investigation.³⁸ The inclu-

33. KISHNER, *supra* note 13, at 11.

34. West & Shah, *supra* note 1.

35. *Id.*

36. D. Hull Youngblood Jr. & Peter N. Flocos, Drafting and Enforcing Complex Indemnification Provisions, 56 PRAC. LAW. 21 (2010); *see also* West & Shah, *supra* note 7.

37. Quaintance, Jr., *supra* note 9.

38. West & Shah, *supra* note 1.

sion of the anti-sandbagging clause provides an additional hurdle for buyer to overcome in enforcing bargained-for indemnification rights against an unsuspecting seller, but does not bar fair claims by buyer.³⁹ Sellers contend that the anti-sandbagging default would keep each party truthful and provide a fair transaction. Yet, is there value in a seller knowing at the time the agreement is negotiated that a buyer is interested in a sandbagging right?⁴⁰ If yes, is there a way to promote buyer disclosure without forcing a buyer to lose its benefit of the bargain?

M&A scholars argue that an anti-sandbagging default rule will do just this. If a buyer values the sandbagging right, the buyer will have to negotiate for the right up-front.⁴¹ This allows the seller to adjust accordingly in response to the request and counter to balance out the risks now faced by each side with the inclusion of a pro-sandbagging right.⁴² In the end buyers who want the right to sandbag will have to negotiate for it, and will incur the costs of the right to do so.⁴³ A default anti-sandbagging rule may be the most effective approach in identifying buyers who want the right to sandbag and who are interested in purchasing such right.⁴⁴ It will induce a party to communicate valuable information to the other and create a penalty default rule.⁴⁵ If a buyer finds the benefits outweigh the costs of disclosing its interest in seeking a pro-sandbagging right, the buyer must bargain around the penalty default anti-sandbagging rule. This default rule will truly make a buyer “purchase” the sandbagging right or find a way to counter the anti-sandbagging default standard.

3. *Can A Buyer Counter An Anti-Sandbagging Default Rule?*

Buyers have limited incentives to agree to an anti-sandbagging provision.⁴⁶ Yet, if a buyer is forced to compromise and agree to an anti-sandbagging provision the buyer has options to counter back and restrict the application of the clause. First, the buyer may require the standard of proof of knowledge to be actual knowledge.⁴⁷ If the buyer does not seek this limitation, its ability to enforce seller’s indemnification obligation may be further restricted by buyer being found to have constructive, implied, or imputed knowledge of the breached represen-

39. *Id.*

40. Whitehead, *supra* note 20.

41. Quaintance, Jr., *supra* note 9.

42. Whitehead, *supra* note 20, at 1089.

43. *Id.*

44. *Id.* at 1089-90.

45. *Id.* at 1105.

46. *Id.* at 1088.

47. Quaintance, Jr., *supra* note 9.

tation and warranty.⁴⁸ The buyer may further counter the inclusion of an anti-sandbagging provision by limiting the scope of knowledge to a fixed set of individuals, or by avoiding the imputation of knowledge and facts gained by buyer's representatives, such as attorneys or accountants, during the diligence process unless expressly communicated to buyer.⁴⁹ Additionally, the buyer may limit the restriction of its knowledge of seller's breach to solely the time prior to execution of an agreement, and not restricting knowledge between signing and closing.⁵⁰ And finally, a buyer can protect itself in the face of an anti-sandbagging provision by negotiating for the burden of proving buyer had actual knowledge be placed on the seller.⁵¹

4. *The Costs of Anti-Sandbagging Default Rule*

While there are benefits from applying an anti-sandbagging default standard, there may equally be as many costs. Many buyers claim that an anti-sandbagging default rule would promote litigation.⁵² While initially this concept appears backwards, as an anti-sandbagging rule would prevent a buyer, with knowledge of the falsity of a seller's warranty, from bringing a post-closing suit, buyers argue that questions of what actually constitutes knowledge would rise more often in litigation.⁵³ This question of knowledge would become a second hurdle for the buyer to overcome to be indemnified in the case of a breach, often already having to prove reliance. Further, buyers contend that an anti-sandbagging default rule would create a seller disclosure problem, even if unintentionally, but at a cost to buyer.⁵⁴ The problem would be seen when sellers choose to disclose later in the negotiating process or "dump" information on the buyer at the last minute, without fear that buyer's knowledge of such breaches, if not disclosed, could affect seller post-closing. The inquiry becomes whether these concerns raised by a buyer will actually arise if an anti-sandbagging default rule becomes the norm. The issue of knowledge may be addressed contractually, allowing the buyer to insulate itself from protection.⁵⁵ A buyer who truly values the ability to sandbag and has concerns over the seller's warranties and its disclosure of information can still negotiate for the right to sandbag.⁵⁶ Further, many pro anti-sandbaggers argue that it is the buyers responsibility

48. See Whitehead, *supra* note 20, at 1106.

49. West & Shah, *supra* note 19.

50. *Id.*

51. *Id.*

52. Whitehead, *supra* note 20, at 1106.

53. See Youngblood Jr. & Flocos, *supra* note 40, at 32.

54. *Id.*

55. *Id.*

56. Romanek, et al., *supra* note 10.

to know what it is buying. However, as addressed later on, a push towards an anti-sandbagging rule is not the current trend, and a pro-sandbagging regime still exists in the United States.

III. IS A SANDBAGGING BUYER REALLY RUTHLESS IN ITS ACTIONS?

In all respects, it takes a brave buyer to deliberately close a transaction in the face of a potentially material breach actually known to buyer, but unknown to seller, resting solely on buyer's assumption that it will have the ability to sue and collect damages from seller after closing.⁵⁷ There are many reasons why a buyer may seek a pro-sandbagging provision, but requesting such a right may come with high costs. Even in the event of a clear breach, it may be unclear before closing whether buyer may treat the breach as material or if the buyer has the right to treat the breach as an unfilled condition to closing. When faced with the deliberation of pursuing a pro-sandbagging provision, a prudent buyer must weigh each risk, and the costs associated to such risks, and review all of its options.

A. WHY A BUYER WOULD WANT TO SANDBAG AN UNSUSPECTING SELLER?

There are many reasons a buyer may vie for a sandbagging right. The first is a simple contractual argument, "[a] deal is [a] deal."⁵⁸ A seller will often negotiate for a combination of provisions that limit buyer's ability to bring suit against seller in the face of a breach of a representation or warranty. The first is the use of a non-reliance clause preventing the buyer from asserting claims based on representations and warranties made outside of the written agreement and forcing buyer to prove reliance on the breached representation or warranty.⁵⁹ Sellers often also seek an "exclusive remedies" clause that limits seller's liability for a breach of a representation or warranty to the specific contractual limitations set forth in the written agreement.⁶⁰ Seller's liability is then further restricted in narrowly negotiated indemnification provisions, often limited with the use of caps, baskets and shortened survival periods.^{61,62} After the inclusion of a non-reliance clause, exclusive remedies provision, and limited indemnification obligations, isn't buyer being prudent and diligent in at-

57. West & Shah, *supra* note 1.

58. *Id.*

59. *Id.*

60. *Id.*

61. Youngblood Jr. & Flocos, *supra* note 40, at 24-25.

62. West & Shah, *supra* note 1.

tempting to restrict the hurdles it must overcome with a pro-sandbagging provision when seller is in fact in breach of the parties' negotiated agreement? Buyer isn't being unethical, a deal is a deal.

Second, a buyer may argue that after it has accepted seller's contractual limitations on its right to recovery against seller, it valued the bargained-for representations and warranties, as so limited by seller, and paid for them outright, knowledge or not.⁶³ The buyer argues that it "purchased the warranties," as a means to allocate risk and minimize cost.⁶⁴ Thus, the cost of its right to sandbag seller is reflected in the price, meriting buyer the right to have a pro-sandbagging clause.⁶⁵ By purchasing the warranties, a buyer who has a particular interest in one of seller's representations and warranties, but may not be able to determine its accuracy before closing, may wish to maintain a clear right to bring a post-closing claim if there is a material breach.⁶⁶

Another reason a buyer may negotiate for a pro-sandbagging provision is to plan for potential "dumping" by the seller of newly discovered information at a late date in the diligence period in an effort to avoid its bargained-for representations and warranties.⁶⁷ Buyers argue that including a pro-sandbagging provision encourages sellers to take extra care with the disclosure schedule process.⁶⁸ Further, buyers often claim that without a pro-sandbagging provision sellers will "play games" with the information given to buyer.⁶⁹ Going up against a seller who dumps information or toys with what to disclose, and when to disclose it, may be difficult for a buyer who is committed to the transaction and finds it difficult to walk-away. Therefore, a pro-sandbagging right could provide essential protection. However, while a buyer may have multiple reasons to seek a sandbagging right, is it ethical for the buyer to sandbag when it had other options?

B. DOES A PRUDENT BUYER REALLY HAVE OTHER OPTIONS?

A buyer who discovers one of seller's representations and warranties is untrue prior to closing has multiple options beyond sandbagging. However, while at first glance these options appear less risky and morally less corrupt than sandbagging, that may not always be the case.⁷⁰ A buyer must first determine how material the potential

63. *Id.*

64. Whitehead, *supra* note 20, at 1085.

65. *Id.* at 1104.

66. *See* Iovine, *supra* note 6.

67. West & Shah, *supra* note 1.

68. Iovine, *supra* note 6.

69. Quaintance, Jr., *supra* note 9.

70. *See* Quaintance, *supra* note 9.

breach is, and whether the discovery of the new liability itself should cause buyer to walk away from the deal.⁷¹ If a buyer wishes to close the transaction even with its new knowledge, and no sandbagging right, the buyer must next determine whether: to disclose the information and waive it; to attempt to renegotiate the agreement (either by disclosing the information and seeking new protections, or expressly asking for a pro-sandbagging right); or to remain silent and run the risk that when debated in court the default rule will not preclude recovery even when the buyer knew of the breach pre-closing.⁷²

If the seller agrees to renegotiate with the buyer after the buyer has revealed a potential material breach, the two most common methods to compensate a buyer for such breach is through a purchase price reduction or special indemnity clause.⁷³ If a special indemnity clause is used, the buyer must ensure it covers losses related to the “specific known issue” and recognize that it may have to face limited recourse with respect to the matter.⁷⁴ It may be difficult for a buyer to correlate the change in value provided by a special indemnity by seller with an agreement not to sandbag, or to waive a sandbagging right.⁷⁵ Further, in revealing the potential material breach pre-closing to seller, buyer risks that seller may choose not to continue with the deal; closing the door on buyer.⁷⁶ Seller may seek other alternatives, especially if faced with a request for a purchase price reduction or special indemnification right by buyer.⁷⁷ Seller may take a risk and attempt to find another buyer who the breach will be less significant to.⁷⁸ Closing with its sandbagging right, buyer removes this option from seller and may actually create less overall risk.⁷⁹

IV. IS THE SELLER REALLY INNOCENT IN THE SANDBAGGING GAME?

A. AN INNOCENT SELLER NEEDS TO EVOKE TRUST

For a seller the incentive to negotiate against a buyer who seeks a pro-sandbagging right is limited.⁸⁰ A seller who wants to create an atmosphere of trust and confidence with its buyer can face troubling accusations of distrust when it negotiates against buyer’s insistence to

71. See Rossman & Moskin, *supra* note 34.

72. Romanek, et al., *supra* note 10.

73. Quaintance, *supra* note 9.

74. West & Shah, *supra* note 1.

75. Whitehead, *supra* note 20 at 1102.

76. *Id.* at 1103.

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.* at 1102.

include a pro-sandbagging right.⁸¹ This resistance is contrary to its goal of demonstrating that buyer can always trust seller and rely on its warranties.⁸² Negotiating with a buyer against a pro-sandbagging right draws the buyer to question seller, putting issues of accuracy at the forefront of negotiations, and placing seller's reliable perception in doubt. This leads many sellers to remain quiet and accept a pro-sandbagging right at the persistence of buyer, or compromise with silence and not push for its own anti-sandbagging protection.⁸³

1. *But Is This Naïve Seller Really Innocent?*

An innocent seller may argue that it is outrageous for a buyer to suggest pro-sandbagging provisions and not instead agree to an anti-sandbagging clause.⁸⁴

"How can anyone suggest that it is acceptable behavior for the buyer to 'lie behind the log' knowing that the seller is incurring liability to the buyer for a representation or warranty that the buyer knows to be untrue and therefore could not possibly have been relied upon by the buyer in entering into the agreement?"⁸⁵

However, more often than not, the inclusion of an anti-sandbagging clause causes the seller to abuse its rights and use its protection as a sword to provide a convenient retort to an indemnity claim by buyer; the "you knew and didn't tell me" defense.⁸⁶ Further, the true potential for sandbagging, including the seller's own anti-sandbagging sword, may generate an incentive for seller to divulge partial or incomplete disclosures on the seller's schedules, or even to withhold information completely until just before closing.⁸⁷ These potential corruptive actions by seller cause the question of whether the seller becomes the sandbagger when a pro-sandbagging provision is not used?

V. THE TRENDS IN SANDBAGGING

Choosing the governing law carefully when sandbagging is essential for both parties, specifically when the contract falls silent on the party's ability to sandbag. Subject to some exceptions, the modern trend throughout the United States (when the parties have left the agreement silent on the issue) has leaned towards allowing a buyer to

81. *Id.*

82. *Id.*

83. *Id.*

84. West & Shah, *supra* note 1.

85. *Id.*

86. *Id.*

87. *Id.*

sandbag the seller and sue for a breach post-closing remedies without regard to its actual pre-closing knowledge.⁸⁸ For example, in 2005, in the case of *Interim Healthcare, Inc. v. Spherion Corp.*,⁸⁹ the Superior Court of Delaware found that the knowledge acquired by the buyer through its due diligence review, that seller's warranties were false, did not have bearing on its right to rely on the express warranties in the agreement.⁹⁰ The court stated that "[r]eliance is not an element of [a] claim for indemnification [arising from a breach of contract]."⁹¹ Therefore, while the agreement appears silent as to the buyer's right to sandbag, the Delaware Superior Court made clear that buyer's knowledge prior to closing would not bar its claim for breach of warranty.⁹²

A more firm example was seen in the New York Court of Appeals case of *CBS Inc. v. Ziff-Davis Pub. Co.*,⁹³ whereby the court concluded that when the warranties are expressly part of the agreement between buyer and seller, and the buyer purchases the warranties believing the promises they represent to be the truth, buyer's knowledge may not prevent a post-closing claim for breach of warranty.⁹⁴ However, subsequent New York case law has limited the application of *Ziff-Davis Pub. Co.* For example, in *Gusmao v. GMT Group, Inc.*,⁹⁵ the district court for the Southern District of New York reviewed the application of New York law in prior cases, and reinforced that New York's definition of reliance requires an examination of both the extent and source of a buyer's knowledge as to the truth of a seller's warranty.⁹⁶ The court then denied the sellers' motion for summary

88. Whitehead, *supra* note 20 at 1084.

89. 884 A.2d 513 (Del. Super. Ct. 2005).

90. *Interim Healthcare, Inc. v. Spherion Corp.*, 884 A.2d 513, 548 (Del. Super. Ct. 2005). *See generally* Iovine, *supra* note 6 (Citing pro-sandbagging as the default in Delaware, and emphasizing both Delaware and New York as two jurisdictions that are often chosen as the governing law for the majority of deal transactions. Further, arguing that under both Delaware and New York law, a buyer is not required to prove reliance in order to recover on a post-closing claim for breach of a known representation or warranty. In comparison to California law, where reliance is viewed as an essential element to a claim or breach of a representation or warranty, and will protect the seller from sandbagging).

91. *Interim Healthcare, Inc.*, 884 A.2d 513 at 549.

92. *Id.*

93. 553 N.E.2d 997 (N.Y. Ct. App. 1990).

94. *CBS Inc. v. Ziff-Davis Pub. Co.*, 553 N.E.2d 997, 1000-01 (1990); *see generally* Whitehead, *supra* note 20 at 1084; *see also* Iovine, *supra* note 6 (Citing that under New York law, there may be a difference in treatment if the seller affirmatively discloses the existence of the breach, opposed to buyer discovering the breach through its own diligence, in determining whether the buyer believed it was purchasing the truth of seller's representations, and thus the buyer may not be permitted to recover for a breach).

95. No. 06 Civ. 5113(GEL), 2008 WL 2980039, (S.D.N.Y. Aug. 1, 2008).

96. In the interim between *Ziff-Davis Pub. Co.* and *Gusmao v. GMT Group, Inc.*, the Second Circuit discussed the issue and applied New York law in two separate cases.

judgment on the breach of warranty claim, finding that the record was not sufficiently developed on the point of the buyer's source of knowledge of the inaccuracy of sellers' warranty pre-closing.⁹⁷ However, *Gusmao* clarified that under New York law, if a seller discloses to buyer pre-closing that a warranty is inaccurate, buyer is deemed to have waived the right to recover for the breach of seller's warranty post-closing, when the purchase agreement is silent on such issue.⁹⁸ On the other hand, if the seller is not the source of a buyer's knowledge of the falsity of the warranty before closing, a buyer is deemed to have bargained for the warranty and may proceed with a breach of warranty claim, despite buyer's knowledge.⁹⁹

A statistical review of publicly available deals between 2007 and 2011 revealed that forty-five to fifty percent of agreements contained a pro-sandbagging provision, regardless of governing law, and forty to fifty percent of agreements were silent.¹⁰⁰ These numbers saw slight deviations over the next couple of years. In a 2013 American Bar Association study entitled *Private Target Mergers & Acquisitions Deal Points Study*,¹⁰¹ the authors found that 10% of deal contained anti-sandbagging clauses; 41% contained pro-sandbagging clauses; and 49% of deals were silent on the issue of sandbagging altogether. This illustrates that sellers may be gaining bargaining power as the M&A market continues to change.¹⁰² The compromise between a buyer and seller is equally as often silence as it is an agreement to include either a pro or anti-sandbagging provision, and in many instances neither

In *Galli v. Metz*, the Second Circuit noted, "[w]here a buyer closes a contract in full knowledge and acceptance of facts disclosed by the seller which would constitute a breach of warranty under the terms of the contract, the buyer should be foreclosed from later asserting the breach. In that situation unless the buyer expressly preserves his rights under warranties (as in *Ziff-Davis*), we think the buyer has waived a breach." *Galli v. Metz*, 973 F.2d 145, 151 (2nd Cir. 1992). Subsequently, the Second Circuit in *Rogath v. Siebenmann*, the court acknowledged that under New York law the court must evaluate both the extent and source of a buyer's knowledge over the truth of seller's warranty, and clarified that if a buyer had independently obtained knowledge of the inaccuracy, or if the inaccuracy was common knowledge, a buyer may not be foreclosed from recovery under a breach of warranty claim based on its knowledge. *Rogath v. Siebenmann*, 129 F.3d 261, 264-65 (2nd Cir.1997).

97. See *Gusmao v. GMT Group, Inc.*, No. 06 Civ. 5113(GEL), 2008 WL 2980039, at *5 (S.D.N.Y. Aug. 1, 2008).

98. *Gusmao*, 2008 WL 2980039, at *9-10.

99. *Id.* at *5.

100. See *Iovine*, *supra*, note 6 (Finding that in 2010 5% of agreements included an anti-sandbagging provision, while 41% contained a pro-sandbagging express right, the remaining 55% were silent).

101. See, ABA's 2013 Private Target Mergers & Acquisitions Deal Points Study, available at www.duanemorris.com/site/static/2013_aba_private_target_ma_deal_points_study.pdf?utm_source=mondaq&utm_medium=syndication&utm_campaign=inter_article_link (providing an advance copy of the study).

102. *Id.* at 77.

party has any incentive to negotiate for either right in light of the unsettled law around sandbagging. The effect of the parties' silence under common law principles differs greatly by jurisdiction.¹⁰³ In a handful of states, including California, Texas, and Maryland silence equates to anti-sandbagging.¹⁰⁴ In opposition, a pro-sandbagging win for the buyer will currently occur in approximately fifteen states, including Delaware, New York, Illinois, and Indiana, if the agreement is silent.¹⁰⁵

While a set pro-sandbagging or anti-sandbagging default rule may affect the outcome when a buyer presents a post-closing claim against seller in the instance of silence, the default rules set within each state have a limited effect on contracting.¹⁰⁶ For instance, in a buyer's market like 2008 and 2009, where the buyer may have lead with a pro-sandbagging request and succeeded due to its greater negotiating leverage, the default rule set in each state becomes irrelevant.¹⁰⁷ The low economic climate, made buyers well positioned to insist on a pro-sandbagging provision. However, this pro-sandbagging success saw a change with a weakened acquisition market in 2010 and 2011, which led sellers to be more successful in removing sandbagging rights from the agreement and settling with silence.¹⁰⁸ This increase in silence is attributed to greater leverage by sellers.¹⁰⁹ As the market continues to strengthen sellers gain bargaining power and are in a better position to defy a buyer's request for a pro-sandbagging provision, however this, in many instances, will often lead to a compromise between the parties of silence.¹¹⁰ So while default state rules governing sandbagging may not be on the forefront of issues when negotiating whether to accept the inclusion of a pro-sandbagging or anti-sandbagging right, in the end, the effect of silence depends solely on the governing law, and compromising with silence without reviewing the applicable governing law may lead to a negative outcome.¹¹¹

Many practitioners have puzzled over this trend of silence. Some suggest that the heated and emotional negotiations over the right to

103. Whitehead, *supra* note 20 at 1084.

104. *Id.*

105. See Iovine, *supra*, note 6 (stating that absent an express provision governing sandbagging, the majority of buyers have some sandbagging right under state common law).

106. See Romanek, et al., *supra*, note 10.

107. Whitehead, *supra*, note 20 at 1099.

108. *Id.* at 1099-1100.

109. *Id.* at 1098.

110. See generally Whitehead, *supra*, note 20.

111. *Id.* at 1100. See also Wilson Chu & Larry Glasgow, *They're Real and They're Spectacular: The 2009 Private M&A Target Deal Points*, 14 M & A LAW. 1 (2010) (stating that "going silent" may benefit a seller because of standards of fairness, that require reliance by the buyer, imposed by courts).

sandbag lead to a compromise by both sides in silence.¹¹² But under this concession of silence, buyers and sellers do not properly allocate risk, do not negotiate appropriately for their sought after rights or adequately for their justified protections, and are not able to allocate resources in a way that accurately reflects their interests.¹¹³ This begs the question of why negotiating sandbagging provisions is being avoided in modern deals and whether the ethical issues associated with sandbagging, and its negative perception, have scared off both sides from pushing for their rights.

VI. IS SANDBAGGING ETHICAL?

Many scholars have recently asked the question whether sandbagging is ethical. With the term's birth stemming from 19th century gang fights¹¹⁴ the term emits unethical use, and can easily be classified as a modern day weapon to undercut the other side. Under both European¹¹⁵ and Canadian¹¹⁶ law, the default rule is consistently in favor of anti-sandbagging.¹¹⁷ An anti-sandbagging provision appeals to one's sense of fairness and often, in negotiations where non-attorneys are present, will make more sense than buyer's argument to "close the merger and then sue . . . for an inaccurate representation even if [buyer] clearly knew . . . the representation was dead wrong."¹¹⁸ Furthermore, "[S]ellers view sandbagging as an issue of fundamental fairness" that influences them to "impute bad motives to buyers that insist on a provision permitting sandbagging."¹¹⁹ Sellers interpret the request for a sandbagging provision as ethically questionable and patently unfair.¹²⁰ It does appear unfair that the buyer should be allowed the right to sue post-closing against an unsuspecting seller. But when negotiating a deal, should fairness come into play? Or should sophisticated parties have the right to negotiate and agree upon contractual terms between each other without being forced

112. Whitehead, *supra*, note 20 at 1101-02.

113. *Id.* at 1107-08.

114. West & Shah, *supra* note 1.

115. See generally Clifford et al., *supra* note 13 (stating in European agreements it is much more frequent to see the inclusion of an anti-sandbagging provision; citing that 51% of deals surveyed included a seller favored prohibition of sandbagging).

116. *Id.* at 149. Finding that generally sandbagging clauses are found less frequently in Canadian deals, anti-sandbagging provisions are twice as likely to be seen than pro-sandbagging clauses. See also Richard E. Clark & Curtis A. Cusinato, *Canadian M&A: Eleven Trends for 2011*, BUSINESS LAW TODAY, April 2011 (sandbagging provisions are less common in Canada than the US, specifically 31% to 47% respectively).

117. See Ana Sofia Batista, et al., *Private Mergers and Acquisitions - Global Trends in Buyer Protection*, 26-SPG Int'l L. Practicum 59 (2013).

118. Romanek, et al., *supra*, note 10.

119. Iovine, *supra*, note 6.

120. *Id.*

to play nice? It is seller's information after-all, how is buyer being unfair from keeping seller's own information from it? The issues of fairness and ethical wrongs associated with sandbagging have arguably led to the trend of silence, making it safer for both sides to avoid the issue and rely on a default state rule.

VII. CONCLUSION

When an agreement is negotiated between sophisticated parties, both buyer and seller should be permitted to receive the benefit of their bargained-for specific rights, and therefore, neither party should be allowed to claim it was sandbagged. Moving forward with negotiating their risks, both parties should keep in mind the unsettled case law surrounding the treatment of sandbagging, and exercise caution in choosing silence over pro-actively negotiating their rights.¹²¹ The rules governing sandbagging are far from absolute,¹²² and each party needs to be aware of the pros and cons associated with agreeing to a pro-sandbagging provision, anti-sandbagging clause, or settling on silence in an agreement. Dealing with the knowledge of a potential breach can be settled by inserting a provision or relying on default state rules, however, each move made by a buyer or seller will shift the allocated risks in the negotiation, and the parties should be aware of the costs associated with this chess game.

121. *Id.*

122. *Id.*

