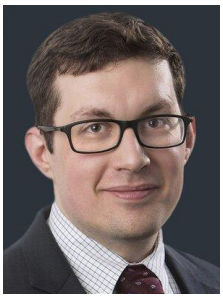
Sandbagging Issues To Watch In Deal Documents

By **Lee Turner Friedman, Adi Herman and Jack Herman** (December 13, 2022)

Lee Turner Friedman

Adi Herman



Jack Herman

Although the prevalent use of representation and warranty insurance in merger and acquisition transactions has more commonly displaced negotiations of sandbagging provisions between buyers and sellers, sandbagging — including its interplay with R&W insurance — remains an important deal issue.

What is sandbagging? In the 19th century, "ruffians roamed the streets" and robbed "unsuspecting victims" using the tactic knowing as sandbagging. They wielded "ostensibly harmless socks" that were in fact "filled with sand and used as weapons," the Chancery Court of Delaware reminded us in the March 9 Arwood v. AW Site Services LLC decision.[1]

Today, though, sandbagging has a different — and, thankfully, less violent — meaning. It describes a buyer that asserts a claim for breach even though it knew, or had reason to know, before the deal closed that a representation was untrue.

In other words, the buyer had knowledge of the breach, or the relevant facts that led to the breach, but went through with the deal anyway, only to bring a claim for breach after closing.

This article explores how transactional practitioners have and continue to address sandbagging in acquisition agreements, and the default rules that courts may apply when the deal parties are silent on the issue. It also explains how sandbagging comes up in the context of R&W insurance policies and any related special indemnities in acquisition agreements.

Contractual Approaches to Sandbagging in Deal Documents

The practice of sandbagging has become so common that dealmakers have developed a standard playbook for addressing it in acquisition agreements.[2] Deal parties can adopt one of three contractual approaches:

- The buyer-friendly pro-sandbagging clause;
- The seller-friendly anti-sandbagging clause; or
- Silence, in which event the parties defer to the default rule of the state whose law governs the agreement.

Pro-Sandbagging Clauses

A pro-sandbagging clause permits a buyer to seek recovery for breach of a representation or warranty even if the buyer knew, or had reason to know, that the representation or warranty was false prior to closing.

For example, according to SRS Acquiom's most recent study of deal terms in mergers and acquisitions, released in May, an agreement might provide that the right to a remedy

> will not be affected by any Knowledge acquired (or capable of being acquired) at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of such representation [or] warranty.[3]

Deal parties also may specifically provide for pro-sandbagging-type language that applies to matters for which a special indemnity was negotiated, particularly when such risks are excluded under a representation and warranty insurance policy.

From the buyer's perspective, a pro-sandbagging clause helps ensure it will receive the benefit of its bargain. The buyer believed its target had a certain value based on representations and warranties made by the seller.

If the representations are false, buyers say, they overpaid and should be compensated. Buyers also argue that pro-sandbagging clauses provide the parties with greater certainty. For example, they remove certain hurdles to recovery, such as a prolonged and costly dispute during the indemnification process about the buyer's pre-closing knowledge.

Anti-Sandbagging Clauses

An anti-sandbagging clause, on the other hand, would prohibit a buyer from seeking recovery where it knew prior to closing (or, depending on its scope, had reason to know) that a representation was false.

For example, according to the SRS Acquiom study, the agreement may provide that seller shall not be liable

> for any Losses resulting from or relating to any inaccuracy in or breach of any representation or warranty in this Agreement if the party seeking indemnification for such Losses had Knowledge of such breach before Closing.[4]

The parties may limit its scope to knowledge obtained by a specific set of individuals, or to knowledge acquired before a specific time.

Anti-sandbagging clauses are uncommon these days. Nevertheless, sellers argue that, in certain contexts, these clauses may promote cooperation between the deal parties.

The lingering threat that a buyer will sandbag the seller can cause tension and distraction if, for example, a co-founder or management seller will remain with the target company following acquisition. Sellers also may argue that they should have the right to cure any issues of which the buyer becomes aware before closing.

Silence

The parties also can remain silent about sandbagging. Despite the potential for uncertainty, this approach appears to be increasingly common.

For example, the most recent American Bar Association Business Law Section's study of deal points in private target M&A — which covers 2020 and Q1 2021 — private-target-public-buyer deals found that 68% of agreements were silent as to sandbagging; in contrast, 41% of agreements were silent on this issue in 2006.[5]

Of deals that addressed sandbagging, the vast majority — more than 90% — permitted it,

according to the study.

In the event of silence, the buyer's ability to recover for breach of representations and warranties will depend on the default rule adopted by the jurisdiction whose law governs the transaction.

What Does Silence Mean?

Where an acquisition agreement is silent as to sandbagging, a court will apply the default rule in the jurisdiction that provides the law governing the agreement. While this varies from state to state, we address here the law of two states — New York and Delaware — that frequently govern acquisition agreements.

New York

Where a contract is otherwise silent on the issue, New York permits sandbagging — but with important limitations. Under New York law, a buyer may enforce an express representation or warranty "even if it had reason to know that the warranted facts were untrue."[6]

But courts have also imposed a condition: The buyer "must show that it believed that it was purchasing the seller's promise regarding the truth of the warranted facts," according to the U.S. Court of Appeals for the Second Circuit's 2007 Merrill Lynch & Co. v. Allegheny Energy Inc. decision.[7]

Thus, a buyer cannot recover if the seller discloses the inaccuracy to the buyer directly prior to closing, unless the buyer expressly preserves its right to bring a claim for breach through a pro-sandbagging provision.

If, on the other hand, the seller is not the source of the buyer's knowledge (e.g., because the fact is "common knowledge" or the buyer learns of the falsity of the facts from a third party), the buyer may recover.[8]

At bottom, the "critical questions" are "what the buyer knew and, most importantly, whether he got that knowledge from the seller," the U.S. Court of Appeals wrote in the 1997 Rogath v. Siebenmann decision.[9]

Delaware

While Delaware is generally considered to be pro-sandbagging, its highest court has yet to state definitively whether its default contracting rules permit sandbagging where a transaction agreement is otherwise silent.

In fact, the Delaware Supreme Court expressly declined to address this "interesting question" in the 2018 Eagle Force Holdings LLC v. Campbell decision,[10] even though then-Chief Justice Leo Strine observed (concurring in part and dissenting in part) that "[v]enerable Delaware law casts doubt" on a party's "ability" to "turn around and sue because what he knew to be false remained so."[11]

In the March 10 March Arwood v. AW Site Services LLC decision, however, the Delaware Chancery Court weighed in. Vice Chancellor Joseph R. Slights III concluded "is, or should be, a pro-sandbagging jurisdiction."[12]

In Arwood, a buyer claimed breach of representations and warranties relating to, among

other things, seller's financial condition and compliance with certain legal requirements.

Because the buyer had nearly full access to the seller's business and financial records during due diligence, one issue at trial was whether the buyer knew or should have known pre-closing that the representations were false, and whether it mattered. Even ignoring the fact that the acquisition agreement appeared to allow sandbagging, the court held that the buyer could assert its claims.

First, the court stated that Delaware's default rules permitted sandbagging — i.e., in the absence of a contractual agreement to the contrary, a buyer can recover on a breach of warranty claim even if the buyer knew, at the time of signing, the representations and warranties were not true.[13]

The court said that a pro-sandbagging rule "supports the notion that representations and warranties serve an important risk allocation function," and that where the agreement is silent, the "buyer may rest on its reasonable belief that it has acquired as part of the transaction the seller's implicit promise to be truthful in its representations."[14]

While there is "something unsettling about allowing a buyer to lay in wait despite awareness of a breach," the court said, "the risk of such litigation, like any other risk, can be managed expressly in the bargain the parties strike," such as through the use of an anti-sandbagging provision.[15] Thus, the court held that the buyer in Arwood could recover regardless of whether it knew the representations and warranties were false prior to closing.

Second, and in the alternative, the court held that sandbagging rules were not even implicated because the evidence in the case did not establish that the buyer actually knew that the representations and warranties were false prior to closing.[16]

In other words, the court concluded that even assuming Delaware prohibited sandbagging as the default rule, it would not matter unless the buyer had actual — and not constructive — knowledge of the truth of the representations and warranties; even demonstrating that the buyer was recklessly indifferent to the truth would be insufficient to bar recovery.

Arwood provides helpful guidance regarding the way Delaware courts may interpret silence in an acquisition agreement. Nevertheless, the law will remain uncertain until the Delaware Supreme Court speaks definitively on the question. And in the meantime, other courts could disagree or distinguish this authority.

Thus, parties would be well-advised to consider including in their acquisition agreements a clause that expressly addresses the issue.

Sandbagging and Representation and Warranty Insurance

It is increasingly common for the parties to an acquisition to obtain representation and warranty insurance. These policies typically have their own form of anti-sandbagging clause: an exclusion from coverage if the insured had knowledge of the applicable breach, as commonly supported by a "no claims" declaration whereby buyer declares that, as of the time the policy is bound and at closing, it does not have such knowledge of a breach.

But such exclusions typically are drafted narrowly, excluding coverage only when a buyer had actual knowledge of the breach — not just knowledge of the facts underlying or causing the breach, and not covering any form of constructive knowledge or knowledge that would have been obtained upon due inquiry. And they are likely to exclude coverage only if a

narrowly defined group of named deal team members had the requisite knowledge.

In addition, an insurer's rights and obligations under the policy are, with some exceptions, typically derivative of those under the acquisition agreement.

Thus, an insurer defending a claim could potentially invoke whatever sandbagging arguments would have been available to the seller under the acquisition agreement. Notably, however, pro-sandbagging clauses appear to be significantly more common in deals covered by representation and warranty insurance.[17]

The SRS Acquiom study found a pro-sandbagging clause in 59% of private-target deals for which it identified a representation and warranty insurance policy, compared to only 33% of deals in which it did not identify a representation and warranty insurance policy.[18]

Key Takeaways

Sandbagging continues to be frequently negotiated between sellers and buyers. However, in the wake of the growing prevalence of no-indemnity deals, the issue of sandbagging has increasingly migrated to the arena of representation and warranty insurance, where a narrowly defined "anti-sandbagging" exclusion applies in practice.

In the event that the acquisition agreement is silent on sandbagging, applicable state law will dictate whether buyer's knowledge could be held against it in seeking recovery for breaches of representations.

While New York case law contemplates certain limitations on buyers' ability to sandbag, Delaware has traditionally been viewed as a more pro-sandbagging jurisdiction. The recent Arwood decision appears to reaffirm such position, although the Delaware Supreme Court has yet to state definitively whether its default contracting rules permit sandbagging where a transaction agreement is otherwise silent.

Practitioners will be well advised to consider the default sandbagging rules of the jurisdiction whose law governs an acquisition agreement.

Buyers should consider adding express pro-sandbagging language, particularly in acquisition agreements providing for a general seller indemnity for breaches of representations — or in connection with specially negotiated indemnities for risks identified in due diligence.

Buyers should also carefully review the scope of sandbagging-like exclusions in the representation and warranty insurance policy to ensure bargained-for coverage or revert to sellers for contractual protections of known and excluded items.

Sellers should pay particular attention to the exact formulation of the representations and warranties, and use appropriate qualifications, limitations or disclosures in order to ensure the representations are accurate.

Lee Turner Friedman and Adi Herman are partners, and Jack A. Herman is an associate, at Kramer Levin Naftalis & Frankel LLP.

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[1] Arwood v. AW Site Servs., LLC, Case No. 2019-0904-JRS, 2022 WL 705841, at *28 (Del. Ch. March 10, 2022) (internal quotation marks omitted).

[2] Id. at *29.

[3] SRS Acquiom, 2022 M&A Deal Terms Study ("SRS Acquiom Deal Terms Study"), at 98, available at https://www.srsacquiom.com/resources/m-a-deal-terms-study/.

[4] Id.

[5] American Bar Association Business Law Section, Private Target Mergers & Acquisitions Deal Points Study (Dec. 30, 2021), at 80.

[6] Merrill Lynch & Co. v. Allegheny Energy, Inc., 500 F.3d 171, 186 (2d Cir. 2007).

[7] Id.

[8] Rogath v. Siebenmann, 129 F.3d 261, 265 (2d Cir. 1997).

[9] Id.

[10] Eagle Force Holdings, LLC v. Campbell, 187 A.3d 1209, 1236 n.185 (Del. 2018).

[11] Id. at 1247.

[12] Arwood, 2022 WL 705841, at *3.

[13] Id. at *29.

[14] Id. at *3/1-/21 (internal quotation marks omitted).

[15] Id.

[16] Id. at *31-*32.

[17] Notably, many transactions covered by representation and warranty insurance do not include an underlying contractual indemnification by the sellers (i.e., "no-indemnity" or "no survival" deals). Because, in the absence of fraud, seller assumes less risk in such deals, it has less incentive to object to a pro-sandbagging provision that gives the buyer the broadest remedies possible. Another possibility is that parties in deals covered by representation and warranty insurance are more likely to negotiate "special indemnities" to cover buyer for specific known risk items that are excluded under the insurance policy. In such instances, pro-sandbagging language is feasible to protect the bargained-for indemnity from any claims regarding buyer's knowledge (which knowledge is the very basis for negotiating such indemnity to begin with).

[18] SRS Acquiom Deal Terms Study at 57.