Sandbagging

From Poker to the World of Mergers and Acquisitions

By Aleksandra Miziolek and Dimitrios Angelakos

In the 1940s, the term "sandbagging" became associated with a common poker strategy of "refrain[ing] from raising at the first opportunity in hopes of raising more steeply later."[1] In recent years, the terms "pro-sandbagging" and "anti-sandbagging" have also been used to describe provisions in a purchase agreement that are intended to clarify the impact of one party's pre-closing knowledge of a breach of the other party's warranty.[2] While typically framed to apply to both parties, the crux of the sandbagging debate is whether a buyer should be able to recover for a breach of warranty, the inaccuracy of which it had knowledge before the closing of the transaction.

Buyers vs. Sellers: Positions on Sandbagging

A pro-sandbagging provision renders a buyer's pre-closing knowledge of a breach of a seller's warranty (whether obtained from the seller, in the course of due diligence, or otherwise) irrelevant to its claim for indemnification for such breach. Most buyers have no intention of sandbagging the seller and prefer to have a pre-closing discussion with the seller regarding any facts that cast doubt on the accuracy of the seller's warranty. However, under certain circumstances, a buyer who has knowledge of the inaccuracy of a seller's warranty may decide that it is more advantageous to sandbag the seller and try to recover on a breach of warranty claim after the closing of the transaction. A typical pro-sandbagging provision reads as follows:

> The right to indemnification, payment, reimbursement, or other remedy based upon any such representation, warranty, covenant, or obligation *will not be affected by…any investigation conducted or any Knowledge 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, or compliance with, such representation, warranty, covenant, or obligation.[3]

Not unexpectedly, an anti-sandbagging provision is one that precludes a buyer from making an indemnification claim for breach of a warranty when the buyer closed on the deal despite knowing the seller's warranty was not accurate. A typical anti-sandbagging provision reads as follows:

> *No party shall be liable* under this Article 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]

At first blush, it may seem patently unfair for a buyer to be able to sue for a breach of a warranty it knew was inaccurate before the closing of the transaction. However, buyers contend that the responsibility for accurate disclosures rests squarely on the shoulders of the seller, and a buyer's ability to rely on the accuracy of a seller's warranty is an integral part of the bargain struck between the parties when entering into the purchase agreement. Furthermore, buyers maintain that any inquiry into a buyer's knowledge regarding the accuracy of the seller's warranties would significantly complicate the indemnification process and allow the seller to stymie a buyer's legitimate damage recovery with a mere allegation that someone in the buyer's organization had knowledge of such inaccuracy.

On the other hand, sellers contend that it is fundamentally unfair to be subjected to full due diligence review by a buyer's sophisticated advisors only to have the buyer withhold discovered information, acquire the business, and seek to recover damages on a breach of warranty claim.

FAST FACTS

"Sandbagging" in the mergers-and-acquisitions context occurs when a party, usually the buyer, seeks to recover for a breach of warranty, the inaccuracy of which it had knowledge before the closing of the transaction. The majority of jurisdictions that have addressed the issue have adopted the modern contract law theory to breach of warranty claims where, typically (but not always), reliance on the accuracy of the warranty is not a requirement for recovery and a buyer's pre-closing knowledge regarding the accuracy of the seller's warranty is irrelevant. While it appears that express "pro-sandbagging provisions" are becoming less frequent in purchase agreements, it is important to understand how the default sandbagging rules of applicable state law will affect recovery under a breach of warranty claim.

So who typically wins the sandbagging battle? As revealed in a 2011 study conducted by the M&A Market Trends Subcommittee of the Mergers & Acquisitions Committee of the American Bar Association, it often ends up being a draw with buyers and sellers increasingly choosing not to address the sandbagging issue in the purchase agreement. Of the merger-and-acquisition agreements reviewed in connection with the 2011 ABA study, 54 percent were silent on the issue of sandbagging compared to only 41 percent in a comparable study released in 2006.[5]

Although a relatively recent study of publicly available transactions did not disclose any correlation between the treatment of sandbagging under applicable state law and the decision not to expressly address the issue in the purchase agreement,[6] the law governing the interpretation of the agreement may have a significant impact on a buyer's right to recover for a breach of warranty claim when the agreement is silent on the issue.

State Law Sandbagging Default Rules

The difference in treatment of sandbagging in various jurisdictions lies in whether the breach of warranty claim is viewed

as a tort claim or a claim for breach of contract. Traditionally, a breach of warranty claim was treated as a fraud claim, sounding in tort with reliance being a necessary element of the claim.[7] If a buyer had knowledge of the breach of warranty, it could not establish that it detrimentally and justifiably relied on the warranty. Accordingly, a sandbagging buyer in a jurisdiction applying a traditional tort approach to warranty claims would be unable to recover for a breach of warranty it knew was untrue.

Over the years, many jurisdictions have changed their approach to breach of warranty claims, instead analyzing such claims under principles of contract law. Generally, under the contract law theory, reliance on the accuracy of the warranty is not a requirement for recovery, thereby rendering irrelevant a buyer's pre-closing knowledge regarding the accuracy of the seller's warranty.[8] These jurisdictions have been referred to as pro-sandbagging jurisdictions.[9]

So who typically wins the sandbagging battle? It often ends up being a draw with buyers and sellers choosing not to address the sandbagging issue in the purchase agreement.

Michigan

The only case to date applying Michigan law to breach of warranty claims in the context of mergers and acquisitions was decided by a district court in Ohio. In *Grupo Condumex, SA v SPX Corporation,*[10] the plaintiff alleged that the defendant breached a warranty in an asset purchase agreement. The warranty provided that no other parties maintained a right of first refusal to purchase the stock of a joint venture the seller transferred to the buyer as part of the sale. The court, in a separate order, determined that the seller breached the warranty and ordered that ownership of the joint venture stock be transferred by the buyer to the party seeking to exercise its right of first refusal. The buyer then sought damages resulting from the seller's breach. As part of the damages litigation, the seller filed a motion to compel discovery in an attempt to determine whether the buyer had knowledge of the existence of the right of first refusal before the closing of the transaction.

The court, applying Michigan law, determined that reliance was not a necessary element of the buyer's claim for damages and, therefore, the buyer's pre-closing knowledge regarding the accuracy of the seller's warranty was irrelevant. Noting that "[m]odern courts in Michigan adjudicating claims for breach of warranty have not required reliance on the victim's part,"[11] the *Grupo Condumex* court did not find any reason to carve out an exception for warranties typically given by parties in the context of mergers and acquisitions. The court then noted that the majority of jurisdictions faced with this issue have reached similar conclusions.[12]

The *Grupo Condumex* decision is straightforward and places Michigan squarely in the pro-sandbagging camp. However, as a Michigan court has not addressed this issue in a mergers-and-acquisitions context, it is instructive to review how other influential jurisdictions have approached the role of reliance and the buyer's knowledge in a claim based on breach of the seller's warranties in a purchase agreement.

Delaware

In 2002, the Delaware Superior Court in the case of *Kelly v McKesson HBOC, Incorporated*[13] considered whether a buyer's reliance on the target's warranty regarding the accuracy of its securities filings was relevant to a breach of warranty claim related to such filings and, therefore, a proper subject for discovery. In denying the plaintiff's motion for summary judgment, the court noted that the extent of the plaintiff's reliance on the warranty relating to the securities filings at issue raised a factual matter precluding summary judgment. The court emphasized that "[a]ccording to sound Delaware law, a plaintiff must establish reliance as a prerequisite for a breach of warranty claim."[14]

In a series of subsequent decisions, however, the Delaware Superior Court and the Delaware Court of Chancery held that reliance was not a requirement of a breach of warranty claim.[15] As pointed out by the court in *Interim Healthcare, Incorporated v Spherion Corporation,* involving a heavily negotiated stock purchase agreement between the parties:

> To the extent Spherion [the seller] warranted a fact or circumstance to be true in the Agreement, plaintiffs were entitled to rely upon the accuracy of the representation irregardless [sic] of what their due diligence may have or should have revealed. In this regard, Spherion accepted the risk of loss to the full extent of its indemnification commitments in the event its covenants were breached.[16]

New York

Unlike Michigan and Delaware, New York's sandbagging default rule is much more nuanced and requires careful analysis. The seminal New York case addressing the reliance requirement in breach of warranty claims in the context of mergers and acquisitions is *CBS Incorporated v Ziff-Davis Publishing Company,*[17] in which the buyer of a consumer magazine business filed suit against the seller for breach of financial statement warranties.

The court in *Ziff-Davis,* diverging from earlier New York case-law requiring reliance as an element of a breach of warranty claim, determined that contract principles, not tort principles, applied, and that "[t]he right to indemnification depends only on establishing that the warranty was breached."[18] However, instead of finding reliance to be an unnecessary element of a breach of warranty claim under New York law, the majority in *Ziff-Davis* simply reinterpreted the meaning of reliance in this context from reliance on the truth of the warranty itself to "reliance on the express warranty as being a part of the bargain between the parties…."[19]

Subsequent cases applying New York law have limited *Ziff-Davis* to the particular circumstances surrounding that case. For example, in *Galli v Metz,*[20] the buyer purchased a petroleum business from the sellers who warranted in the purchase agreement that they were unaware of any facts that might result in a claim that would adversely affect the value of the business.[21] The sellers provided the buyer with such a warranty despite knowing of environmental concerns involving a parcel of property included in the sale.[22] After a bench trial, the district court in *Galli* found that the environmental concerns were "disclosed" to the buyer before closing, and such knowledge precluded the buyer from any recovery.[23] On appeal, the buyer argued that the issue of knowledge was irrelevant in the wake of *Ziff-Davis.*

The Second Circuit in *Galli* reversed the district court, noting that "*Ziff-Davis* has far less force where the parties agree at closing that certain warranties are not accurate."[24] The Second Circuit then explained that while *Ziff-Davis* "does curtail" the role of reliance in breach of warranty claims, the buyer in *Ziff-Davis* had simply challenged the accuracy of the seller's warranty before closing, a challenge the seller rejected. The Second Circuit in *Galli* emphasized that:

> [w]here a buyer closes on a contract in the 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 the warranties (as CBS did in *Ziff-Davis*), we think the buyer has waived the breach.[25]

"A court must evaluate both the extent and the source of the buyer's knowledge about the truth of what the seller is warranting."

Noting that the parties disagreed on whether the seller disclosed the environmental concerns to the buyer or the buyer learned of them through "common knowledge," the Second Circuit in *Galli* remanded the issue for further fact finding by the district court.[26]

Subsequently, in *Rogath v Siebenmann,*[27] the Second Circuit acknowledged the "fine factual distinctions in [New York's] law of warranties: a court must evaluate both the extent and the source of the buyer's knowledge about the truth of what the seller is warranting."[28] Citing *Galli* for the proposition that a buyer cannot enforce a warranty claim against a seller who disclosed the inaccuracy of the warranty to the buyer before closing, the *Rogath* court proceeded to clarify that if the buyer had independently obtained knowledge of the inaccuracy, or if the inaccuracy was simply "common knowledge," the buyer would not be foreclosed from enforcing a breach of warranty claim based on its knowledge.[29]

The most recent New York case to address this issue in the mergers-and-acquisitions context is *Gusmao v GMT Group, Incorporated,*[30] in which a district court for the Southern District of New York attempted to summarize New York's approach to breach of warranty claims. Citing the *Galli* and *Rogath* limitations on *Ziff-Davis,* the *Gusmao* court observed that New York's nuanced definition of "reliance" in a breach of warranty claim requires a close examination of "both the extent and source of the buyer's knowledge" as to the truth of the warranty.[31] The court denied the sellers' motion for summary judgment concerning the breach of warranty claim, finding that the factual record was not sufficiently developed with respect to how the buyer

learned of the inaccuracy of the sellers' warranty before closing.[32] The *Gusmao* decision clarified that, under New York law, if the seller discloses to the buyer before closing that a particular warranty in the purchase agreement is inaccurate, the buyer will be deemed to have waived its right to recover for breach of this warranty after closing unless the buyer "expressly preserves its rights" under the warranty. On the other hand, if the seller is not the source of the buyer's pre-closing knowledge of the inaccuracy of the seller's warranty, then the buyer will be deemed to have "bargained for" such warranty (as protection in case the warranty did, in fact, turn out to be inaccurate) and may proceed with a breach of warranty claim.

Conclusion

The modern trend under state law is to adopt a contract law approach to recovery of damages under a breach of warranty claim in the context of mergers and acquisitions. Under Michigan and Delaware law, this approach renders the buyer's pre-closing knowledge of the inaccuracy of a seller's warranty irrelevant, thereby providing buyers with some protection even if the purchase agreement does not contain an express pro-sandbagging provision. However, when a purchase agreement is governed under New York law, a buyer's knowledge may be very relevant to a breach of warranty claim depending on the source of the knowledge. Given the state law differences even among jurisdictions adopting the contract law approach to breach of warranty claims, a buyer's decision to execute a purchase agreement without an express pro-sandbagging provision should not be made without a close review of the sandbagging default rules adopted by the relevant jurisdiction. ■

Aleksandra (Aleks) Miziolek is a senior member of the Mergers and Acquisitions Practice at Dykema and the director of Dykema's Automotive Industry Group.

Dimitrios (Jimmy) Angelakos is a real estate transactional associate in Dykema's Chicago office. Before joining Dykema, he served as a judicial clerk to Hon. Charles P. Kocoras of the Northern District of Illinois.

ENDNOTES

1. Douglas Harper, *Online Etymology Dictionary* <http://www.etymonline.com/index.php?allowed_in_frame=0&search=sandbag&searchmode=none> (accessed May 8, 2013).
2. For an interesting discussion of how the term "sandbagging" became a popular deal term in the context of mergers and acquisitions, see Whitehead, *Sandbagging: Default rules and acquisition agreements,* 36 Del J Corp L 1081, 1115 n 4 (2011).
3. 1 ABA Mergers & Acquisitions Comm, Model Stock Purchase Agreement With Commentary (2d ed), 299. In the interest of brevity, this article does not address any distinction between the terms "representations" and "warranties" in this context.
4. *Id.* at 301.
5. ABA M&A Market Trends Subcommittee, *2011 Private Target M&A Deal Points Study,* slide 78, accessible at <http://apps.americanbar.org/dch/committee.cfm?com=CL560003> (accessed May 8, 2013).
6. See Whitehead, n 2 *supra* at 1087.
7. See, e.g., *Dehring v N Mich Exploration Co,* 104 Mich App 300, 307; 304 NW2d 560 (1981).
8. See, e.g., *Interim Healthcare, Inc v Spherion,* 884 A2d 513 (Del Super Ct 2005).
9. See Whitehead, n 2 *supra* at 1108–1115.
10. *Grupo Condumex, SA v SPX Corp,* unpublished opinion and order of the US District Court for the ND of Ohio, issued September 19, 2008 (Docket No. 3:99CV7316).
11. *Id.* at *2.
12. *Id.* at *3.
13. *Kelly v McKesson HBOC, Inc,* unpublished opinion of the Superior Court of Delaware, issued January 17, 2002 (Docket No. CIVA 99C-09-265WCC).
14. *Id.* at *8.
15. See *Interim,* n 8 *supra; Gloucester Holding Corp v US Tape & Sticky Products, LLC,* 832 A2d 116 (Del Ch 2003).
16. *Interim,* n 8 *supra* at 548.
17. *CBS Inc v Ziff-Davis Publ Co,* 75 NY2d 496, 506 n 5; 553 NE2d 997 (1990).
18. *Id.* at 503–504.
19. *Id.* at 503.
20. *Galli v Metz,* 973 F2d 145 (CA 2, 1992).
21. *Id.* at 150.
22. *Id.*
23. *Id.* at 150.
24. *Id.* at 151.
25. *Id.* (stating that the buyer's express reservation of rights in *Ziff-Davis,* which was in the form of a pre-closing letter authored by buyer and accepted by seller providing that "the closing would not *constitute a waiver of any rights or defenses either of [the parties] may have,*" was sufficient to preserve a buyer's potential warranty claims).
26. *Id.*
27. *Rogath v Siebenmann,* 129 F3d 261 (CA 2, 1997).
28. *Id.* at 264.
29. *Id.* at 265.
30. *Gusmao v GMT Group, Inc,* unpublished opinion and order of the US District Court for the SD of New York, issued August 1, 2008 (Docket No. 06 Civ 5113 (GEL)).
31. *Id.* at *5.
32. *Id.* at *10.