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Sandbagging Provisions Under Delaware, New York and Texas Law

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I. INTRODUCTION

This memorandum addresses the enforceability of sandbagging provisions in purchase agreements, and the default rules when such purchase agreements are silent with respect to sandbagging, in Delaware, New York, and Texas. The term sandbagging refers to a situation in which the buyer is or becomes aware that a specific representation and warranty made by the seller in the purchase agreement is untrue, closes the transaction despite its knowledge of such breach, and then seeks to hold the seller liable for such breach post-closing. Whether a buyer may bring a post-closing claim for damages despite knowledge of the underlying breach prior to closing can vary according to what law governs the transaction, how and when the buyer discovers the breach, and whether the purchase agreement specifically addresses the issue of sandbagging. Purchase agreements are increasingly silent as to whether sandbagging is allowed or prohibited.¹ Understanding how courts in the governing jurisdiction will treat the claims for breach of representation and warranty of buyers with pre-closing knowledge is therefore, essential to understanding the risks associated with the purchase agreement.

II. IN BRIEF

As a general rule, a buyer may bring a claim for indemnification when a seller breaches a representation and warranty in the purchase agreement. However, the law varies by jurisdiction as to whether a buyer may bring a post-closing claim for indemnification where the buyer knew *prior to closing* that the seller had breached the underlying representation and warranty.

In some jurisdictions, the default position when the agreement is silent regarding sandbagging is that buyers are required to have justifiably relied on the truth and accuracy of the representation and warranty. *See, e.g., Kazerouni v. De Satnick*, 279 Cal. Rptr. 74, 75-76 (Cal. App. 2d 1991) (upholding lower court ruling prohibiting sandbagging on the basis that buyers must prove reliance under California law); *Hendricks v. Callahan*, 972 F.2d 190, 192-96 (8th Cir. 1992) (holding that, under Minnesota law, buyers must prove reliance and upholding lower court ruling against sandbagging buyer for failure to prove reliance). Generally, this reliance requirement means that buyers may *not* bring post-closing claims for indemnification for a

¹ Charles K. Whitehead, *Sandbagging: Default Rules and Acquisition Agreements*, 36 Del. J. Corp. L. 1081, 1096-97 (2011).

breach of representation and warranty if they had knowledge of the breach prior to closing but nevertheless chose to close.

In jurisdictions that do not require buyers to prove reliance, the default position when the purchase agreement is silent regarding sandbagging is that buyers may bring post-closing claims for indemnification for a breach of representation and warranty despite having knowledge of the breach prior to closing. *See Interim Healthcare, Inc. v. Spherion Corp.*, 884 A.2d 513, 535-539, 548 (Del. Super Ct. 2005) *aff'd* 886 A.2d 1278 (Del. 2005) (holding that, where a seller warrants something in the purchase agreement, the buyer has the right to rely upon that warranty and pursue the benefit of the bargain notwithstanding its knowledge of a breach of that warranty).

Regardless of the governing jurisdiction, the analysis is not likely to be so straightforward as to provide that sandbagging is either flatly allowed or disallowed. As explained below, courts may consider several factors that complicate the analysis. Furthermore, parties may modify the default position of the governing jurisdiction contractually by including either an “anti-sandbagging” provision or a “knowledge-savings” provision (also known as a “benefit-of-the-bargain” provision or a “pro-sandbagging” provision) in the purchase agreement. An anti-sandbagging provision expressly prohibits a buyer from bringing a post-closing claim if that buyer learns prior to closing that the representation and warranty at issue was untrue or breached. A knowledge-savings provision may state that the representations and warranties form the basis of the bargain and expressly preserve the buyer’s right to bring post-closing claims for indemnification, regardless of the buyer’s knowledge prior to closing.

This memorandum addresses the law regarding sandbagging under Delaware, New York, and Texas law, with an aim toward providing practical drafting advice to allow buyers and sellers to allocate sandbagging rights and risks in the purchase agreement. Generally speaking, a review of the law in these three jurisdictions reveals that the choice of law to govern purchase agreements with respect to sandbagging provisions is very important, as the ability to allocate rights and risks with certainty using these provisions varies widely according to the governing law. Of the three jurisdictions, Delaware offers the greatest level of certainty. Furthermore, buyers looking to preserve the benefit of the bargain negotiated in the purchase agreement, and sellers looking to thwart sandbagging behavior, should avoid silence regarding sandbagging. Instead, buyers and sellers should seek an express knowledge-savings or anti-sandbagging provision, as applicable, to clarify their expectations about risk allocation for the courts enforcing their purchase agreements.

III. DELAWARE

Recent case law suggests that contracting parties will find the most certainty regarding sandbagging in Delaware, as courts have treated binding contractual promises as the basis of the bargain and have allowed post-closing claims for breach of representations and warranties—even where the buyer has gained pre-closing knowledge of the underlying breach.

A. Default Position—Purchase Agreement is Silent Regarding Sandbagging

Since 2003, courts applying Delaware law have allowed buyers with pre-closing knowledge of a breach of representation and warranty to bring post-closing claims for

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