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A (Foot)note About Sandbagging in M&A Transactions

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The concept of sandbagging is relatively simple. In jurisdictions that allow M&A purchasers to sandbag sellers, a buyer has the right to rely on the verbatim text of the sale agreement and does not need to show it relied on the accuracy of the representations and warranties in the sale agreement in order to sue if one of the representations or warranties is inaccurate. At its extreme, a purchaser can have specific knowledge prior to closing that a representation or warranty is inaccurate, keep that information to itself, and then sue for breach of that representation the day after closing. While the concept has been challenged as both inequitable and unethical by certain commentators and courts, some courts have endorsed the theory by relying on strict rules of contracting.

The issue can arise in one of several ways. At the drafting stage, the contracting parties may seek to include either pro-sandbagging or anti-sandbagging provisions into the agreement of sale. When sophisticated parties agree, the courts will generally enforce the agreed-upon terms. (See, e.g., *Telephia v. Cuppy*, 411 SF. Supp. 2d 1178 (N.D. Cal, 2006).) Most often in litigation, however, the issue arises where the sale agreement is silent, either because neither side raised the issue during the negotiations or because one or both sides rejected pro- or anti- sandbagging language inserted by the other.

Delaware has a complicated history of dealing with sandbagging and its lower courts have grappled with this issue for almost a century with inconsistent results. In 1916, the Superior Court addressed a breach of warranty regarding the soundness of a horse, finding that the plaintiff must prove that "the horse was warranted by the defendant to be sound, and that the plaintiff relied upon such warranty," see *Loper v. Lingo*, 29 Del. 170 (Del. Super. Ct. 1916). Over the subsequent decades, a sporadic, but generally consistent, line of cases held that breach of warranty requires a showing of reliance, which necessarily precludes sandbagging. (See, e.g., *Bleacher v. Bristol-Myers*, 53 Del. 1 (Del. Super. Ct. 1960).)

That changed in *Gloucester Holding v. U.S. Tape & Sticky Products,* 832 A.2d 116 (Del. Ch. 2003), where the court found—without citation to any prior case-law—that "reliance is not an element of a claim for indemnification" for damages caused by a breach of warranty. Later opinions quickly echoed the holding of *Gloucester* and held that "the extent or quality of plaintiffs' due diligence is not relevant to the determination of whether [the defendant] breached its representations and warranties," see *Interim Healthcare v. Spherion,* 884 A.2d 513, 548 (Del. Super. Ct.), aff'd, 886 A.2d 1278 (Del. 2005). Not all courts went down this new line, however, and some continued to follow the *Loper* line of cases. (See *MicroStrategy v. Acacia Research*, No. CIV.A. 5735-VCP, at *10 (Del. Ch. Dec. 30, 2010).)

The Delaware Supreme Court has never analyzed the issue and, as a result, the *Loper* and *Gloucester* lines have persisted in parallel, with the opinions seldom acknowledging the existence of the other. The law across the country is equally inconsistent. In California, for example, anti-sandbagging is the default common law rule. (See, e.g., *Grinnell v. Charles Pfizer & Co.*, 274 Cal.App.2d 424, 440 (Cal. Ct. App. 1969).) Others, such as New York, take a hybrid approach by allowing sandbagging, but with exceptions. Under this approach, the seller's warranties are a part of the basis of the bargain, and thus the buyer can sue on those warranties even if he believed

they were false, as in *CBS v. Ziff–Davis Publishing,* 75 N.Y.2d 496 (1990). However, when the seller discloses the inaccuracy of the warranties, "it cannot be said that the buyer … believed he was purchasing the seller's promise as to the truth of the warranties," as in *Rogath v. Siebenmann*, 129 F.3d 261, 265 (2d Cir. 1997). Therefore, the warranties are not part of the bargain and the buyer cannot sue for breach. Many other courts, however, apply a strict "no reliance" or "pro-sandbagging" default approach. See generally Charles K. Whitehead, "Sandbagging: Default Rules & Acquisition Agreements," 36 Del. J. Cop. Law. 1082, 1108-15 (2011) (collecting cases from many jurisdictions).

The issue has the attention of the Delaware Supreme Court. This past spring, in *Eagle Force Holdings v. Campbell*, — A.3d —- (2018), a majority of the court dropped a footnote that in dicta characterized the sandbagging issue as "interesting" and noted that the Supreme Court had not yet analyzed it. The dissenting opinion also included a footnote, and appeared inclined to require reliance.

Given Delaware's important place in M&A transactions, the Supreme Court should take the appropriate opportunity to clarify the state's default rule on sandbagging. Adopting pro-sandbagging as the default rule would de-emphasize the importance of due diligence and discourage candid communication in the sale process, which is arguably required by the implied covenant of good faith and fair dealing. The better approach is to allow the parties the freedom to contract for a sandbagging right and negotiate its value between them. When they choose not to do so, Delaware courts should not force upon them a default rule that will inevitably produce inequitable results and discourage good faith and fair play.

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