Bloomberg Law Reports® Mergers & Acquisitions

Trends in M&A Provisions: "Sandbagging" and "Anti-Sandbagging" Provisions

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What Are "Sandbagging" and "Anti-Sandbagging" Provisions?

A "sandbagging" provision (sometimes referred to as a "pro-sandbagging" provision) in a M&A agreement (asset purchase agreement, stock purchase agreement, or merger agreement) states that a buyer's remedies against the seller under the agreement will not be impacted by whether or not the buyer had knowledge, prior to closing the deal, of the facts or circumstances giving rise to the claim. In other words, even if the buyer knew of the problem at hand—whether it be the company's non-compliance with applicable laws, a breach of a customer contract, or other breach of a representation, warranty or covenant—it could decide to complete the acquisition with that knowledge, and then proceed against—or "sandbag"—the seller for recourse under the agreement.

An "anti-sandbagging" clause, as the name suggests, prohibits the buyer from "sandbagging" the seller, by limiting the buyer's ability to seek recourse with respect to matters which the buyer knew about at closing.

A typical pro-sandbagging provision could read as follows:

> The rights of the Purchaser to indemnification or any other remedy under this Agreement shall not be impacted or limited by any knowledge that the Purchaser may have acquired, or could have acquired, whether before or after the closing date, nor by any investigation or diligence by the Purchaser. The Seller hereby acknowledges that, regardless of any investigation made (or not made) by or on behalf of the Purchaser, and regardless of the results of any such investigation, the Purchaser has entered into this transaction in express reliance upon the representations and warranties of the Seller made in this Agreement.

A typical anti-sandbagging provision could read as follows:

> The Purchaser acknowledges that it has had the opportunity to conduct due diligence and investigation with respect to the Company, and in no event shall the Seller have any liability to the Purchaser with respect to a breach of representation, warranty or covenant under this Agreement to the extent that the Purchaser knew of such breach as of the Closing Date.[1]

The Buyer's Position

The buyer's arguments for requesting a "sandbagging" provision (and resisting an "anti-sandbagging" provision) generally take the form of one or more of the following:

1. *Eliminates Post-Closing Disputes about "Knowledge."* An anti-sandbagging provision creates an additional hurdle, and potential dispute, for every indemnity claim—*i.e*., before the parties can even reach the merits of the claim, the issue of the buyer's knowledge or lack thereof would need to be resolved. This can be particularly difficult if "knowledge" is defined (or construed) to include any type of constructive knowledge of the buyer (in addition to actual knowledge). Which of the buyer's executives or employees are to be included in the "knowledge pool" and for what purposes—should, for example, an environmental specialist be charged with knowledge about intellectual property issues? And what type of "disclosure" creates "knowledge"—does a passing comment by the company's president about an "employment issue" as the buyer's team is rushing to grab a taxi after a full day's negotiation impart knowledge of that issue?
2. *Dis-incentivizes Proper Diligence.* By eliminating or impairing the ability to assert claims if the seller can show that specific buyer representatives "knew" about the problem, the buyer may be better off not fully diligencing potential risk areas in order to avoid reaching the knowledge hurdle. Full and robust diligence by the buyer is in the interest of both sides.
3. *Seller Disclosures Should Be Used to Impart "Knowledge*." The appropriate way to charge the buyer with knowledge so as to prohibit a claim is to affirmatively disclose the issue within the seller's disclosure schedules. Unless the buyer and seller otherwise agree, which they are free to do, and assuming the disclosure adequately describes the matter as an exception to the appropriate representation or warranty, the buyer would generally not have recourse with respect to facts or circumstances disclosed in the disclosure schedules. As a related point, buyers will often argue that it is not in their interest to "close and sue" on a breach, and that it is far better for a buyer to resolve all outstanding issues, to the extent possible, prior to closing.

The Seller's Position

Sellers generally have their own points of view about the need for an "anti-sandbagging" clause, including the following:

1. "*Close and Sue*." It is unfair for a seller to "open its files" to a buyer for a full due diligence exercise, to then have that buyer withhold information about a problem from the seller, acquire the business, and sue after the fact to adjust the purchase price through a damages claim.
2. *Facilitates Collaborative Disclosures*. An "anti-sandbagging" clause helps ensure that if the buyer learns of a potential problem during its diligence, it will raise the issue with the seller before the closing, which will help facilitate full and responsive disclosure as well as discussions about how to deal with the issue as between the buyer and the seller. For example, if a potential area of litigation or regulatory risk is uncovered by the buyer in its diligence, the seller and buyer could jointly determine the level of risk, whether or not that risk was insured (or insurable), and how the residual risk should be allocated as between buyer and seller—such as through a specific special indemnity subject to caps and time periods tailored to that risk.

Results Where the Agreement Is Silent as to Sandbagging

As noted below, American Bar Association surveys of M&A transactions suggest that M&A agreements are increasingly silent as to sandbagging—*i.e.*, the agreement neither expressly allows nor prohibits sandbagging. In such situations, the state law governing the agreement will determine whether silence on the topic either permits or disallows sandbagging.

State law will differ from state to state, but because New York is often the controlling law in acquisition agreements, a short review of the status of New York law on this issue is instructive. In short, in the absence of an express preservation of the buyer's rights, in New York the issue hinges on whether or not the buyer believed it was "purchasing the promise as to the truth" of the relevant warranties.

CBS Inc. v. Ziff-Davis Publishing Co. et. al[2] established the general rule, which was expanded and clarified in later cases. *Ziff-Davis* involved the purchase of various magazine businesses. The seller warranted in the purchase agreement as to the accuracy of certain financials that the buyer questioned, after the signing of the agreement but prior to the closing, based on its own diligence. The seller said that there was "no merit" to the buyer's position, and the buyer agreed to close "on a mutual understanding that the decision to close, and the closing, [would] not constitute a waiver of any rights or defenses either [party] may have."[3] The buyer then sued, claiming that the seller had breached its warranties with respect to the profitability of the businesses acquired. The court determined that the primary issue was "not whether the buyer believed in the truth of the warranted information, as [the seller] would have it, but 'whether [it] believed [it] was purchasing the [seller's] promise [as to its truth].'"[4] In *Ziff-Davis*, the court found that the buyer was buying businesses "which it believed to be of a certain value based on information furnished by the seller which the seller warranted to be true" and therefore, the buyer was in fact purchasing the promise as to the truth of the warranty.[5]

Later cases in New York expanded on the finding in *Ziff-Davis* to determine when a buyer is purchasing the promise as to the truth of a warranty and when the buyer is not doing so. In *Galli v. Metz*,[6] the court stated that "where 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 that buyer expressly preserves his rights under the warranties (as CBS did in *Ziff-Davis*), we think the buyer has waived the breach."[7] In *Galli*, the court addressed the issue of how the buyer knew that the warranty was not true. If, as stated above, the seller disclosed the problem, the buyer would be precluded because, the logic is, he did not think he was purchasing the truth of that warranty. If, however, the information is disclosed by a third party or is common knowledge, the *Galli* court stated that the buyer would have a stronger argument.[8]

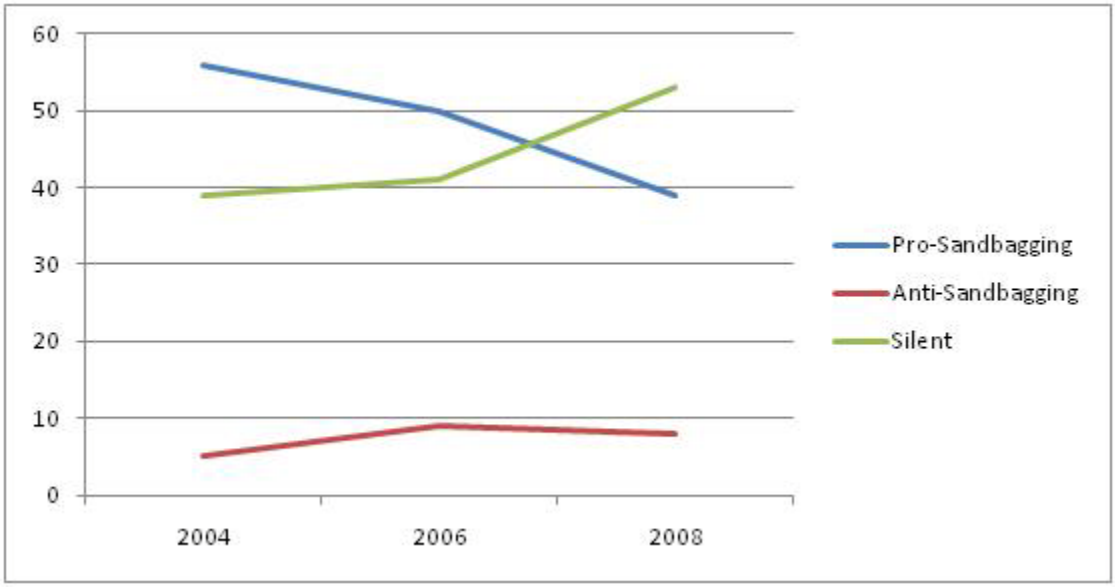
Given the fact-specific nature of these cases and the potential difficulty of determining what was disclosed and by whom, parties entering into an acquisition agreement should be aware that, absent a sandbagging or anti-sandbagging provision (and depending on the applicable state law), any dispute about a breached representation or warranty could potentially lead to a long period of discovery into what the buyer knew and when and how the buyer learned of the information. Further, it is not clear from the case law in New York how the buyer's knowledge is determined. For example, if one sentence hidden in many boxes full of documents provided to the buyer by the seller disclosed information that a warranty might not be true, but the buyer did not come across that sentence, did the buyer know that the warranty was not true and did the seller make the disclosure?

Trends in Usage of Sandbagging and Anti-Sandbagging Provisions

In 2009, the American Bar Association released its Private Target Mergers and Acquisitions Deal Points Study.[9] The 2009 study looked at purchase agreements covering 106 private company transactions that occurred in 2008. These transactions ranged in size from $25 million to $500 million, across a broad range of industry sectors.

According to the 2009 study, 39% of the agreements included a pro-sandbagging provision, 8% of the agreements included an anti-sandbagging provision, and 53% of the agreements were silent on the issue. The ABA's similar review of private company transactions in 2007 for transactions in 2006 showed percentage levels amongst these three options at 50%, 9% and 41%, respectively. Its 2005 review of private company transactions in 2004 reflected these options at 56%, 5% and 39%, respectively.

The chart below shows the trends in how private company M&A agreements are dealing with sandbagging (by percentage, according to the three most recent ABA studies): pro-sandbagging, anti-sandbagging, and silent:



Conclusion

Assuming that the ABA studies reasonably reflect general practice in M&A transactions, it appears that more practitioners are deciding (or agreeing as a compromise) to be silent on the issue of sandbagging. That approach is not, as discussed above, without risk. At the same time, the use of pro-sandbagging clauses seems to be declining (something somewhat surprising to the authors), and the use of anti-sandbagging provisions appears to be holding but fairly infrequent (which is not a surprise to the authors). The result of choosing to be silent on the issue of sandbagging may well depend on what law the parties choose as governing law—a decision often driven more by considerations of indemnification, non-compete enforceability or other issues than by any anti-sandbagging concerns.

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[1] Anti-sandbagging provisions often focus on representations and warranties, but can cover pre-closing covenants as well in deferred sign/close transaction agreements.

[2] 75 N.Y.2d 496 (1990).

[3] *Id.* at 501.

[4] *Id.* at 503 (quoting *Ainger v. Michigan Gen. Corp*., 476 F. Supp. 1209, 1225 (S.D.N.Y. 1979)).

[5] *Id.* at 505.

[6] 973 F.2d 145 (2d Cir. 1992).

[7] *Id.* at 151.

[8] *Id*. The same court, dealing with the sale of goods under the UCC but citing *Ziff-Davis*, concurred that the source of the information is relevant, stating that "what the buyer knew and . . . whether he got that knowledge from the seller are the critical questions." *Rogath v. Siebenmann* 129 F.3d 261, 265 (2d Cir. 1997).

[9] A project of the Mergers & Acquisitions Market Trends Subcommittee of the Mergers & Acquisitions Committee (formerly called the Committee on Negotiated Acquisitions) of the ABA's Section of Business Law; available at http://apps.americanbar.org/dch/committee.cfm?com=CL560003 (last visited March 11, 2011).