Knowledge is Not Necessarily Power: Sandbagging in New York M&A Transactions

Brandon Cole*

* J.D. / M.B.A. Candidate, University of Iowa, 2017; B.B.A., University of Iowa, 2013. I would like to thank Michael Abbott for suggesting the topic of this Note.

I. INTRODUCTION

Sandbagging is a practice in the mergers and acquisitions (M&A)[1] context that involves "one party to an acquisition agreement (most often a buyer) seeking post-closing indemnification for breaches of representations and warranties, which breaches that party was aware of prior to signing the acquisition agreement or, in some cases, closing the transaction."[2] Buyers and sellers of businesses should be aware of this practice as it has implications for both of them. For buyers, it is a potential avenue for indemnification, and for sellers, it means a potential lawsuit.[3] Parties can directly approach this issue by incorporating sandbagging or anti-sandbagging provisions into the acquisition agreement.[4]

However, if either party does not do so and the acquisition agreement is silent on sandbagging, the state law governing the acquisition agreement will determine the appropriate outcome.[5] The focus of this Note, the State of New York, has ambiguous sandbagging case law that has made it difficult to predict what the appropriate outcome would be for buyers and sellers of businesses.[6] Despite that ambiguity, this Note argues that the New York approach is preferable to other approaches—such as those seen in California and Delaware—because it is the most equitable to all parties.

This Note will proceed as follows. Part II will begin with a background on sandbagging that includes a detailed discussion of what sandbagging is, sandbagging trends in the M&A community, and how various courts, with an emphasis on New York courts, approach sandbagging when an acquisition agreement is silent on the matter. Part III will give arguments on the reasons for incorporating a sandbagging or anti-sandbagging provision and it will discuss the various ambiguities under New York sandbagging law. Part IV will include sandbagging related recommendations for buyers and sellers in a transaction. It will also give recommendations for how New York courts, when the acquisition agreement is silent on sandbagging, can solve some of the current ambiguities that have arisen due to the relevant case law. Finally, the Note will conclude with Part V, which will give a brief summary of this Note.

II. BACKGROUND

This Part will first begin with a more detailed discussion of what sandbagging is—including examples of sandbagging provisions and anti-sandbagging provisions. This Part will then provide a brief discussion of sandbagging trends within the M&A community. It will then discuss how various jurisdictions approach sandbagging when the acquisition

1. An acquisition "is the buying of one company (the 'target') by another," while a merger "is a combination of two companies into one larger company." Ian Giddy, *Mergers & Acquisitions: Definitions and Motivations*, N.Y.U., http://pages.stern.nyu.edu/~igiddy/articles/mergers_and_acquisitions.html (last visited Oct. 16, 2016). This Note is primarily concerned with acquisitions.

2. Iovine III, *infra* note 7, at 1.

3. *See id.* (discussing sandbagging and how it can impact the involved parties).

4. McCarthy, *infra* note 10.

5. Avery & Weintraub, *infra* note 15.

6. *See* Wolf & Solum, *infra* note 22, at 1 (discussing how New York state law is less clear as it relates to sandbagging).

agreement is silent on the matter, with an emphasis on New York state law.

A. Sandbagging Explained

Sandbagging is a practice in the M&A context that involves "one party to an acquisition agreement (most often a buyer) seeking post-closing indemnification for breaches of representations and warranties, which breaches that party was aware of prior to signing the acquisition agreement or, in some cases, closing the transaction."[7] An example of a breach of representation and warranty could include an instance where a seller of a business does not accurately depict the profitability of its business to the buyer.[8] Sandbagging can include instances where the seller had knowledge of the breach and instances in which the seller had no knowledge of the breach prior to closing.[9] Parties can directly approach this issue by incorporating sandbagging or anti-sandbagging provisions into the acquisition agreement.[10] An example sandbagging provision may provide:

> 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.[11]

On the other hand, an anti-sandbagging provision may provide: "[n]o 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."[12]

However, trends suggest that acquisition agreements have become increasingly silent on the issue of sandbagging.[13] The most recent data released by the American Bar Association indicates that 56% of acquisition agreements are silent on the matter.[14] Because sandbagging provisions favor the buyer, while anti-sandbagging provisions benefit the seller,[15] one possible reason for this trend is that buyers and sellers agree to be

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7. Luke P. Iovine III, *Sandbagging in M&A Deals: Silence May Not Be Golden*, STAY CURRENT (Paul Hastings, New York, N.Y.), Oct. 2012 at 1, http://www.paulhastings.com/Resources/Upload/Publications/2271.pdf.

8. CBS Inc. v. Ziff-Davis Publ'g Co., 553 N.E.2d 997, 998 (N.Y. 1990).

9. Iovine III, *supra* note 7, at 1.

10. *See* Brendan J. McCarthy, *Sandbagging in M&A Deals: Is Silence Golden For Buyers?*, SRR, http://www.srr.com/article/sandbagging-ma-deals-silence-golden-buyers (last visited Oct. 16, 2016) (discussing the ability to incorporate pro-sandbagging and anti-sandbagging provisions in purchase agreements).

11. Aleksandra Miziolek & Dimitrios Angelakos, *Sandbagging: From Poker to the World of Mergers and Acquisitions*, 92 MICH. B.J. 30, 30 (2013).

12. *Id.* at 31.

13. Avery & Weintraub, *infra* note 15.

14. ABA, *infra* note 17, at 63.

15. *See* Daniel Avery & Daniel H. Weintraub, *Trends in M&A Provisions: "Sandbagging" and "Anti-Sandbagging" Provisions*, BLOOMBERG L. REP.: MERGERS & ACQUISITIONS (2011), http://www.goulstonstorrs.com/portalresource/lookup/wosid/contentpilot-core-6-18120/pdf.name=/avery%20weintraub2%20sandbagging%20provisions%20(2).pdf (discussing the buyer's position for pro-sandbagging provisions and the seller's position for anti-sandbagging provisions).

silent as a compromise.[16] Figure 1 illustrates these trends from 2010 to 2014.

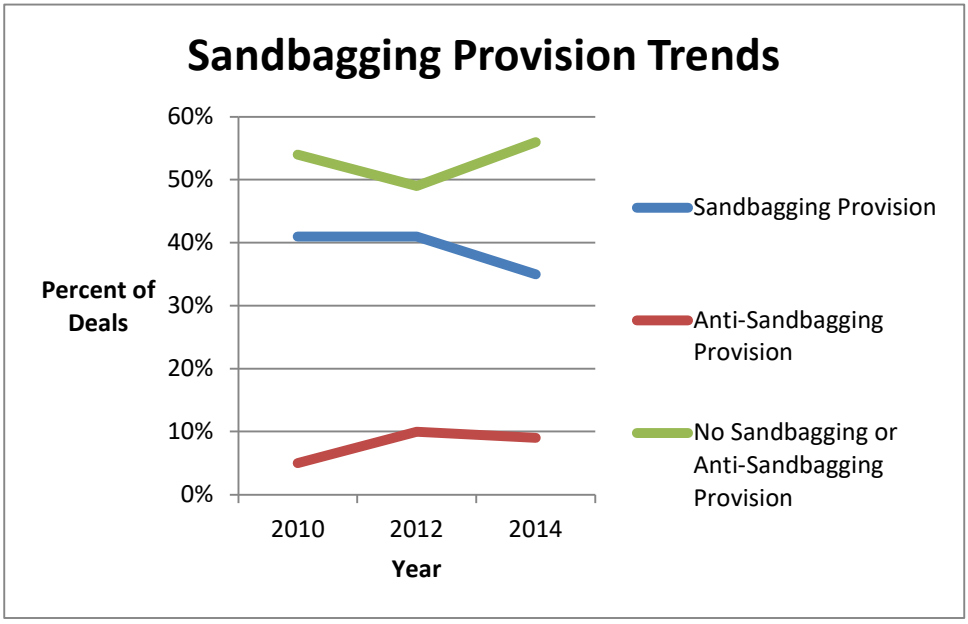

Figure 1 (illustrating the trends from 2010 to 2014)[17]

In situations where the acquisition agreement is silent on sandbagging, the state law governing the acquisition agreement will determine the appropriate outcome.[18] For instance, Delaware does not require a buyer to prove reliance on the truth of the representation in order to assert a breach of warranty claim[19] (thus the buyer can have

16. *Id.*

17. *Private Target M&A Deal Points Study*, ABA 1, 63 (2015), http://www.americanbar.org/content/dam/aba/administrative/business_law/deal_points/2015_private_study.authcheckdam.pdf.

18. Avery & Weintraub, *supra* note 15. For a more detailed look at the approach various states take, see Charles K. Whitehead, *Sandbagging: Default Rules and Acquisition Agreements*, 36 DEL. J. CORP. L. 1081, 1108–15 (2011) (discussing the approaches of 21 states as it relates to sandbagging and breach of warranty claims in commercial transactions). It is also worth noting that the respective state law will determine the appropriate statute of limitations. *See* Presentation, Michael T. Wolf et al., Rep and Warranty Breaches in M&A Transactions: Common Claims and Navigating the Road to Recovery (Feb. 10, 2015), at 21, https://www.acc.com/chapters/chic/upload/Rep-and-Warranty-Breaches-in-MA-Transactions-CLE-Materials.pdf (describing the statute of limitations as the "[d]eadline for filing a particular type of claim"). The statute of limitations in New York is six years, in California four years, and in Delaware three years. *Id.* As it relates to sandbagging and bringing a breach of representation claim, the statute of limitations begins at the time of closing. *Id.*

19. McCarthy, *supra* note 10. For a sandbagging case (where the acquisition agreement is silent on sandbagging) under Delaware law, see Interim Healthcare, Inc. v. Spherion Corp., 884 A.2d 513, 548 (Del. Super. Ct. 2005) (holding no reliance is required for the buyer to make a breach of contract claim); Cobalt Operating, LLC v. James Crystal Enters., LLC, No. Civ. A. 714–VCS, 2007 WL 2142926, at *28 (Del. Ch. July 20, 2007) (holding that the buyer's "breach of contract claim is not dependent on a showing of justifiable reliance").

knowledge of a breach of warranty prior to closing and still successfully sandbag the seller). In contrast, California requires "a buyer to demonstrate that it relied on the truth of the representation in order for it to bring a successful breach of warranty claim"[20] (thus if the buyer has knowledge of a breach of warranty prior to closing, they cannot successfully sandbag the seller).

New York, which is often the governing law in acquisition agreements, takes an approach that is in between Delaware and California.[21] This has resulted in a more ambiguous rule as it relates to pre-closing knowledge and asserting a breach of warranty claim.[22] This Note will focus specifically on New York sandbagging law. The next Section will discuss the line of cases that have led to how sandbagging is handled in the State of New York when an acquisition agreement is silent on the matter.

B. The Foundation of the Current Rule

CBS Inc. v. Ziff-Davis Publishing Co.[23] is responsible for establishing the general rule in New York, which requires a buyer to believe it is "'purchasing the promise as to the truth' of the relevant warranties."[24] In *CBS*, a buyer agreed to acquire a business based on the profitability information that the seller provided in addition to express warranties regarding the information's truthfulness.[25] The buyer, through its own research, came to believe the profitability information was not accurate.[26] The buyer and seller, despite the buyer bringing this discovery to the attention of the seller, agreed to continue with the deal and ultimately closed it ("with the mutual understanding that it would not in any way affect the previously asserted position of either party").[27] The buyer subsequently brought suit for breach of warranty.[28]

The court stated that the appropriate standard is whether the buyer believed it was purchasing the truthfulness of the seller's promise.[29] Thus, the court held the buyer could sue for breach of warranty.[30] They reasoned this by stating "the fact that the buyer has questioned the seller's ability to perform as promised should not relieve the seller of his obligations under the express warranties when he thereafter undertakes to render the

20. McCarthy, *supra* note 10. For a sandbagging case where the acquisition agreement is silent on sandbagging under California law, see Kazerouni v. De Satnick, 279 Cal. Rptr. 74, 76 (Cal. Ct. App. 1991) (holding that the buyer was required to prove reliance); Jue v. Smiser, 28 Cal. Rptr. 2d 242, 244 (Cal. Ct. App. 1994) (holding "reliance must be established [for the buyer] at the time the initial contract is struck").

21. McCarthy, *supra* note 10. New York (along with Delaware) is sometimes referred to as a pro-sandbagging jurisdiction because "a majority of buyers will have some right to sandbag." Iovine III, *supra* note 7, at 2. However, Part II.D illustrates that New York law is not as sandbagging-friendly as Delaware law and thus a smaller amount of buyers have a right to sandbag under New York law.

22. *See* Daniel E. Wolf & Matthew Solum, *Delaware vs. New York Governing Law—Six of One, Half Dozen of Other?*, KIRKLAND M&A UPDATE (KIRKLAND & ELLIS, NEW YORK, N.Y.), DEC. 17, 2013, at 1, http://www.kirkland.com/siteFiles/Publications/MAUpdate_121713.pdf (discussing how New York law is less clear as it relates to sandbagging).

23. CBS Inc. v. Ziff-Davis Publ'g Co., 553 N.E.2d 997 (N.Y. 1990).

24. Avery & Weintraub, *supra* note 15.

25. *CBS*, 553 N.E.2d at 998.

26. *Id.*

27. *Id.*

28. *Id.* at 999.

29. *Id.*

30. *CBS*, 553 N.E.2d at 1002–03.

promised performance."[31]

C. The CBS Rule Gets Clarified

The holding in *CBS* was clarified further by two additional cases. In *Galli v. Metz*,[32] the court stated that when the buyer and seller agree that certain warranties are inaccurate, the buyer is foreclosed from a breach of warranty claim.[33] The court noted that when a party knows that there is a breach of warranty, the source of that knowledge is relevant.[34]

For instance, if a third party disclosed the breach of warranty, the buyer in *Galli* would have a strong argument under the *CBS* rule.[35] This distinction was later illustrated in *Rogath v. Siebenmann*.[36] *Rogath* stated that if the source of buyer knowledge is common knowledge or a third party disclosed the information to them—and the source is not the seller—the buyer may prevail in a breach of warranty claim.[37]

D. Putting It All Together: New York Sandbagging Law Today

Taking all of these cases together, a succinct reading of the New York sandbagging rule could state:

> [U]nless there is an effective pro-sandbagging clause in the M&A agreement, a purchaser's knowledge prior to closing of a breach of a representation, warranty or covenant contained in a M&A agreement will prevent that purchaser from seeking damages or indemnification post-closing IF the purchaser is aware of such breach as a result of the vendor's disclosure.[38]

Like California, the New York approach requires a form of reliance as part of a breach of warranty claim.[39] However, this reliance is limited to the buyer believing "it was purchasing the truth of the warranty" and not actually believing in the warranty itself.[40] The absence of reliance, albeit only in certain situations, is similar to the Delaware rule approach where no reliance is required.[41] These situations, as previously discussed, hinge on how the buyer learned of the breach of warranty.[42] The following

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31. *Id.* at 1001.

32. Galli v. Metz, 973 F.2d 145 (2d Cir. 1992).

33. *Id.* at 151 (holding that when "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").

34. *Id.*

35. *Id.*

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

37. *Id.*; *see also* Gusmao v. GMT Grp., Inc., No. 06 Civ. 5113(GEL), 2008 WL 2980039, at *5 (S.D.N.Y. Aug. 1, 2008) (stating the source of buyer information is a critical question); Merrill Lynch & Co. v. Allegheny Energy, Inc., 500 F.3d 171, 186 (2d Cir. 2007) ("[T]he general rule is that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue.").

38. Joe Brennan, *"Sandbagging" and "Knowledge" Clauses in M&A Agreements*, SHEA NERLAND LAW (Nov. 2, 2012), http://www.snclaw.com/cgblog/48/123/Sandbagging-and-Knowledge-Clauses-in-M-A-Agreements.

39. McCarthy, *supra* note 10.

40. *Id.*

41. *Id.*

42. *Id.*

Part will discuss how this in-between approach in New York results in ambiguities as it relates to pre-closing knowledge and asserting a breach of warranty claim.[43]

III. ANALYSIS

This Part will first discuss a buyer's arguments for incorporating a sandbagging provision in an acquisition agreement. It will then discuss the seller's counter-argument for incorporating an anti-sandbagging provision. Finally, the Part will conclude with a discussion of the ambiguities that arise under New York law when an acquisition agreement is silent on the matter of sandbagging.

A. The Arguments for Incorporating a Sandbagging Provision

A buyer would prefer to include a sandbagging provision for several reasons.[44] The first reason is that a sandbagging provision eliminates potential post-close litigation regarding buyer knowledge.[45] For instance, if an anti-sandbagging provision was included in the acquisition agreement, the problem of whether or not the buyer had knowledge prior to signing the agreement would need to be resolved before the buyer and seller could reach the merits of the breach of warranty claim.[46] This obstacle is magnified if the definition of *knowledge* includes not only actual knowledge, but also constructive knowledge.[47] For instance, it is unclear if a buyer has knowledge in the case of a lower level employee receiving actual knowledge, but not passing it along to an executive.[48] Similarly—for constructive knowledge purposes—it is unclear in what cases should "an environmental specialist be charged with knowledge about intellectual property issues."[49]

A second reason for including a sandbagging provision is that an anti-sandbagging provision encourages a seller to thoroughly prepare disclosure schedules[50] within the acquisition agreement.[51] This allows the buyer to have a more accurate disclosure.[52] Thus, the buyer can better assess potential areas of risk and the seller can minimize the possibility of future litigation by disclosing potential problems.[53]

On the other hand, if an anti-sandbagging provision is included a buyer can argue that the provision could encourage him or her to do a minimal amount of diligence

43. Wolf & Solum, *sup*ra note 22, at 1 (classifying New York law as less clear than Delaware law regarding sandbagging).

44. *See* Avery & Weintraub, *supra* note 15 (discussing the buyer's arguments for wanting to include a sandbagging provision in an acquisition agreement).

45. *Id.*

46. *Id.*

47. *Id.*

48. *See id.* (stating the challenge of deciding which executives or employees should be included in the "knowledge pool").

49. Avery & Weintraub, *supra* note 15.

50. *See* Moncrieff, *infra* note 69 (explaining how disclosure schedules can serve as exceptions to representations and warranties and in turn prevent a buyer from seeking recourse with respect to those matters).

51. *Id.*; *see also* Avery & Weintraub, *supra* note 15 (discussing how buyers argue that using disclosure schedules is the appropriate way for sellers to communicate knowledge to buyers).

52. Moncrieff, *infra* note 69.

53. *See id.* (inferring that, because disclosure schedules can serve as exceptions to representations and warranties, buyers can identify risk areas within these disclosures. This in turn prevents a buyer from seeking recourse with respect to those matters).

because less knowledge could increase the likelihood of successfully seeking recourse.[54] Buyers can argue that closing and suing is not in their best interest and it is preferable to resolve all issues prior to closing.[55] Thus, a buyer can argue that "[f]ull and robust diligence by the buyer is in the interest of both sides."[56]

A buyer can also argue that an anti-sandbagging provision results in a scenario where, if it makes a post-close breach of warranty claim, the "buyer will be unable to prevail on a motion for summary judgment [because the] seller will always raise the factual question of whether the buyer had prior knowledge of the breach."[57] By being unable to prevail on a motion for summary judgment, buyers will potentially have to spend additional time and financial resources on litigation.[58]

One final argument a buyer can make is that they do not want to risk harming their reputation by "unfairly" closing and suing the seller.[59] This is important for frequent buyers, such as private equity firms,[60] who have a need to guard their reputation,[61] because private equity firms rely on doing deals and thus they cannot afford to risk ruining their reputation in order to help ensure they are not neglected by future sellers.[62] If a buyer closed and sued a seller, future sellers would be more hesitant about doing a transaction with that buyer.[63]

B. The Arguments for Incorporating an Anti-Sandbagging Provision

On the other hand, sellers would like to incorporate an anti-sandbagging provision to prevent a buyer from suing for damages subsequent to closing.[64] In the viewpoint of a seller, it is unfair for a buyer to not disclose that they know the seller is potentially

54. *Id.*

55. Avery & Weintraub, *supra* note 15*; see also* Lawrence Hsieh, *Sandbagging Provisions; Cumulative vs. Exclusive Remedies*, GC N.Y. (Aug. 11, 2011), http://gcnewyork.com/columns11/081111hsieh.html (stating that "it's usually in the buyer's best interest to notify the seller" and "[i]n many cases, the parties delay the closing until the seller is able to repair the problem").

56. Avery & Weintraub, *supra* note 15.

57. Andrew N. Davis & Jason C. Hillman, *Sandbagging & Environmental Issues in Corporate Transactions*, CORP.LIVEWIRE (Mar. 5, 2013), http://www.shipmangoodwin.com/files/19375_DavisHillmanSandbagger.pdf.

58. *See* Jason Beaulieu, *The Value of Summary Judgment*, DAILY RECORD (Mar. 16, 2010), http://thedailyrecord.com/2010/03/16/the-value-of-summary-judgment/ (discussing the value of summary judgment as it can save litigants "time, effort, and money").

59. *See* Matthew D. Cain et al., *Broken Promises: The Role of Reputation in Private Equity Contracting and Strategic Default*, 40 J. CORP. L. 565, 593 (2015) (concluding a private equity buyer's "reputation among targets has an identifiable economic value").

60. *See* Kaplan & Strömberg, *infra* note 93, at 121 (describing private equity). An additional example of a frequent buyer could be a strategic acquirer looking to expand their firm, such as Google acquiring advertising technology companies. *See Strategic Acquirer*, STARTUPDEFINITION.COM, http://www.startupdefinition.com/strategic-acquirer (last visited Oct. 16, 2016) (giving the definition of a strategic acquirer and an example).

61. *Negotiating with the Private Equity Buyer: Suggestions for the Owner of the Selling Business*, HAWLEY TROXELL (Feb. 28, 2014), http://www.hawleytroxell.com/2014/02/negotiating-with-the-private-equity-buyer-suggestions-for-the-owner-of-the-selling-business/.

62. *Id.*

63. *See id.* (discussing how a bad reputation can negatively impact a buyer). This statement makes the reasonable assumption that at least some sellers would view a known sandbagger less positively than if they were not a known sandbagger.

64. Avery & Weintraub, *supra* note 15.

breaching the contract and then not say something to fix the problem prior to closing the deal.[65] On a related note, a seller would also argue that an anti-sandbagging provision allows for collaborative disclosures between the buyer and seller.[66] Assuming an anti-sandbagging provision is included, if a buyer becomes aware of an issue during due diligence, the buyer will tell the seller and the parties can negotiate a way to allocate any additional risk.[67] In turn, possible litigation can be avoided for both the buyer and the seller.[68]

C. When the Acquisition Agreement is Silent on Sandbagging or Anti-Sandbagging

If the acquisition agreement is silent on the matter of sandbagging, the governing law determines the issue.[69] If parties cannot agree on whether to include a sandbagging or anti-sandbagging provision, one option is to include a narrow definition of *knowledge* (e.g., a definition limiting knowledge to only *actual* knowledge).[70] This would limit the buyer's potential "knowledge pool," while still immunizing the seller when the buyer had actual knowledge of a breach of warranty.[71]

Remaining silent is another option for the buyer and seller and will allow them to move on with the negotiations of the transaction.[72] This option carries risk—potentially for both the buyer and seller—and its viability depends on the respective jurisdiction's governing case law.[73] A strategic sandbagger[74] also carries a lot of risk, given how fact-intensive these cases can be, and it is not very predictable how a court will come out on a given issue.[75]

Due to how fact-intensive these cases can be in terms of what was or was not disclosed by the seller to the buyer, a buyer claim regarding a breach of warranty by the seller can result in an extensive discovery process.[76] This results in "a time-consuming (and expensive) argument over what knowledge the buyer had pre-closing."[77] To further complicate matters under New York case law, there is still the unsettled question of how

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65. *Id.*

66. *Id.*

67. *Id.*

68. *See id.* (discussing how an anti-sandbagging provision prevents a buyer from closing and suing).

69. Jonathan Moncrieff, *A little knowledge can be a dangerous thing: sandbagging clauses in acquisition agreements*, LEXOLOGY (Oct. 19, 2012), http://www.lexology.com/library/detail.aspx?g=58d6a52f-f780-41a4-aef4-d437a803f7c5; *see* Davis & Hillman, *supra* note 57 (stating how a seller can argue that an anti-sandbagging clause "encourages the buyer to raise any issues with the seller prior to the closing to allow the two sides to discuss the problem and agree on a solution that allocates the risk or liability").

70. Moncrieff, *supra* note 69.

71. *See id.* (discussing how, as it relates to a sandbagging claim against the seller, buyers can limit the definition of knowledge to "actual knowledge on the part of a narrowly-defined group of individuals").

72. *Id.*

73. *Id.*

74. A strategic sandbagger is a buyer who closes on a deal knowing they will ultimately sandbag the seller. *See* Jenkins et al., *infra* note 75 (labeling those who intentionally sandbag as strategic sandbaggers).

75. *See* John Jenkins et al., *Strategic Sandbagging: Let the Buyer Beware*, DEALLAWS..COM (June 8, 2009), http://www.deallawyers.com/blog/2009/06/strategic-sandbagging-let-the-buyer-beware.html (stating that "[m]aybe the most important advice for a buyer is that intentionally sandbagging the other side is a very risky tactic" and how "there are all sorts of ways for courts to distinguish" sandbagging cases).

76. Avery & Weintraub, *supra* note 15; *see* Wolf & Solum, *supra* note 22, at 1 (stating how "New York law is less clear, particularly if the knowledge arose from disclosure by the seller").

77. Davis & Hillman, *supra* note 57.

buyer knowledge is determined.[78] The following "sentence-in-a-box" scenario illustrates this:

> 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?[79]

Further, what if an employee or agent of the buyer indeed came across that sentence (as opposed to not seeing it at all), however they did not realize it was a breach of warranty and thus did not communicate that breach to the buyer. There are also questions surrounding constructive knowledge[80] and it is unclear what types of employees should have known a particular fact.[81] As previously discussed,[82] it is unclear in what cases should "an environmental specialist be charged with knowledge about intellectual property issues."[83] Or, consider the scenario where a company president broadly states there is an "employment issue."[84] It is unclear whether a New York court would say that this is effectively communicating the required knowledge from the seller to the buyer.[85]

Taking the sentence-in-a-box example further,[86] there are still additional matters that can complicate things such as "eleventh hour data dumps" where the seller gives the buyer a large amount of due diligence documents right as the deal is expected to close.[87] Or, similarly, a seller who simply tells the buyer of a possible misrepresentation just before close.[88] Whether or not the buyer knows of a breach of warranty, these types of situations can put the buyer—who has invested time and resources into finishing the deal[89]—in a tough position as they may not want to "'rock the boat' to the point that the seller will walk away from the deal."[90] Rocking the boat could mean the buyer asking for

78. Avery & Weintraub, *supra* note 15.

79. *Id.*

80. Bierzynski v. N.Y. Cent. R.R. Co., 297 N.Y.S.2d 457, 461 (N.Y. App. Div. 1969) (stating how constructive knowledge exists "whenever it is shown that reasonable diligence would have produced actual notice"); *see Constructive Knowledge Law & Legal Definition*, US LEGAL, http://definitions.uslegal.com/c/constructive-knowledge/ (last visited Oct. 16, 2016) (defining constructive knowledge as "[b]y application of reasonable care of diligence if a person should have known a fact, he or she is deemed to have constructive knowledge of that fact").

81. Avery & Weintraub, *supra* note 15 (emphasizing the challenge of deciding which executives or employees should be included in the "knowledge pool").

82. *See supra* note 49 and accompanying text (examining conflicts between imposing a constructive or actual knowledge requirement).

83. Avery & Weintraub, *supra* note 15.

84. *Id.*

85. *Id.*

86. *Id.* at 3 (discussing the sentence-in-a-box example).

87. Hsieh, *supra* note 55.

88. *Id.*

89. *See* Cristina Ferrer et al., *M&A as competitive advantage*, MCKINSEY & CO. (Aug. 2013), http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/m-and-a-as-competitive-advantage (discussing how buyers' unsuccessful attempts at acquiring companies "waste time and resources").

90. *Buyers and Sellers of Businesses Beware: Due Diligence, Sandbagging and the Destruction of Warranties and Representations*, KLEHR HARRISON HARVEY BRANZBURG, http://www.klehr.com/?t=11&la=484 (last visited Oct. 16, 2016).

a lower purchase price or seeking a special indemnification provision.[91] Further, if the deal involves debt from a lender, the lender could be scared off or try to renegotiate more favorable lending terms due to potential extra risks and liabilities.[92] This may be of particular importance to private equity firms, which typically use a large amount of outside debt from lenders to acquire companies.[93] It is ultimately unclear if a court would agree that a buyer who went through with a deal had constructive knowledge in an eleventh hour data dump. The following Part will discuss recommendations for buyers and sellers in M&A transactions, as well as how New York courts should solve the *knowledge* question when acquisition agreements are silent on the matter of sandbagging.

IV. RECOMMENDATION

This Part will first discuss what a buyer should do with regard to sandbagging in a transaction. It will then give recommendations for what the seller should do. Finally, this Part will finish with discussion on how New York courts should approach sandbagging—including the issue of what constitutes knowledge—when an acquisition agreement is silent on the matter of sandbagging.

A. Recommendation for a Buyer

As previously discussed,[94] a buyer would like to have a sandbagging provision in an acquisition agreement for several reasons, such as eliminating post-close litigation regarding buyer knowledge[95] and encouraging a seller to thoroughly prepare disclosure schedules within the acquisition agreement.[96] It is important for a buyer to include in an acquisition agreement provisions reserving the buyer's rights.[97] Otherwise, it is possible for a seller to argue that because the buyer closed while knowing a representation was false, the buyer thus could not have relied on such representation and in turn the buyer may not have a claim in some jurisdictions (including New York).[98] Rights-reserving provisions should:

> [I]nclude a provision to the effect that the seller's representations and the seller's obligation to indemnify the buyer for breaches thereof will not be affected by any investigation by or on behalf of the buyer or by the buyer's knowledge that any such representation is or might be untrue, and a provision to the effect that any waiver of the buyer's rights under the purchase agreement

91. *Id.*

92. *Id.*

93. *See* Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121, 121 (Winter 2009) (discussing what private equity firms do and that they use a large amount of debt relative to equity to acquire companies).

94. *See supra* Part III.A (discussing the arguments for incorporating a sandbagging provision and why a buyer would prefer these).

95. Avery & Weintraub, *supra* note 15.

96. Moncrieff, *supra* note 69.

97. Robert F. Quaintance, Jr., *Can You Sandbag?*, 2 DEBEVOISE & PLIMPTON PRIV. EQUITY REP., no. 2, Winter 2002 at 1, http://www.debevoise.com/~/media/files/insights/publications/2002/02/the%20private%20equity%20report/files/view%20report/fileattachment/winter%202002.pdf.

98. *Id.*

must be express and in writing.[99]

A rights-reserving provision *may* help a buyer in the case where it knew of an untrue representation before closing, but this type of case has not happened in New York and it is ultimately unclear exactly how beneficial (if at all) it would be.[100]

Second, buyers should be cautious about sandbagging due to the surrounding uncertainty. If a buyer knows something is untrue, it should negotiate a lower purchase price or the inclusion of a specific indemnification clause for the untrue representation.[101] If a lower purchase price or specific indemnification clause is not able to be negotiated, it is worth reiterating that at the very least the buyer should always reserve its rights.[102]

Third, and finally, buyers should also resist an anti-sandbagging provision as it limits the buyers rights and "create[s] an extra element of proof (lack of buyer knowledge)."[103] If a buyer must include an anti-sandbagging provision, the buyer can negotiate for a provision declaring that the seller has the burden of proof regarding buyer knowledge.[104] The buyer can also limit the definition of *knowledge* to only *actual* knowledge,[105] and thus exclude *constructive* knowledge.

B. Recommendation for a Seller

The recommendation for a seller is similar to that of a buyer, but just on the opposite side of the same coin. A seller should seek an anti-sandbagging provision as it can prevent a buyer from suing subsequent to closing.[106] If a seller must give in to a sandbagging provision, it should seek to include a broad definition of *knowledge* that includes actual and constructive knowledge on behalf of the buyer.[107] A seller can also make sure the buyer bears the burden of proof regarding this knowledge.[108] Finally, a seller should disclose as much as possible to the buyer.[109] These things together can minimize the possibility that a buyer will be able to seek a post-closing indemnity claim.[110]

C. Recommendation for New York Courts When the Acquisition Agreement is Silent on Sandbagging or Anti-Sandbagging

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99. *Id.* at 18.
100. *Id.*
101. *Id.*
102. Quaintance, *supra* note 97, at 18.
103. *Id.*
104. *Id.*
105. *Id.*
106. Avery & Weintraub, *supra* note 15.
107. *See* Quaintance, *supra* note 97, at 18 (stating how a buyer should limit the definition of *knowledge*). Thus, it can be inferred that a seller should broaden the definition of knowledge.
108. *See id.* (stating that the buyer should negotiate the burden of proof to be on the seller). Thus, it can be inferred that a seller should negotiate that the burden of proof be on the buyer.
109. Admittedly, this comes with some risk as a perceived increase in potential liabilities could possibly scare the buyer away.
110. *See* Avery & Weintraub, *supra* note 15 (discussing how an anti-sandbagging provision can prevent a buyer from closing and then suing the seller); *see also* Quaintance, *supra* note 97, at 18 (discussing how buyers in an acquisition agreement can maintain their rights to seek a post-close indemnity claim). This allows for inferences to be made for what a seller should do to minimize the chances of a post-close indemnity claim.

The New York courts have adopted a hybrid approach that takes the best of both worlds where the standard is not a strict reliance requirement (like California, which has a strict reliance requirement), yet there is still some reliance required (unlike Delaware, which has no reliance requirement).[111] This hybrid approach is actually the most equitable standard. The California approach benefits sellers, while the Delaware approach benefits buyers.[112] The New York hybrid approach combines elements of the California rule and the Delaware rule into a standard that is ultimately fairer for both parties.

However, a problem that arises with the New York approach is that there are questions regarding what constitutes buyer knowledge.[113] Many of these questions can be broken up into two categories: (1) when someone in the buyer's due diligence team receives actual knowledge but does not pass it along; and (2) when someone in the buyer's due diligence team receives (potentially) constructive knowledge but does not realize the misrepresentation and thus does not pass it along.

1. When Someone in the Buyer's Due Diligence Team Receives Actual Knowledge But Does Not Pass it Along

In this scenario, New York courts should consider this as constituting buyer knowledge. In the due diligence process, it is unfeasible and impractical to expect one person to conduct the entire process.[114] For instance, due diligence may require delegation to others, including skilled financial and business representatives, law firms, accounting firms, consulting firms, and investment banking firms.[115] It is reasonable to expect that the buyer will include those individuals in the due diligence process who will tell the buyer if they have actual knowledge of a misrepresentation of warranty. If, for instance, an attorney did not tell her client of a misrepresentation, the buyer still may have recourse against that attorney.[116] However, it would be inequitable for the buyer to have recourse against the seller and it is reasonable to say in this scenario the seller properly disclosed any possible misrepresentation.

2. When Someone in the Buyer's Due Diligence Team Receives (Potentially) Constructive

111. *See supra* Part II.A (comparing and contrasting the sandbagging laws of Delaware, California, and New York).

112. *See* Iovine III, *supra* note 7, at 2 (discussing how sellers are better off if the acquisition agreement is governed by California law, while in Delaware buyers benefit from the pro-sandbagging default rule by having at least some right to sandbag).

113. *See* Wolf & Solum, *supra* note 22 (discussing how New York law is less clear as it relates to sandbagging and buyer knowledge, "particularly if the knowledge arose from disclosure from the seller").

114. *See* Trent Dykes, *M&A Due Diligence: Assembling Your Team And The Due Diligence Request List (Part 3)*, LEXISNEXIS (Apr. 9, 2012, 3:26 PM), http://www.lexisnexis.com/legalnewsroom/banking/b/venture-capital/archive/2012/04/09/m-amp-a-due-diligence-assembling-your-team-and-the-due-diligence-request-list-part-3.aspx (discussing how the due diligence process is a collaborative effort and requires expertise in various areas).

115. *See Due diligence: Main steps and success factors*, GE CAPITAL 2 (2012), http://www.gecapital.eu/en/docs/GE_Capital_Overview_Due_Diligence.pdf (citing the various parties that may be necessary to successfully conduct due diligence for a potential acquisition of another company).

116. *See* Dan Pinnington, *The Most Common Legal Malpractice Claims by Type of Alleged Error*, 36 L. PRAC. 4 (Aug. 2010), http://www.americanbar.org/publications/law_practice_home/law_practice_archive/lpm_magazine_webonly_webonly07101.html (citing procrastination, clerical error, and fraud as types of legal malpractice claims).

Knowledge But Does Not Realize the Misrepresentation and Thus Does Not Pass it Along

In the alternative, someone in the due diligence team may receive (potentially) constructive knowledge of a misrepresentation, but they do not realize it and in turn do not pass it along. As an example, consider the scenario where the buyer allows an environmental specialist to work on profitability due diligence. The specialist receives the information about the misrepresentation but does not recognize it as a misrepresentation and therefore fails to pass this information along (thus the buyer has no actual knowledge). New York courts should not punish the seller for this. It is reasonable to expect that the buyer will put the proper people in place to conduct the different areas of due diligence. Thus, in this scenario New York courts should find there is constructive knowledge on behalf of the buyer and in turn they would not be able to sandbag the seller. In this situation, the buyer may again still have recourse against another party, such as a lawyer who did not recognize a seller's particular violation of the law.[117]

However, going back to the last-minute data dump scenario where, in a box full of documents, there is one sentence that indicates there may be a misrepresentation, it is not reasonable to expect the buyer to have constructive knowledge. The seller should not intentionally hold back information until the last minute, and if they do, it would be unreasonable to think that this imparts knowledge on behalf of the buyer. Even if the withholding of documents is unintentional, buyers should not be barred from sandbagging because the seller waited until the last minute to disclose valuable information.

These scenarios can be reconciled with the definition of *constructive knowledge*, which can be defined as "[b]y application of reasonable care of diligence if a person should have known a fact, he or she is deemed to have constructive knowledge of that fact."[118] In the first scenario, (where the buyer allows an environmental specialist to work on profitability due diligence) one could argue that the environmental specialist should not have known the facts regarding profitability. While that may be true, the buyer should have put in place someone who would be capable of recognizing a misrepresentation. New York courts should not make that the fault of the seller. In the second scenario, with the last-minute data dump, the buyer reasonably does not have time to go through all of the new information and identify possible misrepresentations, and he or she should not be held to have had constructive knowledge of a misrepresentation.

An argument against this recommendation may be that it is unclear exactly how much time prior to closing constitutes a last-minute data dump. It could be as short as a few hours before closing or as long as a week. Thus, it could be argued that there needs to be a line drawn somewhere.

This Note recommends that New York courts should take this question on a case-by-case basis and determine what is reasonable in the case at hand. If the seller gave a buyer a one-page document one week before closing, it seems reasonable the buyer did have constructive knowledge. If the seller gave a buyer a box full of documents one hour before closing, it seems reasonable the buyer did not have constructive knowledge. As constructive knowledge would be a question of fact and not law, a jury would likely have

117. *See id.* (citing failure to know or properly apply the law and inadequate discovery of facts or inadequate investigation as types of legal malpractice claims).

118. US LEGAL, *supra* note 80.

to answer this question.[119]

V. CONCLUSION

Sandbagging is a practice that both buyers and sellers should be aware of throughout the acquisition process. Addressing sandbagging upfront in the acquisition agreement can potentially reduce litigation for both parties. In drafting the acquisition agreement, a buyer should always try to get a sandbagging provision included, while a seller should always try to get an anti-sandbagging provision included.

If the parties are not able to come to an agreement, they are subject to the acquisition agreement's controlling law. In particular, New York has a substantial amount of ambiguities as it relates to sandbagging when the acquisition agreement is silent on the matter. Although there are ambiguities in New York law, the New York approach is still preferable because it does not substantially benefit the buyer or seller like other jurisdictions such as California (benefitting the seller with a reliance requirement) and Delaware (benefitting the buyer with no reliance requirement). New York can solve many of its sandbagging law ambiguities by holding that sandbagging is precluded on behalf of the buyer if anyone in the buyer's due diligence team had actual knowledge of a breach of warranty prior to closing the deal.

Further, in the case of constructive knowledge, New York courts should consider a *reasonableness* standard. On one end of the spectrum, it is reasonable to expect the buyer to include competent people who would be capable of recognizing a misrepresentation. On the other end of the spectrum, a buyer does not reasonably have time to go through all of the new information and identify possible misrepresentation in a last-minute data dump.

Admittedly, this recommendation does not solve all questions of what should constitute buyer knowledge. For instance, the question of exactly how much time prior to closing constitutes a "last-minute data dump" remains unanswered; New York courts should take this on a case-by-case basis and determine what is reasonable in a given case by considering factors such as how much data was given near closing. However, this recommendation is a starting point for New York that would give parties in M&A transactions more guidance than there is currently.

119. *See* WEX, *Question of fact*, CORNELL U. L. SCH.: LEGAL INFO. INSTITUTE, https://www.law.cornell.edu/wex/question_of_fact (last visited Oct. 16, 2016) (discussing how an issue of fact is resolved by a trier of fact such as a jury or, in the case of a bench trial, a judge).