To Sandbag Or Not To Sandbag

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"What do I really know?" "But when did I really know it?" "And what did I understand it to mean?"

Now more than ever buyers are forced to ask themselves these and other esoteric questions. "Sandbag" provisions—designed to govern the effect of the buyer's knowledge on its ability to recover for a breach—are finding their way into our purchase agreements with increased frequency. It is no longer as simple as the seller giving a representation and agreeing that if this statement is false, and the buyer can prove it was harmed by the false representation, the buyer is made whole by the seller. Sandbag provisions are often among the final issues to be resolved in purchase agreement negotiations, and can be emotionally charged.

Sellers may assert that buyers, having deployed multiple teams of advisors, such as legal, financial, accounting, tax, insurance, information systems, environmental, etc. to dissect the target business, know more about that business than the sellers do themselves. Sometimes this is true. But having advisors uncover isolated facts is not the same as connecting the dots to understand their significance in context. Whether the buyer now knows more about the seller's hidden skeletons than the seller itself is hard to say most of the time. But the stage is now set for a dialogue in the negotiations that I hear more often than Hamlet's famous soliloquy:

Seller: I don't want to be sued for something you knew about when we closed.

Buyer: We are not in the business of suing people for things we know about.

The Bag Is Full

Let us understand the terminology. In this context, for a buyer to "sandbag" the seller typically means that the buyer, having knowledge of a misrepresentation prior to closing, nonetheless chooses to remain silent, proceed to close and reserve its right to sue for damages after the closing.

Why it would choose to do so depends on the context. If the misrepresentation were raised before closing, the parties would be obliged to negotiate over its consequences and, failing agreement, might not close at all. But the buyer might not want to risk delaying or losing the deal, or might fear that its bargaining power post-closing would be greater than pre-closing. The equities of the situation may vary depending on whether the misrepresentation was deliberate or inadvertent, resulted from pre-existing facts or new developments.

The relative bargaining power of buyer and seller may depend on how much the buyer has expended in time and money between signing the agreement and the time it discovered the misrepresentation or whether the target business would be materially harmed by abandoning the sale. In short, the motivations on both sides and the relative equities can be complex. Including an "anti-sandbag provision" in the contract prevents a buyer from closing and preserving its right to claim damages by explicitly recognizing the buyer's pre-closing knowledge as a defense, and a "pro-sandbag provision" preserves the buyer's right to bring such a claim by declaring such knowledge to be irrelevant.

Better to Speak Up

Prior to the last decade, most purchase agreements were simply silent as to sandbagging, and the application of law in the primary private equity jurisdictions had neither been robust nor applied with consistent effect. In the most widely used jurisdictions for private equity buyouts, the law varies as to whether a buyer could sue for a known breach where the purchase agreement is silent on the subject.

In Delaware, the buyer is not precluded from recovery based on pre-closing knowledge of the breach because reliance is not an element of a breach of contract claim. The same is true for Massachusetts and, effectively, Illinois (where knowledge is relevant only when the existence of the warranty is in dispute). But in California, the buyer is precluded from recovery because reliance is an element of a breach of warranty claim, and in turn, the buyer must have believed the warranty to be true. New York is less straightforward: reliance is an element of a breach of contract claim, but the buyer does not need to show that it believed the truth of the representation if the court believes the express warranties at issue were bargained-for contractual terms.

In New York, it depends on how and when the buyer came to have knowledge of the breach. If the buyer learned of facts constituting a breach from the seller, the claim is precluded, but the buyer will not be precluded from recovery where the facts were learned by the buyer from a third party (other than an agent of the seller) or the facts were common knowledge.

Given the mixed bag of legal precedent and little published law on the subject, if parties want to ensure a particular outcome, they should be explicit. When the contract is explicit, courts in California, Delaware, Massachusetts and New York have either enforced such provisions or suggested that they would. Presumably Illinois courts would enforce them as well, but there is very little or no case law to rely upon.

Striking a Deal

Recall the seller-buyer dialogue from above. The sand-bagging discussion typically arises at the end of a negotiating session, generally because this provision is contained in the limitations on indemnity at the end of the purchase agreement and the negotiation has gone in order of the agreement. Both parties are anxious to reach agreement and conclude negotiations. The seller may be quite emotional on this point and at this point. There is a certain logic to the seller's position, particularly its view that the potential sandbagged claim should be raised, its consequences fully aired and a mutually satisfactory resolution negotiated before the closing. The buyer feels a sense of control, having the choice of raising the issue pre-closing or waiting. So the buyer agrees to an anti-sandbag.

And then it all starts to sink in. Knowledge is a slippery concept. The seller's return draft will often come back to the buyer with broad application, sweeping in seemingly remote sources of information such as conversations with the target's management team months before, as well as many other formal and informal disclosures along the way, not to mention the electronic data room and the buyer's own market studies, diligence reports and market intelligence. And now consider such standard time-tested boilerplate as the seller's disclaimer of any information or disclosure given to the buyer other than the specific representations in the purchase agreement and disclosure schedules attached to the purchase agreement. Now, with the inclusion of an anti-sandbag provision, the buyer will not be able to rely on anything the seller disclosed outside of the representations and disclosure schedules, no matter how misleading, but any knowledge the buyer obtains, at any time and from any source, will vitiate even those disclosures by the seller.

If the buyer understands the significance of all of these isolated facts and how they contradict the picture otherwise presented by the seller of its business, it might just be "fair."

But facts gathered out of context may be forgotten or not integrated with other facts gathered at other times and by other buyer personnel or advisors. After all, the buyer by definition is the outsider here, less capable of evaluating the significance of all of this information that had been accessible to the seller for a prolonged time period.

When a seller negotiates for anti-sandbag protection, and then proceeds to dump a truck full of knowledge into the buyer's lap, the seller has created a powerful defense to nearly any claim the buyer could make by asserting that the buyer knew about the breach. It may have effectively nullified all the carefully negotiated representations. All the seller needs to do is find something in all of that data that relates to the claim, and suddenly something that was so clearly a claim is now a dicey law suit. The seller has been less than candid, yet the burden of knowledge has been shifted to the buyer. In this situation, the buyer's virtue may have just become its vice.

Some feel that a seller should stand behind its representations in the contract and make the buyer whole if they turn out not to be true, regardless of who knew what and when. Many people stop here. But if you subscribe to the theory that you are not in the private equity business to sue unsuspecting sellers for information that you and your advisors had—and the significance of which you truly understood—at closing time, then we have to seek a middle ground to make the deal. The trick, of course, is writing it.