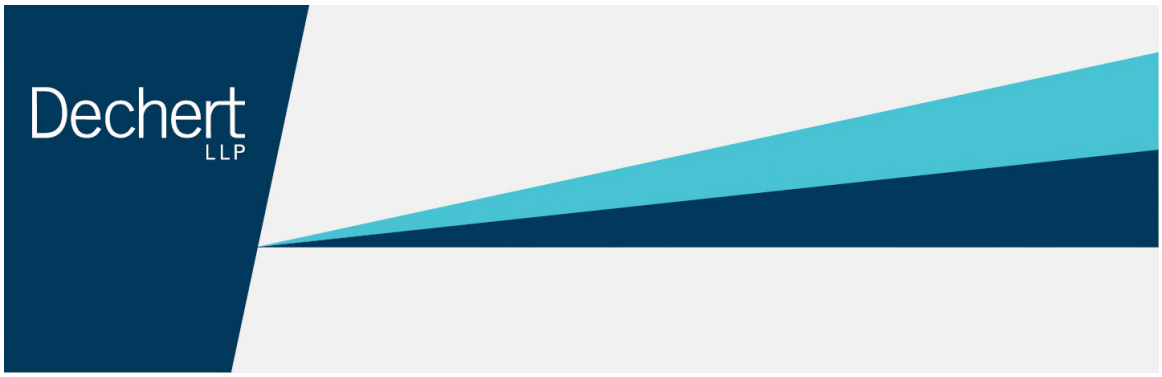

ON**POINT** / A legal update from Dechert's Corporate & Securities Group

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Sandbagging in M&A Transactions: Default Rules in Delaware, New York and California

Highlights

- Buyers and sellers sometimes fail to specify whether the buyer's knowledge of a breach of representations and warranties will bar indemnification.
- Choice of law can change the outcome of "anti-sandbagging" claims as key U.S. states differ on their approach to the buyer's claims when the buyer had pre-closing knowledge of a breach.
- Buyers should consider use of Delaware law or push for explicit pro-sandbagging provisions when an agreement is governed by New York or California law.

One of the most confusing legal issues facing foreign buyers of U.S. assets is governing law. Especially for Asia-based clients whose legal system is civil law based and uniform throughout the country, the U.S.'s state laws/federal laws/common law system is, well, foreign. Often, clients are not aware that different states treat a particular legal issue differently and that choosing whether New York law or Delaware law, for example, will apply will have divergent consequences on a variety of legal issues. Recent market forces have enabled China-based buyers to leverage the high valuations they are enjoying in their home markets in order to bid for U.S.-based assets at never before seen valuations, especially for assets deemed to be critical to economic growth or social services in China. China-based buyers may be able to leverage the high valuations they are offering to dictate the governing law of a document, an issue often not considered to be important by many and an easy "give," to gain some advantage on one of the most critical issues in an acquisition agreement.

In a merger or acquisition, parties negotiating an acquisition agreement often engage in intense negotiations to limit or expand the buyer's indemnification rights. Sellers seek to limit the scope, duration and amount of damages subject to indemnification, while buyers attempt to broaden their indemnification protection. In some cases, the buyer seeks to include a "sandbagging" provision in the acquisition

agreement. Such a provision typically states that the buyer shall be entitled to post-closing indemnification for breaches of representations and warranties made by the seller, whether or not the buyer had knowledge of such breaches prior to closing. On the other hand, the seller tries to add an "anti-sandbagging" provision, which would prevent the buyer from receiving indemnification for a breach of a representation and warranty that the buyer had knowledge of prior to closing. In many cases, however, despite the potential commercial and legal implications of such provisions, the acquisition agreement is left silent on this issue. This article explores the default rule in three major U.S. jurisdictions (Delaware, New York and California) when the agreement is silent on the "sandbagging" issue.

Delaware: Pro-sandbagging

Delaware courts' general position is that when the agreement is silent on the "sandbagging" issue, a buyer is entitled to indemnification for breaches of the seller's representations and warranties even if the buyer knew of the seller's breach prior to closing.

Historically, Delaware courts took a tort-based approach and required reliance in breach of warranty or false representation claims[1]. However, in 2005, the Delaware Superior Court shifted to a contract-based approach and held that reliance is not required and the buyer may hold the seller accountable for the accuracy of its representations and warranties contained in the acquisition agreement[2]. Specifically, the Delaware Court found that "the extent or quality of [the buyers]' due diligence is not relevant to the determination of whether [the seller] breached its representations and warranties in the [a]greement," and as long as the seller "warranted a fact or circumstance to be true in the [a]greement, [the buyers] were entitled to rely upon the accuracy of the representation irregardless of what their due diligence may have or should have revealed."[3] In 2007, the Delaware Court of Chancery affirmed this contract-based approach and held that reliance is not required. In so finding, the Court noted that diligence can be expensive and that representations and warranties to which the parties come to agreement should serve as a risk allocation tool that places the risk of their breaches on the seller.[4] The Court's reasoning was that by obtaining the representations and warranties from the seller, the buyer minimizes its need to verify every minute aspect of the seller's business and places the risk that any such representations and warranties may be false on the seller.[5]

An example for Delaware's "pro-sandbagging" position is *Cobalt Operating, LLC v. James Crystal Enters., LLC*.[6] In *Cobalt*, the Delaware Court of Chancery held that a buyer's due diligence will not preclude its right to a remedy against the seller, because "[the buyer]'s breach of contract claim is not dependent on a showing of justifiable reliance."[7] In *Cobalt*, the buyer entered into an asset purchase agreement with a group of sellers pursuant to which the buyer was to purchase a radio station for approximately $70 million.[8] The buyer calculated the purchase price based on the seller group's representation that the radio station's annual broadcast cash flow from its unaudited financial statements was $5 million and those earnings were sustainable on a going-forward basis.[9] During the due diligence review of the radio station, the buyer disclosed that its cash flow was approximately $4 million, not $5 million, after re-allocating various expenses in accordance with generally accepted accounting principles.[10]

After closing the acquisition, the buyer pursued a breach of warranty claim against the seller group for its breach of several representations and warranties made in the asset purchase agreement, including that the financial statements the seller group provided to the buyer "fairly and accurately reflect the financial condition, operating results, and the income and expenses [of the radio station] and do not fail to reflect any material information bearing on [the radio station's] financial condition or operating results."[11] The seller group raised an anti-sandbagging defense – that the discrepancies that the buyer discovered during its due diligence were the very facts on which the buyer premised its claim. Thus the buyer could not establish that it reasonably relied on the representations the seller group made regarding the accuracy of the radio station's financial statements and was therefore not harmed.[12]

The Court held that reliance is not an element required for a breach of warranty claim under Delaware law and added that the seller group, having contractually promised to the buyer that it could rely on certain representations, cannot now claim that the buyer was "unreasonable in relying on [the seller group's] own binding words."[13]

New York: Pro-sandbagging with Limitations

New York courts take a "pro-sandbagging" view similar to the Delaware courts, but with limitations that could surprise an unwary buyer.[14]

Although New York courts have also decided that a buyer is not required to show reliance, New York courts, unlike Delaware courts, will take into consideration one additional factor in making this reliance determination – whether the source of the buyer's knowledge was the seller or others.[15] The United States Court of Appeals for the Second Circuit in *Galli v. Metz*, 973 F.2d 145 (2d Cir. 1992), interpreting New York case law, has held that if the buyer learned of the breach from the seller through the seller's affirmative disclosure, the buyer "[closing] 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" unless the buyer expressly preserves rights to assert such breach.[16]

In *Galli*, the buyer entered into a stock purchase agreement with a group of sellers pursuant to which the buyer was to purchase a target company from the sellers.[17] In the stock purchase agreement, the sellers represented and warranted to the buyer that "neither [the target company] nor the [sellers] know or have reason to be aware of any facts which might result in any…claim…which might adversely affect the business or condition…of [the target company] or its properties."[18] Prior to the closing, one of the sellers received a notice stating that a piece of property on which one of the target company's subsidiaries had operated a gas station contained certain hazardous waste materials exceeding the levels permitted by the United States Environmental Protection Agency, and in fact, such seller had known of the contamination for twelve years.[19] The sellers disclosed "the problem at the [property]" to the buyer prior to the closing, and the parties closed the transaction.[20] Subsequent to the closing, the subsidiary was named as a third-party defendant in a lawsuit relating to the contamination.[21]

The buyer claimed that the sellers breached the "no claim" warranty because one of the sellers in fact was aware of the contamination and that the buyer's knowledge of the contamination was "irrelevant, since reliance is not an element of breach of warranty under New York law."[22] Although the Second Circuit agreed with this general rule under New York law,[23] it disagreed with the buyer and held that "the buyer has waived the breach" where the buyer knew of the breach disclosed by the sellers but accepted the breach and closed the transaction.[24] The court also noted that if the buyer had learned of the breach from a source other than the sellers, either from its own diligence or from a third-party, the buyer may not be deemed to have waived the breach and may therefore be permitted to recover for such breach.[25]

California: Anti-sandbagging

Unlike Delaware and New York law, California courts require the buyer to demonstrate reliance on the seller's representation and warranty to make a breach of warranty claim in the absence of any "pro-sandbagging" provision.[26] The buyer would generally not be able to prove reliance if the buyer had knowledge of the seller's breach and could not recover for damages caused by a "known" breach.[27]

While this general rule has been followed repeatedly, one California decision, *Telephia, Inc. v. Cuppy*, 411 F. Supp. 2d 1178 (N.D. Cal. 2009), provided guidance to parties regarding the "anti-sandbagging" limitations under California law. In *Telephia*, the Court held that while reliance is an element required to prove a breach of warranty claim by a buyer, so long as a "pro-sandbagging" clause contained in an acquisition agreement between the parties expressly sets forth that the buyer's knowledge would not affect the buyer's reliance, the Court will enforce such provision and will not require the buyer to demonstrate reliance.[28] The "pro-sandbagging" clause at issue in *Telephia* stated as follows:[29]

> "No information or knowledge obtained in any investigation pursuant to this Section 6.1 shall affect or be deemed to modify any representation or warranty contained in this Agreement…"
>
> "No investigation made by or on behalf of [the buyer] with respect to [the seller or the target company] shall be deemed to affect the [buyer's]…reliance on the representations, warranties, covenants, and agreements made by [the target company]."

The Court held that "this contractual language is clear, and that [the seller] may be held accountable to the warranties in the [acquisition agreement] regardless of [the buyer's] reliance on those warranties" as the parties "reached a bargain where [the seller] bore the risk of unexpected problems."[30]

Conclusion

Negotiations between parties to an acquisition agreement can be time-consuming and costly, and the issue of adding a "pro-sandbagging" provision or an "anti-sandbagging" provision to clearly lay out the buyer's indemnification rights may cause even more issues in negotiations between the parties. As a

result, the acquisition agreement is often left silent on this issue, in which case the choice of law becomes a key issue.

Delaware law and New York law may be preferable to buyers as the governing law of an acquisition agreement because in these jurisdictions, a buyer is generally not required to show reliance to claim for a seller's breach of a representation and warranty. On the other hand, sellers may prefer California law as buyers would be required to demonstrate reliance on the seller's representation and warranty to make a breach of warranty claim against the seller. As such, parties to transactions should pay close attention to the way different states treat a buyer's indemnification rights in the absence of any sandbagging provision in the acquisition agreement.

Footnotes

[1] See *Kelly v. McKesson HBOC Inc.*, No. 99C-09-265-WCC (Del. 2002).

[2] See *Interim Healthcare, Inc v. Spherion*, 884 A.2d 513 (Del. 2005), *aff'd*, 886 A.2d 1278 (Del. 2005).

[3] *Interim Healthcare* at 548. See also *Vigortone AG Prods. Inc. v. PM AG Prods. Inc.*, 316 F.3d 641 (7th Cir. 2002), in which the buyer of manufactured swine food could recover for the seller's breach even if the buyer recklessly failed to discover that his purchase contracts were not hedged to mitigate risk in price fluctuations. *Vigortone* at 649. In reaching this conclusion, the court compared its analysis to the idea that a car purchaser can still enforce a car warranty even if he thinks something is misrepresented about the car before purchasing it. *Id*.

[4] *Cobalt Operating, LLC v. James Crystal Enters., LLC,* No. Civ.A. 714-VCS, 2007 WL 214926 at 28 (Del. Ch. July 20, 2007), *judgment entered*, (Del. Ch. Aug. 15, 2007) and *aff'd,* 945 A.2d 594 (Del. 2008). See also *Gloucester Holding Corp. v. U.S. Tape and Sticky Products, LLC,* 832 A.2d 116, 127 (Del. Ch. 2003) (holding that "[r]eliance is not an element of claim for indemnification.").

[5] *Id.* at 27.

[6] See *Cobalt.*

[7] *Id.*

[8] *Id.* at 1.

[9] *Id.*

[10] *Id.* at 7. The buyer, after the signing and prior to the closing, conducted further diligence on the radio station and concluded that its total cash flow for the trailing twelve months leading up the closing was $5.26 million, which conclusion was in fact based on the seller group's fraudulently inflated cash flow. *Id.* at 26. As such, the buyer also pursued a common law fraud claim against the seller group. *Id.* at 1.

[11] *Id.* at 8.

[12] *Id.* at 27.

[13] *Id.* at 28.

[14] *CBS, Inc. v. Ziff-Davis Pub. Co.*, 553 N.E.2d 997 at 1002 (N.Y. 1990).

[15] *Galli* at 151.

[16] *Id.*

[17] *Id.* at 147.

[18] *Id.* at 150.

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.* at 151.

[25] *Id.*

[26] See *Grinnell v. Charles Pfizer Co.*, 79 Cal. Rptr. 369 (Cal. App. 1969).

[27] See *Kazerouni v. De Satnick,* 279 Cal. Rptr. 74, 75-76 (Cal. App. 1991).

[28] *Telephia* at 1188.

[29] *Id.*

[30] *Id.*

This update was authored by:

David K. Cho
Hong Kong
T: +852 3518 4797
david.cho@dechert.com

Seon N. Chung
Hong Kong
T: +852 3518 4753
seon.chung@dechert.com

dechert.com