TO SANDBAG OR NOT TO SANDBAG, THAT IS THE QUESTION

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Anyone who has been involved in a private merger or acquisition knows that one of the most heavily negotiated aspects of any transaction involves the indemnification provisions. This universal fact holds true regardless of whether the deal is structured as a stock or an asset purchase, with the focus on these terms typically increasing as the value of the deal ascends. Indemnification, at its core, is all about risk allocation; it details the rights and duties of the parties when a specific event occurs post-closing, a representation is inaccurate, or a warranty, and/or covenant is breached. Not surprisingly, buyers aim for such terms to be broad and unlimited, while sellers want indemnification provisions to be very narrow and limited. The end result is typically a balance of these competing interests that involves a combination of various mechanisms designed to either create hurdles to recovery or make it easier. One of the most important indemnification concepts, however, is frequently overlooked by both buyers and sellers and can have far reaching consequences: "sandbagging."

In mergers and acquisitions, the concept of sandbagging refers to a situation when the buyer, before closing, discovers, typically through the due diligence process, a misrepresentation or breach of a warranty or covenant by the seller, but chooses not to say anything about it before the transaction closes, and then brings an indemnification claim under the agreement after closing. To prevent this type of situation from occurring, sellers often attempt to negotiate an anti-sandbagging clause, which prevents a buyer from making an indemnification claim in such circumstances. From the seller's perspective, it is completely unfair for a buyer to make an indemnification claim regarding something it knew about and could have addressed prior to closing but chose to ignore. Ironically, at first glance, many people, including buyers, would probably agree that making an indemnification claim in such a situation is unreasonable, but, in reality, the determination of whether a buyer has "knowledge" of a particular fact is not always straightforward. Depending upon if and how a buyer's "knowledge" is defined in an agreement, a buyer could be deemed to have "knowledge" of every single fact, circumstance, or document contained in the disclosure schedules, even if nobody from the buyer's organization actually saw or noticed the specific fact or circumstance at issue.

Given that disclosure schedules may contain exorbitant amounts of informa-

tion, buyers can easily miss or overlook something. The situation is often even more problematic if the scope of the buyer's "knowledge" is also deemed to cover any document or information contained in a transaction data room, regardless of whether or not it is specifically listed or included in the disclosure schedules. In some circumstances, even if the seller is required to list a document on a schedule, but fails to do so, the buyer could be deemed to have "knowledge" if the information is in the data room. At the same time, anti-sandbagging provisions can prevent a buyer from making an indemnification claim post-closing on any matter actually listed in the disclosure schedules. As a result, anti-sandbagging clauses can place a significant burden on a buyer and shift an extraordinary amount of risk away from a seller.

Due to the impact sandbagging can have on the indemnification rights of buyers and sellers, it is critical for both buyers and sellers to carefully consider and understand the implications the concept can have in each transaction they enter and form a comprehensive strategy for dealing with the same. To that end, there are three different approaches buyers and sellers can take with respect to sandbagging in an agreement: (1) include a pro-sandbagging clause; (2) include an anti-sandbagging clause; or (3) remain completely silent on the concept. The best approach and position for a buyer or seller depends upon a variety of factors, including, perhaps, most importantly, the state whose laws will govern the agreement between the parties.

PRO-SANDBAGGING PROVISIONS

Pro-sandbagging provisions, as one might expect, benefit the buyer, and permit the buyer to make an indemnification claim for the inaccuracy of a representation or breach of a covenant or warranty by the seller following the closing of a deal, even if the buyer was aware of the inaccuracy of the representation or breach of the covenant or warranty prior to closing. The inclusion of a pro-sandbagging clause prevents the buyer from needing to prove or show that the buyer did not know about the misrepresentation or breach of the warranty or covenant, because the buyer's knowledge is essentially irrelevant.

ANTI-SANDBAGGING CLAUSES

In contrast to pro-sandbagging provisions, anti-sandbagging clauses benefit the seller, and prevent a buyer from making an indemnification claim arising out of the inaccuracy of a representation or breach of a covenant or warranty by the seller following the closing of a deal if the buyer knew of the misrepresentation or breach of the warranty or covenant prior to closing. Anti-sandbagging provisions can not only effectively provide sellers with an affirmative defense against some indemnification claims, but also require a buyer to both prove the existence of the misrepresentation or breach of warranty or covenant and that the buyer did not have knowledge of the same prior to closing. When an agreement contains an anti-sandbagging provision, the definition of "knowledge" becomes extraordinarily important for buyers, as having a broad definition can preempt and eradicate otherwise valid indemnification claims. Sellers should seek to keep the definition broad enough to cover and incorporate implied and constructive "knowledge," and to include phrases that require "reasonable due inquiry" in the definition. Buyers, on the other hand, should attempt to require actual "knowledge," and keep the "knowledge group" to a limited number of relevant individuals.

SANDBAGGING SILENCE

While it is obvious that including or not including a pro-sandbagging or anti-sandbagging provision in an agreement will have an effect on the indemnification rights of the parties to an agreement, many people fail to realize or appreciate that silence on the concept also has repercussions, some of which may be undesirable or unintended. If an agreement is silent on sandbagging, the state law governing the transaction will be applied to determine whether the buyer's knowledge will preclude indemnification claims. Since each state's laws are different, remaining silent could have adverse consequences. As a result, it is extremely important for both buyers and sellers to know how the state law governing an agreement treats silence on sandbagging, so they can effectively factor the same into their decision making and not unnecessarily use precious negotiating capital. For example, states such as New York and Delaware allow some forms of sandbagging in the event an agreement is silent on the concept, while other states, such as California generally do not permit sandbagging, unless the agreement explicitly allows it. With that being said, however, in New York, silence on sandbagging by itself is not enough to make sandbagging claims permissible; rather, the buyer must believe it was purchasing a "vendor's promise as to the truth," meaning the buyer must not have been told about the inaccuracy of a representation or breach of a warranty or covenant directly from the seller. It is also important to note that the Delaware Supreme Court recently suggested the scope of sandbagging claims is not without some limitation by acknowledging in a footnote of the 2018 case of *Eagle Force Holdings, LLC v. Stanley Campbell* that there is an ongoing debate about whether a buyer can make an indemnification claim for an inaccurate representation or breach of warranty or covenant when it knew at closing about the inaccuracy or breach.

While buyers and sellers can employ a number of tactics, such as baskets, mini-baskets, materiality qualifiers, materiality scrapes, exceptions, and caps, in order to successfully protect their interests in connection with indemnification, it is equally, if not more important, to take into account the effects the governing law has on an agreement, especially with respect to sandbagging claims. Choice of law clauses, while seemingly innocuous, can have long-lasting implications on the range of indemnification claims permitted. Accordingly, buyers and sellers should make sure they have a firm understanding of how the governing law treats sandbagging, so they can form a more effective negotiating strategy, and avoid any unintended consequences.

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