

## SANDBAGGING: DEFAULT RULES AND ACQUISITION AGREEMENTS

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### ABSTRACT

*In the M&A world, a buyer "sandbags" a seller when, knowing the seller has materially breached a warranty, it closes the deal and then asserts a post-closing claim. Traditionally, the buyer must have relied on the warranty, without knowledge of the breach, in order to prevail. The modern trend, with some exceptions, permits the buyer to sue without regard to knowledge. Parties, in both cases, can contract around the default rule—so that the default rule should affect how acquisition agreements are structured. Yet, a survey of publicly available deals, from July 2007 to June 2011, reveals that—regardless of default rule—roughly forty-five to fifty-five percent of contracts contain a pro-sandbagging provision, and roughly forty to fifty percent are silent. Why the similarity in contract provisions?*

*First, the law around sandbagging is unsettled. Buyers who particularly value a sandbagging right may develop standard solutions, relying on the certainty of express contractual language rather than the default rule. Second, under a pro-sandbagging standard, sellers have limited incentive to request an anti-sandbagging provision and buyers have limited incentive to agree to it. The compromise is often silence—with the right to sandbag set by the default rule rather than agreement. Thus, the claim that a buyer's "purchase" of warranties includes a sandbagging right, often used to justify a pro-sandbagging default rule, is open to question. In neither case does a pro-sandbagging default rule reflect a buyer's interest in sandbagging. Rather, bargaining is more likely under an anti-sandbagging default rule, in which case those who particularly value a sandbagging right must expressly negotiate for it.*

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## I. INTRODUCTION

Suppose the following: Seller Co. agreed to sell Buyer Co. all of Seller's interest in its wholly-owned subsidiary, Target Co., for a cash purchase price. The contract included standard negotiated terms, such as Seller's representations and warranties regarding Target's business and operations, which survived the closing.<sup>1</sup> Among the conditions, Buyer's obligation to close was subject to the accuracy of Seller's warranties.<sup>2</sup> Buyer and Seller also agreed that Seller's indemnification of Buyer for its losses was Buyer's sole remedy in the event a Seller warranty was breached.<sup>3</sup> In fact, unknown to Seller, Buyer's CEO learned after the contract was signed (perhaps due to Buyer's investigation of Target) that a Seller warranty was materially

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<sup>1</sup>See generally 1 ABA MERGERS & ACQUISITIONS COMM., MODEL STOCK PURCHASE AGREEMENT WITH COMMENTARY 77-190 (2d ed. 2010) [hereinafter MODEL STOCK AGREEMENT] (providing overview of representations and warranties of sellers); ABA COMM. ON NEGOTIATED ACQUISITIONS, MODEL ASSET PURCHASE AGREEMENT WITH COMMENTARY 69-153 (2001) [hereinafter MODEL ASSET AGREEMENT] (describing representations and warranties of sellers and shareholders); 2 LOU R. KLING & EILEEN T. NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 11.04 (2011) [hereinafter KLING & NUGENT] (explaining specific representations of the seller). In general, a representation is a statement of fact, whereas a warranty is a promise that the fact is true, although the distinction between them has blurred in practice. MODEL STOCK AGREEMENT, *supra*, at 77; MODEL ASSET AGREEMENT, *supra*, at 69.

<sup>2</sup>See MODEL STOCK AGREEMENT, *supra* note 1, at 247-53 (discussing the accuracy of Seller's representations); MODEL ASSET AGREEMENT, *supra* note 1, at 178-82 (discussing the accuracy of representations in the context of an asset agreement); KLING & NUGENT, *supra* note 1, §§ 11.01[3], 14.02[1] (discussing representations and bringdowns).

<sup>3</sup>See generally MODEL STOCK AGREEMENT, *supra* note 1, at 285-349 (providing an overview of indemnification, payment, reimbursement, and remedies); MODEL ASSET AGREEMENT, *supra* note 1, at 214-23 (discussing indemnification and remedies); KLING & NUGENT, *supra* note 1, § 15.02[1][a] (explaining Seller's indemnification for breach of representations and warranties).

inaccurate. Buyer, nevertheless, closed the deal, and then sought to hold Seller liable for its breach.

Transactional lawyers often refer to this practice—knowing of the breach, closing, and then asserting a post-closing claim—as "sandbagging."<sup>4</sup> Buyer, in this case, chose to close its purchase of Target rather than renegotiate the deal's terms or walk away (and then, perhaps, sue Seller).<sup>5</sup> The question is whether Buyer has a post-closing claim under the Seller's indemnity. The answer is surprisingly unsettled.<sup>6</sup>

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<sup>4</sup>The origin of the term "sandbagging" has been the subject of some speculation. See Glenn D. West & Kim M. Shah, *Debunking the Myth of the Sandbagging Buyer: When Sellers Ask Buyers to Agree to Anti-Sandbagging Clauses, Who is Sandbagging Whom?*, 11 THE M&A LAW. 3, 3 (2007) (suggesting that the term may derive from the use of a bag of sand as a weapon, often in a surprise attack). Rick Climan, an M&A partner at Dewey & LeBoeuf, relates the following history: While in college, he and other students held regular late-night poker games. The term "sandbagging" described a "check-raise" gambit—in which a player (usually with a strong hand) would check early in a round of betting in order to lure another into making the opening bet, and then proceed to raise that bet. Years later, Rick began using the term "sandbagging" in internal law firm training sessions to describe a buyer who, knowing of a material breach of a seller's warranty, would wait for the transaction to close before suing the seller. The terminology caught on with colleagues on the ABA Mergers and Acquisitions Committee before becoming a common term of art. Email from Rick Climan to author (Sept. 16, 2011, 11:46PM EST) (on file with author).

<sup>5</sup>See MODEL STOCK AGREEMENT, *supra* note 1, at 219-20; KLING & NUGENT, *supra* note 1, § 15.02[1][b]. This Article's focus is on breach of warranty claims by a buyer who became aware of a breach after signing but before closing the deal. Sandbagging can also occur if a buyer was aware of the breach when it signed the contract. Sandbagging based on pre-signing knowledge may be a particularly difficult claim. See MODEL STOCK AGREEMENT, *supra* note 1, at 199-200; see also Robert F. Quaintance, Jr., *Can You Sandbag?*, 2 THE DEBEVOISE & PLIMPTON PRIVATE EQUITY REPORT (Winter 2002), <http://www.debevoise.com/files/Publication/7c45d322-05a3-48bb-a67d-b0fa8dcbb62/Presentation/PublicationAttachment/d9f42fe7-ef24-40b3-b74c-21f0bbdfa8fb/Winter%202002.pdf> (providing an overview of the mechanics of sandbagging). States adopting a traditional analysis will require the buyer to have relied on the warranty. See *infra* Appendix A; see also *infra* notes 7-10 and accompanying text. A contract-based analysis is also likely to require the warranty to be part of the "basis of the bargain," a difficult assertion to make if the buyer was already aware of the breach when it signed the contract. See *S. Broad. Grp., LLC v. Gem Broad., Inc.*, 145 F. Supp. 2d 1316, 1321, (M.D. Fla. 2001), *aff'd without op.*, 49 F. App'x 288 (11th Cir. 2002).

<sup>6</sup>See generally Frank J. Wozniak, Annotation, *Purchaser's Disbelief in, or Nonreliance Upon, Express Warranties Made by Seller in Contract for Sale of Business as Precluding Action for Breach of Express Warranties*, 7 A.L.R. 5th 841 (1992) (surveying sandbagging law in various jurisdictions); see also *infra* Appendix A (containing a summary of the case law relating to sandbagging in commercial transactions, excluding products liability claims).

Under the traditional default rule, in order to prevail, Buyer must have relied on the warranty,<sup>7</sup> reflecting the action's historical grounding in tort.<sup>8</sup> Seller can argue that Buyer, knowing of the breach, did not rely on the warranty when it decided to close.<sup>9</sup> Seller can also argue that Buyer's decision to go forward acted as a waiver of its claim.<sup>10</sup> More recently, in jurisdictions that have broken with the traditional rule,<sup>11</sup> Buyer instead can bring its suit based on contract law principles,<sup>12</sup> without regard to what it knew at closing.<sup>13</sup> Buyer can argue it bargained for the warranties as a means to allocate risk and minimize cost.<sup>14</sup> Seller, therefore, should be held liable on

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<sup>7</sup>See *Hendricks v. Callahan*, 972 F.2d 190, 194 (8th Cir. 1992) (Minnesota law); *Land v. Roper Corp.*, 531 F.2d 445, 448-49 (10th Cir. 1976) (Kansas law); *Assocs. of San Lazaro v. San Lazaro Park Props.*, 864 P.2d 111, 115 (Colo. 1993) (Colorado law); *Kazerouni v. De Satnick*, 279 Cal. Rptr. 74, 75 (Cal. Ct. App. 1991) (California law).

<sup>8</sup>See WILLIAM L. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 634-35 (4th ed. 1971).

<sup>9</sup>See, e.g., *Land*, 531 F.2d at 449.

<sup>10</sup>See *Galli v. Metz*, 973 F.2d 145, 151 (2d Cir. 1992) (New York law); *Wikoff v. Vanderveld*, 897 F.2d 232, 241 (7th Cir. 1990) (Illinois law); *Assocs. of San Lazaro*, 864 P.2d at 115 (Colorado law).

<sup>11</sup>See *Power Soak Sys., Inc. v. EMCO Holdings, Inc.*, 482 F. Supp. 2d 1125, 1134 (W.D. Mo. 2007) ("The modern trend is that a buyer need not rely on a seller's express warranty in order to recover for the seller's subsequent breach of the express warranty.").

<sup>12</sup>See *Vigortone AG Prods. Inc. v. PM AG Prods. Inc.*, 316 F.3d 641, 649 (7th Cir. 2002) (noting that prior cases, requiring reliance, were "decided at a time when breach of warranty was considered a tort, not, as in the modern cases, a breach of contract"); *CBS Inc. v. Ziff-Davis Publ'g Co.*, 553 N.E.2d 997, 1001 (N.Y. 1990) (stating that "the prevailing perception of an action for breach of express warranty [is] one that is no longer grounded in tort, but essentially in contract").

<sup>13</sup>For example, the New York Court of Appeals concluded, in *Ziff-Davis Publ'g*, that the issue turned on whether the warranties were "bargained-for terms," where the buyer "purchased the seller's promise as to the existence of the warranted facts." 553 N.E.2d at 1001. In that case, the court concluded, the only reliance the buyer must demonstrate is a "reliance on the express warranty as being a part of the bargain between the parties." *Id.*; see also 8 SAMUEL WILLISTON, *A TREATISE ON THE LAW OF CONTRACTS* § 973, at 501 (Walter H. E. Jaeger ed. 1964) ("[I]t is generally and rightly held that inspection by the buyer does not excuse the seller from liability for words which amount to an express warranty, if the difference between the goods and the description was not detected." (footnote omitted)). The buyer's decision to proceed, with knowledge of the breach, could nevertheless constitute a waiver of its warranty claims. See *infra* notes 91-92 and accompanying text.

<sup>14</sup>As Chancellor Strine noted, in *Cobalt Operating, LLC v. James Crystal Enters., LLC*:  
[R]epresentations like the ones made in the [purchase agreement] serve an important risk allocation function. By obtaining the representations it did, [buyer] placed the risk that [target's] financial statements were false and that [target] was

its breach—in effect, a post-closing price adjustment.<sup>15</sup> The parties, however, can contract around both the traditional and modern default rules.<sup>16</sup>

Chief among Buyer's arguments, and often used to justify the modern trend, is the claim that Buyer "purchased the warranties" from Seller, and therefore, the cost of a sandbagging right was reflected in the price it paid.<sup>17</sup>

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operating in an illegal manner on [seller]. Its need then, as a practical business matter, to independently verify those things was lessened because it had the assurance of legal recourse against [seller] in the event the representations turned out to be false.

2007 WL 2142926, at \*28 (Del. Ch. July 20, 2007), *aff'd without op.*, 945 A.2d 594 (Del. 2008). Other courts have also adopted a risk-shifting approach to warranties. See *Galli*, 973 F.2d at 148, 151 (noting that warranties shift the risk from buyers to sellers, in effect, acting like insurance); *Giuffrida v. Am. Family Brands, Inc.*, 1998 WL 196402, at \*4 (E.D. Pa. Apr. 23, 1998) (finding that warranties "define and apportion the risks that the parties negotiated").

<sup>15</sup>See *Metro. Coal Co. v. Howard*, 155 F.2d 780, 784 (2d Cir. 1946) (describing a warranty as "a promise to indemnify the promisee for any loss if the fact warranted proves untrue, for obviously the promisor cannot control what is already in the past"). As the court found in *Vigortone AG Prods.*:

[A] breach of warranty entitles the victim of the breach, by way of damages, to "the difference between the purchasers' reasonable expectations as to the worth of the company, as fairly described in the warranties, and the actual worth of the company as a result of any breach of warranties."

316 F.3d at 648 (quoting *Blodgett Supply Co. v. P.F. Jurges & Co.*, 617 A.2d 123, 127 (Vt. 1992)).

<sup>16</sup>For a description of what a default rule is, see *infra* note 33. The parties' ability to contract around a sandbagging default rule has been upheld. See *S. Broad. Grp., LLC v. Gem Broad. Inc.*, 145 F. Supp. 2d 1316, 1324-25 (M.D. Fla. 2001), *aff'd without op.*, 49 F. App'x 288 (11th Cir. 2002); *Giuffrida*, 1998 WL 196402, at \*4-\*5; *Pegasus Mgmt. Co. v. Lyssa, Inc.*, 995 F. Supp. 29, 39 (D. Mass. 1998).

<sup>17</sup>See *infra* note 68 and accompanying text. In response, Seller has good arguments against Buyer's ability to sandbag. It can point to the unfairness (and questionable ethics) of a buyer who, with access to Seller's files and the business, lies in wait until after closing and then sues on the indemnity. See JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 423 (1975) (finding sandbagging to be "ethically questionable" when the purchaser closes without mentioning the claim and later claims indemnification from the seller when it results in liability); KLING & NUGENT, *supra* note 1, § 15.02[2] at 15-20 (discussing buyer's arguments for representations and warranties in the context where the buyer lies in wait to hit the seller with an indemnification claim after closing); see also James L. Kelly & Meredith Ervine, *To Sandbag or Not to Sandbag*, BUYOUTS, June 20, 2011, available at [http://www.pillsburylaw.com/siteFiles/Publications/AR\\_Buyouts\\_June\\_2011.pdf](http://www.pillsburylaw.com/siteFiles/Publications/AR_Buyouts_June_2011.pdf) (noting that "[i]f the buyer understands the significance of all of [the] isolated facts and how they contradict the picture otherwise presented by the seller of its business, [an anti-sandbagging provision] might just be 'fair'"). Seller may also argue that a rule against sandbagging would promote beneficial collaboration—forcing a discussion upfront of any problems that are uncovered

This Article questions that claim, focusing *not* on the warranties themselves, but on whether the purchase of warranties necessarily includes the purchase of a sandbagging right.<sup>18</sup>

An analysis of 548 publicly available deals, from July 2007 to June 2011, reveals that the incidence of contracts that included a pro-sandbagging

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and who should bear their cost. See Daniel Avery & Daniel H. Weintraub, *Trends in M&A Provisions: "Sandbagging" and "Anti-Sandbagging" Provisions*, BLOOMBERG L. REP.—MERGERS & ACQUISITIONS (2011), [http://www.goulstonstorr.com/portalresource/lookup/wosid/contentpilot-core-6-18120/pdf.name=/avery%20weintraub2%20sandbagging%20provisions%20\(2\).pdf](http://www.goulstonstorr.com/portalresource/lookup/wosid/contentpilot-core-6-18120/pdf.name=/avery%20weintraub2%20sandbagging%20provisions%20(2).pdf) (describing the buyer's position for requesting a sandbagging provision and the seller's position for requesting an anti-sandbagging provision).

<sup>18</sup>A number of other important issues swirl around sandbagging, but are beyond the scope of this Article. They include the applicability of the Uniform Commercial Code ("UCC") to a breach-of-warranty claim, in particular, UCC § 2-313(1). Section 2-313(1)(a) provides, in relevant part, that an express warranty is created by "[a]ny affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain." U.C.C. § 2-313 (2003). Its predecessor, the Uniform Sales Act ("USA") § 12, found an express warranty to be created "if the natural tendency of [the] affirmation or promise is to induce the buyer to purchase the goods, and if the buyer purchases the goods relying thereon." UNIF. SALES ACT, § 12, 3A U.L.A. 7 (2002). Two questions arise: First, does UCC § 2-313(1)(a), which is expressed to cover "goods," also cover the sale of a business? Compare *Ainger v. Mich. Gen. Corp.*, 476 F. Supp. 1209, 1225-26 (S.D.N.Y. 1979) (declining, in *dicta*, to extend UCC § 2-313 to a common law contract action, but noting that "[t]he question of whether the promisee 'relied' on the warranty . . . is whether he believed he was purchasing the promise"), *aff'd*, 632 F.2d 1025 (2d Cir. 1980), and *Kazerouni v. De Satnick*, 279 Cal. Rptr. 74, 75 (Cal. Ct. App. 1991) (limiting UCC § 2-313 to the sale of goods, but finding that reliance on the warranties was required of plaintiffs), with *Land v. Roper Corp.*, 531 F.2d 445, 448 (10th Cir. 1976) ("It is reasonable to infer that the reliance requirement applicable to sales of goods would be extended to the transfer or sale of securities."). Second, if UCC § 2-313(1)(a) is applicable, does the omission of an express reference to reliance (in contrast to USA § 12) mean that reliance is no longer required in a breach-of-warranty action? See generally Robert S. Adler, *The Last Best Argument for Eliminating Reliance from Express Warranties: "Real-World" Consumers Don't Read Warranties*, 45 S.C. L. REV. 429, 430-55 (1994) (describing the history and analyses of UCC § 2-313); Sidney Kwestel, *Freedom from Reliance: A Contract Approach to Express Warranty*, 26 SUFFOLK U. L. REV. 959, 960-1010 (1992) (describing the arguments for and against a reliance requirement). Similarly, if the express warranty is clearly set out in the contract, does UCC § 2-313(1)(a) even apply at all? See *Wikoff v. Vanderveld*, 897 F.2d 232, 241 (7th Cir. 1990) ("The 'basis of the bargain' rule is not applicable to situations where the warranties are clear and express."). The issues also include the applicability of the parol evidence rule to extra-contractual evidence with respect to warranty claims. See Sidney Kwestel, *Express Warranty as Contractual—The Need for a Clear Approach*, 53 MERCER L. REV. 557, 562-71 (2002) (arguing that breaches of express warranty are contractual, and so the parol evidence rule is applicable); see also *Wikoff*, 897 F.2d at 238-40 (noting the possibility of using parol evidence to ascertain the intent of the parties, but declining to use parol evidence because there was no ambiguity).

provision,<sup>19</sup> excluded an anti-sandbagging provision,<sup>20</sup> or was silent has been fairly consistent,<sup>21</sup> regardless of whether the contract was governed by the laws of states (like Delaware and New York) that follow the modern "pro-sandbagging" trend<sup>22</sup> or states (like California) that follow the traditional "anti-sandbagging" rule.<sup>23</sup> The scholarship on default rules suggests that different standards should prompt differences in contracting.<sup>24</sup> Why then, in

<sup>19</sup>An example of a pro-sandbagging provision is as follows:

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 (including any environmental investigation or assessment) conducted or any Knowledge [as separately defined] 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.

MODEL STOCK AGREEMENT, *supra* note 1, at 299.

<sup>20</sup>An example of an anti-sandbagging provision is as follows:

[Except as set forth in a Certificate to be delivered by Buyer at the Closing,] Buyer has no knowledge of any facts or circumstances that would serve as the basis for a claim by Buyer against Sellers based upon a breach of any of the representations and warranties of Sellers contained in this Agreement [or breach of any Sellers' covenants or agreements to be performed by any of them at or prior to Closing]. Buyer shall be deemed to have waived in full any breach of any of Sellers' representations and warranties [and any such covenants and agreements] of which Buyer has knowledge at the Closing.

*Id.* at 301.

<sup>21</sup>See *infra* Table 2, Graphs 1-5 and accompanying text.

<sup>22</sup>See *infra* Appendix A (summarizing New York and Delaware law). Delaware and New York are treated as pro-sandbagging jurisdictions, although the law in both states is not unambiguous. In Delaware, although the Court of Chancery noted that a buyer's breach-of-warranty action does not require a showing of reliance, see *Cobalt Operating, LLC v. James Crystal Enters., LLC*, 2007 WL 2142926, at \*28 (Del. Ch. July 20, 2007), *aff'd without op.*, 945 A.2d 594 (Del. 2008), the opinion did not address the Delaware Superior Court's earlier determination that reliance is a prerequisite for such a claim. See *Kelly v. McKesson HBOC, Inc.*, 2002 WL 88939, at \*8 (Del. Super. Ct. Jan. 17, 2002). In New York, *CBS Inc. v. Ziff-Davis Publ'g Co.*, 553 N.E.2d 997 (N.Y. 1990), appeared to narrow or eliminate the role of reliance in breach-of-warranty actions. The Second Circuit subsequently limited the case to instances when there was a dispute at closing over the accuracy of particular warranties and the buyer expressly preserved its warranty rights. If, instead, a buyer closed on a contract knowing, based on the seller's disclosure, that a warranty was breached, and failed to preserve its rights, the Second Circuit concluded that the buyer would have waived its claims. See *Galli v. Metz*, 973 F.2d 145, 151 (2d Cir. 1992); see also *Rogath v. Siebenmann*, 129 F.3d 261, 264-65 (2d Cir. 1997).

<sup>23</sup>See *infra* Appendix A (summarizing California law).

<sup>24</sup>See *infra* notes 33, 83-86 and accompanying text.

the case of sandbagging, is there a similarity in contract provisions regardless of the default rule?

First, the law around sandbagging is unsettled, varying across jurisdictions and changing over time. Practitioners, therefore, regularly advise buyers to bargain for a pro-sandbagging provision, even if sandbagging is more likely to be upheld without it. Buyers who particularly value a sandbagging right may choose to rely on the certainty of express contractual language rather than the default rule, resulting in a more consistent approach to contracting. The default rule, in that respect, may be overshadowed by legal practice.<sup>25</sup>

Second, under a pro-sandbagging rule, sellers have limited incentive to request an anti-sandbagging provision, and buyers have limited incentive to agree to it. For the buyer, it may be difficult to correlate an increase in value with an agreement to waive a sandbagging right. For the seller, urging buyers to contract around a pro-sandbagging rule is contrary to its goal of demonstrating that buyers can credibly rely on the contract's warranties.<sup>26</sup> The compromise, therefore, is often silence—with the right to sandbag set by the default rule rather than by express agreement.<sup>27</sup>

In neither case does a pro-sandbagging default rule reflect a buyer's interest in, or negotiation for, a sandbagging right. As a result, sellers are less able to identify which buyers are more or less likely to sandbag—and, in light of the uncertainty, they are more likely to reflect the risk of sandbagging in *all* contracts, potentially imposing on all buyers (including those with no interest in sandbagging) some portion of the related cost.

What many courts have failed to consider is whether there is value in sellers knowing at the time the contract is negotiated that a buyer is interested in sandbagging. Not all buyers value a sandbagging right in the same way.<sup>28</sup> The key, therefore, may be to introduce a default rule that promotes buyer disclosure, sometimes referred to as a "penalty default."<sup>29</sup>

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<sup>25</sup>See *infra* notes 53-57 and accompanying text.

<sup>26</sup>See *infra* notes 64-67 and accompanying text.

<sup>27</sup>See *infra* note 73 and accompanying text.

<sup>28</sup>Many U.S. practitioners consider sandbagging to be ethically questionable. See *supra* note 17 and accompanying text. In addition, sandbagging generally is restricted in Europe. See *infra* note 72 and accompanying text.

<sup>29</sup>The concept of a penalty default was introduced in Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 91 (1989) ("Penalty defaults are designed to give at least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer."). See also *infra* notes 79-86 and accompanying text.

Those for whom the benefits of contracting outweigh its costs will choose to bargain around the penalty default, revealing private information in the process. An anti-sandbagging default rule does just that. For some, the cost of negotiating a pro-sandbagging provision will outweigh its benefits.<sup>30</sup> Others who value the ability to sandbag can expressly bargain for it. The seller can reflect that information in its negotiations, potentially adjusting the purchase price and other deal terms (including other contract provisions) in response. As a result, buyers who are particularly interested in a sandbagging right will need to negotiate for it, and only they will incur the incremental cost of doing so.

Part II summarizes the results of a review of 548 acquisition contracts. As it illustrates, pro-sandbagging provisions and silence have been fairly common and anti-sandbagging provisions have been fairly rare—a relationship that has been consistent over time, without regard to governing law. Part II (and Appendix A) broadly divides jurisdictions between pro-sandbagging and anti-sandbagging default rules. Based on that division, roughly one-half of buyers with a sandbagging right relied on an express pro-sandbagging provision and, under a pro-sandbagging default rule, roughly one-half benefited from silence. Consequently, the vast majority of sophisticated buyers<sup>31</sup> in contracts subject to a pro-sandbagging rule held a sandbagging right, whereas sophisticated buyers in contracts subject to an anti-sandbagging rule were significantly less likely to do so.

Part III suggests that, even though pro-sandbagging and anti-sandbagging default rules affect outcome, their effect on contracting may be limited. Part of the reason may be uncertainty in case law. Standard forms may increase certainty, regardless of the governing law. Buyers and sellers may also have limited incentives to negotiate around a default standard, resulting in silence. In light of those findings, Part III argues that an anti-sandbagging default rule may be more effective than the modern approach in identifying buyers who are interested in "purchasing" a sandbagging right. Under a pro-sandbagging default rule, sellers are more likely to pool buyers together—transferring to them, as a group, the cost of sellers' risk of loss if a buyer sandbags. Not all buyers, however, value sandbagging in the same way. By promoting disclosure, an anti-sandbagging rule can help sellers

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<sup>30</sup>Costs, in this context, extend beyond the purchase price. Other costs can arise from changes in the indemnity or other terms of the contract. See *infra* notes 76-78, 87 and accompanying text.

<sup>31</sup>A "sophisticated buyer" is a purchaser represented by an Experienced Law Firm (as defined). See *infra* note 40 and accompanying text.

identify buyers who most value a sandbagging right. Those buyers will need to negotiate for it, and only they will incur the cost of doing so. Buyers and sellers, as a result, can more efficiently allocate resources, potentially increasing value for both.

## II. PRO-SANDBAGGING AND ANTI-SANDBAGGING

This Article contains a descriptive analysis<sup>32</sup> of the effects of pro-sandbagging and anti-sandbagging default rules on contractual sandbagging provisions.<sup>33</sup> Practitioners often caution, in light of the risk of sandbagging,

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<sup>32</sup>The data in this Article are not intended to be a comprehensive analysis of contractual sandbagging provisions. Other factors can affect outcomes, and how those provisions are negotiated will depend on what other concessions are made in the contract. *See infra* notes 34, 60 and accompanying text. Reflecting uncertainty in the case law, law firms may also incorporate standardized approaches to sandbagging, regardless of governing law. *See infra* notes 55-57 and accompanying text. Moreover, the parties' relative bargaining position, based on changes in the acquisition market, can affect outcomes. *See infra* notes 51-52 and accompanying text.

<sup>33</sup>In general, default rules are legal rules that individuals can modify through contract. *See* Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389, 390 (1993) (comparing default rules and immutable rules); *see also* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) (discussing the distinction between default and mandatory rules). A taxonomy of default rules is also included in Schwartz, *supra*, at 390-91. The analysis of default rules starts with the Coase theorem. In a well-known version, so long as individuals act rationally and transaction costs are negligible, legal rules are irrelevant to the efficient allocation of resources. *See* R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960) (noting that if "market transactions are costless . . . rearrangement of rights will always take place if it would lead to an increase in the value of production"). Specifically, the Coase theorem assumes "(a) the parties . . . are informed about relevant economic variables; (b) wealth effects are absent; (c) competitive markets exist; and (d) the cost of making transactions is zero." Schwartz, *supra*, at 397-98. If transacting is costless, parties have every reason to bargain in order to jointly maximize wealth. Law, in that world, has limited relevance, setting the initial rights around which parties can negotiate, but having little effect on the ultimate outcome. *See* Coase, *supra*, at 8; Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 4 (1982) ("The proposition that resource allocation is efficient, regardless of the structure of liability law, provided that bargaining is frictionless, is one version of the Coase Theorem."); Stewart Schwab, *A Coasean Experiment on Contract Presumptions*, 17 J. LEGAL STUD. 237, 242 (1988) ("Probably the most common formulation of the Coase Theorem asserts that, absent transaction costs, interacting parties will reach an efficient outcome even if the law awards initial legal entitlements to less valued uses."). That changes as Coase's transaction-cost assumption is relaxed. Law can begin to affect results, determining which party has what rights and, in turn, setting the relative costs and benefits of bargaining. *See* Coase, *supra*, at 15-19; *see also* RICHARD

that parties should choose a contract's governing law carefully.<sup>34</sup> The reasoning is straightforward: Buyers' sandbagging rights can vary considerably depending on governing law. This Article separates jurisdictions between pro-sandbagging and anti-sandbagging states, although characterizing a state as pro-sandbagging or anti-sandbagging may not provide a complete description of the relevant case law.<sup>35</sup> Based on that separation, the vast majority of buyers, expressly or by default, hold a sandbagging right in deals subject to a pro-sandbagging rule, whereas over forty percent forego that right in deals subject to an anti-sandbagging rule.<sup>36</sup>

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A. POSNER, *ECONOMIC ANALYSIS OF LAW* 56-58 (5th ed. 1998) (noting that, where rights have been initially assigned, transaction costs can affect whether the initial assignments are final); Robert C. Ellickson, *The Case for Coase and Against "Coaseanism"*, 99 *YALE L.J.* 611, 626 (1989) (noting that "legal rules can affect resource allocation"); Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 *YALE L.J.* 615, 624 (1990) (finding that law matters because the initial designation of rights "determines who will bargain and at what cost"); Stewart Schwab, *Coase Defends Coase: Why Lawyers Listen and Economists Do Not*, 87 *MICH. L. REV.* 1171, 1179 (1989) (noting that, contrary to the Coase assumptions, the law's effect is "subtle" and "not yet fully resolved"). Thus, a default rule can lower transaction costs by mimicking what most parties would agree on their own, so long as implementing it is less expensive than negotiation. See Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligations*, 69 *VA. L. REV.* 967, 971 (1983) (suggesting that default rules ideally should mimic agreements that parties would negotiate on their own); see also David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 *MICH. L. REV.* 1815, 1815-16 (1991) (describing the use of "hypothetical bargains" to construe ambiguous contract wording); C. A. Riley, *Designing Default Rules in Contract Law: Consent, Conventionalism, and Efficiency*, 20 *OXFORD J. LEGAL STUD.* 367, 383 (2000) (noting the argument of efficiency theorists that default rules "should mimic the terms that would be chosen by idealized contracting parties who enjoy perfect information, face zero transaction costs, and seek to maximize their joint gains" (citation omitted)). Even then, the parties are free to strike a different deal, bargaining around the default rule if they can reach a more efficient result. See Schwartz, *supra*, at 399 (noting that default rules are "enacted to solve problems for parties, so it follows that parties whose problems are not solved should be free to create their own deal").

<sup>34</sup>See West & Shah, *supra* note 4, at 6. The choice of governing law, however, is more often driven by issues affecting indemnification, the enforceability of restrictions on competition, and other considerations that are not directly related to sandbagging. Avery & Weintraub, *supra* note 17.

<sup>35</sup>For example, Delaware and New York are treated as pro-sandbagging jurisdictions, although the law in both states is not unambiguous. See *supra* note 22.

<sup>36</sup>Over ninety-five percent of sophisticated buyers held a sandbagging right, expressly or by default, in deals governed by Delaware or New York law, whereas only 55.2% held a sandbagging right in deals governed by the law of an Anti-Sandbagging Jurisdiction (as defined). See *infra* Table 2, Charts 1 and 2, and notes 40-41 and accompanying text.

The effect of a pro-sandbagging or anti-sandbagging rule on sandbagging rights is an empirical question. In order to assess that effect, I analyzed a proprietary data set of 884 publicly available stock purchase, asset purchase, and merger agreements from July 2007 to June 2011. The data were compiled randomly using different search terms on the EDGAR system maintained by the Securities and Exchange Commission ("SEC").<sup>37</sup> The search terms were "acquisition," "merger agreement," "purchase agreement," and "asset purchase agreement," yielding 884 different contracts. Sandbagging can occur only when the warranties survive the closing. Thus, contracts whose warranties did not survive were excluded, resulting in an analysis of 548 contracts.

Table 1 divides the data by governing law. Column 1 identifies total contracts<sup>38</sup> and contracts governed by the laws of (i) California, (ii) states that have an anti-sandbagging default rule, including California ("Anti-Sandbagging Jurisdictions" or "ASJ"),<sup>39</sup> (iii) Delaware, and (iv) New York. Column 2 identifies contracts in column 1 where the representations and warranties survive the closing ("R/W Survive"). Columns 3A, 3B, and 3C identify the number and percentage of contracts in column 2: (i) containing a pro-sandbagging provision, (ii) containing an anti-sandbagging provision, and (iii) where the contract is silent.

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<sup>37</sup>As a result, the database includes transactions in which a public company bought or sold a business (in either a stock or asset transaction) and was required to file the contract with the SEC. See SEC Current Report on Form 8-K (requiring disclosure of significant acquisitions and dispositions other than in the ordinary course of business); Regulation S-K, 17 C.F.R. §§ 229.601(b)(2), 601(b)(10) (2010) (requiring filing of material plans of acquisition and disposition and filing of material contracts). The sample is unlikely to include insignificant or immaterial transactions or transactions between private sellers and private buyers, since those contracts are not required to be filed with the SEC.

<sup>38</sup>The total number of contracts in Tables 1 and 2 include contracts whose governing law is not California, an Anti-Sandbagging Jurisdiction, Delaware, or New York.

<sup>39</sup>In Table 1 and Graph 5, those states are California, Colorado, Kansas, Maryland, Minnesota, Montana, and Texas. The relevant case law generally follows the traditional tort approach to sandbagging, requiring a buyer's reliance in order for it to bring a breach-of-warranty claim. See *infra* Appendix A.

*Table 1 – Total Pro-Sandbagging and Anti-Sandbagging*

Governing Law	(1) Total	(2) R/W Survive	(3A) Pro- Sandbagging		(3B) Anti- Sandbagging		(3C) Silent	
			#	%	#	%	#	%
All	884	548	258	47.1	30	5.5	260	47.4
California	56	48	26	54.2	2	4.2	20	41.7
Anti- Sandbagging	104	84	37	44.0	5	6.0	42	50.0
Delaware	450	213	107	50.2	8	3.8	98	46.0
New York	137	111	53	47.7	6	5.4	52	46.8

As Table 1 sets out, within contracts where R/W Survive, 54.2% of buyers under California law ( $n=48$ ) and 44.0% of buyers under ASJ law ( $n=84$ ) obtained an express sandbagging right. The remaining contracts were subject to an anti-sandbagging standard, primarily due to the contracts' silence under an anti-sandbagging default rule. Under Delaware and New York law, 96.2% ( $n=213$ ) and 94.5% ( $n=111$ ) of buyers held a sandbagging right, expressly or by default. Among those buyers, roughly one-half relied on an express pro-sandbagging provision, with most of the remainder benefiting from silence under a pro-sandbagging default rule.

Table 2 refines the data in Table 1 to cover only transactions where both the buyer and the seller were represented by an Experienced Law Firm ("ELF"), yielding 246 contracts.<sup>40</sup> It identifies, in Column 1, the number of ELF contracts where R/W Survive (i) in total and in contracts governed by

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<sup>40</sup> An Experienced Law Firm is a firm included in the 2012 Vault Top 100 list of law firms or that served as counsel (for buyer or seller) in at least three contracts within the data set. For the 2012 Vault Top 100 list of law firms, see *Law Firm Rankings 2012: Vault Law 100*, VAULT, <http://www.vault.com/wps/portal/usa/rankings/individual?rankingId1=2&rankingId2=2&rankings=1&regionId=0> (last visited Oct. 25, 2011). The Experienced Law Firm restriction, of course, may exclude some contracts where both parties are represented by sophisticated counsel.

the laws of: (ii) California, (iii) Anti-Sandbagging Jurisdictions,<sup>41</sup> (iv) Delaware, and (iv) New York. Columns 2A, 2B, and 2C list the number and percentage of contracts in Column 1 (i) containing a pro-sandbagging provision, (ii) containing an anti-sandbagging provision, and (iii) where the contract is silent.

*Table 2 – Total Pro-Sandbagging and Anti-Sandbagging with Experienced Law Firms and Survival of Representations and Warranties*

Governing Law	(1) ELFs	(2A) Pro-Sandbagging		(2B) Anti-Sandbagging		(2C) Silent	
		#	%	#	%	#	%
All	246	124	50.4	9	3.7	113	45.9
California	23	15	65.2	1	4.3	7	30.4
Anti-Sandbagging	29	16	55.2	1	3.4	12	41.4
Delaware	126	65	51.6	4	3.2	57	45.2
New York	49	22	44.9	2	4.1	25	51.0

As Table 2 indicates, pro-sandbagging provisions and silence are fairly common and anti-sandbagging provisions are fairly rare. Within ELF contracts where R/W Survive, 65.2% of buyers under California law ( $n=23$ ) and 55.2% of buyers under ASJ law ( $n=29$ ) obtained an express sandbagging right. The remaining contracts were subject to an anti-sandbagging standard, expressly or by default (California: 34.8%; ASJ: 44.8%). Under Delaware and New York law contracts, 96.8% ( $n=126$ ) and 95.9% ( $n=49$ ) of buyers held a sandbagging right, expressly or by default. Only 3.2% and 4.1% of contracts contained an express anti-sandbagging provision.

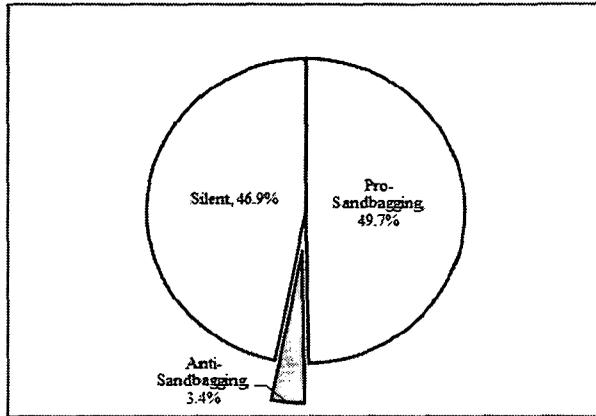
Roughly one-half of buyers with a sandbagging right relied on an express pro-sandbagging provision, and roughly one-half benefited from silence under a pro-sandbagging default rule. Consequently, as Chart 1 sets out, the vast majority of sophisticated buyers under Delaware and New York

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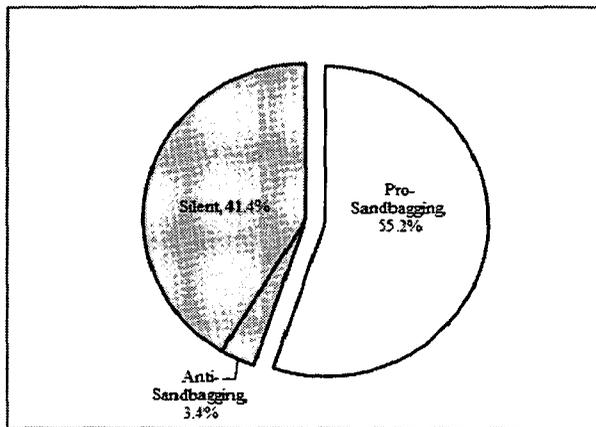
<sup>41</sup>In Table 2 and Graph 2, the Anti-Sandbagging Jurisdictions are California, Maryland, Minnesota, and Texas.

law contracts held a sandbagging right, whereas, as Chart 2 sets out, sophisticated buyers under ASJ law contracts were significantly less likely to do so.

*Chart 1: Delaware & New York Contracts by ELFs and R/W Survive*

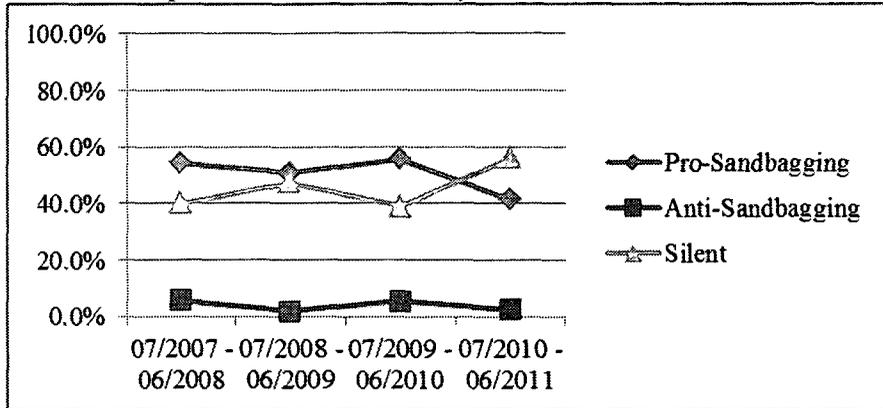


*Chart 2: Anti-Sandbagging Jurisdiction Contracts by ELFs and R/W Survive*

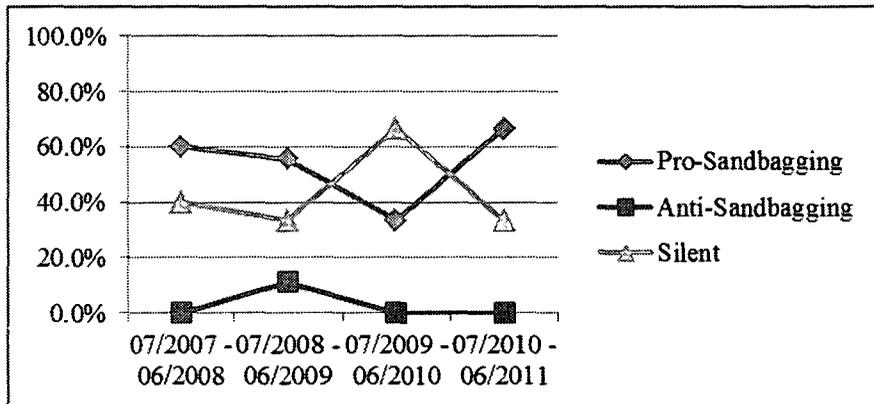


In order to confirm the relationship over time between pro-sandbagging provisions, anti-sandbagging provisions, and silence, the Table 2 data were divided over four consecutive twelve-month periods, between July 2007 and June 2011, (i) in total and in contracts governed by the laws of: (ii) Anti-Sandbagging Jurisdictions, (iii) Delaware, and (iv) New York.

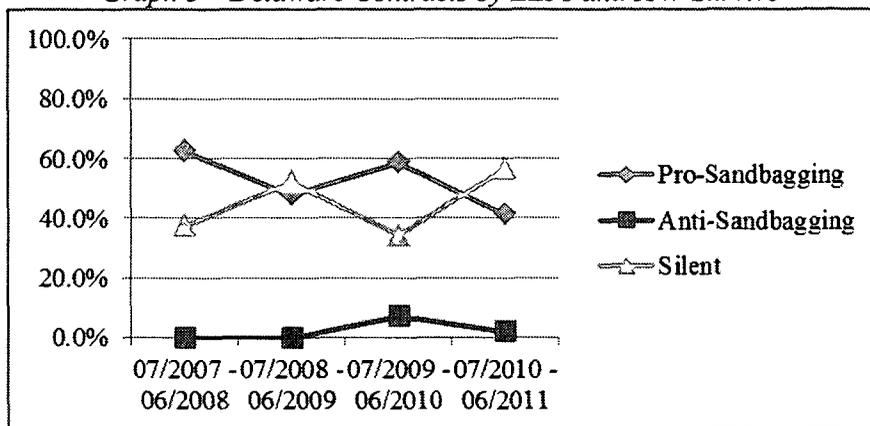
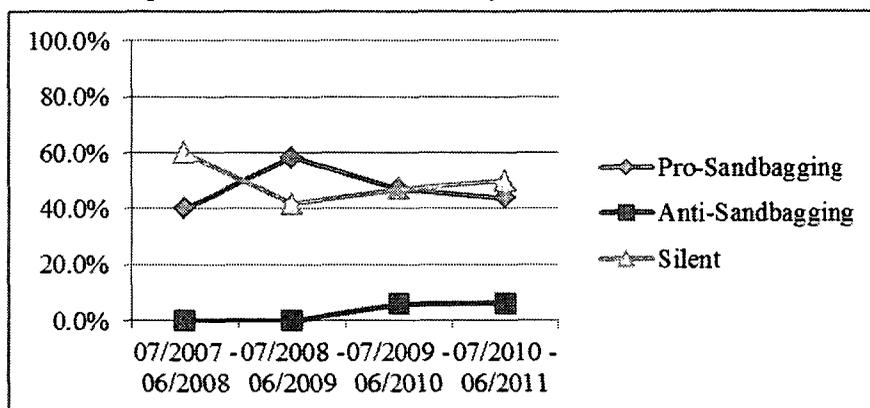
*Graph 1 – Total Contracts by ELFs and R/W Survive*



*Graph 2 – Anti-Sandbagging Jurisdiction Contracts by ELFs and R/W Survive<sup>42</sup>*



<sup>42</sup>The Anti-Sandbagging Jurisdictions in this graph are California, Maryland, Minnesota, and Texas.

*Graph 3 – Delaware Contracts by ELFs and R/W Survive**Graph 4 – New York Contracts by ELFs and R/W Survive*

The results in Graph 1, for total contracts, are consistent with practitioners' reports. Like those observations,<sup>43</sup> I found express pro-sandbagging provisions (Table 2: 50.4%) to be more common than anti-sandbagging provisions (Table 2: 3.7%) and I observed a recent increase in silence (Graph 1). Those observations are also consistent with data from non-ELF

<sup>43</sup> See Avery & Weintraub, *supra* note 17, at 4; Howard T. Spilko & Darius J. Goldman, *The Importance of Sandbagging Provisions from a Buyer's Perspective: What You Know May Harm You*, KRAMER LEVIN M&A PRACTICE GRP. ALERT (June 2009) at 2-3, <http://www.kramerlevin.com/files/Publication/1f4bc50a-ec7a-491b-92e3-01e2c90898c9/Presentation/PublicationAttachment/90cfc07a-0ee2-4ee4-bfa0-1f8eb0d393a/KramerLevinCorporateAlert.pdf> (providing an overview of New York case law and contractual approaches to sandbagging).

transactions where R/W Survive (Table 1).<sup>44</sup> In addition, the relationship among pro-sandbagging provisions, anti-sandbagging provisions, and silence has remained generally the same over time.<sup>45</sup>

Practitioners have observed a recent rise in contracts that are silent on sandbagging, relying instead on the default rule.<sup>46</sup> An increase in pro-sandbagging can be partly attributed to greater negotiating leverage by buyers,<sup>47</sup> and since buyers typically lead-off with a pro-sandbagging provision, an increase in silence can be partly attributed to greater leverage by sellers.<sup>48</sup> Graphs 3 (Delaware) and 4 (New York) reflect a recent rise in silence. Graph 2 (Anti-Sandbagging Jurisdictions) does not, but is based on a limited data set ( $n=29$ ) in which slight variations from year to year can overstate the results. Graph 5, therefore, presents ASJ results again, but using data from Table 1 (non-ELF deals, R/W Survive) and a larger pool of contracts ( $n=84$ ).

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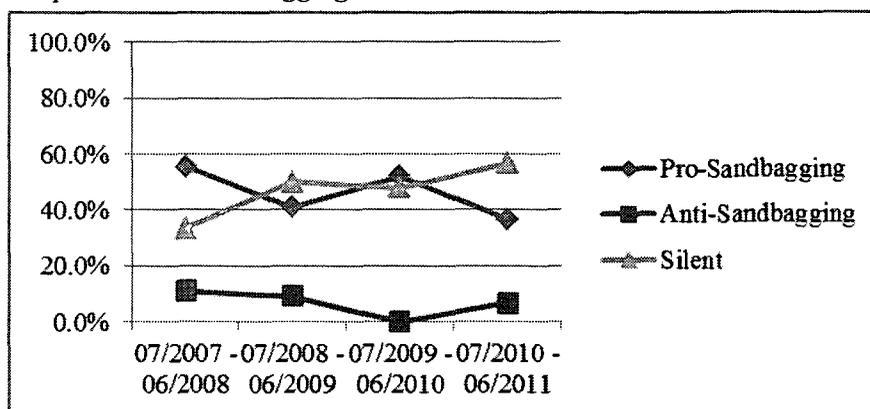
<sup>44</sup>There has been a similar trend in Europe. An increasing number of transactions are silent regarding the extent of a buyer's knowledge needed to bar a claim for breach of warranty, perhaps relying on local law to prohibit sandbagging. See CMS Legal Servs. EEIG, *CMS European M&A Study 2011*, CMS LEGAL, 20 (2011), [http://www.cmslegal.cn/Hubbard.FileSystem/files/Publication/9c81eafb-ea3c-418d-b525-25f9c0a0ec4e/Presentation/PublicationAttachment/28f47286-9f8b-4f83-a564-35265b45f87c/CMS\\_MASStudy2011\\_FINAL.pdf](http://www.cmslegal.cn/Hubbard.FileSystem/files/Publication/9c81eafb-ea3c-418d-b525-25f9c0a0ec4e/Presentation/PublicationAttachment/28f47286-9f8b-4f83-a564-35265b45f87c/CMS_MASStudy2011_FINAL.pdf) (providing an overview of European law applicable to acquisitions); see also *infra* note 72 and accompanying text (noting the norm in the U.S. compared to Europe).

<sup>45</sup>See Avery & Weintraub, *supra* note 17, at 4.

<sup>46</sup>See Spilko & Goldman, *supra* note 43, at 3.

<sup>47</sup>See *id.* at 4.

<sup>48</sup>See Wilson Chu & Larry Glasgow, *Truth or Dare: The Realities of Negotiated Deal Points in M&A*, FINANCIER WORLDWIDE, Apr. 2004, available at [http://www.gardere.com/Content/hubbard/tbl\\_s31Publications/FileUpload137/928/Glasgow-Financier-DEALPTS.pdf](http://www.gardere.com/Content/hubbard/tbl_s31Publications/FileUpload137/928/Glasgow-Financier-DEALPTS.pdf).

Graph 5 – Anti-Sandbagging Jurisdiction Contracts, R/W Survive<sup>49</sup>

Graph 5, like Graphs 3 and 4, illustrates a period-to-period change in pro-sandbagging provisions and silence that is consistent with the leverage thesis.<sup>50</sup> No doubt, a number of factors influenced the change. Part of it, however, may have been due to the decline in buyers in 2008 and 2009, increasing the bargaining strength of those who remained.<sup>51</sup> In the resulting "buyer's market," pro-sandbagging increased in contracts governed by both pro-sandbagging and anti-sandbagging state laws. Buyer advantage, in turn, weakened as the acquisition market returned in 2010 and early 2011.<sup>52</sup>

<sup>49</sup>The Anti-Sandbagging Jurisdictions in this graph are California, Colorado, Kansas, Maryland, Minnesota, Montana, and Texas.

<sup>50</sup>Note, however, that this view is inconsistent with the conventional theoretical claim that bargaining power is not evidenced by changes in the non-price terms of an agreement. See George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1320-21 (1981); Alan Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 VA. L. REV. 1053, 1071-76 (1977).

<sup>51</sup>See Quentin Webb, *M&A or A&E? Crisis to Dominate Dealmaking in 2009*, REUTERS (Dec. 11, 2008, 2:29PM), <http://uk.reuters.com/article/2008/12/11/uk-mergers-sbidUKTRE4BA33F20081211> (predicting a credit crisis-induced drop in acquisitions); *Buyer's Market: Financial Knowledge and Market Shifts Create M&A Opportunities*, WHARTON@WORK (Feb. 2009), <http://executiveeducation.wharton.upenn.edu/wharton-at-work/0902/buyers-market-0902.cfm?searchPos=1> (calling the economic crisis a "golden opportunity" for strategic buyers because fewer firms were competing for deals).

<sup>52</sup>See Anupreeta Das & Gina Chon, *Investors Warm to Big Deals—In this Year's Wave of Large Transactions, Even Acquirers' Shares Get a Boost*, WALL ST. J., Feb. 11, 2001, at C1 ("The big takeover deal has come back, reflecting increased corporate confidence and economic recovery."); Katy Burne, *Bank Lending Goes Long on High Quality*, WALL ST. J., May 17, 2011, at

Sellers were able to negotiate more successfully to remove pro-sandbagging provisions in both types of contracts, resulting in an increase in silence. The effect of silence, however, depended on the governing law. On balance, greater silence in Delaware and New York law contracts favored buyers, whereas silence in ASJ law contracts favored sellers.

### III. DEFAULT RULES AND PENALTY DEFAULTS

What is striking about Graphs 3 (Delaware), 4 (New York) and 5 (Anti-Sandbagging Jurisdictions) are their similarities. In each, pro-sandbagging provisions and silence range from roughly forty percent to sixty percent during the four-year period. Moreover, as Table 2 indicates, regardless of the default rule, roughly forty-five to fifty-five percent of contracts contain a sandbagging provision and roughly forty to fifty percent are silent. This suggests that, even though pro-sandbagging and anti-sandbagging default rules can affect outcomes, they may have only a limited effect on contracting.<sup>53</sup>

Part of the reason for the high level of pro-sandbagging provisions in Delaware and New York law contracts may be that the law around sandbagging is somewhat unsettled.<sup>54</sup> Practitioners, as a result, regularly advise buyers to bargain for a pro-sandbagging provision, even if sandbagging is likely to be upheld without it.<sup>55</sup> The default rule, in that respect, may be overshadowed by practice. Buyers who particularly value a sandbagging right may develop standard solutions, regardless of the governing law.<sup>56</sup> Certainty, in that case, a pro-sandbagging provision may be more important

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C8 (noting an increase in acquisition-related lending by banks).

<sup>53</sup>This assumes that buyers and sellers in each jurisdiction seek similar results—for sellers, minimizing the risk of sandbagging; for buyers, increasing the value of the warranties they receive.

<sup>54</sup>See *supra* note 22 and accompanying text.

<sup>55</sup>See John Jenkins et al., *Strategic Sandbagging: Let the Buyer Beware*, DEALLAWYERS.COM BLOG (June 8, 2009, 6:36 A.M.), <http://www.deallawyers.com/Blog/2009/06/strategic-sandbagging-let-the-buyer-beware.html> (noting that, given the "opaque" case law, buyers benefit from insisting on pro-sandbagging provisions); see also Quaintance, *supra* note 5, at 18 (recommending that buyers protect themselves by expressly preserving their rights and refusing to accept anti-sandbagging provisions); Chu & Glasgow, *supra* note 48.

<sup>56</sup>See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 557 (1990) (arguing against the importance of default rules); see also John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1303 (2001) (arguing that a company's lawyer, rather than the company's characteristics, is the primary influence on takeover defenses chosen at the IPO stage).

than the default rule—resulting in a similarity in contracts across jurisdictions.<sup>57</sup>

What is less clear is why there are similar levels of silence. As noted earlier, practitioners suggest that silence can reflect a compromise between sellers and buyers—generally, a win for sellers; less so in a contract governed by the laws of a pro-sandbagging state.<sup>58</sup> Practitioners also report that sandbagging negotiations, when they arise, are often lengthy, emotional, and heated,<sup>59</sup> typically taking place alongside negotiations over the seller's indemnity.<sup>60</sup> Thus, whether or not the parties agree to silence may be a deliberate outcome. Silence, in that case, may reflect the parties' consent to the default standard.<sup>61</sup>

Sandbagging provisions, however, are rarely negotiated in a vacuum. In a Coasean world, the choice of default rule would be largely irrelevant.<sup>62</sup> The parties could costlessly bargain to reach a more efficient outcome.<sup>63</sup> The

<sup>57</sup>Since sophisticated actors can bargain around a less-efficient default rule, it may be "more important for [a default rule] to be certain than to be right." Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 598 (1990); see also Kelly & Ervine, *supra* note 17 (noting that "if parties want to ensure a particular outcome, they should be explicit"). Standardized language may also reflect an agency problem. A lawyer that takes an unconventional approach to sandbagging—even if it better reflects the governing law to which the contract is subject—may not benefit from doing so if her client (and the other parties) must spend time to understand the new approach. See Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 885 (2010) (describing a similar agency problem arising from lawyers that draft unconventionally precise contract language in corporate acquisition agreements).

<sup>58</sup>See *supra* notes 46-48 and accompanying text.

<sup>59</sup>See MODEL STOCK AGREEMENT, *supra* note 1, at 301.

<sup>60</sup>See Kelly & Ervine, *supra* note 17.

<sup>61</sup>Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 862 (1992) (noting that courts' use of default rules to fill gaps in contracts is based on "consensual authorization," as the parties could have chosen to explicitly fill the gaps at the time of contracting); see also Steven J. Burton, *Default Principles, Legitimacy, and the Authority of a Contract*, 3 S. CAL. INTERDISC. L.J. 115, 154 (1993) (noting that default rules fill gaps, "[t]he contract can derive legitimate authority from consent," and "consent must be voluntary, knowing, and deliberate"); Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination*, 6 J. EMPIRICAL LEGAL STUD. 279, 304 (2009) (treating a company's decision not to opt out of an anti-takeover default rule as acceptance of that rule).

<sup>62</sup>See *supra* note 33.

<sup>63</sup>See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 737-42 (1992). Note that this analysis is based on a Kaldor-Hicks measure of efficiency, in which a default rule maximizes the sum of the affected

incentive to bargain, however, changes as transaction costs are introduced. In the real world, neither the buyer nor the seller has a strong incentive to negotiate around a pro-sandbagging standard. For the buyer, it may be difficult to correlate a change in value—such as an improved indemnity by the seller—with an agreement to waive a sandbagging right. Any benefits may also be outweighed by the costs of negotiating and drafting the terms of an anti-sandbagging provision.<sup>64</sup> That may be particularly true where the likelihood of sandbagging is remote and the expected litigation cost of bringing a sandbagging claim further lowers the probability of a later lawsuit.<sup>65</sup> Thus, a buyer who is uninterested in sandbagging has limited reason to distinguish itself from others.<sup>66</sup> For the seller, the incentive to urge buyers to contract around a pro-sandbagging rule is also limited. During negotiations, sellers seek to demonstrate to buyers that they can credibly rely on the contract's warranties. Urging a buyer to contract around a pro-sandbagging rule may draw those warranties into question, contrary to the seller's interests.<sup>67</sup> The result, therefore, is likely to be silence or, reflecting standard practice, a pro-sandbagging provision.

But at what cost? A pro-sandbagging default rule is often justified on the basis that the buyer "purchased the warranties" from the seller and, therefore, the cost of sandbagging was reflected in the price it paid.<sup>68</sup> Not

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parties' welfare, even though some may benefit at the expense of others. *See* Richard Craswell, *Efficiency and Rational Bargaining in Contractual Settings*, 15 HARV. J.L. & PUB. POL'Y 805, 816-18 (1992) (comparing the Kaldor-Hicks measure of efficiency in cases where the contracting parties are identical and where they are not).

<sup>64</sup>As a result, practitioners often counsel buyers not to accept an anti-sandbagging clause even if they do not intend to sandbag. *See* Quaintance, *supra* note 5, at 18.

<sup>65</sup>*See* Choi & Triantis, *supra* note 57, at 883-84, 888-92 (describing the screening effect of litigation costs as one reason why corporate acquisition agreements include vague terms).

<sup>66</sup>That may change if the number of sandbaggers (or the expectation of sandbagging) increases, also increasing the potential value to non-sandbaggers of identifying their status.

<sup>67</sup>*See* Choi & Triantis, *supra* note 57, at 886-87 (arguing that greater precision in contract language that can trigger termination may inadvertently signal that a party expects the deal price to be adjusted or the deal to be called off). Of course, as practitioners have noted, a seller who believes there is a relatively high risk of sandbagging by a particular buyer may conclude that the costs of an anti-sandbagging provision are outweighed by its benefits. *See* Quaintance, *supra* note 5, at 18.

<sup>68</sup>*See supra* notes 14-15, 17 and accompanying text; *see also* CBS Inc. v. Ziff-Davis Publ'g Co., 553 N.E.2d 997, 1002 (N.Y. 1990) (noting that the purchase price is set "based on information furnished by the seller which the seller warrant[s] to be true"). Practitioners sometimes make a similar claim. *See* MODEL STOCK AGREEMENT, *supra* note 1, at 299-300 (noting that a buyer's "principal rationale" for rejecting an anti-sandbagging provision is that the warranties "presumably entered into Buyer's determination of the price"); *see also* Robert J. Johannes & Thomas A. Simonis, *Buyer's Pre-Closing Knowledge of Seller's Breach of Warranty*, WIS. LAW. (July 2002),

every buyer, however, values a sandbagging right in the same way, nor is everyone equally likely to sandbag.

Some buyers place a premium on the seller's warranties and the ability to sandbag. For example, a buyer who has a particular interest in a seller's warranties, but is unable to assess their accuracy before closing, may wish to maintain a clear right to bring a claim against the seller after closing if there is a material breach. In addition, a buyer may prefer to limit the seller's options to negotiating damages following discovery of a breach. If notified of the breach before closing, the seller may have other alternatives, such as attempting to sell the business to another buyer for whom the breach would be less significant. By closing first, a sandbagger can restrict the seller's ability to do so.<sup>69</sup>

Yet, as the ASJ data indicate, it is far from clear that a pro-sandbagging provision is what parties would negotiate on their own.<sup>70</sup> Deliberate sandbagging is ethically questionable to many,<sup>71</sup> and anti-sandbagging is the norm in Europe.<sup>72</sup> Moreover, in some instances, a knowledgeable buyer may rely on its own information, rather than the seller's warranties, to assess the value of what it is purchasing. For those buyers, a sandbagging right is likely to hold limited value.

Nevertheless, under a pro-sandbagging rule, buyers with little interest in a sandbagging right and whose contracts are silent will remain subject to a pro-sandbagging standard.<sup>73</sup> Sellers, therefore, may treat all buyers as poten-

[http://www.wisbar.org/am/template.cfm?section=wisconsin\\_lawyer&template=/cm/content/display.cfm&contentid=50497](http://www.wisbar.org/am/template.cfm?section=wisconsin_lawyer&template=/cm/content/display.cfm&contentid=50497) (concluding that "the warranties represent the bargained-for economic risk allocation agreed on by the parties"); West & Shah, *supra* note 4, at 6 (noting the buyer's argument that it "priced" the warranties into the consideration it agreed to pay).

<sup>69</sup>The seller, of course, would need to overcome the perception of selling "damaged goods." See Heath Price Tarbert, *Merger Breakup Fees: A Critical Challenge to Anglo-American Corporate Law*, 34 LAW & POL'Y INT'L BUS. 627, 633-34 (2003) (citing F. George Davitt et al., *Orchestrating Takeover Talks: The Corporate Board*, SF86 ALI-ABA 677, 682 (2001)) (noting that target companies have an incentive to use deal protection tools to avoid being viewed as damaged goods).

<sup>70</sup>Within ELF contracts where R/W Survive, 34.8% of buyers under California law and 44.8% of buyers under ASJ law did not obtain a pro-sandbagging provision. See *supra* Table 2 and Chart 2.

<sup>71</sup>See *supra* note 17.

<sup>72</sup>Anti-sandbagging is the common standard in Europe, although the basis for determining knowledge of a breach of warranty varies among countries. See, e.g., WORLD LAW GROUP, INTERNATIONAL BUSINESS ACQUISITIONS: MAJOR LEGAL ISSUES AND DUE DILIGENCE 103, 106-07 (Franz-Jörg Semler et al. eds., 2d ed. 2000) (German law); see also CMS Legal Servs. EEIG, *supra* note 44, at 20 (noting that disclosure and warranty claims vary greatly within European countries).

<sup>73</sup>See *supra* notes 64-66 and accompanying text.

tial sandbaggers—transferring to buyers, as a group, the incremental cost of the risk of sandbagging that the sellers face. That cost may include fewer or more limited warranties or a restriction on the seller's indemnity. Thus, under a pro-sandbagging rule, rather than a buyer "purchasing" its right to sandbag, *all* buyers—except those unlikely few who expressly disclaim sandbagging—may bear a portion (however small) of the related cost.

If sellers are unable to differentiate buyers, they may also fail to efficiently allocate resources; in particular, sellers may fail to be more diligent when providing warranties to buyers who, as potential sandbaggers, have a particular interest in the warranties' accuracy. In acquisitions, a principal gap between sellers and buyers often turns on the value of the business being sold.<sup>74</sup> Typically, a buyer has less information than a seller, creating a "lemons" problem: Unable to differentiate "good" from "bad" businesses, buyers may discount the value of all businesses to reflect the likelihood of making a bad purchase.<sup>75</sup> A seller, instead, can communicate information at lower cost through warranties,<sup>76</sup> on balance, acting as a cost-effective substitute for a buyer's due diligence and, in turn, prompting a higher purchase price.<sup>77</sup> To be sure, most sellers double-check their warranties' accuracy, regardless of the buyer's identity. Yet, buyers who particularly value a seller's assessment may merit additional attention.

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<sup>74</sup>See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 253-56 (1984) (discussing that the "central aspect of [business] transaction[s] is the asset's value").

<sup>75</sup>See George A. Akerlof, *The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489-90 (1970) (illustrating the lemons problem with used automobiles); Charles Wilson, *The Nature of Equilibrium in Markets with Adverse Selection*, 11 BELL J. ECON. 108, 108-09 (1980) (discussing that, where adverse selection is possible in markets, the price-setting mechanisms can affect the welfare of market participants); Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461, 469-70 (1981) (discussing buyer's inability to identify quality products in markets).

<sup>76</sup>See MODEL STOCK AGREEMENT, *supra* note 1, at 78; MODEL ASSET AGREEMENT, *supra* note 1, at 69-70. The seller has a powerful incentive to provide those warranties. If the seller has information, but refuses to provide it, the buyer is likely to conclude that the information is negative—causing a drop in what the buyer is willing to pay. See Grossman, *supra* note 75, at 469. Information costs can also make the deal more expensive, further eroding the purchase price. In that respect, the seller and the buyer are aligned—a failure to span the information gap or lower costs is likely to harm both. See Robert Cooter et al., *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225, 242-44 (1982) (comparing the optimistic and pessimistic approaches to bargaining); Gilson, *supra* note 74, at 269-72 (arguing that facilitating the transfer of information benefits both parties).

<sup>77</sup>See *supra* notes 14-15 and accompanying text.

Sellers, in that case, can take additional precautions to ensure the accuracy of what they provide. If sellers can provide that assurance, buyers with a particular interest can bargain for it—potentially enhancing value for both.<sup>78</sup>

Doing so, however, requires that sellers be able to differentiate buyers. So-called "penalty defaults"—relatively new to contract scholarship,<sup>79</sup> but whose concept has been with us for millennia<sup>80</sup>—offer one possible solution.<sup>81</sup> A penalty default provides a means to induce one party to convey valuable information to another.<sup>82</sup> The key is its ability to cause a separating equilibrium. Unlike a standard default rule, which appeals to a broad group, a penalty default prompts parties to separate through contracting.<sup>83</sup> Those for whom the benefits outweigh the costs will choose to bargain around the penalty default, revealing private information in the process.<sup>84</sup> The remainder will elect to continue to be subject to the default standard.<sup>85</sup> The key is whether the value from disclosure outweighs the incremental costs of contracting. If aggregate costs exceed benefits, then a traditional default rule—reflecting the consensus standard—may be more efficient. If, however, the net benefits of disclosure are positive, a penalty default may be more valuable.<sup>86</sup>

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<sup>78</sup>See William Bishop, *The Contract-Tort Boundary and the Economics of Insurance*, 12 J. LEGAL STUD. 241, 254-60 (1983) (discussing the role of contract law in encouraging the efficient transfer of information).

<sup>79</sup>See *supra* note 33 and accompanying text.

<sup>80</sup>Perhaps the most well-known example is of the two women who came to King Solomon with a baby whom each claimed as her own. Solomon said he would split the baby in half. The second woman accepted the decision. The first woman begged the King to give the baby to the second, based upon which he announced the first to be the mother. 1 *Kings* 3:16-28 (The New American Bible (1970)).

<sup>81</sup>See Ayres & Gertner, *supra* note 29, at 91.

<sup>82</sup>See *id.* at 97.

<sup>83</sup>*Id.*

<sup>84</sup>See *id.* at 91 ("[P]enalty defaults are purposefully set at what the parties would not want—in order to encourage the parties to reveal information to each other."); Johnston, *supra* note 33, at 625 ("The standard prescription for choosing default rules must be qualified to take into account the fact that information is revealed in bargaining around the default."); Scott, *supra* note 57, at 609-10 ("Certain default rules are set, not because they represent the ultimate allocations preferred by most bargainers, but rather because they are best suited to inducing one party to share important information with the other.").

<sup>85</sup>See Ayres & Gertner, *supra* note 29, at 94-95, 112.

<sup>86</sup>See *id.* at 112.

In that respect, an anti-sandbagging default rule may be optimal.<sup>87</sup> It would require buyers who value a sandbagging right—those who are willing to "purchase" that right—to identify themselves to sellers and then expressly bargain for it. For those buyers, the benefits must outweigh the costs, including the transaction costs of bargaining around the rule as well as the seller's interest in modifying the indemnity and other contractual terms in response. An anti-sandbagging rule may also be optimal if silence is a common compromise. In that case, buyers can use the compromise to negotiate other concessions, creating a clearer trade-off than under a pro-sandbagging standard. Once a buyer interested in a sandbagging right is identified, the seller can reflect that information in the resources it devotes to double-checking its warranties, as well as in its negotiations, potentially adjusting the purchase price and other deal terms in response. As a result, a buyer interested in a sandbagging right will need to negotiate for it, and only those buyers who particularly value a sandbagging right will incur the cost of doing so.

Buyers sometimes express concern that an anti-sandbagging rule will promote litigation. For example, a rule that blocks sandbagging based on a buyer's knowledge before closing may raise questions about what constitutes "knowledge," permitting sellers to throw hurdles in the way of legitimate post-closing indemnity claims.<sup>88</sup> An anti-sandbagging rule may also limit a seller's interest in complete disclosure. The seller could disclose a problem, but intentionally do so in a way that fails to catch the buyer's attention.<sup>89</sup> The

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<sup>87</sup> A similar argument for a pro-sandbagging default rule is more difficult to make. As noted earlier, a pro-sandbagging rule is more likely to result in a pooling among sellers and buyers—without the separating effect of a penalty default. See *supra* Chart 1. For the buyer, it may be difficult to correlate an increase in value with an agreement to waive a sandbagging right, although that may change if the number of sandbaggers (or the expectation of sandbagging) also increases. For the seller, urging buyers to contract around a pro-sandbagging rule is contrary to its goal of demonstrating that buyers can credibly rely on the contract's warranties. See *supra* notes 64-67 and accompanying text.

<sup>88</sup> See *Grupo Condumex, S.A. v. SPX Corp.*, 2008 WL 4372678, at \*2 n.2 (N.D. Ohio Sept. 19, 2008); *Giuffrida v. Am. Family Brands, Inc.*, 1998 WL 196402, at \*4-\*5 (E.D. Pa. Apr. 23, 1998); see also *KLING & NUGENT*, *supra* note 1, at § 15.02[2] ("Issues of knowledge inject substantial litigation uncertainty into any situation."); *Quaintance*, *supra* note 5, at 18 (stating that anti-sandbagging provisions "create an extra element of proof . . . on every indemnity claim"); *West & Shah*, *supra* note 4, at 3, 6-7 (advising that the buyer has an increased burden of proof).

<sup>89</sup> See *Quaintance*, *supra* note 5, at 1 (noting that this sometimes occurs as part of a last minute data dump); see also *MODEL STOCK AGREEMENT*, *supra* note 1, at 299 (noting that "prior to assuming control of the target, it is impossible to know its true state of affairs"); *Kelly & Ervine*,

response is that a penalty default is intended to set a baseline around which buyers can (and should) negotiate. Concerns over the scope of "knowledge" can be addressed through contract.<sup>90</sup> Part of the concern can also be addressed through the default rule itself. For example, imposing on sellers the burden of proving buyers' knowledge is consistent with the doctrine of waiver,<sup>91</sup> and limiting its scope—such as only to information that sellers expressly give to buyers—can further assist in mitigating litigation costs.<sup>92</sup>

#### IV. CONCLUSION

It is difficult, based on the ASJ data, to argue that a pro-sandbagging standard is what a significant majority of parties would negotiate on their own. Yet, as this Article has explained, a buyer under a pro-sandbagging default rule is more likely to be subject to a pro-sandbagging standard even if it has limited interest in a sandbagging right. The result is that sellers and buyers are less able to optimally allocate risk, and sellers—unable to differentiate among buyers—are also unable to allocate resources in a way that reflects the buyers' interests in the warranties.

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*supra* note 17 (observing that when the seller "proceeds to dump a truck full of knowledge into the buyer's lap . . . [i]t may have effectively nullified all the carefully negotiated representations").

<sup>90</sup>An example of a pro-sandbagging provision that addresses knowledge appears *supra* at note 19. See also MODEL STOCK AGREEMENT, *supra* note 1, at 301 ("If Buyer is willing to accept some limitation on its entitlement to indemnification based on its knowledge, it should carefully define the circumstances in which knowledge is to have this effect."); KLING & NUGENT, *supra* note 1, at § 11.02; Byron F. Egan et al., Contractual Limitations on Seller Liability in M&A Transactions 24 (Apr. 22, 2010), available at <http://images.jw.com/com/publications/1362.pdf> (applying the MODEL STOCK AGREEMENT); West & Shah, *supra* note 4, at 7-8 (advising buyers to limit the scope of knowledge to a few people).

<sup>91</sup>See 28 AM. JUR. 2D *Estoppel and Waiver* § 225 (2011) ("The party claiming a waiver has the burden of proof of the facts on which the party relies to establish such waiver, and unless such proof is forthcoming the party cannot sustain the claim." (citations omitted)); see also Landgarten v. York Research Corp., 1988 WL 7392, at \*3 (Del. Ch. Feb. 3, 1988) ("The party claiming a waiver has the burden of proof on that issue."); 1800 Smith St. Assocs., LP v. Gencarelli, 888 A.2d 46, 55 n.4 (R.I. 2005) ("[W]aiver of contractual provisions is not lightly to be inferred . . . . The party claiming that there has been a waiver of a contractual provision has the burden of proof.").

<sup>92</sup>For example, the Second Circuit's waiver analysis depends on the source of the buyer's information. If the seller is not the source—for example, if it is "common knowledge" that the warranty was false or the buyer learned of the breach from a third party—the buyer may still prevail on its breach-of-warranty claim. In that case, the court has reasoned, "it is not unrealistic to assume that the buyer purchased the seller's warranty 'as insurance against any future claims,' and that is why he insisted on the inclusion of the warranties in the bill of sale." Rogath v. Siebenmann, 129 F.3d 261, 265 (2d Cir. 1997) (quoting Galli v. Metz, 973 F.2d 145, 151 (2d Cir. 1992)).

So why have modern courts not adopted an anti-sandbagging default rule? The answer, most likely, is framed by the cases that are litigated. In many cases, the parties simply failed to include a sandbagging provision in the contract and the issue, for whatever reason, was never clearly negotiated.<sup>93</sup> Subsequently faced with losses, the buyer then argued it should be entitled to the warranties' benefit, irrespective of what it may have known at closing. There is an appeal to that position, consistent with the view that all parties benefit if a buyer can rely on what a seller has warranted. What that view fails to reflect is that not everyone chooses to sandbag or values sandbagging in the same way. By pooling buyers, a pro-sandbagging default rule can affect the risk-bearing decision (and the associated costs) of others in a way that an anti-sandbagging rule would not. By contrast, under an anti-sandbagging default rule, buyers who value a sandbagging right must expressly bargain for it—signaling to sellers who they are. The outcome is likely to be a more efficient allocation of risk, as well as who should bear its cost.

APPENDIX A: SURVEY OF SANDBAGGING CASE LAW IN COMMERCIAL  
TRANSACTIONS  
(EXCLUDING PRODUCTS LIABILITY CLAIMS)

Set forth below is a summary of sandbagging cases involving commercial transactions, excluding products liability claims. The summary is organized in two sections. The first summarizes cases that adopted a "contract approach" to breach-of-warranty claims, and the second summarizes cases following the "tort approach."<sup>94</sup>

**Contract Approach (No Reliance Requirement):**

1. **Connecticut:** A Massachusetts federal district court predicted that the Connecticut Supreme Court would not require proof of reliance in a

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<sup>93</sup>The reluctance may reflect practitioners' experience with lengthy, emotional, and heated sandbagging negotiations, when they occur. *See supra* note 59 and accompanying text.

<sup>94</sup>The summaries contained in this appendix are not complete descriptions of the applicable law. They reflect case law as of June 2011, the final period in which acquisition agreements were reviewed for this Article. In addition, characterizing a jurisdiction as adopting a "contract" or "tort" approach may not provide a complete description of the relevant case law. For example, Delaware and New York are treated as pro-sandbagging jurisdictions, although the law in both states is not unambiguous. *See supra* note 22 and accompanying text.

breach-of-contract claim based upon a bargained-for express warranty.<sup>95</sup> Note that, in this case, the court partly relied on a pro-sandbagging provision in the contract.<sup>96</sup>

2. **Delaware:** In 2002, the Delaware Superior Court found that "a plaintiff must establish reliance as a prerequisite for a breach-of-warranty claim."<sup>97</sup> An Illinois federal district court, applying Delaware law, also found reliance to be required in a breach-of-warranty claim.<sup>98</sup> Subsequently, in 2005, the Superior Court concluded that reliance was not a requirement of a breach-of-warranty claim involving the sale of a home health care company.<sup>99</sup> Knowledge acquired by the purchaser through its own due diligence had no bearing on its right to rely on the seller's warranties.<sup>100</sup> In 2007, the Delaware Court of Chancery ruled that a buyer's claim did not require a showing of reliance, although it based its decision in part on a provision in the contract that stated that the buyer's inspection or investigation would not affect any of the seller's warranties.<sup>101</sup> The Seventh Circuit, in an earlier 2002 opinion, also raised doubts over whether Delaware would follow a tort approach in analyzing breach-of-warranty claims.<sup>102</sup>
3. **Florida:** A Florida federal district court predicted in *Southern Broadcasting* that a Florida court "would embrace the modern view that express warranties are bargained-for terms of a contractual agreement," and did not require reliance for an action for breach of contract "notwithstanding proof of non-reliance at the time of closing on the

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<sup>95</sup>See *Pegasus Mgmt. Co. v. Lyssa, Inc.*, 995 F. Supp. 29, 39 (D. Mass. 1998); see also *Wechsler v. Long Island Rehab. Ctr of Nassau, Inc.*, 1996 WL 590679 at \*22 (Mass. Super. Ct. Sept. 4, 1996) (holding that reliance on the factual truth of each warranty is not a required element of a breach-of-warranty claim).

<sup>96</sup>See *id.*

<sup>97</sup>*Kelly v. McKesson HBOC, Inc.*, 2002 WL 88939, at \*8 (Del. Super. Ct. Jan. 17, 2002).

<sup>98</sup>*Middleby Corp. v. Hussman Corp.*, 1992 WL 220922, at \*6 (N.D. Ill. Aug. 27, 1992) ("At issue is whether reliance on a warranty is an essential element of a warranty claim under Delaware law . . . several old—but apparently still viable—[Delaware] decisions answer the question in the affirmative.").

<sup>99</sup>*Interim Healthcare, Inc. v. Spherion Corp.*, 884 A.2d 513, 548 (Del. Super. Ct. 2005).

<sup>100</sup>See *id.*

<sup>101</sup>*Cobalt Operating, LLC v. James Crystal Enters., LLC*, 2007 WL 2142926, at \*28 (Del. Ch. July 20, 2007), *aff'd without op.*, 945 A.2d 594 (Del. 2008).

<sup>102</sup>*Vigortone AG Prods., Inc. v. PM AG Prods., Inc.*, 316 F.3d 641, 649 (7th Cir. 2002).

contract."<sup>103</sup> *Southern Broadcasting* distinguished *Hobco Inc. v. Tallahassee Associates*<sup>104</sup> and *Thursby v. Reynolds Metals Co.*<sup>105</sup> as cases concerned with the timing of reliance, noting that reliance, if any, is required "at the time the contract is formed," not between signing and closing.<sup>106</sup> A subsequent Florida federal district court noted, in *dicta*, that the Florida law on the issue of reliance is "unsettled," comparing *Southern Broadcasting* with *Hobco*.<sup>107</sup>

4. **Illinois:** Reliance was unnecessary to recover for a breach of warranty where the buyer relied on the warranty at signing but the sale never closed.<sup>108</sup> The Seventh Circuit noted that a plaintiff need not prove that a warranty was a basis of the bargain between seller and buyer "where the warranties are clear and express."<sup>109</sup> An Illinois federal district court also found that knowledge of a breach at signing did not bar a subsequent breach-of-warranty claim.<sup>110</sup>
5. **Indiana:** In a breach-of-warranty claim, it is unnecessary for the buyer to have relied on the warranty even when a reasonable buyer would have known prior to signing that it was false.<sup>111</sup> Note that in *Jackson v.*

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<sup>103</sup>*S. Broad. Grp., LLC v. Gem Broad. Inc.*, 145 F. Supp. 2d 1316, 1321, 1324 (M.D. Fla. 2001) (citing *Lennar Homes, Inc. v. Masonite Corp.*, 32 F. Supp. 2d 396 (E.D.La. 1998), to the effect that the "Florida Supreme Court has not yet decided whether proof of reliance is required to recover for breach of an express written warranty"), *aff'd without op.* 49 F. App'x 288 (11th Cir. 2002).

<sup>104</sup>807 F.2d 1529, 1533 (11th Cir. 1987) ("Under Florida law, an express warranty may arise only where justifiable reliance upon assertions or affirmations is part of the basis of the bargain.").

<sup>105</sup>466 So. 2d 245, 250 (Fla. Dist. Ct. App. 1984) (holding that an express warranty arises when the seller asserts facts which the buyer does not know before the beginning of the transaction and on which the buyer relies).

<sup>106</sup>*S. Broad. Grp.*, 145 F. Supp. 2d at 1324.

<sup>107</sup>*Leeward v. Galaxy Cable Inc.*, 2006 WL 2868928, at \*7 & n.30 (M.D. Fla. Oct. 6, 2006).

<sup>108</sup>*See Indeck N. Am. Power Fund, L.P. v. Norweb PLC*, 735 N.E.2d 649, 659 (Ill. App. Ct. 2000) ("To recover on a warranty claim, a party need only show that the warranty is party [sic] of the contract, and is relied upon.").

<sup>109</sup>*Wikoff v. Vanderveld*, 897 F.2d 232, 241 (7th Cir. 1990) (remanding the case to determine whether a breach of warranty had occurred).

<sup>110</sup>*See Pension Benefit Guar. Corp. v. Ziffer*, 1994 U.S. Dist. LEXUS 87, at \*15-\*16, \*23 (N.D. Ill. Jan. 4, 1994).

<sup>111</sup>*See Essex Grp., Inc. v. Nill*, 594 N.E.2d 503, 506-07 (Ind. Ct. App. 1992); *Shambaugh v. Lindsay*, 445 N.E.2d 124, 125-27 (Ind. Ct. App. 1983); *see also Seibert v. Mock*, 510 N.E.2d 1373,

*Russell*,<sup>112</sup> a buyer who knew that the seller's warranties were untrue prior to signing was precluded from asserting a breach-of-warranty action when the contract included an anti-sandbagging provision.<sup>113</sup>

6. **Massachusetts:** Buyers are entitled to recover damages for a breach of warranty despite their knowing at the time of signing that the warranty was untrue.<sup>114</sup>
7. **Michigan:** An Ohio federal district court, applying Michigan law, concluded that Michigan views claims for breach of warranty to be firmly rooted in principles of contract rather than tort.<sup>115</sup>
8. **Missouri:** A Missouri federal district court found that, under Missouri law, a buyer is not required to have relied on the content of the warranty.<sup>116</sup> The court noted that the key consideration was whether the buyer "believed it was purchasing the seller's promise as to its truth," not whether the buyer believed the truth of the warranty itself.<sup>117</sup>
9. **Montana:** In a widely-cited case, a Montana federal district court found that pre-signing knowledge did not bar recovery because "[t]he warranty is as much a part of the contract as any other part, and the right to damages on the breach depends on nothing more than the breach of warranty."<sup>118</sup>

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1376 (Ind. Ct. App. 1987) (noting that express warranties by a seller will not be abrogated because the buyer performed an inspection of the property).

<sup>112</sup>498 N.E.2d 22 (Ind. Ct. App. 1986).

<sup>113</sup>*Id.* at 36.

<sup>114</sup>*See Richards v. Saveway Oil Co.*, 314 N.E.2d 923, 925 (Mass. App. Ct. 1974); *Wechsler v. Long Island Rehab. Ctr. of Nassau*, 1996 WL 590679, at \*22-\*23 (Mass. Super. Ct. Sept. 4, 1996); *see also Mowbray v. Waste Mgmt. Holdings, Inc.*, 189 F.R.D. 194, 197 (D. Mass. 1999) (noting that an express warranty does not require reliance, but an implied warranty does).

<sup>115</sup>*Grupo Condumex, S.A. v. SPX Corp.*, 2008 WL 4372678, at \*4 (N.D. Ohio Sept. 19, 2008).

<sup>116</sup>*Power Soak Sys., Inc. v. EMCO Holdings, Inc.*, 482 F. Supp. 2d 1125, 1134 (W.D. Mo. 2007); *see also HALO Branded Solutions, Inc. v. Goldman*, 784 F. Supp. 2d 966, 969-70 (N.D. Ill. 2011) (Illinois court interpreting Missouri law to not require reliance); *Interco Inc. v. Randustrial Corp.*, 533 S.W.2d 257, 261 (Mo. Ct. App. 1976).

<sup>117</sup>*Power Soak Sys.*, 482 F. Supp. 2d at 1134 (quoting *CBS Inc. v. Ziff-Davis Publ'g Co.*, 553 N.E.2d 997, 1001 (N.Y. 1990)).

<sup>118</sup>*Glacier Gen. Assurance Co. v. Cas. Indem. Exch.*, 435 F. Supp. 855, 860 (D. Mont.

10. *New Hampshire*: A Wisconsin federal district court, applying New Hampshire law, held that a buyer who relied on misstatements at the time of contracting did not need to show it relied on specific information in the agreements, but rather that it relied on the seller's "representation that the . . . agreements were valid and enforceable."<sup>119</sup>
11. *New Mexico*: The New Mexico Supreme Court found that a buyer's "reliance is not an element of a claim for breach of an express warranty reduced to writing."<sup>120</sup>
12. *New York*: In *Ziff-Davis Publishing*, the court concluded that a buyer's knowledge does not prohibit a breach-of-warranty claim when the warranties are part of the contract and the buyer believes it is purchasing the seller's promise as to the truth of the warranties.<sup>121</sup> Key to the decision was the buyer's identification of the seller's misstatements before closing and its express reservation of its rights against the seller.<sup>122</sup> The Second Circuit limited *Ziff-Davis Publishing* in *Galli v. Metz*,<sup>123</sup> a case where the buyer, at the time of contracting, knew that certain warranties were incorrect.<sup>124</sup> The court noted that "[w]here 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."<sup>125</sup> If, however, the source of the buyer's knowledge was other than the seller, the court in *Gusmao v. GMT Group, Inc.*<sup>126</sup> found that a buyer with full knowledge of a warranty's

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1977).

<sup>119</sup>*Leaf Funding, Inc. v. Cool Express Wis., Inc.*, 2009 WL 330157, at \*7 (W.D. Wis. Feb. 9, 2009).

<sup>120</sup>*C.R. Anthony Co. v. Loretto Mall Partners*, 817 P.2d 238, 246 (N.M. 1991).

<sup>121</sup>*Ziff-Davis Publ'g*, 553 N.E.2d at 1000-01.

<sup>122</sup>*See id.*

<sup>123</sup>973 F.2d 145 (2d Cir. 1992).

<sup>124</sup>*Id.* at 150-51.

<sup>125</sup>*Id.* at 151; *see also Merrill Lynch & Co. Inc. v. Allegheny Energy, Inc.*, 500 F.3d 171, 186 (2d Cir. 2007) (noting that "the general rule is that a buyer may enforce an express warranty even if it had reason to know the warranted facts were untrue," although "[t]he plaintiff must show that it believed that it was purchasing seller's promise regarding the truth of the warranted facts").

<sup>126</sup>2008 WL 2980039 (S.D.N.Y. Aug. 1, 2008).

inaccuracy would not be precluded from a breach-of-warranty claim, even in the absence of an express anti-waiver provision.<sup>127</sup>

13. **Pennsylvania:** A Pennsylvania federal district court predicted that the Pennsylvania Supreme Court would not require a showing of reliance for a breach-of-warranty claim, noting that the opposite approach would be "inconsistent with the commercial realities of these complex purchase agreements negotiated over several months by sophisticated parties."<sup>128</sup>
14. **West Virginia:** A West Virginia federal district court, relying in part on a pro-sandbagging clause, noted that reliance on the seller's warranties was not necessary for a breach-of-warranty claim where the buyer did not know at signing that the warranties were untrue and there was a question as to what it knew at closing.<sup>129</sup> The court found, however, that if the seller could show that the buyer knew about the misstatement "and was not misled regarding its significance," the buyer would not be able to recover because the seller's misstatement would not have caused the buyer's injury.<sup>130</sup> Consequently, one court has interpreted West Virginia's approach to involve the waiver of a claim if the buyer knows of the breach and proceeds to close anyway.<sup>131</sup>
15. **Wisconsin:** A Minnesota federal district court, interpreting Wisconsin law, held that reliance on written warranties is unnecessary for a breach-of-warranty claim.<sup>132</sup> The court noted that Wisconsin has embraced the economic loss doctrine, under which "a purchaser's right to recover for . . . losses [caused by defective goods] is strictly a matter of contract"

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<sup>127</sup>*Id.* at \*5.

<sup>128</sup>*Giuffrida v. Am. Family Brands, Inc.*, 1998 WL 196402, at \*4 (E.D. Pa. Apr. 23, 1998). See also *id.* at \*3 n.8 (noting that *In Re Carter's Claim*, 134 A.2d 908 (Pa. 1957), "does not speak to whether the [Pennsylvania Supreme] Court would require reliance as an element," because the Court's decision "depended solely on the language of the agreement before it").

<sup>129</sup>*Allegheny & W. Energy Corp. v. Columbia Gas Sys., Inc.*, 1986 WL 13360, at \*6-\*8 (S.D. W. Va. June 30, 1986).

<sup>130</sup>*Id.* at \*6.

<sup>131</sup>See *Lennar Homes, Inc. v. Masonite Corp.* 32 F. Supp. 2d 396, 400 (E.D. La. 1998).

<sup>132</sup>*Pentair, Inc. v. Wis. Energy Corp.*, 662 F. Supp. 2d 1134, 1139, 1142 (D. Minn. 2009) (citing *Dittman v. Nagel*, 168 N.W.2d 190, 192-96 (Wis. 1969), as evidence that Wisconsin law does not require proof of reliance where "there was . . . no dispute that the representation was in fact a warranty").

rather than tort.<sup>133</sup> The court also refused to find that the buyer had waived its rights, since such a waiver had not been agreed in writing.<sup>134</sup>

### **Tort Approach (Reliance Requirement):**

1. **California:** Reliance is required for a breach-of-warranty claim involving the sale of a business.<sup>135</sup> Note that a California federal district court has found reliance to be unnecessary when the buyer knew the falsity of the warranties before the purchase agreement was signed and, perhaps more importantly, the agreement provided that the buyer's reliance would not be affected by any investigation.<sup>136</sup> The *Telephia* court distinguished *Kazerouni* by noting, in part, that *Kazerouni* "did not consider whether a bargained-for, risk-shifting provision . . . should be enforced" and, unlike *Telephia*, did not involve a pro-sandbagging clause in the contract at issue.<sup>137</sup>
2. **Colorado:** Clear reliance by a buyer is a requirement to recover for a breach of warranty.<sup>138</sup> In *San Lazaro*, the buyer discovered inaccuracies due to its own independent investigation after signing, and consequently it did not rely on the seller's information at closing and thus waived its warranty claim.<sup>139</sup>
3. **Kansas:** The Tenth Circuit held that, under Kansas law, reliance on a warranty is a prerequisite to an action for a breach of warranty.<sup>140</sup> Subsequently, a Massachusetts federal district court suggested that the Kansas Supreme Court today might decide to follow the "modern" contract approach.<sup>141</sup>

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<sup>133</sup>*Id.* at 1140.

<sup>134</sup>*Id.* at 1146.

<sup>135</sup>*See Kazerouni v. De Satnick*, 279 Cal. Rptr. 74, 75-76 (Cal. Ct. App. 1991).

<sup>136</sup>*Telephia, Inc. v. Cuppy*, 411 F. Supp. 2d 1178, 1188 (N.D. Cal. 2006).

<sup>137</sup>*Id.* at 1188 & n.5.

<sup>138</sup>*See Assocs. of San Lazaro v. San Lazaro Park Props.*, 864 P.2d 111, 115 (Colo. 1993).

<sup>139</sup>*Id.* at 114-15.

<sup>140</sup>*Land v. Roper Corp.*, 531 F.2d 445, 449 (10th Cir. 1976); *but see Prof'l Serv. Indus., Inc. v. Kimbrell*, 834 F. Supp. 1305, 1311 (D. Kan. 1993) (discussing that *Land* does not apply to transactions arising under the UCC).

<sup>141</sup>*Mowbray v. Waste Mgmt. Holdings, Inc.*, 189 F.R.D. 194, 200 (D. Mass. 1999).

4. **Maryland:** A Maryland federal district court held that, under Maryland law, reliance is required to recover on a breach-of-warranty claim.<sup>142</sup>
5. **Minnesota:** The Eighth Circuit, applying Minnesota law, held that the buyer's reliance is required for a breach-of-warranty claim in a transaction that does not fall under the UCC.<sup>143</sup> A Massachusetts federal district court has since suggested that, if the Supreme Court of Minnesota were to decide the case today, it would follow the contract approach.<sup>144</sup>
6. **Texas:** A Texas federal district court noted, in *dicta*, that reliance is "an element" of a breach-of-warranty claim.<sup>145</sup> In a case involving the sale of goods, a Texas appellate court also found that reliance is a relevant requirement.<sup>146</sup>

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<sup>142</sup>See *SpinCycle, Inc. v. Kalender*, 186 F. Supp. 2d 585, 588-89 (D. Md. 2002) (holding that the buyer had relied on the seller's warranty even where the buyer made its own investigation after the signing of the asset purchase agreement); see also *Fischbach & Moore Int'l Corp. v. Crane Barge R-14*, 632 F.2d 1123, 1125 (4th Cir. 1980) ("Recovery in warranty . . . will not be permitted if the buyer of the goods had actual knowledge of their nonconformity [or] if the buyer had knowledge of facts which were so obvious that the nonconformity must have been known.").

<sup>143</sup>*Hendricks v. Callahan*, 972 F.2d 190, 194 (8th Cir. 1992); see also *Alley Constr. Co. v. State*, 219 N.W.2d 922, 924 (Minn. 1974) (rejecting the defendant's suggestion that an inference of reliance as an element of a breach-of-warranty claim was unsupported by the evidence).

<sup>144</sup>*Mowbray*, 189 F.R.D. at 200.

<sup>145</sup>*Gale v. Carnrite*, 2007 WL 654620, at \*3 (S.D. Tex. Feb. 27, 2007).

<sup>146</sup>*Gen. Motors Corp. v. Garza*, 179 S.W.3d 76, 82 (Tex. Ct. App. 2005).

