Preserving (or Limiting) Contractual Claims to Address 'Sandbagging'


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The Delaware Court of Chancery's decision in *Universal Enterprise Group, L.P. v. Duncan Petroleum Corporation*, No. 4948-VCL (Del. Ch. July 1, 2013), follows recent a line of Delaware cases indicating that the Delaware courts may permit some degree of so-called "sandbagging." The opinion also serves as a reminder that buyers and sellers should take particular care when allocating the risks in acquisition agreements.

The term "sandbagging" has been used generally in the M&A context to refer to the buyer's assertion of post-closing claims for breach of representation and warranty despite its pre-closing knowledge that the seller's representations or warranties were not true and correct when made. Although counterparties may contract around sandbagging by expressly preserving or limiting the buyer's right to assert claims in cases where it knew (or was on notice) of a seller's breach prior to closing, in the absence of a "pro-sandbagging" or "anti-sandbagging" provision, the permissibility of sandbagging is a matter of the law of the jurisdiction governing the agreement.

Certain earlier cases of the Delaware courts could be read to suggest that a buyer seeking to assert a claim for breach of representation or warranty is required to show that it had relied on the representation or warranty giving rise to its claim, including *Kelly v. McKesson HBOC*, No. 99C-09-265-WCC (Del. Super. Jan. 17, 2002), *Bleacher v. Bristol-Myers*, 163 A.2d 526 (Del. Super. 1960), and *Loper v. Lingo*, 97 A. 585 (Del. Super. 1916). Under that type of framework, a buyer that learned through pre-closing due diligence that certain of the seller's representations and warranties were not true and correct but proceeded to closing in spite of that information would be largely precluded from establishing a viable claim for breach because of the difficulty of demonstrating that it had justifiably relied on a representation or warranty that it knew was not true and correct when made.

In *Universal* and other more recent opinions, however, Delaware courts have indicated that a seller's breach of its representations and warranties constitutes a breach of contract and, therefore, does not require the buyer to demonstrate reliance, as in *Interim Healthcare v. Spherion*, 884 A.2d 513 (Del. Super. 2005), *Cobalt Operating v. James Crystal Enterprises*, No. 714-VCS (Del. Ch. July 20, 2007), and *Hudson's Bay Co. Luxembourg v. JZ LLC*, No. 10C-12-107-JRJ (Del. Super. July 26, 2011). Under that framework, the extent or quality of the buyer's due diligence is largely irrelevant to the determination of whether the seller breached its representations and warranties. Rather, to borrow a phrase from a court in New York, generally thought to be a pro-sandbagging jurisdiction, "the critical question is not whether the buyer believed in the truth of the warranted information ... but whether it believed it was purchasing the seller's promise as to its

truth," which the court held in *CBS v. Ziff-Davis Publishing*, 553 N.E.2d 997, 1000-01 (N.Y. 1990). Viewed in this light, eliminating the reliance requirement as an element of a claim for breach of representation or warranty preserves the principal risk-allocation function of representations and warranties in an agreement by minimizing the buyer's need to verify every aspect of the seller's business.

Importantly, however, most cases in which the Delaware courts have asserted that a buyer is not required to show reliance have arisen out of transactions in which the buyer, prior to closing, did not have actual knowledge that the seller's representations and warranties were not true and correct. In *Cobalt*, for example, the court noted that the buyer's failure to uncover the seller's fraudulent manipulation of its revenue and financial statements during due diligence was not unreasonable because the seller intentionally concealed the false information. *Cobalt* thus left open the question of whether a buyer with actual pre-closing knowledge that the seller's representations and warranties were false could still hold the seller liable for that breach.

Although the court in *Universal* did not find that the buyer had actual knowledge that the seller breached its representations and warranties as to environmental compliance, the court did note that the buyer had knowledge of the "likely breach" and "likely falsity" of such representations and warranties. Notwithstanding this level of knowledge, the buyer arguably limited its vulnerability to the argument that it had waived its breach of contract claim by renegotiating the agreement to address such risk and reaffirming its rights to hold the seller liable for breaches of its representations and warranties. While the court refused to award rescission or rescissory damages on the basis that the buyer agreed to close the transaction despite being on notice of the potential breach of the seller's representations and warranties, the court did award the buyer the actual damages it suffered as a result of the seller's false representation and warranty.

Universal does not fully and finally address the question of whether Delaware is a pro- or anti-sandbagging jurisdiction, but it does indicate that the Delaware courts may not require a buyer to demonstrate reliance on the seller's representations and warranties to assert a successful claim for breach of those representations and warranties. That said, where a buyer has actual knowledge of a breach (or likely breach) of the seller's representations and warranties and proceeds to closing, it should not expect, by default, a remedy of rescission or rescissory damages. Accordingly, a buyer should seek to negotiate to expressly preserve its rights to rely on the seller's representations and warranties under the agreement, regardless of what the due diligence review uncovers, while a seller should continue to seek to limit the buyer's ability to rely on the representations and warranties.

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