Good Tactics or Bad Faith: The Divisive Issue of Sandbagging in M&A

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Introduction

There are few issues in a private M&A transaction as potentially divisive as the treatment of "sandbagging" in the purchase agreement. "Sandbagging" occurs when the buyer has knowledge of a breach by the seller of a representation, warranty or covenant, closes the transaction despite such knowledge and then seeks indemnification from the seller post-closing for losses caused by the breach. The concept of "sandbagging" goes beyond M&A tactics and strategy and can become a debate between buyer and seller about fundamental concepts of honesty, fairness and good faith. This article will explain what sandbagging is, provide examples of "pro" and "anti" sandbagging provisions, discuss how prevalent these provisions are in the Canadian M&A market and explore how Canadian courts have dealt with the issue.

What is Sandbagging in M&A?

The purchase agreement in a private M&A transaction typically includes a range of representations, warranties and covenants that a seller makes to a buyer in regard to the company or asset being bought and sold. "Sandbagging" occurs when the buyer learns that one or more of these representations, warranties or covenants is inaccurate, does not communicate that knowledge to the seller, completes the transaction despite such knowledge and then seeks indemnification from the seller post-closing for losses arising from the inaccuracy. Purchase agreements in a private M&A transaction typically include one of the following general approaches to sandbagging: "pro-sandbagging" provisions can be included stating that sandbagging is allowable, "anti-sandbagging" provisions can be included stating that sandbagging is prohibited or the agreement can remain silent on the issue.

Given their respective interests, buyers tend to prefer pro-sandbagging provisions and sellers tend to prefer anti-sandbagging provisions. Buyers pushing for the inclusion of a pro-sandbagging clause can make a number of arguments:

Sandbagging encourages full and accurate disclosure on the part of the seller.
A buyer's ability to rely on the correctness of a seller's representations and warranties is an integral part of the bargain between the parties. In other words, a pro-sandbagging clause is simply a reflection of one of the core tenets of M&A: that responsibility for accurate disclosure lies with the seller.
Sandbagging discourages the seller from drowning the buyer in disclosure and then claiming the buyer had knowledge of a breach in light of its access to extensive materials. Put differently, it limits a tactical approach to disclosure by the seller.
Sellers pushing for the use of an anti-sandbagging clause can likewise advance a number of arguments:

It is simply unfair that the onus for full disclosure lies only with the seller with no reciprocal obligation on the buyer to reveal what it has learned.
The diligence process should encourage the buyer to raise concerns and provide the seller the opportunity to address them and, if necessary, rectify deficiencies, rather than allowing the buyer to weaponize the post-closing indemnification process.
It is unfair for sellers to be put through a full due diligence review by the buyer only to have the buyer withhold knowledge of a breach by the seller and then capitalize on what might have simply been an oversight.
The relative merits of these arguments can vary depending on the dynamics of the deal and the circumstances of both parties. For instance, if the buyer is a large corporation conducting diligence through a range of external advisors, the fact that one part of its team gained knowledge of an inaccuracy might not mean that this knowledge was communicated to decision makers or that the full consequence of the inaccuracy was understood. By contrast, if the seller is unsophisticated it may be that after a comprehensive diligence review the buyer has far more granular information about the business or asset than the seller, such that a pro-sandbagging provision would only increase the buyer's existing informational advantage.

Examples of Pro and Anti Sandbagging Provisions[1]

Pro-Sandbagging

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 conducted or any Knowledge 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.

Anti-Sandbagging

No party shall be liable under this Article for any Losses resulting from or relating to any inaccuracy in or breach of any representation or warranty in this Agreement if the party seeking indemnification for such Losses had Knowledge of such Breach before Closing.

The Role of "Knowledge" in Anti-Sandbagging Provisions

The core function of an anti-sandbagging provision is that it prevents a buyer from claiming under its indemnity if the buyer had knowledge of the breach forming the basis of its claim before the transaction closed. The definition of "Knowledge", therefore, is key to the rest of the provision. A more expansive definition that captures implied or constructive knowledge casts such a large net that a buyer may find it difficult to disprove knowledge when making a claim. This becomes particularly true when the seller has made extensive disclosure or when the buyer relied on a large deal team.

Remaining Silent on Sandbagging

Where the purchase agreement is silent on the issue, the legality of sandbagging will be determined by the law in the jurisdiction governing the purchase agreement. To that end, parties should look to what elements are required to establish breach of contract in the jurisdiction they have chosen to govern disputes under the purchase agreement. The key factor is likely to be how the selected jurisdiction treats prior knowledge of a breach and whether reliance is a necessary component of breach of contract.

What is Market?

The American Bar Association's 2016 Canadian Private Target Mergers & Acquisitions Deal Points Study — a common reference point for market practice in private acquisition transactions — suggests that 31% of Canadian deals include pro-sandbagging clauses (15% in 2014 study, 24% in 2012 study and 10% in 2010 study), 15% include anti-sandbagging clauses (14% in 2014 study, 9% in 2012 study and 21% in 2010 study) and 54% are silent on the issue (71% in 2014 study, 67% in 2012 study and 69% in 2010 study). Clearly, the market is becoming more attuned to this issue and more agreements are explicitly addressing it. Having said that, the lack of a sandbagging clause one way or the other may be just as much a result of a strategic decision as the inclusion of one, as discussed below.

What Have Courts Said?

The case law around sandbagging was already unsettled in Canada and has now entered a new phase of potential uncertainty in the wake of the Supreme Court of Canada's 2014 Bhasin v Hrynew decision.

In Canada, there has yet to be a definitive ruling on the issue of sandbagging. In Transamerica Life Canada Inc. v ING Canada Inc. a seller claimed that a buyer breached an implied duty of good faith and fair dealing in so far as it closed a transaction despite having knowledge of a breach. The motion judge dismissed the pleadings but the decision was ultimately overturned at the Ontario Court of Appeal on the basis that the law was unclear and so warranted further inquiry by a trial judge.

In Bhasin v Hrynew, the Supreme Court recognized good faith contractual performance as a general organizing principle of Canadian common law, and that parties to a contract are under a duty to act honestly in the performance of their contractual obligations. Honest performance requires that parties "not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract." While it is likely that the organizing principle set out in Bhasin v Hrynew will have implications for how Canadian courts treat sandbagging going forward, there is no Canadian case law yet to suggest what exactly the consequences will be.

Case law in the U.S. indicates that explicit pro-sandbagging and anti-sandbagging clauses are often enforceable. When an agreement is silent on sandbagging, however, the law varies between states and is generally tied to whether that state treats reliance as a necessary component of a claim for breach of contract. For example, Delaware takes a contract-based approach and does not require a buyer to show reliance on a seller representation, warranty or covenant in order to establish breach. By contrast, California does require a buyer to demonstrate that it relied on the truth of a seller representation, warranty or covenant in order to find a breach.

Conclusion

The decision to request either a pro-sandbagging or anti-sandbagging clause can be an important part of a negotiation. As noted at the outset, either clause raises issues of fairness and good faith that can result in acrimonious discussions that, in turn, can poison the buyer-seller relationship. For a buyer, the price of a pro-sandbagging clause may be to give up something else of value. A seller, on the other hand, may be content to rely on the developing law of good faith in contract as protection rather than seek an express anti-sandbagging clause. Accordingly, the decision regarding sandbagging provisions is worth some deliberate attention on the part of buyers and sellers — it is not just a legal discussion.

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