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Is Delaware Really a 'Sandbagging State'?

Recent comments in a Delaware Supreme Court decision cast some doubts on the "pro-sandbagging" reputation of Delaware.

In the private M&A context, "sandbagging" refers to a buyer, who despite having knowledge of a breach of representation or warranty by a seller at some time before closing, proceeds with the closing and then seeks indemnification from the seller for the breach of representation or warranty of which it had prior knowledge.

The popular belief among dealmakers has been that Delaware is generally "pro-sandbagging" meaning that, absent an express provision barring post-closing claims for known breaches (i.e., an "anti-sandbagging provision"), pre-closing knowledge of a breach is not a bar to seeking indemnification recovery as actual reliance by the buyer on the false representation is not a requisite component of a breach claim. Vice Chancellor Laster, in a 2015 transcript ruling, appeared to support this approach, saying:

> "The fact that the buyers conducted due diligence also does not prevent a suit for fraud. Delaware is what is affectionately known as a "sandbagging" state. That's a negative spin on it, but the positive spin on it is we let people allocate risk through representations and warranties. And if you have allocated risk through representations and warranties, the fact that you may do due diligence doesn't contravene the allocation of risk. We have the contract control, as opposed to a loose sense of what people may have known or not known, depending on the due diligence they conducted."

While noting that most of the Delaware cases have involved situations where knowledge of the breach was discovered by the buyer after signing and before closing, most commentators believe that the same "pro-sandbagging" default rule would apply if the buyer's knowledge of the breach was obtained prior to signing based on the same reliance-based reasoning.

A recent decision by the Delaware Supreme Court calls into question the strength of some of these assumptions under Delaware law.

While not a central element of the decision at hand, both the majority opinion (written by Justice Valihura) and a partial dissent (by Chief Justice Strine) addressed in passing the sandbagging question. In a footnote which acknowledges that the court did not need to decide this issue as the question was not before the court, Justice Valihura wrote: "We acknowledge the debate over whether a party can recover on a breach of warranty claim where the parties know that, at signing, certain of them were not true. [Defendant] argues that reliance is required, but we have not yet resolved this interesting question."

The footnote goes on to note that a majority of the states follow the well-known *Ziff-Davis* decision from the New York Court of Appeals which holds that reliance is not required to recover for a breach of representation or warranty. Interestingly, the footnote does not mention a number of subsequent federal cases applying New York law (like *Galli*) that appear to have narrowed the holding in *Ziff-Davis* both by suggesting that knowledge of the breach pre-signing, as opposed to only pre-closing, may prevent a buyer from later claiming indemnification for a breach and by taking account of the additional factor of the source of the knowledge (i.e., if the knowledge is received based on disclosure by the seller as opposed to the buyer's own work, then a post-closing indemnification claim may not be successful unless an express "pro-sandbagging" provision was included in the agreement).

In his partial dissent, Chief Justice Strine appears to similarly raise doubts about Delaware's pro-sandbagging regime, saying: "Thus, to the extent [Plaintiff] is seeking damages because [Defendant] supposedly made

promises that were false, there is doubt that he can then turn around and sue because what he knew to be false remained so. Venerable Delaware law casts doubt on [Plaintiff's] ability to do so…".

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While none of these judicial comments are binding and merely question the status of the law on the issue, dealmakers still may be surprised at the doubts cast on the "pro-sandbagging" reputation of Delaware. Parties may wish to take account of these comments from the Supreme Court in negotiating purchase agreement provisions relating to sandbagging.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland author or your regular Kirkland contact.

Daniel E. Wolf
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/dwolf
+1 212-446-4884
