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Delaware Law, Friend or Foe? The Debate Surrounding Sandbagging and How Delaware's Highest Court Should Rule on a Default Rule

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DELAWARE LAW, FRIEND OR FOE? THE DEBATE SURROUNDING SANDBAGGING AND HOW DELAWARE’S HIGHEST COURT SHOULD RULE ON A DEFAULT RULE

*Seth Cleary**

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I. INTRODUCTION

*“Here, corporate law is an industry that is important unto itself, and we know that if we are perceived as unfair, it matters.”*¹

IMAGINE this scenario. You, a buy-side mergers and acquisitions (M&A) attorney, are approached to guide Company A through its acquisition of Company B. You navigate Company A through signing a confidentiality agreement, sifting through the initial disclosure of financial information and schedules, and negotiating a draft agreement.² This purchase agreement contains conditions precedent to closing; other representations and warranties on some of the disclosed information; a damages provision; a capped, sole-remedy indemnity; and a standard representations and warranties insurance (RWI) policy for several issues.³ The deal is proceeding according to plan; however, mere days before closing, your deal team begins to seriously doubt some of the warranted information even though Company B continues to defend their accuracy. What do you advise Company A to do? One option would be to advise the client to walk away from the deal, but this could lead to break-up fees or litigation by the seller.⁴ Another option would be to negotiate a purchase price adjustment from Company B, but this strategy becomes unworkable if Company B continues to claim the information is accurate and that Company A is contractually bound to close.⁵ A final option

1. John Gapper, *Capitalist Punishment*, FIN. TIMES (Jan. 28, 2005), <https://www.ft.com/content/8561245e-7032-11d9-b572-00000e2511c8> [Permalink unavailable] (quoting Chancellor Leo E. Strine as he discusses the Supreme Court of Delaware’s balancing act when making judicial decisions).

2. See *Asset Acquisition: Overview*, PRAC. L. CORP. & SEC., <https://1.next.westlaw.com/Document/Ibb0a875eef0511e28578f7ccc38dcbec/View/FullText.html> [Permalink unavailable] (last visited Sept. 14, 2019) (detailing the process for a typical asset purchase agreement).

3. See *id.*

4. See Charles Whitehead, *Sandbagging: Default Rules and Acquisition Agreements*, 36 DEL. J. CORP. L. 1081, 1083 (2011) (discussing the options available to a buyer instead of closing). While walking away from the deal is a viable option in many transactions, parties may not agree that the representations or warranties are in breach. In addition, there may be ramifications as far as break-up fees or potential litigation, since a seller can sue on the theory that it met the conditions of closing and the buyer breached. See Joanna Bliss et al., *Breaking Up Is Hard to Do and Must be Done Carefully*, WEIL GOTSHAL 2–3 (Oct. 2008), https://www.weil.com/~media/files/pdfs/pe_alert_oct_2008.pdf [https://perma.cc/GW7F-AH47] (discussing the available contractual provisions a buyer may be bound by if it fails to close the transaction).

5. See Bliss et al., *supra* note 4, at 2–3. In addition, some agreements have a survival clause that prevents representations or warranties from surviving the closing, forcing a party to either begin a legal action prior to closing or waive those rights by closing. See Byron F. Egan et al., *Contractual Limitations on Seller Liability in M&A Agreements*, JACKSON WALKER 27 (Oct. 18, 2012), <http://www.jw.com/wp-content/uploads/2016/05/1790.pdf> [https://perma.cc/S4HJ-DLAR] (discussing Delaware purchase agreements and the ability to contractually terminate representations and warranties at closing).

would be to close the deal and pursue the indemnity because your agreement doesn't mention any buyer reliance or knowledge requirement, but this also has drawbacks of recovery risk and any RWI policy potentially excluding coverage of the claim.⁶

The viability of this last path for Company A, which is commonly referred to as sandbagging, has been seriously called into question by a recent Supreme Court of Delaware case, *Eagle Force Holdings, LLC v. Campbell*.⁷ Both the majority and concurring opinions used dicta to signal that Delaware law, which was previously thought to be settled,⁸ may change for these types of post-closing breach-of-contract claims.⁹ Specifically, the court called into question whether a party to an acquisition agreement could succeed on a breach-of-contract claim when the buyer knows that a seller's express representations or warranties are in breach prior to closing.¹⁰ The claim in this situation, which is often predicated on breach of an express warranty,¹¹ was generally thought to be permissible under Delaware law so long as there was not an anti-sandbagging provision or the buyer waived its claim.¹² Contrary to this understanding of Delaware law, the majority did not cite to the line of cases thought to be the justification for this default rule.¹³ Instead, the court commented on

6. The standard RWI policy carves out coverage for claims where the buyer knows about a breach prior to closing. *See, e.g.*, Emily Maier, *Guide to Representations and Warranty Insurance*, WOODRUFF SAWYER 5 (Aug. 28, 2018), https://woodrufflawyer.com/wp-content/uploads/2018/09/WS_RepsWarranties_Insurance_Guide_9_4.pdf [<https://perma.cc/8GGM-DDW3>] (discussing common clauses in RWI); Kirk Sanderson, *What is Representations and Warranties Insurance?*, LEXIS PRAC. ADVISOR (2015), http://s3.amazonaws.com/equityrisk.com/asset_files/86/original.pdf [<https://perma.cc/5359-UMBD>]. This position taken by insurers is unsurprising as coverage of the sandbagging buyer leads to the moral hazard where the buyer would not be incentivized to resolve the dispute before closing.

7. 187 A.3d 1209, 1236 n.185 (Del. 2018); *id.* at 1247 n.38 (Strine, J., concurring).

8. *See, e.g.*, Soren Lindstrom, *M&A Update: Maybe Delaware Is Not Pro-Sandbagging After All?*, LINKEDIN (Aug. 2, 2018), <https://www.linkedin.com/pulse/ma-update-maybe-delaware-pro-sandbagging-after-all-soren-lindstrom> [<https://perma.cc/S6QQ-MUJN>] (discussing the “common belief among dealmakers . . . that Delaware is a ‘pro-sandbagging’ jurisdiction”); Glenn D. West, *A Delaware Supreme Court Footnote Reignites Concerns About the Reliability of Contractual Representations & Warranties—Are Deal Lawyers Really Going to Start Debating Sandbagging Again?*, GLOBAL PRIV. EQUITY WATCH (Oct. 1, 2018), <https://privateequity.weil.com/insights/delaware-supreme-court-footnote/> [<https://perma.cc/3L22-C5W3>] (noting that, prior to the decision, most deal lawyers believed that Delaware would not require a reliance element).

9. *Eagle Force*, 187 A.3d at 1236 n.185; *id.* at 1247 (Strine, J., concurring).

10. *Id.* at 1236 n.185 (majority opinion).

11. The author recognizes that there is a common law distinction between the terms “representation” and “warranty.” However, it is not uncommon for practitioners to refer to them interchangeably or together throughout an acquisition agreement. *See* Tina L. Stark, *Nonbinding Opinion: Another View of Reps and Warranties*, BUS. L. TODAY, Jan.–Feb. 2006, at 8, 8–9 (2006) (discussing the common law distinction between a representation and a warranty and the difference in causes of action depending on which is used). Nevertheless, this paper focuses primarily on breach-of-warranty claims, as buyers will often bring the contract action under this theory.

12. *See* West, *supra* note 8; *see also* Sara Garcia Duran & Sacha Jamal, *Possible Shift in Delaware Law: Buyer's Silence on Sandbagging Is Not Golden*, BUS. L. TODAY, Sept. 2018, at 1, 1–2 (discussing the deal community's general consensus that the Delaware default position is pro-sandbagging).

13. *Eagle Force*, 187 A.3d at 1236 n.185.

persuasive authority from New York that differs slightly from previous perceptions of the Delaware default rule,¹⁴ which was followed by a bold declaration that the law is “not yet resolved [on] this interesting question.”¹⁵ This footnote, paired with several sentences in the concurring opinion,¹⁶ has led to speculation on how the court would rule in the future.¹⁷ Because Delaware is the choice of law used in a majority of M&A deals, certainty in default rules is a necessity for its contractarian approach to corporate law.¹⁸ As such, this new uncertainty, if left unclarified by the Supreme Court of Delaware, could create higher transaction costs for negotiating future M&A deals and distortions in deal prices—an undesirable result for a state whose business has become corporate law.¹⁹

Thus, the primary aim of this paper will be two-fold: first, to summarize the existing legal thought about contract claims in Delaware and cases with these types of claims, and second, to recommend a rule for Delaware courts to adopt. Within this recommendation, the paper will predict how the court is likely to rule, as well as put forth a framework, through use of a penalty default, in order to reach an optimal default rule. In Part II of this paper, the background for the use of the term sandbagging and its meaning in the M&A context is first laid out. Next, the paper will discuss the conflicting historical roots of breach of warranty as well as the law and economics movement and its effect on Delaware contract law generally. Then, the relevant Delaware precedent will be summarized, and the two existing lines of Delaware precedent will be expounded upon. Finally, existing New York case law dealing with sandbagging will be summarized.

In Part III, the paper will predict how the court would likely rule if the issue was squarely before it. In addition, this section will also propose a penalty default that most optimally creates an information-forcing effect between the parties. Part IV provides recommendations for both buyers and sellers, including model provisions, as well as other factors that should be considered when negotiating provisions relating to a sandbagging claim. Part V summarizes and concludes the paper.

14. See *infra* Part II.C (discussing the nuances of New York’s default position).

15. *Eagle Force*, 187 A.2d at 1236 n.185.

16. See *id.* at 1247 (Strine, J., concurring).

17. See, e.g., West, *supra* note 8; Daniel E. Wolf, *Sandbagging in Delaware*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 20, 2018), <https://corpgov.law.harvard.edu/2018/06/20/sandbagging-in-delaware/> [<https://perma.cc/XGL5-U5XS>].

18. See generally Brett H. McDonnell, *Sticky Defaults and Altering Rules in Corporate Law*, 60 SMU L. REV. 383, 384 (2007) (discussing how most of corporate law “is and should be governed by default rules [as] a central tenet”).

19. While a default rule does not preclude parties under a Delaware agreement from negotiating to the contrary, default rules have a large impact on the transaction costs of both due diligence and negotiations depending on whether the default rule is pro-buyer, pro-seller, or somewhere in between. See Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389, 390–91 (1993) (discussing several of the theories posited for default rules and explaining their differences from immutable rules).

II. BACKGROUND

The term “sandbagger” is commonly used in golf to denote a player who pretends, usually through an inflated handicap, to be worse than they are to take advantage of the opposition.²⁰ This term, which did not originate from golf,²¹ is used broadly in many situations, and *Merriam-Webster* defines it as meaning “to conceal or misrepresent one’s true position, potential, or intent” or to “treat unfairly or harshly.”²² In the United States M&A context, sandbagging is often used to describe a situation where a buyer knows that a seller’s representations or warranties are in breach prior to closing, but in spite of this breach, the buyer closes the transaction and then pursues indemnification.²³

Initially, this scenario may seem to fit *Merriam-Webster*’s definition of being unfair or harsh, as the buyer knows it has an actionable claim based on the breach and, as a result, may have a superior bargaining position to renegotiate or close and then pursue damages. However, other commentators have pushed back on the use of the term “sandbagging” as they posit that the risk has already been encompassed in the purchase price, making it in no way unfair that the buyer found the breach prior to closing.²⁴ As a result, there is a debate surrounding if the term “sandbagger” is an apt description, and legal scholars and other commentators fall on either side of the issue based on ethical,²⁵ utilitarian,²⁶ or plain fairness grounds.²⁷

The author recognizes that there is an ongoing trend in United States M&A agreements for the damages in post-closing claims to be limited through a sole remedies clause to an indemnification provision and be

20. See Dale Hartley, *Games Master Manipulators Play: Sandbagging*, PSYCHOLOGY TODAY (May 4, 2017), <https://www.psychologytoday.com/us/blog/machiavellians-gulling-the-rubes/201705/games-master-manipulators-play-sandbagging> [https://perma.cc/E43Y-76U6] (further discussing the use of sandbagging in the context of trial advocacy and poker).

21. The origination of the word “sandbagger” as a descriptive verb began at the turn of the twentieth century “to describe the act of bludgeoning someone with a small, sand-filled bag” *Sandbag*, MERRIAM-WEBSTER ONLINE DICTIONARY, <https://www.merriam-webster.com/dictionary/sandbagging> [https://perma.cc/3PG9-QC4S] (last visited Sept. 14, 2019).

22. *Id.*

23. 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 M&A LAW. 3, 4 (2007).

24. See *id.* at 3 (positing that a buyer is reasonable to expect the benefit of the negotiated bargain they struck with the seller).

25. See JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 423 (1975) (discussing sandbagging as “ethically questionable”); see also Stacey A. Shadden, *How to Sandbag Your Opponent in the Unsuspecting World of High Stakes Acquisitions*, 47 CREIGHTON L. REV. 459, 474–75 (2014) (discussing the ethics of Canada and Europe’s anti-sandbagging approach and the ethical considerations for a sandbagging buyer).

26. See Whitehead, *supra* note 4, at 1107 (advocating that a pro-sandbagging default rule leads to parties being “less able to optimally allocate risk”).

27. See West & Shah, *supra* note 23, at 3 (postulating that the buyer may not be the sandbagger because the seller is the one who made the express warranty to not misrepresent information).

supplemented or supplanted by RWI.²⁸ However, discussion of these topics is limited to only general trends,²⁹ especially in light of recent prevailing market dynamics that have resulted in historically low indemnity caps³⁰ and the immaturity of the market for RWI generally.³¹ Furthermore, given that the typical buyer-side RWI policy contains a knowledge carveout, RWI is likely to be inapplicable as part of the calculus for deciding a default rule based on risk shifting between the parties.³² In the remainder of Part II, this paper will discuss: (A) the origin of claims based on breach of warranty under tort law, (B) the existing body of case law for Delaware courts, and (C) the New York sandbagging default rule and its nuanced interpretations.

A. BREACH-OF-WARRANTY CLAIMS

The following section will detail the historical development of breach-of-warranty claims particularly as this is the primary type of claim brought by a sandbagging buyer and affects the default rules set by courts. The historical backdrop for a breach-of-warranty claim is one not founded in the law of contract but instead in the law of tort.³³ While claims based solely in contract have existed for quite some time,³⁴ breach-of-warranty claims, until the early twentieth century, were largely brought on tort principles.³⁵ The use of the law of torts for a breach-of-

28. See, e.g., *Market Trends: Indemnification Provisions in Asset Purchase Transactions*, LEXIS PRAC. ADVISOR J. (Feb. 9, 2017), <https://www.lexisnexis.com/lexis-practice-advisor/the-journal/b/lpa/posts/market-trends-indemnification-provisions-in-asset-purchase-transactions> [Permalink unavailable] [hereinafter *Market Trends*] (the results of a survey of 142 transactions from January 1, 2016, to September 6, 2016, showed that 60% of deals limited claims exclusively to indemnity); see also James Moriarty & Major McCargo, *Deal Points Study*, KRAMER LEVIN (Dec. 3, 2018), <https://www.kramerlevin.com/en/perspectives-search/deal-points-study-representations-and-warranties-insurance-continues-its-significant-influence-on-M&A-deal-terms.html> [<https://perma.cc/D9WC-KGZY>] (detailing the results of a survey of ninety-three middle-market private deals that revealed RWI was used in 65% of deals, indemnity caps have been going down, and deals have “increasingly seller-friendly terms”).

29. Undoubtedly, the use of sole remedy clauses and carved-out indemnity clauses interplays with the risk-allocating functions of representations and warranties between parties. However, given the variability in deals and lack of publicly available information on private deals, these topics will be limited to general trends for describing purchase and merger agreements.

30. See *2019 M&A Outlook: It's Still a Seller's Market—For Now*, BUS. WIRE (Jan. 29, 2019, 8:00 AM), <https://www.businesswire.com/news/home/20190129005187/en/> [<https://perma.cc/25X4-E8QX>] (results of a survey of over 600 U.S. companies showed a continued appetite for M&A, continuing a years-long trend that is reinforcing the seller's market).

31. See *AIG, M&A INSURANCE—THE NEW NORMAL? 2* (2018), <https://www.aig.com/content/dam/aig/america-canada/us/documents/insights/aig-manda-claimsintelligence-2018-r-and-w.pdf> [<https://perma.cc/D23J-F3T5>] (discussing the maturation and evolution of the RWI market and the rise in claims to almost one in every five transactions).

32. See sources cited *supra* note 6.

33. See J.B. Ames, *The History of Assumpsit*, 2 HARV. L. REV. 1, 8 (1888) (discussing the earliest known warranty claim and how breach of warranty “in its origin [was] a pure action of tort”).

34. *Id.*

35. See Samuel Williston, *What Constitutes an Express Warranty in the Law of Sales*, 21 HARV. L. REV. 555, 555–56 (1908).

warranty claim, according to William Prosser, was historically “utilized to avoid the consequences of contract law” such as the privity requirement.³⁶ Thus, it is unsurprising that some characteristics of tort law may still invade modern breach-of-warranty claims; however, in light of current contracting norms, revising breach of warranty, at least in the M&A context, solely as a contract claim has been increasingly adopted by courts.³⁷ Neither Delaware’s legislature nor the Supreme Court of Delaware have ruled on this issue; however, the remainder of this subsection details the paradigm generally adopted in Delaware and provides an effective lens through which to view the other Delaware case law and New York authority on breach of warranty.³⁸

1. *The Law and Economics Movement and Its Impact on Contract Claims*

The law and economics (or contractarian)³⁹ legal approach to Delaware corporate law and its effect on default contracting norms generally provides, at least in this author’s opinion, a basis to help predict a new breach-of-warranty default rule and supports selection of a penalty default rule. As a general proposition, law and economics builds on the theory of the corporation being no more than an extension of agency law built on inter- and intra-contractual arrangements between agents, principals, and third parties.⁴⁰ This view is generally considered to “dominate the academic study of corporate law.”⁴¹ And much of the literature relates to how adoption of this view in legal structure leads to societally efficient outcomes by providing dependable legal frameworks with contractual flexibility between parties.⁴² Such a view is important in this con-

36. *Ainger v. Mich. Gen. Corp.*, 476 F. Supp. 1209, 1225 n.65 (S.D.N.Y. 1979), *aff’d*, 632 F.2d 1025 (2d Cir. 1980) (citing W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 95, at 634–35 (4th ed. 1971)).

37. See Mathew J. Duchemin, *Whether Reliance on the Warranty Is Required in a Common Law Action for Breach of an Express Warranty?*, 82 MARQ. L. REV. 689–91 (1999) (discussing the blurring of contract and tort law for breach-of-contract claims and how a separation is the preferred outcome and trend).

38. See *infra* Part II.B–C.

39. The author notes that, from a pure theory perspective, advocates of the law and economics practicum and supporters of the broader contractarian approach are not identical. However, for this work, and given the general interchangeability of the terms adopted by practitioners and scholars, they will be used as synonyms. See David Millon, *Default Rules, Wealth Distribution, and Corporate Law Reform: Employment at Will Versus Job Security*, 146 U. PA. L. REV. 975, 977–78, 977 n.10 (1998) (noting that “[w]hen thinking about law and economics in the field of corporate law, one inevitably thinks about contractarianism”).

40. See William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993) (discussing generally the theoretical foundation for the “nexus of contracts” or contractarian view of the firm).

41. *Id.* at 1399.

42. See Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 488 (1987) (discussing the balance of Delaware corporate law between the expectation that “Delaware’s law will remain relatively stable” by not changing existing rules “for less desirable ones” and the reality that Delaware corporate law must “be flexible enough to respond rapidly to changing circumstances in the marketplace”).

text, as Delaware has been regarded as the most whole-hearted adopter of this view, and its judges and legislature are sensitive to providing an optimal corporate legal environment based in large part on this theory.⁴³

Therefore, the law and economics theory, and the even broader “strong contractarian bent,”⁴⁴ adopted by Delaware is important in predicting a workable default rule in the breach-of-contract context.⁴⁵ This is not to say that the theory has been wholly adopted by scholars⁴⁶ but that even a minimalist observer of the contractarian theory on Delaware’s bench would be influenced by its prevalence in Delaware corporate law.⁴⁷ Furthermore, even a penalty default rule would in some regard have to adhere to the general prevalence of contractarian gap filling in Delaware in order to fit within the larger contracting norm. As a result, any default rule adopted by the Delaware courts will likely be influenced by contractarianism, and understanding its relative importance will help predict a default rule.

B. DELAWARE CASE LAW

Delaware is considered by many as allowing parties great latitude when contracting and having that freedom judicially enforced.⁴⁸ This general adherence to contracts, or contractarian approach, has been attributed by many to be a product of the state’s long history as the de facto incorporation state, with the state being preferred as a choice of venue to adjudicate commercial disputes in many transactions.⁴⁹ This adherence to and dependence on a contractarian approach to construing contracts is likely an important factor for understanding how any court, even one in Delaware, could find that the contract alone is not dispositive. And since sandbagging claims arise from express warranties or representations,

43. Furthermore, another reason for this adoption, and relevant to this work, is the unique structure and politics of Delaware generally. See Mark J. Roe, *Delaware’s Politics*, 118 HARV. L. REV. 2491, 2537 (2005) (discussing Delaware’s law-making process and how shareholders and managers dominate this process for the goal of promoting efficient corporate rules). And as one author has posited, “Delaware’s lawmaking structure makes contractarian results more likely . . .” *Id.* This result may not be a surprise given the general assumption for law and economics theory that Delaware corporate law, through its adoption of a contractarian approach, is efficient. See Macey & Miller, *supra* note 42, at 473.

44. See West, *supra* note 8 (discussing the general adoption of a contractarian approach to contract interpretation in Delaware).

45. See Roe, *supra* note 43, at 2536 (discussing how “Delaware corporate law comes close to reflecting the contractarian agenda”).

46. See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 758–60 (1995) (criticizing some of the underlying assumptions of the contractarian theory of the firm and the law and economics movement’s theories on efficient corporate law).

47. See *supra* notes 38–42 and accompanying text.

48. See *supra* Part II.A.1 (discussing the general adoption of economic theory in the conception of the firm and default contract terms); see also West, *supra* note 8 (discussing Delaware’s adoption of its “stated contractarian principals”).

49. See Omari Scott Simmons, *Branding the Small Wonder: Delaware’s Dominance and the Market for Corporate Law*, 42 U. RICH. L. REV. 1129, 1180 (2008) (discussing the power and influence of the Delaware “brand” in corporate law and corporate disputes).

which are treated like contract claims under the modern trend,⁵⁰ an easy answer to the question of how Delaware would decide a sandbagging default would be by the contract terms.⁵¹ However, this simple approach to the issue is flawed because it does not consider the intermixing of tort and contract principles that afflict Delaware's pro-contract jurisprudence,⁵² and this approach is not determinative because many agreements are silent on the sandbagging issue. Therefore, in order to provide a basis for a probative analysis, the remainder of this subsection will detail the diverging lines of cases under Delaware law and the recent Supreme Court of Delaware case dealing with sandbagging.

1. Cases Supporting a Tort-Like Reliance Element

Prior to the court's 2003 decision in *Gloucester Holding Corp. v. U.S. Tape & Sticky Products, LLC*,⁵³ Delaware had limited jurisprudence to guide courts in cases involving a sandbagging buyer. However, even within this limited body of case law, the general rule for a breach-of-warranty claim was that it included a reliance element.⁵⁴ As one case declared, a common origin for a reliance element within a breach of warranty comes from the case *Loper v. Lingo*.⁵⁵ In *Loper*, the court set the elements for a buyer to recover as: (1) "that at the time of the sale the [goods were] warranted by the [seller] to be sound, and that *the [buyer] relied upon such warranty*"; (2) that there has been a breach of the warranty . . . ; and (3) that [the buyer] has sustained damages by reason of said breach."⁵⁶ Spawning from this admittedly aged decision,⁵⁷ several Delaware decisions reaffirmed that reliance, in its traditional sense,⁵⁸ is a required element of a breach-of-warranty claim.⁵⁹ Notably, while none of

50. See *infra* Part II.A.

51. See West, *supra* note 8 (discussing the general trend in Delaware to enforce agreements according to their terms).

52. See generally Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the “Entire” Deal?*, 64 BUS. LAW. 999, 1001 (2009) (discussing the intermixing of tort and contract principles in Delaware for the enforcement of negotiated acquisition agreements).

53. 832 A.2d 116 (Del. Ch. 2003).

54. See *Loper v. Lingo*, 97 A. 585, 586 (Del. Super. Ct. 1916).

55. *Vigorone AG Prods., Inc. v. PM AG Prods., Inc.*, 316 F.3d 641, 649 (7th Cir. 2002) (declaring *Loper*, 97 A. at 586, "the *fons et origo* of Delaware's unorthodox position" on buyer reliance in a breach-of-warranty claim).

56. *Loper*, 97 A. at 586 (emphasis added).

57. See *Vigorone AG Prods.*, 316 F.3d at 649 (for a discussion from Judge Richard Posner on the repetition of the use of *Loper*, 97 A. at 586, in Delaware as good law being "unthinking" in light of the fact that breach of warranty was considered a tort instead of a contract claim when *Loper* was decided); see also Aleksandra Miziolek & Dimitrios Angelakos, *Contract Drafting: Sandbagging: From Poker to the World of Mergers and Acquisitions*, 92 MICH. B.J. 30, 34 (2013) (explaining that "[t]he modern trend under state law is to adopt a contract law approach" to breach of warranty claims).

58. Reference to a traditional or tort reliance that allows recovery of damages is generally considered to be composed of the following elements: (1) actual reliance by the buyer and (2) the reliance was reasonable. See Jim Leitzel, *Reliance and Contract Breach*, 52 L. & CONTEMP. PROBS. 87, 90–91 (1989).

59. See *Harvard Indus. Inc. v. Wendel*, 178 A.2d 486, 496 (Del. Ch. 1962); *Bleacher v. Bristol-Myers Co.*, 163 A.2d 526, 527 (Del. Super. Ct. 1960); *Kelly v. McKeeson HBOC*,

these cases have been explicitly overruled, only one case has held reliance as an element for a breach-of-warranty claim after *Gloucester* was decided.⁶⁰ In fact, all but a few of these cases were decided before the mass acceptance of the law-and-economics theory in Delaware, and that alone may cast doubt on their probative value as predictors of future Delaware cases.⁶¹

2. Case Law Supporting a Modern Contractarian Approach

Since 2003, only one case has followed the *Loper* line of precedent,⁶² with Delaware courts instead favoring the approach adopted in *Gloucester*. In *Gloucester*, the buyer of substantially all of a seller's assets counterclaimed both fraud and misrepresentation claims based on the seller's failure to disclose certain documents.⁶³ In negotiating the transaction and at closing, the seller, in several sections of the asset purchase agreement, made representations that there were no omissions to the financial statements and that they were prepared in accordance with GAAP.⁶⁴ The buyer, given the "fast track" nature of the transaction (signed and closed in one month), negotiated for and included an indemnification warrant by the seller that would serve as the sole remedy for any breach of the representations or warranties.⁶⁵ In the ensuing litigation, the seller argued on a motion for failure to state a claim that the buyer had to plead a reliance element in order to recover the indemnity on a breach-of-contract claim.⁶⁶ The court disposed of this assertion by stating that "[r]eliance is not an element of [a] claim for indemnification" based on misrepresentations in the warranted evaluation materials.⁶⁷ The court offered no citation to authority in disclaiming reliance as an element of the breach-of-contract claim, and the judge specifically made no reference to prior Delaware breach-of-warranty cases.⁶⁸

Inc., No. CIV.A. 99C-09-265WCC, 2002 WL 88939, at *8 (Del. Super. Ct. Jan. 17, 2002) (denying summary judgment because the shareholders' reliance on a warranty was an unresolved question of fact and a necessary element under "sound Delaware law").

60. See *MicroStrategy Inc. v. Acacia Research Corp.*, No. 5735-VCP, 2010 WL 5550455, at *10 (Del. Ch. Dec. 30, 2010) (declaring that "[u]nder Delaware law, 'a plaintiff must establish reliance as a prerequisite for a breach of warranty claim'" (quoting *Kelly*, 2002 WL 88939, at *8)).

61. See *supra* Part I.

62. See *MicroStrategy Inc.*, 2010 WL 5550455, at *10.

63. *Gloucester Holding Corp. v. U.S. Tape & Sticky Products, LLC*, 832 A.2d 116, 118 (Del. Ch. 2003) (the suit was brought by the seller after the buyer refused to pay the full amount under the purchase agreement).

64. *Id.* at 121-22.

65. *Id.* at 122.

66. *Id.* at 127.

67. *Id.* at 127-28; see also *Hudson's Bay Co. Lux., S.A.R.L. v. JZ LLC, C.A. No. 10C-12-107-JRJ CCLD*, 2011 WL 3082339, at *2 (Del. Super. Ct. July 26, 2011) ("It is well settled under Delaware law that the extent or quality of the buyer's due diligence is not relevant to the determination of whether the seller breached its representations and warranties in the agreement.>").

68. See *Gloucester*, 832 A.2d at 127-29.

In another widely cited case, *Interim Healthcare, Inc. v. Spherion Corp.*, an acquiror in a stock purchase, like in *Gloucester*, brought breach-of-contract claims under the contract's indemnity.⁶⁹ The court cited to *Gloucester* in reaffirming that reliance is not an element of a breach-of-warranty claim.⁷⁰ However, the court went further in its explanation by boldly claiming that the buyer was "entitled to rely upon the accuracy of the representation irregardless of what their due diligence may have or should have revealed."⁷¹ This case, paired with *Gloucester*, represents a clear shift away from a reliance element in Delaware courts; however, until 2007, a breach-of-warranty claim had not been decided in the sandbagging context.

Finally, in *Cobalt Operating, LLC v. James Crystal Enterprises, LLC*, Leo Strine, then a Vice Chancellor of the Court of Chancery, ruled explicitly that a purchaser need not show reliance on an allegedly breached representation to recover damages.⁷² Of potential importance to the current state of the law, Chancellor Strine did not stop after ruling that reliance was not necessary but instead, in dicta, continued discussing the "important risk allocation function" of express and unqualified representations.⁷³ However, Chancellor Strine's posture on this issue may be limited to the facts of *Cobalt*, since the seller intentionally hid information that would have shown the falsehood of the representations even after the buyer requested the information during due diligence.⁷⁴

3. Eagle Force and Its Place Within Precedent

In the Supreme Court of Delaware's recent case—*Eagle Force*—discussing the rights of a sandbagging buyer, neither the majority nor the concurring opinions found the sandbagging claims central to the court's holding, yet both took occasion to discuss the current state of the law in dicta.⁷⁵ The underlying case involved a complex financing and formation agreement between two businessmen where the parties were disputing the contract formation of a contribution agreement.⁷⁶ At particular issue, and the issue relevant to a potential sandbagging claim, was a section of the agreement that represented and warranted that Kay, the transferring party, would confer all of the targeted companies' securities at closing.⁷⁷

69. *Interim Healthcare, Inc. v. Spherion Corp.*, 884 A.2d 513, 517 (Del. Super. Ct. 2005).

70. *Id.* at 548.

71. *Id.*

72. *Cobalt Operating, LLC v. James Crystal Enters., LLC*, No. Civ.A. 714-VCS, 2007 WL 2142926, at *27 (Del. Ch. 2007), *aff'd*, 945 A.2d 594 (Del. 2008) (affirming without the reliance issues for the express warranty being on appeal).

73. *Id.* at *28 (focusing particularly on the high cost of due diligence and how representations and warranties in the contract could "minimize a buyer's need to verify every minute aspect of a seller's business").

74. *Id.*

75. *Eagle Force Holdings, LLC v. Campbell*, 187 A.3d 1209, 1236 n.185, 1247 n.38 (Del. 2018).

76. *See id.* at 1221–27.

77. *Id.* at 1234.

The provision detailing the contribution of all the securities, the key consideration for Kay's side of the transaction, had blank schedules relating to certain representations, except for an employee interest appreciation plan, which was filled in but left in brackets.⁷⁸ Because of the incomplete schedule and the implication of the employee stock appreciation plan, the trial court held it to be an incomplete material term, precluding the contract from being formed.⁷⁹ The Supreme Court of Delaware interpreted this provision differently and subsequently reversed the Court of Chancery. The court held that, regardless of the fact that both parties knew the transferring party did not own all the stock, the transferring party, nevertheless, represented that it could by closing through its signature of the document, thereby forming an enforceable agreement.⁸⁰

After deciding to overrule the trial court, the court proceeded in a footnote to comment on the ramifications of the decision of finding contract formation, namely by musing about whether the buyer would be precluded from a breach-of-warranty claim.⁸¹ In the appeal, the transferor argued that reliance was a requirement, but the court, in what can only be described as dicta, declared the issue unresolved but an "interesting question."⁸² The court did not cite to either line of precedent discussed above, instead favoring a citation to an earlier Supreme Court of Delaware decision that, like *Eagle Force*, did not reach the breach-of-warranty claim.⁸³ Stopping here would have been enough to cause uncertainty in the deal community, but the court continued by citing an influential New York Court of Appeals case, acknowledging that a majority of states had followed this New York Court of Appeals decision, which does not require "traditional reliance."⁸⁴

In a concurring-in-part and dissenting-in-part opinion (hereinafter the concurring opinion), Chancellor Strine, while discussing the definiteness of the agreement, also doubted the ability of the contributing party to sue the transferring party.⁸⁵ In particular, Chancellor Strine expressed "doubt

78. *Id.* at 1234–35.

79. *Id.* The trial court reasoned that, because an employee compensation plan existed on the schedules, the transferring party could not in fact own all of the interest in the limited liability corporation as represented. *See Eagle Force Holdings, LLC v. Campbell*, No. 10803–VCMR, 2017 WL 3833210, at *9 (Del. Ch. Sept. 1, 2017). As a result, the party making the representation could never have transferred all interest as required by the agreement, and the other party knew this. *Id.* at *9–11, 16.

80. *See Eagle Force*, 187 A.3d at 1235. Such an interpretation supports the broad proposition that Delaware courts adopt the contractarian view of contracts and enforce these agreements by their terms even when it results in harsh outcomes.

81. *See id.* at 1236 n.185.

82. *Id.*

83. *Id.* (citing *Genencor Int'l, Inc. v. Novo Nordisk A/S*, 766 A.2d 8, 12 n.8 (Del. 2000) (failing to reach the issue on appeal but, nevertheless, discussing the case law cited by the opposition brief relating to well-established New York cases)).

84. *Id.* (citing *CBS Inc. v. Ziff-Davis Publ'g Co.*, 553 N.E.2d 997, 1001 (N.Y. 1990) (stating that this view of reliance reflected the "prevailing perception of an action for breach of express warranty as one that is no longer grounded in tort, but essentially in contract"))).

85. *Id.* at 1247 (Strine, C., concurring).

that [Kay could] then turn around and sue because what [Kay] knew to be false remained so.”⁸⁶ While not expressly laying out his reasons, Chancellor Strine made reference to “[v]enerable Delaware law” as casting doubt on Kay’s ability to recover on a breach-of-representation theory.⁸⁷ Strikingly, this seems at odds with his previous opinions on the Court of Chancery, but once again, the unique factual scenario may be a distinguishing factor.⁸⁸

While both the majority and the concurring opinions seem to indicate that the buyer’s claim for breach of warranty may not be tenable under Delaware law, neither cited to existing Delaware cases ruling on the issue.⁸⁹ Nevertheless, both opinions did provide insight, through reference to other cases, on how the court might rule on the issue in the future.⁹⁰ Therefore, a prediction of the court’s future position necessitates further discussion of relevant New York law, given the majority’s citation to New York’s seminal case.⁹¹

C. NEW YORK CASE LAW

1. CBS Inc. v. Ziff-Davis Publishing Co.: *The Preeminent Pro-Sandbagging Case*

In an often cited and influential case, *CBS Inc. v. Ziff-Davis Publishing Co.*, the New York Court of Appeals, New York’s highest court, seemingly clarified whether breach of warranty was a contract or tort claim—in favor of the former.⁹² Building on prior cases,⁹³ the court did not find that traditional reliance was required in order to pursue a breach-of-war-

86. *Id.* (citing the majority opinion’s discussion of the Court of Chancery’s findings that the transferor could not provide the requisite consideration as he did not own all the interest).

87. *Id.* In support of this position, the concurring opinion referenced only one case, *Clough v. Cook*, 87 A. 1017, 1019–20 (Del. Ch. 1913), which holds that a party cannot bring a claim on a false representation when the party knows the representation is false when the contract was signed. *See id.* at 1018–19 (discussing the “general rule that a misrepresentation must be relied upon by the party receiving it”) (internal citations omitted).

88. *See supra* notes 72–74 and accompanying text.

89. The omission by Chancellor Strine to cite *Cobalt* was interesting in light of its general acceptance by practitioners as the strongest case for a pro-sandbagging default rule position. *See* Adrian Szykowski, *Devils in the Details: An Essay Examining the Significance of Jurisdictional Default Rules in the Mergers and Acquisitions Context*, 4 EMORY CORP. GOV. & ACCOUNTABILITY REV. 441, 445 (2017) (discussing *Cobalt* as solidifying Delaware’s pro-sandbagging default). Furthermore, the pointed omission to cite to other Delaware cases dealing with express breach of warranty, even in the UCC context, is particularly concerning as it gives little, if any, guidance for how to approach breach-of-warranty claims generally.

90. *See Eagle Force*, 187 A.3d at 1236–37, 1247–49.

91. *See id.* at 1236 n.185 (citing *CBS Inc. v. Ziff-Davis Publ’g Co.*, 553 N.E.2d 997, 1001 (N.Y. 1990)).

92. *Ziff-Davis*, 553 N.E.2d at 1000–01. While not the first case in New York refusing to require a reliance element, this case is generally considered the root of current New York breach-of-warranty (and through implication, sandbagging) jurisprudence.

93. *See, e.g., Ainger v. Mich. Gen. Corp.*, 476 F.Supp. 1209, 1224–25 (S.D.N.Y. 1979), *aff’d*, 632 F.2d 1025 (2d Cir. 1980) (ruling that the elements for a breach-of-warranty claim did not include a reliance element); *Overstreet v. Norden Labs.*, 669 F.2d 1286, 1291 (6th Cir. 1982); *Pritchard v. Liggett & Myers Tobacco Co.*, 350 F.2d 479, 483 (3d Cir. 1965).

ranty claim.⁹⁴ Instead, the court held that a buyer need only rely on the belief that it was purchasing an express warranty for the seller's promise that the information was true.⁹⁵

In the underlying transaction, CBS purchased from Ziff-Davis Publishing certain media businesses after having reviewed financial statements describing the state of the businesses.⁹⁶ In the purchase agreement, the seller warranted that the accuracy of these and future financial statements and the seller warranted that there would be no materially adverse change in the media businesses until closing.⁹⁷ After reviewing the previously disclosed financial statements and new unaudited statements, CBS not only doubted the accuracy of the profitability figures but also notified Ziff-Davis about their doubts.⁹⁸ Nevertheless, upon notice of these doubts, Ziff-Davis continued to warrant the financial statements, threatening "to pursue all of its rights and remedies as provided by law" if CBS did not close.⁹⁹ Following this threat, the buyer closed the transaction but only upon the express condition that closing did "not constitute a waiver."¹⁰⁰

After closing, the buyer then sued the seller for breach of an express warranty based on the allegedly defective financial statements.¹⁰¹ In its defense, Ziff-Davis claimed that, given CBS's disbelief in the warranty prior to closing, CBS could not claim to rely on the warranty—effectively precluding recovery because of this lack of reliance.¹⁰² The court rejected this argument in favor of CBS's claim that reliance on the truth of the representation and warranty at closing was not necessary.¹⁰³ Instead, the court required only that the buyer "rel[y] on the express warranty as being a part of the bargain between the parties."¹⁰⁴ Given the express reservation of CBS prior to closing, the court found this sufficient to carry the burden that it relied on the warranty when striking the bargain.¹⁰⁵

94. *Ziff-Davis*, 75 N.Y.2d at 1000–01. *Ziff-Davis's* arguments for a reliance element were similar to what are common to fraud and misrepresentation claims, i.e., "a belief in the truth of the representations made in the express warranty and a change of position in reliance on that belief." *Id.* at 1000.

95. *Id.* at 1000–01.

96. *Id.* at 998.

97. *Id.*

98. *Id.* The court stated that "it must be emphasized" that CBS learned of the falsity of the statements after signing but before closing. *Id.* at 1000. The court's emphasis here may signal that the holding is only limited to claims when the buyer learns of a warranty's falsity after signing.

99. *Id.* at 999.

100. *Id.* The purchase agreement also contained an express provision that CBS would be allowed to rely on its own accountant's representations of the validity of the financial disclosures made by Ziff-Davis. *Id.* at 1003 (Bellacosa, J., dissenting).

101. *Id.* at 999 (majority opinion). The buyer was able to bring the claim post-closing based on a survival clause which allowed the accuracy of the representations and warranties to "survive the closing, notwithstanding any investigation" by CBS. *Id.*

102. *Id.* at 999–1000.

103. *Id.* at 1000–01.

104. *Id.* at 1001.

105. *Id.*

As a result of this decision, courts must now go into the additional fact inquiry of whether the buyer actually negotiated for the warranty and relied on it. Such a rule is not altogether different from a strict breach-of-contract claim, but it, nevertheless, does create a nuanced, though limited, reliance element.¹⁰⁶ And while deriving the New York default rule seems fairly straightforward, some scholars have noted the uniquely buyer-friendly facts of *Ziff-Davis* create some latent ambiguities in the application of the rule in similar cases.¹⁰⁷

2. *Ziff-Davis's Progeny*

While the New York Court of Appeals has yet to rule on another case involving a sandbagging provision, three federal court cases, all applying New York law, may have further explained the New York default rule from *Ziff-Davis*.¹⁰⁸ In *Galli v. Metz*, a transaction to sell a petroleum business was signed and closed on the same day with payment via a promissory note.¹⁰⁹ After one month, the buyer attempted to reduce the note's payment on several theories.¹¹⁰ The buyer's main argument was based on two breach-of-warranty claims involving a major tax levy and lawsuit with a customer, respectively.¹¹¹ The court denied the buyer relief, reasoning that the buyer had waived its right to the express warranty in the closing documents.¹¹² To rectify this result with its mandatory precedent—*Ziff-Davis*—the United States Court of Appeals for the Second Circuit distinguished the case on its facts and expanded *Ziff-Davis* to preclude “a buyer . . . [who] in full knowledge and acceptance of facts disclosed by the seller” signs and closes the transaction anyway.¹¹³

After *Galli*, the Second Circuit was again presented with a similar breach-of-warranty claim where the buyer of a painting signed the bill of sale based on assurances in the agreement that the seller had no adverse information regarding the painting's authenticity.¹¹⁴ The court, applying

106. *See id.*

107. *See* Robert Quaintance, Jr., *Can You Sandbag? When a Buyer Knows Seller's Reps and Warranties Are Untrue*, 5 M&A LAW. 8 (2002) (discussing a limited reading of the court's holding in *Ziff-Davis* considering the facts of the case and how the opinion is structured).

108. *See, e.g.*, *Rogath v. Siebenmann*, 129 F.3d 261, 264 (2d Cir. 1997); *Galli v. Metz*, 973 F.2d 145, 151 (2d Cir. 1992); *Coastal Power Int'l, Ltd. v. Transcon. Capital Corp.*, 10 F. Supp. 2d 345, 360 (S.D.N.Y. 1998).

109. *Galli*, 973 F.2d at 147.

110. *Id.*

111. *Id.*

112. *See id.* at 149–51 (reasoning that such a waiver was based on the simultaneous signing and closing of the agreement, indicating that the buyer did not rely on the warranties because there was no diligence to check their accuracy).

113. *Id.* at 151 (distilling the rule to require the buyer to “expressly preserve[] his rights under the warranties”); *cf.* *CBS, Inc. v. Ziff-Davis Publishing Co.*, 553 N.E.2d 997, 1000–01 (N.Y. 1990) (finding the buyer had already signed the purchase agreement when it found that the warranty was untrue but had expressly reserved its rights at closing).

114. *Rogath v. Siebenmann*, 129 F.3d 261, 265 (2d Cir. 1997) (noting that, while this case fell under the UCC as a sale of goods transaction, the *Ziff-Davis* line of precedent, nevertheless, applied for the express warranty in the bill of sale).

both *Ziff-Davis* and *Galli*, reasoned that the buyer could still prevail on the breach-of-warranty claim even if the buyer knew, through a third party or “common knowledge,” that the seller’s claim is false, but only so long as the buyer “expressly preserves [its] rights.”¹¹⁵ In essence, *Rogath* clarified an ambiguity in *Galli* by stating that knowledge of the warranty’s falsity is relevant, but only if the source is the seller.¹¹⁶ As a result of these cases, the law is nuanced and somewhat unclear. But at the very least, it is fair to reason that the law will preserve any buyer’s sandbagging claim, so long as it expressly reserves the right to rely on a warranty, representation, or covenant.¹¹⁷

3. *The Synthesized New York Rule*

Applying *Ziff-Davis* and the clarifying federal cases, the New York default rule could be read as:

In the absence of a pro-sandbagging clause in the agreement, a purchaser who prior to signing knows of a breach of a representation, warranty, or covenant contained in the agreement will be precluded from seeking post-closing damages or indemnification if the purchaser is aware of such breach as a result of the seller’s disclosure.¹¹⁸

However, if the clarifying federal cases after *Ziff-Davis* are not taken into account by Delaware, then the New York rule would read: “In the absence of a clause or language to the contrary, a purchaser need only show that it relied on the information being represented or warranted as true and that it had a contractual right to seek damages for the information being untrue under a breach of contract claim.”¹¹⁹ As both proposed readings show, the New York rule does not contain a true reliance element. Instead, New York law requires a party asserting breach to prove that the warranty was a right that the buyer thought it was buying as part of the transaction. Simply stated, the buyer must believe that it is purchasing a right to a claim and that the warranty purely is “insurance against any future claims.”¹²⁰ While neither of the above interpretations

115. *Id.*

116. *See id.*; *see also* Brandon Cole, *Knowledge Is Not Necessarily Power: Sandbagging in New York M&A Transactions*, 42 J. CORP. L. 445, 450 (2016) (discussing the nuanced rule from the *Galli* case); *Merrill Lynch & Co. Inc. v. Allegheny Energy, Inc.*, 500 F.3d 171, 186 (2d Cir. 2007) (“[T]he general rule is that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue.”); *Coastal Power Int’l, Ltd. v. Transcon. Capital Corp.*, 10 F. Supp. 2d 345, 361 (S.D.N.Y. 1998) (“The buyer’s awareness of [the warranty’s falseness] from other sources, however, creates no such difficulty.”).

117. *See* Cole, *supra* note 116, at 455–56.

118. *See* Joe Brennan, “Sandbagging” and “Knowledge” Clauses in M&A Agreements, NERLAND LINDSEY (Nov. 2, 2012), <http://www.snclaw.com/cgblog/48/123/Sandbagging-and-Knowledge-Clauses-in-M-A-Agreements> [<https://perma.cc/Y4UP-PNZY>] (presenting a consolidation of the default rule in New York).

119. *See* *CBS Inc. v. Ziff-Davis Publ’g Co.*, 553 N.E.2d 997, 1000–01 (N.Y. 1990) (construing reliance as “requiring no more than reliance on the express warranty as being a part of the bargain”).

120. *Rogath*, 129 F.3d at 265.

of the rule are fully contractarian given the presence of a tort-like element of reliance, this slight detour from a pure contract claim may nonetheless be considered and adopted by Delaware,¹²¹ especially in light of the citation to New York authority in the *Eagle Force* case.¹²²

III. ANALYSIS

In the following section, this paper will first propose a penalty default rule that best solves the asymmetrical information problems of M&A transactions, which typically is the key issue in sandbagging claims. The next portion will analyze the various precedents in Delaware and New York to predict how the Supreme Court of Delaware would rule on the issue. Throughout both analyses, a fundamental underpinning will consist of the broader contractarian approach that the courts and contracting parties generally take in these agreements.

A. JUSTIFICATION FOR A PRO-SANDBAGGING RULE: PENALTY DEFAULTS

An efficient default sandbagging position can be analyzed by way of proposing a “penalty default” rule on one party to promote more efficient contracting in the overall transaction.¹²³ A penalty default has been applied in other contexts,¹²⁴ but a penalty default has only been proposed in this context as additional support for an anti-sandbagging position.¹²⁵ In other contexts, the theoretical justification for selecting penalty defaults to promote efficient markets has been criticized based primarily on differences in party sophistication;¹²⁶ however, unlike those contexts, in

121. When interpreting New York law, Chancellor Strine discussed the differences in the public policy reasons for allowing a buyer who finds a representation to be false after signing but before closing to sue post-closing and the case of allowing a buyer to just walk the deal in lieu of closing. *In re IBP, Inc. S'holder Litig.*, 789 A.2d 14, 82 n.200 (Del. Ch. 2001).

122. *See supra* note 84 and accompanying text.

123. The term “penalty default” was coined by Ian Ayres and Robert Gertner to propose a new method for courts to fill in contracts that left certain terms silent. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 91 (1989).

124. *See, e.g.*, John S. Applegate, *Bridging the Data Gap: Balancing the Supply and Demand for Chemical Information*, 86 *TEX. L. REV.* 1365, 1400–01 (2008) (applying information-forcing rules in the environmental context); I. Glenn Cohen, *The Right Not to Be a Genetic Parent?*, 81 *S. CAL. L. REV.* 1115, 1188 (2008) (proposing the use of information-forcing rules for disclosure of use of genetic material); Alex Reinart, *Pleading as Information-Forcing*, 75 *L. & CONTEMP. PROBS.* 1, 3 (2012) (discussing the benefits and drawbacks of information forcing through a penalty default pleading standard).

125. Charles Whitehead first proposed the penalty default rule in the sandbagging context in order to advocate for an anti-sandbagging default rule nationally. *See Whitehead, supra* note 4, at 1100–07. While this effort was laudable and based on compiled empirical data from various deals, the efficacy of the penalty default to produce the desired anti-sandbagging result does not reflect current market trends and, particularly, Delaware’s unique approach to contracts. *See id.* at 1093–100 (detailing the results of a compilation of various deals between 2007–2010).

126. A common criticism of this approach is that, even when default rules are information forcing, parties do not change their contract negotiation position for other reasons.

M&A negotiations, both parties are likely to be relatively sophisticated.¹²⁷ Thus, the analysis of different penalty defaults in this context would theoretically be sound in order to reach an efficient and definite default rule—a goal central to Delaware’s corporate law prominence.¹²⁸

Generally, the use of a penalty default is for the primary objective of reaching more efficient societal outcomes, namely lower transaction costs and more efficient price finding.¹²⁹ While parties would presumably already advocate on their own behalf for better outcomes, scholars have noted the information asymmetries that exist between parties and how it leads to parties foregoing more efficient negotiations.¹³⁰ Because of these asymmetries and the effect on splitting the contractual pie, some parties will “prefer to have inefficient precaution rather than pay a higher price” if all information was disclosed.¹³¹ This election to choose inefficient outcomes on a deal-by-deal basis is not efficient at the system level but may be remedied by selecting default rules that force parties to share information.¹³² Accordingly, lawmakers and courts should select default rules that induce knowledgeable parties to disclose in a manner that leads to better price discovery and lower costs.¹³³

M&A transactions are no stranger to information asymmetry between parties as the complexity of corporate structures and the costs of due dili-

See, e.g., J.H. Verkerke, *Legal Ignorance and Information-Forcing Rules*, 56 WM. & MARY L. REV. 899, 906 (2015) (criticizing information-forcing rules in the context of form contracts because of consumer indifference to disclosures from the sophisticated party about the penalty default).

127. *See* Ari Dropkin, *Skin in the Game: The Promise of Contingency-Based M&A Fees*, 103 GEO. L.J. 1061, 1063 (2015) (describing transactional lawyers as “crucial” to M&A deals).

128. *See* John Armour et al., *Delaware’s Balancing Act*, 87 IND. L.J. 1345, 1347 (2012) (discussing the “value-added” effect of using Delaware corporate law to govern choice-of-law provisions in transactions and when incorporating); *see also* Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1773 (2006) (discussing how a legislative response to new or novel issues is delayed “until the Delaware courts decide at least one case squarely”).

129. Ayres & Gertner, *supra* note 123, at 91. The use of penalty defaults generally fits within the larger vein of law and economics literature, which makes it a relevant and adoptable analysis for Delaware. *See infra* Part I (discussing the adoption of contractarian approaches to contracts by both practitioners and the courts).

130. *See* Verkerke, *supra* note 126, at 906. In a Coasean world where transaction costs would allow full negotiation of all terms, parties would not have to pick and choose which issues to negotiate; however, the realities of high transaction costs make it necessary to create default rules to promote more efficient contracting. *See* Whitehead, *supra* note 4, at 1090 n.3 (discussing the Coasean theory and subsequent modifications by other scholars which take into account the costs of contracting).

131. Ayres & Gertner, *supra* note 123, at 94; *cf.* Paul B. Stephan, *Bond v. United States and Information-Forcing Defaults: The Work that Presumptions Do*, 90 NOTRE DAME L. REV. 1465, 1477 (2015) (discussing the efficient decision making of parties without taking into account precaution inefficiencies).

132. *See* Ayres & Gertner, *supra* note 123, at 94–97.

133. *See* Mathew D. Cain et al., *Broken Promises: The Role of Reputation in Private Equity Contracting and Strategic Default*, 40 J. CORP. L. 565, 575–76 (2015) (discussing how either a wary buyer or wary seller will move the purchase price to account for skepticism of the other party’s disclosures).

gence can lead to parties either strategically withholding information¹³⁴ or relying on *ex post* litigation to remedy disclosure issues through use of an indemnity or RWI.¹³⁵ In fact, it is common practice for a Delaware M&A transaction to be silent on the issue of sandbagging, and parties instead risk adjusting through the indemnity clause or scope of representations.¹³⁶ Therefore, while the use of a penalty default could serve as an effective mechanism to promote better practices through promoting disclosure, it must be tailored to the concerns of sandbagging claims and the effects such rules would have on the parties in terms of other costs.¹³⁷

1. *An Unqualified Pro-Sandbagging Rule*

In applying the penalty default, the primary goal would be stimulating information-forcing behavior between parties. Under a pro-sandbagging default rule, the penalty imposed would fall to the seller, as it would be liable for post-closing indemnity claims that could only be mitigated through disclosure.¹³⁸ Since the majority of the penalty would fall to the seller, a seller who wants to avoid a sandbagging buyer would be charged with either: (1) negotiating around the default rule or (2) minimizing the chance of a sandbagging claim. Under either option, more disclosure is likely to occur, notwithstanding the various other costs such a default would impose.

Under the first option, there are several hurdles the seller would face when negotiating for an anti-sandbagging clause.¹³⁹ First, the current deal-making market has a low incidence rate of anti-sandbagging provisions even though the previous consensus was a pure pro-sandbagging rule.¹⁴⁰ This fact alone may lead to the inference that buyers discount

134. Ayres & Gertner, *supra* note 123, at 94; *see also* Stephan, *supra* note 131, at 1476–78 (discussing how one party often has more information but will only disclose information when doing so will increase the joint surplus, or value created, by contracting with the other party).

135. *See* Jeffrey Chapman et al., *Representations and Warranties Insurance in M&A Transactions*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 11, 2017), <https://corpgov.law.harvard.edu/2017/12/11/representations-and-warranties-insurance-in-ma-transactions/> [<https://perma.cc/T57T-8VL3>] (discussing the rise in representation and warranty insurance as a risk-adjusting mechanism in M&A deals for both buyers and sellers).

136. *See* ABA, DEAL POINTS STUDY: PRIVATE TARGET MERGERS & ACQUISITIONS 60 (2017), https://www.americanbar.org/groups/business_law/committees/ma/deal_points/ [Permalink unavailable] (reviewing 139 deals from 2016 to 2017 for sandbagging provisions and finding that 51% were silent on the issue).

137. *See* Dropkin, *supra* note 127, at 1073–74 (discussing how “contractual arrangement is typically dictated by transaction costs flowing from controllable risk and the allocation of uncontrollable risk”).

138. *Cf.* Whitehead, *supra* note 4, at 1088–89 (postulating that a seller in a pro-sandbagging jurisdiction, fearing a buyer bringing a claim, will “reflect the risk of sandbagging in all contracts,” which would lead to all buyers sharing at least some of the costs).

139. *See id.* at 1101 (noting that practitioners claim that these types of negotiations “are often lengthy, emotional, and heated”).

140. *See* *What's Market Analytics: Sandbagging Provisions (2017)*, PRAC. L. CORP. & SEC. (Dec. 27, 2017), <https://us.practicallaw.thomsonreuters.com/w-012-3972> [Permalink unavailable] [hereinafter *What's Market Analytics*] (only 3% of the surveyed deals contained anti-sandbagging provisions). Furthermore, this trend directly contradicts the as-

acquisitions that contain this clause.¹⁴¹ On the other hand, a rational seller that values an anti-sandbagging right would be able to reassure the buyer through either more disclosure or more expansive warranties.¹⁴² In this way, hurdles to negotiating an anti-sandbagging right promote information forcing between parties. But this view of sellers, as previously mentioned, may be optimistic because parties do not always negotiate rationally,¹⁴³ and if more disclosure or warranties alone were enough to negotiate for anti-sandbagging clauses, there would arguably be a higher incidence rate for these clauses.¹⁴⁴

Under the second option, sellers would have multiple actions available to reduce the chance that a sandbagging claim might be brought. The easiest method would be to conduct due diligence on all represented material in order to ensure that no misleading or inaccurate information exists.¹⁴⁵ However, this method would be inefficient in the vast majority of deals, as this amount of due diligence would incur substantial transaction costs on the part of the seller.¹⁴⁶ Another action the seller could take would be disclosing potential inaccuracies up front. Adopting such an approach runs the risk that the buyer could sour on the deal or ask for a reduced price since risks would be known.¹⁴⁷ But on the other hand, this increased disclosure would give buyers greater opportunity to model and understand their risks, validating the penalty default's central premise of information forcing to reach efficient outcomes. Accordingly, both options to the seller would likely promote increased disclosure, but this penalty default must still be weighed against an anti-sandbagging penalty default.

sumption that a seller's market would change the dynamics and increase the incidence rate of anti-sandbagging provisions. *Cf.* Whitehead, *supra* note 4, at 1094 (showing an incidence rate of 3.2% for anti-sandbagging provisions).

141. *See* Cain et al., *supra* note 133, at 575–76.

142. *See* Whitehead, *supra* note 4, at 1104 (discussing how a seller may be able to communicate information at a lower cost through the use of warranties, as opposed to just disclosing the information).

143. *See supra* note 131 and accompanying text.

144. This inference is hard to arrive at by empirical evidence alone as the majority of Delaware agreements are silent on the issue, producing a confounding variable to testing. *See* Whitehead, *supra* note 4, at 1089 (discussing the odd phenomenon of pro-sandbagging or silence being common with anti-sandbagging clauses consistently over time regardless of governing law).

145. To be sure, this is the solution a Coasean type theory of contracting would reach, as the seller would be able to warrant and represent with its best confidence the fully vetted material. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960).

146. Unlike the Coasean world, high transaction costs associated with lawyers, investment bankers, and accountants exist in a deal and can create cost-prohibitive barriers. However, this is not to say sellers will not, or should not, engage in diligence, as the norm is to fully investigate the assets being sold. *See* Whitehead, *supra* note 4, at 1104 (discussing how most sellers will “double-check” at least the accuracy of their warranties).

147. On the other hand, such disclosure could increase the pool of potential bidders, and drive up the price, as the inherent risk of inaccuracies would decrease, causing more buyers to consider the sale. *See* Cain et al., *supra* note 133, at 574–77 (discussing the role of reputation and disclosure in reducing buyer discounts on assets sold).

2. *Anti-Sandbagging*

Applying this model to an anti-sandbagging default could potentially be more beneficial than a pure pro-sandbagging default rule.¹⁴⁸ Under such a penalty default, the buyer would face a default rule of silence being equivalent to an anti-sandbagging provision, and such a buyer, upon learning of any inaccuracy prior to closing, would need to disclose this fact to the seller and renegotiate or give up the contractual right post-closing.¹⁴⁹ This leaves the buyer with two means to counteract the default: (1) negotiate around the default rule or (2) request more documents and conduct more pre-signing diligence to avoid sandbagging altogether.

Turning to the first option available to a buyer, the buyer could renegotiate for a sandbagging right outright. In return, the seller would be able to negotiate a premium or other favorable term, such as a narrower warranty, by selling a pro-sandbagging provision to the buyer.¹⁵⁰ However, this does little for changing the information flow between the parties and could even lead to less sharing.¹⁵¹ Furthermore, once the buyer attains the sandbagging right, it would then face a seller attempting to mitigate, through disclosure, any sandbagging claim, as illustrated in the example above. But with the costs already sunk by both parties to negotiate around the anti-sandbagging default, this would provide no additional benefit over a pro-sandbagging default.¹⁵² A second option would be for the buyer to negotiate a relaxation or limitation on the knowledge requirement.¹⁵³ But even this limitation on knowledge would never be extended past actual knowledge, leaving the buyer with the evidentiary burden of disproving knowledge on every claim.¹⁵⁴ And this lower

148. This conclusion was put forward by Charles Whitehead when analyzing a large sample size of deals. Whitehead, *supra* note 4, at 1106. The article asserts that when “the net benefits of disclosure are positive, a penalty default may be more valuable.” *Id.* at 1105. However, in concluding that anti-sandbagging accrues net benefits to disclosure, the article failed to rebut the argument made by some, West & Shah, *supra* note 23, at 4, that sellers are disincentivized to disclose evidence of breach or will instead dump the data at the last minute. Whitehead, *supra* note 4, at 1106–07.

149. It is worth noting that while the buyer would be precluded from bringing a breach-of-warranty claim, it could still bring an action based on misrepresentation or fraud on the part of the buyer, but such a claim would run into issues for the buyer to meet the traditional reliance elements.

150. See Whitehead, *supra* note 4, at 1105–07 (discussing the sale of a sandbagging right to a willing buyer).

151. See Daniel Avery et al., *Trends in M&A Provisions: “Sandbagging” and “Anti-Sandbagging” Provisions*, BLOOMBERG L. REP. (2018), <https://www.bloomberglaw.com/product/BLPG/document/XBBHJ1TS000000?documentName=ORCA96399.pdf&fmt=pdf> [Permalink unavailable] (arguing that an anti-sandbagging clause would lead to less diligence on both sides).

152. Cf. Whitehead, *supra* note 4, at 1106 (finding that an anti-sandbagging default would be more optimal than a pro-sandbagging default rule, as sellers would be able to differentiate potential buyers interested in a sandbagging right and silence on the issue would allow the buyer to negotiate favorable terms).

153. Shadden, *supra* note 25, at 465–66.

154. See *id.*; see also Cole, *supra* note 116, at 453 (discussing the risk a sandbagging buyer takes given the unpredictability of the court system in these fact-intensive cases).

amount of due diligence may lead to higher discounts due to buyers being less sure of what they are buying.¹⁵⁵ Therefore, a buyer faces attenuated circumstances where the costs of negotiating for a sandbagging right would be less than the benefit, thereby nullifying the benefits of a penalty default.¹⁵⁶

Alternatively, the buyer could push for more disclosure pre-signing as a means to narrow the terms it negotiates for those representations and warranties that seem accurate.¹⁵⁷ While seemingly not inefficient because the buyer is likely to complete the diligence at some point, markets are competitive, and there could be several buyers vying for the same set of assets. This would create multiple, larger due diligence projects, all prior to signing. Furthermore, when an anti-sandbagging clause is the default, sellers may have less incentive to share data up front and, instead, favor disclosure after signing, which would allow them to argue constructive or actual notice on the part of the buyer.¹⁵⁸ Conversely, buyers may be more reluctant to request information from the seller, fearing either an actual- or constructive-knowledge theory with an anti-sandbagging clause in the agreement.¹⁵⁹ As a result of these arguments, an anti-sandbagging default rule likely is not an efficient mechanism to promote information sharing between the parties. Thus, under the penalty default rule analysis, the pro-sandbagging default rule best serves the purpose of promoting information sharing between parties in order to reduce transaction costs and increase price discovery.

B. PRECEDENT PREDICTS A RULE SIMILAR TO NEW YORK LAW

Notwithstanding the beneficial default position discussed above, given Delaware's lower court precedent, New York precedent, and Chancellor Strine's previous opinions, the Delaware Supreme Court is likely to create a rule very similar, if not identical, to that of New York. A difficulty in predicting the adoption of *Ziff-Davis*, however, is predicting how the court will interpret *Ziff-Davis* in light of the subsequent New York federal cases. Therefore, the following subsection will first predict and explain why the court is likely to adopt the New York rule. It will then predict the other boundaries of such a default rule in light of subsequent federal cases applying the New York rule.

155. This is the classic lemons problem: the buyer, not knowing which goods are lemons, will discount all of the goods to reallocate the cost of one lemon.

156. See generally Cole, *supra* note 116, at 454–55 (discussing the various hurdles a buyer faces when pursuing a claim under an anti-sandbagging default or clause).

157. In doing so, the buyer would presumably be able to arrive at a more efficient purchase price by knowing its risks and only seeking representations and warranties on riskier projections or statements. See generally Lietzel, *supra* note 58, at 99–100 (discussing scenarios in which the buyer will negotiate for additional reliance expectation, but only when the benefits of contract completion outweigh the costs).

158. *Id.*

159. See Cole, *supra* note 116, at 451 (noting how constructive-knowledge standards “magnif[y]” the issues when an anti-sandbagging clause exists).

1. *The Delaware Courts are Likely to Follow the New York Approach*

In the recent Supreme Court of Delaware decision, the only Delaware case cited by the majority opinion is seemingly misplaced when referring to this type of breach-of-warranty claim, leaving a reader unclear as to which line of Delaware precedent will be followed.¹⁶⁰ In the Delaware case that was cited, the buyer was attempting to use the doctrine of equitable estoppel to prevent the seller from nullifying a breach-of-warranty claim through a detrimental reliance defense.¹⁶¹ The court never reached this argument, or the underlying issue of whether reliance was an element at all, and ruled on other grounds.¹⁶² Therefore, this case provides little probative value for how the court might rule.¹⁶³

Notwithstanding the lack of a citation to other Delaware law in *Eagle Force*, previous cases, particularly post-*Gloucester* cases, should not be discounted for their influence over how the court would rule.¹⁶⁴ The underlying ruling in the *Eagle Force* case was that a contract could be formed in spite of the fact that a term, which was the key consideration for one side, could never be fulfilled.¹⁶⁵ This strict construction of the risk allocation, in spite of the major term being objectively inaccurate, reinforces the prevailing view that Delaware courts are contractarian. And this contractarian view of risk allocation parallels much of the foundational reasoning for many of the post-*Gloucester* cases.¹⁶⁶ As a result, *Eagle Force* is indicative that some form of the approach to breach of warranty and representation taken in the post-*Gloucester* cases will be adopted. If adopted, this would effectively make the default rule pro-sandbagging. This is because a seller's arguments of waiver and detrimental reliance would likely have no effect on the express contractual nature of the representations and warranties, since breach of warranty or repre-

160. *See* Genencor Int'l, Inc. v. Novo Nordisk A/S, 766 A.2d 8, 12 n.8 (Del. 2000).

161. *Id.* at 11. The Supreme Court of Delaware read the lower court's ruling differently than both parties and found that the omission of a patent in the contract constituted a part of the bargained-for exchange. *Id.* Therefore, the reliance element did not need to be in dispute as a means to incorporate the missing patent as part of the transaction. *Id.* at 12.

162. *Id.*

163. By disposing of the breach-of-warranty issue on other grounds, it was unnecessary to discuss the buyer's assertion that breach-of-warranty claims have no reliance element. *Id.* However, the court, in an unnecessary footnote, cited the buyer position, which was supported by the *Ziff-Davis* case, but ultimately claimed that it "d[id] not need to address this argument." *Id.* at 12 n.8.

164. *See supra* Part II.

165. *Eagle Force Holdings, LLC v. Campbell*, 187 A.3d 1209, 1236–37 (Del. 2018).

166. *See* *Cobalt Operating, LLC v. James Crystal Enters., LLC*, No. Civ.A. 714–VCS, 2007 WL 2142926, at *28 (Del. Ch. 2007), *aff'd*, 945 A.2d 594 (Del. 2008) (reasoning that contractual representations "serve an important risk allocation function" and require no justified reliance); *Interim Healthcare, Inc. v. Spherion Corp.*, 884 A.2d 513, 548 (Del. Super. Ct. 2005) (holding that reasonable reliance is not required for a breach-of-warranty claim and the buyer can rely on the representations "irregardless of what their due diligence may have or should have revealed").

sentation under the post-*Gloucester* cases sheds the tort-like element of reliance.¹⁶⁷

Further bolstering this prediction of a pro-sandbagging default rule are the various cases, including *Eagle Force*, that Chancellor Strine has written in the past.¹⁶⁸ Beginning with his concurring opinion in *Eagle Force*, which was joined by Justice Vaughn, there was no citation to Delaware case law except for an obscure 100-year-old case.¹⁶⁹ Seemingly, this citation stands for the proposition that when a party signs a contract with a representation that it knows is false, they cannot later sue based on reliance on the representation.¹⁷⁰ This language seems to echo that which encompasses the New York rule; in other words, breach of representation may only be brought if the party relied on the representation as being a part of the contract.¹⁷¹

Chancellor Strine also wrote the influential *Cobalt* decision within the post-*Gloucester* line of cases, and in extensive dicta, his discussion of the risk-allocative features of representations and warranties was illustrative.¹⁷² Specifically, the opinion gave effect to the risk-allocative function of a representation as lessening a burden of verification of the representation and as a means to reduce costly due diligence.¹⁷³ Chancellor Strine has also demonstrated his stance towards sandbagging when applying New York law to a pre-signing sandbagging claim.¹⁷⁴ While the analysis used did not require a specific holding on this issue, a lengthy footnote discussed New York law in relation to the subsequent federal cases.¹⁷⁵ Ultimately, the probative value of this case was that public policy considerations may be different depending on the timeframe in which the signing and closing occur, and the language of the opinion seems to be hostile to recovery when the buyer suspects inaccuracy at the time of signing.¹⁷⁶ Taken together, the opinions of Chancellor Strine, and their deference to a contractarian view of breach of representation and warranty, signal that a pro-sandbagging default rule is likely the side his vote will fall on.

But this conclusion that *Eagle Force* will adopt a contractarian approach to representations and warranties still does not resolve how Delaware will fit within, or adopt, the New York case law. As mentioned

167. See *Gloucester Holding Corp. v. U.S. Tape & Sticky Prods., LLC*, 832 A.2d 116, 127 (stating that “reliance is not an element,” even though the opposing party claimed that the plaintiff had to prove that it was justified in relying on the evaluation material); see also cases cited *supra* note 166 and accompanying text.

168. See *Eagle Force*, 187 A.3d at 1247; *Cobalt*, 2007 WL 2142926, at *27; *In re IBP, Inc. S’holder Litig.*, 789 A.2d 14, 82 n.200 (Del. Ch. 2001) (applying New York law in the sandbagging situation where the buyer knows a provision is in breach prior to signing).

169. See *Eagle Force*, 187 A.3d at 1247 n.39 (citing *Clough v. Cook*, 87 A. 1017, 1018 (Del. Ch. 1913)).

170. *Id.*

171. See *supra* Part III (setting out the New York default position).

172. *Cobalt*, 2007 WL 2142926, at *27–28.

173. See *id.* at *28.

174. See *In re IBP, Inc. S’holder Litig.*, 789 A.2d 14, 82 n.200 (Del. Ch. 2001).

175. See *id.*

176. See *id.*

above,¹⁷⁷ there are several interpretations of New York law under the *Ziff-Davis* line of cases.¹⁷⁸ Furthermore, the majority's opinion in *Eagle Force* did not cite any of these cases or any other *Ziff-Davis* prodigy.¹⁷⁹ But what *Eagle Force* did cite was a definitive part of *Ziff-Davis* that couched "breach of express warranty as [an action] that is no longer grounded in tort, but essentially in contract."¹⁸⁰ The parenthetical also stated the general rule of *Ziff-Davis* that a party must have believed and relied that the representation or warranty was "part of the bargain."¹⁸¹ However, while citation to this part of *Ziff-Davis* is not dispositive for all sandbagging claims,¹⁸² it does indicate that the rule out of Delaware will likely mirror the *Ziff-Davis* rule, at least insofar as breach of warranty not having a traditional reliance element.¹⁸³

In summation, given the court's reaffirmation of a contractarian approach to contracts, citation to and reasoning relating to *Ziff-Davis*, and Chancellor Strine's position in this and similar cases, Delaware is likely to adopt a pro-sandbagging default rule that at least follows the *Ziff-Davis* case but may go so far as requiring no reliance element like in the post-*Gloucester* cases. Furthermore, Delaware has yet to indicate how it will adopt or reject the progeny of *Ziff-Davis*, but if Chancellor Strine's opinion in a previous New York case could be extrapolated, it seems as if it would not be fully adopted.¹⁸⁴ Finally, it is worth noting that, while a pro-sandbagging rule is the likely outcome if the issue was squarely before the court, some scholars have mentioned Delaware's slow adoption of new rules and changes that could delay a ruling for quite some time.¹⁸⁵ Nevertheless, given the broad consensus that Delaware was a pro-sandbagging state before *Eagle Force* and how the decision still fits within Delaware's much broader contractarian narrative, a future decision is likely to happen soon.

IV. RECOMMENDATIONS AND STRATEGIES

Given the current unsettled nature of Delaware law, both the buyer and seller in a transaction should not rely on silence for the issue of sandbagging in an acquisition agreement. The following subsections will recommend contractual language to use, depending on the side of the

177. See *supra* Part III.C.3.

178. See *supra* notes 91–92 and accompanying text.

179. See *Eagle Force Holdings LLC, v. Campbell*, 187 A.3d 1209, 1236 n.185 (Del. 2018).

180. *Id.* (quoting *CBS Inc. v. Ziff-Davis Publ'g Co.*, 553 N.E.2d 997, 1000–01 (N.Y. 1990)).

181. See *id.*

182. See *supra* note 91 and accompanying text (discussing the ambiguity of the *Ziff-Davis* case).

183. See *Eagle Force*, 187 A.3d at 1236 n.185 (discussing the majority view as adopting the New York line of cases).

184. See *In re IBP, Inc. S'holder Litig.*, 789 A.2d 14, 82 n.200 (Del. Ch. 2001).

185. See Hamermesh, *supra* note 128, at 1771 (recognizing the critique of Delaware corporate law as being slow to evolve, but positing that this is due to "guiding jurisprudential conceptions" of finding the right law).

transaction the party represents. The recommendations aim to help parties limit exposure to disputes given the current ambiguity in Delaware law and also provide appropriate language, regardless of where the Supreme Court of Delaware draws the line for the default rule.

A. PRO-BUYER PROVISIONS

To protect their interest, a buyer should include a pro-sandbagging provision in its contract, regardless of how the Delaware court is likely to come out on the issue.¹⁸⁶ In doing so, the buyer protects its interests and limits the ability of the seller to argue or successfully litigate their way out of obligations in the case of a post-closing dispute arising.¹⁸⁷ In addition, an anti-waiver clause is important because a seller could argue that, in lieu of renegotiating or creating a special indemnity, the buyer closed the transaction and effectively waived its breach-of-contract claim.¹⁸⁸ Such an anti-waiver provision within the pro-sandbagging provision might read:

The representations, warranties, and covenants of the [Indemnifying Party], and any right of [Indemnified Party] to indemnification secured under this Agreement with respect thereto, shall not be affected or deemed waived by reason of any knowledge, actual or constructive, on the part of [Indemnified Party], or their respective representatives, of the fact that any of [Indemnifying Party's] representations, warranties, or covenants are, were, or might be inaccurate, as the case may be.¹⁸⁹

Alternatively to closing, and regardless of the inclusion or omission of a sandbagging provision, a buyer would be well advised to renegotiate the indemnity for the allegedly inaccurate representations or warranties.¹⁹⁰ Otherwise, the buyer faces the proposition that it knows the extent that the indemnity cap will already have claims against it, and the transaction may not be as attractive, especially considering that the buyer's diligence has already uncovered one inaccuracy.¹⁹¹

186. See Cole, *supra* note 116, at 455–56 (discussing the waiver issue and proposing an anti-waiver provision under New York law to supplement the pro-sandbagging default position).

187. See generally West, *supra* note 8 (making recommendations for buyers and sellers for sandbagging and related provisions).

188. See West & Shah, *supra* note 23, at 4 (discussing the waiver defense that a seller might argue).

189. For another example, see *Purchase Agreement: Sandbagging and Anti-Sandbagging*, PRAC. L. CORP. & SEC., [https://www.westlaw.com/w-002-5153?view=hidealldraftingnotes&transitionType=Default&contextData=\(sc.Default\)&VR=3.0&RS=cb1.0](https://www.westlaw.com/w-002-5153?view=hidealldraftingnotes&transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cb1.0) [Permalink unavailable] (last visited Sept. 14, 2019) [hereinafter *Purchase Agreement*] (proposing an example of a pro-buyer sandbagging provision with guidance); see also Duran & Jamal, *supra* note 12, at 1–2 (proposing a model sandbagging provision for buyers regardless of the default rule selected by Delaware).

190. See West & Shah, *supra* note 23, at 7.

191. See *id.*

B. PRO-SELLER PROVISIONS

Sellers, even under the previously assumed pro-sandbagging default, have historically not included anti-sandbagging provisions in agreements.¹⁹² Instead, sellers have favored silence or adjusting the indemnity, especially in light of the current seller's market that has allowed caps at or below 10% of the transaction.¹⁹³ However, in the event that a seller wished to protect itself from the sandbagging buyer, such a provision could read:

[Seller] shall not be liable for any losses incurred under this Agreement based on or arising out of any inaccuracy in or breach of any of the representations, warranties, or covenants of [Seller/the Company] contained in this Agreement if Buyer had knowledge, actual or constructive, of such inaccuracy or breach prior to the Closing.¹⁹⁴

Furthermore, a key issue the seller must consider when negotiating this provision is the knowledge requirement.¹⁹⁵ A buyer, not wanting to be held liable under a constructive-knowledge theory, will likely push for not only the exclusion of any knowledge limiting provision but also a narrowly defined knowledge standard.¹⁹⁶ Hence, it is important for the seller to favor a broadly constructed knowledge standard in order for the clause to have the most preclusive effect on any claims that might arise post-closing.

V. CONCLUSION

While the current state of the law in Delaware is unsettled for how an agreement will be construed when silent, parties are still free to and should include their own sandbagging provisions.¹⁹⁷ In spite of this current ambiguity, a prediction of a new default rule is tenable and is likely to be some form of a pro-sandbagging rule. Furthermore, analysis of an optimal rule under the penalty default framework yields the same result as being efficient from a systematic standpoint. And both prediction and justification, when paired with Delaware's general contractarian approach to contracts, further reinforce the selection of a pro-sandbagging default. In any case, only time will tell how the court will rule or if this clause will become a nonissue with the rise in other recovery methods

192. See *What's Market Analytics*, *supra* note 140 (showing that the incidence rate is around 2% in Delaware); Whitehead, *supra* note 4, at 1086–87 (discussing the consistently low anti-sandbagging incidence rate over four years).

193. *Market Trends*, *supra* note 28. The current market trend is for an indemnity clause in roughly 96% of asset purchase agreements for deals totaling more than \$100 million. *Id.* Furthermore, roughly 87% of these indemnities included caps with an average cap of about 8% of the purchase price. *Id.*

194. For another example, see *Purchase Agreement*, *supra* note 189 (proposing an example of a pro-seller sandbagging provision with guidance).

195. See Cole, *supra* note 116, at 456 (recommending a buyer consider a knowledge standard to govern the transaction).

196. See Duran & Jamal, *supra* note 12, at 1–2.

197. See *supra* Part V (discussing strategies for both buyers and sellers when negotiating sandbagging provisions).

(such as RWI). In the meantime, both buyers and sellers should be wary of a situation where sandbagging can occur and should prepare accordingly.