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# Does Sandbagging Hurt? – The Importance and Enforceability of Sandbagging Provisions in Bank M&A Deals

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## What is sandbagging?

The term "sandbagging" carries many meanings. Bankers facing an upcoming acquisition, no matter whether they are acquiring or divesting, are likely to hear the term. The term, along with its antithesis "anti-sandbagging," describes one of the means by which the parties allocate post-closing risk.

Throughout the transaction lifecycle, parties engage in due diligence, a process allowing the buyer to look "under the hood" of the seller and determine what exactly they are purchasing. Due diligence is designed to protect the buyer from known risks or risks that could be known through investigation.

When it comes time to sign the transaction documents, the buyer and seller make representations to each other, allowing the parties to enter into the transaction with a full understanding of the transaction's value. By their nature, the seller's representations are more substantial. For example, the seller will represent to the buyer that it owns all of its property free and clear of liens and encumbrances, all promissory notes are genuine, all tangible property of the seller is in good repair and condition, there are no regulatory memoranda or orders, there are no unaddressed tax obligations, and all liabilities or deviations from the aforementioned statements have been disclosed to the buyer.

Sandbagging in the context of mergers and acquisitions determines the enforceability of a breach of a representation when the buyer has advance knowledge of the breach. A sandbagging clause provides post-closing recourse to a buyer if the seller breaches a representation even if the buyer had knowledge of the facts giving rise to the breach through other investigatory means, typically through the due diligence process. In essence, sandbagging places the burden of making an accurate representation on the party making the representation, no exceptions. Alternatively, an anti-sandbagging clause prohibits the buyer from seeking post-closing recourse regarding matters which the buyer knew about at or prior to closing. An anti-sandbagging clause shifts the burden to the party with knowledge. If the buyer discovers an issue with the seller any time prior to or at closing, it is the

responsibility of the buyer to resolve the issue, i.e., step away from the deal, renegotiate the purchase price to account for the liability, or accept the risk of liability and continue with the transaction as planned.

Anti-sandbagging clauses shift the focus from the misrepresentation of the seller to the knowledge of the buyer. However, it does not make sense for the buyer to sandbag the seller. A better time to raise the issue of a misrepresentation by a seller is before the closing when the matter can be dealt with by an adjustment to the purchase price or creation of an escrow. If the buyer waits until after the closing (that is, sandbags the seller), the buyer must go through the indemnification process outlined in the purchase agreement to find recourse. This subjects the buyer to caps on liability, deductible buckets, and time limits to make a claim. Plus, if the issue ends up being contested, the result is a lengthy litigation process with an uncertain outcome. It is far simpler to renegotiate the purchase price before closing.

## What does it mean to be a “pro-sandbagging state”?

What happens if the agreement has neither a sandbagging nor anti-sandbagging clause? When the buyer has knowledge of a breach of representation by the seller prior to or at closing, the ability of the buyer to seek indemnification for the breach varies by state. Delaware and New York law both generally permit sandbagging when a contract is silent on the point, whereas California law does not. Neither the Iowa Supreme Court nor the Court of Appeals has ruled on the issue of sandbagging, but both have given the inclination to look to the Delaware courts for guidance. Minnesota courts, like California, have been known to require reliance on the buyer’s part to recover post-closing. However, some scholars believe that if the issue were again in front of the Minnesota courts, they would likely join the pro-sandbagging states.

## What does this mean for your bank?

National studies of key deal points reveal that most acquisition agreements are silent on the topic of sandbagging. Those agreements that do address the issue are overwhelmingly pro-sandbagging. For the seller, this means it will be difficult to negotiate an anti-sandbagging clause. Leaving the purchase agreement silent on the issue in a state like Iowa will likely still allow the buyer to sandbag. In any event, buyers are almost always better off conducting a robust due diligence, and prior to closing, adjusting the purchase price or increasing the escrow amount to cover the cost of any liabilities discovered.