Connecticut Law Tribune
April 8, 2013
An ALM Publication

LAND USE & ENVIRONMENTAL LAW

Environmental 'Sandbagging' In Corporate Transactions

Sometimes property buyers stay silent rather than point out problems

By ANDREW N. DAVIS and JASON C. HILLMAN

Golfers dread hitting the links with a sandbagger. That's the fellow golfer who hides their real playing abilities to gain a competitive advantage. As in the golfing world, sandbaggers exist in the corporate mergers and acquisitions world, where "sandbagging" occurs when a buyer, who becomes aware pre-closing that a particular representation or warranty (or covenant) made by the seller in the transaction agreement is untrue, nevertheless proceeds to close the deal, and later seeks post-closing indemnification from the seller for a breach.

Though at first glance it may seem that M&A sandbaggers have intentions as sinister as their counterparts on the golf course, there may be valid reasons to sandbag in a transaction other than to gain an ethically questionable advantage. It may be that as of the closing it's unclear whether there's a breach, or that the breach appears insignificant or the potential losses are simply incalculable. It may be that the buyer discovered the potential breach through its own independent investigation and has been unable to verify prior to closing the breach through any materials provided by the seller.

Or perhaps, as we see often in the context of environmental due diligence, the seller, to satisfy its disclosure obligations associated with the environmental representations and warranties, rather than make specific, detailed disclosures, "data dumps" on the buyer historical environmental reports (often hundreds of pages long when factoring in the dense database report and other appendices attached thereto) at the eleventh hour before the closing, ostensibly giving the buyer "knowledge" of anything disclosed therein.

If the seller limits its representations and warranties with a wholesale reference to the data dump materials (e.g., "Except as set forth in the environmental reports provided to buyer…") and the buyer accepts that and closes, the buyer likely loses any related post-closing claims with respect to environmental issues raised in the reports, even if the issues are buried in the appendices. But if the seller does not insert such a relevant exception, the buyer may decide not to spend last-minute, pre-closing time analyzing the data dump materials in detail. Or, if the buyer does, the buyer may decide not to discuss with the seller any discovered evidence of a breach, regarding sandbagging as a practical alternative to more negotiation and a delayed closing.

Regardless of a buyer's reasoning, the assumption that a buyer can remain silent and successfully "close and sue" (especially in the environmental context following a "data dump" situation) is a dangerous one to make, particularly because the law on sandbagging is, much like our golf games, all over the place.

Andrew N. Davis

Jason C. Hillman

Determining A Breach

If the agreement is silent on the issue, whether a buyer can successfully sandbag depends on the governing law of the acquisition agreement. In a number of states, to prevail on a claim for seller's breach of a representation, a buyer must prove it relied on the truth of the seller representation. But the buyer certainly can't prove it relied on the truth of a representation if the buyer had pre-closing knowledge that the representation was in fact false. As is often the case in these jurisdictions, the inquiry turns into a time-consuming (and expensive) argument over what knowledge the buyer had pre-closing. Is the buyer charged with knowledge of every fact included in the hundreds of pages of environmental reports dumped on it two days before closing? If so, no sandbagging allowed.

Other states approach sandbagging differently. For example, the Court of Appeals of Indiana has ruled the buyer of an industrial waste disposal site had a claim for breach of a warranty related to environmental liabilities associated with the site even though the buyer knew pre-closing of the breach. Rather than looking at whether in fact the buyer relied on the warranty, the court adopted the position that the right to damages on such a breach depends on nothing more than whether the seller breached its warranty, regardless of the buyer's knowledge. Thus, in these states, what the buyer did or did not know is irrelevant, and thus any inquiry into the buyer's knowledge need not be made.

Delaware, too, likely follows this approach, though it isn't perfectly clear. The Delaware Supreme Court recently affirmed without comment a lower court's decision holding justifiable reliance on a representation is not necessary to succeed on a breach claim. But neither court mentioned the long line of Delaware cases holding the opposite — that in order for a seller to be responsible for a breach of warranty claim, the buyer must have relied upon the warranty.

Yet other states, like New York, take a hybrid approach: the buyer must show it believed it was purchasing the promise as to the truth of the warranty, and not that it believed in the truth of the warranty, to prevail on a breach of warranty claim.

Sandbagging Provisions

With the law as varied as it is, some parties refuse to remain silent on the issue and choose to preemptively address sandbagging in the acquisition agreement. A buyer may try to include in the agreement a "pro-sandbagging" provision stating that the buyer's pre-closing knowledge of the seller's breach of a representation does not impact any of the buyer's post-closing remedies against the seller for that breach.

From a buyer's perspective, of course this makes sense. Not only does such a provision eliminate altogether the time-consuming post-closing inquiry into what the buyer actually did or did not know pre-closing, but it also prevents sellers from getting away with the data dump method of imparting knowledge and avoiding claims (assuming there is no relevant exception to the representations and warranties).

With the law as varied as it is, some parties refuse to remain silent on the issue and choose to preemptively address sandbagging in the acquisition agreement.

Moreover, a pro-sandbagging provision ensures that a buyer reaps the benefits of bargained-for representations. (While such a provision may benefit a buyer, we note that a buyer has other options for boxing-in environmental risks. For example, we often design and utilize bespoke environmental insurance policies tailored to the specific environmental realities of the deal to supplement and/or backstop any seller indemnity.)

On the other hand, a seller may try to include an "anti-sandbagging" provision in the agreement. An anti-sandbagging provision prevents a buyer from bringing a post-closing claim for breach of a representation if the buyer had knowledge of the breach prior to the closing. Coupled with a provision stating the buyer has knowledge of any and all facts in the disclosed documents (typically expressed as an exception to the seller's representations and warranties) — say, lengthy environmental reports — provided to the buyer pre-closing, an anti-sandbagging clause can be quite disadvantageous to a buyer.

A seller will argue that it is unreasonable for a buyer not to accept an anti-sandbagging clause. Such a clause prevents the buyer, after looking through the seller's "file cabinets" (whether in a real or virtual dataroom) as part of its due diligence, from withholding information from the seller and then suing immediately after closing. That strategy is completely unfair, says a seller. The better approach is to include an anti-sandbagging clause that encourages the buyer to raise any issues with the seller prior to the closing to allow the two sides to discuss the problem and agree on a solution that allocates the risk or liability.

From a buyer's perspective, an anti-sandbagging clause is troublesome because it means that if a buyer makes a post-closing indemnification claim, including one that without the anti-sandbagging clause would have been uncontested, the buyer will be unable to prevail on a motion for summary judgment since the seller always will raise the factual question of whether the buyer had prior knowledge of the breach. If an anti-sandbagging provision is included in the agreement, the buyer should limit it to actual knowledge of certain specifically identified officers of the buyer and avoid the constructive knowledge — "knew or should have known" — definition of the buyer's knowledge. In the environmental context, limiting the anti-sandbagging clause to actual knowledge (and requiring the seller to make specific, detailed disclosures of exceptions to its environmental representations and warranties) is critical for a buyer to avoid being charged with knowledge of a potential environmental issue that is only alluded to and buried on one page of a massive, last-minute data dump.

As the 2011 ABA Private Target Deal Points Study reports, nearly half of all transactions analyzed included one sandbagging provision or the other. Depending on which side of the table you are sitting on, the due diligence strategy of the other side, and which law governs your acquisition agreement, proactively addressing sandbagging in the agreement (including in the context of environmental risks and liabilities) is critical. ■

Andrew N. Davis is a partner in the Real Estate, Environmental and Land Use practice at Shipman & Goodwin LLP in Hartford and Jason C. Hillman is an associate in the firm's Business and Finance practice. They have been involved in several corporate and real estate deals nationally involving contaminated property, utilizing creative contracting, environmental insurance and other risk transfer strategies to manage environmental risks and close transactions. Davis can be reached at adavis@goodwin.com; Hillman can be reached at jhillman@goodwin.com.