

Merger and Purchase Agreements Governed by Maryland Law: “Sandbagging”

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In the acquisition context, “sandbagging” refers to circumstances where one party, typically the buyer, enters into a purchase agreement knowing representations and warranties made by another party, typically the seller, are false. Alternatively, the buyer may enter into the agreement in good faith, but then discover the falsity prior to closing. In either case, a purchase agreement may (1) permit indemnification claims in such circumstances (a “pro-sandbagging” provision); (2) disclaim indemnification claims in such circumstances (an “anti-sandbagging” provision); or (3) remain silent on the subject. When an agreement is silent, the governing law will determine whether a party may “sandbag” an opponent and then later assert an indemnification claim based upon the breach, or not.

Background

Historically, to bring a claim for a breach of a representation or warranty a party must have relied on the false statement. Breach of warranty was largely treated as a tort, so prior knowledge of the breach would preclude reasonable reliance on the representation and, therefore, bar a claim for breach. Even as claims concerning the breach of a representation or warranty came to be reviewed under contract principles, courts continued follow this historical analysis and consider whether the representation actually induced action. Thus, many jurisdictions, including most prominently California, continue to require that a claimant rely on a representation to bring a valid indemnification claim for a breach of the same (at least in the absence of a pro-sandbagging provision). See *Kazerouni v. De Satnick*, 279 Cal. Rptr. 74, 75-76 (Cal. App. 1991); but see *Telephia, Inc. v. Cuppy*, 411 F. Supp. 2d 1178 (N.D. Cal. 2009) (enforcing pro-sandbagging and denying motion for summary judgment). In these jurisdictions, silence as to sandbagging means that a buyer’s pre-closing knowledge of a breach of a representation or warranty will bar the claim.

The modern approach, grounded in freedom of contract principles, permits sandbagging even in the absence of an express pro-sandbagging provision. Courts applying this modern approach treat the claim for a breach of a representation in the purchase agreement like any other breach of contract claim. Accordingly, “[t]he key question is not ‘whether the buyer believed in the truth of the warranted information . . . but whether it believed it was purchasing the seller’s promise as to its truth.’” *Power Soak Sys. v. EMCO Holdings, Inc.*, 482 F. Supp. 2d 1125, 1134 (W.D. Mo. 2007)(quoting *CBS Inc. v. Ziff-Davis Publishing Co.*, 75 N.Y.2d 496, 503, 553 N.E.2d 997, 554 N.Y.S.2d 449 (N.Y. 1990)). Advocates for this modern position generally offer two supporting reasons for rejecting the need to show reliance. First, representations and warranties in a purchase agreement allocate risk between the parties as to certain topics. Where a representation or warranty may be in doubt, or where damage resulting from a known breach of the same may be speculative, buyers and sellers should be able to allocate that the associate risk through representations in their agreement. Second, an anti-sandbagging rule, where knowledge precludes a breach of contract claim, increases the cost of the due diligence process. Stated otherwise, if a buyer is on notice that a representation in a purchase agreement may be false, and sandbagging is not permitted, the prudent buyer must incur the additional expense to ascertain the liability associated with the issue. Pro-sandbagging jurisdictions conclude the default rule should be otherwise.

Delaware courts follow the modern approach; if a purchase agreement is silent with respect to sandbagging, a buyer is entitled to indemnification for breach of the seller’s representations and warranties even if the buyer knew of the seller’s breach prior to closing. See *Interim Healthcare, Inc. v. Spherion*

Corp., 884 A.2d 513, 548 (Del. Super Ct. 2005) *aff’d* 886 A.2d 1278 (Del. 2005). New York courts also follow the modern approach (*CBS Inc.*, 553 N.E.2d 997) but subject to a somewhat nuanced exception: if a buyer learns of the breach from the seller or its disclosure, and nevertheless closes the transaction, the buyer is foreclosed from later asserting an indemnification claim based on the breach unless the buyer expressly preserves such right. See *Galli v. Metz*, 973 F.2d 145 (2d Cir. 1992).

Sandbagging in Maryland

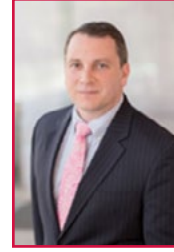
Although the Court of Appeals of Maryland holds Delaware corporate law decisions in high regard, the Court of Appeals has not had an occasion to address sandbagging in the context of an indemnification claim attendant to a merger or purchase agreement since *Interim Healthcare*. Most recently, the United States District Court for the District of Maryland considered a defendant’s motion for summary judgment in relation to an indemnification claim brought by a buyer against a seller for the breach of certain warranties under an asset purchase agreement. *Spincycle, Inc. v. Kalender*, 186 F. Supp. 2d 585 (D. Md. 2002). The seller asserted, in part, that the claim was barred because the buyer did not actually rely on the representation in closing the transaction. Although the Court ultimately denied the motion for summary judgment, the Court did not hold that the buyer’s pre-closing knowledge and pre-closing diligence were immaterial or irrelevant. Instead, citing *Fischbach & Moore Int’l Corp. v. Crane Barge R-14*, 632 F.2d 1123, 1125 (4th Cir. 1980) as to the elements of the claim, the Court held that there was evidence of reliance by the buyer on the relevant representation. Accordingly, unless and until the Court of Appeals adopts the modern position, existing case law suggests that Maryland remains

continued on page 2

continued from page 1

an anti-sandbagging jurisdiction more in line with California than Delaware. Accordingly, “going silent” in a purchase agreement governed by Maryland law likely requires that a buyer prove justifiable reliance to bring an indemnification claim based on the breach of a representation or warranty. Buyers and sellers should plan and negotiate accordingly.

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