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March 21, 2022

DELAWARE COURT OF CHANCERY ADDRESSES THE CONTOURS OF SANDBAGGING

To Our Clients and Friends:

"Sandbagging" in the acquisition context refers to a situation where a buyer closes an acquisition on the basis of representations in the purchase agreement it knows to be false, then proceeds to sue the seller post-closing based on a breach of those same representations. Although Delaware was historically regarded as a pro-sandbagging jurisdiction, the Delaware Supreme Court's stance on sandbagging came into question following dicta contained in a 2018 decision, *Eagle Force Holdings, LLC v. Campbell*. In *Eagle Force*, a footnote by Justice Valihura stated that the Supreme Court had not resolved the "interesting question" of "whether a party can recover on a breach of warranty claim where the parties know that, at signing, certain of them were not true," while then-Chief Justice Strine in his partial dissent expressed "doubt" that a plaintiff can "turn around and sue because what he knew to be false remained so." But we now have a (mostly) clear statement on the subject from the Chancery Court. In *Arwood v. AW Site Services, LLC*, Vice Chancellor Slights upheld a buyer's claim for breach of representations, notwithstanding the sellers' sandbagging objections based on the buyer's extensive due diligence.

The *Arwood* decision arose out of a post-closing dispute over an alleged fraudulent billing scheme that caused a substantial overstatement of revenue. After the closing, the sellers sued the buyer to release funds held in escrow. The buyer countered with claims for fraud and breach of representations regarding the financial condition and lawful operations of the target business, in each case related to the alleged fraudulent billing scheme. The Chancery Court dismissed most claims of both parties, but it upheld the buyer's claim for breach of contract based on inaccurate representations.

Notably, the Court rejected the sellers' sandbagging defense to the buyer's breach of contract claim. The sellers had asserted that, given the buyer's intimate knowledge of the sellers' business and unrestricted access to information in diligence, the buyer either knew the sellers' representations to be untrue, or acted with reckless disregard for the truth. As a result, the sellers contended, the buyer should be precluded from recovering based on breach of representations it knew or should have known to be false. The Court disagreed: "In my view, Delaware is, or should be, a pro-sandbagging jurisdiction. The sandbagging defense is inconsistent with our profoundly contractarian predisposition."

The Court also distinguished between the standard required to prevail in a breach of contract claim as compared to a fraud claim. The Court noted that, to prove fraud, the plaintiff must prove that its action was taken in justifiable reliance on the subject representation, and whether reliance is justified is measured in context, based on the plaintiff's knowledge and experience as well as the relationship of the parties. The Court concluded that recklessness on the part of the buyer in relying on representations it might easily have determined to be untrue can defeat a claim against the seller for fraud (because reliance

was not "justified"), just as recklessness on the part of the seller in making inaccurate representations can result in fraud liability. In the instant case, the Court found that the buyer's complete access to information regarding the target business (where "the source of the fraud stared them in the face"), the buyer's knowledge that the sellers did not have reliable financial systems and lacked sophistication, and the buyer's financial savvy, rendered any reliance on the false representations unjustified.

However, the Court noted that reliance, justified or not, does not come into play in breach of contract cases premised on inaccurate representations. All that mattered was that the seller made the representations as embodied within the contractual language. "The reasonableness, or not, of [Buyer]'s reliance upon the sellers' representations is not a relevant consideration in assessing the bona fides of [Buyer's] indemnification claim." The sellers represented a fact to be true in the acquisition agreement and as such, the buyer was entitled to the benefit of the representation, regardless of any diligence conducted or what the buyer "should have known" as a result thereof.

Notwithstanding *Arwood*, the final word regarding Delaware's position on sandbagging remains to be spoken: the opinion notes that, as expressed in *Eagle Force*, the Delaware Supreme Court has not yet conclusively resolved the issue. In any event, under *Arwood,* to the extent the viability of sandbagging remains open in Delaware, it does so solely in the case of a buyer's actual knowledge. For Vice Chancellor Slights, whether a buyer had constructive knowledge of the truth is not relevant to the sandbagging inquiry, a position the Vice Chancellor believes is shared by the Delaware Supreme Court. Or, as per an *Arwood* footnote, "I note that the term's origin is consistent with this conclusion. Sandbagging robbers knew their sock weapons were filled with sand; they did not swing socks at unsuspecting victims with reckless disregard for their weapons' efficacy."

Where does *Arwood* leave parties as to inclusion of sandbagging language in the acquisition agreement, and the effect of a buyer's knowledge of falsity when the agreement is silent? The Chancery Court indicated that in the absence of specific contractual language addressing the issue, the parties will have implicitly opted for Delaware's default rule that permits sandbagging. However, if the parties wish to provide for a different result, they remain free to include express anti-sandbagging clauses, which per the Court constitute "effective risk management tools that every transactional planner now has in her toolbox."

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Mergers and Acquisitions or Private Equity practice groups, or the authors:

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