M&A After *Eagle Force*: An Economic Analysis of Sandbagging Default Rules

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In the Mergers & Acquisitions (M&A) context, a buyer "sandbags" a seller when the buyer, despite knowing pre-closing that the seller materially breached a representation or warranty, closes the deal anyway and subsequently seeks indemnification from the seller for the damages arising out of the breach. Traditionally, most courts are "anti-sandbagging" courts that require buyers to rely on the warranty without knowledge of the breach to prevail. The modern trend, however, generally considers buyers' knowledge of the breach to be immaterial. While parties can and do contract around the rule, empirical studies show parties are often silent—allowing a state's default rule to fill the interstice. Accordingly, state default rules are often outcome-determinative of sandbagging claims.

Dealmakers have long considered Delaware a "pro-sandbagging" state following the modern trend. A recent decision by the Delaware Supreme Court, however, calls into question the strength of that assumption. In Eagle Force Holdings, LLC. v. Campbell*, both the majority and dissent characterized Delaware's sandbagging default rule as an open question. This has generated substantial concern from dealmakers, who are now unsure whether to advise their clients to expend the significant resources necessary to contract around Delaware's sandbagging default rule. Given the size, volume, and velocity of Delaware deal flow, as well as the influence of its corporate law, clarifying Delaware's sandbagging default rule is a pressing matter that courts should quickly resolve.*

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In light of the confusion engendered by the decision, this Note engages in an economic analysis of the impact of anti-sandbagging vis-à-vis pro-sandbagging default rules to help courts appreciate the economic tradeoffs between the two. Contrary to past work on the subject, this Note concludes that a clear pro-sandbagging default rule is more efficient than its anti-sandbagging counterpart. This finding not only sheds light on how efficiency-minded courts and legislatures should approach the enactment of a sandbagging default rule, but also contributes to the growing law and economics literature on default rules by offering a novel approach to comparing the merits of two competing standards.

INTRODUCTION

In the 19th century, ruffians roamed the streets armed with cotton socks. These ostensibly harmless socks were filled with sand and used as weapons to rob innocent, unsuspecting victims. Sandbaggers, as they came to be known, were reviled for their deceitful treachery: representing themselves as harmless, until they have you where they want you. Then, revealing their true intentions, they spring their trap on the unwitting.

Fast forward to 2019, and "sandbagging" has made its way into the Mergers and Acquisitions (M&A) legal lexicon. In the M&A context, a buyer "sandbags" a seller when the buyer, despite actually or ostensibly knowing pre-closing that the seller has materially breached a representation or warranty (R&W), closes the deal and then seeks indemnification from the seller for the breach.[1]

Sellers and buyers are divided on whether states should allow sandbagging. Sellers object to the practice, arguing buyers act unethically when they do not

1. *See* 1 ABA MERGERS & ACQUISITIONS COMM., MODEL STOCK PURCHASE AGREEMENT WITH COMMENTARY 288–89 (2d ed. 2010).

alert the seller about a provisional defect and instead close the transaction and seek indemnification.[2] From the buyer's perspective, however, "sandbagging" can be a misnomer. While buyers may be *theoretically able* to detect a breach, they may not be *practically able* to detect it. This could be due to actions of the seller, who dumps "newly discovered" information on the buyer at a later date. Buyers argue that if sandbagging is not allowed, the buyer may be left without recourse in the event of an R&W breach.

The controversy extends to the default rule that controls an acquisition contract in the absence of express sandbagging provisions. There are essentially two camps. "Anti-sandbagging" states do not allow a buyer to sue a seller for breach of warranty if the buyer knew (or should have known) of the breach prior to closing without an express contractual provision to the contrary.[3] "Pro-sandbagging" jurisdictions take the opposite position, allowing buyers to litigate breach of warranty regardless of whether they knew of the breach pre-closing, absent an express provision to the contrary.[4]

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2. *See* JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 423 (1975).

3. Anti-sandbagging jurisdictions include California (*see* Grinnell v. Charles Pfizer & Co., 79 Cal. Rptr. 369 (Cal. Ct. App. 1969)), Colorado (*see* Assocs. of San Lazaro v. San Lazaro Park Props., 864 P.2d 111, 115 (Colo. 1993)), Kansas (*see* Land v. Roper Corp., 531 F.2d 445, 449 (10th Cir. 1976)), Maryland (*see* SpinCycle, Inc. v. Kalender, 186 F. Supp. 2d 585, 588–89 (D. Md. 2002)); *see also* Fischbach & Moore Int'l v. Crane Barge R-14, 632 F.2d 1123, 1125 (4th Cir. 1980)), Minnesota (*see* Hendricks v. Callahan, 972 F.2d 190, 194 (8th Cir. 1992); *see also* Alley Constr. Co. v. State, 219 N.W.2d 922, 924 (Minn. 1974)), and Texas (*see* Gale v. Carnrite, No. H-05-4092, 2007 WL 654620, at *3 (S.D. Tex. Feb. 27, 2007); *see also* Gen. Motors Corp. v. Garza, 179 S.W.3d 76, 82 (Tex. App. 2005)). *See generally* Charles K. Whitehead*, Sandbagging: Default Rules and Acquisition Agreements,* 36 DEL. J. CORP. L. 1081, 1108–15 (2011) (providing a comprehensive overview of states' sandbagging rules).

4. Pro-sandbagging jurisdictions include Connecticut (*see* Pegasus Mgmt. Co. v. Lyssa, Inc., 995 F. Supp. 29, 39 (D. Mass. 1998) (predicting the Connecticut Supreme Court would disregard reliance in a breach-of-warranty claim)), Florida (*see* S. Broad. Grp. v. Gem Broad., Inc., 145 F. Supp. 2d 1316, 1321–24 (M.D. Fla. 2001)), Illinois (*see* Pension Benefit Guar. Corp. v. Ziffer, No. 91-C-7762, 1994 U.S. Dist. LEXIS 87, at *15–*23 (N.D. Ill. Jan. 4, 1994)), Indiana (*see* Essex Grp. v. Nill, 594 N.E.2d 503, 506–07 (Ind. Ct. App. 1992)), Massachusetts (*see* Richards v. Saveway Oil Co., 314 N.E.2d 923, 925 (Mass. App. Ct. 1974)), Michigan (*see* Grupo Condurnex, S.A. v. SPX Corp., No. 3:99CV7316, 2008 WL 4372678, at *4 (N.D. Ohio Sept. 19, 2008) (applying Michigan law)), Missouri (*see* Power Soak Sys. v. EMCO Holdings, 482 F. Supp. 2d 1125, 1134 (W.D. Mo. 2007)), Montana (*see* Glacier Gen. Assurance Co. v. Cas. Indem. Exch., 435 F. Supp. 855, 860 (D. Mont. 1977)), New Hampshire (*see* Leaf Funding, Inc. v. Cool Express Wis., Inc., No. 07-cv-0589-bbc, 2009 WL 330157, at *7 (W.D. Wis. Feb. 9, 2009) (applying New Hampshire law)), New Mexico (*see* C.R. Anthony Co. v. Loretto Mall Partners, 817 P.2d 238, 246 (N.M. 1991)), Pennsylvania (*see* Giuffrida v. Am. Family Brands, Inc., Nos. CIV.A. 96-7062, CIV.A. 96-7256, 1998 WL 196402, at *4 (E.D. Pa. Apr. 23, 1998)), West Virginia (*see* Allegheny & W. Energy Corp. v. Columbia Gas Sys., Civ. A. No. 2:85-0652, 1986 WL 13360, at *6–*8 (S.D. W. Va. June 30, 1986)), and Wisconsin (*see* Pentair, Inc. v. Wis. Energy Corp., 662 F. Supp. 2d 1134, 1139, 1142 (D. Minn. 2009) (applying Wisconsin law)). *See generally* Whitehead*, supra* note 3 (providing a comprehensive overview of states' sandbagging rules). Note also that the nomenclature "pro-sandbagging" is suboptimal given the term's negative connotations. It could alternatively be termed a "pro-seller responsibility" rule. Nevertheless, this Note uses the descriptor "pro-sandbagging" to stay consistent with past literature.

The debate over sandbagging has recently come to the fore as Delaware's Supreme Court has cast ambiguity on how Delaware treats sandbagging.[5] The new caselaw surprised dealmakers under the popular impression that Delaware was staunchly pro-sandbagging.[6] The size, volume, and velocity of M&A deals in Delaware, as well as Delaware corporate law's influence over the rest of the states, make its default rule consequential.

This Note tackles this timely issue by engaging in a comparative economic analysis of the two possible default rules. Unlike the debate on the ethics of sandbagging, the economic consequence of a default rule is an empirical question with a right and wrong answer. This Note argues that the only other scholarly article on the issue got it wrong. In that article, Professor Charles Whitehead concluded that an anti-sandbagging default rule is economically optimal.[7] This conclusion was grounded in an economic argument for "penalty defaults"—rules "designed to give at least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer."[8] However, that theory's necessary preconditions are absent in the sandbagging context, making its application inapt.

This Note's first-principles economic analysis of each default rule shows a pro-sandbagging default rule is more efficient than its anti-sandbagging counterpart, which has important implications for efficiency-minded legislators, courts, and dealmakers. Original analysis reveals that buyers undertake the significant cost of negotiating a pro-sandbagging provision.[9] A pro-sandbagging rule would reduce or eliminate these ex ante contracting costs, while also lowering ex post costs on the judicial system by reducing sandbagging litigation. This finding implicates the current debate in Delaware, the broader propriety of sandbagging default rules in all jurisdictions, and dealmakers' choice of law governing their transactions.

This Note proceeds as follows. Part I provides background on sandbagging and the state of Delaware law. Part II exposes the flaws of past scholarly work positing that an anti-sandbagging penalty default rule is economically most

5. *See infra* Part I (documenting how Delaware's default rule regarding sandbagging has changed over time).

6. *See* 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/SD7Y-6M5F].

7. *See* Whitehead, *supra* note 3, at 1108.

8. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989).

9. For example, the rise of R&W insurance in the past few years shows parties are willing to spend significant sums to hedge sandbagging risk. *See* James J. Moriarty & Major McCargo, *Deal Points Study: Representations and Warranties Insurance Continues its Significant Influence on M&A Deal Terms*, 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/U4KD-N489] (documenting the increased use of representation and warranty insurance, especially among financial buyers as opposed to strategic buyers).

efficient, arguing that it is an unreliable guide for efficiency-minded judges and legislators. Part III then engages in economic analysis of the optimal default rule, concluding that a pro-sandbagging default rule is economically most efficient. Part IV discusses the implications of this analysis, and Part V concludes.

I.
BACKGROUND

Until recently, dealmakers and scholars have characterized Delaware as a pro-sandbagging state.[10] This Part traces Delaware's sandbagging jurisprudence and ultimately problematizes that claim. It first offers a brief primer on sandbagging law to ground discussion. It then reviews relevant caselaw to explain why Delaware's Supreme Court recently characterized Delaware's sandbagging default rule as an open question. While there is ostensible support for the view that Delaware is pro-sandbagging, closer analysis shows Delaware law is ambiguous on the point.

A. Sandbagging and Default Rules: A Primer

Parties can expressly agree whether a buyer should be able to sue a seller post-closing for an R&W breach if they knew of the breach pre-closing. A pro-sandbagging provision typically allows the buyer to seek indemnification from the seller for any losses suffered by the buyer due to a breach by the seller of a representation, warranty, or covenant—even if the buyer had knowledge of the breach prior to closing. This is in the best interest of buyers. In contrast, an anti-sandbagging provision explicitly prohibits a buyer from commencing a post-closing claim for indemnification where the buyer had knowledge of a breach by the seller prior to closing, yet proceeded to close the transaction without addressing the issue. This is in the best interest of sellers.

When the contract is silent, jurisdictions are split on whether sandbagging should be allowed.[11] Some jurisdictions adopt the so-called traditional default rule: prohibiting the buyer from suing the seller post-closing for false R&Ws if the buyer knew of the breach pre-closing.[12] This is an outgrowth of the breach of warranty action's roots in tort.[13] The premise is that R&Ws are not legally

10. *See* Whitehead, *supra* note 3, at 1087 (suggesting that Delaware is pro-sandbagging); *see also* Wolf, *supra* note 6 (suggesting that dealmakers characterized Delaware as pro-sandbagging until recently).

11. *See generally* Frank J. Wozniak, Annotation, *Purchaser's Disbelief in, or Nonreliance Upon, Express Warranties Made by Seller in Contract for Sale of Business as Precluding Action for Breach of Express Warranties*, 7 A.L.R.5th 841 (1992) (surveying sandbagging law in various jurisdictions).

12. *See* cases cited *supra* note 3.

13. *See* WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS 634–35 (4th ed. 1971).

binding, so buyers cannot sue for false R&Ws.[14] But courts allow buyers to make a tort claim for misrepresentation to provide some relief for deception.[15] One element of that claim is reliance, which depends on the buyer's knowledge. The buyer's prior knowledge of false R&Ws bars their sandbagging claim under the rationale that a buyer cannot be held to rely on a seller's misstatement if the buyer knew the statement was false pre-closing.[16]

However, as breach of warranty metamorphosed from a matter of tort law into a matter of contract law, some jurisdictions departed from the traditional tort-based rule.[17] R&Ws became binding contractual obligations.[18] In effect, the buyer purchased the seller's promise that the company would meet its R&Ws; the seller cannot avoid that promise because the buyer knew it was inaccurate.[19] Thus, the modern trend allows a buyer to bring suit against a seller for breach of warranty irrespective of the buyer's knowledge at the time of closing.

B. Delaware's Sandbagging Jurisprudence.

Until recently, scholars and practitioners were under the popular impression that Delaware was a pro-sandbagging state. Scholars have authored law review articles under that assumption.[20] Kirkland & Ellis M&A partner Daniel Wolf agreed, stating in 2018 that "[t]he popular belief among dealmakers has been that Delaware is generally 'pro-sandbagging' . . . ."[21]

This notion had basis in the state's case law. In *Cobalt Operating, LLC v. James Crystal Enters., LLC*, then-Vice Chancellor Leo Strine held that a buyer did not need to prove justifiable reliance to bring a breach of contract claim arising out of an acquisition agreement.[22] Because reliance is the element upon which sandbagging cases typically turn, this decision signaled Delaware was pro-sandbagging. Vice Chancellor J. Travis Laster later endorsed this view in a

14. *See* 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 L. 3, 4–5 (2007).

15. *See* Sara Garcia Duran & Sacha Jamal, *Possible Shift in Delaware Law: Buyer's Silence on Sandbagging is not Golden*, BUS. L. TODAY (Sept. 28, 2018), https://businesslawtoday.org/2018/09/possible-shift-delaware-law-buyers-silence-sandbagging-not-golden/#_ftnref8 [https://perma.cc/B9QN-3B7K].

16. *See* 37 AM. JUR. 2D *Fraud and Deceit* § 231 (2013).

17. *See, e.g.*, Power Soak Sys. v. Emco Holdings, 482 F. Supp. 2d 1125, 1134 (W.D. Mo. 2007).

18. *See, e.g.*, CBS v. Ziff-Davis Publ'g Co., 553 N.E.2d 997, 1000–01 (N.Y. 1990) ("The critical 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].'" (quoting Ainger v. Mich. Gen. Corp, 476 F. Supp 1209, 1225 (S.D.N.Y. 1979)).

19. *See CBS*, 553 N.E.2d at 1001 ("[T]he fact that the buyer has questioned the seller's ability to perform as promised should not relieve the seller of his obligations under the express warranties when he thereafter undertakes to render the promised performance.").

20. *See, e.g.*, Whitehead, *supra* note 3.

21. Wolf, *supra* note 6.

22. No. Civ.A. 714–VCS, 2007 WL 2142926, at *28 (Del. Ch. July 20, 2007), *aff'd without op.*, 945 A.2d 594 (Del. 2008).

2015 ruling, stating definitively that "Delaware is what is affectionately known as a 'sandbagging' state."[23]

But now-Chief Justice Strine and his compatriots on the Delaware Supreme Court have cast doubt on the state's presumed pro-sandbagging default position. In *Eagle Force Holdings, LLC v. Campbell*, the majority (written by Justice Karen Valihura) and partial dissent (written by Chief Justice Strine) stated in dicta that Delaware's sandbagging default rule was unsettled.[24] In a footnote, Justice Valihura's majority opinion noted that Delaware has "not yet resolved th[e] interesting question" of "whether a party can recover on a breach of warranty claim where the parties know that, at signing, certain [warranties] were not true."[25] In his dissent, Chief Justice Strine agreed. Ostensibly overlooking his own precedent,[26] he cited a more-than-century-old case to support his proposition that "[v]enerable Delaware law casts doubt on [plaintiff buyer's] ability" to seek damages because defendant made promises known by plaintiff to be false.[27]

In fact, there is truth in the Delaware Supreme Court's contention: Delaware's sandbagging default rule is ambiguous. In the 1910s, the Delaware Superior Court held buyers must show reliance to succeed in a breach-of-warranty claim, announcing the traditional rule.[28] This stance was reaffirmed in 2002.[29] Then, in 2005, the Superior Court reversed course, holding buyers need not show reliance to establish a claim for breach.[30] The Chancery Court subsequently decided in favor of sandbagging in *Cobalt*.[31] The problem is *Cobalt* can be easily distinguished from other cases because (1) the contract at issue contained a clause that representations would not be affected by due diligence, and (2) the court determined the defendant had intentionally hidden its fraud and gave plaintiff misleading explanations upon inquiries about inconsistencies

23. *See* NASDI Holdings v. N. Am. Leasing, No. 10540-VCL, slip. op. at 57 (Del. Ch. Oct. 23, 2015).

24. 187 A.3d 1209 (Del. 2018).

25. *Id.* at 1236 n.185.

26. *See, e.g.*, *Cobalt*, 2007 WL 2142926, at *28 ("[Defendant]'s breach of contract claim is not dependent on a showing of justifiable reliance. That is for a good reason . . . . [R]epresentations like the ones made in the Asset Purchase Agreement serve an important risk allocation function.").

27. *Eagle Force*, 187 A.3d at 1247 (Strine C.J. & Vaughn, J., concurring in part and dissenting in part) (citing Clough v. Cook, 87 A. 1017, 1018 (Del. Ch. 1913)).

28. *See Clough*, 87 A. at 1018; *see also* Loper v. Lingo, 97 A. 585, 586 (Del. Super. Ct. 1916).

29. *See* Kelly v. McKesson HBOC, Inc., No. Civ.A. 99C–09–265WCC, 2002 WL 88939, at *8 (Del. Super. Ct. Jan. 17, 2002) ("According to sound Delaware law, a plaintiff must establish reliance as a prerequisite for a breach of warranty claim.").

30. *See* Interim Healthcare, Inc. v. Spherion Corp., 884 A.2d 513, 548 (Del. Super. Ct. 2005). ("[T]he extent or quality of plaintiffs' due diligence is not relevant to the determination of whether [defendant] breached its representations and warranties in the Agreement . . . . [P]laintiffs were entitled to rely upon the accuracy of the representation irregardless [sic] of what their due diligence may have or should have revealed.").

31. *See Cobalt*, 2007 WL 2142926, at *28.

discovered in the diligence process.[32] These differences raise questions as to *Cobalt's* precedential value.

Thus, Delaware law is in a state of flux—unsettling expectations and increasing transaction costs. Because parties do not know which rule applies, they cannot fashion their deals with a proper understanding of their rights and duties should negotiations go sideways. Entire legal doctrines have been developed to prevent this state of affairs.[33] Moreover, ambiguous default rules may force parties to expend resources to negotiate an express pro- or anti-sandbagging clause in the purchase agreement.[34] Delaware courts therefore should clarify their state's default rule.

Whether a judge favors a tort or contract approach to breach of warranty, each doctrine weighs efficiency concerns.[35] For example, the Hand Formula is an efficiency-minded approach to negligence that is widely used in tort cases.[36] Similarly, contract law generally endorses breach where the performance of a contract incurs greater losses for the parties than breach and damages.[37] The next Sections address which default rule is economically optimal.

II.
THE PENALTY DEFAULT FALLACY

The only other academic piece on default sandbagging rules advocates for an anti-sandbagging default standard based on an economic argument for a penalty default rule. The penalty default rule theory posits that courts and legislatures should, under certain conditions, diverge from what the parties would have contracted for to give at least one party an incentive to contract around the default rule and choose affirmatively the contract provision they prefer.[38]

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32. Duran & Jamal, *supra* note 15.

33. *See, e.g.*, Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487, 495–96 (1941) (holding choice of law rules are substantive and federal courts must follow the choice of law rules of the forum state because parties have an interest in knowing their rights and duties prior to legal action).

34. *See, e.g.*, Daniel Avery & Daniel H. Weintraub, *Trends in M&A Provisions: "Sandbagging" and "Anti-Sandbagging" Provisions*, 5 BLOOMBERG L. REP. 1, 3 (2011) (explaining practitioners are well-advised to negotiate express sandbagging provisions because "absent a sandbagging or anti-sandbagging provision . . . any dispute about a breached representation or warranty could potentially lead to a long period of discovery").

35. *See generally* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (6th ed. 2003) (arguing most legal rules can be viewed as incentivizing individuals to act efficiently).

36. *See, e.g.*, U.S. Fid. & Guar. Co. v. Plovidba, 683 F.2d 1022, 1026 (7th Cir. 1982) (lauding the Learned Hand formula as a "valuable aid to clear thinking about the factors that are relevant to a judgment of negligence").

37. *See* Maria Bigoni, et al., *Unbundling Efficient Breach* 1–2 (Univ. of Chi.: Coase-Sandor Inst. for Law & Econ., Working Paper No. 695, 2014) (explaining that both economic and moral theories of contract law "consider the failure to perform on a promise excusable in at least some subset of cases when the net social benefit of breach is sufficiently large").

38. Ayres & Gertner, *supra* note 8.

Put plainly, the penalty default argument for anti-sandbagging is this: an anti-sandbagging penalty default rule forcing a buyer to negotiate a pro-sandbagging provision would serve an important information-revealing function. Only those buyers who value the ability to sandbag would expressly bargain for it. A buyer bargaining for a pro-sandbagging provision allegedly signals to the seller that the buyer may be untrustworthy. The seller can value that information, adjusting the purchase price and other deal terms in exchange. By advocating for a penalty default rule, Professor Whitehead implies that the aggregate incremental costs of contracting around an anti-sandbagging default rule are less than the marginal value the seller receives through the buyer's disclosure of their interest in sandbagging.[39]

However, the penalty default theory is inapt in the sandbagging context for at least two reasons. First, penalty default rules are conceptually suspect.[40] Application of the penalty default rule overlooks the possibility of a better contract that attains efficiency without the costly requirement of negotiating around a default rule. In the case of sandbagging, this may take the form of fewer, vaguer, or more limited representations or warranties. For example, a seller may ask the buyer to trade out a representation's language requiring "constructive knowledge" (i.e., imposing a duty on the seller to inquire or reasonably investigate under certain circumstances) in favor of language requiring only "actual knowledge" (i.e., knowledge that one using reasonable care or diligence should have). Like an anti-sandbagging default rule, this language would reduce the seller's risk exposure to ex post litigation. Unlike an anti-sandbagging default rule, such language does not necessitate incurring evidently outsized costs associated with express negotiation of a pro-sandbagging provision around an anti-sandbagging default rule.

Indeed, the outsized cost of negotiating a sandbagging provision is likely fatal to a penalty default argument. Silence is prevalent in all acquisition agreements irrespective of the outcome-determinative sandbagging default rule.[41] This indicates negotiating a sandbagging provision is a blunt instrument that parties rarely perceive to be worth its cost. Negotiations may also have negative externalities. An anti-sandbagging rule could create a "lemons" problem: because buyers have less information than sellers about the target business, they may discount the value of all businesses to reflect the chance of making a bad purchase.[42] A pro-sandbagging default rule may remove these costs by making silence reflect what most parties would have wanted, and by

39. *See* Whitehead, *supra* note 3, at 1105–07.

40. *See, e.g.*, Eric Maskin, *On the Rationale for Penalty Default Rules*, 33 FL. ST. U. L. REV. 557 (2006); Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563 (2006).

41. *See infra* Part III.A.

42. *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489–90 (1970); Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461, 469–70 (1981).

placing liability on the party best able to mitigate risk of breach ex ante. Any excessive marginal benefit the buyer receives through a pro-sandbagging default rule can be negotiated to parity through more precise tools, like changing the language of other provisions.

Second, even if we accept that a penalty default rule is conceptually sound in some instances, sandbagging is not one of those instances. The efficiency gains of a penalty default rule's information-forcing function are contingent on the clarity of the signal conveyed by the negotiation. If an anti-sandbagging penalty default rule is justified in its ability to communicate a message to the seller, that message must be unambiguous.

But a buyer's negotiation for sandbagging rights does not communicate any coherent piece of information to the seller. The buyer may want a pro-sandbagging clause because they want to litigate a known R&W inaccuracy post-closing. This tells the seller that the buyer is untrustworthy; the seller should be cautious, expend resources to recheck its R&Ws, and resist the change. Alternatively, the buyer may want a pro-sandbagging clause because they cannot get a clear sense of some aspect of the target business. This tells the seller that the buyer is uninformed; the seller should be aggressive, perhaps adopting the provision in exchange for other concessions. Consequently, if the negotiation of a sandbagging provision is an informative proxy, it is a noisy one that can point the seller in conflicting directions.

Because a penalty default rule in the context of sandbagging is inapt, a new economic analysis comparing the relative efficiency of either rule is warranted; the next Section does so.

III.
ECONOMIC ANALYSIS OF DEFAULT RULES

This Section reasons from first principles that Delaware should retain a pro-sandbagging default rule. While the choice of default rule would be irrelevant in a Coasean world,[43] the existence of transaction costs frustrates perfectly efficient bargaining for sandbagging rights. Deals demand time from high paid professionals like lawyers, accountants, financial advisors, and company employees. In large transactions, there may be tens of thousands of pages of documents. The volume of work creates high due diligence costs for the party bearing liability for false R&Ws. Thus, the efficient choice of default rule depends entirely on which particular transaction costs are present in a sandbagging negotiation, and which default rule better minimizes those costs. To

43. Coase's theorem is a legal and economic theory that states that, where there are complete competitive markets with no transaction costs, bargaining will lead to a Pareto efficient outcome regardless of the initial allocation of property rights. *See* R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960) (noting that if "market transactions are costless . . . rearrangement of rights will always take place if it would lead to an increase in the value of production"). The analysis of default rules commonly starts with, and builds out from, the Coase theorem.

analyze transaction costs, I invoke Judge Richard Posner's social cost of contract value equation:[44]

Social cost of Contract = ex ante drafting cost + ex post litigation cost * (probability of litigation) + Judicial error

To compare the social cost of contract in a pro-sandbagging regime with an anti-sandbagging regime, I analyze each variable under both regimes, and set up the equation as an inequality. For example:

Social cost of contract (anti-sandbagging) > Social cost of contract (pro-sandbagging)

The default rule with less social cost is economically preferable. I now proceed with the economic analysis.

A. Ex Ante Drafting Costs

With respect to sandbagging, acquisition agreements can either: (1) contain a pro-sandbagging provision, (2) contain an anti-sandbagging provision, or (3) remain silent, deferring to the default rule. Silence is the most cost-effective drafting solution because parties need not assume the costs of negotiating a provision either way.[45] Indeed, practitioners report sandbagging negotiations are often lengthy and "emotionally charged."[46] Time costs parties money. The question, then, is: Which default rule best minimizes the need to negotiate an express provision?

This is an empirical question with a ready answer. A 2011 study surveying acquisition agreements across a number of states found 96.2 percent of buyers held a sandbagging right under Delaware law when the state was presumed pro-sandbagging.[47] Roughly half of those buyers relied on an express pro-sandbagging provision, with most of the remainder opting for silence.[48] Conversely, in anti-sandbagging states, roughly half of acquisition agreements included a pro-sandbagging clause, with most of the remainder opting for

44. Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1583 (2005). "Social transaction costs of a contract" is defined as the social transaction costs of a contract. *See id.* It is "social" because it includes costs to third parties like the courts. It begins with the cost incurred to create the contract. Added to this is the total cost of potential litigation, including the cost to third parties like the judiciary, multiplied by the probability of litigation. This gives the expected litigation cost. Finally, we add the cost associated with the likelihood the judiciary errs in its dispute resolution.

45. *See* Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983) ("Ideally, the preformulated rules supplied by the state should mimic the agreements contracting parties would reach were they costlessly to bargain out each detail of the transaction.").

46. *See* James L. Kelly & Meredith Ervine, *To Sandbag or Not to Sandbag*, BUYOUTS (June 20, 2011), http://www.pillsburylaw.com/siteFiles/Publications/AR_Buyouts_June_2011.pdf [https://perma.cc/ENN7-43FD].

47. Whitehead, *supra* note 3, at 1093.

48. *Id.*

silence.[49] A 2017 study indicates these trends hold today, at least in middle-market M&A deals.[50] This shows nearly all parties opt to allow for sandbagging in pro-sandbagging regimes, whereas roughly half of parties assume the cost of negotiating a pro-sandbagging provision in anti-sandbagging regimes. Few parties negotiate anti-sandbagging clauses. Thus, ex ante costs are lower in a pro-sandbagging default regime since silence under that standard gives most parties what they would have bargained for.

But this cost differential arguably would not hold in practice. The empirics reveal buyers negotiate express pro-sandbagging provisions into acquisition agreements at roughly similar rates irrespective of the default standard. This statistic may equalize default rules' ex ante drafting costs.

However, this counterargument is premised on two unfounded assumptions. First, it assumes a newly-announced default rule would get the same results as Delaware's 2011 rule. But Delaware's default rule was somewhat ambiguous during the time period leading up to the study.[51] Consequently, some practitioners advised buyers to bargain for a pro-sandbagging provision irrespective of Delaware's default regime.[52] A clear default rule may curb this extra bargaining.

Second, this counterargument wrongfully presumes provisions departing from a default standard are as expensive as provisions abiding by a jurisdiction's default standard. Humans' status quo bias ensures parties are less likely to object to, or extensively negotiate, express provisions formalizing default rules.[53] By contrast, an active effort to depart from the default rule signals to the counterparty that the other side may now be untrustworthy.[54] This phenomenon finds empirical support in the 2011 study's documentation of higher rates of

49. *Id.*

50. *See* AMERICAN BAR ASSOCIATION, M&A CARVEOUT TRANSACTIONS DEAL POINTS STUDY 9091 (2017).

51. In *Cobalt Operating, LLC v. James Crystal Enters., LLC*, No. Civ.A. 714–VCS, 2007 WL 2142926, at *28 (Del. Ch. July 20, 2007), *aff'd without op.*, 945 A.2d 594 (Del. 2008), Delaware's Court of Chancery noted that a buyer's breach-of-warranty action does not require a showing of reliance, but left unaddressed the Delaware Superior Court's earlier determination that reliance is a prerequisite for such a claim. *See* Kelly v. McKesson HBOC, Inc., No. Civ.A. 99C–09–265WCC, 2002 WL 88939, at *8 (Del. Super. Ct. Jan. 17, 2002).

52. *See* John Jenkins, *Strategic Sandbagging: Let the Buyer Beware*, DEALLAWYERS.COM BLOG (June 8, 2009), https://www.deallawyers.com/blog/2009/06/strategic-sandbagging-let-the-buyer-beware.html [https://perma.cc/QMK8-E6CM] (noting that, given the "somewhat opaque" case law, buyers benefit from insisting on pro-sandbagging provisions); *see also* Robert F. Quaintance, Jr., *Can You Sandbag?*, DEBEVOISE & PLIMPTON PRIVATE EQUITY REPORT, WINTER 2002, at 1, 18 (2002) (advising buyers expressly preserve their right to sandbag).

53. *See* Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 611–12 (1998) (explaining that cognitive biases—specifically the status quo bias—change the substantive preferences of contracting parties, making default terms perceivedly more desirable).

54. *See* Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 886–87 (2010) (arguing that a party's insistence on greater precision in contract language that can trigger termination may inadvertently signal that a party expects the deal price to be adjusted or the deal to be called off).

express provisions consonant with (as opposed to divergent from) the jurisdiction's default rule.[55] Perceived untrustworthiness increases transaction costs substantially and is correlated with lower information-sharing between contract partners.[56] When one party cannot take the word of its counterparty on faith, it must assume the cost of verifying the counterparty's representations for itself. And "misreading a counterparty's actions as opportunistic leads to retaliation, which in turn leads to responsive retaliation."[57] Especially in M&A, when the seller's legal life frequently ends upon the deal's execution, sellers may become more opportunistic without an incentive to maintain a good reputation for possible future dealings.[58]

Sandbagging default rules are critical in helping parties reduce ex ante drafting costs. Parties' choice of contracts' governing law is generally unrelated to a jurisdiction's sandbagging rule.[59] Furthermore, silence is prevalent irrespective of a state's default rule, indicating that the cost of negotiating express sandbagging provisions often exceeds its benefits. The foregoing data and analysis shows most parties prefer a pro-sandbagging contract. Therefore, put simply:

Ex ante drafting cost (anti-sandbagging) > Ex ante drafting cost (pro-sandbagging)

B. Ex Post Litigation Cost

There are maximally two steps to litigating a sandbagging dispute; both require time and resources. The first is whether the seller's R&Ws are in fact false. This inquiry is necessary in both anti- and pro-sandbagging jurisdictions. The second is the extent of the buyer's knowledge relating to the truth-value of the seller's R&Ws. This is only necessary in anti-sandbagging jurisdictions because pro-sandbagging jurisdictions are agnostic to buyers' knowledge of sellers' lies. Thus, the cost of litigation is less in a pro-sandbagging jurisdiction. Therefore:

Ex post litigation cost (anti-sandbagging) > Ex post litigation cost (pro-sandbagging)

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55. *See* Whitehead, *supra* note 3, at 1093.

56. *See* Jeffrey H. Dyers & Wujin Chu, *The Role of Trustworthiness in Reducing Transaction Costs and Improving Performance: Empirical Evidence from the United States, Japan, and Korea*, 14 ORG. SCI. 57 (2003) (demonstrating empirically that perceived trustworthiness between suppliers and buyers reduces transaction costs substantially by reducing time spent negotiating, and is also correlated with greater information sharing).

57. Ronald J. Gilson, et al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1394–95 (2010).

58. *See* Andreas Diekmann, *The Power of Reciprocity: Fairness, Reciprocity, and Stakes in Variants of the Dictator Game*, 48 J. CONFLICT RESOL. 487 (2004).

59. The choice of governing law is often driven by issues affecting indemnification, the enforceability of restrictions on competition, and other considerations that are not directly related to sandbagging. *See* Avery & Weintraub, *supra* note 34, at 5.

C. Probability of Litigation

Original data analysis suggests a pro-sandbagging default rule is less likely to lead to litigation. A Bloomberg Law search of transactional precedents between July 2007 and June 2011[60] revealed 147 mergers governed by anti-sandbagging California law, and one thousand mergers governed by pro-sandbagging Delaware law. A Lexis search for sandbagging litigation cases revealed three sandbagging cases in California and four sandbagging cases in Delaware in the same period.[61] Thus, the litigation-to-deal ratio in an anti-sandbagging state is 3:147, or 2 percent, while the litigation-to-deal ratio in a pro-sandbagging state is 4:1000, or 0.4 percent. This does not definitively speak to the relative probability of litigation because Bloomberg's database comprises only public mergers. Lexis is also blind to arbitration. Thus, while instructive, further analysis is necessary.

Professor Whitehead's study offered empirical evidence that parties believe the probability of sandbagging litigation is negligible in either jurisdiction. Parties were silent on sandbagging in roughly half of contracts, irrespective of the governing jurisdiction's default rule. Thus, roughly half of parties determined the ex ante cost of negotiating the provision exceeds the ex post litigation cost multiplied by the probability of litigation. This is not because ex post litigation is inexpensive: Indemnifying a buyer for breach of warranty can be costly, particularly if multiples of the cost are at issue due to the pricing formula used by the buyer in the acquisition. Hence, parties' acquiescence to an outcome-determinative default rule signals they perceive the probability of litigating the matter to be so remote that the costs of negotiating an explicit sandbagging provision exceed its benefits. This is consistent with contract literature suggesting parties spend less time negotiating a contingency clause on the belief that an enforcement action is unlikely.[62]

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60. These dates were chosen because this is the time period Charles Whitehead analyzed in the only other article analyzing sandbagging default rules. *See* Whitehead, *supra* note 3. The fact that this documents "old" trends does not make the resulting analyses any less potent: the default rule's effect on the probability of litigation should remain constant over time.

61. The search terms "breach! or violat! w/5 warranty and merger or acqui! and agreement and date > 2006 and date < 2012" yielded eighty-eight California cases and thirty-eight Delaware cases. These cases were analyzed manually by the author to determine whether they involved a sandbagging claim. The three sandbagging cases found in California during the relevant time period are: Apparel v. Sweet Sportswear, No. B203995, 2010 Cal. App. Unpub. LEXIS 5127 (Cal. Ct. App. July 7, 2010); Ascent Media Grp. v. Interested Underwriters at Lloyd's, No. B199042, 2008 Cal. App. Unpub. Lexis 5425, 2008 WL 2600728 (Cal. Ct. App. July 2, 2008); and Ousley v. Fid. Nat'l Fin., No. A120692, 2009 Cal. App. Unpub. LEXIS 7878 (Cal. Ct. App. Sep. 30, 2009). The four Delaware cases found during the relevant time period are: Airborne Health , Inc. v. Squid Soap, LP, 984 A.2d 126 (Del. Ch. 2009); Ameristar Casinos, Inc. v. Resorts Int'l Holdings, LLC, No. CIV.A. 3685–VCS, 2010 Del. Ch. LEXIS 107 (Del. Ch. May 11, 2010); Postorivo v. AG Paintball Holdings, Inc., Nos. 2991–VCP, 3111–VCP, 2008 Del. Ch. LEXIS 29 (Del. Ch. Feb. 29, 2008); and Rhodes v. SilkRoad Equity, LLC, C.A. No. 2133-VCN, 2009 Del. Ch. LEXIS 50 (Del. Ch. April 15, 2009).

62. Choi & Triantis, *supra* note 54, at 851–54.

The least-cost-avoider principle dictates the probability of litigation is lower in a pro-sandbagging jurisdiction.[63] It asserts liability should bear on the party best positioned to mitigate risk at the lowest cost.[64] Because sellers are more familiar with their businesses, they are better equipped to create accurate R&Ws at lower cost.[65] A pro-sandbagging rule incentivizes sellers to use their superior knowledge to ensure R&Ws are accurate or else risk liability.

Game theory also posits the goal of mitigating the probability of litigation is best achieved by a pro-sandbagging rule. In any M&A interaction, the buyer is often engaged in a "repeat game" (i.e., an extensive form game that consists of a number of repetitions of some base game) whereas the seller may be engaged in a "single-shot game" (i.e., a non-repeated game). Buyers thus must worry about the impact of their present actions on future dealings with other players. Their reputation as an untrustworthy buyer may make other sellers beware in future dealings, creating disincentives to breach.[66] This effect is exacerbated by the growing popularity of auctions in the acquisition context, where a buyer's reputation can be critical to the success of its bid for the target company.[67] Single-shot sellers, however, do not share that concern. Because sellers do not suffer costs that carry with them through future games wherein their reputation matters, they are more likely to play fast and loose in representing their business.

For example, under an anti-sandbagging default rule, the seller may dump "newly discovered" information on the buyer at a late date to avoid its bargained-for representations and warranties. Unlike a typical buyer, the seller may not have to worry about its reputation post-closing; at that time, it will have ceased to exist. Because the buyer technically has the data prior to closing, the buyer may not be able to show reliance in a breach of warranty proceeding. Conversely, under a pro-sandbagging default rule, the buyer is less likely to sandbag without ethical justification because its reputation as an untrustworthy acquirer may harm

63. This is not new wisdom. Judge Learned Hand said it best in 1946: "A warranty is an assurance by one party to a contract of the existence of a fact upon which the other party may rely. It is intended precisely to relieve the promisee of any duty to ascertain the fact for himself; *it amounts to a promise to indemnify the promisee for any loss if the fact warranted proves untrue, for obviously the promisor cannot control what is already in the past*." Metro. Coal Co. v. Howard, 155 F.2d 780, 784 (2d Cir. 1946) (emphasis added).

64. *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972) (arguing that the efficient allocation of risk should be the economic and social objective pursued by the courts and governments, and that risks should be allocated to the party that is best positioned to know about the risks and take precautions designed to avoid the event or accident).

65. *See* West & Shah, *supra* note 14, at 3.

66. *See* ROBERT AXELROD, THE EVOLUTION OF COOPERATION 27–54 (1984) (explaining the tit-for-tat strategy—i.e., mirroring opponent's decision to cooperate or defect in the previous round—in a multi-round prisoner dilemma).

67. *See, e.g.*, *Auction Sales Grow in Popularity as an M&A Tool*, BOWMANS (Oct. 12, 2017), https://www.bowmanslaw.com/press_releases/auction-sales-grow-popularity-ma-tool/ [https://perma.cc/27WZ-D7PJ].

its future acquisition bids. And the seller cannot engage in unethical tactics to shore up its legal defense because the default rule renders such action fruitless.

In sum, empirics, as well as legal and mathematical theory, indicate the probability of litigation is at worst the same in pro- and anti-sandbagging jurisdictions, and likely less in the former. Therefore:

$$\text{Probability of litigation (anti-sandbagging)} \geq \text{Probability of litigation (pro-sandbagging)}$$

D. Judicial Error

Finally, evaluation of likelihood of judicial error is simple if one premise is accepted: all else equal, judicial decisionmakers are more likely to err when they have more inquiries to make. As demonstrated *supra*, anti-sandbagging requires all the same judicial inquiries as pro-sandbagging, plus an inquiry into the buyer's mind-state. Thus, there is a higher chance of judicial error in an anti-sandbagging jurisdiction. As a result:

$$\text{Judicial error (anti-sandbagging)} > \text{Judicial error (pro-sandbagging)}$$

IV.
IMPLICATIONS

Application of the Posner-ian inequality shows that a pro-sandbagging default rule is more efficient than its anti-sandbagging counterpart, but this Note's implications are broader. Scholars' economic analysis of default rules has typically stopped after determining what most parties would bargain for ex ante.[68] This Note's approach shows why this is wrong: it ignores ex post transaction costs. While parties' ex ante decision may reflect their *perception* of ex post costs, variables like the probability of litigation are opaque and require disciplined empirical analysis. Parties' assessments also ignore the social costs of ex ante provisions. A party may rationally shift ex ante costs to ex post dispute resolution mechanisms, but this discounts negative externalities like the court's caseload. By more rigorously analyzing prospective litigation liability and likelihood, jurisdictions' default rules would weigh not only what contracting parties desire, but also what judges and the broader public (which suffers when courts are clogged) would pay.

The process of reconsidering the economic impact of default rules may be accelerated by scholars, who can use this methodology in future research. For example, post-employment restrictive covenants (limiting former employees' actions after the employment relationship terminates) are currently treated

68. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1433 (1989) (positing the default term should be "the term that the parties would have selected"); Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353, 361 (1988) (proposing as default rule "the contract that most well-informed persons would have adopted if they were to bargain about the matter").

differently in different jurisdictions. New York allows them;[69] California does not.[70] This topic is of broad interest to lawyers, employers, and employees. Analysis of the total social cost of a contract would show which default rule is economically preferable. This is one example of how the methodology created here has implications in other contexts.

CONCLUSION

This Note shows that a pro-sandbagging default rule is most efficient. It first debunked past penalty default arguments by explaining negotiation of a sandbagging provision does not reveal any coherent piece of information. Then, it used Posner's equation to show a pro-sandbagging default rule is more efficient. A pro-sandbagging default rule has lower ex ante contracting costs because it gives the majority of parties what they would have bargained for. It has lower ex post litigation costs and a lower likelihood of judicial error because it requires fewer judicial inquiries. Finally, it has lower probability of litigation because liability is imposed on the party best able to mitigate it.

This Note makes two contributions. First, it helps efficiency-minded judges and legislators decide which sandbagging default rule their jurisdiction should adopt. This question is a pressing concern for Delaware, but it also informs different jurisdictions considering the same question. Second, this Note contributes to the growing academic literature on default rules by offering a novel approach to comparing transaction costs of different default rules through a Posner-ian inequality.

Efficiency, of course, is not the be-all and end-all of equitable default rule decisions. But it is certainly a factor worth considering. By adopting a pro-sandbagging default rule, Delaware and other courts facing this issue will more efficiently allocate risk, decreasing transaction costs and reducing sandbagging litigation that may otherwise clog the courts.

69. *See* BDO Seidman v. Hirshberg, 712 N.E.2d 1220, 1223 (N.Y. 1999) (allowing restrictive covenants so long as they "[1] [are] for the protection of the *legitimate interest* of the employer, (2) [do] not impose undue hardship on the employee, and (3) [are] not injurious to the public").

70. CAL. BUS. & PROF. CODE § 16600 (West 2020).