Clause for Concern? Sandbagging Provisions in Canadian M&A

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Sandbagging: *To conceal or misrepresent one's true position, potential or intent, especially in order to take advantage of.*

The use of express sandbagging language in M&A agreements (whether "pro" or "anti"), or the decision to remain silent, is commonly one of the most acrimonious issues faced by M&A practitioners in private acquisitions. The frequency of these provisions in Canadian M&A and the question of their enforceability are commonly discussed in light of evolving market practice and the historically limited guidance from Canadian courts.

HOW DOES SANDBAGGING WORK?

In the course of negotiating a definitive acquisition agreement, a buyer will typically extract detailed representations and warranties from the seller regarding the business to be acquired, along with an indemnity (subject to customary limitations) whereby the seller will agree to indemnify the buyer post-closing should any of the reps and warranties prove to be untrue.

The issue of "sandbagging" arises where an acquisition agreement has been signed and the deal subsequently closes, but there is an untrue seller rep and warranty in the agreement, and the buyer knows prior to closing that the rep and warranty is untrue but proceeds with the closing. In these circumstances, the question is whether the buyer should be able to sue for a breach of the untrue rep and warranty — can the buyer "sandbag" the seller? Sandbagging provisions are intended to expressly address the parties' negotiated agreement on this issue.

THE PROS AND CONS OF SANDBAGGING

Parties have three options available to address this question: pro-sandbagging language, anti-sandbagging language, or silence. For obvious reasons, a seller will generally try to negotiate anti-sandbagging language, while a buyer may push for pro-sandbagging.

✓ PRO-SANDBAGGING

The following is one example of a typical pro-sandbagging clause, from the American Bar Association's (ABA) *Model Asset Purchase Agreement*:

> **No Waiver.** The right to indemnification, reimbursement or other remedy based on such representations, warranties, covenants and obligations shall not be affected by any investigation conducted with respect to, or any Knowledge acquired (or capable of being acquired) at any time.

A buyer will often argue that this kind of pro-sandbagging provision encourages better disclosure and helps to protect the buyer from last-minute surprises, including issues uncovered during the interim period between signing and closing. A buyer will also want to ensure that its management does not have "knowledge" of a breach imputed to it where voluminous diligence materials have been made available and its review has been circumscribed.

✗ ANTI-SANDBAGGING

By contrast, the following is an example of a typical anti-sandbagging clause, from the ABA's *2015 Canadian Private Target M&A Deal Points Study* (ABA's 2015 Study):

> **Indemnity by the Seller.** Notwithstanding the foregoing indemnities for breach of any representation or warranty, the Seller shall not be liable under this Indemnity provision for any damages based upon or arising out of any breach of any of the representations or warranties of the Seller contained in this Agreement if the Buyer had Knowledge of such breach prior to or at the Closing.

This form of anti-sandbagging provision may be coupled with an express representation and warranty by the buyer that it has no knowledge of any breach of a representation, warranty or covenant at either signing or closing.

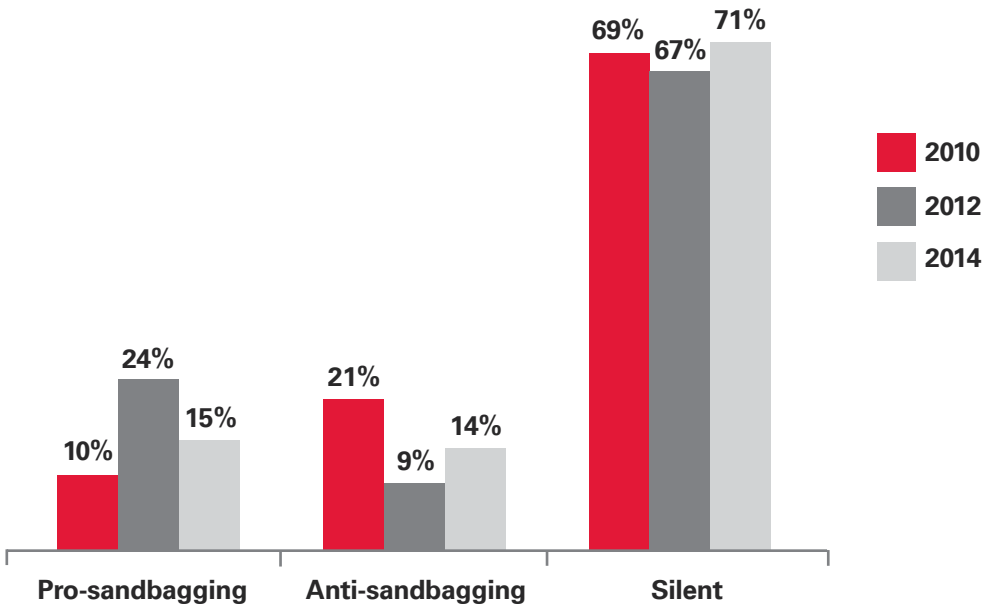
A seller will often take the position that anti-sandbagging language encourages the buyer to bring forward any potential diligence issues before closing, and to avoid a "gotcha" scenario where the buyer seeks to use an indemnity claim to effectively reduce the purchase price.

Where a buyer makes a post-closing indemnity claim, this type of anti-sandbagging provision typically leads to disputes around what the purchaser "knew" pre-closing. Accordingly, parties should take care to specify what will constitute "knowledge of the buyer", including which individuals at the buyer's organization have knowledge that could preclude a claim.

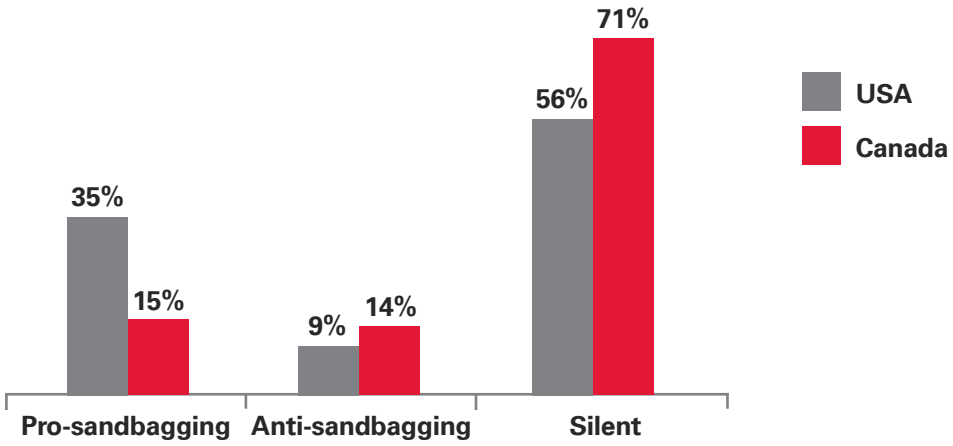
The use of either a pro- or anti-sandbagging provision will always be highly fact-dependent and influenced by the tone and history of negotiations, the parties' relative bargaining power and nature of the diligence conducted.

MARKET PRACTICE: CANADA VS. U.S.

In Canada, agreements are most often silent on the question of sandbagging, with nearly 71 per cent of agreements not including any form of express sandbagging clauses. The remaining agreements are split about evenly between pro-sandbagging (15 per cent) and anti-sandbagging (14 per cent) provisions, according to the ABA's 2015 Study.



By comparison, the ABA's 2015 Study found that U.S. agreements are also typically silent on sandbagging, with nearly 56 per cent not including any form of sandbagging clauses in 2014. Those that do address the issue, however, more often include pro-sandbagging (35 per cent) than anti-sandbagging (nine per cent) provisions.



ENFORCEABILITY IN CANADA

When an agreement is silent on sandbagging, Canadian courts have been somewhat inconsistent about the buyer's ability to bring a claim. For example, in a 2001 decision, the Court of Appeal of Alberta allowed a buyer to obtain the benefit of a warranty it knew to be untrue. In contrast, in 2003, the Ontario Court of Appeal did not reject a defence to a claim for a breach of a rep and warranty based on the purchaser's prior knowledge; instead, the defence was rejected on the basis that there may have been a violation of the duty of good faith.

While the Ontario case was ultimately settled, it notably considers the element of "good faith" when considering a sandbagging remedy. The importance of "good faith" has received renewed scrutiny in light of the Supreme Court of Canada's 2014 decision in *Bhasin v. Hrynew*, which recognized an organizing principle of good faith and a duty of honest performance in Canadian contract law. A sandbagging dispute has not been examined by a Canadian court since *Bhasin* and, as such, it is difficult to predict which way a Canadian court might rule in the future. For more information on Bhasin, please see our:

- December 2015 *Blakes Bulletin: Termination of Contracts — Good Faith Implications*
- October 2015 *Blakes Bulletin: Bhasin Anniversary: You Gotta Have Faith?*
- November 2014 *Blakes Bulletin: Let's Be Honest: SCC Finds All Contracting Parties Owe Each Other a Duty of Honesty*

Express sandbagging provisions (whether "pro" or "anti") have not yet been considered directly by a Canadian court. Furthermore, should Canadian courts look for guidance from the U.S. or U.K. (as is common in Canadian cases), they will not find much clarity. In the U.S., pro-sandbagging provisions have been previously enforced, for example, in the New York Court of Appeals' 1990 decision, *CBS Inc. v. Ziff-Davis Publishing Co. et al*. However, where a contract is silent on sandbagging, the courts have not taken a clear stance (for example, see the United States Court of Appeals for the Second Circuit's 1992 decision, *Galli v. Metz* and the Delaware Superior Court's 2005 decision *Interim Healthcare, Inc. v. Spherion Corp*.). U.K. courts have been similarly unclear, and the question of sandbagging has only been considered as an ancillary issue to a dispute (for example, see the England and Wales Court of Appeal's 1992 decision, *Eurocopy plc v. Teesdale and others*, and its 2005 decision, *Infiniteland Ltd. v. Artisan Contracting Ltd.*).

As with any such decision, we expect that the specific language of the acquisition agreement, and the facts leading up to the dispute (including the parties' behaviour), will be key factors in any Canadian court's future decision.

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