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SANDBAGGING THE UNSOPHISTICATED SELLER: *ARWOOD V. AW SITE SERVICES, LLC*

INTRODUCTION

A. Lead-In

In *Arwood v. AW Site Services, LLC*,[1] the Delaware Court of Chancery sought to resolve the question raised in *Eagle Force Holdings, LLC v. Campbell*[2] as to whether the common law of Delaware allowed a party to a contract to recover on a breach of warranty claim for a warranty that the party knew, at signing, was false—a practice known as "sandbagging."[3]

B. Statement of Facts

Like a Horatio Alger character, plaintiff John D. Arwood came from humble beginnings but eventually grew into success. A self-described "[l]ifelong garbage man,"[4] Arwood entered the waste disposal industry "as a child collecting 'aluminum cans and pop bottles' from the side of the road."[5] He ultimately built a business that he would sell for millions.[6] Yet Arwood's entrepreneurship did not translate into a knack for the niceties of financial accounting. Regarding such formalities, Arwood was an "alarmingly unsophisticated businessman. . . . [H]e did not track costs or

1. No. 2019-0904-JRS, 2022 WL 705841 (Del. Ch. Mar. 9, 2022).
2. 187 A.3d 1209 (Del. 2018).
3. *Arwood*, 2022 WL 705841, at *28–29 (asking the parties to address "the current state of 'sandbagging' as a defense under Delaware law, particularly in light of our Supreme Court's opinion in *Eagle Force Holdings, LLC v. Campbell*").
4. JOHN ARWOOD, https://johnarwood.com [https://perma.cc/Y9CF-6AMM].
5. *Arwood*, 2022 WL 705841, at *1.
6. *Id.* at *2. The sale ultimately netted him a lawsuit as well. *Id.*

keep a reliable profit and loss statement for the business, and he likely had no idea how to do so."[7]

The issue of Arwood's inadequate recordkeeping arose when Broadtree Partners, a private equity firm, expressed interest in purchasing his business.[8] To enable Broadtree's due diligence and valuation studies, Arwood gave Broadtree "full and unfettered access" to his companies' financial records.[9] This arrangement ultimately enabled Arwood and Broadtree to enter into an Asset Purchase Agreement (APA) on October 19, 2018, through which Broadtree acquired Arwood's business for approximately $16 million.[10]

The APA contained "incongruit[ies]" that reflected the unusual arrangement by which Arwood had facilitated Broadtree's due diligence.[11] For example, Arwood had represented and warranted to Broadtree in the APA that certain financial statements were "complete and accurate in all respects," despite the fact that *Broadtree itself* had created those very financial statements for its own use.[12] In short, "[a]lthough the typical dynamic is that the buyer relies on the seller for the accuracy of the financial statements, this case strangely presents the opposite dynamic."[13]

Post-acquisition, the parties eventually found themselves on adversarial footing.[14] Arwood brought suit in the Delaware Court of Chancery, demanding Broadtree release escrow funds that Arwood believed to be his due.[15] Broadtree counterclaimed, in part alleging that Arwood had breached the APA's representations and warranties,[16] including Arwood's representations that "the Financial Statements are complete and accurate in all respects" and "[e]ach Seller Entity has materially complied with and is currently in compliance with all Laws of federal, state, local and foreign governments."[17] In defense, Arwood responded that due to the open access to his financial records he gave Broadtree, "Broadtree knew as much about the businesses [it] was acquiring as he did."[18] Thus, Arwood argued that Broadtree could not bring a valid claim for breach of warranties when

7. *Id.* at *22.
8. *Id.* at *1.
9. *Id.* at *1.
10. *Id.* at *2.
11. *Id.* at *33.
12. *Id.*
13. *Id.*
14. *Id.* at *2 ("Arwood continued to work for [Broadtree's subsidiary] post-closing until the parties had a falling out and this litigation ensued.").
15. *Id.*
16. *Id.* at *27.
17. *Id.* at *32–34.
18. *Id.* at *2.

Broadtree "either knew pre-closing that the representations were false or [was] recklessly indifferent to their truth."[19]

C. Posture and Holding

The court held that a party bringing a breach of express warranty claim need not show reliance on the warranty as an element of their claim.[20]

I. HISTORY

"Sandbagging," in the mergers and acquisitions (M&A) context, refers to when a buyer, knowing that a seller's representations and warranties are materially breached, nevertheless closes on the deal and subsequently asserts a post-closing claim.[21] A default rule[22] that requires a showing of reliance for breach of warranty, and thus disallows sandbagging, is deemed "anti-sandbagging," while a "pro-sandbagging" default rule is one that does not require reliance.[23] Early Delaware caselaw assumed that reliance was an element of a breach of express warranty claim.[24] This requirement thus reflected an anti-sandbagging, tort-law framework for breach of warranty cases.[25] However, beginning with the 2003 case *Gloucester Holding Corp. v. U.S. Tape & Sticky Products, LLC*,[26] Delaware courts have uniformly[27] adopted a pro-sandbagging, contract-law approach[28] to breach of warranty

19. *Id.* at *3.

20. *Id.* at *31.

21. Charles K. Whitehead, *Sandbagging: Default Rules and Acquisition Agreements*, 36 DEL. J. CORP. L. 1081, 1081 (2011).

22. In contract law, "default rules" refer to background legal rules that apply to contracting parties by default, unless they explicitly specify otherwise. *See generally* Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389 (1993).

23. *See* Whitehead, *supra* note 21, at 1087, 1108–15 (categorizing various jurisdictions as anti- or pro-sandbagging on the basis of whether they require reliance as an element of breach-of-warranty claims).

24. *See, e.g.*, Clough v. Cook, 87 A. 1017, 1018–19 (Del. Ch. 1913) ("The general rule [is] that a misrepresentation must be relied upon by the party receiving it in order that it may be sufficient ground for impeaching or defeating a contract . . . ."); Loper v. Lingo, 97 A. 585, 586 (Del. Super. Ct. 1916) (A plaintiff bringing a breach of warranty claim must allege, *inter alia*, "that at the time of the sale the [good] was warranted by the defendant to be sound, and that the plaintiff relied upon such warranty.").

25. Griffith Kimball, *Sandbagging:* Eagle Force Holdings *& the Market's Reaction*, 46 BYU L. REV. 571, 574 (2021) ("Traditionally, a buyer must have relied on the seller's warranty in order to bring a claim, 'reflecting the action's historical grounding in tort.'").

26. 832 A.2d 116 (Del. Ch. 2003).

27. *See* Seth Cleary, *Delaware Law, Friend or Foe? The Debate Surrounding Sandbagging and How Delaware's Highest Court Should Rule on A Default Rule*, 72 SMU L. REV. 821, 830 (2019) ("Since 2003, only one case has followed the *Loper* line of precedent [that holds reliance is an element of breach of warranty], with Delaware courts instead favoring the approach adopted in *Gloucester*.").

28. Kimball, *supra* note 25, at 574–75 ("Sandbagging law has evolved from tort to contract law, and 'modern theory' courts like Delaware and New York generally consider the representations and warranties as bargained-for provisions and refuse to change the parties' deliberate allocation of risk." (footnote omitted)).

claims, one that excludes reliance as an element of the claim.[29] In *Interim Healthcare, Inc. v. Spherion Corp.*,[30] the Delaware Superior Court reaffirmed *Gloucester*'s holding that reliance is not an element of breach of warranty,[31] and further noted that the "plaintiffs were entitled to rely upon the accuracy of the representation irregardless of what their due diligence may have or should have revealed."[32] Subsequently, in *Cobalt Operating, LLC v. James Crystal Enterprises, LLC*,[33] the Delaware Chancery Court reaffirmed that a buyer need not show reliance on a representation in a claim for its breach.[34] In dicta, the court expanded upon its holding, and justified it as upholding a private ordering framework that enables the parties to efficiently allocate risk,[35] which the court characterized as extra-pertinent in the context of M&A transactions' high due diligence costs.[36]

This line of cases contributed to a perception that Delaware was firmly "pro-sandbagging."[37] However, the Delaware Supreme Court's 2018 decision in *Eagle Force Holdings, LLC v. Campbell*[38] contained dicta that seemingly threw this consensus into disarray.[39] The court acknowledged "the debate over whether a party can recover on a breach of warranty claim where the parties know that, at signing, certain of them were not true . . . " but noted that the court "ha[d] not yet resolved this interesting question."[40]

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29. *See, e.g.*, *Gloucester Holding Corp.*, 832 A.2d at 127 ("Reliance is not an element of [a] claim for indemnification.").

30. 884 A.2d 513 (Del. Super. Ct. 2005).

31. *Id.* at 548 ("Reliance is not an element of [a] claim for indemnification [arising from a breach of contract]." (alteration in original) (quoting *Gloucester Holding Corp.*, 832 A.2d at 127))).

32. *Id.*

33. No. Civ. A. 714-VCS, 2007 WL 2142926 (Del. Ch. July 20, 2007), *aff'd*, 945 A.2d 594 (Del. 2008).

34. *Id.* at *28 ("Cobalt's breach of contract claim is not dependent on a showing of justifiable reliance.").

35. *Id.* ("[R]epresentations like the ones made in the Asset Purchase Agreement serve an important risk allocation function. By obtaining the representations it did, Cobalt placed the risk that WRMF's financial statements were false and that WRMF was operating in an illegal manner on Crystal."); *accord* Whitehead, *supra* note 21, at 1084 ("More recently, in jurisdictions that have broken with the traditional rule, Buyer instead can bring its [breach of warranty] suit based on contract law principles, without regard to what it knew at closing. Buyer can argue it bargained for the warranties as a means to allocate risk and minimize cost." (footnotes omitted)).

36. *Cobalt Operating, LLC*, 2007 WL 2142926, at *28 ("Due diligence is expensive and parties to contracts in the mergers and acquisitions arena often negotiate for contractual representations that minimize a buyer's need to verify every minute aspect of a seller's business.").

37. See Kimball, *supra* note 25, at 575 n.10 for a list of sources standing for this proposition.

38. 187 A.3d 1209 (Del. 2018).

39. *See, e.g.*, Daniel L. Chase, *M&A After* Eagle Force*: An Economic Analysis of Sandbagging Default Rules*, 108 CALIF. L. REV. 1665, 1668 (2020) ("The debate over sandbagging has recently come to the fore as Delaware's Supreme Court [in *Eagle Force*] has cast ambiguity on how Delaware treats sandbagging."); Cleary, *supra* note 27, at 824 (noting that the sandbagging discussion in *Eagle Force* "led to speculation on how the court would rule in the future"). *But see* Kimball, *supra* note 25, at 584 ("Today, despite the uncertainty caused by the *Eagle Force* footnote, many attorneys still feel confident that Delaware remains a pro-sandbagging state.").

40. *Eagle Force Holdings, LLC*, 187 A.3d at 1236 n.185.

The Delaware Supreme Court, by raising this "interesting question,"[41] unsettled an important doctrine in the consequential field of Delaware M&A law.[42] Therefore it is unsurprising that although the Delaware Supreme Court has not revisited sandbagging since *Eagle Force*, the Delaware Court of Chancery has found it necessary to do so.[43]

In the post-*Eagle Force* case *Akorn, Inc. v. Fresenius Kabi AG*,[44] the Delaware Court of Chancery reaffirmed *Cobalt*'s pro-sandbagging holding that a buyer need not show reliance in a breach of warranty claim.[45] Despite directly addressing Delaware sandbagging doctrine, *Akorn* did not cite *Eagle Force*.[46] Nevertheless, its discussion of sandbagging doctrine, including a footnote citing a lengthy list of pro-sandbagging Delaware caselaw,[47] implicitly rejected *Eagle Force*'s suggestion that Delaware's sandbagging doctrine was undecided.[48]

II. ANALYSIS

A. *Court's Analysis*

In *Arwood*, the Delaware Court of Chancery affirmed that "Delaware law allows a buyer to 'sandbag' a seller."[49] The court reasoned that Delaware law is "contractarian . . . respect[ing] contracting parties' 'right to enter into good and bad contracts.'"[50] The court endorsed *Akorn*'s reasoning that requiring reliance for a breach of warranty claim would require the "amorphous and tort-like concept of assumption of risk"[51] to control such

41. *Id.*

42. *See* Chase, *supra* note 39, at 1668 ("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 [sandbagging] default rule consequential."). *But cf.* Kimball, *supra* note 25, at 591 ("Perhaps the biggest takeaway from the empirical research is that there was no strong market reaction in the Delaware-governed agreements after *Eagle Force* was decided, despite strong recommendations by attorneys to include pro-sandbagging provisions.").

43. *See infra* notes 44–45 and accompanying text.

44. No. 2018-0300-JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018).

45. *Id.* at 76 ("[A] breach of contract claim is not dependent on a showing of justifiable reliance." (quoting Cobalt Operating, LLC v. James Crystal Enters., LLC, No. Civ. A. 714-VCS, 2007 WL 2142926 (Del. Ch. July 20, 2007), *aff'd*, 945 A.2d 594 (Del. 2008))).

46. *See id.* at 76–82.

47. *Id.* at 77 n.756.

48. Kimball, *supra* note 25, at 582–83 (*Akorn*'s "citation of *Cobalt* and a lengthy string cite of other Delaware cases rebuts the point made in the *Eagle Force* footnote that there is a debate on this issue, and it especially refutes Chief Justice Strine's opinion that '[v]enerable Delaware law casts doubt on [the buyer's] ability' to sue when the buyer is aware that information represented to was false." (alteration in original) (footnote omitted)).

49. Arwood v. AW Site Servs., LLC, No. 2019-0904-JRS, 2022 WL 705841, at *28 (Del. Ch. Mar. 9, 2022).

50. *Id.* at *29 (citations omitted).

51. *Id.* at *30 (quoting Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *77 n.756 (Del. Ch. Oct. 1, 2018)).

claims, which would risk such cases "devolv[ing]" into fact-intensive disputes revolving around what parties learned, or should have learned, in the course of due diligence.[52] The court thus maintained that a pro-sandbagging rule provides for more efficient adjudication of breach of warranty claims than an approach that utilizes tort concepts.[53]

The court reasoned that Delaware precedent supports a contractarian approach to breach of warranty claims because "the settled Delaware law [is] that 'reliance is not an element of a claim'" for breach of warranty.[54] This assertion of pro-sandbagging's "settled" status in Delaware law implicitly rejected Chief Justice Strine's contention in *Eagle Force* that "[v]enerable Delaware law casts doubt"[55] on the permissibility of sandbagging.[56] The court suggested that the "reasoning of our [pro-sandbagging] law is sound" because it allows contracting parties to efficiently allocate risk when contracting.[57] The court noted that a buyer can minimize their "need to verify every minute aspect of a seller's business" by securing representations from the seller.[58] The buyer thereby places the risk of the seller providing false financial statements (for example) upon the seller themself, thus reducing the cost of the buyer's due diligence.[59] And the seller, having made the representation, can hardly complain if the buyer subsequently relies upon it.[60] It is worth noting that the notion of "reliance" that undergirds the pro-sandbagging rule is, somewhat counterintuitively, one in which the promisee relies on the promisor having *made* the promise,

52. *Id.*; *see also* Whitehead, *supra* note 21, at 1106 ("Buyers sometimes express concern that an anti-sandbagging rule will promote litigation.").

53. A similar argument is advanced by Daniel L. Chase, *supra* note 39, at 1677. Chase notes that in both anti- and pro-sandbagging jurisdictions, adjudicating a sandbagging dispute requires determining "whether the seller's R&Ws are in fact false," whereas inquiry into "the extent of the buyer's knowledge relating to the truth-value of the seller's R&Ws . . . is only necessary in anti-sandbagging jurisdictions because pro-sandbagging jurisdictions are agnostic to buyers' knowledge of sellers' lies." *Id.* Chase further notes that a pro-sandbagging rule is less likely to lead to litigation in the first place and poses a reduced risk of judicial error. *Id.* at 1678–80.

54. *Arwood*, 2022 WL 705841, at *30 (quoting *Akorn, Inc.*, 2018 WL 4719347, at *77 n.756).

55. Eagle Force Holdings, LLC v. Campbell, 187 A.3d 1209, 1247 (Del. 2018) (Strine, C.J., concurring in part and dissenting in part).

56. See *supra* note 48 for a discussion of a similar assertion, appearing in *Akorn, Inc.*, 2018 WL 4719347, that pro-sandbagging is Delaware's "settled" doctrine. Both *Arwood* and *Akorn* stand for the assertion that, although Delaware may have required reliance in a breach of warranty claim in the halcyon days of yesteryear, the settled law today is contrary to such a rule.

57. *Arwood*, 2022 WL 705841, at *30; *see also supra* note 28 and accompanying text for caselaw and scholarship making this same observation.

58. *Arwood*, 2022 WL 705841, at *30.

59. *Id.*

60. *See id.* ("Having contractually promised [the buyer] that it could rely on certain representations, [the seller] is in no position to contend that [the buyer] was unreasonable in relying on [the seller's] own binding words." (alterations in original) (quoting *Akorn, Inc.*, 2018 WL 4719347, at *77–78)).

but not on the actual *veracity* of that promise.[61] Indeed, sandbagging is, by definition, implicated when the promisee *did not* rely on the accuracy of the relevant representation.[62]

The court noted that some perceive sandbagging as "simply unfair or 'ethically questionable,'"[63] and acknowledged that "there is something unsettling" about the practice.[64] But the court reasoned that parties can simply manage the risk of unfair sandbagging in their contracts.[65] The court noted that allowing contracting parties to contractually manage this risk is consistent with Delaware's contractarian policy and that there was no reason to disturb this policy when "every transactional planner now has [anti-sandbagging clauses] in her toolbox."[66]

The court, having endorsed the ability of parties to contractually manage the risk of sandbagging, concluded that when a warranty is breached, "the buyer may recover—regardless of whether she relied on the warranty or believed it to be true when made."[67] Such a buyer need only reasonably believe that they had acquired the seller's "promise to be truthful in its representations."[68] In other words, the only reasonable reliance a buyer need show is their belief that the promise was made, not that it was accurate.[69]

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61. *See, e.g.*, Whitehead, *supra* note 21, at 1084–85 (noting under pro-sandbagging rules, buyers need not have relied on the contents of warranties, but rather, on their having "bargained for the warranties as a means to allocate risk and minimize cost. . . . [T]he claim [is] that Buyer 'purchased the warranties' from Seller, and therefore, the cost of a sandbagging right was reflected in the price it paid." (footnotes omitted)).

62. *See, e.g.*, Stacey A. Shadden, *How to Sandbag Your Opponent in the Unsuspecting World of High Stakes Acquisitions*, 47 CREIGHTON L. REV. 459, 459 (2014) ("A 'sandbagging' buyer refers to the situation where a buyer is or becomes aware that a specific representation and warranty made by the seller is false, yet instead of alerting the seller to this fact, the buyer consummates the transaction, despite its knowledge of the breach, and seeks post-closing damages against the seller for the breach.").

63. *Arwood*, 2022 WL 705841, at *30 n.288 ("Many scholars have recently asked the question whether sandbagging is ethical . . . Under both European and Canadian law, the default rule is consistently in favor of anti-sandbagging. An anti-sandbagging provision appeals to one's sense of fairness . . . ." (citing Shadden, *supra* note 62, at 474)).

64. *Id.* at *30.

65. *Id.* Of course, this response rings hollow when its premise—that the relevant counterparties are able to adequately protect themselves—is inapplicable to the facts. Thus, the "unsettling" aspect of sandbagging is most apparent when a sophisticated buyer sandbags an unsophisticated seller, in which case the latter may not be able to effectively protect themselves by contract. *See* Aleksandra Miziolek & Dimitrios Angelakos, *Sandbagging: From Poker to the World of Mergers and Acquisitions*, MICH. BAR J., June 2013, at 30, 31 ("[S]ellers contend that it is fundamentally unfair to be subjected to full due diligence review by a buyer's sophisticated advisors only to have the buyer withhold discovered information, acquire the business, and seek to recover damages on a breach of warranty claim.").

66. *Arwood*, 2022 WL 705841, at *30. *But cf.* Kimball, *supra* note 25, at 586 (finding that, in a survey of 200 randomly selected purchase agreements, anti-sandbagging provisions appeared in less than 10% of the agreements).

67. *Arwood*, 2022 WL 705841, at *31.

68. *Id.*

69. See *supra* note 61 and accompanying text for a discussion of this concept.

B. Author's Analysis

Ultimately, *Arwood*'s pro-sandbagging disposition was unsurprising.[70] What makes *Arwood* remarkable—and disappointing—is what it did *not* say. In *Arwood*, there was an extreme disparity in sophistication between the sandbagger and sandbaggee.[71] In light of this disparity, the typical private ordering justifications for a pro-sandbagging rule were at their nadir; the ethical quandaries raised by sandbagging, their zenith.[72] Nevertheless, *Arwood* simply recited sandbagging's standard justifications and brushed off its ethical tensions.[73] In doing so, the court missed an opportunity to defend the wisdom of the pro-sandbagging rule even as applied to a situation for which the rule seemed highly inapt.

The court correctly noted that a pro-sandbagging rule is more consistent with Delaware's contractarian regime than an anti-sandbagging approach that requires resorting to the "amorphous and tort-like concept of assumption of risk."[74] In *Eagle Force*, the Delaware Supreme Court similarly endorsed a contract law, rather than tort law, approach to analyzing the role of reliance in breach of express warranty claims.[75] However, the court's reasoning that a reliance requirement would engender fact-intensive disputes revolving around what parties learned, or should have learned, in the course of due diligence,[76] is questionable.[77] Of course, a sandbagging approach that looks no further than the contract itself is more readily adjudicated than one that requires analyzing what the parties actually knew.[78] But the court held that "'sandbagging' is implicated only when a

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70. *See Arwood*, 2022 WL 705841, at *30 ("[Our pro-sandbagging] perspective is entirely consistent with, and driven by, the settled Delaware law that 'reliance is not an element of a claim . . . for breach of any of the representations or warranties in the agreement.'" (quoting Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *77 n.756 (Del. Ch. Oct. 1, 2018))).

71. *See infra* notes 96–102 and accompanying text.

72. *See infra* notes 94–111 and accompanying text.

73. *See Arwood*, 2022 WL 705841, at *28–31; *see also infra* notes 93–95.

74. *Arwood*, 2022 WL 705841, at *30 (quoting *Akorn, Inc.*, 2018 WL 4719347, at *77 n.756).

75. Eagle Force Holdings, LLC v. Campbell, 187 A.3d 1209, 1236 n.185 (Del. 2018) ("[T]he prevailing perception of an action for breach of express warranty [is] one that is no longer grounded in tort, but essentially in contract." (citing CBS Inc. v. Ziff-Davis Publ'g Co., 553 N.E.2d 997, 1001 (N.Y. 1990))).

76. *See Arwood*, 2022 WL 705841, at *30.

77. To the extent that the court was raising the issue of adjudication difficulties attendant with tort, rather than contract, analysis, this concern fits with the Delaware courts' policy rationale for their contractarian preferences—namely, efficiency. *See* Abry Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1059–60 (Del. Ch. 2006) ("On the other hand, there is also a strong American tradition of freedom of contract, and that tradition is especially strong in our State, which prides itself on having commercial laws that are efficient.").

78. *See* Jacek Jastrzębski, *"Sandbagging" and the Distinction Between Warranty Clauses and Contractual Indemnities*, 19 U.C. DAVIS BUS. L.J. 207, 248 (2019) (describing the hypothesis that "under the anti-sandbagging approach, the seller is awarded a knowledge-based defense that can lead to

buyer has actual knowledge that a representation is false.[79] This conception of sandbagging excludes constructive knowledge,[80] and therefore provides a narrower scope for the factual inquiry: the parties' actual knowledge.[81] Furthermore, this narrower scope obviates the need, in sandbagging disputes, to engage in an unwieldy, tort-law analysis regarding whether a party should be held to have constructive knowledge of facts because they acted with reckless indifference toward their existence.[82] Indeed, the scope of an inquiry into the buyer's knowledge is rendered even more judicially manageable by caveating that the buyer's only relevant knowledge is of facts disclosed by the seller himself—an approach taken by New York courts.[83] Under New York's approach, the breadth of any inquiry into a buyer's knowledge is significantly narrowed by considering only the information the buyer learned directly from the seller.[84] Therefore, the court's own cabining of sandbagging's knowledge inquiry to actual knowledge, combined with New York's example of a modified knowledge requirement, suggests that an anti-sandbagging framework need not necessarily overburden judicial economy.[85] Furthermore, judicial economy

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lengthy and costly court proceedings, including protracted evidentiary processes related to establishing the buyer's actual or constructive knowledge"); *see also supra* note 53 and accompanying text for additional discussion of judicial economy concerns in this context.

79. *Arwood*, 2022 WL 705841, at *32.

80. *See id.* at *31 (endorsing the proposition that "the applicable inquiry is what the buyer *knew* at the time of signing, not what the buyers *should have known*" (emphasis in original)).

81. *See* Brandon Cole, *Knowledge Is Not Necessarily Power: Sandbagging in New York M&A Transactions*, 42 J. CORP. L. 445, 451 (2016) (Under anti-sandbagging rules, "the problem of whether or not the buyer had knowledge prior to signing the agreement would need to be resolved before the buyer and seller could reach the merits of the breach of warranty claim. *This obstacle is magnified if the definition of* knowledge *includes not only actual knowledge, but also constructive knowledge.*" (emphasis added) (footnotes omitted)).

82. *See Arwood*, 2022 WL 705841, at *32 ("[R]ecklessness is not actual knowledge. And actual knowledge appears to be what is required to trigger the sandbagging inquiry . . . . (footnote omitted)); *see also* 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 LAW., Jan. 2007 (describing a seller that "does not wish to expose itself to the vagaries of extra-contractual claims based on what the seller might have known or might have told the buyer outside the four corners of the agreement.").

83. *See, e.g.*, Jastrzębski, *supra* note 78, at 218 (Under New York law, "knowledge received from the seller could bar potential claims related to breach of warranties, [while] information acquired from third parties would not have this effect on liability."); Galli v. Metz, 973 F.2d 145, 151 (2d Cir. 1992) ("Where a buyer closes on a contract in the full knowledge and acceptance of facts *disclosed by the seller* which would constitute a breach of warranty under the terms of the contract, the buyer should be foreclosed from later asserting the breach." (emphasis added)).

84. In *Arwood*, however, the scope of the inquiry into the buyer's knowledge would not have been narrowed by limiting the relevant knowledge under consideration to those facts disclosed by Arwood himself. Arwood granted the buyers total access to his company's financials, and the information therein provided the basis for their subsequent deal. *See Arwood*, 2022 WL 705841, at *9–11.

85. Of course, from a strict contractarian perspective, even a highly limited scope of investigation into issues of reliance is undesirable. *See* West & Shah, *supra* note 82 (suggesting that New York,

concerns with anti-sandbagging rules can be mitigated not only by a narrowed scope of what qualifies as "knowledge," but also by putting the burden of proving the buyer's knowledge upon the seller.[86]

The court's cursory treatment of sandbagging's "simply unfair or 'ethically questionable'"[87] nature left much to be desired. Indeed, the term "sandbagging" itself "carries a 'negative connotation,'"[88] and Chief Justice Strine's anti-sandbagging concurrence in *Eagle Force* seemingly reflected his moral uneasiness with the practice.[89] Chief Justice Strine cited "[v]enerable Delaware law"[90] to support his anti-sandbagging stance, but the antiquity of the source he cited, as well as a wealth of more recent cases with the opposite disposition,[91] suggests he was motivated not so much by precedent as by a perception that sandbagging—at least as manifested in *Eagle Force*—is an inequitable practice.[92] Therefore, the court would have done well to address the ethical aspect of sandbagging, which has also been raised by legal scholars, head-on.[93] Instead, the court acknowledged that there is "something [morally] unsettling" about sandbagging, but swiftly

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"having purportedly adopted the modern contract-based approach" to sandbagging, deviated from this approach "by suggesting that a buyer that closes a transaction in the face of a known breach by the seller of an express representation or warranty (at least in the circumstance where such breach is in fact disclosed to the buyer by the seller prior to closing) waives its rights to sue on that known breach").

86. *See* Whitehead, *supra* note 21, at 1107 ("[I]mposing on sellers the burden of proving buyers' knowledge is consistent with the doctrine of waiver, and limiting its scope—such as only to information that sellers expressly give to buyers—can further assist in mitigating litigation costs." (footnote omitted)).

87. *Arwood*, 2022 WL 705841, at *30 ("Others view sandbagging as simply unfair or 'ethically questionable.'").

88. *Id.* at *28 (quoting Shadden, *supra* note 62, at 459).

89. Eagle Force Holdings, LLC v. Campbell, 187 A.3d 1209, 1247 (Del. 2018) (Strine, C.J., concurring in part and dissenting in part) ("[T]o the extent Kay is seeking damages because Campbell supposedly made promises that were false, there is doubt that he can then turn around and sue because what he knew to be false remained so.").

90. *Id.*

91. Chief Justice Strine cited *Clough v. Cook*, 87 A. 1017, 1018 (Del. Ch. 1913). More recent Delaware caselaw with a pro-sandbagging disposition includes *Interim Healthcare, Inc. v. Spherion Corp.*, 884 A.2d 513, 548 (Del. Super. Ct. 2005), and *Gloucester Holding Corp. v. U.S. Tape & Sticky Products, LLC*, 832 A.2d 116, 127 (Del. Ch. 2003).

92. *But see* Cleary, *supra* note 27, at 844 (arguing that Chancellor Strine's *Eagle Force* concurrence was advocating that reliance on the representation being *part of the contract* is necessary, rather than reliance on the *accuracy* of the representation itself).

93. *See, e.g.*, Shadden, *supra* note 62, at 474 ("An anti-sandbagging provision appeals to one's sense of fairness and often, in negotiations where non-attorneys are present, will make more sense than buyer's argument to 'close the merger and then sue . . . for an inaccurate representation even if [buyer] clearly knew . . . the representation was dead wrong.'" (alterations in original) (footnote omitted)); Cole, *supra* note 81, at 453 ("In the viewpoint of a seller, it is unfair for a buyer to not disclose that they know the seller is potentially breaching the contract and then not say something to fix the problem prior to closing the deal."); Jastrzębski, *supra* note 78, at 248 ("If one party, in good faith, assures the other of certain circumstances and the other accepts this assurance with awareness of its falsity (with the intention of 'buying a claim'), then the latter party's conduct may be unethical or possibly bad faith.").

dismissed these concerns because the risk of sandbagging "can be managed expressly in the bargain the parties strike."[94]

This perfunctory, private-ordering-based dismissal of sandbagging's ethical problems, while certainly standard pro-sandbagging judicial fare,[95] was particularly unsatisfying in light of *Arwood*'s facts. Indeed, *Arwood* poses a stark example of how sandbagging can raise ethical questions to which "private ordering" presents a deeply unsatisfactory answer.[96] Arwood "was a decidedly unsophisticated seller"[97] who contracted with "highly sophisticated, intelligent buyers"[98] whom he "implicit[ly] trust[ed]."[99] Arwood furnished the buyers with "nearly unlimited access"[100] to both his business and personal financial records to enable them to conduct due diligence.[101] On these facts, *Arwood* raises the specter of a highly sophisticated seller taking advantage—by way of sandbagging—of a commensurately unsophisticated buyer, and thus a private ordering justification for sandbagging in this context seems incongruous.[102] When such a "substantial (and unusual) disparity in the business acumens of buyer and seller"[103] exists, the court's assertion that the buyer's risk of sandbagging can be managed through contractual "private ordering" rings hollow.[104] As Delaware case law reflects, a preference for private ordering

94. Arwood v. AW Site Servs., LLC, No. 2019-0904-JRS, 2022 WL 705841, at *30 (Del. Ch. Mar. 9, 2022).

95. *See, e.g.*, 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*, 945 A.2d 594 (Del. 2008) ("Having contractually promised Cobalt that it could rely on certain representations, Crystal is in no position to contend that Cobalt was unreasonable in relying on Crystal's own binding words.").

96. Private ordering justifications for sandbagging tend to assume that the contracting parties are sophisticated. *See, e.g.*, West & Shah, *supra* note 82 ("When a contract is negotiated between *sophisticated* parties and those risks have been thus contractually allocated, tort-based concepts should not be permitted to create uncertainty in either party's rights or obligations." (emphasis added)); *Arwood*, 2022 WL 705841, at *30 ("'[A]nti-sandbagging clauses' have emerged as effective risk management tools that every transactional planner now has in her toolbox.").

97. *Arwood*, 2022 WL 705841, at *2.

98. *Id.*

99. *Id.* at *11.

100. *Id.*

101. *Id.* at *9.

102. *See, e.g.*, Kimball, *supra* note 25, at 583–84 ("Edgarton and Quigley wrote that 'given the robust body of Chancery Court case law and the jurisdiction's longstanding embrace of freedom of contract between *sophisticated* corporate parties, Delaware courts appear likely to continue to affirm a strict pro-sandbagging approach.'" (emphasis added) (citation omitted)).

103. *Arwood*, 2022 WL 705841, at *22.

104. *See, e.g.*, Norton v. Poplos, 443 A.2d 1, 7 (Del. 1982) ("We see no reason why a court of equity should enforce a standard 'boiler plate' provision that would permit one who makes a material misrepresentation to retain the benefit resulting from that misrepresentation at the expense of an innocent party."); James v. Nat'l Fin., LLC, 132 A.3d 799, 827–28 (Del. Ch. 2016) (noting that in unconscionability analyses, "Delaware decisions also exhibit sensitivity to situations in which a sophisticated actor has taken advantage of someone who is underprivileged, unsophisticated, uneducated, or illiterate").

does not require affording inequitable actors cart blanche, nor does it require that the courts give their imprimatur to inequitable practices.[105]

Because *Arwood*'s contracting parties were so mismatched in terms of their sophistication, the "information-forcing" rationale for a pro-sandbagging default rule also bears less weight.[106] The "information-forcing" rationale assumes that, when contracting parties face a significant information asymmetry, a default pro-sandbagging rule will force the seller to either divulge more information or otherwise bear the risk of any inaccuracies in their disclosures.[107] Yet the force of this rationale has been criticized when "differences in party sophistication" exist among contracting parties.[108] Furthermore, the usual rebuttal to this criticism—namely, that parties to M&A transactions are typically sophisticated[109]—even if broadly accurate, clearly was not descriptive of the seller in *Arwood*.[110] Not only does the information-forcing rationale bear less weight when contracting parties are unequally sophisticated, it is also entirely inapposite under the facts of *Arwood*, where the seller actually provided the buyer with complete access to all the relevant information that they had available.[111]

Nevertheless, it can be argued that a baseline assumption that M&A counterparties are sophisticated is generally accurate,[112] notwithstanding

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105. *See, e.g.*, Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) ("[I]nequitable action does not become permissible simply because it is legally possible.").

106. For a discussion of default rules and "information-forcing," see generally Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989). For a discussion of default rules as applied to sandbagging, see Whitehead, *supra* note 21, at 1100–08.

107. Such an argument is employed in *Arwood*:

> Due diligence is expensive and parties to contracts in the mergers and acquisitions arena often negotiate for contractual representations that minimize a buyer's need to verify every minute aspect of a seller's business. In other words, representations like the ones made in [the agreement] serve an important risk allocation function.

Arwood, 2022 WL 705841, at *30 (quoting 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*, 945 A.2d 594 (Del. 2008)).

108. Cleary, *supra* note 27, at 837.

109. *See id.* at 837–38 ("In other contexts, the theoretical justification for selecting penalty defaults to promote efficient markets has been criticized based primarily on differences in party sophistication; however, unlike those contexts, in M&A negotiations, both parties are likely to be relatively sophisticated."); *see also Arwood*, 2022 WL 705841, at *30 ("'[A]nti-sandbagging clauses' have emerged as effective risk management tools that every transactional planner now has in her toolbox.").

110. The court described Arwood as an "alarmingly unsophisticated businessman" who "lacked the know-how or inclination to prepare financial records or to formulate useful valuations." *Arwood*, 2022 WL 705841, at *22, *1.

111. *Id.* at *11.

112. *See, e.g.*, Robert T. Miller, *Rule 10b-5 and Business Combination Transactions*, 21 U. PA. J. BUS. L. 533 (2019) ("Parties to large business combination transactions are paradigmatically sophisticated, profit-maximizing entities.").

that certain private equity transactions, like that in *Arwood*,[113] feature a seller that is an unsophisticated small business.[114] Indeed, even in such transactions, it has been argued that sellers are protected from unfair sandbagging because private equity buyers "cannot afford to risk ruining their reputation in order to help ensure they are not neglected by future sellers."[115] But the *Arwood* court, far from relying on the existence of such protections for unsophisticated entities like *Arwood*'s seller, instead presented a justification for sandbagging that, counterfactually in context, assumed the seller was in fact sophisticated.[116]

CONCLUSION

Arwood was a predictable installment in Delaware's pro-sandbagging tradition. Its conclusions echoed those of other post-*Eagle Force* cases that, despite *Eagle Force*'s calling into question the status of Delaware's sandbagging law,[117] have resoundingly affirmed the state's pro-sandbagging posture.[118] What is surprising about *Arwood*, however, was the court's near refusal to address the moral uneasiness that sandbagging raised in the case. Discomfort with sandbagging's moral dimensions has haunted Delaware caselaw, but this concern is often readily dismissed as undue solicitude for highly sophisticated M&A litigants.[119] *Arwood* presented an opportunity to justify the pro-sandbagging rule as applied against a manifestly *unsophisticated* party.[120] Unfortunately, the court chose not to explore the equitable implications of sandbagging so clearly raised on the facts of the case.

Jack Podolsky[*]

113. Broadtree Partners, the buyer in *Arwood*, was a private equity firm. *Arwood*, 2022 WL 705841, at *1.

114. *See, e.g.*, Jason D. Navarino & Christine N. Restrepo, *Selling to Private Equity: Not an Exit, but a New Chapter*, N.J. LAW. MAG., Aug. 2021, at 28, 32–33 ("The private equity market offers business owners tremendous opportunity to make a lucrative exit from established businesses with a track record of success. But sellers in private equity deals must realize that their deal counterparties are likely to be highly experienced in M&A deals . . . .").

115. Cole, *supra* note 81, at 452.

116. Compare the court's finding that "[a]lthough the typical dynamic is that the buyer relies on the seller for the accuracy of the financial statements, this case strangely presents the opposite dynamic," *Arwood*, 2022 WL 705841, at *33, with the court's assertion that the buyer was "entitled to believe that it was 'purchasing [the Selling Entities'] promise' that the representations and warranties were true, and it may recover damages if that promise was breached." *Id.* at *31 (alteration in original).

117. *See supra* notes 38–39 and accompanying text.

118. *See supra* note 56 and accompanying text.

119. *See supra* notes 87–94, 106–10 and accompanying text.

120. *See supra* note 110 and accompanying text.

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