“SANDBAGGING” AND THE DISTINCTION BETWEEN WARRANTY CLAUSES AND CONTRACTUAL INDEMNITIES

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I. RESEARCH PROBLEM AND APPROACH

In a merger and acquisitions (M&A) setting, the buyer typically collects information on the target company. The seller or the target mostly provides information during the due diligence process, but the buyer may also obtain information independently. Finally, the transactional agreement includes a set of warranties related to the operations of the target company. These warranties state certain facts or circumstances that render the party who made a warranty (the warrantor) liable to the party receiving such a warranty (the warrantee) for losses if the warranty is not true. Now, let us assume that the buyer of a business knew while entering into the agreement that some of the warranties given by the seller were not true¹ and later claimed breach of warranty. This issue has become known in the United States as “sandbagging;”² a warrantee “sandbags” the

¹ For the time being I put aside the source of the buyer’s knowledge, whether it was derived from the information provided by the seller or acquired otherwise.

² The term “sandbagging” is said to have various roots, from Nineteenth Century gang wars, Stacey A. Shadden, How to Sandbag Your Opponent in the Unsuspecting World of High Stakes Acquisitions, 47 CREIGHTON L. REV. 459 (2014); 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. 3 (2007); through poker, Aleksandra Miziolek & Dimitros Angelakos, From Poker to the World of Mergers and Acquisitions, 92 MICH. B.J. 30 (2013); Charles K. Whitehead, Sandbagging: Default Rules and Acquisition Agreements, 26 DEL. J. CORP. L. 1081, 1083 n.4 (2011); to golf, Shadden, supra, at 459; West & Shah, supra, at 3.

warrantor if he enters into an agreement knowing that a warranty clause is incorrect and subsequently brings a claim against the warrantor for the breach of warranty that was known to the warrantee on the execution date. The question is whether the buyer’s knowledge that the warranty is untrue shall prevent him from bringing a warranty claim. According to the “pro-sandbagging” approach, the buyer’s knowledge shall not prevent him from bringing a successful claim for breach of warranty. Conversely, the “anti-sandbagging” approach bars claims by a buyer who knew that the warranty was untrue.

The research I conducted on the topic of sandbagging leads to several interesting conclusions, which I discuss in this paper. The first interesting observation is that legal systems vary significantly on this topic. In the United States, state laws differ in their approach to the sandbagging problem. The trend in the United States is to move towards the pro-sandbagging rule. The most prominent U.S. corporate jurisdictions (Delaware and New York) generally follow the pro-sandbagging approach, which some also believe to be the modern approach. Since New York’s approach is more nuanced, and there are prominent M&A cases dealing specifically with this problem, I will use New York law as proxy for modern U.S. law in this respect. Under English law, anti-sandbagging is the general rule. Despite the lack of clear authority on this matter, it may be inferred from case law that English courts are more likely to adopt the anti-sandbagging approach. This appears also to be true for continental Europe, where the patterns of practice seem to generally follow English law as far as M&A contracting is concerned, and in respect of sandbagging specifically. Therefore, the English model will be also used as proxy for European market practice.

The second observation is that, in U.S. law, there is no clarity — both in terms of statutes and case law — across various state laws on the approach; agreements very often remain silent on this issue, thereby leaving its resolution to the default rules of each state. Therefore, the default rules may be important, even though parties can contract for a pro-sandbagging or anti-sandbagging solution in their agreement.

In this paper, I firstly present the different approaches taken by U.S. and English law with respect to the functional distinction between contractual warranties and indemnifications. This serves as an introduction of the various

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3 Whitehead, supra note 2, at 1083; e.g., id. at 1108–15 for a survey of 21 state laws and their approach to sandbagging. Since contract law is largely governed by state law and not federal law, whenever in this paper I refer to “U.S. law” or “the U.S.” I am referencing state law across the country and the states as a group rather than federal laws or institutions.

4 See Duchemin, supra note 2, at 701; Whitehead, supra note 2, at 1087.

5 See Whitehead, supra note 2, at 1103, for Europe; see also Shadden, supra note 2, at 474, for Canada and Europe.
approaches to sandbagging. Secondly, I present the currently prevailing American approach, with reliance being one of the conditions, and the doctrinal consideration underlying this approach. This approach departed from the traditional common law approach to warranty liability. Thirdly, I discuss why the default rule on sandbagging is relevant, even though the parties could potentially contract out the rule’s effects. Fourthly, I present fairness and efficiency considerations related to sandbagging. Finally, I also propose further efficiency arguments which I believe to support the English default rule — with no sandbagging, but with identified risks covered by specific indemnities.

II. WARRANTIES AND CONTRACTUAL INDEMNITIES: ENGLISH AND U.S. STANDARDS COMPARED

Under English M&A practice, there is a relatively clear functional distinction between warranties and contractual indemnities. Warranties protect buyers against unknown risks, while indemnities protect against specific identified (known) risks. Typically, the buyer is only successful in seeking a contractual indemnity for a specific risk that he has identified (e.g., during his due diligence) and potentially for residual tax liabilities. If for some reason — e.g., due to the difficulty in assessing the probability of the materialization or quantification of a risk — the parties agree not to deduct the value at risk from the price, but to have it otherwise economically covered by the seller, the indemnity clause is a proper contractual tool for such an allocation. One reason for using contractual indemnities is that the buyer cannot expect to address the identified risk through warranties because his knowledge of this risk is likely to preclude him from bringing a successful warranty claim. Accordingly, the

8 Charles Russell LLP, *supra* note 7, at 3.
10 Agnew, *supra* note 6, at 3; SINCLAIR ON WARRANTIES AND INDEMNITIES ON SHARE AND ASSET SALES 5 (Robert Thompson ed., 10th ed. 2017). There may be additional reasons, since under English law other benefits of indemnities vis-à-vis warranties have been identified as well. They relate to the measure of compensation (under a warranty claim the adequate measure is the measure of damages for breach of contract, while an indemnity claim allows the indemnitee to recover dollar-per-dollar the entire “liability or loss” related to a specific risk. SINCLAIR ON WARRANTIES AND INDEMNITIES ON SHARE AND ASSET SALES 4–5 (Robert Thompson ed., 10th ed.
indemnity clause is the contractual tool for allocating to the seller a risk that is known to the buyer. Pre-signing disclosure or knowledge generally operates against warranties by limiting the potential recovery thereunder, but they do not operate against indemnities.

The U.S. standard is to generally have all the warranties backed by indemnities. Hence, the U.S. contractual practice distinguishes “general indemnities” (“regular indemnities”) and “standalone indemnities” (“special indemnities”). A “general indemnification” provides that the seller (as the indemnitor) will indemnify the indemnitees (the parties receiving indemnification) for losses incurred by the indemnitees as a result of the indemnitor’s breach of representations, warranties, covenants or other obligations under the transaction documents.

Conversely, “standalone indemnities” (“special indemnities”) are not related to any underlying breach (of a representation or warranty or covenant or other obligation of the indemnitor) but cover specific matters, separately and independently from the general indemnities. Such “standalone indemnities” are said to typically cover two separate types of matters: (1) matters for which the buyer does not wish to assume any post-closing responsibility (tax liability can be an example); and (2) matters arising during the buyer’s diligence that pose an unusual, unexpected, or unquantifiable risk. In the U.S., all representations and warranties are generally backed by the seller’s obligation to indemnify for any breach of them, so the distinction in acquisition agreements between representations and warranties on one hand and contractual indemnifications on the other becomes vague; in each case the buyer will technically bring an

2017) (“On a more general basis, indemnities also arose in circumstances where damages for breach of warranty might not have put the purchaser in a position to rectify the problem without cost to itself; for example, if the defect in one of the acquired assets did not affect the overall value of the company, an indemnity, which gives rise to an automatic right to payment in prescribed circumstances might be more appropriate.”); see also Agnew, supra note 6, at 3. To the non-applicability to the indemnities of certain doctrines that apply to contractual damages (remoteness, foreseeability, duty to mitigate, see also Agnew, supra note 6, at 3. In this respect, the main advantage of having an indemnity for the buyer is that he does not have to demonstrate the impact on the value of the target shares, but can easily enforce his indemnity claim for the amounts of the liability or loss incurred. The relatively easy enforcement of indemnity claims is said to make sellers unwilling to agree on indemnities, Charles Russell LLP, Warranties and Indemnities Explained, BOXINGTON 3, except for cases where there is a specifically identified risk that the parties agree to allocate to the seller under an indemnity clause rather than deduct from the price. A discussion on the different measures of compensation remains beyond the scope of this paper.


12 Id. at 1–3.

13 Id. at 2.
indemnification claim.\textsuperscript{14} However, a “general indemnity” is triggered by a breach of representation or warranty (or another promise referred to in the general indemnity clause), while the “standalone indemnity” does not require any breach but solely “liability or loss” being incurred in connection with the indemnified matters (e.g., tax liability, environmental liability, specified litigation, etc.).\textsuperscript{15}

The English (and European) application of contractual indemnities corresponds to the American concept of “standalone indemnities.” The standard of having every breach of contract (including breach of warranty) backed by a “general indemnity” has not been followed in the English and European market.\textsuperscript{16}

\textsuperscript{14} Another difference is that modern U.S. contracting practices do not distinguish representations, warranties, and indemnification clauses. It is said that in U.S. law, “there is no longer any distinction in contract between a warranty, a representation, and a separately indemnifiable matter in the U.S. (if there ever was).” West & Shah, supra note 2, at 5. This appears contrary to the traditional approach of English law which distinguished representations, as statement of facts potentially giving rise to tort claims and rescission rights, and warranties, as contractual promises in which a breach could entitle the warrantee to claim damages for breach of contract, but not to rescind the agreement. See Zakrzewski, \textit{Representations and Warranties Distinguished}, BUTTENSOWTH J. INT. BANKING & FIN. L. 341, 342 (2013). Typically, under English law, a seller would deliberately avoid the notion of “representation” (and only give “warranties”) in the acquisition agreement to channel the effects of a potential breach through contract claims only and prevent any “importation of tort concepts into a contractual arrangement.” West & Shah, \textit{supra} note 2, at 4–5. Contrarily, under U.S. law the concept of “representations and warranties” is generally used uniformly, without regard to the tort-based nature of the first and the now-contractual nature of the latter. See Kenneth A. Adams, \textit{Eliminating the Phrase “Represents and Warrants” from Contracts}, 16 TENN. J. BUS. L. 203, 203 (2015), for critical comments on this contractual practice. I believe the American approach, foregoing earlier distinctions between representations and warranties, is the better one, particularly from the standpoint of certainty of contract and the priority of private ordering. An extensive discussion related to the benefits of a uniform and contractual approach to both misrepresentation and warranty remains beyond the scope of this paper. For recent American writing on potential contractual approach to negligent representations, see Mark P. Gergen, \textit{Negligent Misrepresentation as Contract}, 1 CALIF. L. REV. 953, 953 (2013). I fully agree that “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.” West & Shah, \textit{supra} note 2, at 7. From the point of view of this paper, however, it is not the vanishing distinction between representations and warranties that is critical. It is rather the functional difference between the warranties and the contractual indemnifications.

\textsuperscript{15} Avery & Huang, \textit{supra} note 11, at 3.

\textsuperscript{16} See Charles Russell LLP, \textit{supra} note 7, at 3 (“The UK has so far resisted the buyer-friendly approach common in US M&A transactions under which all warranties are given ‘on an indemnity basis.’ The UK practice is for sellers to only give indemnities in respect of specifically identified risks.”). The American standard is viewed as buyer-friendly as it allows the buyer to bring a claim without demonstrating the damage as it would be required under the rules applicable to damages for breach of contract. See also Agnew, \textit{supra} note 6, at 3. English writing perceives the standard as buyer friendly due to a potentially different scope of liability under a contractual indemnity and under a warranty clause in English law. This difference is rooted in the historic distinction of the action of debt and will not be discussed in this paper. See WAYNE COURTNEY, \textit{CONTRACTUAL INDEMNITIES} (Oxford, 1st ed. 2014); Rafal Zakrzewski, \textit{The Nature of a Claim on an Indemnity}, 22
What appears to also distinguish the U.S. and the English (European) acquisition practice is the significance of the buyer’s knowledge in the context of the enforceability of his warranty claims.\textsuperscript{17} While both legal systems lack full clarity on this matter, under English law, it is rather assumed that the buyer’s knowledge that the warranty is untrue can prevent him from bringing a successful warranty claim.\textsuperscript{18} Despite the lack of clear authority, some court opinions support this view. In \textit{Eurocopy plc v. Teesdale},\textsuperscript{19} there was a contractual provision that the warranties given were subject only to the matters set out in the disclosure letter — but that no other information of which the buyer had actual, constructive, or imputed knowledge would preclude the buyer claiming breach of warranty or reduce any amount recoverable in respect of breach of warranty.\textsuperscript{20} The court suggested that a buyer may be prevented from bringing a warranty claim if he has actual knowledge of certain facts, even if they are not in the disclosure letter.\textsuperscript{21} Accordingly, a general clause allowing the buyer to bring warranty claims irrespective of his knowledge may be unenforceable under English law.\textsuperscript{22} Furthermore, absent any contractual regulation of the buyer’s knowledge of circumstances that render a seller’s warranty incorrect, the buyer is still barred from bringing a successful warranty claim. This default rule appears to follow the anti-sandbagging approach. Ultimately, under the English and European acquisition agreement standard, risks that have been identified by the buyer


\textsuperscript{18} \textit{Id.} at 5–6; McNaughton & Poxon, \textit{supra} note 9, at 3–4.

\textsuperscript{19} \textit{Eurocopy v. Teesdale, B.C.L.C. 1067 (1992).}

\textsuperscript{20} \textit{JONESDAY COMMENTARY, supra note 17, at 5–6.}

\textsuperscript{21} However, since only an interlocutory hearing was held and the parties settled, the court has not reached a final decision. It is said, though, that the obiter dicta in later cases do not disagree with the court’s approach in Eurocopy. McNaughton & Poxon, \textit{supra} note 9, at 3; \textit{JONESDAY COMMENTARY, supra note 17, at 6.}

\textsuperscript{22} It is unclear to what extent this approach was followed by the dicta in \textit{Infiniteland v. Artisan Contracting Ltd, [2005] EWCA Civ. 758 (2005); see JONESDAY COMMENTARY, supra note 17, at 6; McNaughton & Poxon, supra note 9, at 3. The issues discussed in this case related to the distinctions between actual knowledge and constructive knowledge, and actual knowledge and imputed knowledge. In particular, the question was whether the buyer’s accountants’ knowledge can be viewed as seller knowledge (absent a contractual language extending the definition of buyer’s knowledge to his agents’ knowledge) — the court answered this question negatively, while saying that parties are free to provide for a broader definition of “buyer’s knowledge.” See JONESDAY COMMENTARY, supra note 17, at 6. However, what may flow from this case, is that generally at least buyer’s actual knowledge of the warranty being false will preclude his claims for a breach thereof.
before signing the acquisition agreement should be dealt with under a contractual indemnity. Warranties may not afford the buyer any protection as his knowledge can bar warranty claims.

In U.S. law, however, legal literature clearly posits that the pro-sandbagging approach is the modern trend in acquisition agreements. While specific pro-sandbagging or anti-sandbagging contractual clauses are enforceable, the default rule (be it the U.S. rule or the English rule) remains relevant for reasons discussed in more detail below.

III. APPROACH TO SANDBAGGING IN U.S. LAW

United States law on sandbagging is “surprisingly unsettled” and varies considerably across the states. Legal journals have identified a trend of wider

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23 In the European standard, the focus is mainly on the signing knowledge, since all warranties may not necessarily be repeated at closing and if they are deemed repeated of if the seller is to repeat them at closing there will be typically a specific contractual framework for interim period (post-signing, pre-closing) disclosures. Moreover, a breach of warranty generally does not allow the buyer to walk away from a transaction, leaving him only with a post-closing claim. This is different in the U.S. market, where all representations and warranties are typically to be repeated at closing and any breach of any of these representations or warranties allows the buyer to walk away from the transaction; additionally in U.S. public deals representations and indemnities typically expire at closing. See John C. Coates, Allocating Risk Through Contract: Evidence from M&A and Policy Implications, HARVARD LAW SCHOOL JOHN M. OLIN CENTER FOR LAW 729, 26 (Aug. 22, 2012); CLAIRE HILL, BRIAN QUINN, & STEVEN DAVIDOFF SOLOMON, MERGERS & ACQUISITIONS: LAW, THEORY AND PRACTICE 409 (West Academic, 1st ed. 2015). Therefore, in the U.S. the sandbagging problem may appear in two timing dimensions. Firstly, it may relate to the pre-signing knowledge of the buyer who accepts warranties at signing while knowing of them being untrue as of this date. Secondly, there is the case of the buyer who acquires knowledge of the facts rendering a warranty untrue in the interim period (between signing and closing) but nonetheless proceeds with closing despite being entitled to walk away. Accordingly, the “sandbagging” question in the U.S. may require an additional distinction. See West & Shah, supra note 2, at 7.


25 Duchemin, supra note 2, at 693–704; Whitehead, supra note 2, at 1087.

26 Whitehead, supra note 2, at 1083.

27 Duchemin, supra note 2, at 693–704; Whitehead, supra note 2, at 1108–15 (comparing selected state laws). California is typically said to be a “reliance” state, where the buyer needs to demonstrate reliance to the warranties. Cole, supra note 2, at 449; Whitehead, supra note 2, at 1087. California law is contrasted with Delaware law where reliance is not required. Cole, supra note 2, at 448; Whitehead, supra note 2, at 1087. Matthew Duchemin contrasts Kansas and Minnesota law on the one hand with New York and Indiana law on the other hand. Duchemin, supra note 2, at 693–704. New York law, a prominent jurisdiction for acquisition agreements, is sometimes also said to follow the “contractual” or “non-reliance” trend. Whitehead, supra note 2,
approval for the pro-sandbagging approach. Typically, the states that follow the anti-sandbagging rule are more strongly rooted in the tortious nature of warranty liability, while those that adopt the pro-sandbagging rule have moved to the modern, contractual approach to warranty liability. Legal writing has classified states according to their approach to the sandbagging issue based on a thorough survey of available case law. A number of states, including some prominent contract law jurisdictions such as California, tend to preclude a warranty claim of a buyer who knowingly accepted an incorrect warranty. Others, such as Delaware, either do not bar such claims or follow a more nuanced approach (New York). Generally, there are two observations based on the comparative (interstate) and empirical analysis.

Firstly, the trend is that U.S. state law is gradually moving from anti-sandbagging positions to pro-sandbagging positions. This trend also coincides with the changing approach to warranty liability and its roots in tort law. While U.S. law has long recognized the generally contractual nature of warranty liability, tort elements remained a part of the warranty theory. The move from anti-sandbagging to pro-sandbagging is a step in finally abandoning the reliance requirement, which is a remnant of a tort-based doctrine, in warranty law. The doctrinal discussion related to sandbagging focuses strongly on the reliance requirement.

Secondly, the two most prominent American corporate and M&A jurisdictions, Delaware and New York, have adopted the pro-sandbagging rule as their default. While some Delaware courts have held explicitly that reliance is not required to bring a claim related to breach of warranties, the approach under New York law remains more nuanced.

In one of the widely cited cases, a New York state court found that the buyer’s knowledge of the circumstances giving rise to a warranty breach shall not preclude his warranty claim. The court cited to Judge Learned Hand’s definition at 1087. But see id. at 1091 n.35. Yet its position appears more nuanced and can be fairly characterized as being “in between” Delaware and California. Cole, supra note 2, at 449; for further reading on the developments and distinctions under New York law in this field, see also Iovine, supra note 2; Kornfeind, supra note 2, at 680; Quaintance, supra note 2.

See Miziolek & Angelakos, supra note 2, at 34; Whitehead, supra note 2, at 1084. By referring to a rule as a “pro-sandbagging” rule I mean a rule that allows the warrantee to bring warranty claims notwithstanding the former’s knowledge of the circumstances giving rise to a warranty claim. Conversely, the “anti-sandbagging” rule precludes the warranty from bringing such claims if he had known of the relevant circumstance constituting the breach of warranty.
of warranty as “an assurance by one party to a contract of the existence of a fact upon which the other party may rely” which “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.” The court also held that the analysis of reliance requirement in actions for breach of express warranties adopted in Ainger was correct. Ultimately, the New York Court of Appeals held that “[t]he critical question is not whether the buyer believed in the truth of the warranted information, as Ziff–Davis would have it, but ‘whether [it] believed [it] was purchasing the [seller’s] promise [as to its truth.]’” The requirement of reliance will be satisfied by the buyer’s reliance on the express warranty being a part of the bargain between the parties. The court provided the following commentary:

The express warranty is as much a part of the contract as any other term. Once the express warranty is shown to have been relied on as part of the contract, the right to be indemnified in damages for its breach does not depend on proof that the buyer thereafter believed that the assurances of fact made in the warranty would be fulfilled. The right to indemnification depends only on establishing that the warranty was breached[.] At first glance, this may be a clear demonstration of New York law following the pro-sandbagging approach. However, it is crucial to note that in this case, the buyer acquired knowledge in the interim period (post-signing, pre-

35 Metropolitan Coal Co. v. Howard, 155 F.2d 780, 784 (2d Cir. 1946).
36 CBS, Inc., 553 N.E.2d at 1000.
37 Id. at 1001.
38 Id.
39 Id.
closing) and not prior to signing. Moreover, in CBS, there was a dispute between the parties in the pre-closing period on whether the warranty was breached, and the buyer proceeded with closing while expressly reserving his rights related to the discovered warranty breach. Therefore, the CBS conclusion does not imply that a buyer who had the knowledge of a warranty breach as of the date of contracting (signing, as opposed to closing) would be precluded from bringing a claim related to such breach.

In a later case, the Second Circuit (applying New York law) distinguished CBS and limited the application of the pro-sandbagging rule by distinguishing cases where there was a dispute between the parties regarding the truth of the warranties from cases where both parties were aware of the warranties’ falsity.\(^40\) The federal court also held the following:

\[\text{Ziff–Davis has far less force where the parties agree at closing that certain warranties are not accurate. 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.} \(41\)\]

The federal court distinguished cases based on the source of the buyer’s knowledge. If the knowledge comes from the seller and the matter was discussed between the parties, the seller may argue that the buyer waived his claim for a breach related to the facts that were known to him. If, however, “a third person disclosed the problems to [the buyer]” it may be assumed “that [the buyer] purchased the sellers’ warranty as insurance against any future claims.”\(^42\) In such a situation, the buyer would have a strong claim.

Subsequently, federal courts struggled to apply New York law, which involved reconciling the broad wording of the Aigner and CBS rulings with the limitations coming from the factual background of CBS and also the limiting language of Galli. On the one hand, those federal courts appear to confirm the general pro-sandbagging trend,\(^43\) but on the other hand, they introduce additional conditions\(^44\) and further build upon some of the distinctions, such as the

\[\begin{align*}
40\text{ Galli v. Metz, 973 F.2d 145, 151 (2d Cir. 1992).} \\
41\text{Id. at 151.} \\
42\text{Id.} \\
43\text{“In contrast to the reliance required to make out a claim for fraud, the general rule is that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue. Rogath v. Siebenmann, 129 F.3d 261, 265 (2d Cir.1997) (stating that buyer with knowledge of falsity of warranted facts may purchase seller’s warranty as insurance against future claims); Vigortone AG Prods., Inc. v. PM AG Prods., Inc., 316 F.3d 641, 648 (7th Cir. 2002).” Merrill Lynch & Co. Inc. v. Allegheny Energy, Inc., 500 F.3d 171, 186 (2d Cir. 2007).} \\
44\text{“This rule is subject to an important condition. The plaintiff must show that it believed that it was purchasing seller’s promise regarding the truth of the warranted facts. . . We have held that}\n\end{align*}\]
distinction related to the sources of buyer’s knowledge. In *Gusmao v. GMT*, the U.S. District Court for the Southern District of New York, applying New York law in an acquisition setting, followed a 1997 Second Circuit decision by finding that the particular conception of reliance in the law of express warranties mandates “fine factual distinctions in [New York’s] law of warranties: a court must evaluate both the extent and the source of the buyer’s knowledge about the truth of what the seller is warranting.” Where the “seller is not the source of the buyer’s knowledge, e.g., if it is merely ‘common knowledge’ that the facts warranted are false, or the buyer has been informed of the falsity of the facts by some third party, the buyer may prevail in his claim for breach of warranty. In other words, while knowledge received from the seller could bar potential claims related to breach of warranties, information acquired from third parties would not have this effect on liability. This distinction appears to follow the opinion of the *Galli* court, which held that if the buyer’s knowledge comes from a third party (and not from the seller) the buyer may be just purchasing insurance.

Ultimately, there appears to be a general pro-sandbagging trend across U.S. state laws. The most prominent American transactional jurisdictions — Delaware and New York — tend to follow this trend, with New York law being more nuanced in this respect. Given this trend in Delaware and New York, despite the unsettled approach of U.S. law on sandbagging, the U.S. approach where the seller has disclosed at the outset facts that would constitute a breach of warranty, that is to say, the inaccuracy of certain warranties, and the buyer closes with full knowledge and acceptance of those inaccuracies, the buyer cannot later be said to believe he was purchasing the seller’s promise respecting the truth of the warranties.” Merrill Lynch & Co. Inc., 500 F.3d at 186.

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46 *Rogath*, 129 F.3d at 264. Despite *Rogath* being higher authority, I have cited primarily to *Gusmao* because *Rogath* is not an M&A case, while *Gusmao* is.
48 *Rogath*, 129 F.3d at 265; followed by *Gusmao*, 2008 WL 2980039, at *5. According to the court, in such a situation, it is “not unrealistic to assume that the buyer purchased the seller’s warranty ‘as insurance against any future claims,’ and that is why he insisted on the inclusion of the warranties in the bill of sale.” *Rogath*, 129 F.3d at 265.
49 Or, as the Second Circuit puts it:

In short, where the seller discloses up front the inaccuracy of certain of his warranties, it cannot be said that the buyer — absent the express preservation of his rights — believed he was purchasing the seller’s promise as to the truth of the warranties. Accordingly, what the buyer knew and, most importantly, whether he got that knowledge from the seller are the critical questions.

50 ”“Whether the ‘basis of the bargain’ requirement implies that the buyer must rely on the seller’s statements to recover and what the nature of that reliance requirement is are unsettled questions. Not surprisingly, this same confusion haunted the New York courts for a time.” *Id.* at 263–64.
should be viewed as different from the prevailing English and Canadian standards, where anti-sandbagging is the norm.51

American legal academics have presented proposals for both pro-sandbagging and anti-sandbagging clauses, along with potential buy-side or sell-side negotiating strategies.52 Under U.S. law, parties may contract around any default rules and provide both for either a pro-sandbagging or an anti-sandbagging contractual framework. The following discussion will focus, however, on the default rules in this field.

IV. DOCTRINAL CONSIDERATIONS ON SANDBAGGING UNDER U.S. LAW

A. Introduction. Common Law v. UCC

The sandbagging problem is an issue of whether or not the buyer’s (or more generally, the warrantee’s) reliance is required to bring a claim for breach of an express warranty. This matter of reliance on express warranties has been discussed both under the common law53 and UCC.54 Some papers express the need for a clear distinction between the reliance matter under common law and under the UCC.55 The sale of business through an acquisition agreement generally does not constitute a sale of goods and therefore does not fall within the scope of UCC Article 2.56 However, while acquisition cases are typically not decided on the basis of the UCC,57 some courts (e.g., the New York Court of Appeals) tend to rely heavily on UCC authorities, expressly noting that the “analogy to the Uniform Commercial Code is ‘instructive.’”58 Moreover, as others have noted, “both the CBS court and its dissent explicitly and implicitly drew from the Code to support their rationale” and “cited with approval sales actions governed by statute.”59 Additionally, some academic articles expressly claim that the

51 See Whitehead, supra note 2, at 1103 for Europe; see also Shadden, supra note 2, at 474 for Canada and Europe.
52 E.g., Avery & Weintraub, supra note 2, at 451–55; West & Shah, supra note 2, at 6–7 (providing potential buy-side arguments), at 5–6 (providing sample contract clauses); Shadden, supra note 2, at 465–66 (for buyer strategies to counter an anti-sandbagging approach).
53 Duchemin, supra note 2, at 689.
55 Duchemin, supra note 2, at 689.
57 Like it was the case in CBS. See Rogath v. Siebenmann, 129 F.3d 261, 264 (2d Cir.1997).
59 Kornfeind, supra note 2, at 680; Quaintance, supra note 2, at 684.
requirements for the creation of an express warranty (including the question of reliance) should be approached uniformly with respect to both transactions for the sale of a business and those for the sale of goods. Therefore, following this approach, the discussion below will take into account both the arguments raised at common law and under UCC Article 2 with respect to acquisition agreements.

B. Arguments Related to the (Abolished?) Reliance Requirement

The main argument supporting the pro-sandbagging approach rests on the contractual nature of warranties and the developments under the Uniform Sales Act (USA) and the UCC. It points to the evolution of warranty law from tort to contract. This evolution is typically illustrated by the changes in the relevant provisions of the USA and the UCC.

At the time that the USA was enacted, U.S. law had already departed from the tortious nature of warranty and was moving towards a contractual approach. Nevertheless, the element of reliance still played a focal role in the definition of an express warranty. USA Section 12 provided that “[a]ny affirmation of fact or any promise by the seller relating to the goods is an express warranty if the natural tendency of such affirmation or promise is to induce the buyer to purchase the goods, and if the buyer purchases the goods relying thereon.” UCC Article 2-313 introduced a change to this language which initially read “[a]ny affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes a basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise.” The change from “reliance” to the “basis of the bargain” phrasing was intended to eliminate the tort element of reliance and treat the express warranty as “purely contractual.” However, the nature and extent of the change arising out of the revised wording was not clear. Many expressed that the “basis of the bargain” language was substantively the same as the USA’s reliance requirement. Others,

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60 Kwestel, Freedom from Reliance: A Contract Approach to Express Warranty, supra note 2, at 968–69, also mentioning sale of business.
63 Id.
64 Id. The author describes the evolution of the relevant parts of the sales law: what later became UCC Article 2-313 constituted earlier Section 37 of a 1944 of the draft Uniform Revised Sales Act (URSA). The proposed change introduced in URSA § 37 vis-à-vis USA § 12 was explained by Hiram Thomas, The Proposed Uniform Revised Sales Act, 2 BUS. LAW. 16, 18 (1947) in the following way: “The ancient element of tort in express warranties, the natural tendency of the warranty to induce a purchase and the buyer’s reliance on the warranty in making the purchase (perpetuated in Sec. 12 of the existing Act), has been wholly eliminated and an express warranty is treated as purely contractual, a part of the bargain.” See id. at n.9.
including Professor J. Honnold, indicated that it was unclear to what extent the language that later became UCC Article 2-313 changed the law on the reliance issue.  

Ultimately, neither the UCC nor the states’ implementing statutes expressly state whether reliance is required to create an express warranty. In the current wording of UCC Article 2-313, the “basis of the bargain” has been replaced with “part of the basis of the bargain.” This change, however, does not shed light on either the reliance issue or the question of the significance of the buyer’s knowledge. Case law related to sales of goods remains remarkably unsettled as to whether the “part of the basis of the bargain” wording aboliishes the requirement of reliance in respect of express warranties. Later draft revisions of UCC Article 2, some of which could have had an effect on the approach to buyer’s knowledge (e.g., by referring to the reasonable expectations of the buyer), were ultimately rejected. I will discuss them later with regard to the implications of the evolution of warranty law.

Under the current language of the UCC, and taking into account the difference vis-à-vis earlier language of the USA, certain authors claim that the tortious concept of reliance was finally abolished, and express warranties should be enforced in exactly the same way as any other seller’s promises are. This view is supported by the argument that if the seller’s affirmations or statements are a part of the bargain, then the buyer has paid for all of them, so the buyer should be entitled to enforce them on contractual basis without reference to any

65 Id. at 961–64.
66 Id. at 965.
67 The change from the “basis of the bargain” language to the “part of the basis of the bargain” language, promoted by the N.Y. State Law Revision Commission, was intended to avoid an interpretation that the affirmation must have been a basic element of the bargain and the major inducement for the buyer to enter into the agreement. See id. at 962–63 nn.10–11; White, supra note 2, at 2095 n.19; Kwestel, Freedom from Reliance: A Contract Approach to Express Warranty, supra note 2, at 963 nn.10–11.
68 The “part of the basis of the bargain” has been criticized as not carrying any intrinsic meaning that would be helpful for solving the knowledge or reliance issue — see the writing, including Professor Honnold, cited by Kwestel, Freedom from Reliance: A Contract Approach to Express Warranty, supra note 2, at 963–67; White, supra note 2, at 2095.
69 Professor White surveyed numerous cases in his empirical research on this subject. See White, supra note 2, at 2098–2102. Professor White concluded:

The second lesson from the cases is that reliance lives. A minority of the courts explicitly require reliance as a condition to buyer’s recovery. But even in courts that do not insist upon reliance, there is often a recognition of its significance by a finding that the buyer did rely.

Id. at 2106.
70 Kwestel, Freedom from Reliance: A Contract Approach to Express Warranty, supra note 2, at 969.
other legal theory, like reliance.\textsuperscript{71} Under this view, the buyer’s knowledge — absent statutory or contractual language to the contrary — generally would not preclude him from bringing a successful warranty claim. This reasoning is similar to the arguments raised by courts applying New York law, particularly in \textit{CBS} and \textit{Galli}.\textsuperscript{72}

The argument acknowledges that an express warranty may be construed in a twofold manner. Firstly, a seller’s promise as to the existence or nonexistence of a present or past fact can be seen as “a promise to indemnify the buyer in the future if the facts were not as represented.”\textsuperscript{73} Secondly, another approach “would view a promise relating to the quality of the goods as a term of the seller’s offer or promise to sell.”\textsuperscript{74} The claim is such that whether we view a warranty as merely a seller’s promise to be liable to the buyer or as a term of his offer to sell, the promise should be treated and enforced in exactly the same way.\textsuperscript{75} Accordingly, if a promise or affirmation of fact should be enforceable in the same manner as any other contractual promise, the question becomes whether reliance by a promisee is necessary for enforcement.\textsuperscript{76} Professor Kwestel ultimately finds that with a move of the warranty law from tort to contract, and with a corresponding change in UCC Article 2-313(1) vis-à-vis USA Section 12, reliance shall no longer be required for a formation of an express warranty. Such a warranty should also be enforceable to the same extent as every other contractual promise of the seller.\textsuperscript{77}

\textsuperscript{71} This argument is among the pro-sandbagging argument mentioned by practitioners. \textit{See} Duchemin, \textit{supra} note 2, at 706; West & Shah, \textit{supra} note 2, at 4.

\textsuperscript{72} \textit{See} CBS Inc. v. Ziff-Davis Pub. Co., 553 N.E.2d 997, 1001 (N.Y. 1990); Galli v. Metz, 973 F.2d 145, 151 (2d Cir. 1992). This argument is also referred to as one of the arguments or strategies that can be applied by the buyer while negotiating for a pro-sandbagging clause. \textit{See} West & Shah, \textit{supra} note 2, at 6.

\textsuperscript{73} \textit{Id.} at 969.

\textsuperscript{74} \textit{Id.} at 982.

\textsuperscript{75} \textit{Id.} at 1013, 1029. However, Professor Kwestel writes that “while lack of reliance may be irrelevant to contract formation, it may well be relevant to judging the degree of contract performance.” \textit{Id.} at 1015. Moreover, the buyer’s knowledge may be a relevant factor in determining the scope of damages as such knowledge should be taken into account while measuring the expectation interest. \textit{Id.} at 1016. In another paper, Professor Kwestel expressly states that the “impression that a buyer may be entitled to recover on the seller’s warranty to the same extent as a buyer who did not know that the warranty was inaccurate” would be “erroneous.” Kwestel, \textit{Express Warranty as Contractual – The Need for a Clear Approach}, \textit{supra} note 2, at 578. Regardless of the source of the buyer’s knowledge (this is a reference to the distinction applied under New York law), a “buyer’s knowledge should make a difference on two issues: consequential damages and rescission.” \textit{Id.} at 579. Specifically, a knowing buyer shall not have the right to seek consequential damages or rescind the agreement. \textit{Id.} at 579–80.
The major argument supporting the claim that the buyer’s knowledge of a fact rendering a contractual warranty untrue shall not preclude his warranty claims is the following: under modern contract law, express warranties are of purely contractual nature and should be construed and enforced in exactly the same method as other terms of the agreement. This is confirmed by the “part of the basis of the bargain” language in UCC Article 2-313(1). Law does not require reliance for the formation of a bargained-for agreement. Accordingly, the tort-rooted concept of reliance shall not play any role in establishing the formation or effects of express warranties. It follows that there is no basis for the relevance of the buyer’s knowledge of the false warranty in the context of express warranties. The buyer would simply “purchase” the seller’s warranties as bargained-for terms of the agreement, and would be in a position to bring a successful warranty claim irrespective of his knowledge. This argument will be further discussed and evaluated in a later section of this paper.

The reliance argument is fundamental to the doctrinal discussion of the sandbagging matter under U.S. law. In addition to this major argument, rules of contractual interpretation are brought to the discussion on whether a seller can invoke the buyer’s knowledge as a defense against warranty claims absent contractual language expressly permitting it. Some of them (e.g., parole evidence rule, plain meaning rule) relate to rules that are also treated differently under various state laws, and remain subject to the ongoing evolution in U.S. law. The outcome of applying those rules then depend on the form (e.g., soft form versus hard form) applied by the court. Nevertheless, those canons do not provide clear guidance on the sandbagging issue. Those other rules are only briefly flagged in the following paragraphs.

Firstly, if warranties are contractual in nature, the parole evidence rule could potentially limit the references to any extrinsic circumstances (e.g., the buyer’s knowledge) in determining the scope and enforceability of contractual warranties. The claim is that, if the seller can benefit from the parole evidence rule by eliminating oral pre-contractual representations or warranties, the buyer should equally have the benefit of disregarding any extrinsic circumstances, such as his knowledge. The actual treatment of this issue may depend on whether the court follows the soft or the hard form of the parole evidence rule. In a court that follows the soft form, the parole evidence rule does not necessarily bar the seller from bringing extrinsic evidence related to the buyer’s knowledge, even under unambiguous contract language.

Secondly, if a contractual warranty is general, there may be a question of interpretation of the warranty when the buyer knew that the warranty was false.

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78 Kwestel, Express Warranty as Contractual – The Need for a Clear Approach, supra note 2, at 567.
79 Id. at 568.
For instance, if there is a general warranty that “there are no outstanding claims against the Company,”80 then the question is whether the fact that the buyer knew about certain claims against X mandates an interpretation that the warranty actually said “except for claims known to the buyer, there are no outstanding claims against the Company.”81 Under state contract law, this interpretive problem may be resolved under the plain meaning rule. Similarly, under the parole evidence rule, the treatment of this issue may depend on what form of the plain meaning rule the court chooses to follow. Under the modern form of the plain meaning rule, the buyer’s knowledge of outstanding claims against the seller can justify an interpretation of a general warranty that there are no outstanding claims outside of those that have been disclosed, or those that the buyer is aware of.82 However, the question is whether an interpretative approach can apply to contractual warranties that are very specific. It is doubtful. For example, if the warranty says “there are only five employee claims pending against the Company” and the buyer is aware of seven claims, or if the seller warrants “the off-balance sheet liabilities of the Company amount for $X” and the buyer knows that they amount for at least $Y (where Y is higher than X), then the interpretative approach cannot solve the sandbagging issue.

Thirdly, the common law concept of reformation has also been discussed in the context of a buyer knowing an express warranty is untrue. If the warranty is specific, the seller is not likely to demonstrate that the real agreement of the parties is different from what is in the writing (unless there has been a printing mistake). Using the latter example from above, it is unlikely that the seller can demonstrate that, despite the contractual warranty on off-balance sheet liabilities stating SX, the parties’ agreement was for the seller to warrant $Y. Even if the warranty is general, it is unclear whether the seller can satisfy the high burden of proof that is required for reformation.83

Finally, in an attempt to distinguish among different sandbagging situations, courts applying New York law have used the “waiver theory”. Under this theory, depending on the source of the buyer’s knowledge (either the seller or third parties or public domain), the buyer’s agreement containing a warranty that the buyer knows to be false can be viewed as a waiver of the buyer’s rights under that warranty. As the Second Circuit held in Galli v. Metz:

80 This example follows the example given by Professor S. Kwestel. Id.
81 Quoting an example by Professor Williston who described it a question of construction: “This is a rule of construction, and is based on an endeavor by the court to give effect to the intention of the parties. If the seller of a horse which is obviously blind, and which both parties know to be blind, says he is sound, the meaning of sound as used in that connection must be sound except as to his eyes. The same rule is applicable to a defect which is not obvious, but of which the seller tells the buyer, or of which the buyer knows.” Id. at 570 n.62.
82 Id. at 568–69.
83 Id. at 571.
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. In that situation, unless the buyer expressly preserves his rights under the warranties (as CBS did in Ziff–Davis), we think the buyer has waived the breach.84

Conversely, if the buyer’s knowledge comes from a third party or constitutes general knowledge, then “it is possible [. . .] that [the buyer] purchased the sellers’ warranty as insurance against any future claims.”85 The “waiver theory” is an attempt to distinguish cases where the buyer’s knowledge is acquired as a consequence of his own effort and data-gathering endeavors from those situations where information has been furnished by the seller. I believe this distinction to be rooted in underlying policy considerations concerning information gathering and exchange at a pre-contractual phase rather than in doctrinal or conceptual deliberations. This approach appears to be supported by policy considerations that should generally encourage information gathering by buyers to the extent they can obtain such knowledge without incurring excessive costs.

C. Discussion Related to the Reliance Requirement

In this part of the paper, I attempt to evaluate the discussion related to the reliance requirement in the context of the contractual nature of express warranties. For reasons to follow, I believe that the contractual nature of an express warranty does not mandate the pro-sandbagging rule.

Both the question of the relevance of the buyer’s knowledge (and his reliance on the seller’s warranties) and the concept and understanding of this reliance are typically discussed in the context of the tortious or contractual nature of warranties. In broad terms, the general claim is that because warranties have moved to the domain of contract law and finally lost their tortious elements, reliance should not be required any longer as an element for construction of a warranty or for enforcement of the warranty claim. State laws that follow the reliance requirement and preclude the knowing buyer from bringing indemnity claims remain rooted in the tort approach to warranty law.86

However, as New York law demonstrates, the key issue is not necessarily whether reliance is required but rather how reliance should be understood in the

84 Galli v. Metz, 973 F.2d 145, 151 (2d Cir. 1992).
85 Id.
86 Duchemin, supra note 2, at 705, for Kansa law; Whitehead, supra note 2, at 1084 n.7, mentioning Minnesota, Kansas, Colorado and California law.
context of a contractual warranty claim. Traditionally, reliance refers to the buyer’s “reliance on the truthfulness of a seller’s warranty, not the reliance on a promise necessary for the formation of a warranty.” Under the modern contractual approach, however, reliance requires “no more than reliance on the express warranty as being a part of the bargain between the parties.” In the majority’s comment on the dissent, the CBS court clearly said that it is not discarding the reliance requirement; it is merely following a different concept of reliance, as previously laid down by the Ainger court. So it is not clear whether under the contractual nature of express warranties we require reliance at all, but we understand the reliance requirement only as a question of whether the buyer reasonably believed he was purchasing the seller’s promise.

Ultimately, the focal issue of reliance may be phrased in a two-part manner: whether reliance is required and the nature of reliance in respect of express warranties. Under the modern trend, the answer to the first question is negative if reliance is defined as the buyer’s reliance on the truthfulness of a seller’s warranty. If, however, reliance is defined following the approach of the Ainger and CBS courts, reliance is required but can be established if the buyer “believed he was purchasing the promise” (which is to be judged “by the objective test of what his promise would be understood to mean by a reasonable man in the situation of the promisee”). In other words, under CBS, reliance is established if “the express warranties are bargained-for terms of the seller.”

Moreover, keeping in mind how strongly the courts rely on UCC authorities in M&A cases, I believe that the inquiry is similar under the UCC.

87 Duchemin, supra note 2, at 689, 707–08.

It is true that courts, especially in New York, use the word “reliance” in warranty cases. In these contexts, however, the word relates to the first element of proof, existence of the contract, because there can be no contract, no express warranty, without a “meeting of the minds.” The question of whether the promisee “relied” on the warranty, then, is whether he believed he was purchasing the promise. As to the promisor’s mental state in contract formation, it is judged “by the objective test of what his promise would be understood to mean by a reasonable man in the situation of the promisee.” 476 F. Supp. 1209, 1225 (S.D.N.Y. 1979), aff’d, 632 F.2d 1025 (2d Cir. 1980).

89 “[I]n its statement that our “holding discards reliance as a necessary element to maintain an action for breach of an express warranty” (dissenting opn., id. at 506) the dissent obviously misses the point of our decision. We do not hold that no reliance is required, but that the required reliance is established if, as here, the express warranties are bargained-for terms of the seller.” Id.
90 See Ainger, 476 F. Supp. at 1225, followed by CBS Inc. v. Ziff-Davis Pub. Co., 75 N.Y.2d at 506. See also Cole, supra note 2, at 450–51, who also notes that New York law has not abolished the requirement of reliance but rather changed its meaning.
91 Ainger, 476 F. Supp. at 1225.
92 CBS, Inc., 553 N.E.2d at 1001.
Article 2 approach to express warranties. If we were to follow the approach of the New York law and adapt it to the UCC setting, the reliance question would be whether a warranty has “become part of the basis of the bargain.” Ultimately, the question can be either whether reliance is required or what is the appropriate understanding of reliance under the contractual theory of warranty and under the “part of the basis of the bargain” concept?

I believe that the inquiry regarding the buyer’s knowledge should not be framed as a matter of the tortious or contractual nature of warranties, but rather as a question: is there a place for reliance of other equivalent concept in the purely contractual setting? Under New York law it is clear that the reliance requirement does not disappear if the warranty is viewed as contractual. However, the focus then changes from the buyer induced by the warranty to the buyer’s reasonable belief that he purchased the seller’s promise as a bargained-for part of the agreement. Similarly, under UCC Article 2-313(1)(a), the reliance question can be framed as not relating to whether the buyer was induced by a warranty (traditional understanding of reliance), but rather to whether the warranty is “a part of the basis of the bargain.” UCC Article 2-313(1)(a) does not specify when an “affirmation of fact or promise made by the seller to the buyer which relates to the goods . . . becomes part of the basis of the bargain.” It merely requires that it becomes such part. Moreover, since there is such a specific requirement, it does not always or automatically become such part; otherwise this requirement would be superfluous.

Now, we come to the question of when the warranty becomes a “part of the basis of the bargain.” The question can be also phrased, following the Ainger court, as when the buyer can reasonably believe that by having a contractual warranty in the agreement he is purchasing a seller’s promise.

The Ainger court stated that the buyer’s belief as to whether he is purchasing a promise should be judged “by the objective test of what his promise would be understood to mean by a reasonable man in the situation of the promisee.” There appears the question whether a reasonable buyer can believe to be purchasing a warranty claim against the seller if he knows that the warranty made by the seller is incorrect. One can argue that the buyer’s knowledge of the affirmation or promise being incorrect is an element that should be taken into account while determining whether he could have reasonably believed to be purchasing a promise — and accordingly, whether an affirmation or promise has become part of the bargain.

Now, the situation is as follows. Firstly, the wording of UCC Article 2-313(1) does not mention reliance. Secondly, it remains disputable whether the UCC — by not mentioning reliance and replacing it with the “part of the basis of

93 U.C.C. § 2-313 (AM. LAW INST. & UNIF. COMM’N 2019).
94 Ainger, 476 F. Supp. at 1225 (citation omitted).
the bargain” wording — indeed abolished the requirement of reliance or whether it is still embedded in the concept of a contractual warranty. Thirdly, New York law related to acquisition agreements, while heavily relying on UCC authorities and following the contractual nature of warranties, rejected the reliance requirement if it was to be construed as the buyer’s belief “in the truth of the warranted information.”

Fourthly, however, New York law did not reject the reliance requirement as such, but provided it with a new understanding: “whether [the buyer] believed [it] was purchasing the [seller’s] promise [as to the warranty’s truth].” Fifthly, in judging the belief of the buyer on whether he was purchasing such a promise, New York law applies “the objective test of what his promise would be understood to mean by a reasonable man in the situation of the promisee.”

Drawing a parallel, there may be some sort of equivalence between the “reliance” requirement, as construed under New York law, and the conditions that have to be met for an affirmation or promise to become a “part of the basis of the bargain” under UCC Article 2-313(1).

The UCC Article 2-313(1) does not impose any reasonableness test on the part of the buyer to determine whether an affirmation or promise becomes “a part of the basis of the bargain” or not. However, similarly to the New York rule, neither does UCC Article 2-313 say that such an affirmation or promise always becomes such a part. It merely requires that an affirmation or promise becomes such part, without specifying when it does so. Legal writing did suggest that a “reasonable expectations” test should be applied to determine whether an affirmation or promise has become “a part of the basis of the bargain.”

Interestingly, Professor Murray explicitly states that “a reliance or inducement test under UCC Article 2-313 is contrary to the terms of the statute and its comments.” At the same time, he believes that a “proper analysis concentrates on and protects a buyer’s reasonable expectations” for “this is the only test that conforms to the statutory language, the comments, and the underlying philosophy of Article 2.” This appears similar or parallel to the developments in New York law, which abolished the requirement of the buyer’s reliance (understood as his belief in the truth of the warranties) but then replaced it with the requirement that the buyer (acting reasonably) believed he was purchasing the seller’s promise. Finally, one of Professor Murray’s examples on when an affirmation or promise

95  Id. at 503.
96  CBS, Inc., 553 N.E.2d at 1000–01 (quoting Ainger, 476 F. Supp. at 1225) (internal quotation marks omitted) (“The critical question is not whether the buyer believed in the truth of the warranted information, as Ziff-Davis would have it, but ‘whether [it] believed [it] was purchasing the [seller’s] promise [as to its truth].’”)
97  Ainger, 476 F. Supp. at 1225.
99  Id.
100  Id.
Ed 2] “Sandbagging” does not become “a part of basis of the bargain” for failing the “reasonable expectations test” is exactly the case where the buyer knows such an affirmation or promise to be untrue. The logic behind this reasoning is clear: if the buyer knows that an affirmation or promise is untrue, then the buyer cannot reasonably believe to be purchasing the seller’s promise as to its truth.

There have been attempts to introduce the reasonable expectations measure as a test for an inclusion of certain affirmations or promises into the “basis of the bargain” or for their exclusion therefrom. These changes failed to make their way into the language of the UCC Article 2-313(1), which in this respect continues to be an enigma as far as the relevance of reliance and its relation to the “basis of the bargain” concept is concerned. However, the “reasonable expectations” test, which is rooted in common law and has been in parallel applied in sandbagging cases under New York law, appears well-suited to solve at least some issues of the approach to reliance in the law of warranties. In particular, it may be useful to provide some guidance on the sandbagging problem.

The “reasonable expectations” theory bridges the potential gap between the contractual nature of a warranty and the “part of basis of the bargain” language in UCC Article 2-313(1) on one hand and the general anti-sandbagging rule on the other hand. The “reasonable expectations” approach may bridge these two statements in excluding warranties that are known by the buyer to be false from the “basis of the bargain.” Under the “reasonable expectations” approach, which despite draft revisions did not find its way to the UCC Article 2-313(1), the buyer’s knowledge that the warranty is untrue can, absent contractual regulation to the contrary, preclude the buyer’s warranty claims.
Finally, I come to one of Professor Kwestel’s key questions: why should a warranty be treated in a different manner than other terms?107 This question relates to Professor Kwestel’s claim that an express warranty is a term of the agreement that is not different from any other term,108 which follows from the contractual nature of the warranty.109 Therefore, any buyer’s knowledge shall not

evolution of the warranty law from a tort-rooted concept to a purely contractual one is illustrated by the differences between the USA, the UCC and finally the CISG. White, Freeing the Tortious Soul of Express Warranty Law, supra note 2, at 2090. Professor White claims that the CISG “may be regarded as the last step in the move to contract, for it abandons the last vestige of tort and self-consciously makes express warranty into contract and nothing more.” Id. “Indeed, the final stage of the warranty’s evolution from initially a tort-based idea, through the stage of a “curious hybrid, born of the illicit intercourse of tort and contract.” See Duchemin, supra note 2, at 691 n.15, citing to S. Williston and W.L. Prosser to a purely contract concept may have been reached in CISG Article 35. Obviously, CISG is not using the “part of the basis of the bargain” wording which would be hardly understandable beyond the common law culture. Nonetheless, it is said to have generally followed the common law approach in adopting one general concept of breach of contract which includes the warranty breach. Ulrich Magnus, The Vienna Sales Convention (CISG) between Civil and Common law – Best of all Worlds?, 3 J. CIV. L. STUD. 68, 75 (2010) (“Each party is strictly liable for any breach of the contractual promise it gave (so called unitary approach because there is only one category of breach of contract; by contrast the civilian jurisdictions distinguish between general breach and special breach of warranty).”). It also adopts a broad concept of “lack of conformity” of goods that covers both breach an express and an implied warranty, as per the American terminology. Moreover, similarly to UCC Article 2-316 (which relates to “implied warranties”), CISG Article 35(3) explicitly provides the seller with a defense related to the buyer’s actual or presumed knowledge of lack of conformity. Were we to follow the plain meaning of CISG 35(3), which explicitly refers to the “preceding paragraph”, this “knowledge defense” would be limited to implied warranties (and this is why CISG Article 35(2) is said to correspond to UCC Article 2-316) and would not operate against express warranties (as CISG Article 35(3) does not refer to Article 35(1)). Although there are some differences in opinions, this is the prevailing view under CISG Article 35(3). However, at the same time legal authorities under CISG Article 35(3) put forward multiple theories that can effectively extend the scope of the “knowledge defense” also to express warranties. These theories include interpretation, venire contra factum proprium, breach of good faith by the knowing buyer etc. Some of them are similar or parallel to the theories that have been discussed in this context under common law (interpretation, see above and see Kwestel, Express Warranty as Contractual – The Need for a Clear Approach, supra note 2, at 568.). Others are probably not applicable, e.g., because of the different approach to the “general obligation to act in good faith”. What is however particularly relevant, that even though the drafters of the CISG have not decided to extend the “knowledge defense” to express warranties (despite such proposals being brought by some delegations and despite some of the national laws allowing the seller to invoke such defense also against express warranties), there still are attempts to allow extend this defense to express warranties on the basis of other legal theories.

107 Kwestel, Express Warranty as Contractual – The Need for a Clear Approach, supra note 2, at 558 (“[N]o one has explained why a seller’s promise as to the quality of the goods should be treated differently from any of the seller’s other promises to the buyer including, for example, her promise as to the quantity of the goods to be delivered.”).

108 Id.

play any role in the context of his enforcement of a warranty, like it does not in the context of enforcement of other terms of the contract (e.g., a quantity term). To expand on this example: my understanding of this claim is that, under a warranty, a buyer’s knowledge of the warranty not being true should be no more relevant than the buyer’s knowledge that the seller is not willing or not able to deliver the agreed quantity would be under a quantity term.\footnote{110}

While warranties are promises from the point of view of contract law, their nature is different from what we would call a “promise” within a common sense of this word. Technically, by making a warranty the warrantor does not promise to achieve a specific state of affairs. This is particularly clear if it relates to past or present circumstances. The warrantor merely undertakes to be liable if this state of affair does not exist. Therefore, it is not clear whether warranties shall be at all times afforded exactly the same effect as any other promises or contract terms. There may be a potential explanation for a different treatment of warranties than some other contract terms. It can be explained under the theory of “primary” and “secondary” obligations. This distinction is fundamental under European civil law theories; however, it has been present in American academic writing as well.\footnote{111} A primary obligation is a performance obligation; it typically refers to the debtor’s duty to deliver goods, effect payments, or perform certain services. Generally, “[the] formation of a contract creates an original primary obligation.”\footnote{112} If there is a breach of this primary obligation, a secondary obligation arises. Typically, a secondary obligation is the obligation to pay damages for breach of contract. Depending on the circumstances and the nature of the breach, the secondary obligation may replace the primary obligation, or they may co-exist.\footnote{113} Now, what is the benefit of applying this theory to express warranties? This theory clearly shows the peculiar nature of a contractual warranty. On the one hand, because it is a contractual promise, an express warranty gives rise to a primary obligation. On the other hand, however, since warranties typically relate to past or present events, there can be no performance under this primary obligation other than damages. Hence, the warranty is a strange form of promise as it relates to past or present events that cannot become the object of a performance obligation. The seller’s only promise is to be liable.

\footnote{110}{Id. at 988 (“[W]ith respect to a sales contract, this [lack of reliance] means that a buyer is entitled to the benefit of her bargain without inquiry into the reasons that motivated her to make the promise or render the performance in exchange for the seller’s promises.”).}

\footnote{111}{Arthur Corbin, Discharge of Contracts, 22 YALE L.J. 513, 513 (1913).}

\footnote{112}{Id.}

\footnote{113}{Id. (“Upon the breach of this primary obligation, there arises a secondary or remedial obligation to pay damages. Under some circumstances the secondary obligation wholly replaces the primary one, which is regarded as extinguished. Under other circumstances both will exist together.”).}
This is reflected Judge Learned Hand’s famous definition of warranty under New York law:

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.114

This approach to express warranties was consistent with Restatement (First) of Contracts Section 2(2), which read:

Words which in terms promise the happening or failure to happen of something not within human control, or the existence or non-existence of a present or past state of facts, are to be interpreted as a promise or undertaking to be answerable for such proximate damage as may be caused by the failure to happen or the happening of the specified event, or by the existence or non-existence of the asserted state of facts.115

Although the Restatement (Second) did not adopt the above language as part of the new Section 2, the comments to the new Section 2 clearly demonstrate that the logic behind the previous version remains valid.116 It may be argued that,

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115  RESTATEMENT (FIRST) OF CONTRACTS § 2 cmt. a (Am. Law Inst. 1932) (“Even where the undertaking relates to an existing or past fact, as in case of a warranty that a horse is sound, or that a ship arrived in a foreign port some days previously, the existence and validity of the undertaking is dealt with in the same way as if the warrantor could cause the fact to be as he asserted, though the meaning of words in terms promising the existence of present or past facts must be interpreted as stated in Subsection (2).”).


d. Promise of event beyond human control; warranty. Words which in terms promise that an event not within human control will occur may be interpreted to include a promise to answer for harm caused by the failure of the event to occur. An example is a warranty of an existing or past fact, such as a warranty that a horse is sound, or that a ship arrived in a foreign port some days previously.
in the sale of goods, a warranty can be equally explained as a description of the goods that are to be delivered by the seller. Accordingly, a breach of a warranty is just another breach of the seller’s primary obligation to deliver goods as agreed in the contract. However, this argument seems plausible only in respect to some warranties and definitely cannot apply to the whole range of representations and warranties typically agreed upon in an acquisition agreement or another complex commercial contract (e.g., financing agreement, joint-venture agreement, etc.). If the transaction is a sale of non-specific or unascertained goods, a warranty can be simply a description of the goods and a term that gives rise to the seller’s primary obligation to deliver the goods “as warranted.” However, if the goods are specific or ascertained, or if the warranty does not relate directly to the features of the goods being sold (which may be the case for acquisition scenarios), the argument that it is a description that shapes the seller’s obligation to deliver appears artificial. Moreover, if the goods are specific or ascertained, or if the transaction does not pertain directly to the features of the goods being sold, but is a sale of business, then this approach is likely to lead to a finding that a warranty clause imposes an obligation that is beyond human control or impossible. For example, if an acquisition agreement that governs the sale of all outstanding stock of company X provides for a warranty that there are only 5 employee claims pending against X, it is not reasonable to assume that this warranty imposes on the seller the primary obligation for there to be a company X with only 5 employee claims pending against it. Courts would construe such a warranty as a promise by the seller to be liable for the damage resulting of his warranty not being true. The comment to Restatement (Second) of Contracts Section 2 supports this position: if we were to construe such a warranty

Such promises are often made when the parties are ignorant of the actual facts regarding which they bargain, and may be dealt with as if the warrantor could cause the fact to be as he asserted. It is then immaterial that the actual condition of affairs may be irrevocably fixed before the promise is made.

Words of warranty, like other conduct, must be interpreted in the light of the circumstances and the reasonable expectations of the parties. In an insurance contract, a “warranty” by the insured is usually not a promise at all; it may be merely a representation of fact, or, more commonly, the fact warranted is a condition of the insurer’s duty to pay (see § 225(3)). In the sale of goods, on the other hand, a similar warranty normally also includes a promise to answer for damages. See Uniform Commercial Code § 2-715.

117 Kwestel, Freedom from Reliance: A Contract Approach to Express Warranty, supra note 2, at 993, 1029. This argumentation appears particularly tempting under the wording of CISG Article 35 and of the European regulations on consumer protection in sale of goods. As mentioned earlier, these regulations have an impact on European law-making that goes beyond consumer protection. Conceptually, they may appear well-fitted for the sale of unspecific (unascertained) goods: if the seller promises to deliver X barrels of oil or Y tons of coal of a given quality, such a description may be viewed as defining his performance obligation. However, where specific (ascertained) goods or real estate are concerned, the construction of a primary performance obligation seems artificial.
as imposing any other primary obligation, then the rule would mean that the warranty was merely a promise to answer for harm. Accordingly, there will ultimately be no other primary obligation imposed on the warrantor than to be liable for harm suffered by the warrantee.

Now, let me return to Professor Kwestel’s question: why should an express warranty be treated in a different manner than a quantity or time of performance term? A potential answer is that the reason for a different approach is that the warrantor does not undertake any primary obligation (performance obligation) except to be liable. By bargaining for a seller’s warranty, the buyer does not bargain for the seller’s promise to perform but rather for the seller’s promise to be liable if the warranted facts or circumstances turn out not to be true. The question is, then, whether the buyer should have the benefit of this liability if he knew that this statement was untrue. In such a case, the buyer would not be purchasing the assurance — he would be merely purchasing a claim. However, what the warrantor is selling (the assurance) is not what the warrantee is buying (the claim). The question is now whether this is enough to distinguish warranty clauses from other terms of the agreement. Still, the conceptual difference between a promise to do X (which implies a promise to be liable for a failure to do X) appears to be different from a promise merely to liable if X is not true. The case of a warrantee knowingly obtaining a false warranty is similar to that of a promisee bargaining for a promise while knowing that it is impossible to perform. Now, the answer depends on whether the promissor assumed the risk of initial impossibility of performance. It can be a matter of construction or interpretation, which makes it difficult to provide a general answer. However, if I were to choose the default rule, I would rather hold that the promissor is not liable for the promisee’s expectation interest.

A potential argument that would favor enforcement, irrespective of the buyer’s knowledge, is the “insurance argument” brought by the Second Circuit in Galli v. Metz. The Court held that if a particular problem was common knowledge, “it is possible that a third person disclosed the problems to [the buyer] and that [the buyer] purchased the sellers’ warranty as insurance against any future claims.”118 The Court limited the application of the “insurance argument” to situations where the seller was not the source of the buyer’s knowledge. A potential policy reason could be that the law should not punish the buyer for his information gathering endeavors. Under such policy considerations, the seller should not benefit from the buyer’s information gathering efforts by being released from liability, and the buyer should not be penalized for undertaking such efforts by having his claims precluded.

The next question is whether a warranty clause is the perfect instrument for such an insurance-type allocation of risk. It is doubtful whether the “insurance

118 Galli v. Metz, 973 F.2d 145, 151 (2d Cir. 1992).
argument” works if the buyer actually knows that the warranty is false and expects to buy a claim. If the parties allocate risks that are either unknown to both of them (which is the typical case under contractual warranties) or known to both of them (typical for contractual standalone indemnities), then we have an insurance-type situation. However, if one party enters into the agreement with a positive knowledge of a risk that is apparently unknown to the other party, but without the two parties’ mutual understanding of the nature of the risk covered by the warranty (as an unknown risk or a known risk), it is doubtful whether the “insurance” argument should favor the party purchasing an assurance that they know to be false. Actually, the knowing party is purchasing a claim rather than an assurance. The point here is that maybe distinct contractual tools should be applied to cases where the risk is an “unknown” one and for those where the risk is “known” (has been identified). If warranties are to protect the buyer against risks that he has not identified and also against consequences of facts that he was aware of, then we are applying one contractual instrument to two different kinds of situations. The next part of the paper will discuss why it would be beneficial to have identified risks dealt with by a different legal instrument rather than the one that is used to protect the warrantee against unidentified risks.

In summary, doctrinal arguments do not provide clear guidance on the effects of buyer’s knowledge on his warranty claims. The UCC has replaced the “reliance” requirement with the “part of the basis of the bargain” language. It remains unclear whether this change has ultimately deprived buyer’s knowledge of the warranty being untrue of any impact on his warranty claims. Under the “reasonable expectations” approach, one may still argue that a buyer who knows of a warranty being untrue should not “reasonably” expect it to become a “part of the basis of the bargain.” Under New York common law, the reliance element is not finally abolished but instead has evolved from the traditional understanding (reliance as to the truth of the warranty) to a modern one (reliance as to purchasing the warrantor’s promise of the warranty being true). This evolution appears to follow warranty law’s move from a concept rooted in law of torts to a purely contractual one, as well as a parallel development in the UCC.

The question remains open whether it is optimal to have one contractual instrument as a tool for allocating both unknown risks and known risks. Additional policy and efficiency considerations should be taken into account when answering this inquiry.

For reasons that follow I believe that it is better to have two distinct contractual instruments, with one typically used to address the risks of the unknown and the other to allocate specifically identified risks. This approach would allow the parties to consciously and more accurately price the value and cost related to particular terms of the agreement.
V. WHY DOES THE DEFAULT RULE MATTER?

As a scholarly paper demonstrates, despite the lack of a clear approach to sandbagging across the U.S., and sometimes within a state, a remarkably high percentage of acquisition agreements remains silent on this issue and leave it to default rules. 119 According to empirical research conducted by Charles K. Whitehead, about 40% to 50% of acquisition agreements are silent on the sandbagging matter. 120 Newer data demonstrates that this was the case in more than 56% of acquisition agreements. 121 Moreover, empirical evidence shows that this contracting pattern is roughly the same irrespective of whether the agreement is governed by a pro-sandbagging or anti-sandbagging state law. 122 Parties tend to defer to default rules, regardless of what the default rules of a given state law are.

Legal articles have identified several factors that lead a significant majority of parties negotiating acquisition agreements to leave this issue open. Firstly, potential negotiations of a sandbagging clause may entail significant amounts of time and effort. It may be a pragmatic solution not to bear this cost up-front. 123 Therefore, parties may deliberately avoid negotiating this clause and remain silent on this topic. However, the effect is that the parties defer to default rules despite that the rules vary across the states and that state law may be unsettled.

Secondly, as Professor Whitehead explains, both in pro-sandbagging and anti-sandbagging jurisdictions neither the seller nor the buyer may have sufficient incentive to contract around the default rule. In a pro-sandbagging jurisdiction, the buyer generally is not willing to waive his sandbagging rights, as it is unlikely that he can be compensated for identifying himself as a non-sandbagger by a corresponding difference in valuation of the business. 124 Moreover, the cost and effort required to negotiate an anti-sandbagging clause may be disproportionately high compared to the relatively remote litigation risk and low probability of the clause becoming relevant. The seller, on the other hand, may not be willing to push hard for an anti-sandbagging clause, as this could undermine the credibility

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119 Whitehead, supra note 2, at 1100.
120 Id. at 1094 (at the same time, about 45% to 55% (depending on the jurisdiction) contained a pro-sandbagging provision and the rest provide for an anti-sandbagging clause).
121 Cole, supra note 2, at 447, 448 (citing to a 2015 ABA survey).
122 Whitehead, supra note 2, at 1100.
123 This is a kind of a “strategic vagueness” argument: it is not efficient for the parties to bear up-front the costs of a protracted negotiation process (“front-end cost”) if the litigation risk related to such a clause is remote. See Albert Choi & George Triantis, Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions, 119 Yale L.J. 848, 848 (2010); Robert E. Scott & George G. Triantis, Anticipating Litigation in Contract Design, 115 Yale L.J. 814 (2006); Robert E. Scott & George G. Triantis, Incomplete Contracts and the Theory of Contract Design, 56 Case W. Res. L. Rev. 187 (2005) for further discussion.
124 Whitehead, supra note 2, at 1102.
of his warranties and destroy their potential signaling effect. In an anti-
sandbagging jurisdiction, the buyer’s insistence on a pro-sandbagging clause in
the agreement may be ethically questionable.

Whether the resources and costs of contracting around the default rules
are better allocated with the pro-sandbagging or the anti-sandbagging default rule
will be discussed in the next part of this paper. The point here is that, despite
that the law on sandbagging varies across states and remains unsettled, parties
often defer to default rules by remaining silent on this point in the agreement.

VI. EFFICIENCY AND FAIRNESS CONSIDERATIONS RELATED TO SANDBAGGING

In U.S. legal writing, policy arguments have been made to support either
the pro-sandbagging and anti-sandbagging approach as the default rule. Professor
Whitehead claims that an anti-sandbagging default rule is more efficient, as it
allows the seller to identify the buyers that are interested in purchasing the right
to sandbag. Buyers interested in acquiring sandbagging rights would need to
identify themselves and pay for these rights, as the seller would be pricing-in
the risk of liability in connection with information that was available to the buyer.
Under the pro-sandbagging standard, the seller must treat all buyers as potential
sandbaggers, and always price-in the risk of being sued in connection with
warranty breaches that were or could have been known to the buyer based on the
information the parties had at the date of the agreement. Accordingly, all buyers
would be paying for the right to sandbag — including those who are not
interested in purchasing this right.

Even if it is correct to assume that, under a pro-sandbagging rule, the
right to sandbag has been priced into the commercial terms of the transaction and
accordingly paid by the buyer, not all buyers may value this right in the same

125 Id.
126 Id.
127 Id. at 1105–06.
128 Id. at 1106.
129 Id. at 1104.
130 This is one of the pro-sandbagging arguments that was used by the CBS court. “CBS was not
merely buying identified consumer magazine businesses. It was buying businesses which it
believed to be of a certain value based on information furnished by the seller which the seller
however, that CBS was not aware of the breach as of the date of signing the agreement (and
agreeing to the commercial terms), but only discovered the breach in the interim period (post-
signing, pre-closing) and, though having the walk-away right, nonetheless decided to close while
reserving its warranty claims. The argument that the price is agreed under the assumption of all the
warranties being true appears also to be one of the standard buy-side negotiation arguments. See
West & Shah, supra note 2, at 6. This may open however a broader discussion on whether a buyer
who knows of a warranty being incorrect should price the transaction based on his knowledge or
rather disregard this knowledge and price it as if all the warranties were true. I believe that in
way.\textsuperscript{131} There may be buyers who do not value sandbagging rights highly enough to pay for them. Therefore, one reason for not valuing sandbagging rights may be that sandbagging can appear ethically questionable, and is not standard in contractual practice outside the U.S.\textsuperscript{132} Another reason is that there are knowledgeable buyers who rely on their own due diligence and price all gathered information into the commercial terms of the transaction.\textsuperscript{133}

At the same time, according to Professor Whitehead’s analysis, under a pro-sandbagging standard neither the buyer nor the seller is economically incentivized to contract around the default rule. The buyer has no incentive because it is unlikely that waiving his sandbagging rights has a direct impact on the commercial terms of the transaction and thus allows him to pay less for the target.\textsuperscript{134} On the other hand, as Professor Whitehead notes, the sellers “seek to demonstrate to buyers that they can credibly rely on the contract’s warranties. Urging a buyer to contract around a pro-sandbagging rule may draw those warranties into question, contrary to the seller’s interests.”\textsuperscript{135} According to Professor Whitehead, the inefficiency of the pro-sandbagging default rule is related, firstly, to the limited incentives for the parties to contract around these rules, and secondly, to the fact that under such rule, the buyer interested in buying sandbagging rights is not distinguished from those not interested in paying for these rights. All buyers will be treated as potential sandbaggers, except for those who agree to contract around the default rule. Finally, all buyers will have to pay for the right to sandbag, even if they are not interested in this right. Conversely, under an anti-sandbagging default rule, a buyer would have to negotiate for a

\textsuperscript{131} Whitehead, \textit{supra} note 2, at 1102.
\textsuperscript{132} \textit{Id.} at 1103.
\textsuperscript{133} \textit{Id.} This argument applies to pre-signing knowledge, as the commercial terms of the transaction are agreed before signing. Accordingly, it does not hold for knowledge acquired in the interim period (e.g., post-signing, pre-closing).
\textsuperscript{134} \textit{Id.} at 1102.
\textsuperscript{135} \textit{Id.} Based on the European standard and experience I do not believe that a European seller would refrain from negotiating for an anti-sandbagging clause based on these considerations. The disclosure provisions of an acquisition agreement (setting the standard for seller’s disclosure and buyer’s knowledge as well as the effects thereof on seller’s liability) are typically heavily negotiated by the parties. The seller’s arguments can be that if the buyer has identified a certain risk, he has priced it into the commercial terms of the transaction, so the seller cannot still be liable for it as he would then be penalized twice (this argument applies to pre-signing disclosure and not interim disclosure, but, as mentioned, the question of interim disclosure requires a different approach under the U.S. and the English or European standard, as in European transactions the truth of all representations and warranties typically is not a condition to close).
sandbagging right and purchase it. Such a rule would then operate as a “penalty default rule.”

A different opinion was presented by Matthew J. Duchemin, who believes that the contractual approach (which requires no reliance on the truth of warranties) is a more logical, fair, and economically efficient one. His efficiency considerations are based mainly on the observation that the contractual (and pro-sandbagging) approach “ensures that the buyer and seller will get what they bargained for in the contract. It also ensures that the buyer will get the promises for which he or she paid.” The seller can be protected under the waiver theory, which may lead to a conclusion that, by knowingly accepting a false warranty, the warrantee waives its rights thereunder.

Certain fairness and efficiency considerations that may speak against an anti-sandbagging default rule have been presented by Stacey A. Shadden. Potential costs related to the anti-sandbagging rule include the seller’s incentive to produce (at the buyer’s cost) an excessive disclosure, which provides the buyer with tons of mostly irrelevant materials. Such a disclosure simply increases a seller’s chances of having a potential knowledge-based defense in case of a warranty breach. This may also take the form of the so called “last-minute-dumps,” where the seller provides the buyer with an information pack immediately before signing, hoping that the buyer will not be able to identify any adverse information and price it into the transaction, allowing the seller to benefit from the anti-sandbagging rule. The buyer’s suspicions regarding the risk of the seller’s “last-minute-dump” may be one of the reasons why the buyer would insist on a pro-sandbagging clause. However, a more appropriate response

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136 Shadden, supra note 2, at 465.
137 Whitehead, supra note 2, at 1105. For further reading on the “penalty default rules.” See Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 YALE L.J. 87 (1989) (“One of the claims of the theory of penalty default rules is that such default rules should ‘encourage the parties to reveal information to each other or to third parties (especially the courts).’”). The theory of penalty default rules is an influential one in American writing, was however also subject to critique. See Eric Maskin, On The Rationale For Penalty Default Rules, 33 FLA. ST. U. L. REV. 557 (2006); Eric A. Posner, There Are No Penalty Default Rules in Contract Law, John M. Olin Program in Law and Economics Working Paper No. 237, 2005; see also the response from Professor Ayres in Ian Ayres, Ya-HUH: There Are and Should Be Penalty Defaults, 33 FLA. ST. U. L. REV. 589 (2006).
138 Duchemin, supra note 2, at 711.
139 Id. at 709. As said above, however, it is not clear to what extent the buyer really prices in this warranty knowing (as of signing) that the facts warranted are not true (footnotes omitted).
140 Id. at 710 (referring to Galli v. Metz, but without any specific guidance on the applicability of the waiver approach). The application of the waiver doctrine may be relatively complicated. See id. at 560, for the questions raised.
141 Shadden, supra note 2, at 466.
142 Id.
143 Id.
144 Id. at 468.
from a buyer could be to demand additional time for analyzing and considering the additional disclosure, or alternatively, to freeze the disclosure prior to signing.

Further arguments supporting the pro-sandbagging rule rely on the enhanced certainty following from this approach. Firstly, the approach seems to be in line with the “a deal is a deal” approach that typically underpins complex commercial contracting.\(^\text{145}\) Parties generally prefer certainty, and want the agreement to be their entire deal that can be enforced without reference to extrinsic circumstances, like the buyer’s knowledge. This functional argument appears consistent with Professor Kwestel’s argumentation related to the parole evidence and plain meaning rules.\(^\text{146}\) Secondly, an advantage of the pro-sandbagging approach is that it reduces the uncertainty related to enforcement of warranty claims and the risk related to protracted court proceedings, with the seller attempting to demonstrate the buyer’s knowledge of circumstances that give rise to the warranty being breached.\(^\text{147}\)

To summarize, there are policy considerations supporting either the anti-sandbagging and pro-sandbagging default rules. On one hand, the argument that appears to me to be the most relevant support for the anti-sandbagging rule is based on the analysis by Professor Whitehead. It points to the adequate pricing of the contractual rights by both parties and to the value of pre-contractual exchange of information. On the other hand, the certainty argument favors enforcement of warranty claims without regard to any extrinsic circumstances (e.g. buyer’s knowledge) that can be demonstrated in court only after a costly and time-consuming evidentiary process. In the next part of the paper, I will evaluate the strength of these arguments, taking into account available alternatives to the pro-sandbagging approach.

**VII. FURTHER EFFICIENCY CONSIDERATIONS: VALUE CREATION BY WARRANTIES AND INDEMNITIES — UNKNOWN RISKS VERSUS KNOWN RISKS**

In evaluating the efficiency considerations related to sandbagging, I will apply the methodology and terminology used in Professor Gilson’s paper on

\(^\text{145}\) *Id.* at 467. This argument appears similar to the argument used by a Pennsylvania court which rejected the reliance approach “because that approach is inconsistent with the commercial realities of these complex purchase agreements negotiated over several months by sophisticated parties. The representations and warranties in these transactions define and apportion the risks that the parties negotiated. The amount of risk assumed by the sellers is part of the bargain and protects the investment that buyers make in sellers’ business.” Giuffrida v. Am. Family Brands, Inc., No. Civ. A. 96-7062, 1998 WL 196402, at *4 (E.D. Pa. Apr. 23, 1998); see also Whitehead, *supra* note 2, at 1113.


\(^\text{147}\) See West & Shah, *supra* note 2, at 6.
value creation by lawyers. I assume that the economic incentive for contracting is that it can create an overall value surplus that is distributed between the parties. A possible guiding principle for designing default rules is their potential to maximize this surplus (the “value-creation”). Therefore, optimal default rules regarding sandbagging will be discussed from the point of view of their value-creating potential. Although there may be alternative approaches, the assumption here is that a better default rule is one that leaves more room for cooperative bargaining, including “collaborative disclosure”. This is also in line with the theory of “penalty default rules,” which enhance the efficiency of contracting by promoting information exchange.

I believe the key question here to be whether warranty clauses should be generally applied to address both unknown and identified risks, or should they rather be a contractual tool for allocating only unknown risks while allowing identified risks to be allocated either by another type of contractual clause (a “special” or “standalone” indemnification clause) or through a negotiated pro-sandbagging clause covering all or some of the warranties. The first option corresponds to the pro-sandbagging approach, while the second corresponds to the anti-sandbagging approach.

Now, in following Professor Gilson’s method, I will discuss the value-creating mechanism related to contractual allocation of unknown risks and known (identified) risks. Based on this discussion, I will evaluate the efficiency considerations related to the sandbagging problem.

The value-creating mechanism of allocation of unknown risks is related to information asymmetry and information-gathering costs. The value-creating mechanism of allocation of identified risks involves the minimization of the cost of risk and the imposition of the relevant risk on the party who values this risk less (attributes a lower cost to this risk, the “least-cost avoider”). The difference between these value-creating mechanisms supports a claim that contractual instruments allocating either unknown or identified risks shall be clearly identifiable as having either purpose. Ultimately, this favors a general anti-sandbagging approach to warranty clauses.

Contractual warranties have a value-creating function, helping parties to overcome asymmetry of information and minimize the total cost of information.

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149 Claire A. Hill & Christopher King, How Do German Contracts Do as Much with Fewer Words, 79 CHI. KENT. L. REV. 889, 890 (2004) (“Contracting aims to create a bigger transactional pie in a world where parties’ incentives are misaligned and they need to coordinate the production of information, specify future rights, duties and procedures, and allocate risks.”).

150 Cole, supra note 2, at 453; Avery & Weintraub, supra note 2, at 2.

151 See Ayres & Gertner, supra note 137, at 91; see also Duchemin, supra note 2, at 711.
gathering and verification.\textsuperscript{152} By giving a warranty, the seller is forced to conduct an information production and verification exercise. The cost of such exercise for the seller, as the current owner of the business, should typically be inferior to the cost that the buyer would bear in connection with such data gathering and verification and also to the value that the buyer attributes to this verification. A set of warranties related to the business operation of the target company may create value for the buyer by reducing overall information production and verification cost.\textsuperscript{153} At the same time, the seller’s potential liability for breach of warranties is a contractual tool incentivizing him to provide accurate information.

In the context of information costs the warranties perform also a “signaling” function.\textsuperscript{154} The seller’s willingness to give certain assurances “signals” to the buyer particular quality of the asset being sold and thereby increases the seller’s potential for obtaining a satisfactory valuation. Such willingness may come from the seller’s typically low information production and verification costs, particularly due to the fact that, prior to the consummation of the transaction, it is the seller who controls the company and may exert influence on its directors and officers (in accordance with applicable corporate laws). Due to this signaling effect, warranty clauses may foster exchange by allowing the parties to agree on a valuation that is attractive to both the seller and the buyer. This occurs when the buyer’s willingness to pay the seller for his information production and verification exercise outweighs the seller’s costs of such an exercise.

Thus, the first value-creating component of contractual warranties is related to overcoming asymmetry of information, and arises from the difference in the costs of information production and verification. Typically, these costs are lower for the seller than they would be for the buyer, in particular in the transaction structure where the seller sells 100\% of stock in a closely held company. Accordingly, overall value can be created by attributing these costs to the seller, and the buyer paying for that by pricing it into the transaction value. Obviously, no value is created by overcoming information asymmetry and reducing overall cost of gathering and evaluating information to the extent

\textsuperscript{152} Gilson, \textit{supra} note 148, at 269.
\textsuperscript{153} \textit{Id.}
that both buyer and seller have knowledge of the relevant circumstances, or where either party has knowledge of such facts without the other party having the same knowledge. The value-creation mechanism related to information gathering and verification cost applies only when the circumstances which would render a warranty clause untrue are unknown to both parties. If the buyer knows of such circumstances, he cannot be paying for the seller’s information production effort.

Still, there is the argument, as raised by the Second Circuit in *Galli v. Metz*, that the buyer may be purchasing insurance. This argument will be discussed in the next part to determine whether such an insurance purchase can be both value-creating and efficient. Indeed, in parallel to the signaling and information function, the warranties also clearly perform an “insurance” function by allocating certain risks to the seller. If a warranty proves untrue, the buyer may have a warranty claim against the seller that will shift the burden of a given risk to the seller. Now, in this context, warranties may appear to have a certain value-creating function. They may create overall value to the extent that the costs of bearing this risk are lower for the seller that they would be for the buyer. Allocation of risk can be value-creating if a certain risk would have a lower cost for the seller than it has for the buyer.

It does not, however, seem possible to make such a determination *ex ante* with respect to warranties that protect the buyer without identifying the specified risks that are to be covered. The value-creation mechanism of risk allocation can work only to the extent that both parties identify a specific risk and agree to have it allocated contractually in a manner that does not follow the general risk allocation rules that would apply absent the agreement. In the M&A setting, this typically means allocating to the seller a risk that, under general rules, would be transferred to the buyer as part of the business.

With respect to circumstances that are unknown to both parties, the allocation of risk to the seller may prove randomly efficient or inefficient depending on the risk that materializes. Now, the condition for the efficiency of such risk allocation is both parties’ knowledge (and each party’s knowledge about the other party’s knowledge) of the specific risk. If only one party has knowledge of this specific risk (i.e., the circumstances that would render a warranty clause warranting the lack of such risks untrue), then this mechanism cannot be efficient. In such a setting, only one party is consciously allocating its risk to the other party, while the other party unknowingly runs into it without an opportunity to price it into the transaction.

This inefficiency is true for scenarios where the seller knowingly gives false warranties and also where the buyer knowingly accepts false warranties. This paper does not deal with the first scenario, which should be discussed in the context of fraud or deceit. In the sandbagging context, I focus only on the second scenario, in which the buyer knows or has reasons to know that the warranty is
false. If the buyer has knowledge of circumstances giving rise to a specific risk and negotiates for a warranty that he knows to be false, he is “buying the claim” rather than compensating the seller for his information production costs and for obtaining the assurance.

The problem is, however, that the unknowing seller cannot be reasonably viewed as selling this claim, because he is not aware of the nature of the risk that was identified by the buyer. Accordingly, the seller is not likely to price it properly. This appears to be a source of inefficiency in situations where the knowing buyer buys a warranty claim — with knowledge of the nature, scope, and magnitude of the risk — while the seller is unaware and unable to price the undertaken liability.

Now, the conclusion from the foregoing discussion is that there can be twofold value-creating effects of a contractual warranty.

The first relates to overcoming asymmetry of information and to the reduction of information production and verification costs. Value can be created by reducing these costs to the extent warranties cover risk arising from circumstances that are unknown to both parties. If these circumstances are known to the buyer, it cannot be reasonably assumed that he attributes any value to the seller assuming liability for identifying them. The buyer is merely attempting to purchase a warranty claim.

The second relates to the reduction of overall costs of risk by allocating the risk to the party who can bear this risk more cheaply, or in other words, whomever values the risk lower than the other party does (“least-cost avoider”). Now, this mechanism can be efficient if both parties are taking conscious decisions on allocation of risk. However, this requires the risk to be identified and specified. If the risk is unknown to both parties, then the value-creation through reduction of overall costs of risk is random. Without knowing the relevant risk, the parties cannot rationally attribute a value thereto and optimally allocate the risk to the party that will bear it at a lower cost. Hence, efficiency requires mutual knowledge and identification of the circumstances and the risk that they give rise to.

For the efficiency of the contract, it seems crucial that both parties are aware of the value-creating mechanism of the contractual tool they are choosing to apply. Under the pro-sandbagging scenario, the warranty may have a value-creating effect in connection with both the cost of information and cost of risk. However, the problem is that the seller may recognize what value the purchaser is

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155 Another interesting problem arises where both parties knowingly accept a false warranty clause. In such a setting, I believe the seller shall not be released from liability due to buyer’s knowledge, unless the clause can be interpreted as excluding liability for circumstances known to both parties. This may be argued in respect of general warranties but is not likely to succeed in respect with specific ones. In addition, seller’s potential liability for deceit would need to be discussed.
aiming to seize: the value of the seller’s information production exercise (and potential value of seller being liable for the irregularities that were unidentified by the buyer), or the value of the seller’s liability for risks known to the buyer. For the contracting process to be efficient (and to allow both parties to properly price the contractual non-pricing terms), both parties should be aware of the value-creating mechanism that applies. This may not be true in the pro-sandbagging scenario, where the buyer might be actually purchasing a claim while the seller is selling something else. However, if we assume the anti-sandbagging approach, the value-creation under contractual warranties is related mainly to overcoming information costs. Typically, the seller, who has owned the business for some time and controls the directors, has lower costs of information production and information verification than the buyer. Hence, it may be more efficient for the seller to take the risk of the information, as it is the seller who can manage this risk at a lower cost by conducting his own information production and verification exercise.

This value-creating mechanism works mainly to the extent the seller assumes either the risk of inaccuracy of information that he can verify or — in the legal term — liability for them. If warranties go beyond what the seller is able to verify, there is the potential value-creating element related to the allocation of risk, but it can be unpredictable *ex ante* because it is not clear who would be the more efficient risk bearer of an unknown risk. However, the buyer will not be able to consciously allocate risk without the seller’s awareness that an identified and specific risk is indeed shifting between the parties.

The foregoing discussion supports the findings of Professor Whitehead. It is more efficient to allow the seller to generally assume that the buyer is not purchasing claims for identified risks. If the buyer intends to do so, he should identify himself as willing to negotiate for sandbagging rights, or he should

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156 The interplay between value-creation and value-distribution in respect of warranty clause depends also on the design of particular warranty clauses, e.g. on the seller’s knowledge qualifiers or materiality qualifiers. I write more on these topics in Jacek Jastrzębski, *Value creation in negotiations of contractual warranties and indemnifications*, EUR. COMPANY & FIN. L. REV. (forthcoming Mar. 2019).

157 In addition, substituting buyer’s verification with seller’s verification may be related to the buyer’s or target’s unwillingness to disclose certain business-sensitive information; to some extent such a disclosure may be also limited due to regulatory constraints (professional secrecy, anti-trust laws). Instead of allowing the seller to review certain documents, the seller may prefer to assure the buyer e.g. on the market-standard terms thereof, lack of unusual termination rights or liquidated damages clauses.

158 In the typical transactional setting this is reflected by a “seller’s knowledge”-based qualification of some of the warranties, which are then given “to the seller’s best knowledge”. The “seller’s best knowledge” is typically defined in the acquisition agreement.

159 Whitehead, *supra* note 2, at 1104.

160 *Id.* at 1106.
negotiate for a specific “standalone” indemnity clause. 161 Therefore, the anti-sandbagging approach appears to allow the parties to more accurately price the contractual terms and also enhance the efficiency of the contracting process. This is in line with the argument that anti-sandbagging favors “collaborative disclosure.” 162

As previously discussed, contractual allocation of identified risks can also deliver overall value increase when the risk is shifted to the party who can bear it at a lower cost. It is efficient for the parties to shift this risk and to then compensate the risk-bearing party, as the value of such compensation can be higher than the risk-bearing party’s cost and also lower than a potential cost to the other party. Hence, contractual clauses that relate to identified risks and shift them to the appropriate party, who would not bear them absent contractual arrangement, may have a value-creating effect.

The pre-condition for such clauses enhancing efficiency of the contracting process is that both parties know what is actually being contracted for when they consider a particular clause. Only then can both parties adequately price the value of this clause. There is clearly a need for a contractual instrument that would allow the parties to allocate identified risks related to circumstances known to the parties.

For reasons stated above, I believe that these contractual tools should be recognizable as having such an effect and should be distinguishable from general warranties. Therefore, I believe that the ideal contractual instrument for allocating specific, identified risks that are known to the parties is a “special” or “standalone” indemnification clause. While negotiating such a clause, the parties will clearly understand that the potential value produced by this contractual arrangement comes from allocating a specific risk to the cheaper risk bearer (“least-cost avoider”). The efficiency mechanism here is clear, and both parties are in a position to price the clause according to their respective costs of risks and the value that they place on having this risk allocated to the other party.

The example of “standalone” (“special”) indemnities also demonstrates that a buyer who has identified specific risks related to the target has available

161 This solution is suggested as an alternative to a pro-sandbagging clause. West & Shah, supra note 2, at 6; Shadden, supra note 2, at 469.

162 Cole, supra note 2, at 453; Avery & Weintraub, supra note 2, at 2:

An “anti-sandbagging” clause helps ensure that if the buyer learns of a potential problem during its diligence, it will raise the issue with the seller before the closing, which will help facilitate full and responsive disclosure as well as discussions about how to deal with the issue as between the buyer and the seller. For example, if a potential area of litigation or regulatory risk is uncovered by the buyer in its diligence, the seller and buyer could jointly determine the level of risk, whether or not that risk was insured (or insurable), and how the residual risk should be allocated as between buyer and seller—such as through a specific special indemnity subject to caps and time periods tailored to that risk.
contractual tools for potentially (subject to the parties’ mutual agreement) allocating the economic burden of this risk to the seller. The buyer can either negotiate for a pro-sandbagging clause (a general one or related to certain warranties) or for a “standalone” specific indemnity covering the identified risk.\footnote{This alternative negotiation strategy is mentioned also by West & Shah, supra note 2, at 6; Shadden, supra note 2, at 469.} The seller should insist that the buyer indicate the specific risk that he has identified and expected to be covered, notwithstanding the buyer’s knowledge, rather than agree to a general pro-sandbagging rule that may capture more than just the risks that the parties have consciously agreed to remain with the seller.

Now, there remain some questions: why follow the anti-sandbagging default standard and use two contractual instruments (warranty clauses and “standalone” indemnity clauses) if one (warranty clauses) could be sufficient under the pro-sandbagging standard? “Standalone” indemnity clauses may not be an “off-the-rack” legal tool that can be easily copy-pasted from one agreement to the other, so perhaps the cost of applying them in parallel to a standard set of warranties accompanied with the sandbagging right would be a more efficient scenario? Actually, I do not believe either circumstance to be the case.

“Standalone” indemnity clauses have become relatively common in acquisition agreements,\footnote{See Avery & Huang, supra note 11, at 3, for statistics regarding the use of “standalone indemnification clauses.”} and a skilled transaction lawyer can easily advise his client on possible designs of such clauses. They can be viewed as an easily available (in terms of the required legal skills) and inexpensive (in terms of legal costs) contractual solutions to the problem of how to deal with a risk that the buyer has identified and fears are precluded from a breach of warranty claim due to his pre-signing knowledge. Accordingly, I believe the legal cost to the buyer of negotiating for a “standalone” indemnity clause and the incremental complexity of the agreement related to the insertion of a “standalone” indemnity do not outweigh the benefits to the efficiency of the contracting process that I have discussed above.

Obviously, there may be other “costs” of negotiating for the indemnity, this cost being the top-up in price that the seller expects to receive for staying with a given risk post-closing. However, this goes to the root of the value-considerations underpinning the negotiations of an acquisition agreement. It also confirms that making the buyer ask for a specific “standalone” indemnity, rather than remaining silent and sandbagging the seller under a general pro-sandbagging rule, is the more economically efficient way of contracting. Both parties can price the risk and decide what would constitute optimal allocation thereof. The availability of efficient alternative legal tools for allocating identified risks is a strong argument for excluding the right to sandbag under the general anti-
sandbagging default rule. The benefit of increased efficiency of the contracting process outweighs the cost related to the functional distinction between warranty clauses and “standalone” contractual indemnifications.

The foregoing considerations are in line with the fairness approach. It is not unfair to contractually allocate specific risks to a party that would not bear them absent a contract, as long as both parties are indeed contracting for an allocation of these specific risks. 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. It appears that expecting the buyer in such a situation to negotiate for a specific “standalone” indemnification clause is a far better standard. Such an approach clearly shows that what the parties have mutually agreed and contracted for is the conscious contractual allocation of an identified risk.

The argument that it is fair for the buyer to have the right to sandbag because he paid for the business being sold “as warranted” is not compelling. If a sophisticated buyer is aware of certain adverse circumstances related to the target business, it is not reasonable to assume that he does not price these circumstances into his valuation just because of a general contractual assurance of their absence. Conversely, the argument that the buyer will have to pay for specific “standalone” indemnification clause as it is not already included clearly confirms that such a coverage of identified risks is not necessarily contemplated under the general standard for warranty liability.

A possible counterargument to the general anti-sandbagging position includes the following: if the buyer’s knowledge precluded him from bringing warranty claims, he would not be incentivized to undertake information gathering activity even when he is well-positioned to obtain such information from third parties. Default rules should foster reasonable information gathering efforts rather than discourage the buyer from collecting information. New York law attempted to achieve this aim by distinguishing buyer’s knowledge that has been obtained from the seller, from knowledge acquired from third parties or from the public domain.165 Now, the question is, whether this should be the optimal default rule. Is the optimal default rule that only the buyer’s knowledge, provided to him by the seller, releases the latter from liability under express warranties?

This last hypothesis appears consistent with the enforcement certainty argument that supports the general pro-sandbagging rule. The hypothesis claims that, under the anti-sandbagging approach, the seller is awarded a knowledge-based defense that can lead to lengthy and costly court proceedings, including protracted evidentiary processes related to establishing the buyer’s actual or constructive knowledge. Contrarily, a pro-sandbagging rule provides the buyer

165 Galli v. Metz, 973 F.2d 145, 151 (2d Cir. 1992).
with a cleanly enforceable claim. There is some definite truth to this argument, as a potential evidentiary process can substantially increase the cost and time of enforcing a warranty claim. It may appear reasonable to define the scope of information that will be deemed to be “disclosed” to the buyer and, accordingly, to qualify the seller’s liability under the warranty clauses.\textsuperscript{166}

As far as the certainty of enforcement argument is concerned, I acknowledge that extending the releasing effect of buyer knowledge to information obtained from third parties may expose the buyer to enforcement costs related to evidentiary process. However, conclusive proof that the buyer was aware of a given fact appears to impose a relatively high burden, which is with the seller. A potential way to reduce the costs related to uncertainty of enforcement would be to elevate the standard of proof that is required from the seller in order to avoid liability due to buyer’s knowledge.\textsuperscript{167}

\textsuperscript{166} In European transactions, this matter is typically the subject of contractual regulations. It is common to have the content of the data room in electronic form attached to the acquisition agreement. If only information provided by the seller constitutes disclosure, with the effect of excluding seller’s liability, then this may reasonably limit the potential scope of the fact-specific discussions as to the extent of the disclosure (Still, it is significantly different from the situation in the pro-sandbagging setting where only specific (and negotiated) disclosure made in the agreement or in the schedules will have an effect of releasing the seller from liability. See Cole, supra note 2, at 451–52 (discussing potential arguments of the buyer’s while negotiating for a sandbagging provision). The effect of forcing the seller to produce extensive disclosure schedules is a potential benefit of the pro-sandbagging approach. I believe however that even under the anti-sandbagging approach the seller is incentivized to provide disclosure schedules as it significantly facilitates his potential proof of buyer’s knowledge. Disclosure letters and other disclosure schedules are typically applied also in European transaction even though the standard there is the anti-sandbagging approach. Obviously, the role of disclosure schedules is far more significant under the anti-sandbagging standard). An open issue remains however the approach to buyer’s knowledge obtained from third parties or independently. The question is which arguments prevail. Does the goal of having both parties aware of the economics underlying a warranty clause (reduction of information costs v. reduction of costs of risk) outweigh the goal of encouraging independent information production by the buyer? Ultimately, I believe that the first argument prevails, and under the default rule the buyer’s knowledge obtained from third parties should have the same effect on liability that the knowledge acquired from third parties. Parties may contract around this rule and potentially limit the scope of disclosure having such effect to information provided by the seller.

\textsuperscript{167} This would mirror a similar logic that is applied to deceit and the possibility to contract-out liability for deceit. With the current rule being rather that liability for deceit cannot be contracted-out, the alternative solution is to impose a high standard of proof. See Mark P. Gergen, Contracting Out Liability for Deceit, Inadvertent Misrepresentation and Negligent Misstatement, in EXPLORING CONTRACT LAW 237, 265–66 (Jason W. Neyers et al. eds., 2009) (“clear and convincing evidence”).
VIII. SUMMARY

The doctrinal discussion on the reliance requirement under warranty clauses in U.S. law focuses on the evolution of warranties from tort law to contract law and tends to abolish the remains of tort-rooted concepts, including reliance. However, both the common law and the UCC remain unsettled on the issue of sandbagging.

Some claim that the drafters of the UCC wanted to free the law of express warranties from the tortious concepts of reliance that had been previously present in the USA. Nevertheless, there are still authorities finding the reliance requirement in the current “part of the basis of the bargain” wording of UCC Article 2-313. Moreover, effects similar to those stemming from the reliance requirement, in particular as far as the case of the buyer’s knowledge is concerned, may follow from the application of the “reasonable expectations” doctrine.

At common law, the approach to sandbagging differs across states. New York law, which is particularly prominent in the field of M&A transactions, generally follows the rules stemming from the contractual nature of the warranties. However, it did not expressly abolish the reliance requirement, but rather rephrased it to cover the question whether the buyer reasonably understood to be purchasing the seller’s promise as to the truth of the warranty. This still leaves some room for interpretation. Moreover, courts applying New York law have made certain distinctions related — i.e., to the source of the buyer’s knowledge, the time when the buyer acquired the knowledge, etc. The New York modern approach to reliance, coupled with the “reasonable expectations” doctrine, provides useful guidance on the sandbagging issue. It is not clear whether a buyer who knows of a warranty being untrue can meet the reasonable expectations doctr in the case by arguing that the warranty is a “part of the basis of the bargain.” While the sandbagging problem may be difficult to solve solely through doctrinal arguments, I believe that additional efficiency considerations support anti-sandbagging as the default rule.

In addition to the considerations discussed in legal writing so far, particularly by Professor Whitehead, I propose additional arguments for this claim. In applying Professor Gilson’s terminology, I find that the value-creation mechanisms are different if it comes to allocating unknown risks (where the value comes from a reduction of information costs) or identified risks (where the value

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170 See Whitehead, supra note 2, pt. 6, at 1102–05.
comes from a reduction of overall costs of risk). The parties can properly price a contractual term only if there is clarity on the value-creating mechanism, thereby distinguishing clauses allocating identified risks from those that merely serve as assurances. I believe that warranties — absent contractual language to the contrary — should not protect the buyer against risks arising from circumstances that the buyer was aware of; such risks can be ideally allocated under a specific “standalone” indemnification clause. This corresponds to the English and Canadian transactional practice rather than the American trend.

Finally, my conclusion supports the general “anti-sandbagging” default rule, which is consistent with the findings of Professor Whitehead. It also provides a rationale for a functional distinction between contractual warranties and indemnification clauses, which is particularly interesting from the comparative perspective, since American transactional practice seems to forego the distinctions among representations and warranties and indemnities. The difference is relevant in the context of the buyer’s knowledge of particular risks arising of circumstances which would render a warranty untrue, if given. If the parties intend to contractually allocate such risks, I believe the preferable tool for such a conscious allocation is an indemnification clause rather than a contractual warranty.

171 West & Shah, supra note 2, at 5. As much as I believe the direction of abolishing the distinction between representations and warranties to be a reasonable one, I still see some value in distinguishing contractual indemnities on the one hand from representations and warranties on the other hand.