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SANDBAGGING IN CANADIAN LAW AND PRACTICE

Camden Hutchison*

In the language of mergers and acquisitions, "sandbagging" refers to situations in which a buyer brings an indemnification claim for a breach of the seller's representations and warranties that the buyer was aware of prior to closing. In contractual negotiations, sellers often argue that sandbagging allows unscrupulous buyers to reduce the agreed-upon purchase price by abusing the indemnification mechanism. For their part, buyers argue that sandbagging can protect their legitimate contractual interests, particularly in cases where a seller seeks to dispute a valid indemnification claim. This tension between buyers and sellers is heightened by the fact that the legal status of sandbagging in Canada is unclear. Although transactional lawyers generally believe that courts will enforce clear "pro" or "anti" sandbagging provisions—i.e., contractual provisions that expressly permit or forbid sandbagging—whether courts will permit sandbagging in the face of contractual silence is uncertain.

In light of this uncertainty, this article argues that courts should adopt a clear "pro-sandbagging" default rule in cases where the acquisition agreement is silent. Although sandbagging is controversial, this article argues that there are important practical and economic reasons to allow buyers to bring indemnification claims for contractual breaches of which they allegedly had knowledge. My central argument is that a pro-sandbagging default rule is economically efficient in that it (1) facilitates the informational purpose of contractual representations and warranties and (2) reduces ex post litigation costs. By interpreting the terms of M&A agreements strictly—thereby allowing sandbagging—courts can increase legal

* Associate Professor, Peter A. Allard School of Law, University of British Columbia. I would like to thank Ryan Black, Paul Blyschak, Christian Gauthier, Valerie Mann, Bradley Newby, Jason Osborn, and Susan Tomaine for helpful insights regarding the negotiation of pro- and anti-sandbagging provisions. I would also like to thank Yara Nijm for helpful editing and research assistance. Any errors are my own.

certainty while facilitating the production of valuable information, ultimately benefiting both buyers and sellers.

I. INTRODUCTION

In the language of mergers and acquisitions (M&A), "sandbagging" refers to situations in which a buyer brings an indemnification claim for a breach of the seller's representations and warranties that the buyer was aware of prior to closing.[1] Invoking the tactics of nineteenth-century street gangs that waylaid their victims with sand-filled socks, the term is meant to suggest unfair or dishonest conduct on the part of the buyer.[2] Sellers often argue that sandbagging allows unscrupulous buyers to reduce the negotiated purchase price by abusing the indemnification mechanism. For their part, buyers argue that sandbagging can protect their legitimate contractual interests, particularly in cases where sellers seek to dispute valid indemnification claims. Given the ethical implications of sandbagging and its sensitivity for both buyers and sellers, negotiations over sandbagging can be particularly contentious.[3]

This tension is heightened by the fact that the legal status of sandbagging in Canada is unclear. Although transactional lawyers generally believe that courts will enforce clear "pro" or "anti" sandbagging provisions—i.e., contractual provisions that expressly permit or forbid sandbagging—whether courts will allow sandbagging in cases of contractual silence is uncertain.[4] The relevant case

1. Kim M Shah & Glenn D West, "Debunking the Myth of the Sandbagging Buyer: When Sellers Ask Buyers to Agree to Anti-Sandbagging Clauses, Who Is Sandbagging Whom?" *The M&A Lawyer* (January 2007) at pp. 1-2; Practical Law Canada Corporate and Securities, *Share Purchase Agreement (pro-purchaser long form)* (Thomson Reuters).
2. Kim M Shah & Glenn D West, "Debunking the Myth of the Sandbagging Buyer: When Sellers Ask Buyers to Agree to Anti-Sandbagging Clauses, Who Is Sandbagging Whom?" *The M&A Lawyer* (January 2007) at p. 1. The origins of the term "sandbagging" are uncertain. Although it is often ascribed to nineteenth-century street gangs, the term also exists in golf, auto racing, horse racing, sailing, martial arts, pool, and poker. In competitive contexts, the term generally means deceiving one's opponent by pretending to be in a weak or disadvantaged position.
3. Thomas Taylor, "'Sandbagging' in M&A transactions", (12 June 2019), online: *Dentons* <https://www.dentons.com/en/insights/articles/2019/june/12/sandbagging-in-m-a-transactions>; Charles Whitehead, "Sandbagging: Default Rules and Acquisition Agreements" (2011), 36 Del. J. Corp. L. 1081.
4. See Andrew Bunston, Colin Cameron-Vendrig & Paul Mingay, "Good Tactics or Bad Faith: The Divisive Issue of Sandbagging in M&A", (19 January 2017), online: *BLG* <https://www.blg.com/en/insights/2017/01/good-tactics-or-bad-

law is sparse and points in conflicting directions.[5] To make matters worse, the Supreme Court of Canada's recent announcement of an "organizing principle of good faith" in Canadian contract law has further muddied the waters.[6] This legal uncertainty has significant implications for Canadian M&A transactions, the majority of which feature no express pro- or anti-sandbagging provisions.[7] The result is that buyers lack certainty that their indemnification claims will be respected in cases where the seller can credibly argue that the buyer had prior knowledge of the breach.

Given the importance of legal certainty to corporate transactions, this article argues that courts should adopt a clear "pro-sandbagging" default rule in cases where the acquisition agreement is silent. Although sandbagging is often caricatured as deceitful, I argue that there are important practical and economic reasons for buyers to claim indemnification for breaches of which they allegedly had knowledge. My central argument is that a pro-sandbagging default rule is economically efficient in that it (1) facilitates the informational purpose of contractual representations and warranties and (2) reduces *ex post* litigation costs. By interpreting the provisions of M&A agreements strictly—thereby allowing sandbagging—courts can increase legal certainty while facilitating the production of valuable information, ultimately benefiting both buyers and sellers.[8] Under my proposal, parties that wish to opt out of a pro-sandbagging default rule and negotiate an anti-sandbagging rule would remain free to do so.

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faith-the-divisive-issue-of-sandbagging-in-ma>; Laurie Duke & Sophia Tolias, "Catching the Sandbagger off the Green: Sandbagging in M&A", (11 April 2017), online: *Torys* <https://www.torys.com/our-latest-thinking/publications/2017/04/catching-the-sandbagger-off-the-green-sandbagging-in-m-and-a>; Neill May, "Sandbagging: When Parties to M&A Deals Press Their Advantage by Exaggerating Their Weaknesses", (3 June 2022), online: *Canadian Lawyer* <https://www.canadianlawyermag.com/news/opinion/sandbagging-when-parties-to-ma-deals-press-their-advantage-by-exaggerating-their-weaknesses/367177>.

5. See, e.g., *Eagle Resources Ltd. v. MacDonald*, 2001 ABCA 264 (Alta. C.A.), reconsideration / rehearing refused 2002 ABCA 1 (Alta. C.A.), additional reasons 2002 ABCA 12 (Alta. C.A.), leave to appeal refused 2002 CarswellAlta 1130, 2002 CarswellAlta 1131 (S.C.C.); *North Sun Mortgage Corp. v. Crossley*, 2002 ABQB 66 (Alta. Q.B.); *Transamerica Life Canada Inc. v. ING Canada Inc.*, 2003 CarswellOnt 4834 (Ont. C.A.); *6038212 Canada Inc. v. 1230367 Ontario Ltd.*, 2014 CarswellOnt 6434 (Ont. C.A.).
6. See *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) [*Bhasin*]; *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.) [*C.M. Callow Inc.*].
7. See the discussion in Part II below.
8. According to the language of most M&A agreements, the buyer's knowledge has no bearing on indemnification rights. See footnote 15 and accompanying text.

The remainder of this article proceeds as follows. Part II discusses the negotiation and practical consequences of sandbagging provisions in M&A agreements. This discussion addresses buyers' and sellers' arguments for and against sandbagging, as well as the relative prevalence of pro-sandbagging provisions, anti-sandbagging provisions, and contractual silence in acquisition agreements. Part III explores the unsettled status of sandbagging under Canadian law, including the development of (1) the operating principle of good faith and (2) the duty of honest contractual performance under *Bhasin* and *C.M. Callow Inc.* Part IV recommends that courts establish a pro-sandbagging default rule under Canadian contract law. This part discusses the economic implications of sandbagging and how a pro-sandbagging default rule can be reconciled with *Bhasin* and *C.M. Callow Inc.* Part V concludes, offering a critical perspective on recent trends in the contract jurisprudence of the Supreme Court.

II. SANDBAGGING IN CANADIAN M&A TRANSACTIONS

In agreements for the sale and purchase of private companies,[9] the seller typically makes a number of representations and warranties regarding the business, financial, and legal status of the company being sold. These representations—essentially factual promises as to the quality of the business—are in turn backed by an indemnification mechanism by which the buyer can seek damages for losses associated with misstatements by the seller. Since buyers typically conduct due diligence on the target company prior to closing, it is possible for a buyer to close an acquisition with knowledge of a seller's "breach of rep." Seeking indemnification for a known breach of rep constitutes "sandbagging," a controversial practice that can raise difficult legal and ethical issues.[10] Given its controversial nature, sandbagging is often specifically addressed during the parties' contractual negotiations. Indeed, many acquisition agreements include express pro-[11] or

9. Sandbagging is not an issue in public-company transactions, which generally do not include indemnification.

10. "Sandbagging" is not a precise legal term, but rather a general description of the practice of seeking indemnification for known breaches. "Sandbagging" can encompass situations in which the buyer either did or did not notify the seller of the breach prior to closing, for example.

11. The following is a typical pro-sandbagging provision: "The representations, warranties and covenants of the Indemnifying Party, and the Indemnified Party's right to indemnification with respect thereto, shall not be affected or deemed waived by reason of any investigation made by or on behalf of the Indemnified

anti-[12] sandbagging provisions, and even in transactions where the acquisition agreement is silent, this silence is often an agreed-upon resolution of the parties' explicit negotiation of the issue. Although the term "sandbagging" implies deceitful conduct, the reality is that buyers and sellers have legitimate arguments for and against sandbagging, as discussed below.

1. Arguments for and Against Sandbagging

There are several legitimate reasons for buyers to demand sandbagging rights. Perhaps the most important is that an explicit right to sandbagging protects the buyer from claims that the buyer had (or should have had) knowledge of a particular breach. This is an important protection given the expansive disclosure by sellers during the due diligence process, and the risk that a seller may use its disclosure to limit the buyer's indemnification rights. For example, if a seller is able to argue that it disclosed information relating to a breach of rep during the due diligence process, it may be able to credibly argue that the buyer had "knowledge" (either actual or constructive) of the underlying breach.[13] Some sellers even abuse the due diligence process by "dumping" an overwhelming amount of disclosure on the buyer shortly before closing.[14] If the buyer proceeds to close, the seller can potentially argue that the buyer had knowledge of anything and everything disclosed, regardless of the buyer's actual awareness of any breach. A pro-sandbagging provision prevents these tactics by removing the buyer's knowledge from judicial consideration. Even in cases

Party (including by any of its Representatives) or by reason of the fact that the Indemnified Party or any of its Representatives knew or should have known that any such representation or warranty is, was or might be inaccurate or by reason of the Indemnified Party's waiver of any [closing condition], as the case may be." "Share Purchase Agreement (pro-purchaser long form)," Practicing Law. See also Note: Effect of Investigation.

12. The following is a typical anti-sandbagging provision: "Vendor shall not be liable [for indemnification of] any Losses based upon or arising out of any inaccuracy in or breach of any of the representations or warranties of Vendor set out in this Agreement if Purchaser had knowledge of such inaccuracy or breach before the Closing." "Share Purchase Agreement (pro-vendor long form)," Practicing Law. See also Note: Anti-Sandbagging.
13. "Knowledge" may be defined in the agreement to include constructive knowledge (i.e., what the buyer should have known upon reasonable investigation) in addition to actual knowledge. The definition of knowledge negotiated by the parties is therefore very important to construing and applying sandbagging provisions.
14. This is especially a concern when a seller is continuously uploading materials to a virtual data room.

where the seller does not abuse the due diligence process, a pro-sandbagging provision can preclude expensive and uncertain post-closing litigation over what the buyer did or did not know.

Another argument in support of sandbagging is that the buyer is purchasing the representations and warranties themselves, independent of the buyer's knowledge. Representations and warranties are literally that—warranties—and buyers can argue that their knowledge of the underlying business is irrelevant. To provide an analogy, suspicion or even knowledge that a consumer durable (such as an automobile) may be unreliable in no way affects its warranty. In addition, the buyer's right to indemnification is presumably included in the purchase price, which (all else being equal) would have otherwise been lower. From the buyer's perspective, indemnification is a form of negotiated financial protection that should mitigate its losses independent of the buyer's due diligence. As discussed in Part IV, the contrary position has the ironic effect of turning the buyer's due diligence against it.

Finally, even where the acquisition agreement is silent, the language and structure of most acquisition agreements contemplate sandbagging as a matter of contractual interpretation. Absent an express anti-sandbagging provision,[15] there is nothing in the language of most acquisition agreements that prevents buyers from bringing indemnification claims for known breaches. Indeed, as discussed in Part III, legal presumptions against sandbagging derive not from traditional contract law, but rather from equitable principles derived from tort law. Thus, buyers can credibly argue that a pro-sandbagging provision simply clarifies the existing logic of representations and warranties.

Sellers, of course, have a much different perspective on sandbagging. Sellers are concerned that buyers may discover a breach of rep during the due diligence process (or through independent investigation), conceal the breach from the seller, and then close the transaction with the intent of seeking indemnification. Not only does this tactic deprive the seller of crucial information, it can also force the seller to accept a lower purchase than they would have otherwise agreed to. If a buyer demands a purchase-price reduction based on issues uncovered in due diligence prior to closing, the seller remains free to walk away from the deal if the parties cannot agree on a renegotiated price. If,

15. As discussed in Part II.2, express anti-sandbagging agreements are relatively rare.

however, the buyer brings a successful indemnification claim *after* the closing, the seller is effectively forced to accept a lower purchase price. Not only is this an economic risk for the seller, it also entails (arguably) unethical conduct on the part of the buyer. Thus, sellers often take a strong stance against pro-sandbagging provisions.

2. Prevalence of Sandbagging Provisions

Buyers and sellers can resolve negotiations over sandbagging in one of three ways: (1) agreeing to a pro-sandbagging provision; (2) agreeing to an anti-sandbagging provision; or (3) contractual silence. The prevalence of each of these approaches can be gleaned from deal points studies, such as those published by the American Bar Association. These studies suggest that pro-sandbagging provisions are somewhat more common than anti-sandbagging provisions, and that contractual silence has (until recently) been more prevalent in Canada than in the United States.

In researching this article, I examined three series of deal points studies: the American Bar Association's private target M&A deal points studies for Canada and the U.S.,[16] and Practical Law's Canadian private M&A deal points studies.[17] Unfortunately, all of these studies are limited to private transactions in which the buyer was a public company.[18] Since most acquisitions of private companies are effectuated by other private companies, this reduces the representativeness of these studies. Nevertheless, deal points studies can still illustrate broader trends. These trends, as reflected in each series, are depicted below.

16. *Private Target Mergers & Acquisitions Deal Points Study* (American Bar Association, 2007-21); *Canadian Private Mergers & Acquisitions Deal Points Study* (American Bar Association, 2010-18).
17. *What's Market: Legal Trends in Canadian Private M&A* (Practical Law, 2017-22). Note that the Practical Law studies cover transactions from the year prior to publication.
18. The terms of purely private transactions are almost always confidential. Under U.S. and Canadian securities law, however, public companies must disclose material transactions—including the underlying agreement—as part of their public disclosure obligations. For this reason, deal points studies generally include acquisitions by public buyers, but not private buyers.

Table 1. Canadian Private Mergers & Acquisitions Deal Points Study (Canada)

Annual Percentages: Pro-Sandbagging Provisions, Anti-Sandbagging Provisions, and Contractual Silence

Year	Pro-Sandbagging Provision	Anti-Sandbagging Provision	Contractual Silence
2010	10%	21%	69%
2012	24%	9%	67%
2014	15%	14%	71%
2016	31%	15%	54%
2018	22%	12%	66%

Table 2. What's Market: Legal Trends in Canadian Private M&A (Canada)

Annual Percentages: Pro-Sandbagging Provisions, Anti-Sandbagging Provisions, and Contractual Silence

Year	Pro-Sandbagging Provision	Anti-Sandbagging Provision	Contractual Silence
2016	19%	23%	58%
2017	20%	25%	55%
2018	17%	19%	64%
2019	20%	18%	62%
2020	23%	22%	55%
2021	14%	19%	67%
2022	12%	20%	68%

Table 3. Private Target Mergers & Acquisitions Deal Points Study (U.S.)

Annual Percentages: Pro-Sandbagging Provisions, Anti-Sandbagging Provisions, and Contractual Silence

Year	Pro-Sandbagging Provision	Anti-Sandbagging Provision	Contractual Silence
2007	50%	9%	41%
2009	39%	8%	53%
2011	41%	5%	54%
2013	41%	10%	49%
2015	35%	9%	56%
2017	42%	6%	51%
2019	37%	4%	59%
2021	29%	2%	68%
2023	19%	5%	76%

Although there is considerable variation year to year, these studies reveal certain patterns. With respect to Canada, the proportion of pro-sandbagging and anti-sandbagging provisions is relatively comparable,[19] whereas the most common outcome is contractual silence. In most years, both anti-sandbagging and contractual silence were more common in Canada than the U.S., where parties are more likely to agree to pro-sandbagging provisions. According to the American Bar Association's private deal studies, pro-sandbagging provisions are included in approximately one-third to one-half of U.S. acquisition agreements, whereas anti-sandbagging provisions are relatively rare. Interestingly, the prevalence of contractual silence in U.S. agreements has been increasing over time, with the percentage of agreements that do not mention sandbagging exceeding that of Canada in 2021 and 2023.

19. The average annual percentages are 20.4% "pro" and 14.2% "anti" in the American Bar Association studies, and 17.9% "pro" and 20.9% "anti" in the Practical Law studies. The combined averages across both studies are 19.2% "pro" and 17.6% "anti."

What explains these trends? First, it is important to understand that, in most cases, contractual silence is *not* the result of inattention by the parties but is instead an intentional negotiation outcome. As confirmed by interviews with practitioners, negotiations over sandbagging are often difficult and contentious.[20] If mishandled, these negotiations can become a source of tension between the parties. Parties are often willing to leave the issue out of the agreement entirely, implicitly deferring its resolution to the unlikely event of litigation.[21]

Understanding that contractual silence is often a deliberate choice, two questions spring from the data: first, why has contractual silence been more common in Canada than the U.S., and second, why has contractual silence in the U.S. been increasing? As to the first question, my interviews with Canadian practitioners indicate that lawyers in Canada are less concerned by litigation risk than their American counterparts for a variety of reasons, including the infrequency of civil jury trials,[22] lower damages awards,[23] and the "English rule" of awarding costs.[24] One interlocuter commented that U.S. practitioners are more aggressive in arguing for pro-sandbagging provisions. Somewhat surprisingly, some of the Canadian practitioners I spoke with conveyed a degree of comfort that a court would "get it right" if the issue went to

20. As background research for this article, I conducted informal interviews with Ryan Black, Paul Blyschak, Christian Gauthier, Valerie Mann, Bradley Newby, Jason Osborn, and Susan Tomaine.

21. Although leaving the agreement silent exposes the parties to litigation risk, doing so may be rational if the transaction costs of negotiating a sandbagging provision exceed the costs of litigation, discounted by its probability.

22. The availability of civil juries varies among Canadian provinces, but they generally play less of a role than in U.S. jurisdictions. W A Bogart, "'Guardian of Civil Rights . . . Medieval Relic': The Civil Jury in Canada." (1999), 62: 2 Law & Contemp Probs 305 at pp. 305-06.

23. The U.S. features notoriously high damages awards, partly as a result of the leeway given to award punitive damages; other western countries, including Canada, have placed greater limits on damages awards. John Y Gotanda, "Punitive Damages: A Comparative Analysis," (2004), 42:2 Colum. J. Transnat'l L. 391 at p. 441.

24. Under the English rule, the successful party has their reasonable attorneys' fees paid for by the losing party, versus the American rule, where each party pays their own legal fees regardless of outcome. Theodore Eisenberg & Geoffrey P Miller, "The English Versus the American Rule on Attorney Fees: An Empirical Study of Public Company Contracts" (2013), 98:2 Cornell L.R. 327 at p. 327. The English rule reduces litigation and deters Canadian litigants from taking frivolous or trivial actions that would unnecessarily increase the cost of the opposing party's legal fees. Robert J Drake & Robert D Malen, "Rule 57 (costs of proceedings)," in Noel Semple, ed, *Civil Procedure and Practice in Ontario* (Canadian Legal Information Institute, 2022).

litigation, despite the lack of certainty in Canadian case law (discussed in Part III).

As to the second question, there appears to be no relationship between the increasing prevalence of contractual silence and legal changes in any major U.S. jurisdiction.[25] Although it is therefore difficult to say what has caused the increase, I attribute it to two possible factors. The first is simply a pro-seller market. In the U.S., pro-sandbagging provisions have traditionally been more common than anti-sandbagging provisions, which are generally considered "not market." As the recovery from the great financial crisis, low interest rates, and inflated asset values created increasingly favourable conditions for sellers, the market may have shifted from pro-sandbagging to contractual silence (the incrementally pro-seller outcome). However, the fact that contractual silence has continued to increase following the market contraction of 2022 may call this explanation into question.[26] The second and perhaps more likely factor is the rise of representation and warranty insurance.[27] This insurance product, which has replaced indemnification in many deals, does not cover known breaches and renders sandbagging provisions largely irrelevant. Note, however, that representation and warranty insurance is less common in Canada, and therefore cannot explain the Canadian data.[28]

Whatever the explanation, the most important finding in the Canadian studies for purposes of this article is that most Canadian M&A agreements include neither pro- nor anti-sandbagging provisions. The prevalence of contractual silence in Canadian

25. Developments in the law of Delaware and New York are discussed in Part III.A. These developments do not plausibly account for the increase in contractual silence.
26. According to most metrics, the M&A markets peaked in 2021 and significantly contracted in 2022 and 2023.
27. According to the American Bar Association, the percentage of transactions in which the acquisition agreement references representation and warranty insurance increased from 29% in 2016 to 65% in 2020. Since not all transactions featuring representation and warranty insurance include references in the agreement, these figures likely understate the percentage of transactions that include representation and warranty insurance, at least with respect to public buyers.
28. Although precise data on the prevalence of representation and warranty insurance in Canada are scarce, representation and warranty insurance is almost certainly less common than in the U.S. According to Practical Law's 2023 *What's Market: Legal Trends in Canadian Private M&A* study, representation and warranty insurance was present in 8% of all transactions, and 22% of transactions valued over $100 million. The accuracy of this data is questionable, however, for the same reason mentioned in footnote 27.

agreements is important given the unsettled state of the law. Without greater clarity, parties face the spectre of uncertain litigation.

III. THE UNSETTLED STATUS OF SANDBAGGING UNDER CANADIAN LAW

Under Canadian contract law, the default rule regarding sandbagging—i.e., whether courts will permit sandbagging in the absence of a clear pro- or anti-sandbagging provision—is unclear. Cases in lower courts are few and far between and provide inconstant guidance depending on the court and jurisdiction. More recently, the Supreme Court of Canada has announced that "good faith contractual performance" is an organizing principle of contract law, a development with potential implications for sandbagging.[29] Together, these features of the law—inconsistent lower court decisions and innovative Supreme Court decisions—have rendered sandbagging uncertain. Although similar uncertainty exists outside Canada, other jurisdictions enjoy more developed (and potentially instructive) jurisprudence.

1. Sandbagging in Peer Jurisdictions

For reasons of both commercial significance and geographic proximity, the U.S. has a major influence on Canadian M&A practice. Although the legal treatment of sandbagging varies from state to state, case law in two of the U.S.'s most influential state jurisdictions—Delaware and New York—is relatively well developed.[30] Under Delaware law, the traditional view is that representations and warranties are unaffected by the buyer's knowledge. This view—reflecting a strict interpretation of contractual language—is well summarized by Vice Chancellor Laster's oral opinion in *NASDI Holdings, LLC v. North American Leasing, Inc.*:

> The fact that the buyers conducted due diligence also does not prevent a suit for fraud. Delaware is what is affectionately known as a "sandbagging" state. That's a negative spin on it, but the positive spin on it is we

29. *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) at para. 33; *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.) at para. 2.

30. Delaware and New York are the most common choices of governing law for large acquisitions in the U.S. For a broader survey of sandbagging law in the U.S., see Charles Whitehead, "Sandbagging: Default Rules and Acquisition Agreements" (2011), 36 Del. J. Corp. L. 1081, Appendix A.

> let people allocate risk through representations and warranties. And if you have allocated risk through representations and warranties, the fact that you may do due diligence doesn't contravene the allocation of risk. We have the contract control, as opposed to a loose sense of what people may have known or not known, depending on the due diligence they conducted.[31]

This pro-sandbagging stance was questioned in *Eagle Force Holdings, LLC v. Campbell*, in which both the majority and dissent suggested that the permissibility of sandbagging remained unsettled under Delaware law.[32] The more traditional view of sandbagging was reestablished in subsequent cases, however, including *Arwood v. AW Site Services, LLC*.[33] In *Arwood*, the Delaware Chancery Court upheld a buyer's claim for breach of rep, notwithstanding the seller's sandbagging defence, which was predicated on the buyer's extensive due diligence. In the words of Vice Chancellor Slights, "Delaware is, or should be, a pro-sandbagging jurisdiction. The sandbagging defense is inconsistent with our profoundly contractarian predisposition."[34] This decision and others have confirmed the permissibility of sandbagging under Delaware law.

New York—another important commercial jurisdiction—is less expressly pro-sandbagging. The leading precedent in New York is *CBS Inc. v. Ziff-Davis Publishing Co.*,[35] which held that although reliance is required for a successful breach of warranty claim, reliance need not be on the literal truth of the seller's representations, but rather on the seller's *promise* as to the truth.[36] In other words, if a buyer reasonably believes that it is purchasing the

31. *NASDI Holding, LLC v. North Am. Leasing, Inc.*, Doc. 10540-VCL (October 23, 2015) at p. 57.
32. *Eagle Force Holdings, LLC v. Campbell*, 187 A.3d 1209 (Del., 2018). This suggestion came as a surprise to many U.S. practitioners, who had grown comfortable that Delaware courts would allow sandbagging in the face of contractual silence. See Griffith Kimball, "Sandbagging: Eagle Force Holdings and The Market's Reaction" (2021), 46:2 B.Y.U.L. Rev. 571. Interestingly, given the timing of the decision, *Eagle Force Holdings, LLC v. Campbell* does not appear to have had any effect on the proportion of U.S. agreements that include pro-sandbagging provisions, which actually decreased after 2018.
33. *Arwood v. AW Site Services, LLC*, CA No. 2019-0904-JRS, 2022 WL 705841 (Ch. Ct. Del., 2022). Although other Delaware cases have addressed sandbagging, *Arwood* is the clearest affirmation of sandbagging post-*Eagle Force Holdings, LLC v. Campbell*.
34. *Arwood v. AW Site Services, LLC*, CA No. 2019-0904-JRS, 2022 WL 705841 (Ch. Ct. Del., 2022) at p. 3.
35. *CBS Inc. v. Ziff-Davis Publishing Co.*, 75 N.Y.2d 496 (N.Y. App., 1990).
36. *CBS Inc. v. Ziff-Davis Publishing Co.*, 75 N.Y.2d 496 (N.Y. App., 1990) at p. 504.

seller's representations and warranties for value, it is entitled to rely upon them, even if it suspects them to be untrue. In this context, the source of the buyer's knowledge is relevant. If the buyer obtains its knowledge from a third party or through independent investigation, for example, it has greater latitude to sandbag. If the buyer obtains its knowledge directly from the seller, however, it may be precluded from suing for breach of rep. Finally, regardless of the buyer's knowledge, New York courts (like Delaware courts) will enforce clear pro-sandbagging provisions.[37] These principles have been developed over a number of cases such that, although New York law is less pro-sandbagging than Delaware law, it is nonetheless clearer than Canadian jurisprudence.[38]

Apart from the U.S., Canada's major peer jurisdiction is the United Kingdom,[39] which has historically been the leading influence on Canadian contract law. Interestingly, unlike many American states, English law is relatively anti-sandbagging.[40] Indeed, under English law, it is doubtful that a buyer can sue for breach of rep if the buyer had prior knowledge of the breach, even

37. "Sandbagging Clauses in Acquisition Agreements: A Little Knowledge Can Be a Dangerous Thing", (29 October 2012), online: *Stikeman Elliott* <https://www.stikeman.com/en-ca/kh/canadian-ma-law/sandbagging-clauses-in-acquisition-agreements-a-little-knowledge-can-be-a-dangerous-thing>.

38. "Sandbagging Clauses in Acquisition Agreements: A Little Knowledge Can Be a Dangerous Thing", (29 October 2012), online: *Stikeman Elliott* <https://www.stikeman.com/en-ca/kh/canadian-ma-law/sandbagging-clauses-in-acquisition-agreements-a-little-knowledge-can-be-a-dangerous-thing>.

39. Today, specifically the law of England and Wales (I have not examined the law of Northern Ireland or Scotland). Although Canadian corporate practice is more influenced by the U.S., Canadian contract jurisprudence has historically followed English law. Australia and New Zealand are also relevant peer jurisdictions, but are less influential than the U.S. and U.K. Although I have not conducted a thorough review of Australian and New Zealand jurisprudence, it appears that both pro- and anti-sandbagging provisions are regularly negotiated and legally enforceable in both countries.

40. "Sandbagging Clauses in Acquisition Agreements: A Little Knowledge Can Be a Dangerous Thing", (29 October 2012), online: *Stikeman Elliott* <https://www.stikeman.com/en-ca/kh/canadian-ma-law/sandbagging-clauses-in-acquisition-agreements-a-little-knowledge-can-be-a-dangerous-thing>; "US vs UK Private M&A — Two Agreements Divided by a Common Language?", (25 October 2018), online: *Cooley* <https://cooleyma.com/2018/10/25/us-vs-uk-private-ma-two-agreements-divided-by-a-common-language/?utm_source=mondaq&utm_-medium=syndication&utm_term=CorporateCommercial-Law&utm_content=articleoriginal&utm_campaign=article>; "US/UK M&A: Disclosure", (21 September 2021), online: *Lewis Silkin* <https://www.lewissilkin.com/en/insights/usuk-m-a-disclosure>. See also Andrew Milano & Stephen Walters, *M&A Practice in the UK and the US: A Comparison (and some observations on the impact of covid-19)* (2020).

where the acquisition agreement contains an express pro-sandbagging provision.[41] This surprising difference between English and U.S. law may be due to English law's conception of representations as a basis for tort rather than contract claims.[42] This tort-like conception of representations—and a consequent requirement of reliance—is suggested by the leading case of *Eurocopy PLC v. Teesdale and others*,[43] in which a buyer was prevented from recovering for misstatements of which it had knowledge, notwithstanding the existence of a contractual pro-sandbagging provision.[44] Although subsequent case law has complicated matters somewhat,[45] English practitioners are far more cautious regarding the use of pro-sandbagging provisions than their North American counterparts.[46] In addition, and consistent with continental European practice, *anti*-sandbagging provisions are relatively common in the U.K.[47] Thus, at least as compared to Delaware, England can be characterized as an anti-sandbagging jurisdiction.

41. Although the term "sandbagging" is not generally used in U.K. practice, agreements often refer to similar concepts of buyer's knowledge and reliance. See "Sandbagging Clauses in Acquisition Agreements: A Little Knowledge Can Be a Dangerous Thing", (29 October 2012), online: *Stikeman Elliott* <https://www.stikeman.com/en-ca/kh/canadian-ma-law/sandbagging-clauses-in-acquisition-agreements-a-little-knowledge-can-be-a-dangerous-thing>; "Some Differences in Law and Practice Between U.K. and U.S. Stock Purchase Agreements", (2007), *Jones Day*.
42. See Rafal Zakrzewski, "Representations and Warranties Distinguished" (2013), 6 J. Int'l Banking & Fin. L. 341.
43. *Eurocopy PLC v. Teesdale and others*, [1992] B.C.L.C. 1067.
44. See John Phillips et al, "Mergers and Acquisitions: Some Practices Still Vary Between U.S.", *The National Law Journal* (25 June 2007).
45. *Infiniteland and another v. Artisan Contracting Ltd.*, [2005] EWCA Civ 758.
46. "Sandbagging Clauses in Acquisition Agreements: A Little Knowledge Can Be a Dangerous Thing", (29 October 2012), online: *Stikeman Elliott* <https://www.stikeman.com/en-ca/kh/canadian-ma-law/sandbagging-clauses-in-acquisition-agreements-a-little-knowledge-can-be-a-dangerous-thing>; "US vs UK Private M&A — Two Agreements Divided by a Common Language?", (25 October 2018), online: *Cooley* <https://cooleyma.com/2018/10/25/us-vs-uk-private-ma-two-agreements-divided-by-a-common-language/?utm_source=mondaq&utm_medium=syndication&utm_term=CorporateCommercial-Law&utm_content=articleoriginal&utm_campaign=article>; "US/UK M&A: Disclosure", (21 September 2021), online: *Lewis Silkin* <https://www.lewissilkin.com/en/insights/usuk-m-a-disclosure>. See also Andrew Milano & Stephen Walters, *M&A Practice in the UK and the US: A Comparison (and some observations on the impact of covid-19)* (2020).
47. See Eva Davis, Mary Lundstrom & Nicholas Usher, "UK M&A Deals: What a US Buyer Should Expect", (2014), online: *Winston & Strawn LLP* <https://www.winston.com/a/web/105605/UK-MA-Deals-What-a-US-Buyer-Should-Expect-Davis-in-Transaction.pdf>; "US/UK M&A: Disclosure", (2021), online: *Lewis Silkin* <https://www.lewissilkin.com/en/insights/usuk-m-a-disclosure>;

2. Canadian Sandbagging Cases

If Delaware is pro-sandbagging, and England is anti-sandbagging, the most that can be said of Canada is that the state of the law is unclear. Even prior to *Bhasin*, lower court decisions were inconsistent, with different courts articulating different legal standards. Surveying the case law illustrates this inconsistency, as the leading cases are (1) an Alberta Court of Appeal decision, which appears to endorse sandbagging, and (2) an Ontario Court of Appeal decision, which calls the practice into question.

In the Alberta case of *Eagle Resources Ltd. v. MacDonald*,[48] the buyer of the shares of an oil and gas company sued the seller for breach of warranty. The buyer claimed that the seller had misrepresented the value of a key oil field owned by the company by failing to disclose an updated value assessment. The seller argued that the buyer was aware of oil field's true value and had not relied on the seller's disclosure. At trial, the Court of Queen's Bench considered the plaintiff's claim under both tort and contract theories.[49] Although the court found that the buyer had *not* relied on the seller's disclosure, it held that reliance was unnecessary to the buyer's contractual claim.[50] However, the court also held that absence of reliance negated the buyer's damages, rendering its claim irrelevant.[51]

On appeal, the Alberta Court of Appeal took a more contractarian approach, holding the seller strictly to the warranty language of the contract.[52] The court found that the buyer had

Andrew Milano & Stephen Walters, *M&A Practice in the UK and the US: A Comparison (and some observations on the impact of covid-19)* (2020).

48. *Eagle Resources Ltd. v. MacDonald*, 2000 ABQB 590 (Alta. Q.B.), reversed 2001 ABCA 264 (Alta. C.A.), reconsideration / rehearing refused 2002 ABCA 1 (Alta. C.A.), additional reasons 2002 ABCA 12 (Alta. C.A.), leave to appeal refused 2002 CarswellAlta 1130, 2002 CarswellAlta 1131 (S.C.C.).

49. The plaintiff sued for breach of contract and for the tort of deceit and misrepresentation.

50. The court denied the plaintiff's tort claim due to lack of reliance.

51. *Eagle Resources Ltd. v. MacDonald*, 2000 ABQB 590 (Alta. Q.B.) at para. 136, reversed 2001 ABCA 264 (Alta. C.A.), reconsideration / rehearing refused 2002 ABCA 1 (Alta. C.A.), additional reasons 2002 ABCA 12 (Alta. C.A.), leave to appeal refused 2002 CarswellAlta 1130, 2002 CarswellAlta 1131 (S.C.C.). The trial court calculated damages of $3.75 million in the alternative (a calculation which the Court of Appeal ultimately rejected). *Eagle Resources Ltd. v. MacDonald*, 2000 ABQB 590 (Alta. Q.B.) at para. 64, reversed 2001 ABCA 264 (Alta. C.A.), reconsideration / rehearing refused 2002 ABCA 1 (Alta. C.A.), additional reasons 2002 ABCA 12 (Alta. C.A.), leave to appeal refused 2002 CarswellAlta 1130, 2002 CarswellAlta 1131 (S.C.C.).

52. *Eagle Resources Ltd. v. MacDonald*, 2001 ABCA 264 (Alta. C.A.), reconsidera-

suffered damages by relying on the financial protection of the warranty itself, notwithstanding its knowledge of the underlying breach. Interestingly, the court's language is conceptually similar to that of Vice Chancellor Laster in *NASDI Holdings, LLC v. North American Leasing, Inc.*:

> The argument of counsel for the respondent is that the purchaser knew the facts. But clause 3.3(g) does not speak of that. It warrants that all facts, reports, etc. are in the contract, not that the purchaser has been told about them. It is no bar to enforcing a contract that the buyer was sceptical as to whether the vendor would perform it, or could perform it, or that the buyer had reason to be sceptical.

On this basis, the court held that the buyer was entitled to compensation and remanded the case to the trial court for a proper calculation of damages. As there have not been any subsequent sandbagging cases in Alberta, *Eagle Resources Ltd. v. MacDonald* appears to be the leading authority in the province.

In Ontario, the case law is more conflicted. In *Transamerica Life Canada Inc. v. ING Canada Inc.*,[53] the Ontario Court of Appeal left the question of sandbagging unresolved. The case involved the sale of NN Life Insurance Company of Canada by ING Canada Inc. to Transamerica Life Canada Inc. After the closing, the buyer sued the seller for breaches of representations and warranties relating to the seller and NN Life Insurance Company of Canada's accounting systems. The seller defended the action by arguing that, in light of the buyer's extensive due diligence, the buyer was either aware of, or wilfully blind to, the company's accounting problems, and that the buyer owed the seller a duty to warn it of its own breach. Citing *Eagle Resources Ltd. v. MacDonald,* the trial court rejected this defence, stating that "the parties' obligations under the [purchase agreement] are governed solely by the express terms of their agreement"[54] and that "[t]he enforcement of a warranty does not depend on the purchaser's belief as to the truthfulness of the warranted facts."[55]

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tion / rehearing refused 2002 ABCA 1 (Alta. C.A.), additional reasons 2002 ABCA 12 (Alta. C.A.), leave to appeal refused 2002 CarswellAlta 1130, 2002 CarswellAlta 1131 (S.C.C.).

53. *Transamerica Life Canada Inc. v. ING Canada Inc.*, 2002 CarswellOnt 4114 (Ont. S.C.J.), reversed in part 2003 CarswellOnt 4834 (Ont. C.A.); *Transamerica Life Canada Inc. v. ING Canada Inc.*, 2003 CarswellOnt 4834 (Ont. C.A.).
54. *Transamerica Life Canada Inc. v. ING Canada Inc.*, 2002 CarswellOnt 4114 (Ont. S.C.J.) at para. 12, reversed in part 2003 CarswellOnt 4834 (Ont. C.A.).
55. *Transamerica Life Canada Inc. v. ING Canada Inc.*, 2002 CarswellOnt 4114 (Ont. S.C.J.) at para. 16, reversed in part 2003 CarswellOnt 4834 (Ont. C.A.).

The ruling on appeal was much more ambiguous, however. Reversing the trial court, the Ontario Court of Appeal held that the underlying issue (i.e., whether the buyer owed a duty to warn the seller of a breach of rep) was insufficiently settled in Canadian law, such that it was inappropriate for the trial court to have granted the buyer's motion to strike. The Court of Appeal held that the trial court should have examined whether the intention of the parties and the broader factual context may have created an implied duty of good faith and fair dealing, requiring the buyer to reveal any known or discovered breaches to the seller.[56] Although the court's reasons did not hold that any such duty existed (only that it may have existed, depending on the factual context), it nevertheless called the validity of sandbagging into question—and anticipated the Supreme Court's later pronouncements regarding good faith contractual performance in *Bhasin* and *C.M. Callow Inc.*

3. The Principle of Good Faith Under *Bhasin* and *C.M. Callow Inc.*

Together, *Bhasin* and *C.M. Callow Inc.* represent a significant development in Canadian contract law. Although neither case deals with sandbagging, they both impose new standards of honesty and good faith in contractual performance, which the Court adopts (in the words of *Bhasin*) as a "general organizing principle" of the common law.[57] These cases establish that commercial parties are subject to a mutual duty of honesty but fail to specify the content of that duty in specific cases. For this reason, *Bhasin* and *C.M. Callow Inc.* have potentially reduced contractual certainty.

Bhasin, decided in 2014, was a landmark decision in Canadian contract law. In *Bhasin*, the Supreme Court announced—for the first time—that good faith contractual performance is a "general organizing principle" of the common law, which "underpins and informs" a number of specific legal rules.[58] One of these rules, according to the Court, is a duty to act honestly in the performance

56. Note, however, that the acquisition agreement in *Transamerica Life Canada Inc v. ING Canada Inc* contained an interim price adjustment mechanism which Transamerica Life Canada Inc. arguably frustrated by failing to warn ING Canada Inc. of its own breach. The factual context of the case is therefore slightly different from the typical sandbagging dispute.
57. *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) at para. 33.
58. *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) at para. 33.

of contractual obligations.[59] This duty requires that parties "not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract."[60] Although the facts of *Bhasin* have little to do with sandbagging—they instead concern a financial company that dishonestly failed to renew a dealership contract—the duty of honesty in contractual performance, as articulated in the Court's reasons, has implications for buyers' indemnification rights under M&A agreements.

Imagine, for example, a typical situation in which the buyer performs extensive due diligence of business, financial, and legal materials provided by the seller. Assume that following the closing, the buyer attempts to sue the seller for breach of one or more representations, and that the underlying breach was disclosed or otherwise included in the due diligence materials provided by the seller. Under *Bhasin*, could the buyer's knowledge (either actual or constructive) of the underlying breach preclude it from bringing an indemnification claim? The logic of *Bhasin* might invite sellers to argue that failure by the buyer to warn the seller of a potential breach constitutes a form of dishonesty, at least in the absence of a contractual pro-sandbagging provision. Even "honest" (i.e., fully transparent) buyers may face the possibility of litigation over what they did or did not know prior to closing. This possibility introduces new uncertainties into buyers' ability to rely on indemnification provisions. However, *Bhasin* limited these uncertainties by expressly denying any duty of affirmative disclosure. In the words of the Court:

> [The duty of honesty] does not impose a duty of loyalty or of disclosure or require a party to forego advantages flowing from the contract; it is a simple requirement not to lie or mislead the other party about one's contractual performance.[61]

Thus, despite expanding parties' duties of good faith, *Bhasin* made clear that parties have no affirmative duty to protect each other. In the sandbagging context, this would seem to foreclose any duty on the part of buyers to warn sellers of potential breaches.

This protection is called into question by *C.M Callow Inc.*, however. *C.M. Callow Inc.* involved facts analogous to *Bhasin*—the defendant in *C.M. Callow Inc.* also declined to renew a contract under conditions of dishonesty and was also found liable

59. *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) at para. 33.
60. *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) at para. 73.
61. *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) at para. 73.

to the plaintiff. The difference between the two cases is that the "dishonesty" at issue in *C.M Callow Inc*. did not involve affirmative lies on the part of the defendant, but rather a failure to correct the plaintiff's mistaken assumption that the contract would be renewed. The factual question of whether the defendant had lead the plaintiff to form this assumption was ambiguous, and it is therefore unclear whether *C.M. Callow Inc*. extends *Bhasin* to non-disclosure.[62] The Court insists that it does not—and that parties remain free to withhold information from a contractual counterparty unless their actions caused the counterparty's false impression—and yet it is difficult to identify how the defendant in *C.M. Callow Inc*. actively mislead the plaintiff.[63] The Court states that the duty of honesty may prohibit "half-truths, omissions, and even silence, depending on the circumstances," but provides little guidance as to what these circumstances may be.[64] Complicating matters further, *C.M Callow Inc*. explicitly adopts the civil law principle that, in the Court's language, "no contractual right may be exercised dishonestly and therefore contrary to the requirements of good faith," a doctrine which departs from the contractarian emphasis of English common law, and which has its own complex history in civilian jurisprudence.[65] Given the ambiguity as to how the defendant misled the plaintiff, *C.M Callow Inc*. arguably imposes a duty of affirmative disclosure, at least as a practical matter.

Together, both cases have heightened the requirements of commercial honesty in a manner that implicates sandbagging. Do buyers now have a duty to inform sellers of breaches of representations, whether discovered in due diligence or otherwise? Does the stereotypical example of sandbagging—i.e., when a buyer brings an indemnification claim for a breach that was known to the

62. The facts of the case are confusing in that the trial court found that the defendant actively mislead the plaintiff, including by "continuing to represent that the contract was not in danger" after deciding to terminate the contract, and by engaging in "active communications" that deceived the defendant. *C.M. Callow Inc. v. Tammy Zollinger et al*., 2017 ONSC 7095, 2017 CarswellOnt 18587 (Ont. S.C.J.) at paras. 65-66, reversed *CM Callow Inc. v. Zollinger*, 2018 ONCA 896 (Ont. C.A.), reversed *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.). Yet the Supreme Court states that "there is no outright lie present" in the facts of the case. *CM Callow Inc*. at para. 89. Thus, the basic factual question of whether or not the defendant affirmatively lied to the plaintiff is surprisingly unclear.

63. Côté J.'s dissent highlights the lack of a clear finding that the defendant affirmatively misled the plaintiff.

64. *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.) at para. 91.

65. See *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.) at para. 57.

buyer prior to closing—now constitute dishonesty? Following *Bhasin* and especially *C.M. Callow Inc.*, the answers to these questions are unclear, at least in the absence of an express pro-sandbagging provision.[66] Indeed, Anna Wong has argued that *Bhasin* and *C.M. Callow* depart from contract principles altogether, and instead import tort-like concepts into Canadian contract law.[67] All that said, the following Part IV explains why adopting a pro-sandbagging default rule would not only advance commercial interests, but can also be reconciled with *Bhasin* and *C.M. Callow Inc.*

IV. PRO-SANDBAGGING AS AN EFFICIENT DEFAULT RULE

The remainder of this article will argue that Canadian courts should adopt a pro-sandbagging default rule. The thrust of my argument is that (1) clear default rules enhance contractual certainty and (2) a pro-sandbagging default rule is economically efficient. I will also argue that, in the M&A context, a pro-sandbagging rule can be reconciled with the duty of honesty articulated in *Bhasin* and *C.M. Callow Inc.*

1. The Economics of Default Rules

"Default rules" are legal rules that can be modified or disregarded by private parties upon mutual agreement.[68] A pro-sandbagging default rule, for example, allows buyers to sandbag unless otherwise agreed to by the parties. Lawmakers have two alternatives to specifying default rules. The first is to impose "mandatory rules," binding rules that cannot be modified by agreement. The second is the absence of any rule at all—i.e., circumstances in which courts or other decision makers must make *ad hoc* judgements based on open-ended considerations. In the common law of contracts, there has traditionally been a strong presumption in favour of default rules.

This presumption has multiple rationales. First—and most fundamentally—is the recognition that clear rules are preferable to

66. Both *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) and *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.) suggest that sophisticated parties may modify or lessen the duty of honesty through express agreement.
67. Anna Wong, "Duty of Honest Performance: A Tort Dressed in Contract Clothing" (2022), 100:1 Can. Bar. Rev. 95.
68. Ian Ayres & Robert Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989), 99:1 Yale L.J. 87 at p. 87.

ad hoc decision making. Clear legal rules provide parties with certainty and predictability, allowing them to plan their business affairs and reducing the costs of potential legal disputes.[69] Uncertainty can impede commercial relationships and prevent mutually-beneficial transactions. Second, in choosing between default and mandatary rules, it is generally more efficient to allow parties to specify the terms of their own legal relationships. The principle of freedom of contract is grounded in the insight that contracting parties are better positioned to judge their own economic interests than third-party decision makers (who are not party to the transaction and do not internalize its costs and benefits).[70] More prosaically, it is simply difficult for lawmakers to create one-size-fits-all legal rules appropriate to the wide variety of commercial and economic contexts in which contracts are formed. Allowing parties to contract out of default rules and to customize their commercial relationships facilitates economic activity.

If rules are better than no rules, and default rules are better than mandatory rules, the policy question then becomes how to select the optimal default rule. In a world of Coasian bargaining, the choice of default rule would not matter, as parties could costlessly and seamlessly negotiate for their preferred rule.[71] In a reality of transaction costs and imperfect information, however, the choice of default rule matters greatly, in that parties must expend resources to modify the default rule.[72] The law and economics

69. According to the English judge and legal reformer Mackenzie Chalmers, "[t]he object of the man of business is not to get a scientific decision on a particular point, but to avoid litigation altogether. On the whole, he would rather have a somewhat inconvenient rule clearly stated than a more convenient rule worked out by a series of protracted and expensive litigations, pending which he does not know how to act." Mackenzie Chalmers, "Codification of Mercantile Law" (1902), 25 Ann. Rep. ABA 282 at p. 288.

70. In the words of the Supreme Court, "[t]he classic paradigm underlying freedom of contract is the 'freely negotiated bargain or exchange' between 'autonomous and self-interested parties.' At the heart of this theory is the belief that contracting parties are best-placed to judge and protect their interests in the bargaining process." *Uber Technologies Inc. v. Heller*, 2020 SCC 16 (S.C.C.) at para. 56. "Freedom of contract is of central importance to the Canadian commercial and legal system and, to promote the certainty and stability of contractual relations, often trumps other societal values. Indeed, a hallmark of a free society is the freedom of individuals to arrange their affairs without fear of overreaching interference by the state, including the courts." *Uber Technologies Inc. v. Heller*, 2020 SCC 16 (S.C.C.) at para. 107, Brown J, concurring.

71. See Ronald Coase, "The Problem of Social Cost" (1960), 3 J. Law Econ. 1.

72. For an analysis of the obstacles to renegotiating default rules, see Omri Ben-Shahar & John Pottow, "On the Stickiness of Default Rules" (2006), 33:3 Fla. St. U.L. Rev. 651.

literature provides two criteria for selecting default rules.[73] The first (and most common) criterion is to select the rule that the parties "would have wanted"—i.e., the rule that most parties would have negotiated in the absence of transaction costs.[74] By providing standard terms that most parties would have negotiated anyway, the legal system can reduce the costs of entering transactions.[75] The second criterion is the concept of "penalty defaults," first advanced by Ayres and Gertner.[76] Penalty defaults are default rules that *encourage* the parties to specify their own rule, or else face a suboptimal "penalty" rule. Penalty defaults are efficient when it is cheaper for the parties to negotiate a term *ex ante* than it is for courts to estimate *ex post* what the parties would have wanted.[77]

Neither of these criteria—the "would have wanted" standard or imposing a penalty default—are easily applicable to the sandbagging context. Imputing what the parties would have wanted is difficult in the absence of a clear market standard as to the permissibility of sandbagging. As discussed in Part II.B, the most common practice is to avoid the sandbagging issue altogether by intentionally leaving the agreement silent. Where parties intentionally (and rationally) leave an issue unresolved, it is difficult for courts to determine what they would have wanted. As discussed below, this determination requires an economic analysis of the transaction itself.

Imposing a penalty default is even more fraught. Although sandbagging is characterized by significant *ex post* judicial costs,[78]

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73. Ian Ayres & Robert Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989), 99:1 Yale L.J. 87 at pp. 89-95.
74. Ian Ayres & Robert Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989), 99:1 Yale L.J. 87 at pp. 89-90.
75. In their influential article on the economics of default rules, Ian Ayres and Robert Gertner distinguish between "tailored" and "untailored" default rules. Tailored default rules attempt to provide what the specific parties would have wanted. Untailored default rules attempt to provide what most parties would have wanted. My own argument is for an untailored default rule, as untailored defaults are more efficient in the standardized context of M&A agreements. Note that under an untailored default rule, parties with idiosyncratic preferences remain free to negotiate their own rule.
76. Ian Ayres & Robert Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989), 99:1 Yale L.J. p. 87.
77. That is, when encouraging the parties to determine the rule in advance is cheaper than litigating it. See the discussion of zero-quantity defaults in Ian Ayres & Robert Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989), 99:1 Yale L.J. 87 at pp. 95-97.
78. Given that buyers will invariably argue in favour of sandbagging and sellers will

it is also characterized by high *ex ante* negotiation costs.[79] Even where litigation costs are high, it is not an answer to impose a potentially suboptimal default rule when parties are unlikely to renegotiate. Interestingly, Charles Whitehead has presented a more refined argument in favour of an anti-sandbagging penalty default.[80] According to Whitehead, an anti-sandbagging penalty default forces buyers that value sandbagging to negotiate around the default, thereby revealing important information to the seller—i.e., that the buyer intends to engage in sandbagging. This argument is unpersuasive, however, in that it assumes that sandbagging is such an unusually aggressive tactic that a buyer's willingness to sandbag conveys meaningful information to the seller. As discussed in Part II.1., the reality is that nearly all buyers have a potential interest in sandbagging in order to protect themselves from strategic behaviour by sellers. Indeed, Whitehead's argument can just as easily be flipped to argue in favour of a pro-sandbagging rule: a seller's desire to prohibit sandbagging may reveal the seller's own penchant for aggressive tactics. The point is that sandbagging is rarely a clear moral issue, and that buyers have legitimate reasons to protect their indemnification rights.

Given the lack of a clear market practice and the inappropriateness of imposing a penalty default, choosing the optimal default rule requires further analysis. Determining what the parties "would have wanted" becomes identifying the efficient rule, which in turn requires an examination of the structure of M&A agreements. Ultimately, courts should select the default rule that best supports these agreements' function.

2. Sandbagging and Information Asymmetry

Sandbagging stems from two features of private M&A agreements: (1) representations and warranties; and (2) indemnification. In a standard acquisition agreement, the seller represents and warrants a number of facts about the company being sold. By making these representations and warranties, the seller is promising that the represented facts are true and correct as of the closing.[81] The indemnification provisions—typically contained in a

argue against sandbagging, it can be very difficult for courts to determine the appropriate rule in the face of contractual silence.

79. As discussed, the costs of resolving the sandbagging issue are so high that parties often opt for contractual silence.

80. Charles Whitehead, "Sandbagging: Default Rules and Acquisition Agreements" (2011), 36 Del. J. Corp. L. 1081..

separate part of the agreement—provide the buyer with financial recourse if any of the representations and warranties are untrue. Subject to certain limitations,[82] the buyer can sue the seller for losses associated with any breach.

Representations and warranties, and the indemnification provisions that support them, are intended to address the information asymmetry that exists between buyers and sellers. Given the complexity of any modern business, sellers invariably have better information regarding the economic, financial, and legal characteristics of the company being sold than potential buyers. Many buyers are therefore rationally concerned that the company may have hidden issues that would reduce its economic value. Indeed, the very fact that a business is being sold may be a negative quality signal—an example of the classic adverse selection problem.[83] Markets characterized by information asymmetry will not function efficiently (or at all) without effective means for developing information.[84] In the M&A context, much of this information is provided by the seller's representations and warranties.

Representations and warranties provide information in two ways. First, and most directly, they are literal statements of fact, supported by the seller's disclosure schedules[85] and (ideally) corroborated by the buyer's due diligence. Simply negotiating the representations and warranties can often provide information about the company. Second, and equally important, a seller's willingness to stand by its representations is itself a source of information that the representations are true. A rational seller would avoid making false representations if doing so subjects it to liability. In this sense, representations are a form of "costly signal" which, if inaccurate, penalize the seller.[86] Contractual or legal rules

81. Note that representations and warranties are typically subject to negotiated qualifications.
82. Again, the seller and the buyer often negotiate qualifications as to materiality, time, and amount of recoverable losses.
83. The fact that a businessowner is seeking to sell their business may indicate that there is something wrong with it. See George Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism" (1970), 84:3 Quarterly Journal of Economics 488; Carol L Cain et al, "Ethics, Adverse Selection, Target Method of Sale Strategies, and Akerlof's Lemons Problem" (2021), 10:3 Accounting & Fin Research 1.
84. George Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism" (1970), 84:3 Quarterly J. of Econ. 488.
85. Disclosure schedules (or in Canadian practice, the "disclosure letter") are factual disclosures that qualify the seller's representations and warranties. Although the disclosure schedules limit the seller's potential liability, they are also a source of detailed information about the company.

that mitigate this penalty reduce the credibility of the seller's representations.

In the M&A context, an anti-sandbagging rule may undermine representations and warranties by reducing the parties' incentives to develop information. Under an anti-sandbagging rule, sellers will be less meticulous in ensuring that their representations are true if they can simply swamp the buyer with expansive disclosure. In economic terms, an anti-sandbagging rule therefore produces "noisy" information.[87] For their part, buyers face an ironic problem under an anti-sandbagging rule: any facts discovered by the buyer—through due diligence or otherwise—can be used against them by the seller to defend against an indemnification claim. Buyers therefore face perverse incentives to limit their due diligence, exacerbating the information asymmetry problem. As a general matter, forcing parties to reveal sensitive information reduces incentives to obtain the information in the first place, thereby reducing the amount of socially valuable information.[88] This is particularly true when information is obtained through costly effort by one of the parties. Given sellers' natural reluctance to reveal negative information, and the cost to buyers of obtaining information, an anti-sandbagging rule may actually reduce the total supply of information.

A pro-sandbagging rule, conversely, encourages the development of information. Sellers must be careful that their representations and warranties are correct, or else risk an indemnification claim. Not only does this increase the seller's credibility, it also encourages the seller to investigate and fully understand their own company.[89] For their part, buyers are fully incentivized to diligence

86. By indemnifying the buyer against breaches of representations and warranties, the seller commits to paying *ex post* costs if its representations are untrue. This is conceptually similar to "tying hands" in the context of (for example) international relations. See James D Fearon, "Signaling Foreign Policy Interests: Tying Hands Versus Sinking Costs" (1997), 41:1 J. Confl. Resolution 68.

87. Noisy information includes data that are inaccurate, incomplete, irrelevant, or meaningless, resulting in an inability to clearly interpret it. For a discussion of noise as it relates to the economics of information, see Dinei Florêncio & Cormac Herley, "Sex, Lies and Cyber-Crime Surveys" in Bruce Schneier, ed, *Economics of Information Security and Privacy III* (New York City: Springer, 2013) 35 at p. 37. For a description of noise in the computer science context, see Shivani Gupta & Atul Gupta, "Dealing with Noise Problem in Machine Learning Data-sets: A Systematic Review" (2019), 161 Procedia Computer Sci. 466.

88. Ian Ayres & Robert Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989), 99:1 Yale L.J. 87 at p. 107.

89. Depending on the quality of the target company's governance and information systems, it is not at all implausible for a seller to be unaware of its own breaches.

the target, as knowledge of a breach—whether actual or constructive—cannot be used against them. Not only do buyers have strong incentives to conduct thorough due diligence, they can also place greater reliance on the seller's representations, reducing the information problems inherent to M&A transactions.

A pro-sandbagging default rule would also reduce litigation costs, as it eliminates the question of the buyer's "knowledge" as a litigation issue. Judicial determination of what the buyer did or did not know (or what the buyer should have known) prior to closing is a complex, fact-intensive, and often uncertain exercise. This is especially true when the seller claims to have disclosed information relating to a breach of rep of which the buyer disclaims knowledge. Both parties may be telling the truth if the information was "hidden" in broader disclosure. By removing the question of the buyer's knowledge from judicial consideration entirely, a pro-sandbagging rule greatly simplifies post-closing disputes, as the question becomes simply whether or not the representation was breached. Moreover, since sellers are unlikely to negotiate an anti-sandbagging provision, a pro-sandbagging default is unlikely to add to negotiation costs.[90]

A pro-sandbagging rule is not without potential downsides, however. Encouraging both the buyer and the seller to carefully investigate the target company may result in an inefficient duplication of information costs. Given the fact that buyers will almost always conduct at least some due diligence, however, it seems unlikely that the marginal cost of a pro-sandbagging rule (as compared to an anti-sandbagging rule) would exceed its informational benefits. Perhaps more concerningly, a pro-sandbagging rule potentially reverses the adverse selection problem that exists between buyers and sellers. A robust pro-sandbagging rule could select for *buyers* in possession of adverse information about the target company. In theory, buyers that possess adverse information unknown to the seller could sandbag as a means of reducing the purchase price post-closing. In reality, however, this seems unlikely. Not only are there few real-world situations in which the buyer possesses more information about the company than the seller but bringing an indemnification claim—even under a pro-sandbagging rule—involves significant cost and uncertainty compared to simply negotiating a lower purchase price. Practical

90. See Part II.

experience teaches that most buyers are unwilling to close a deal in expectation of litigation.[91]

Thus, although not without potential disadvantages, a pro-sandbagging rule is likely to be more efficient than an anti-sandbagging rule. Moreover, although the direct benefits of a pro-sandbagging rule inhere primarily to buyers, these benefits should be partially shared with sellers in the form of greater willingness on the part of buyers to enter into transactions and/or pay higher purchase prices. When viewed from the perspective of the broader market, a pro-sandbagging rule benefits both buyers and sellers.

3. Reconciling the Law and Economics of Sandbagging

This article has argued that a pro-sandbagging default rule is economically efficient. As discussed in Part III.3, however, *Bhasin* and *C.M. Callow Inc.* impose a duty of honest contractual performance which extends, under certain conditions, to correcting a counterparty's mistaken assumptions. In light of arguments that sandbagging is commercially dishonest, can a pro-sandbagging default rule be reconciled with *Bhasin* and *C.M. Callow Inc.*? In this Part IV.C, I argue that *Bhasin* and *C.M. Callow Inc.* do not prohibit sandbagging, at least as between commercially sophisticated parties.

The duty of honest contractual performance, as formulated in *Bhasin*, requires that parties not "lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract."[92] To determine whether dishonest conduct is linked to the performance of a contract, the test is whether a right or duty under the contract was exercised dishonesty.[93] Although the duty of honest performance is not, technically speaking, a duty of affirmative disclosure, parties are obligated to correct a false impression created by their own actions.[94] That said,

91. A minority of buyers are, however, which accords with the stereotypical account of sandbagging. A much more common scenario is where a buyer identifies an issue, raises it with the seller prior to closing, and agrees to resolve any losses as a post-closing indemnification claim.

92. *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) at para. 73.

93. *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.) at para. 37.

94. *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.) at para. 38. For a sophisticated discussion of *CM Callow Inc*, particularly its holding that knowingly misleading a counterparty may create an affirmative duty to correct the counterparty's misunderstanding, see Robert Yalden, "New Perspectives on Good Faith in Contractual Negotiation" (2023), 67 Can. Bus. L.J. 165 at pp. 182-84.

a contracting party "is not required to correct a misapprehension to which it has not contributed."[95] Importantly, "[t]he entire context, which includes the nature of the parties' relationship, is to be considered" when determining whether a party acted dishonestly.[96]

These contextual considerations are crucial when it comes to M&A transactions, which typically involve sophisticated parties represented by sophisticated legal counsel. For the reasons discussed in Part IV.B, there is not (and should not be) any general expectation that buyers notify sellers of their own contractual breaches. In a corporate acquisition, the buyer is effectively purchasing the seller's representations and should be entitled to the benefit of the bargain. As *C.M. Callow Inc.* emphasises, buyers "need not subvert their own interests to those of the counterparty by acting as a fiduciary or in a selfless manner."[97] Buyers are only prohibited from actively misleading the seller.[98]

Canadian courts should clarify that in the specific context of M&A transactions between sophisticated parties, nothing less than affirmative lies constitutes contractual dishonesty. In particular, courts should clarify that the following tactics are not "dishonest" within the meaning of *Bhasin* and *C.M. Callow Inc.*: (1) failing to notify the seller of a breach of its own representations; (2) indicating willingness to close, despite a breach of the seller's representations; or (3) indicating satisfaction with the seller's due diligence disclosures, despite a breach of the seller's representations. Although these tactics may result in a false sense of security on the part of the seller, they are not "dishonest" given the purpose and function of representations and warranties. Under a proper

95. *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.) at para. 133.
96. *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.) at para. 133.
97. *C.M. Callow Inc. v. Zollinger*, 2020 SCC 45 (S.C.C.) at para. 47.
98. In addition, note that many acquisition agreements include an "entire agreement" provision, which limits the introduction of parole evidence regarding the parties' communications outside the four corners of the agreement. In *CM Callow Inc*, the Supreme Court held that the duty of honest performance cannot be waived, which would seem to limit the scope of entire agreement provisions. In *Bhasin*, however, the Court declined to enforce an entire agreement provision not because such provisions are inherently invalid, but because the trial court found an "imbalance of power" between the parties such that enforcing the agreement would be "unjust or inequitable." *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) at para. 25. The Court left open the possibility that—perhaps in other contexts—parties could modify the mandatory duty of honest performance "in express terms." See *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.) at para. 78.

understanding of the mechanics of M&A agreements, only a buyer that affirmatively lies about the truth of the seller's representations would be acting dishonesty in the terms of *Bhasin* and *C.M. Callow Inc*. This standard would capture—and only capture—genuinely dishonest sandbagging.

In short, any court that deals with sandbagging under *Bhasin* and *C.M. Callow Inc*. should be mindful of the contractual purpose of representations and warranties. Allowing sellers to avoid indemnification claims due to the buyer's knowledge will only worsen the information problems that characterize M&A transactions, ultimately reducing the market for all sellers. Fortunately, holding sophisticated parties to the terms of their agreements is consistent with the contextual emphasis of *Bhasin* and *C.M. Callow Inc*. In the M&A context, there is no commercial expectation that parties reveal their bargaining positions, and the reality is that sandbagging rarely involves active dishonesty. In order to provide certainty to participants in the M&A market, Canadian courts should therefore adopt a pro-sandbagging default rule.

V. CONCLUSION

Sandbagging is a perennial issue in negotiating M&A transactions. Given the legitimate arguments for and against sandbagging—and the emotional sensitivity of sandbagging itself—negotiating sandbagging provisions can be particularly difficult. Indeed, parties often "compromise" by leaving the agreement silent, deferring the question of sandbagging to the background law of the applicable jurisdiction. In Canada, the law regarding sandbagging is unfortunately unclear, exposing parties to significant legal uncertainty. This uncertainty has been exacerbated by recent decisions of the Supreme Court, which have imposed new duties of honesty and good faith in contractual performance.

Contrary to stereotypical perceptions of sandbagging, this article has argued that sandbagging is a legitimate practice in many circumstances, and that courts should allow sandbagging unless the parties otherwise agree. Sandbagging can protect buyers from strategic behaviour on the part of sellers, such as over-inclusive or last-minute disclosure. Perhaps more importantly, sandbagging supports the underlying function of representations and warranties, which is to reduce the information asymmetry between buyers and sellers. A pro-sandbagging rule encourages

both parties to investigate the company and encourages the buyer to rely on the seller's guarantees. An anti-sandbagging rule, conversely, disincentivizes buyers from investigating the company lest they be deemed to have "knowledge" of the seller's misstatements. For their part, sellers have weaker incentives to ensure the accuracy of their own promises, especially if they can overwhelm the buyer with strategic disclosure. By establishing a pro-sandbagging default rule, courts can facilitate the informational function of representations and warranties, while allowing parties to negotiate an anti-sandbagging rule if they so choose. Given the practical realities of sandbagging as a legitimate exercise of contractual rights, a pro-sandbagging rule is also consistent with existing Supreme Court precedent, absent active dishonesty on the part of the buyer.

As a final note, although I have argued a pro-sandbagging rule is consistent with *Bhasin* and *C.M. Callow Inc.*, the necessity of examining this question at all speaks to concerning developments in the contract jurisprudence of the Supreme Court. The Court's decisions in *Bhasin* and *C.M. Callow Inc.* appear to be motivated by equitable considerations—specifically, reluctance to allow parties to benefit from morally questionable business practices. Both decisions engage in an almost tort-like analysis of business relationships, and do not shy away from modifying the law's traditional emphasis on freedom of contract.[99] Although appealing in the abstract (and under the specific facts of *Bhasin* and *C.M. Callow*), this approach raises serious issues for parties that are attempting to plan complex business transactions. In the world of M&A, for example, it is essential that parties can rely on the terms of their written agreements without fear that a court will reshape their bargain after the fact.[100] This is especially true given the

99. Anna Wong, "Duty of Honest Performance: A Tort Dressed in Contract Clothing" (2022), 100:1 Can. Bar. Rev. 95.

100. In the famous words of *Vallejo v. Wheeler*, "in all mercantile transactions the great object should be certainty: and therefore, it is of more consequence that a rule should be certain, than whether the rule is established one way or the other. Because speculators in trade then know which ground to go upon." *Vallejo v. Wheeler* (1774), 1 Cowp. 143 at p. 153. See also footnote 66 and accompanying text. For discussion of the implications of legal uncertainty in the Delaware sandbagging context, see Griffith Kimball, "Sandbagging: Eagle Force Holdings and The Market's Reaction" (2021), 46:2 B.Y.U.L. Rev. 571. For discussion of the pernicious effects of legal uncertainty in other contexts, see Adam Chertok, "Rethinking the U.S. Approach to Material Adverse Change Clauses in Merger Agreements" (2011) 19 U. Miami Comp. L. Rev. 99 at pp. 199-123; Heidi Hansberry, "In Spite of its Good Intentions, the Dodd-Frank Act Has Created a FCPA Monster" (2012), 102 J. Crim. L. & Criminology 195 at p. 214.

potentially profound differences between *ex ante* expectations and *ex post* outcomes, and the factual disagreements inevitable in an adversarial legal system.[101] Relations or conduct that appear unfair *ex post* may be fully consistent with the parties' *ex ante* allocation of business risk. Although prohibiting outright fraud increases commercial certainty, courts should be careful not to rewrite legitimate contracts. If parties lose faith in the enforceability of their agreements, they may become reluctant to enter value-enhancing transactions.

101. It is important to keep in mind that courts rarely have access to an objective record of the facts, but must instead mediate between competing, stylized, and self-interested versions of the facts. It is precisely this subjective nature of the factual record that makes disputes over buyer's knowledge so uncertain.