GARRIGUES

Pro-sandbagging and anti-sandbagging clauses in M&A deals: regulation in Latin America

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When negotiating a corporate merger or acquisition, both buyers and sellers would benefit from agreeing to and contractually specifying their position about sandbagging, which is when a buyer knows that a seller's representation or warranty is false or inaccurate but goes ahead and signs the agreement in order to later pursue a claim against the seller. In this article, we will discuss on how sandbagging provisions (or the silence on such) is regulated in Colombia, Mexico, Chile, Brazil and Peru, as well as case law, if any.

One of the main issues to be hammered out when negotiating a merger or acquisition is, undoubtedly, what claims a buyer can make to the seller in connection with the business or company acquired and the legal and contractual rules governing such claims. As we know, whether or not the seller can be found liable depends to a large extent on what the buyer knew about the target before signing and whether or not it accepted the consequences of such contingencies.

This is where sandbagging clauses come in play. In order to understand the concept, it is helpful to recall the origin of this term. In golf, a "sandbagger" is a person who pretends to be a worse player than he really is in order to take advantage of his or her rival. By lying about his abilities, a sandbagger gains additional handicap strokes and increases his chances of winning.

In asset and share purchases, sandbagging typically refers to a situation in which the buyer is aware (either through its due diligence or its prior knowledge) that a representation or warranty is false or inaccurate but nevertheless proceeds to sign the agreement or close the deal, and later sues the seller over the breach.

A pro-sandbagging clause, then, establishes that the buyer's right to indemnification is not limited by the knowledge that it may or may not have had or that it could have obtained through a legal due diligence, while an anti-sandbagging clause prohibits the buyer from seeking post-closing recourse for any breach it already knew about.

It is increasingly common to see M&A negotiations in which sellers want to include an an anti-sandbagging clause by which buyers may not sue them for any inaccuracies in their representations and warranties if the buyer was aware (or could be aware based on the information disclosed) of such falsehood or inaccuracy. Naturally, some buyers will strongly resist against such clauses, since they play a significant role in the allocation of risks.

What happens if the two parties cannot agree on what constitutes prior knowledge by the buyer about the existence of contingencies? Could the buyer be prevented from suing if it had prior knowledge of a given fact, based, for example, on the obligation to negotiate and conclude contracts in good faith? The answer to these questions could depend on how the buyer gained the knowledge (if the seller disclosed the breach to the buyer or if the buyer learned it from a third party or through its own due diligence)

and, naturally, on the law applicable in the jurisdiction in which the deal is carried out. In that regard, it is interesting to briefly analyze the possible weight of pro-sandbagging and anti-sandbagging clauses in some of the chief jurisdictions in Latin America, namely Colombia, Mexico, Chile, Brazil and Peru.

In order to avoid subsequent disputes, sellers and buyers should come to an agreement about sandbagging, given that, as we have indicated, the judge or arbitrator will take into consideration the parties' shared intention when interpreting contract clauses.

Colombia

General framework

Under Colombian law, there is no rule either expressly allowing nor prohibiting pro-sandbagging or anti-sandbagging clauses. Consequently, the validity of such clauses must be analyzed under general civil law principles.

The general analysis is framed under the principle of the parties' right to autonomously express their will in a contract, under which contractual clauses agreed are deemed as law for the contracting parties (article 1602 of the Colombian Civil Code) and are valid and binding thereon, provided they do not violate mandatory and/or public policy provisions.

Under the principle of the parties' right to autonomously express their will in a contract, any contractual allocation of risks and any liability rules that do not violate mandatory and/or public policy provisions (article 1604 of the Colombian Civil Code) are considered valid in Colombia. Court cases and rulings have repeatedly upheld this conclusion. When analyzing this issue, the Colombian Constitutional Court has concluded that contracting parties are free to accept or modify the scope of their respective liability, including "intensifying or reducing the debtor's liability standards" (decision C-1008/2010, M.P. Luis Ernesto Vargas Silva).

Since pro-sandbagging and anti-sandbagging provisions essentially imply the contractual allocation of risks and liability, particularly in regards to the assumption of liability derived from a potentially damaging contingency already known by the buyer, these provisions must be considered valid and binding in Colombia, as explained above. Naturally, barring any willful misconduct, which cannot be forgiven in advance as it is morally and legally unacceptable (article 1522 of the Colombian Civil Code), and to which the parties cannot contractually agree since such agreement would exceed the permitted limits of the parties' right to express their will in a contract.

Case law precedents

The Colombian courts have yet to systematically and thoroughly analyze the validity of pro-sandbagging and anti-sandbagging clauses. However, some arbitration tribunals have recognized the existence of such agreements and have not ruled against their validity nor have they been declared contrary to Colombian law.

For example, in the March 30, 2006, arbitration award in Bancolombia S.A. vs Jaime Gilinski, the tribunal acknowledged that the sellers could be held liable for inaccuracies in the representations and warranties set out in the contract "irrespective of whether or not they relate to matters that the [buyer] could have learned through the [buyer due diligence]". Similarly, in the September 14, 2011 arbitral award issued in the dispute between Balclin Investments S.L. et. al. and Jairo Andrés Gutierrez et. al., the arbitration tribunal did not invalidate the contractual clause whereby the buyers' rights to receive indemnification were not limited by any due diligence or investigation they could have conducted in the context of a shares acquisition.

Contractual silence

If the parties have intentionally kept silent in a contract about the effects of buyer's knowledge of potential contingencies in an M&A deal, or have simply omitted specific clauses in this regard, the contract's interpretation becomes very challenging. To answer the question of whether the buyer's pre-signing knowledge of a breach releases the seller from liability, one must look at the applicable interpretation criteria and, in each specific case, rationally study the theory of civil and commercial sales and purchases and analyze the evidence in light of the correlation between the different legal principles that could apply to the case in question, such as contractual good faith, the parties' duty of loyalty, defects in consent, liability for latent defects in the item sold, and even the presumption that an item sold is in guaranteed good working condition, as regulated in article 932 of the Colombian Commercial Code.

Conclusion and recommendation

Given the logical and unavoidable complexities that arise when contracts are silent (intentionally or otherwise) on this matter, we strongly recommend that parties negotiate and previously and expressly agree on the scope of their liability, and of course within the framework set forth by the law, in order to clearly, unmistakably and accurately define the legal issues that could derive from indemnification for contingencies with respect to the target company of which the buyer was already aware.

Mexico

General framework

Since Mexican law does not expressly establish sandbagging rules, the general regulations and principles of civil and corporate/commercial law apply. Of note, there are no specific consequences when parties remain silent in their contracts, given that none are established in either the Mexican Commercial Code or the Mexican Federal Civil Code.[1] In terms of consent, the Federal Civil Code only recognizes express consent and implied consent, defining the latter as that which results from facts or acts that allow to assume consent or that authorize a party to presume consent has been given, except in the cases in which, by law or by agreement, the intention must be expressly stated. This absence of express legal provision can lead to several challenges, namely: (i) determining whether such contractual silence can be understood as a type of implied consent and, therefore, trigger any particular legal consequences for the parties; and (ii) evidencing that the party receiving or knowing the information actually knew it.

Contractual silence

As stated above, there are no specific regulations on how to interpret contractual silence. The Mexican Commercial Code and the Federal Civil Code (which is supplementary in contractual/commercial matters) do, however, recognize the parties' freedom of contract and their ability to agree to the clauses they deem appropriate in order to govern the different contractual situations (subject to certain limits, as noted below).

There are, however, certain legal precedents that reflect contradictory views on the meaning of silence. These precedents do not constitute case law and therefore judges are not obligated to take them into account when ruling on a dispute involving contractual silence.

[1] For the purposes of this article, we refer only to commercial acts and to the legislation applicable thereto, and not to any specific rules on consent that could exist in the state civil codes.

In the first of these precedents,[2] it was clearly established that silence should be interpreted as implied consent. This would mean that, in the absence of an express contractual provision, the buyer's silence regarding the inaccuracy of a representation or warranty made by the seller would, in principle, preclude the buyer from subsequently claiming indemnification. This is pursuant to the very criteria mentioned above, which holds that the effectiveness of implied consent is founded, accordingly, on the principle of contradiction: consent is presumed because a disagreement would contradict the facts, and silence creates an obligation, when between the parties there is an ongoing contractual relationship that, in its progressive development, imposes the obligation to respond.

The other available precedent,[3] however, would establish the contrary. In this case, the competent Circuit Court decided that contractual silence does not produce, on its own, any active legal effect whatsoever, and therefore the failure to act by the party that received the offer cannot, on its own, constitute an expression of the intention to accept, given that silence is a mere abstention from doing or saying that, from an objective standpoint, lacks any active significance. In that regard, the court concluded that the law (which, as we have seen, does not exist in this case) or the previously expressed will of the parties must determine whether the failure to act (i.e., silence) of the party receiving the offer should be considered acceptance (thereby giving an active nature to the mere failure to act). Consequently, the parties need to agree, in advance, that the silence of the party receiving the offer or information is equivalent to acceptance.

What happens if contracts are silent but contingencies are known and the deal is completed anyway? If this situation is not regulated in the contract, the seller would have to evidence that the buyer knew of such situations and expressly accepted them. In contrast, the buyer could argue that silence regarding certain situations lacks meaning in and of itself and that there are no elements for evidencing that such situations had been accepted.

What happens if contingencies are known and a pro-sandbagging clause is agreed? Would it be valid? Based on the terms of the Federal Civil Code, the parties can agree to liability rules except in those cases where the law expressly determines otherwise. It should be noted that, under Mexican law, as a general rule, civil liability derived from willful misconduct and bad faith cannot be waived.

This would mean that a pro-sandbagging clause agreed between parties would be valid under Mexican law, as it constitutes a regulation by the parties of the civil liability that would derive for the seller in connection with the sale even if the buyer, in fact, knew of a given contingency before signing a contract.

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[2] Isolated excerpt *Corporate/Commercial Contracts*: P./J., Weekly Report of the Judiciary and its Gazette, Fifth Period, Book IX, June 2012, p. 824. Digital registration 281055.

[3] Isolated excerpt *Contractual Silence. Meaning and scope*: P./J., Weekly Report of the Judiciary and its Gazette, Tenth Period, volume XXIII, p. 913. Digital registration 2001040.

Conclusion and recommendation

In light of the foregoing (the absence of a specific rule on the issue and the ambiguity of the precedents), in practice, to deal with this question in Mexico, contracts should include express provisions that: (i) establish the consequences for the buyer of keeping silent about facts it knows or that were disclosed to it by the seller through the customary due diligence process and the respective disclosure schedules; and (ii) if appropriate (depending on which side prevails in the negotiations), whereby the buyer expressly waives the right to demand any indemnification whatsoever in connection with the contingencies disclosed and which the buyer did not oppose.

Chile

General framework

Chilean civil law does not establish a general rule for how a contract will be affected if one of the parties is aware of the existence of contingencies relating to the subject-matter of the contract or the representations made by the other party before the contract was signed but nevertheless goes ahead with the contract. This is particularly relevant in the context of share or asset purchases, and the effects that follow if one of the contracting parties enters into the contract aware of the existence of a latent defect or a flaw in the thing sold. From a practical standpoint, this means whether or not a buyer (or seller) knows –or should know– that a given representation or warranty made by the other party is false or incomplete.

The Chilean Civil Code –particularly when it comes to purchase agreements– directly recognizes the principle that if the buyer had prior knowledge of any contingency or defect in the asset being purchased and sold, then it will not be entitled to claim certain remedies or rights from the seller. By way of example, when addressing the requirements for classifying whether or not a flaw is a latent defect, article 1858 states that the defect must not have been disclosed by the seller and must be such that the buyer could have failed to notice it without gross negligence on its part or that it could not have been able to easily detect by reason of its profession or occupation. If the buyer was aware of the defect, it would be prohibited from seeking indemnification deriving from the latent defects of the thing purchased. The same principle is reflected in article 1814 of the Chilean Civil Code in cases where a seller sells a thing knowing that it does not exist. In this case, the seller must compensate for the damage caused to the good-faith buyer, unless the buyer was aware that the thing sold did not exist, in which case the seller owes them no compensation, since the damage would result from the buyer's own actions.

In addition, when it comes to errors or willful misconduct, the Chilean Civil Code offers an equivalent response, namely that the buyer's knowledge of the falseness of a representation when entering into a contract precludes an occurrence of error or willful misconduct. In particular, although there is no legal concept of error under Chilean law, articles 1452 and 1455 of the Chilean Civil Code –which contemplate the scenarios in which error voids consent– foresee cases in which there was a false representation of reality, meaning that a buyer cannot assert a false representation of reality if it was aware of it at the time of purchase. Following the same logic, article 44 of the Chilean

Civil Code defines willful misconduct as the active intent to cause damage –in other words, defrauding the buyer– but if the buyer has prior knowledge of the fraud (the falseness of the representation), there would be no fraud and it cannot seek to have the contract rendered null and void on grounds of the other party's willful misconduct.

Case law precedents

Multiple authors have expressed their views on this issue, but it is not entirely settled in the legal literature, as there is no unanimous opinion on the liability rules that apply when representations and warranties have been breached. In any event, we can observe some common ground in the sense of understanding that the seller may potentially evade liability, or at least reduce it, if it proves that the buyer was actually aware of the falseness –or inaccuracy– of the representation.

However, it is perfectly lawful, as has been held by Chilean courts of law and arbitration, for the parties, foreseeing this lack of a solution, to expressly establish the effects that will result from a breach of a representation and what will happen if the seller (or buyer) had or should have had knowledge of such a breach, by means of certain pro-sandbagging or anti-sandbagging clauses. In such clauses, the parties would agree that prior knowledge of the falseness or inaccuracy of a representation either does or does not preclude the party concerned from seeking damages. Doing so is nothing more than an application of the general principle that, under private law, the parties' freedom of contract should prevail.

That said, in the courts, there are few actual rulings on the issue, since disputes in share or asset deals are typically resolved through arbitration. One arbitration ruling that particularly stands out in this regard is that issued by the arbitration judge Enrique Barros Bourie, who, in resolving a dispute in the sale of a chain of pharmacies, held that since representations are a mechanism for allocating the risks of the falseness or inaccuracy of representations, and since they contain a promise that they are true and accurate, they are, in his opinion, obligations to achieve a specific result. However, if the purchaser knows beforehand that they are not true, there is no risk of that being the case, since they are not actually true and therefore there is no liability. The required proof, however, is strict in nature and must actually show that there was such knowledge and accordingly, in principle, a buyer's knowledge of a company's situation following a due diligence process does not per se preclude the seller from being liable.

Conclusion and recommendation

Unless the effect has been expressly regulated, according to the above-mentioned principle, if the buyer (or seller) was previously aware of a breach by the other party and now wants to litigate about the breach, it will at least see its right to seek damages reduced, given that it would ultimately be understood that it participated in, and potentially caused, the breach itself (and no one can profit from their own negligence or willful misconduct), or else that it simply accepted the risk inherent in the breach. However, the burden of proof is shifted and it will fall to the seller (or buyer) to prove that there was knowledge and the effects that follow from it.

Brasil*

*(this section was prepared by independent Brazilian law firm NBF|A)

In Brazil, the so-called sandbagging clauses are not expressly regulated by law, and therefore the general rules and principles of civil law shall apply to them.

In general, Brazilian law enshrines the principles of parties' autonomy of the will and *pacta sunt servanda* ("agreements must be kept"). In fact, a recent reform of the Brazilian Civil Code (Law 10,406/2002) has reinforced these principles, by establishing, among others, that the state shall have a minimum role in private contractual dealings and that state courts shall only interfere in contracts in exceptional circumstances.

Accordingly, if the parties decide to include either a pro-sandbagging or an anti-sandbagging clause in their purchase agreement, said clause will be initially valid and binding, unless the damaged party is able to evidence to the courts the existence of certain elements that may justify the contract being deemed invalid and/or ineffective.

Normally, whether or not sandbagging clauses are deemed invalid and/or ineffective ties in with another equally important principle in Brazil: objective good faith. Under this principle, the contracting parties are required to maintain a standard of ethical and social conduct, which means acting correctly, with probity and honesty in all phases of a contractual relationship.

This principle was also bolstered with the recent reform of the Brazilian Civil Code, with lawmakers establishing good faith as one of the criteria for interpreting contracts. One of the most important case law development on that matter relates to the duty of the parties to mitigate - in good faith - their own loss or damages as well as that of their counterparties.

In light of the above, even if parties expressly agree on a pro-sandbagging provision, such clause may be reviewed by judges and courts, based on the principle of objective good faith, in cases where the buyer was previously aware of the contingency and/or breach of the seller's representations, but remained silent in order to obtain a subsequent remedy, either for having acted dishonestly (contrary to good faith), or for not having acted to mitigate the seller's losses.

Likewise, if there is an anti-sandbagging provision, but it is proven that the seller omitted important information or disclosed it in an intentionally inaccurate manner, it will be possible to challenge the limitation set forth by such provision and establish the consequent duty to indemnify based on the principle of objective good faith.

As for the cases where contracts remain silent on sandbagging, the courts must weigh the different principles mentioned above in view of the facts of the case and the evidence adduced in the process, so as to determine whether or not the seller must pay damages in each specific case.

The comments set out above are based on an interpretation of Brazilian law and reflect the majority position in Brazilian case law. However, there are very few public precedents on sandbagging clauses in Brazil, mainly because M&A agreements are typically subject to arbitration or other confidential dispute resolution mechanisms.

Peru

General framework

Anti-sandbagging is regulated in articles 1327 and 1504 of the Peruvian Civil Code, although the parties may agree to include stipulations to the contrary. In other words, in the absence of a pro-sandbagging provision, the anti-sandbagging rules established in the Civil Code will be applicable.

Specifically, in the context of a share or asset purchase agreement subject to Peruvian law, if the parties do not include a pro-sandbagging provision and the buyer ends up claiming the seller for damages with basis on a misrepresentation granted by the seller, the seller can argue that it is not obligated to pay damages if it can demonstrate that the buyer was in a position to know about the misrepresentation granted by the seller and, therefore, about the underlying contingency which is the subject matter of the claim, before the execution of the purchase agreement. Indeed, based on Peruvian rules on the burden of proof in lawsuits about contracts, if the buyer attempts to oppose the anti-sandbagging rules envisaged in the code, it is the burden to the seller to demonstrate that the buyer knew of the breach beforehand.

Along these lines, there are two aspects to be considered when seeking to demonstrate the buyer's knowledge with a view to applying the anti-sandbagging rules:

1. **Disclosure**. As may occur in other jurisdictions, the main sources of evidence are the information made available to the buyer during the due diligence review of the target and the information available from public sources, the latter particularly in the case of targets that are listed companies.

   That said, is the seller required to prove that the contingency to which the claim relates was expressly identified and quantified, for example, in the due diligence information?

2. **Standard of knowledge**. The answer to the last question is no. However, the polar opposite, i.e., giving casual or deliberately vague references to situations that could give rise to contingencies in order to later allege the buyer's knowledge — is not a valid position either.

   In that respect, the Peruvian Civil Code regulates, with regards to the knowledge of the buyer, the "ordinary diligence" standard (an objective standard) and the standard of "the diligence to be expected given its personal capacity and the

circumstances" (a subjective standard). These two standards are not meant to be jointly, so either one can be applied independently of the other.

From a practical viewpoint, let us imagine, for example, that the target was in breach of a contract and that, after the sale and purchase is closed, that breach gives rise to a legal dispute. The seller cannot argue that the buyer was in a position to know of such breach by simply evidencing that it was given a copy of the target's contract, since acting with ordinary diligence and the diligence to be expected in light of its personal capacities, the buyer could not have known that the target was not in compliance with that particular contract. The seller could, however, make that same argument if, along with the contract, it had provided the buyer with a letter from the target's counterparty alleging that obligations had been breached.

Case law precedents

In Peru, there is no generally or mandatory applicable case law, essentially because share and asset purchase agreements are typically subject to arbitration, which are private and confidential proceedings whose effects apply only to the litigating parties.

Despite there being no criteria established through case law on the application of the Civil Code articles mentioned above, there is a clear tendency among buyers to attempt to include pro-sandbagging clauses in sale and purchase agreements subject to Peruvian law.

Conclusions and recommendations

The following positions are commonly seen in contract negotiations:

1. **Sellers**. i) Sellers may adopt a wait-and-see attitude in the hope that the buyer will not propose a pro-sandbagging clause, so that if a contingency does materialize, they can later argue that the Civil Code's standard anti-sandbagging rules are applicable; or (ii) they may take a pro-active approach, seeking to include an anti-sandbagging clause in the agreement, something that a sofisticated buyer will immediately notice.

2. **Buyers**. For buyers, it is essential: (i) to include an express pro-sandbagging clause in the contract, and (ii) to contest the seller's proposals if the seller takes a pro-active approach, particularly in the case of the proposals envisaged in point (a) (ii) above, which allocate the risk on to the buyer simply on account of it having carried out a due diligence.

As a general view, there is a significant trend towards pro-sandbagging clauses being accepted in share and asset purchase agreements, the discussions focusing primarily on the representations and warranties, the exemption from liability in relation to matters disclosed in the disclosure schedules, and the limitations on indemnification obligations.

Contacts

Colombia

Ignacio Londoño
Partner

ignacio.londono@garrigues.com
View complete profile

Paola Valderrama
Senior Associate

paola.valderrama@garrigues.com
View complete profile

Juan Sebastián Parra
Associate

juan.sebastian.parra@garrigues.com
View complete profile

Mexico

Gerardo Lemus
Partner

gerardo.lemus@garrigues.com
View complete profile

Chile

Octavio Bofill Brito
Associate

octavio.bofill@garrigues.com
View complete profile

Carlos Arias López
Senior Associate

carlos.arias@garrigues.com
View complete profile

Rodrigo Fernández Robinson
Partner

rodrigo.fernandez@garrigues.com
View complete profile

Brasil*

* In collaboration with Brazilian law firm NBF|A

Cindy Takahashi
Associate

cindy.scofano@nbfa.com.br

Tomás Borges
Partner

tomas.borges@nbfa.com.br

Peru

Héctor Zegarra
Principal Associate

hector.zegarra@garrigues.com
View complete profile

Sergio Amiel
Partner

sergio.amiel@garrigues.com
View complete profile

GARRIGUES

info@garrigues.com

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