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They don’t call it a survival clause for nothing; poor contract drafting can make your chances of obtaining a legal remedy as good as dead

By Jeffrey H. LaBarge

In GRT, Inc. v. Marathon GTF Tech., Ltd., 2011 Del. Ch. LEXIS 99 (July 11, 2011), the Court of Chancery of the State of Delaware held that a clause limiting the period of time for which contractual representations and warranties survive closing acted as a statute of limitations on the buyer’s ability to commence litigation for breach.

When negotiating the purchase and sale agreement in an M&A deal, the seller often includes a number of clauses that limit the seller’s liability for damages arising from its breach of the contract. One of those clauses, commonly referred to as the “Survival Clause,” typically sets forth that the representations and warranties of the seller “survive” the closing only for a certain period of time. Although the representations and warranties that a seller makes about its business typically form the foundation upon which the buyer bases its decision to purchase the seller’s business, including the amount of the purchase price, it is not always clear to the parties, or their lawyers, exactly what it means for the representations and warranties to “survive” closing. How the Survival Clause is worded, and the law applicable to the particular contract, can have a dramatic effect on its meaning and interpretation. Accordingly, when drafting the Survival Clause, it is very important to (i) clearly understand what the parties intend the Survival Clause to mean, and (ii) make sure that the Survival Clause is worded in a manner that it will be enforced as the parties intend under the law applicable to the contract.

Typically, a seller intends the Survival Clause to act as a statute of limitations for the buyer to bring a claim for breach of the seller’s representations and warranties. A buyer, on the other hand, may view the Survival Clause not as a statute of limitations, but as simply a mechanism requiring that it notify the seller of a breach within a certain period of time; not that the buyer must also commence litigation within that period of time.

A statute of limitations is a law that limits the time in which a certain legal claim may be brought against another party. If you fail to commence litigation within the applicable statute of limitations, your claim is barred and you have lost the possibility of obtaining a legal remedy for your claim. Depending on the applicable state law, typically the statute of limitations for breach of a contract is three years or six years. However, the statute of limitations may be shortened by the agreement of the
parties in a contract. It is not uncommon for parties to a purchase and sale agreement in a private target M&A deal to agree that representations and warranties will survive somewhere between twelve and twenty-four months following closing; which in each case is much shorter than the three-year or six-year statute of limitations. So, if a Survival Clause acts as a statute of limitations, the effect is a waiver of the buyer's right to commence litigation within the longer period of time than it would have been able to do so absent the Survival Clause.

Whether or not a Survival Clause acts as a statute of limitations depends upon its wording and the law applicable to the contract. Some courts, such as those in New York and California, take a very narrow view of whether a Survival Clause shortens the applicable statute of limitations. That view has developed out of a public policy concern that does not favor contract clauses that “limit the right to sue to a period shorter than that granted by statute…because they are in derogation of the statutory limitation. Hence, they should be construed with strictness against the party invoking them.” *Hurlbut v. Christiano*, 405 N.Y.S. 2d. 871, 873 (App. Div., 4th Dep’t, 1978). For example, in the *Hurlbut* case, the court found that the following Survival Clause did not act as a statute of limitations: “The parties hereto further agree that the representations and warranties set forth in Sections 4.01(d) and 4.03(g) of the Purchase Agreement between them dated February 29, 1972 shall survive the closing for a period of (3) years.” In making that ruling, the *Hurlbut* court found “[t]he language of the agreement is clear and unambiguous and suggests nothing from which a shortened period of limitations can be inferred.” Instead, the *Hurlbut* court interpreted the clause to be “clearly a precaution to protect [the seller] against existing violations for which no notices had as yet been received and which, in the absence of this agreement, might not be actionable.”

Other courts have taken a very different view of a similarly worded Survival Clause. In *State Street Bank & Trust Co. v. Denman Tire Corp.*, 240 F.3d 83, 87 (1st Cir., 2001), the United States Court of Appeals for the First Circuit, applying Illinois law, held that a Survival Clause stating that representations and warranties “shall expire on the second anniversary of Closing” clearly described a contractual statute of limitations that required the buyer to commence litigation within that two-year period.

Whether a Survival Clause acts as a statute of limitations was addressed by the Delaware Court of Chancery in *GRT, Inc. v. Marathon GTF Tech., Ltd.*, 2011 Del. Ch. LEXIS 99 *25 (July 22, 2011). In the *GRT* case, the Survival Clause at issue set forth that “…All other representations and warranties in Sections 3 and 4 will survive for twelve (12) months after the Closing Date, and will thereafter terminate, together with any associated right of indemnification pursuant to Section 7.2 or 7.3 or the remedies provided pursuant to Section 7.4.” The *GRT* court held that the Survival Clause did act as a statute of limitations. In doing so, the *GRT* court noted that the Delaware courts do not share the same public policy concerns as the courts of California and New York. It also noted that it felt that the Survival Clause at issue would satisfy the stricter standard of California and New York law, in that it not only terminated the representations and warranties, but also terminated the indemnification remedy for breach of the representations and warranties. The *GRT* court believed that the fact that indemnification was the sole remedy for breach of the contract, coupled with the Survival Clause applying to the indemnification right of the buyer, underscored “the parties intention to make indisputable clear…that the Survival Clause was intended to establish the statute of limitations for claims alleging breach of the [representations and warranties].” The *GRT* court went on to explain that its holding was consistent with other cases where Delaware courts have interpreted
contractual provisions which limit survival of representations and warranties as evidencing the parties' intent to shorten the period of limitations in which a claim for breach of those representations may be brought. Sterling Network Exch., LLC v. Digital Phoenix Van Buren, LLC, 2008 Del. Super. LEXIS 475, at *1 (Del. Super. Mar. 28, 2008) (holding, on the basis of a Survival Clause that limited the survival of representations and warranties to six months after closing, that the contract placed time limitations of six months on claims arising from those representations, and that an action alleging breach of those representations should be dismissed because it was filed after the six month survival period expired). Finally, the GRT court noted that the business context of the agreement supported its ruling, in that to hold the Survival Clause did not shorten the statute of limitations to one year would mean that the buyer could discover a problem on the last day of the survival period, stay quiet for three years, and then sue at the end of the traditional three-year statute of limitations. The GRT court noted that it was unlikely that the parties intended such an extended statute of limitations in an industry where technology is constantly changing and it is important that technology stay up to date.

Application of the laws of New York, Delaware or California tend to be the most typical choice for a purchase and sale agreement in an M&A deal. However, the applicable law can have a dramatically different effect on the interpretation and enforceability of a Survival Clause. As a seller, ensuring that the Survival Clause acts as a statute of limitations will provide comfort that once the survival period ends, the seller no longer needs to worry about a claim by the buyer that the seller breached its representations and warranties. Conversely, a buyer should be careful that in agreeing to a Survival Clause, it does not inadvertently waive its right to a longer statute of limitations, which could have a significant effect on its ability to seek a legal remedy to obtain the benefit of the bargain it negotiated in the deal.

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