

Mergers & Acquisitions Alert

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Survival of Reps and Warranties: Avoiding Unpleasant Surprises for Buyers

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Background

Survival of representations and warranties (“reps and warranties”) is among the staples of highly negotiated provisions in M&A purchase agreements. The length of the survival period limits the time during which claims may be brought for breaches of reps and warranties. When negotiating such survival periods, it is critical to understand the role of the applicable statutes of limitations. Failure to do so can potentially leave the unwary buyer without recourse for breaches of reps and warranties, despite express wording in the purchase agreement to the contrary.

Survival of Reps and Warranties

Reps and warranties are often subject to varying survival periods set forth in a “survival clause.” For example, general reps and warranties as to the condition of the target’s business, assets and operations — e.g., financial statements, contracts, employees, insurance and permits — are often subject to the shortest survival period, typically ranging from 6 to 24 months from the closing of the transaction and often coterminous with the escrow period in deals with an escrow. Reps and warranties involving certain governmental matters — e.g., taxes and sometimes environmental matters — are commonly intended to be subject to survival periods tied to the underlying statute of limitations for the government or other entities to make claims in connection with such reps and warranties. “Special” or “fundamental” reps and warranties — e.g., capitalization, lack of broker involvement, good standing, enforceability and authority to transact business — are often intended to be subject to purportedly “indefinite” survival periods. As discussed below, however, these longer survival periods are not always enforceable.

The Impact of Applicable Statutes of Limitations on Survival of Reps and Warranties

A statute of limitations operates to limit the time during which a claim may be brought against a party. If a purchase agreement is silent as to survival, reps and warranties survive until the applicable jurisdiction’s statute of limitations for claims for breach of contract lapses. If a survival clause is included in the purchase agreement, whether or not it is enforceable will depend on its wording and the law of the jurisdiction; but as a general rule, the survival clause may have the effect of shortening the default statute of limitations for breach of contract, but it may not extend survival beyond it.

Statutes of limitations for claims for breach of contract vary considerably by jurisdiction. When negotiating purchase agreements, care should be taken to understand the effect of different jurisdictions’ laws on the survival of reps and warranties. Delaware, for example, has a 3-year statute of limitations, while California has a 4-year statute of limitations. In contrast, in New York and Massachusetts, the statute of limitations is 6 years. This means that as a practical matter, for example, notwithstanding a reference to any longer “applicable” statute of limitations under the

tax code (i.e., the period in which the IRS could assess an additional tax liability for a pre-closing period) for the survival of tax reps and warranties in a purchase agreement, the period during which a buyer may make claims on a breach of such tax reps and warranties will terminate in 3 years under Delaware law and in 6 years under New York law, regardless of the underlying applicable statute of limitations period.

Tolling

Similarly, M&A purchase agreements typically provide that if a claim is properly made within the specified survival period, the statute of limitations applicable to such claim will be tolled or suspended until such claim is fully settled and resolved. Again, notwithstanding such contractual language, the statute of limitations may in fact apply and any such suit brought after the expiration of the statute of limitations (even if notice of the claim was timely delivered) may be time-barred.

Extending the Applicable Statute of Limitations with Infrequently Used “Sealed” Contracts

With careful drafting, appropriate jurisdiction selection and the use of a “sealed” contract, it is possible to draft purchase agreements with reps and warranties enforceable for the terms intended by the parties. Buyers, of course, will favor longer survival periods, and if such longer terms are negotiated, ensuring that these survival clauses are enforceable is vital.

Delaware law, for example, provides for a 20-year statute of limitations for contracts complying with the requisite formalities to constitute an agreement executed “under seal.” Such 20-year period can then be reduced to the desired length for each rep and warranty. Thus, if the purchase agreement is properly executed “under seal,” the survival provision can specify that (i) the general reps and warranties shall survive for, say, 18 months, (ii) the tax reps and warranties shall survive for 6 years plus 60 days, (iii) the fundamental reps and warranties shall survive for 20 years and (iv) any claim with respect to which notice is properly delivered may survive for the specified time period negotiated by the parties (provided such time period is not longer than the 20-year anniversary of the contract). Execution under seal also extends the statute of limitations to 20 years for contracts governed by Massachusetts law but has no effect on contracts governed by New York or California law. The formalities required to execute a contract under seal vary by jurisdiction.

As discussed above, when negotiating survival provisions in purchase agreements, it is important to not only understand the interplay between the survival period set forth in the purchase agreement and the applicable statute of limitations, but to also consult an expert in the event of any uncertainty in order to ensure that the parties’ intended negotiated terms are not only reflected in the purchase agreement, but also are enforceable. For further information, please contact the authors of this alert or your regular counsel at Mintz Levin.

Post Script

The Delaware legislature has recently proposed revisions to the Delaware law governing the 3-year statute of limitations for breach of contract that would, if adopted, permit parties to certain contracts to opt out of the 3-year statute of limitation period that would otherwise apply and give effect to a longer limitations period (up to 20 years) without requiring the parties to enter into a contract “under seal.”

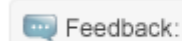
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