The Interpretation of Contractual Survival Clauses

Barry M. Klayman and Mark E. Felger, Delaware Business Court Insider

March 12, 2014

We wrote recently about two cases interpreting contractual survival clauses under Delaware law. The cases—GRT v. Marathon GTF Technology, C.A. No. 5571-CS (Del. Ch. Jul. 11, 2011), and ENI Holdings v. KBR Group Holdings, C.A. No. 8075-VCG (Del. Ch. Nov. 27, 2013)—held that provisions limiting the period of time in which representations and warranties survive closing act as a statute of limitations on the nonbreaching party's ability to commence litigation for breach. The two cases also hold some other important lessons regarding the interpretation and effect of survival clauses that may surprise practitioners who are not familiar with them.

In Marathon, then-Chancellor Leo E. Strine Jr. wrote that there were four distinct ways to address the duration of contractual representations and warranties: the contract can provide that the representations and warranties terminate at closing; the contract can be silent on whether the representations and warranties survive closing or expire upon closing; the contract can provide a definite period during which the representations and warranties survive closing; or the contract can provide that the representations and warranties survive indefinitely.

Strine discussed each of the four scenarios. In the first scenario, where the representations and warranties terminate upon closing, the parties make clear their intent that the representations and warranties can provide no basis for a post-closing lawsuit seeking a remedy for an alleged misrepresentation. When the representations and warranties terminate, so does the right to sue on them. In such cases, however, the representations and warranties can provide a basis to avoid
closing to the extent their truth is made a condition to closing, but they will not provide a basis for a post-closing suit.

In the second scenario, where the contract is silent as to the survival of the representations and warranties, it is not clear whether they survive the closing. Strine cited to several commentaries that suggested that unless the parties agree to a survival clause extending the representations and warranties past the closing date, the breaching party cannot be sued for damages post-closing for their later discovered breach. Strine also cited to one treatise that suggested the result may depend on whether the representations and warranties refer to a post-closing event or circumstance or the pre-closing condition of the company's business. In the former case, the representations and warranties may survive closing; in the latter, they will not. In any case, Strine noted that the parties are at risk if their agreement is silent on the question of the survival of any representations and warranties: "The better and more certain practice is to have the contract expressly state whether or not the representations and warranties survive the closing, and therefore will provide a basis for a post-closing lawsuit."

In the third scenario, where the contract contains a discrete survival period, the effect is to limit the time period during which a claim for breach of a representation or warranty may be filed. The survival clause acts as a contractual statute of limitations. That is the holding of both Marathon and ENI Holdings.

In the last scenario, where the representations and warranties are said to survive indefinitely, the result is surprising. According to Strine in Marathon, in that case the ordinarily applicable statute of limitations governs the time period in which an action for breach can be brought. This is because of the public policy underlying statutes of limitations in general, and the refusal of courts to permit parties to extend the limitations period beyond the legislatively determined statute of limitations.

"A survival clause that states generally that the representations and warranties will survive closing, or one that provides that the representations and warranties will survive indefinitely, is treated as if it expressly provided that the representations and warranties would survive for the applicable statute of limitations," Strine said.

This is not the result that one would predict based on the plain meaning of the language in the contract. In both Marathon and ENI Holdings, the survival clause contained different scenarios depending on the representation or warranty that was involved. The survival clause in Marathon provided that some representations and warranties survived indefinitely after closing, others survived until the expiration of the applicable statute of limitations, and yet others survived for a period of 12 months after closing. Marathon suggests that despite the express language of the survival clause, the representations and warranties that survive indefinitely should be treated no differently than those that survive until the expiration of the applicable statute of limitations, and the outcome would be the same for both sets of representations and warranties as if the agreement had merely provided that they all survived the closing without stating any definite survival period.
The result seems odd and counterintuitive. Generally speaking, the statute of limitations is an affirmative defense that can be waived. Parties do it often enough in the context of tolling agreements, where they agree to extend the period for filing suit. It is unclear why the parties cannot agree in advance to extend the statute of limitations for any breach of their agreement. However, based on *Marathon*, while they can shorten the limitations period by contract, they cannot extend it.

*ENI Holdings* also addressed another interesting issue: Will the discovery rule toll the contractual limitations period? Vice Chancellor Sam Glasscock III held that it would not—application of the discovery rule to a contractual limitations period is inappropriate where the inherent unknowability of a potential claim is itself knowable or predictable and the proper source of negotiation and resolution between the parties to the contract. To paraphrase former Secretary of Defense Donald Rumsfeld, there are known knowns, known unknowns and unknown unknowns. *ENI Holdings* said that if the parties have contracted for an abbreviated limitations period, they have made provision for the known knowns and the known unknowns, and there is no room for the unknown unknowns. However, the court did leave open the possibility that the nonbreaching party could invoke the doctrines of equitable tolling and fraudulent concealment to avoid the contractual limitations period.

The interpretation and effect of provisions dealing with the survival of contractual representations and warranties under Delaware law are not as simple as may first appear, despite the oft-heard admonition that they merely present a question of pure contract interpretation. As *Marathon* and *ENI Holdings* suggest, the plain language of the parties' contract will not always control. Practitioners must take care that in drafting survival clauses, they clearly express the parties' intent and, given the holdings and discussion of survival clauses in these two cases, carefully consider the legal backdrop.

*Barry M. Klayman* is a member in the commercial litigation group and the bankruptcy, insolvency and restructuring practice group at Cozen O'Connor. He regularly appears in Chancery Court. *Mark E. Felger* is co-chair of the bankruptcy, insolvency and restructuring practice group at the firm.