

## **Expanded Liability for Representations and Warranties: Limiting Survival Provisions**

***By Barrett Howell of Winstead PC<sup>1</sup>***

You represent Parent Corp and its subsidiary, Target Corp, in a transaction involving the sale of all of Target's stock. You and Acquirer Corp's counsel negotiate representations, warranties, and the survival provision. Your clients' representations and warranties regarding the value of Target's inventory survive until one-year after closing. The transaction closes and everyone walks away happy. Six months later, however, Parent receives an indemnification notice in which Acquirer claims Parent significantly overstated the value of Target's inventory in the purchase agreement. You and Parent begin working with Acquirer in attempts to resolve the dispute without resorting to litigation. Eighteen months later, however, with no resolution in sight, Acquirer sues. You tell Parent not to worry, the one-year survival period that the parties intensely negotiated, agreed upon, and clearly contained in the purchase agreement bars Acquirer's claim, right?

Maybe not. In a recent Ninth Circuit decision, the court strictly interpreted a survival provision, holding that the provision established the period during which a breach could occur or the parties could discover a breach, but did not limit the time during which a party could file suit. Rather, according to the Ninth Circuit, so long as Acquirer discovered the breach during the survival period, Acquirer could file suit anytime prior to the expiration of the applicable statute of limitations.

### **The Facts: *Western Filter Corp. v. Argan, Inc.***

*Western Filter Corp. v. Argan, Inc.*, 2008 U.S. App. LEXIS 18147 (9th Cir. Aug. 25, 2008), involved a post-merger dispute over inventory valuation. Western Filter and Puroflow, a wholly-owned subsidiary of Argan, were competitors in the aerospace and automotive filtration products industries. On October 30, 2003, Western Filter and Argan entered into a stock purchase agreement pursuant to which Western Filter acquired all of Puroflow's stock for a purchase price of \$3.5 million. Section 8.1 of the stock purchase agreement contained a survival provision that stated the "representations and warranties of [Western Filter] and [Argan] in this Agreement shall survive the Closing for a period of one year, except the representations and warranties contained in Section 3.1(a), (b), (c), and (f) and 3.2(a) and (b) shall survive indefinitely."<sup>2</sup>

Soon after closing, Western Filter discovered that Puroflow's inventory was worth significantly less than Argan had represented. According to Western Filter, nearly \$1 million of Puroflow's \$1.8 million inventory was worthless, obsolete, non-usable, non-saleable, and had to be written off.<sup>3</sup> Consequently, on September 17, 2004, Western Filter sent a letter to Argan, accusing it of having "grossly misrepresented the financial condition of Puroflow."<sup>4</sup> Unable to resolve the dispute, Western Filter sued Argan six months later in California state court. Argan removed the

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<sup>2</sup> *Western Filter Corp. v. Argan, Inc.*, 2008 U.S. App. LEXIS 18147, at \*3 (9th Cir. Aug. 25, 2008).

<sup>3</sup> *Western Filter Corp. v. Argan, Inc.*, Case No. 05-03548, at \*1-2 (C.D. Cal. March 15, 2007).

<sup>4</sup> *Western Filter Corp.*, 2008 U.S. App. LEXIS 18147, at \*4.

case to federal district court. The relevant dates are summarized as follows:

<b><u>Date</u></b>	<b><u>Event</u></b>
October 30, 2003	Western Filter and Argan execute the stock purchase agreement.
September 17, 2004	Western Filter sends an indemnification letter accusing Argan of having significantly misrepresented Puroflow's financial condition.
October 30, 2004	According to Argan, the date upon which its inventory valuation representations and warranties terminated.
March 22, 2005	Western Filter sues Argan.

Ruling on Argan's motion for summary judgment, the district court found that the one-year survival provision contained in the stock purchase agreement barred Western Filter's claims.<sup>5</sup> Specifically, the district court found, "[t]he plain meaning of section 8.1's provisions clearly indicate that, if [Argan] breached certain representations and warranties, then for a one-year period after the closing Western Filter could file a claim against defendants for such breach...."<sup>6</sup> Because Western Filter had filed its complaint outside the one-year survival period, the district court found its claims were barred and granted Argan's motion for summary judgment. Western Filter appealed the district court's ruling to the Ninth Circuit.

On appeal, Western Filter argued that the one-year survival period established only the time during which a breach could occur or be discovered, but did not limit the period during which a suit arising out of a breach could be filed.<sup>7</sup> As the transaction closed on October 30, 2003 and the purchase agreement contained a one-year survival period, Western Filter's position was that Argan was liable for any breaches that occurred or were discovered through October 30, 2004. The survival provision, however, did not require that Western Filter file or provide notice of a claim by October 30, 2004.

Rather, according to Western Filter's argument, the occurrence or discovery of a breach during the one-year survival period triggered the commencement of the applicable statute of limitations, only upon the expiration of which would Western Filter's claim be barred. As the Ninth Circuit explained, "the Survival Clause can also be reasonably read as Western Filter suggests: that the one-year limitation serves only to specify when a breach of the representations and warranties may occur, but not when an action must be filed."<sup>8</sup> Argan, on the other hand, argued that the survival period constituted a contractual agreement to shorten the applicable statute of limitations period, thereby limiting both the time during which a breach could occur as well as the time during which a party could file suit arising from the breach.<sup>9</sup>

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<sup>5</sup> *Western Filter Corp.*, Case No. 05-03548 (C.D. Cal. March 15, 2007).

<sup>6</sup> *Id.* at \*6.

<sup>7</sup> *Western Filter Corp.*, 2008 U.S. App. LEXIS 18147, at \*9.

<sup>8</sup> *Western Filter Corp.*, 2008 U.S. App. LEXIS 18147, at \*16.

<sup>9</sup> *Western Filter Corp.*, 2008 U.S. App. LEXIS 18147, at \*9.

The Ninth Circuit held that while a contractual agreement to shorten the statute of limitations is permissible under California law, it “must be clear and explicit, and is to be strictly construed against the party invoking the provision.”<sup>10</sup> The court noted that the survival provision contained no language specifying when a party must file a claim. As a result, the Ninth Circuit deemed the survival provision language ambiguous and reversed the district court’s entry of summary judgment.

### **Limited Survival Periods**

In the context of private company transactions, parties commonly represent and warrant the existence or non-existence of certain facts and conditions as of the date of execution of the purchase agreement and, if applicable, as of the date of closing. If after the execution of the purchase agreement but before the closing date, one party discovers that the other party has materially breached a representation or warranty, the non-breaching party can usually walk away from the deal, and may be able to recover damages from the breaching party. Where the breach is not discovered until after closing, if the agreement is silent as to the survival or termination of representations and warranties, then the non-breaching party’s claim is subject to the applicable statute of limitations period. But by including a survival provision, the parties shorten the time a non-breaching party has to discover and seek indemnification for breaches of representations and warranties.

Sellers’ representations and warranties typically create larger liability exposure than those of buyers. It is therefore in the sellers’ interest to negotiate as short a survival period as possible. This is particularly true where sellers are required to escrow funds to cover potential indemnification claims. Conversely, buyers seek as lengthy a survival period as possible, or at least a reasonable amount of time to discover the basis for, and assert, any potential indemnification claims. It is critical for parties and their attorneys to fully understand how the language of the survival provision affects potential recovery or liability for inaccurate representations and warranties. As the *Western Filter* case demonstrates, where the survival provision does not expressly state that a claim must be filed prior to the expiration of the survival period, a seller could wind up with significantly more liability exposure than it bargained for.

A survival provision typically accomplishes two things: (1) it extends certain representations and warranties beyond the closing date; and (2) it limits the time in which a party may bring a claim for breaches of those representations and warranties. As the Ninth Circuit explained in *Western Filter*, both California and New York highly disfavor contractual agreements that limit the statute of limitations or the time in which a claim may be brought for post-closing discovery of breaches of representations and warranties. Consequently, according to the Ninth Circuit, both California and New York strictly construe such provisions against the party invoking its protection.<sup>11</sup> As a result, the parties must state their intentions clearly and explicitly in order for such agreements to be effective.

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<sup>10</sup> *Western Filter Corp.*, 2008 U.S. App. LEXIS 18147, at \*10, 13-14.

<sup>11</sup> *Western Filter Corp.*, 2008 U.S. App. LEXIS 18147, at \*10, 13-14.

The Ninth Circuit's opinion seems to refer interchangeably to post-closing breaches of representations and warranties and post-closing discovery of those breaches. It is difficult to imagine, however, how a party could breach representations and warranties after closing. A post-closing breach more likely arises from a party's wrongful refusal to indemnify. Apparently ignoring this distinction, the Ninth Circuit interpreted the one-year survival period as expanding, rather than shortening, the time Western Filter had to assert its breach claim.

Had the merger agreement said nothing about termination or survival of representations and warranties, Western Filter's claim would have been subject to California's four year statute of limitations applicable to breach of contract claims. But by including the survival provision, according to the Ninth Circuit's logic, Western Filter had one year from closing to discover the breach and then four years from the date of discovery to assert any claims arising from the breach. After having agreed upon a one-year survival period, Argan was most likely not happy to learn that it had potential liability exposure up to *five years* after closing.

### **Indefinite Survival Periods**

At the other end of the spectrum, purchase agreements may also contain indefinite or unlimited survival periods. In a footnote to the *Western Filter* opinion, the Ninth Circuit stated "an action for a breach of the representations and warranties covered by the 'indefinitely' portion of the Survival Clause may be discovered anytime during the applicable statute of limitations."<sup>12</sup>

Although not entirely clear, the court seemingly infers that there is no time limit on filing an action arising out of breaches of indefinite representations and warranties, so long as the breach was discovered during the applicable statute of limitations period. The California statute of limitations for fraud claims is three years.<sup>13</sup> Therefore, applying the reasoning of the *Western Filter* holding, where a seller breaches an indefinite representation and warranty as the result of fraud, if the buyer does not discover the fraud within three years of closing, the statute of limitations bars buyer's claim.

### **Practice Pointers**

Although the Ninth Circuit's decision in *Western Filter* is based on California law, you would be wise to consider the implications of the court's logic when negotiating and drafting survival provisions. In light of *Western Filter*, survival provisions should clearly and explicitly set forth the parties' agreed upon intent as to both potential liability and the time within which a claim must be noticed or filed. Specifically, survival provisions should state that:

- The representations and warranties survive the closing date until a specified termination date;
- Any claim, demand, action, or suit for indemnification arising from a breach of the surviving representations and warranties must be filed, or at a minimum, noticed, prior to the termination date;

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<sup>12</sup> *Western Filter Corp.*, 2008 U.S. App. LEXIS 18147, at \*17 n.8.

<sup>13</sup> Cal. Civ. Proc. Code § 338(d).

- A claim becomes barred if not filed (or noticed) during the survival period; and
- The parties intend to shorten (in the case of limited survival provisions) or lengthen (in the case of unlimited or indefinite survival provisions) the applicable statute of limitations period.

Also, you should research the law of the governing state to:

- Identify any anomalies or unique issues with respect to that state's interpretation of survival provisions and contractual agreements that limit or extend the applicable statute of limitations; and
- Determine whether any magic words are required for effectiveness.