DELAWARE CORPORATE LAW BULLETIN

# Purchase Agreement's Failure To Toll Running of Survival Period Dooms Indemnification Claims Despite Buyer's Timely Claim Notice

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*Vice Chancellor holds disappointed buyer to "bargained-for 'risk allocation'" clearly and unambiguously memorialized in purchase agreement*

INTRODUCTION ........ 368
I. FACTUAL BACKGROUND ........ 369
  *A. Strategic Overlap* ........ 369
  *B. Asset Purchase Agreement* ........ 369
  *C. Customer Relationships Jeopardized* ........ 370
II. VICE CHANCELLOR SLIGHTS' ANALYSIS ........ 371
  *A. Indemnification Claims* ........ *371*
  *B. Implied Covenant Claims* ........ 373
  *C. Fraud Claims* ........ 373
CONCLUSION ........ 374

## INTRODUCTION

In the context of contracts governing merger and acquisition ("*M&A*") transactions, survival clauses specify the period of time after closing during which the buyer may claim indemnification from the seller for losses caused by various breaches of the contract. In other words, contractual survival clauses seek to alter the statutory limitations period for bringing such claims based on a breach of contract theory. Survival is typically a heavily negotiated feature of private M&A contracts. In public M&A, however, market practice is to specify that most contract provisions do not survive closing.

Under the Delaware "default rule . . . representations and warranties do not survive closing, but parties may agree to create a contractual survival period if they so choose." If the purchase contract states that representations and warranties survive closing but does not specify a survival period, the "default statute of limitations for breach of contract [of] three years" applies. Subject to certain limitations, Delaware allows a buyer and seller to negotiate a contractual survival period for representations and warranties which may be shorter or longer than the statutory default period.

In practice, if a buyer determines that a seller's representation and warranty was untrue as of the closing date and losses have been incurred as a result, the buyer must provide adequate notice to the seller within the contractual survival period to pursue its indemnity claim. Both parties then usually negotiate and, in the best of worlds, come to an agreement as to whether the seller is required to indemnify the buyer. When the parties cannot reach an agreement, the buyer may elect to pursue litigation (assuming they have not opted in the purchase contract to arbitrate their disputes). The question then becomes whether the litigation is timely brought in light of the survival provision.

Vice Chancellor Joseph R. Slights III of the Delaware Court of Chancery ("*Chancery Court*") was confronted with this very issue in *Pilot Air Freight, LLC v. Manna Freight Sys.*, No. 2019-0992-JRS, 2020 WL 5588671 (Del. Ch. Sept. 18, 2020). Pilot Air Freight, LLC ("*Pilot*") and Manna Freight Systems, Inc. ("*Manna*"), together with its two owners ("*Sellers*"), entered into an asset purchase agreement ("*APA*") that, among other things, created a survival period of fifteen months. Although Pilot notified Sellers *within this survival period* of an indemnity claim, the parties were unable to negotiate a settlement, and Pilot brought suit in Chancery Court. However, Pilot did not file this lawsuit until *after the survival period*. Vice Chancellor Slights,

recognizing that the APA did not "toll the survival period" once Pilot sent its claim notice to Sellers, ruled that Pilot's litigation was *not* timely commenced. The Vice Chancellor's decision offers an important lesson to M&A participants and their legal counsel: unless a purchase contract effectively tolls the running of the survival period upon notification to a seller of buyer's indemnity claim, *both* the delivery of the claim notice *and* the commencement of any related litigation must occur within the contractual survival period.

## I. FACTUAL BACKGROUND

### *A. Strategic Overlap*

Both Pilot and Manna were "engaged in the trucking and logistics industry." For its part, Manna "focused on providing 'final mile' delivery services, specializing in more difficult deliveries," and its "business relied heavily on revenue generated from repeat customers." Recognizing the strategic overlap between the businesses, and in an effort "to 'provide customers with a complete package of delivery solutions' " that would "offer its 'full mile' services to Manna's 'last mile customers,' " Pilot began negotiations with Sellers to acquire Manna's business.

### *B. Asset Purchase Agreement*

On June 26, 2018, Pilot, Manna, and Sellers signed the "heavily negotiated" APA for the purchase by Pilot of "substantially all the assets" of Manna. The transaction closed on July 16, 2018 ("*Closing Date*"). The APA allocated a variety of risks associated with the Manna business between Pilot and Sellers.

*First*, pursuant to the APA's non-reliance provision ("*Non-Reliance Provision*"), Pilot agreed "it was not relying on any extra-contractual representations or warranties when it entered into the APA." On the other hand, Pilot retained its litigation options "in connection with any action or claim based upon *intentional fraud . . . in this Agreement*."

*Second*, an integration clause provided that the APA, together with the associated disclosure schedules, "constitute[d] the entire agreement between the parties," and "supersede[d] any prior understandings, agreements, or representations and warranties by or among the parties."

*Third*, Pilot negotiated for specific representations and warranties from Sellers "regarding the fitness of Manna's trucking

business" including, notably, the "stability" of Manna's customer base. The status of Manna's customer base was of "critical importance" to Pilot because Pilot hoped to "market its [own] logistics services to Manna's customers." In fact, "a significant component of Pilot's valuation of Manna was Manna's 'projected future customer revenues.' " To that end, the APA's customer-related representations and warranties ("*Customer Representations*") listed Manna's thirty largest customers for 2017 and warranted that none of these customers had notified Manna that it "intends or expects, after the Closing Date, to stop or materially decrease the volume of, or change, adjust or modify in any materially adverse manner any of the material terms . . . with respect to its purchasing of services from [Manna]."

*Fourth*, Sellers agreed to "indemnify, defend and hold [Pilot] . . . harmless from and against any and all loss, liability, damage, or expense . . . arising out of, resulting from or due to . . . any breach or inaccuracy . . . of any representation and warranty of" Sellers in the APA.

*Fifth*, "most" of Sellers' representations and warranties, including the Customer Representations, were scheduled to "survive for a period of 15 months after the Closing" ("*Survival Period*"), after which claims arising therefrom would be "time barred."

### *C. Customer Relationships Jeopardized*

Post-closing, Pilot discovered that during "2017 and 2018, Manna's business relationships with certain key customers fell into jeopardy." In fact, before or soon after the APA signing date, Manna internally identified two of its largest customers as "lost customer[s]" and was informed by another "that it no longer intended to be a customer." Sellers disclosed to Pilot some, but not all, of the information concerning the "lost customer[s]," while failing to disclose any information with respect to the third customer. Sellers similarly failed to adequately disclose a number of changes regarding key vendors. Pilot learned of these issues "at some point after [the Closing Date]."

After learning of these issues, Pilot sought to stem its losses. On October 14, 2019—*during* the Survival Period—Pilot sent Sellers an indemnification demand ("*Claim Notice*") seeking "in excess of $6.9 million because of Sellers' alleged wrongdoing in connection with the APA." When negotiations to resolve these clams failed, on December 11, 2019—*after* the Survival Period—Pilot filed suit in Chancery Court. Pilot's lawsuit alleged "fraud, breach of representations and warranties

and breach of the implied covenant of good faith and fair dealing" on the part of Sellers.

Sellers moved to dismiss. With respect to Pilot's breach of representations and warranties and other contract claims ("*Indemnification Claims*"), Sellers responded that because Pilot's litigation was filed after expiration of the Survival Period, it was not timely commenced. With respect to Pilot's other claims, Sellers argued they were "not well-pled."

## II. VICE CHANCELLOR SLIGHTS' ANALYSIS

Vice Chancellor Slights granted Sellers' motion to dismiss both the Indemnification Claims (with the exception of a "minor dispute involving Manna's accounts receivable"), focusing primarily on expiration of the Survival Period, and the claim based on the implied covenant of good faith and fair dealing ("*Implied Covenant Claim*"). On the other hand, he refused to dismiss Pilot's fraud claims.

### *A. Indemnification Claims*

In refusing to dismiss the Indemnification Claims, Vice Chancellor Slights noted that "[d]espite the 'critical importance' of customer relationships to Pilot's plans for Manna's assets, it offers no viable excuse for waiting until *after* the fifteen-month contractual limitations period expired to seek indemnification." Of course, this is not quite right: Pilot notified Sellers of its issues with the Customer Representations *during* the Survival Period but failed to pursue the Indemnification Claims in Chancery Court until *after* the Survival Period lapsed.

In this connection, the Vice Chancellor observed that the APA expressly included a fifteen-month survival period for most of Sellers' representations and warranties—including the Customer Representations—effectively shortening the post-closing limitations period in which to bring indemnity claims for breach of representations and warranties from three years to fifteen months. Although Pilot delivered the Claim Notice within the Survival Period, it did not file its Chancery Court complaint until more than fifteen months after closing, making it "untimely" for purposes of the APA.

Pilot nevertheless offered four arguments to change the Vice Chancellor's mind, none of which he found convincing.

*First*, Pilot pointed out that the APA provided that Sellers' indemnification obligations, as well as other covenants, "shall survive

for three (3) years after the Closing Date." Pilot claimed this provision, notwithstanding the Survival Period, gave it three years from the Closing Date to commence litigation of the Indemnification Claims. Recognizing that he "must interpret contractual provisions in a way that gives effect to every term of the instrument," the Vice Chancellor explained that the Survival Period was a "*subset*" of the longer three-year survival provision that "explicitly subjects breach of representation and warranty claims to a truncated 15-month survival period."

*Second*, Pilot argued that the Claim Notice, delivered *before* the end of the Survival Period, was " 'plainly sufficient to' toll" the Survival Period. The Vice Chancellor disagreed, noting that "nothing in the APA says that an indemnification *demand* (rather than filing suit) will toll the survival period." Although " '[p]arties may contractually agree that an indemnification notice tolls the limitation period until the underlying claim is resolved,' the APA contains no such tolling provision." Accordingly, the Vice Chancellor invoked Delaware's "default" rule: "[W]hen parties have shortened the statute of limitations by providing that representations and warranties survive only through a specified date, the party claiming breach *must file suit* within the specified time period. Providing notice within the specified time period is not enough."

*Third*, Pilot claimed that the language of the APA creating the Survival Period—"[a]ll representations and warranties set forth in this Agreement shall survive for a period of 15 months after the Closing"—was inadequate to achieve its intended purpose. Rather, Pilot contended that the APA should have "expressly state[d] that representations and warranties '***terminated*** on the survival expiration date.' " The Vice Chancellor rejected this contention, explaining that "Delaware does not require explicit language to set a contractual limitations period." The APA formulation was sufficient.

*Fourth*, Pilot attempted to invoke the "doctrine of fraudulent concealment" to toll the contractual limitations period. In this connection, Pilot claimed that the Customer Representations " 'put [it] off the "trail of inquiry," ' meaning that Pilot relied on the [Customer Representations] and did not notice the departure of key customers until it was too late." This argument failed as well. According to the Vice Chancellor, any " 'relief' from the limitations period" provided by this doctrine "extends only until the plaintiff is put on inquiry notice." And, further, " 'inquiry notice does not require actual discovery of the reason for injury,' but instead 'exists when plaintiff becomes aware of facts sufficient to put a person of ordinary intelligence and prudence on

inquiry which, if pursued, would lead to the discovery of injury.' " Applying these principles, the Vice Chancellor concluded that "by the time Pilot took the helm at [Manna], ship's alarms had been ringing for months. Against this backdrop, . . . Pilot cannot make a reasonably conceivable case for fraudulent concealment given that it was indisputably on inquiry notice of the alleged breach well within the limitations period."

### *B. Implied Covenant Claims*

Vice Chancellor Slights explained that the implied covenant of good faith and fair dealing "involves a cautious enterprise, inferring contractual terms to handle . . . contractual gaps that the asserting party pleads neither party anticipated." The Implied Covenant Claim failed for two reasons. *First*, because Pilot's "grievances . . . rest[ed] on the same factual allegations that support Pilot's breach of contract claims," they could not "sustain a viable claim for breach of the implied covenant." *Second*, Pilot failed to identify "a 'gap that the implied covenant might fill.' " Simply put, because the APA was so "carefully negotiated," it left no "gap within which the implied covenant might fit."

### *C. Fraud Claims*

Pilot also claimed that "the same course of conduct underlying its breach of contract claims also gives rise to actionable fraud." As an initial matter, Vice Chancellor Slights found that Pilot's fraud claims were timely brought because the APA stated that nothing in the agreement (i.e., the Survival Period) limited Pilot's right to bring a claim for intentional fraud. Moreover, according to the Vice Chancellor, Pilot's claims that relied on deficiencies in the Customer Representations, as opposed to "extra-contractual promises, representations or warranties," not only were not barred by the Non-Reliance Provision, but also "pled reasonably conceivable fraud claims."

Finally, the Vice Chancellor ruled that Pilot's fraud claims were not simply improper " 'bootstrapped' breach of contract claims" subject to dismissal. To the contrary, "improper bootstrapping does not occur" when (i) "plaintiff has made particularized allegations that a seller knew contractual representations were false or [plaintiff has] lied," (ii) damages alleged in the fraud claim "may be different from plaintiff's breach of contract claim[s]," (iii) "the conduct occurs prior to the execution of the contract," or (iv) "the breach of contract claim is not well-pled." Inasmuch as "Pilot's fraud claims fall squarely within

several, if not all, of these non-bootstrapping spaces," Vice Chancellor Slights denied dismissal of Pilot's fraud claims to this extent.

## CONCLUSION

Vice Chancellor Slights held Pilot and Sellers to their "bargained-for 'risk allocation' " as articulated in the APA. Particularly with regard to the Survival Period, "[i]f Pilot wanted a longer period within which to ascertain whether Sellers' representations and warranties were accurate, it could have shifted that risk to the Sellers by negotiating a longer survival period." Perhaps even more to the point, had Pilot's legal counsel included fairly standard tolling language in establishing the Survival Period, the Claim Notice would have tolled the running of the contractually agreed limitations period, thereby permitting Pilot to timely file the Indemnification Claims with the Chancery Court. However, "[n]ow that Pilot memorialized the terms of its agreement with Sellers in the form of a clear and unambiguous contract, the Court cannot allow Pilot to re-trade rights it knowingly bargained away."