

# Reps and Warranties Insurance vs. Traditional Indemnity: A Comprehensive Guide

The landscape of mergers and acquisitions (“M&A”) is constantly evolving, with deal structures becoming increasingly sophisticated to mitigate risks and optimize outcomes for all parties. A critical element of any M&A transaction is the allocation of risk associated with potential breaches of representations and warranties made by the seller regarding the target company and its business operations. Historically, this risk was primarily managed through a traditional indemnity structure negotiated between buyer and seller parties in the purchase agreement governing the M&A transaction. However, in recent years, Representations and Warranties Insurance (“RWI”) has emerged as a powerful alternative, fundamentally reshaping how M&A deals are negotiated and closed.

When planning an M&A transaction, both buyers and sellers of all sophistication levels should think about how to best allocate this risk and whether a traditional indemnity structure or RWI is preferable. This article provides an in-depth analysis of both traditional indemnity structures and RWI, outlining their fundamental mechanics, key differences, and the respective advantages and disadvantages for both sellers and buyers.

## The Traditional Indemnity Structure

In a traditional M&A transaction, the seller provides representations and warranties to the buyer regarding the target company's business, assets, liabilities, and operations in the purchase agreement governing the M&A transaction. These representations are statements of fact at a specific point in time (usually the closing date), and warranties are promises that those facts are true. If a representation or warranty proves to be untrue, and the buyer suffers damages as a result, the seller is obligated to indemnify the buyer for those losses.

### Key components of a traditional indemnity structure include:

**Representations and Warranties (“R&Ws”):** If an R&W made by seller proves to be untrue, this triggers an indemnification obligation that buyer can pursue against seller. They cover a wide range of areas and typically consist of “basic” or “general” R&Ws and “fundamental” R&Ws that are allocated and negotiated between the parties:

- **Fundamental R&Ws:** These are considered critical and are often subject to longer survival periods and higher or no caps (as summarized below). Common examples include corporate existence, authority to transact, capitalization, and title to shares. A buyer may propose for other R&Ws that are traditionally viewed as general R&Ws to be elevated to fundamental R&Ws if they are considered to be high-risk areas based on diligence findings or otherwise crucial to the business given the specific

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industry a seller operates in. For example, if the target company develops and sells software, a buyer may want to propose intellectual property R&Ws to be fundamental R&Ws given the importance of ensuring the target company owns the software it develops and sells.

- **General R&Ws:** These cover all other aspects of the business, such as financial statements, material contracts, litigation, employment matters, data privacy and security matters, environmental matters, intellectual property, insurance and compliance with laws.

**Indemnification Obligation:** This is the seller's promise to compensate the buyer for losses arising from breaches of R&Ws, as well as other specified matters outside the scope of this article (e.g., pre-closing taxes, certain litigation).

**Survival Period:** This defines the timeframe during which the buyer can make an indemnity claim. Fundamental R&Ws typically have longer survival periods (e.g., 5-7 years, applicable statute of limitations or even indefinitely) compared to general R&Ws (e.g., 12-24 months).

**Baskets:** Refers to a threshold dollar amount of losses arising from breaches of R&Ws that must be met before a buyer can make a claim for indemnification against a seller, typically around 0.5-1% of the purchase price. This limits the seller's initial exposure, ensuring that only claims which exceed a certain financial limit will trigger the seller's obligation to indemnify the buyer. Think of it like a minimum claim amount.

- **Deductible Basket:** The seller is only liable for losses that exceed the specified basket threshold, and the buyer bears the losses up to that amount. It functions very similarly to a standard insurance deductible. This structure is preferable to sellers.
- **Tipping Basket:** Similar to a deductible basket, but once the aggregate losses exceed the basket amount the seller is liable for the entire amount of losses, not just the amount exceeding the basket. This structure is preferable to buyers, however deductible baskets are more common in the market.

**Caps:** This is the maximum amount the seller is obligated to pay under the indemnity. Caps for general R&Ws are typically a percentage of the purchase price (e.g., 10-20%), while fundamental R&Ws often have higher caps (e.g. the full purchase price) or no caps at all.

**Escrow/Holdback:** A portion of the purchase price is often either set aside in an escrow account or "held back" as a reduction to the purchase price paid to seller at closing for a specified period post-closing (matching the general R&W survival period) to cover potential indemnity claims. Amounts of this indemnity escrow or holdback are negotiated between the parties based on issues identified during the diligence process of the M&A transaction. This provides the buyer with a direct source of recovery and reduces the need to pursue the seller directly post-closing. After the expiration of the R&W survival period, the indemnity escrow or holdback amount (net of any indemnity claims made by buyer) is released and paid to seller.

With traditional indemnity, it is important to keep in mind that everything is negotiable and the structure that ends up in place depends on the risk tolerance of the parties, the results of diligence conducted during the deal process and certain company or industry specific considerations and nuances. While the foregoing are the typical provisions and market ranges for specific terms, every deal is different depending on the preferences of the parties to the transaction.

### Representations and Warranties Insurance (RWI)

RWI is an insurance policy that transfers the risk of financial loss arising from breaches of R&Ws from the seller and buyer parties to an insurance carrier. While RWI has existed for some time, its widespread adoption in M&A deals is a more recent phenomenon, driven by its ability to facilitate cleaner exits for sellers and provide enhanced protection for buyers.

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In general, the use of RWI is reserved for larger deals where the transaction value is at least \$20-30 million, in part due to the costs of the policy as well as the increased inherent risk associated with larger deals.

A typical policy will provide coverage for ~10% of the transaction value, with the premium being ~3% of the coverage amount, a retention (i.e., deductible) of ~0.5-1% of the transaction value and an underwriting fee that is typically ~\$25,000-\$50,000 depending on the transaction size and complexity.

However, premium amounts have been decreasing and now it is not uncommon to be able to obtain premiums under 3%. With that being said, many insurers require a minimum premium amount of ~\$100,000-\$150,000.

These fixed fees are a major reason as to why the use of RWI has traditionally been reserved for larger transactions as, on smaller transactions, they lead to higher relative costs (see the table below). However, there are certain strategic reasons why using RWI might be worth the additional transaction cost which are summarized further below in this article.

### Example Policy Cost Structure

	Transaction A	Transaction B	Transaction C
Deal Price (total enterprise value)	\$100,000,000	\$30,000,000	\$20,000,000
Policy Coverage Limit (10% of deal price)	\$10,000,000	\$3,000,000	\$2,000,000
*Policy Premium (3% of limit or minimum)	\$300,000	\$100,000	\$100,000
Retention (1% of deal price)	\$1,000,000	\$300,000	\$200,000
*Underwriting Fee	\$40,000	\$40,000	\$40,000
*Costs as a % of deal price	0.34%	0.47%	0.7%

### Key Characteristics of RWI

**Coverage:** RWI policies typically cover breaches of most general R&Ws made by the seller in the purchase agreement. Fundamental R&Ws may also be covered, often with higher limits and longer policy periods.

**Policyholder:** While historically RWI could be "seller-side" or "buyer-side," the vast majority of RWI policies today are buyer-side policies. This means the buyer is the insured party and makes claims directly against the insurer, not the seller.

**Retention (Deductible):** Similar to a traditional deductible basket, RWI policies have a "retention" amount that the buyer must bear before the insurance coverage kicks in. This retention is typically a percentage of the transaction value (e.g., ~1%). In some buyer-side policies, a portion of the retention is covered by a small seller indemnity or escrow, with the remaining portion effectively acting as the buyer's self-insured layer.

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**Policy Limit:** This is the maximum amount the insurer will pay out under the policy. The policy limit is typically a percentage of the transaction value (e.g., ~10%, and while higher limits are available they will result in larger premiums).

**Policy Period:** The duration of the RWI policy. This generally aligns with the survival periods for R&Ws in the underlying purchase agreement, however standard periods under a policy are typically 3 years for general R&Ws and 6 years for fundamental R&Ws.

**Exclusions:** RWI policies contain exclusions for certain risks, such as: forward-looking statements or covenants, purchase price adjustments, known issues disclosed or identified in the diligence process, certain environmental liabilities or highly specific tax matters (though these can sometimes be covered by standalone policies), and cybersecurity breaches (unless specifically underwritten).

### Pros and Cons of RWI vs. Traditional Indemnity

The choice between RWI and a traditional indemnity structure has significant implications for both sellers and buyers, in which the general pros and cons for both sides are summarized below.

#### For Sellers

##### Traditional Indemnity – Pros

**Direct Control:** Sellers retain direct control over managing and defending against claims, potentially allowing for more tailored responses or settlements with the buyer. Sellers can also more creatively negotiate the scope and duration of indemnity directly with the buyer as opposed to relying on insurer-imposed limitations and exclusions under RWI.

**Lower Transaction Costs:** No insurance premium to pay, which can be attractive for smaller deals or sellers unwilling to bear the cost of RWI. Further, the depth of formal diligence required for an RWI policy can lead to significantly higher legal fees than with a negotiated indemnity structure.

**Less Documentation:** Sellers can focus on the R&Ws and indemnity terms in the purchase agreement, whereas RWI introduces a separate, complex policy that must be negotiated with the insurer.

**Fewer Disclosure Requirements:** The disclosure and diligence workstream under this structure is typically much less burdensome than under RWI, as RWI underwriters typically require an extensive disclosure and diligence process which can take time away from focusing on other important aspects of the deal.

##### Traditional Indemnity – Cons

**Post-Closing Liability Exposure:** The seller remains directly liable for breaches of R&Ws, creating an ongoing contingent liability that can hinder post-closing liquidity and future planning. The uncertainty surrounding potentially significant future claims is often the primary reason for sellers to explore RWI as an alternative option so they can more confidently reinvest their closing proceeds.

**Escrow/Holdback:** A significant portion of the sale proceeds may be tied up in escrow or held back by the buyer, delaying full access to funds and impacting return on investment.

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**Reputational Risk:** Direct disputes with the buyer over indemnity claims can strain relationships and potentially impact future business dealings.

**Administrative Burden:** Managing and responding to indemnity claims post-closing can be time-consuming and resource-intensive.

### Representations and Warranties Insurance (RWI) – Pros

**Clean Exit/Reduced Post-Closing Liability Exposure:** This is arguably the most significant benefit for sellers. RWI effectively eliminates or caps the seller's exposure to indemnity claims, often at a very low "strip" indemnity or a portion of the retention. Sellers can walk away from the deal with their closing proceeds without having to worry about significant future claims.

**Maximized Sale Proceeds and Enhanced Liquidity:** By transferring risk to an insurer, sellers can avoid large escrows or holdbacks, thereby maximizing the immediate cash proceeds from the sale. As discussed above, with a traditional indemnity structure the buyer will likely require the seller to place a portion of the closing proceeds into escrow or hold back a portion of the purchase price as security for any future R&W breaches, which reduces the amount of funds immediately available to the seller. With large transactions, the amount of escrowed or held back funds can become significantly high (in the millions) and the seller can miss out on significant growth that would have been available by being able to immediately reinvest such funds elsewhere.

**Improved Deal Certainty:** The presence of RWI can streamline negotiations, as buyers may be less focused on aggressive indemnity terms when they have insurance coverage. This can lead to faster and more predictable closings.

**Attractive to Financial Sponsors:** Private equity firms and other financial sponsors, who aim for clean exits and rapid fund distributions, find RWI particularly appealing.

### Representations and Warranties Insurance (RWI) – Cons

**Insurance Premium Cost:** The seller may be asked to pay the RWI premium (though often the buyer bears this cost, or it is split).

**Underwriting Process:** The insurer will conduct its own diligence on the target company, which can be an additional layer of review and potentially uncover issues that need to be addressed. This process can be time-consuming, though it often leverages the buyer's diligence.

**Exclusions:** RWI policies may have exclusions, meaning some risks will not be covered, leaving the seller potentially exposed for those specific items (e.g., known issues, forward-looking statements) and eliminating the "full walk-away" appeal of RWI for sellers.

**Insurers' Right of Subrogation (Limited in Buyer-Side Policies):** This refers to the insurer's legal right to "step into the shoes" of the insured party and pursue a claim against the other for a breach of R&Ws after the insurer has paid the insured for the covered loss. While buyer-side policies generally waive the insurer's right of subrogation against the seller (except in cases of fraud), this is a key point to confirm.

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### For Buyers

#### Traditional Indemnity – Pros

**Direct Recourse to Seller:** The buyer has direct recourse to the seller for breaches of R&Ws, which can be appealing if the buyer has a strong relationship with the seller or perceives the seller as financially robust.

**Lower Cost:** RWI policies often require significantly more formal legal diligence to be conducted and, as a result, the legal fees associated with a deal using RWI are higher. Additionally, the buyer doesn't incur the cost of an RWI premium or underwriting fees.

**Tailored Indemnity:** The buyer can negotiate specific indemnity provisions and caps that are precisely tailored to the perceived risks of the transaction rather than relying on insurer-imposed terms under RWI.

**Leverage:** In deals where the buyer has negotiating leverage, they can use indemnity terms to shift more risk to the seller.

#### Traditional Indemnity – Cons

**Seller Solvency Risk:** The buyer's ability to recover depends entirely on the seller's financial capacity and willingness to pay. If the seller is a special purpose vehicle (SPV) or individual with limited assets, recovery can be challenging and in these cases buyers typically request a solvency R&W or a parent guaranty from a more solvent entity to ensure the buyer would get paid in the event an indemnification claim is made, which can cause more complicated negotiations and delays.

**Disputes and Litigation:** Indemnity claims can lead to contentious disputes, potentially requiring litigation, which is costly, time-consuming, and can damage relationships.

**Limited Recovery:** Recovery is capped by the negotiated indemnity cap or by any amounts put in escrow for indemnity claims, which may not be sufficient to cover all losses.

**Administrative Burden:** Pursuing claims, negotiating settlements, and potentially litigating with the seller can divert management attention and resources.

#### Representations and Warranties Insurance (RWI) – Pros

**Enhanced Protection/Deeper Pocket:** RWI provides a financially robust backstop for indemnity claims, as the buyer is indemnified by a creditworthy insurance carrier, rather than solely relying on the seller. This can be particularly valuable in deals with multiple sellers or a less financially robust seller.

**Streamlined Claims Process:** Making a claim against an RWI policy is often more straightforward and less contentious than pursuing a claim directly against the seller. Insurers are in the business of paying valid claims.

**Competitive Advantage in Acquisitions:** In an auction process, offering RWI can make a buyer's bid more attractive by allowing the seller to achieve a cleaner exit.

**Preservation of Relationship:** RWI shifts the burden of disputes from the buyer-seller relationship to the buyer-insurer relationship, preserving the goodwill between the parties, which can be crucial for ongoing commercial relationships (e.g., if the seller is staying on as management or in the case of a rollover).

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**Increased Certainty of Recovery:** The buyer has greater certainty of recovering losses up to the policy limit and within the policy terms.

**Longer Survival Periods (Potentially):** RWI policies can sometimes offer longer coverage periods for general R&Ws than sellers might be willing to provide directly.

### Representations and Warranties Insurance (RWI) – Cons

**Additional Cost:** The buyer typically bears the cost of the RWI premium and underwriting fees in addition to the heightened legal fees associated with obtaining RWI policies, which adds to transaction expenses.

**Retention/Deductible:** The buyer is still typically responsible for the retention amount before the policy pays out.

**Exclusions:** The policy may have exclusions, meaning not all potential breaches of R&Ws are covered. Buyers must carefully review the exclusions and understand whether it is their burden to show that the exclusion does or does not apply.

**Underwriting Scrutiny:** While the insurer's diligence helps validate the R&Ws, it can also lead to specific exclusions or limitations if issues are identified.

**"Known Unknowns":** RWI generally does not cover "known unknowns" – issues that were identified in diligence but whose full impact is not yet quantifiable.

**Policy Terms and Conditions:** The buyer needs to thoroughly review and negotiate the RWI policy terms and conditions to ensure adequate coverage and avoid surprises, which could potentially delay a fast-moving deal since the RWI workstream is typically one of the last workstreams to be finalized in an M&A transaction.

### Conclusion

The decision to utilize RWI or a traditional indemnity structure in an M&A transaction is a strategic one, with many distinct advantages and disadvantages for both sellers and buyers. While traditional indemnity remains a viable option, particularly for smaller, less complex deals, RWI has become increasingly prevalent due to its ability to de-risk transactions, facilitate cleaner exits for sellers, and provide enhanced protection for buyers.

M&A lawyers play a crucial role in advising their clients on these options, helping them navigate the complexities of each structure, negotiate favorable terms, and ultimately choose the approach that best aligns with their risk appetite, financial objectives, and the specific dynamics of the deal. We encourage you to contact a member of Koley Jessen's **Mergers & Acquisitions team** with any questions you may have regarding these considerations, or if you would like assistance in strategizing what transaction structure is best for you.

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i Anushka Shah, Representations & Warranties Insurance: An emerging M&A tool, NYUJLB (2024), <https://www.nyujlb.org/single-post/representations-warranties-insurance-an-emerging-m-a-tool#:~:text=What%20is%20RWI?,percent%20of%20the%20coverage%20limits>.

ii Benjamin Bodurian, Jeffrey Chapman & Jonathan Whalen, Representations and warranties insurance in M&A Transactions, The Harvard Law School Forum on Corporate Governance (2017), <https://corpgov.law.harvard.edu/2017/12/11/representations-and-warranties-insurance-in-ma-transactions/>.

iii Reps and Warranties Insurance Market Trends Cheat Sheet, Ice Miller LLP (2024), <https://www.icemiller.com/thought-leadership/rep-and-warranties-insurance-market-trends-cheat-sheet>.