

Utilizing Rep and Warranties Insurance in CRE Transactions

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The use of transactional representations and warranties insurance is now well established, but that was not the case only a dozen years ago, when RWI in corporate mergers and acquisitions transactions was a growing, but still nascent, trend.^[1]

Insurance industry and commercial real estate legal trends indicate that the use of RWI in commercial real estate transactions currently is at approximately the same point of advancement and maturation as the use of RWI in corporate M&A deals was in 2013, which could indicate substantial future growth in the next several years.

Based on discussions with insurance industry representatives, we believe the number of CRE RWI policies issued has nearly quadrupled in recent years.

Seller representations and warranties, along with related issues such as postclosing survival and escrows, often are among the most intensely negotiated provisions in CRE purchase and sale agreements, or PSAs. CRE RWI provides a number of solutions that can be beneficial to both sellers and buyers, making it an increasingly popular tool in CRE transactions.

CRE RWI is a specialized insurance product suitable for deployment in all CRE transactions. It can be used in straight asset sales and acquisitions, i.e., fee conveyance transactions; entity stock sales and acquisitions; and real estate investment trust sales and acquisitions.

CRE RWI is useful in bridging gaps between the scope and extent of representations and warranties CRE sellers are willing to provide and those CRE buyers require. It reduces the length and complexity of negotiations, accelerates the closing process, minimizes or eliminates seller liabilities, and enhances buyer remedies postclosing.

CRE sellers and buyers share a common ultimate objective: to document transactions in binding PSAs and close them as smoothly and efficiently as possible. However, even after agreeing to key deal points — purchase price, inspection period, diligence deposit, closing date, etc. — in a term sheet, conflicting concepts often surface during the PSA negotiation process.

These conflicting positions frequently include the nature and extent of seller representations and warranties, the monetary ceiling on seller liability attached to surviving representations and warranties, the postclosing survival period applicable to seller representations and warranties, and the terms and duration of any escrow to be funded by the seller at closing to secure surviving seller representations and warranties. CRE RWI can help resolve these issues satisfactorily for both parties.

CRE RWI policies cover standard seller representations and warranties in PSAs relating to the organization and good standing of the seller, the seller's power and authority, affiliate transactions, compliance with laws, Office of Foreign Assets Control matters, tax matters, and other general and fundamental seller representations and warranties.

Fundamental representations and warranties typically encompass the seller's organization and good standing, the seller's power and authority, etc.

Additionally, in cases where sellers are unwilling to give certain representations and warranties, or are willing to give them only in a limited fashion, a CRE RWI policy can provide synthetic coverage for certain representations and warranties, subject to appropriate diligence efforts and determinations.

For the purpose of the CRE RWI policy, synthetic representations and warranties are set forth in the policy and are treated as if they had been included in the PSA by the parties.

Synthetic CRE RWI coverage is most commonly deployed where sellers are unwilling to give representations and warranties relating to the condition of the property, environmental matters, and the rent roll, if the property has tenants. CRE RWI is increasingly used to address specific deal dynamics present in CRE transactions that are less common in corporate M&A transactions.

If a CRE transaction is structured and negotiated from the offering and term sheet stage to include CRE RWI, friction between the seller and buyer regarding seller representations and warranties can be reduced significantly.

This often results in a more expeditious PSA negotiation process and a smoother, more streamlined progression to closing. Upon closing, the seller can freely deploy or distribute all the net closing proceeds without holdbacks or escrows, and without concerns about trailing postclosing contingent liabilities.

From the buyer's perspective, postclosing assurance is provided by the insurance company, up to the CRE RWI policy limit, covering any losses arising from any breaches in the seller's representations and warranties in the PSA.

This avoids concerns about the sufficiency of a postclosing escrow or financial backing for surviving seller indemnities, and with the added benefit of synthetic representations and warranties negotiated between the buyer and the insurance company.

CRE RWI policy premiums are fully paid at closing, with no recurring payments. A business issue associated with CRE RWI that must be addressed between sellers and buyers is which party will pay the policy premium. This topic is negotiated on a transaction-by-transaction basis, but it is common for sellers and buyers to share the

premium cost in some manner.

While CRE RWI premiums vary depending on specific risks being underwritten, the premiums typically are less than those for traditional M&A RWI. The amount of the insured limit is a portion of the total purchase price agreed upon by the buyer and the insurance company.

Buyers might consider, as an appropriate insured limit, the aggregate amount of postclosing seller liability they could reasonably have expected to negotiate without CRE RWI coverage, although many buyers elect a higher insured amount than what sellers might have agreed to provide in the form of a postclosing escrow or indemnity.

Excluded from coverage under CRE RWI policies are issues known to the buyer and forward-looking representations and warranties.

The standard policy period for claims made by the buyer under a CRE RWI policy is three years for general representations and warranties, and six years for fundamental representations and warranties from the binding date of the CRE RWI policy, which frequently is the same date as the date the PSA is executed.

In most cases, the coverage period under CRE RWI policies is substantially longer than any postclosing liability and indemnity period sellers would have granted without CRE RWI.

The retention, or deductible, under CRE RWI policies is usually 0.25% of the purchase price, decreasing to 0.10% on the first anniversary of the closing. Additionally, CRE RWI policies cover consequential damages incurred by insureds for breaches of insured representations and warranties, a concept rarely agreed to by sellers in postclosing indemnity or escrow arrangements.

For CRE transactions involving the transfer of REIT interests, subject to appropriate diligence efforts and determinations and a will-level REIT opinion, CRE RWI policies offer coverage for seller REIT-related representations and warranties in the PSA, in addition to coverage for the other typical seller representations and warranties.

CRE RWI policies should not be considered an alternative to title insurance policies, which buyers should always obtain in addition to any CRE RWI policies.

The diligence efforts and documentation required by insurance companies to underwrite CRE RWI policies generally are not more extensive than those buyers would pursue routinely without CRE RWI.

These efforts and documentation typically include a property condition report; a Phase 1 environmental site assessment; a title examination and commitment; a zoning report; a rent roll report and diligence if the property has tenants; litigation, lien and bankruptcy searches; and similar standard diligence reports and assessments.

CRE RWI policies also insure buyers for representations and warranties fraudulently made by sellers, and insurers issuing CRE RWI policies will waive all subrogation claims against sellers, except for seller fraud.

Some savvy buyers, angling for an advantage over competitors, are choosing to make CRE RWI a component of

their offers and bids when pursuing highly sought-after properties.

By offering CRE RWI as part of their offers and bids, buyers are able to demonstrate to sellers that they can avoid many pitfalls and complexities that historically have bogged down negotiations and slowed closings, and can lay the groundwork for a speedy and smooth closing process.

Additionally, in some cases, CRE lenders have started to require CRE RWI when the loan-to-value ratio exceeds 50%. These trends suggest that the use of CRE RWI is likely to become more prevalent in the near term.

Parties in CRE transactions can leverage CRE RWI to more effectively and efficiently achieve their mutual objectives and manage deal risk. It seems probable that the next few years will witness an uptick in the issuance of CRE RWI policies, akin to the increase seen since the early 2010s in the use of transactional RWI in corporate M&A transactions.

[1] Hamed Meski and Brandon Vongsawad, Why You Need M&A Reps and Warranties Insurance, *Law360* (July 13, 2013 edition), <https://www.law360.com/articles/461255/why-you-need-m-a-reps-and-warranties-insurance>.

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