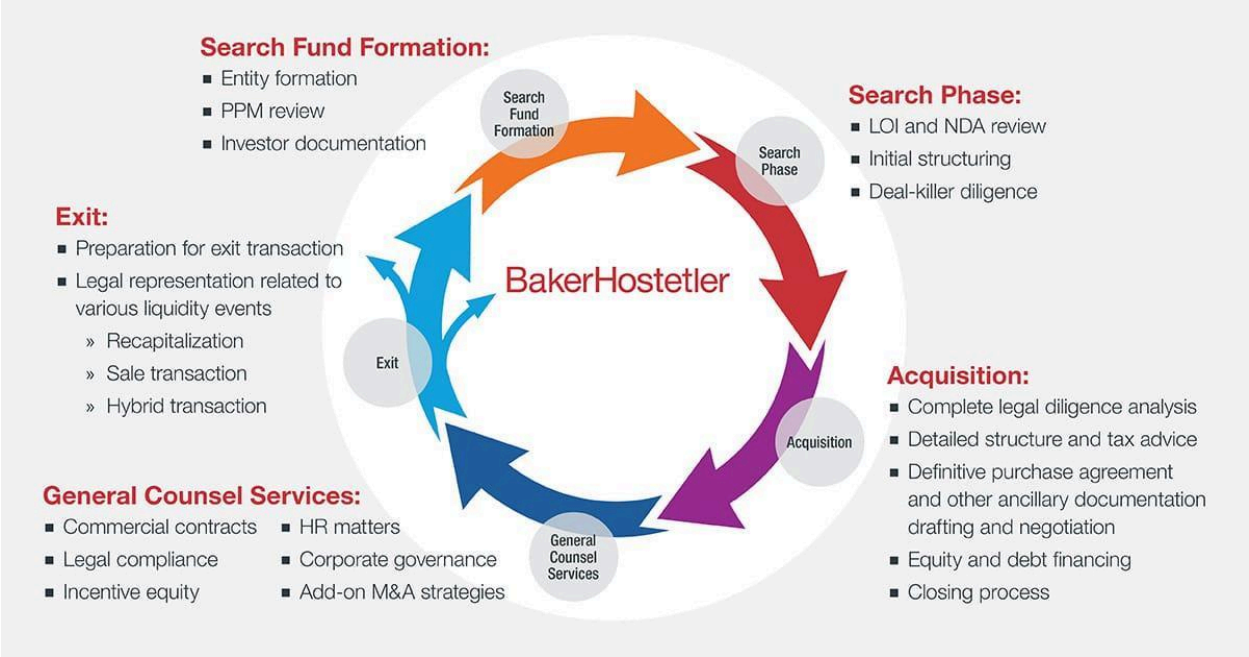
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For questions regarding the content of this memorandum or to learn more about the BakerHostetler Search Fund and Entrepreneurship Through Acquisition team, please feel free to contact any of the following attorneys at BakerHostetler: (i) Raam S. Jani (312-416-6225; rjani@bakerlaw.com); (ii) Reed F. Leigh (713-331-8454; rleigh@bakerlaw.com).

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TO: Center for Entrepreneurial Studies, Stanford Graduate School of Business

FROM: Baker & Hostetler LLP

DATE: September 19, 2025

SUBJECT: **Legal Memorandum on RWI Policies**

This memorandum provides a general overview of representation and warranty insurance policies ("RWI Policies") utilized in lower-middle-market mergers and acquisitions of privately held companies. While this memorandum is intended to be a general primer with respect to the utilization of RWI Policies and associated market terms, it is not intended to encompass every unique situation that may arise in lower-middle-market transactions. Each transaction has multiple variables that determine whether an RWI Policy is the right approach for a respective transaction, and this memorandum is not intended to be interpreted that an RWI Policy is the best (or only) way to protect a party to a negotiated transaction.

I. Introduction.

In the complex world of buying and selling companies, lower-middle-market transactions face unique challenges, such as first-time sellers, the possibility of unsophisticated seller counsel and gaps between the representations and warranties a seller is making and the accuracy behind such representations and warranties. All of these challenges are intertwined, and one increasingly important transaction tool with respect to potentially mitigating these risks and challenges is the utilization of an RWI Policy. An RWI Policy is specific transaction insurance coverage that covers breaches of seller representations and warranties set forth in the definitive acquisition agreement. RWI Policies can be either "buy-side" policies or "sell-side" policies, the most common of which in today's market is a "buy-side" policy obtained by the buyer. Although "sell-side" policies are discussed briefly below, the focus of this memorandum is on "buy-side" policies given such policies make up the vast majority of the RWI Policies utilized in negotiated transactions.

The use of RWI Policies in lower-middle-market transactions has increased over the past several years. Historically, RWI Policies were generally used for $75 million+ transactions. However, as the overall costs of obtaining an RWI Policy for lower-middle-market transactions have decreased, more buyers are turning to RWI Policies to protect their interests and sellers are generally aligned given RWI Policies limit a seller's post-closing liability. For example, in a transaction without the usage of an RWI Policy, a buyer may ask for 5-15% of the purchase price to be placed with a third party escrow agent for 12-24 months. In a transaction with an RWI Policy, a buyer would typically only ask for half the retention amount (the retention amount is discussed in more detail below) to be placed with a third party escrow agent, thus putting more money in the sellers pocket at closing.

II. Purpose.

There a few key reasons why parties are in favor of obtaining an RWI Policy in lower-middle-market transactions such as risk mitigation and enhancing the likelihood of streamlined and efficient negotiations between the buyer and the seller, such as limiting the need for the seller to negotiate and qualify each seller representation. Although a seller's representations should still be true and accurate and a buyer is required to evidence to the RWI Policy provider that it has properly diligenced against the seller representations, the underlying premise is that, since the parties are allocating risk to a third party (i.e. the RWI Policy provider), the buyer should get stronger representations and the seller should be less concerned with line-by-line negotiations of the representations its making. However, the reps still need to be factual and accurate.

- **Risk Mitigation**: An RWI Policy provides coverage if a seller's representations warranties, which are factual statements about the seller's business made in a definitive acquisition agreement, are proven to be untrue following the closing of the negotiation transaction. The resulting losses, unless such losses are related to an exclusion (as further discussed below), are covered under the RWI Policy, reducing recourse against the seller. Typically, a definitive acquisition agreement will require the buyer to make a claim against the RWI Policy before the buyer can make a claim against the seller. A seller is generally in favor of obtaining an RWI Policy because it limits its post-closing liability and provides more certainty as to the amount of seller proceeds subject to recoupment by buyer due to a seller's breach of a representation or warranty.

- **Streamlined Negotiations**: RWI Policies limit the need for a buyer and seller to significantly negotiate the representations and warranties being made by seller. The stronger the representations and warranties, the more coverage available under the RWI Policy. Additionally, obtaining an RWI Policy reduces the need for a seller escrow or other post-closing holdback, thus further streamlining negotiations for an expediate closing with less conflict.

III. Buy-Side Versus Sell-Side Insurance Coverage.

There are two main types of RWI Policies: a "buy-side" representations and warranties insurance policy and a "sell-side" representations and warranties insurance policy. As is likely obvious, a "buy-side" RWI Policy is obtained by a buyer and a "sell-side" RWI Policy obtained by a seller; however, such policies differ in application and a "buy-side" RWI Policy is typically used more often than a "sell-side" RWI Policy.

A buy-side RWI Policy is first party coverage for a buyer. This means that the RWI Policy provider directly compensates the buyer in the event of a claim against the policy for a breach of a representation or warranty made by the seller. A sell-side RWI policy is similar to a buy-side RWI Policy except that a sell-side policy is obtained by the seller to utilize in the event a buyer makes a claim directly against the seller following the closing. Generally, a buy-side RWI Policy is preferred and more widely utilized because a buyer prefers to be the party to make

a claim against the insurance policy, as opposed to relying on the seller to make a claim against a sell-side RWI Policy.

IV. RWI Policy Coverage Terms.

Included below are standard market terms for an RWI Policy in lower-middle-market transactions. Each transaction will have varying terms based on the chosen insurance provider, the size of the transaction and any other specific transaction-related variable.

- **Coverage Limit**: The coverage limit is the amount of coverage available under an RWI Policy. A party will not be able to make a claim against the RWI Policy in excess of the stated coverage limit. The coverage limit in lower-middle-market transactions ranges typically ranges from 5–20% of the enterprise value (with approximately 10% being the most common). The higher the coverage limit, the higher the cost to obtain the RWI Policy.

- **Retention Amount**: The retention amount (also referred to as the deductible) is the amount a party must pay out of pocket before the RWI Policy comes into play. Often times the retention amount is split 50/50 between a buyer and a seller; however, this is purely a business point between the buyer and seller. The retention amount is historically between 0.5–2% of the enterprise value but is subject to varying market conditions. The lower the retention amount, the higher the cost to obtain the RWI Policy.

- **Coverage Period**: The typical coverage period for non-fundamental representations is three years, while the typical coverage period for fundamental representations is six years.

- **Premium Amount**: The premium amount is a one-time payment owed to the RWI Policy insurer at the closing of the underlying transaction. The premium amount is historically between 2.5–4% of the coverage limit but is subject to varying market conditions.

The costs associated with obtaining an RWI Policy are often split between the buyer and the seller in lower-middle-market transactions. However, sometimes one party will bear all of the costs depending on the nature of the transaction and leverage between the parties.

V. Due Diligence and Exclusions.

RWI Policy providers require a significant amount of diligence to be completed prior to binding the policy, including almost always requiring the delivery of fulsome diligence memorandums from each of the buyer's legal counsel, tax due diligence provider, financial due diligence provider, environmental due diligence provider, insurance due diligence provider, information technology due diligence provider and others depending on the nature of the transaction and the industry of the target company. This is a significant lift for buyer's service providers, but notably also requires active participation from the seller and its counsel. Without seller's cooperation and the timely delivery of requested diligence materials to buyer and its

service providers, the binding of the policy (and in turn the closing of the transaction) can be delayed. Helping sellers, especially unsophisticated sellers, understand this is paramount to having a smooth diligence process.

The RWI Policy provider will review in detail the delivered due diligence memorandums along with the seller's disclosure schedule, which is the seller's delivery of the exceptions to the representations and warranties that the buyer is asking seller to make with respect to the target business. In connection with the buyer's diligence and the seller's preparation of its disclosure schedule, certain exposures may be identified such as misclassification of employees/independent contractors, known litigation, tax audits, environmental liabilities and others depending on the nature of the target's business. Such exposures may be determined to be considered "exclusions" under the RWI Policy, meaning losses associated with such matters would not be covered under the RWI Policy. Often times, a buyer will try to negotiate with the seller to include any exclusions as a "specific indemnity" under the purchase agreement.

Exclusions are generally divided into two categories: universal exclusions, which are excluded from essentially all RWI Policies, and deal specific exclusions, which are contingent upon the nature of the target company and any specific diligence findings. Typically, the universal exclusions consist of the following: (i) matters of which the buyer's internal deal team had actual knowledge (i.e. known risks and known breaches of representations), (ii) fines and penalties that are uninsurable by law, (iii) purchase price adjustments and (iv) interim breaches (i.e. breaches of representations between signing and closing). As mentioned, RWI Policy providers focus on all areas of diligence. However, the main areas to which extra scrutiny is generally provided are included below and depending on to what extent the RWI Policy provider gets comfortable, such items may ultimately become deal specific exclusions:

- Pre-closing reorganizations
- Fair labor standards act and other wage & hour issues
- Misclassification of employees as contractors
- Environmental contamination
- Foreign corrupt practices act and other anti-bribery & corruption laws
- Cybersecurity and data protection
- Product and service liability
- Jurisdictional restrictions
- Condition of real property

VI. Practice Tips.

Determining early on in negotiations with a counterparty whether an RWI Policy is the right fit for your transaction is extremely important and will lead to a much smoother process. Working with a reputable RWI Policy broker should not be underestimated. These specialized brokers see a high volume of RWI Policies and understand the market terms, know which providers are easy to work with and which are not and have a sense of the ease (or lack thereof) of various RWI provider's claims processes.

Once an RWI broker is engaged, they will be able to obtain non-binding indications (or NBILs) from multiple RWI providers. Each NBIL will contain the proposed premium, coverage limits, retention amounts, universal exclusions and areas of heightened risk. The RWI broker will help the party obtaining the policy think about which policy will be the right fit given any specific nuances of underlying transaction.

Finally, sophisticated legal counsel will also be able to help review the NBILs and provide meaningful feedback given their experience with RWI Policies, and likely even experience with each of the RWI Policy providers who provided NBILs. Using the knowledge and experience of third-party advisors helps make for an efficient RWI process.

VII. Conclusion and Final Thoughts

RWI Policies have evolved into a mechanism utilized in lower-middle-market transactions, offering the opportunity to appropriately allocate risk, accelerate the negotiation of the underlying transaction and provide for certainty around a buyer's post-closing recovery options. As pricing for RWI Policies has decreased over the past several years for lower-middle-market transactions, more buyers are turning to RWI Policies to protect their interests and more sellers are in favor of the idea in order to significantly reduce the amount of holdbacks and post-closing liabilities in connection with any breaches of the seller's representations and warranties. As the RWI insurance market continues to refine its offerings for lower-middle-market transactions, RWI Policies will be increasingly used by buyers and sellers.