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Continued Benefits of Title Insurance Despite Growth of RWI

By Peter E. Fisch & Salvatore Gogliormella
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Representations and warranties insurance (RWI) has become increasingly prominent in commercial real estate transactions because it affords buyers recourse for issues that are first uncovered after closing while permitting sellers to avoid liability for those issues.

RWI offers the added benefit of allowing sellers to take the closing proceeds without any holdback escrow or other credit support, since the buyer relies on the RWI and the seller does not have liability for warranty breaches after closing.

As the utilization of RWI in commercial real estate deals has accelerated, some have asked whether RWI coverage effectively supplants the coverage traditionally provided by title insurance. Although RWI certainly has its place, title insurance can provide meaningful benefits that are not provided by RWI even in transactions in which RWI is obtained.

The State of RWI

RWI emerged during the late 1990s as a way for sellers to limit post-closing indemnification


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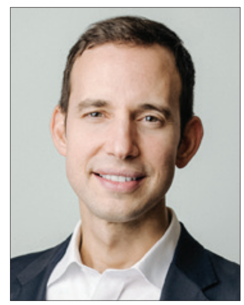
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obligations and remained something of a niche product for a number of years. In the 2010s, the use of RWI in private mergers and acquisitions (M&A) transactions exploded. One 2019 study found that, between 2008 and 2018, the total number of RWI policies issued in North America rose from 40 (providing $541 million in coverage) to over 1,500 (providing over $38 billion in coverage).

RWI has become an industry staple in private M&A transactions, and a Private Target Mergers & Acquisitions Deal Points Study by the American Bar Association estimated that RWI was obtained in 55% of private M&A transactions in 2023.

In the late 2010s and early 2020s, RWI's usage expanded beyond M&A transactions and into (among other areas) commercial real estate transactions. While RWI has grown considerably more common in real estate transactions since then, its utilization rate in those transactions is, as of now, still appreciably lower than in private M&A.

The benefits of RWI in real estate transactions largely mirror those provided in M&A transactions. A seller typically makes certain factual representations about the asset or business being sold. If the buyer has recourse against the seller after closing if any of those representations turn out to be false, the seller bears a risk of significant post-closing liability.

As is often the case in commercial real estate transactions, where a seller will have limited or no assets after closing, the buyer will generally require that the seller deliver a guaranty from a creditworthy affiliate or principal, or deposit a portion of the sale proceeds in escrow with a third party (commonly a title insurance company), in order to provide security for the seller's obligation to indemnify the buyer after closing for damages resulting from a misrepresentation.

RWI shifts the risk of post-closing liability from the seller (and any guarantor) onto the insurer and gives the buyer comfort that it will have recourse to a solvent entity post-closing.

The State of Title Insurance

Unlike RWI (still a nascent and occasional feature of real estate transactions), title insurance was first introduced in 1868, became standardized nationwide following World War II, and has become a near-universal component of real estate transactions.

Similar to RWI, title insurance offers protection to buyers in the event that defects are uncovered after closing, and also indirectly benefits sellers by affording buyers an alternative source of recovery and by clearing buyers' path to closing.

Due to the presence of title insurance, it is highly unusual for a seller in a real estate transaction (in which RWI is not used) to make any representations and warranties regarding the condition of title. Before issuing a policy, the title insurance company will conduct a search of the public records to confirm title to the property and identify liens, encumbrances and other defects.

In many cases, issues found in the search are resolved before the transaction is closed and the policy is issued. If a previously undetected defect covered by the policy is discovered post-closing, the buyer can file a claim with the insurer, which will in turn investigate the claim, defend the insured against third-party actions, and cover losses to the insured, subject to the terms and conditions of the policy.

For an RWI policy to provide comparable title coverage, the subject agreement would have to include significant title representations that are tailored as closely as possible to provide similar coverage to a title policy, and title diligence would have to be performed by the buyer to avoid a policy exclusion for those representations.

Gaps in Coverage

Although there may be overlap in the coverages provided by RWI and title insurance, RWI's coverage is subject to certain gaps that title insurance is able to fill.

Each RWI policy is tailored to the specific transaction, and the resulting coverage is the product of negotiation. RWI's coverage is limited to breaches of the seller's representations, which are often qualified by the seller's knowledge.

While RWI policies frequently disregard materiality qualifiers in sellers' representations, RWI insurers often leave knowledge qualifiers intact (and may even propose adding knowledge qualifiers to certain representations). In that event, an insured will be entitled to recover on a claim that the knowledge-qualified representation was false only if it is proven that the seller actually knew (or, in some cases, should have known) that the representation was false.

There are many instances in which a seller may be unaware of inaccuracies in its representations. For example, a contractor or vendor may have performed work or furnished materials at the property prior to closing—at the request of a tenant and without the seller's knowledge—and a resulting mechanic's lien that is only filed after closing may (under the laws of most jurisdictions) "relate back" to the date on which the work was performed or the materials were furnished.

If the relevant representation of the seller is knowledge-qualified, the RWI policy may not protect the buyer in this instance.

A title insurance policy, in contrast, would typically cover this risk, in part because the title insurance company relies only on a limited basis on assurances from the seller and relies primarily on its own title review.It is also worth noting that as a practical matter, it is difficult to tailor the representations covered by an RWI policy to exactly duplicate the coverage that a title policy provides.

Monetary Limitations

RWI and title insurance also differ in the monetary limitations they impose on coverage. Because RWI is intended to serve as a substitute for the recourse that buyers would otherwise have against sellers under contractual indemnities, RWI coverage is typically subject to a cap and a deductible (just as a contractual indemnity would normally be).

The cap in an RWI policy is generally between 10% and 20% of the value of the transaction, and the deductible is generally between 0.5% and 1% of the value of the transaction.

Because title insurance is intended to protect buyers against (among other things) the potential for a total loss of its investment (in, for example, the extremely remote instance in which the seller did not have, or did not validly convey, title to the property), the coverage under a title insurance policy is generally capped at the purchase price paid for the property. In fact, many states' regulations specifically prohibit title insurers from knowingly issuing a policy in an amount less than the purchase price.

And title insurance is not subject to any deductible. A recovery between an RWI policy's cap and deductible may well be adequate in many cases, and the cases in which it is not adequate may be relatively rare. That said, it is important to bear in mind the impact of these monetary limitations on the recoveries available under the different insurance products.

Temporal Limitations

Survival periods represent a further difference between the two products. Because (as noted above) RWI is meant to be an alternative to a contractual indemnity, its protection is not indefinite. In an RWI policy, each category of representation carries a defined claims period after which coverage lapses entirely.

Claims for breaches of general representations can typically be made for a few years after closing. Fundamental representations, including title representations, typically survive 3 to 6 years after closing. Title insurance is indefinite—it remains in full force for as long as the insured has an interest in the property (and on a more limited basis after the insured disposes of its interest).

For risks that are slow to surface, this open-ended duration is a structural advantage that RWI (with its time-limited claims periods) cannot replicate.Often title issues do not surface until the insured goes to sell or refinance a property and the buyer or lender uncovers an issue in its title diligence, which in most cases would be well beyond the survival period of an RWI policy.

Marketability and Lender Requirements

In most cases, a lender making a loan that is secured primarily by real property will require a loan policy of title insurance to insure the lien of its mortgage.

Where a loan policy is necessary for this purpose, the additional cost of obtaining an owner's policy is frequently much lower than it would otherwise be, on account of "simultaneous issue" rates in many jurisdictions.

Moreover, if a property owner already has an owner's policy of title insurance, the owner may be entitled to a discounted premium for a loan policy obtained in connection with a subsequent financing, and a future buyer may be entitled to a discounted premium for its own owner's policy, on account of "reissue" rates in many jurisdictions.

An existing policy can save time as well as money when those future transactions occur. Existing title insurance can increase the marketability of a property by providing additional assurance that there are no serious defects in title that predate the issuance of the policy.

While a lender could obtain a collateral assignment of the proceeds of an RWI policy or in some cases may be added as a loss payee, the protection would be more limited than a title policy and, most importantly, in addition to providing assurances as to the borrower's title, a lender's title policy also insures the validity of the lender's mortgage lien.

Seller Liability

RWI policies offer an added benefit to the seller in that the RWI policy typically contains a waiver of subrogation (with the exclusion of seller fraud), so that the insurer waives recourse against the seller for the seller's representation breach that gives rise to a claim under the RWI policy.

While a title insurance policy does not provide recourse to the seller for every claim caused by the seller, the title insurer will not issue a policy without an affidavit of title from the seller as to certain matters, and the insurer would have a direct claim against the seller for any breach of the representations or any matter covered by a seller indemnity in the affidavit of title.

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