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## **RWI PRACTICE INSIGHTS SERIES**

### **A Sheep in Wolf’s Clothing: The Fines or Penalties Exclusion in Representation and Warranty Insurance (RWI) Policies**

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#### **Introduction**

The exclusions clause of an insurance policy sets forth a series of exceptions to coverage under the policy, either as to types of event or subject matter or as to types of loss.[1] Unlike other clauses of an insurance policy, for which the burden of proof is typically on the insured, in the case of the exclusions clause of an insurance policy, the burden of proof is typically on the insurer. Insurance policy exclusions are like wolves in the fold: they prey on events, subject matters, or losses that would otherwise be covered by the policy.

However, in a modern RWI policy, the fines or penalties exclusion has evolved to become a sheep in wolf’s clothing. The typical fines or penalties exclusion in a modern RWI policy effectively acts to confirm coverage for fines or penalties[2] unless a very rigorous series of conditions can be met by the insurer that would exclude coverage. This article sets forth a typical example of the fines or penalties exclusion in a modern RWI policy[3] and explains how the exclusion should be applied and interpreted in furtherance of its inclusionary effect. This inclusionary effect can be particularly significant for RWI policies written in industries such as healthcare, where fines and penalties can represent one of the most significant potential risks of a regulatory representation and warranty breach.

#### **Example of the Exclusion**

An example of the fines or penalties exclusion in full

“The Insurer shall not be liable to pay, nor shall the Retention be eroded by, that portion of any Loss to the extent that such portion constitutes:

(ii) fines or penalties, but only if such fines or penalties are prohibited at law from being insured as to the Named Insured under the applicable law of the Most Favorable Jurisdiction;”

#### An example of a “Most Favorable Jurisdiction” definition in full

“Most Favorable Jurisdiction means, with respect to the interpretation of coverage for fines and/or penalties under this Policy, the law of the jurisdiction most favorable to the insurability of fines and penalties, provided that such jurisdiction either: (1) has a substantial relationship to any Insured, the matter in which the fines or penalties were imposed, the claim for which the fines or penalties were imposed, or the conduct or occurrence for which the fines or penalties were imposed; (2) is the state in which the Insurer is incorporated or maintains its principal place of business, or where this Policy was made, or the laws of which govern this Policy pursuant to the governing law provision of this Policy; or (3) is any other jurisdiction the laws of which could be chosen by the parties to apply to this Policy, such matter, and such interpretation and which would allow such insurance of the Named Insured with respect thereto.”

#### **Anatomy and Meaning of the Exclusion**

“but only if such fines or penalties are prohibited at law from being insured”

##### *Meaning of this portion of the exclusion*

In early versions of RWI policies, the exclusion for fines or penalties often began and ended with “fines or penalties.” However, the exclusion evolved to add everything that follows “fines or penalties,” starting with the phrase “, but only if.” The effect of that phrase is to nullify the exclusion for fines or penalties unless each of the conditions following that phrase is met. Effectively, the added language turns the exclusion on its head.

That turning on its head starts with the phrase “prohibited at law from being insured.” If, and only if, applicable law prohibits fines or penalties from being insured does the exclusion even potentially come into play to preclude coverage.[4]

##### *Applicable law as to the exclusion*

##### *No RWI law prohibiting the insurability of fines or penalties*

The first problem for an insurer trying to meet its burden of proving that the fines or penalties exclusion applies to prohibit insurability is the dearth of applicable law prohibiting fines or penalties from being insurable under an RWI policy.[5] Because of the unique nature of an RWI policy, as discussed below at “as to the Named Insured,” an insured can (and should) take the position that recourse to applicable law regarding other types of insurance policies or other types of loss is inapposite.

### *Very limited law as to other types of insurance policies*

Even as to non-RWI types of insurance policies, there is very little in the way of applicable law.[6] Moreover, what reported law that does exist rarely provides a bright-line rule prohibiting insurability in all cases, focusing instead on the type of violation (in particular, whether it was criminal or civil), the measure of culpability (such as intent, recklessness, negligence, moral reprehensibility, or moral turpitude)[7], or the purpose of the fine or penalty in question (such as punishment, deterrence, or compensation).

In any event, even if law applicable to other types of insurance is determined to be relevant, a threshold question is whether the exclusion requires a determination as to the specific type of fine or penalty, the measure of culpability, the purpose of the law, or whether instead the exclusion only applies if the jurisdiction in question has a bright-line rule prohibiting the insurability of fines or penalties in all instances.[8]

### *Analogous law regarding the insurability of punitive damages*

The most analogous issue of law regarding insurability of fines or penalties is insurability of punitive damages. However, there is no RWI law prohibiting the insurability of punitive damages. Thus, an insurer trying to meet its burden of proving that the fines or penalties exclusion in an RWI policy is applicable would have to establish not only that applicable law prohibits the insurability of punitive damages, but also that this prohibition is so analogous as to compel the conclusion that fines and penalties are not insurable under an RWI policy. Such a conclusion is a bridge too far.

### “as to the Named Insured”

#### *Meaning of this portion of the exclusion*

This portion of the exclusion means that the determination of insurability of fines or penalties is to be made as to the buyer, which is the named insured in a buyer-side RWI policy.[9] However, the insured that is the subject of the wrongdoing that gives rise to the fines or penalties assessment in question will in all instances have been a member of the target group prior to the acquisition of the target by the buyer, when the target group was still owned by the seller.

#### *Why the focus on the Named Insured makes a difference as to the exclusion*

Requiring the insurability determination to be made as to the named insured may well be the most inclusionary aspect of the fines or penalties exclusion. In many jurisdictions, the reason for prohibiting insurability of fines or penalties is public policy based on moral hazard: that an insured will “exercise less care to avoid incurring an insured loss than would be exercised if the loss were not insured.”[10] In other jurisdictions, the public policy rationale for prohibiting insurability is to require the wrongdoer to bear the responsibility and consequences of the wrongdoing, and in particular fines or penalties imposed by a

governmental agency for the wrongdoing. By shifting the focus of the insurability determination to the buyer instead of the member of the target group whose wrongdoing caused the fines or penalties to be imposed, the fines or penalties exclusion puts the insurability determination in the best possible light to favor coverage.

The unique nature of RWI comes into play as to both public policy rationales. The normal insurance context for a public policy prohibition is liability insurance, including D&O and E&O insurance. For liability insurance, the insured risk is prospective. The insured (or its parent organization) arranges insurance for the purpose of protecting itself from loss for wrongdoing of the insured that has not yet occurred and therefore is unknown.

In the RWI context, the insured risk is retrospective, even though the consequences may be prospective. The buyer arranges insurance for the purpose of protecting itself from loss for wrongdoing by a member of the target group that occurred prior to the acquisition and is unknown to the buyer.[11] The seller, rather than the buyer, will have been the owner of the target group at the time of the wrongdoing, and the loss incurred by the buyer will be to the value of what it acquired. It is this unique nature of RWI that should make the shift in focus to the buyer as named insured conclusive as to the determination of insurability of fines or penalties in favor of coverage.[12]

“under the applicable law of the Most Favorable Jurisdiction”

*Meaning of this portion of the exclusion*

This portion of the exclusion has the effect, through the definition of “Most Favorable Jurisdiction,” of requiring the determination of insurability to be made as to a number of potential jurisdictions. If, and only if, all of such jurisdictions prohibit the insurability of fines and penalties does the exclusion apply.[13]

*Why the focus on the Most Favorable Jurisdiction makes a difference as to the exclusion*

The focus on the Most Favorable Jurisdiction likely seals the deal in favor of coverage of fines or penalties as it relates to the RWI policy exclusion, even if there is still a question after applying all the other factors in favor of insurability.[14] Choosing among a number of potentially applicable jurisdictions under the “Most Favorable Jurisdiction” definition, and still ending up with a prohibition of insurability, is hard to imagine.

## **Conclusion; Practice Tips**

### Conclusion

A fines or penalties exclusion in an RWI policy that looks anything like the example provided in this article should not be feared, but instead embraced, by attorneys for insureds. Even though it is among exclusions and appears to be one, it contains inclusionary considerations that effectively make it an “anti-exclusion.”

### Practice tips for attorneys for insureds

- In the policy arrangement and negotiation phase, try to get a fines or penalties exclusion that looks like the example provided.
- If the exclusion says anything more than “[criminal/civil] fines and penalties”, it may be more of an inclusion than an exclusion.
- Be prepared to push back on any attempt by the insurer to deny coverage based on such an exclusion.
- Search for applicable law specific as to RWI, and if there continues to be none, be prepared to make your stand on that basis as to any analogy assertions, based on the unique nature of RWI.
- Consider how any public policy consideration might apply differently to a buyer, who did not own the target group at the time of the wrongdoing in question.
- Be prepared to assert the M&A indemnification replacement argument in favor of coverage, particularly if there continues to be no unfavorable law in that context.
- Review the “Most Favorable Jurisdiction” definition carefully, and be prepared to try to stretch its boundaries.
- Watch out for rules/regulations applicable to the fines or penalties in question that contain their own prohibition on insurability.
- Consider the purpose of the fines or penalties in question, specifically whether they are criminal in nature and have a punitive or deterrent purpose, but even then be prepared to push back on a denial of coverage that is based on such an exclusion.

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*[1] This article focuses on U.S. RWI policies and U.S. law. For an excellent compendium of the laws of other countries regarding the insurability of fines or penalties under D&O insurance policies, see “A global guide to the insurability of fines and penalties” published by Marsh, in partnership with global law firm Clyde & Co, available in the “Insights” section of each of those firms’ websites, [www.marsh.com](http://www.marsh.com) and [www.clydeco.com](http://www.clydeco.com). This article also focuses on buyer-side RWI policies. Whether an insured wrongdoing public policy argument may have more purchase in the case of a seller-side RWI policy is beyond the scope of this article.*

*[2] This effect of the fines or penalties exclusion is sometimes referred to in this article as the “inclusionary effect.”*

*[3] No distinction is made in this article between exclusions for criminal fines or penalties and for civil fines or penalties, even though some RWI policies have separate exclusions for*

each type. As discussed in this article, whether a fine or penalty is criminal or civil in nature, regardless of whether it is technically so classified, may be relevant to a determination of insurability.

[4] However, see the discussion later in this article about whether the inclusionary effect of this exclusion can ever overcome an actual prohibition of insurability under applicable law.

[5] This dearth of law may simply be a function of the dearth of case law regarding RWI policies generally, resulting from the prevalence of settlement or arbitration as the method of resolving RWI policy coverage disputes. However, even in the case of indemnification for a private company acquisition, where the formal method of resolving a dispute is more likely to be a judicial proceeding, there appears to be a dearth of case law to the effect that the acquiror cannot be indemnified by the seller for a fine or penalty incurred by a target company with respect to a third-party claim.

[6] “Law” in this context may refer to case law, statute, or regulation/rule. For a discussion of the insurability of civil fines or penalties under law generally, see “The Insurability of Civil Fines and Penalties”, Kenneth S. Abraham, *Torts, Trial & Insurance Practice Law Journal*, Fall 2023, available at [www.americanbar.org/groups/tort\\_trial\\_insurance\\_practice/resources/journal/2023-fall/insurability-civil-fines-penalties/](http://www.americanbar.org/groups/tort_trial_insurance_practice/resources/journal/2023-fall/insurability-civil-fines-penalties/).

[7] Many liability insurance policies, including D&O and E&O policies, contain “conduct” provisions that may serve to exclude coverage for losses such as criminal fines or penalties, even in the absence of a provision in the policy’s exclusions clause to that effect. And some liability insurance policies provide coverage only for “damages”, which some courts have construed to exclude fines or penalties. RWI policies do not include comparable conduct and loss limitation provisions.

[8] In this regard, whether the antecedent for “such fines or penalties” in the exclusion is intended to be all fines or penalties or the specific fines or penalties in question is indeterminate.

[9] While it is conceivable that a different insured in the buyer group could be the named insured in a buyer-side RWI policy, there is no good reason for a different insured to be the named insured and many good reasons for the buyer to be the named insured.

[10] “Civil Fines and Penalties Insurability”, Abraham, at p.7 (footnote omitted).

[11] The buyer will, among other things, sign a No Claims Declaration (NCD) to help ensure that any insured risk is unknown to the buyer.

[12] In the context of M&A indemnification, the buyer is normally seeking indemnification from the seller, which owned the target group at the time of the wrongdoing. This may help explain the dearth of M&A cases in which the seller tries to assert a public policy rationale to prohibit its indemnification of the buyer for fines or penalties. That RWI functions as a

*replacement for most or all of seller indemnification in the private company acquisition context should be a factor favoring coverage of fines or penalties.*

*[13] How a jurisdiction could prohibit insurability and still be the Most Favorable Jurisdiction as to insurability is a mystery.*

*[14] One important caveat here: the inclusionary effect provisions of the exclusion only apply to the question of whether the RWI policy exclusion applies. If there is a jurisdiction out there, the laws of which apply to the question of whether the RWI policy covers fines or penalties, and those laws prohibit insurability, then the insurer could still try to deny coverage based on that prohibition. However, the named insured then should assert the inclusionary effect of the RWI policy exclusion as evidence that it was the intent of the insurer and the named insured to provide coverage of fines or penalties.*