DEFENSES TO FIDELITY BOND CLAIMS BASED ON THE WRONGDOER'S OWNERSHIP AND CONTROL OF THE COMPANY

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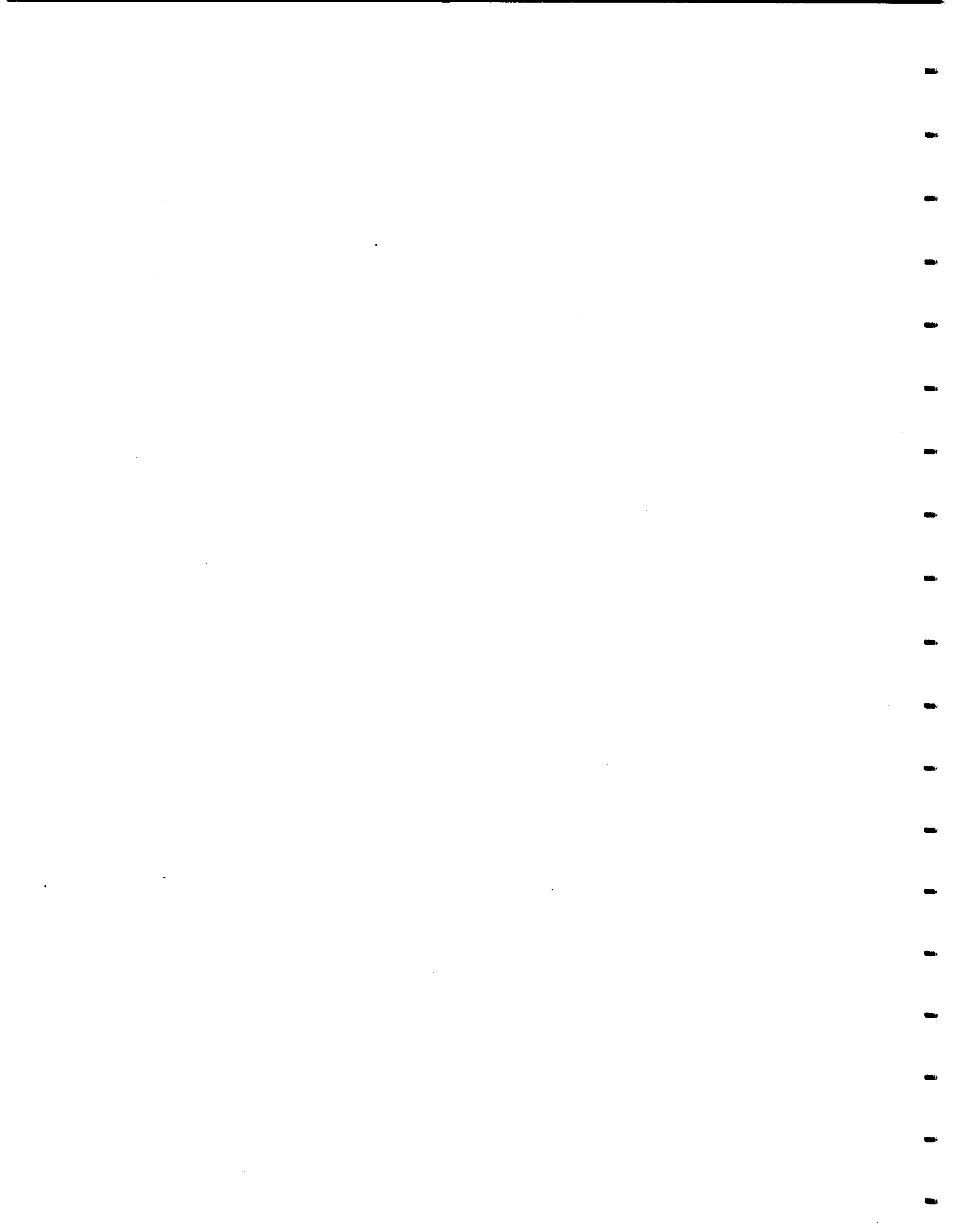

DEFENSES TO FIDELITY BOND CLAIMS BASED ON THE WRONGDOER'S OWNERSHIP AND CONTROL OF THE COMPANY

Some of the strongest defenses to fidelity bond claims under Insuring Agreement "A" (Dishonesty) arise when the allegedly dishonest acts are committed by or at the direction of a person who has substantial ownership of and control over the company. These claims typically appear after the bad actor has been ousted from control of the company, and new management (or a receiver or bankruptcy trustee) has discovered actions which, it contends, are dishonest acts. However, these claims also arise in the context of a corporate takeover. The affected company is acquired and then allegedly "looted" as a cash source either to finance the purchase or for other of the purchaser's operations. Upon the expulsion of the parent company from controlling ownership, the new management brings a fidelity bond claim, asserting that the transactions ordered by the previous management amounted to dishonest acts. Given the persistence and expansion of the context in which these issues arise, this paper will review cases both recognizing and rejecting bond claim defenses based upon the commission of acts by one who owns or controls the company.

There are four possible defenses to such claims. The first defense is that even dishonest acts are not covered where the wrongdoer has control over the company because such a person is not an "employee" as defined in the bond. The second defense is that, under those circumstances, the actions cannot realistically be called "dishonest." The third defense is based on the common law doctrine of corporate "alter ego," and is that where the

corporation is a mere extension of the identity of the wrongdoer, the individual's knowledge of his own fraudulent actions must be imputed to the company. The fourth defense is based on the equitable principle that one should not be able to insure himself against his own fraud. All of these defenses, while legally distinct, arise from similar factual patterns.

DEFENSES BASED ON THE BOND

A. ACTIONS COMMITTED BY A PERSON WHO EXERCISES CONTROL OVER THE INSURED ARE NOT COVERED BECAUSE THEY ARE NOT THE ACTIONS OF AN "EMPLOYEE" AS DEFINED IN THE BOND.

A common defense recognized in fidelity bond cases is that the persons committing the dishonest acts so dominated corporate affairs that they cannot be deemed "employees" whose actions would be covered under the policy. Many cases have evaluated this defense and its applicability in specific circumstances. These cases presume an action or transaction is dishonest, and use control to determine whether the wrongdoer should be deemed a covered employee. The holdings of the cases are extremely dependent upon often small variations in facts. Yet, comparing the cases which accept the defense with those which reject it is useful in developing (and educating a court regarding) a conceptual framework which may be used to evaluate most fact situations.

One of the first decisions addressing the "employee" defense is McKee v. Great American Ins. Co., 316 F.2d 473 (5th Cir. 1973). A Trustee in bankruptcy sued the issuer of a commercial blanket bond. The bond had been issued to the "principal officer and sole stockholder of the two bankrupt companies." Id. at 474. The

losses sustained were due to the fraudulent actions of this person. In a one-paragraph opinion, the court held that "we conclude, as did the district court in granting the defendant's motion for summary judgment, that the bonds did not cover the defalcations of . . . the principal officer and sole stockholder of the corporations." Id.

The seminal case concerning the "employee" defense is the well-known decision of Kerr v. Aetna Casualty and Surety Co., 350 F.2d 146, 153 (4th Cir. 1965). Two individuals, Cudd and Coan, owned a constellation of financial services corporations. After those corporations went bankrupt, the receivers brought assorted claims under the corporations' fidelity bonds. In one case, Cudd and Coan were the sole shareholders, who elected themselves the sole directors, who appointed themselves the chief executive officers of a company. The company advanced money for personal expenses, and Cudd and Coan then deleted the resulting debts from the corporate books with no repayment. Id. at 154.

The fidelity policy defined "employees" as "officers . . . in the service of the insured . . . whom the insured has the right to govern and direct at all times in the performance of such service." In concluding that the policy did not cover Cudd and Coan's actions, the court held that:

> Cudd and Coan as directors probably had the technical right to control Cudd and Coan as officers. But such a theoretical and unrealistic right of control did not make Cudd and Coan "Employees" of Underwriters covered by the bond. Such a bond is not intended to cover the fraud and dishonesty of men who are in effect the sole stockholders as well as the only directors of a closely held corporation. As noted above, the bond is intended to

> protect the corporation from the fraud and dishonesty of employees, not to protect its creditors from the fraud and dishonesty of its stockholders and directors.

Id. at 154-55. The court' language indicates that Cudd and Coan's extensive control over the corporation precluded the fraud from being deemed a fraud against the company, and in fact transformed the fraud into a corporate act directed against creditors.

The Fourth Circuit revisited the issue in Phoenix Savings and Loan v. Aetna Casualty and Surety Co., 381 F.2d 245 (4th Cir. 1967). In that case, the three wrongdoers owned a substantial percentage but less than 50% of the corporate voting stock. They were directors of the company but not a majority of the Board. They were high-ranking executive officers at the time of the fraudulent acts, but not the only officers. The trial court granted Aetna a summary judgement on its defense that the wrongdoers were not "employees" under the reasoning of Kerr. The appellate court reversed the summary judgement. The court held that there was a significant dispute over whether they "owned directly or indirectly a majority of the voting stock, [whether] they constituted or controlled a majority of the board of directors, or [whether] they had substantial control of all of the corporate affairs when all of the alleged fraudulent acts were consummated." Id. at 250. See also Charm Promotions, Inc. v. Travelers Indemnity Co., 447 F.2d 607 (5th Cir. 1971)(Summary judgement in favor of the insurer reversed where there were issues of fact concerning the wrongdoers' ability to control the business).

The same case returned to the Fourth Circuit in Phoenix Savings and Loan v. Aetna Casualty and Surety Co., 427 F.2d 862 (4th Cir. 1970)("Phoenix II"). The trial court had granted Aetna a JNOV, on the grounds that Aetna had proved additional facts demonstrating that the wrongdoers had exercised the type of control the court required in Phoenix I. The court again reversed, on the grounds that Aetna's proof was not conclusive enough to justify a JNOV, and that the jury should decide the issue. The decision, however, did have some significant new aspects. First, the Court noted that the definition of "Employee" in the bond was different from that in Kerr, in that the bond simply defined "Employees" as officers, without including language pertaining to the company's right to control such persons' conduct. The court nevertheless expressly recognized that such a condition was inherent in the very use of the word "employee," thereby establishing that the lack of such language on the face of the bond did not impair the viability of the defense. Id. at 871. In addition, the court recognized that the "control" defense could be viable enough for a jury to decide even without the overwhelming proof of control present in Kerr.

In First Nat'l. Life Ins. Co. v. Fidelity and Deposit Co. of Maryland, 525 F.2d 966 (5th Cir. 1976), FNL sued under a fidelity bond "for losses incurred when purchasers of controlling stock in FNL's parent company raided the assets of FNL." Id. at 967. First National Life ("FNL") was a 100% owned subsidiary. A group of promoters bought sufficient voting stock of FNL's parent to control

a majority of the Board for $2 million, with a $500,000 down payment. Almost simultaneously, they elected themselves officers and directors of both the parent and FNL, sold $1 million of corporate bonds which FNL had in its portfolio, and used the money to "reimburse" themselves for the down payment and split the rest. "In effect, the purchasing group both looted FNL to buy it and vice versa." Id. at 967.

The policy defined "employee," as a person "in the service of the Insured . . . and whom the Insured has the right to govern and direct at all times in the performance of such service." Id. at 968. The court concluded that:

> Those who conceived and executed this plan to gain personal enrichment at FNL's expense elected themselves as officers and directors. The moment their official status gave them access to FNL's assets, they appropriated them as booty for the capture. Their momentary status as officials never placed them "in the service" of FNL, for they served only themselves. Their ill-gotten gains did not "compensate" them for they had done nothing compensable.
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> . . . .
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> The fact that the bond did not expressly exclude coverage of a scheme as complex and as devious as the one carried out by this capture of the company's parent, and thus its management, by strangers who placed themselves in the positions of power they used to gain access to its assets, cannot afford the basis for a claim.

Id. at 970. Thus, "the perpetrators of this fraud were not covered by the bond's undertaking to insure against the fraudulent or dishonest acts of employees." Id. at 967.

The Sixth Circuit recognized the validity of the control person defense in FDIC v. Aetna Casualty and Surety Co., 947 F.2d 196 (6th Cir. 1991). The court characterized the defense as

follows:

> A fidelity bond insures a corporation against losses resulting from the acts of its employees but acts by the corporation itself are not insured. If an individual . . . dominates a corporation based on authority derived from his ownership of stock and offices held in the corporation, the individual constitutes the alter ego of the corporation and, as such, is no longer an employee within the terms of the bond.

Id. at 208-209. The court recognized the validity of this defense, even where the bond did not contain explicit language pertaining to the corporation's right to "control" its employees. The court recognized that this defense was based on the insurance contract, but, unfortunately, also confused the issue by calling the defense an "aspect" of the alter ego defense.

The Ninth Circuit has recognized the "employee" defense in California Union Ins. Co. v. American Diversified Savings Bank, 948 F.2d 556 (9th Cir. 1991). The wrongdoers were the sole stockholders and principal officers and directors of the bank. The policy defined "employee" as an individual whom the insured "has the right to govern and direct" in the performance of his duties. Id. at 566. The court concluded that "[b]ecause [the wrongdoers] controlled the Insured, ranter then the Insured's controlling them, they do not meet the policy definition of "employees."

Several state courts have also recognized the control person defense. In Employers Administrative Service, Inc. v. Hartford Accident and Indemnity Co., 709 P.2d 559 (Ariz.App. 1985), the court, construing a bond with the same language contained in bond in the California Union case, held that a corporation did not have the actual right to govern and direct its sole shareholders,

officers and directors. Thus, the dishonest acts of such persons would not be covered. In United States Fidelity and Guarantee Co. v. Three Garden Village Lt'd. Partnership, 551 A.2d 881, aff'd 567 A.2d 85 (Md. 1985), the court applied the Kerr analysis to deny coverage for actions of the corporation's sole stockholder, officer and director.

Notwithstanding the widespread acceptance and success of the control person defense, there are decisions which, while recognizing the validity of the defense, have refused to apply it to specific facts.

In Insurance Company of North America v. Greenberg, 405 F.2d 330 (10th Cir. 1969), the bonding company raised the "employee" defense against claims based upon actions of two individuals, who, together, held all corporate offices and were also directors. The court refused to allow the defense, holding that the wrongdoers were not majority shareholders, nor the sole directors. Given that there were independent shareholders and directors, the wrongdoers' control over management was not sufficient to take them out of the definition of "employee." Id. at 333.

In General Finance Corp. v. Fidelity and Casualty Co. of New York, 439 F.2d 984 (8th Cir. 1971), the alleged wrongful acts were a series of transactions between various corporations. The wrongdoer was the president of the involved corporations. He and his wife owned a majority share of the stock in only one. He was a principal officer and director in each, but not the only one. The insurer argued that his actions should be excluded from

coverage because he was not an "employee," again defined in the policy as a person whom the corporation had "the right to govern and direct." Id. at 984. The court ruled that there were not sufficient facts justifying the exclusion of the wrongdoer from coverage.

The court noted that majority stock ownership alone was insufficient, stating that insurers could easily protect themselves from the risks of majority ownership through riders to the bond. Id. The court also noted that, in the eyes of the law, the corporations were legally distinct and the directors invested with the right to control the officers. There was some evidence that the directors generally "rubber stamped" the actions of the wrongdoer, but there was no showing that the wrongdoer had the actual power to control the directors. Thus, so long as the directors retained the right to "govern and direct" the wrongdoer, even if that power was not exercised, the wrongdoer would be considered a covered "employee."

General Finance presents a much more strictly legalistic analysis than Kerr and its progeny. The Kerr cases suggest that a pragmatic evaluation of control is appropriate, and that ambiguous facts should be sent to the jury for a determination of control. General Finance, however, employs a technical analysis based on the "legal distinctness" between corporations and between officers and directors. In particular, it seems evident that under the analysis of Kerr, Phoenix I and Phoenix II the demonstrable lack of directorial supervision over the wrongdoer would raise at

least a jury issue supporting the control person defense.

A more recent, and more troubling, decision rejecting the control person defense is FDIC v. New Hampshire Insurance Co., 953 F.2d 478 (9th Cir. 1992). New Hampshire involved wrongful actions by a sole shareholder who was also the Chairman of the Board and Chief Executive Officer of the bank. The policy, however, defined "employee" as "an officer or other employee of the insured while employed in, at, or by any of the Insured's offices . . ." Id. at 482. The policy did not contain language concerning the insured's right to govern, direct or control in the definition of employee. The court absolutely rejected the control person defense based upon the lack of the above language:

> Thus, in both of the cases relied upon by New Hampshire [Kerr and Three Garden Village] the courts were concerned with a special limitation on the definition of the term "employee" not present in this matter. Molinaro, as an officer of Ramona, was an employee under the plain meaning of the broad definition of that term set forth in . . . the bond.

Id. Under this reasoning, the control person defense is invalid under any bond which does not explicitly define "employee" in terms of the insured's right to control. This could eliminate the defense for the majority of bonds currently being written.

There is, however, a conceptual flaw in the New Hampshire court's reasoning which may be used as a basis to argue around the decision. The policy did not define the term "employee." Indeed, the policy language -- an "employee" is an "employee" of the insured "employed in" the insured's premises -- is meaningless as a definition. The policy simply lists certain individuals and

positions to which the term "employee" applies. The concept of control over the employee's actions is inherent in any definition of employee; it is not a "special limitation." Black's Law Dictionary, Seventh Edition, still includes the element of control over the person's actions in the definition of "employee."

This conclusion is supported by the decisions in Phoenix I and Phoenix II. In both cases, the court noted that the policy definition of employee did not contain the "control" language of the policy in Kerr. Nevertheless, the courts recognized that the concept of control was essential to judicially established and recognized definitions of employee. Thus, the lack of such language did not create any legally significant difference between the bonds justifying not applying the "control" test to determine if the wrongdoer was or was not a covered employee. In addition, the decision in FDIC v. Aetna Casualty and Surety Co., 947 F.2d 196, suprá., also recognized the possible viability of the "control" test even where the policy did not explicitly include the "govern and direct" language. In all three cases upholding the defense, the policy language was substantially identical to that in New Hampshire. Thus, the New Hampshire decision may be presented as an aberration at odds with the prevailing trend.

B. CORPORATE TRANSACTIONS WHICH ARE CONDUCTED OPENLY AND IN ACCORDANCE WITH CORPORATE BY-LAWS ARE NOT "DISHONEST" ACTS UNDER THE BOND EVEN IF THEY ARE DESIGNED TO CAUSE A LOSS TO THE SUBSIDIARY.

In many situations, and as the cases cited above have shown, bond claims may be based upon corporate business transactions allegedly entered into for an improper purpose, as opposed to

traditional types of employee theft. In these situations, it may be possible to argue that such transactions are not "dishonest" as to the company if they are ordered by the controlling shareholders, conducted with the knowledge and consent of the officers and directors, and are carried out in accordance with corporate by-laws. Indeed, it may be impossible for a claimant to rationalize the theory that a corporation's actions specifically ordered by 100% of its shareholders can be "fraudulent or dishonest" as to the corporation, even if the transactions are intended to result in a loss to the company.

In General Extrusions, Inc. v. American Surety Co. of New York, 167 N.E. 2d 367 (Ohio App. 1959), Extrusions, had obtained a surety bond against loss caused by any "fraudulent or dishonest act" of employees. After the bond issued, 100% of Extrusions' stock was sold to Ace Industries Company (Ace). Ace financed the acquisition by agreeing to pay the former stockholders installments. Ace's President and Treasurer were made the President and Secretary of Extrusions. Ace then began paying the installments by using funds advanced from Extrusions. Extrusions's President began making advances to Ace which violated Extrusions' Articles of Incorporation. In addition, the Extrusions/Ace officers transferred property from Extrusions to Ace without Extrusions receiving any compensation. Ace ultimately defaulted on the Note, and control over Extrusions was returned to its former shareholders, who then made a claim under the bond for losses arising from the loans and property transfers. The surety denied

coverage on the grounds that the actions were not "fraudulent and dishonest acts." Id. at 368.

The court affirmed. The court recognized that the Extrusions/Ace officers had a fiduciary duty towards Extrusions. In addition, the court adopted the broadest possible definition of "fraud." Nevertheless, the court concluded as follows:

> [W]e cannot under the facts of the case we review and the law as superior courts have spelled it out for us catalog the actions of [the employees] while acting in a fiduciary capacity "fraudulent and dishonest" so as to bind the surety.
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> Ace and Extrusions and their respective officers were fully informed at the time the transactions took place as to the loans and the sale of the personal property to Ace. Under these conditions we do not understand how the parties could defraud themselves.

Id. at 369. The focus of the decision was not on the loss to the subsidiary, but on whether (1) the transaction was ordered by the subsidiary's shareholders, and (2) whether the subsidiary, through its management, knew of and voluntarily agreed to the transactions. Where these factors are present, there can be no fraud. General Extrusions is still good law, although it has not been cited by any other case.

Kerr, supra., further support this approach to the "dishonesty" issue. Several of the claims involved transactions between corporations which were 100% owned by Cudd and Coan, but had other officers and directors. The alleged wrongful acts, consisting of transactions between various corporations in the conglomerate which resulted in losses for the benefit of other

corporations, were disclosed to the other directors, or undertaken openly by corporate officers. These facts precluded a finding of fraudulent or dishonest conduct. Id. at 151 and 153.[1]

By contrast, in General Finance Corp. v. Fidelity and Casualty Co. of New York, 439 F.2d 981 (8th Cir. 1981), the majority stockholder who was also an officer and director of General Finance, engaged in a series of transactions, primarily loans and advances, "taking money from GFC to bail out other failing companies." Id. at 985. However, all of these transactions violated corporate by-laws requiring the board of directors to know of and authorize loans and advances over $5,000.00. Another wrongful act, the payment of a dividend when the corporation was losing money, was undertaken by an individual director who had no authority to pay a dividend without prior board approval.

General Extrusions, Kerr, and General Finance establish the standards for evaluating "dishonesty" where business transactions are alleged to constitute "dishonest" acts. If the transactions are disclosed to and approved by the Boards, and if the transactions are undertaken by officers with valid authority, they are not "fraudulent or dishonest" acts even though the transaction might cause, and might be intended to cause, a loss to one of the

[1] The only transaction which the trial court found to be dishonest was for one company where Cudd and Coan, the sole directors, had the company advance them personal expenses. The appeals court did not determine whether the finding of dishonesty was correct, but denied coverage under the "alter ego" theory discussed below. Id. at 154. Even so, the character of the act found to be dishonest, secret personal enrichment, contrasts strongly with the character of the acts found to be not dishonest, open and disclosed corporate transactions.

companies involved. If, however, the transactions are concealed from those who must approve, and are undertaken without following corporate management procedures, they may be found to be dishonest acts. It should be noted, however, that General Extrusions and General Finance are directly at odds as to the significance of the violation of corporate articles or by-laws. It seem that the General Extrusions analysis is the better view, since "dishonesty" is usually evaluated in accordance with moral turpitude and concealment as opposed to violations of techincal rules. After all, if the controlling shareholders, directors and officers openly and freely choose to disregard corporate internal regulations, it is hard to term that choice "dishonest."

DEFENSES BASED UPON THE COMMON LAW

A. IF THE WRONGDOER IS THE "ALTER EGO" OF THE INSURED, THE WRONGDOER'S KNOWLEDGE OF HIS FRAUD MAY BE IMPUTED TO THE INSURED.

A defense which has become more accepted by the courts is the true "alter ego" defense. Where the wrongdoer exercises a sufficient degree of control over the insured company, his knowledge of his own fraudulent actions may be imputed to the company. This in turn may establish defenses to coverage based upon failure to disclose the fraudulent actions in the policy or renewal applications, termination of coverage as to the wrongdoer, or failure of the insured to timely report a dishonest act within the periods established by the policy.

This defense obviously raises many of the same factual issues as the "employee" defense discussed above. The defenses, however,

are legally distinct. The "employee" defense is based upon the definition of terms contained in the insurance contract itself. The factual inquiry focuses on whether there are corporate mechanisms which permit the insured company to control the actions of the wrongdoer. The "alter ego" defense, however, is based on the common law of corporations and agency. The factual inquiry is whether there is such unity between the wrongdoer and the corporation that the wrongdoer's knowledge must be deemed that of the corporation. See, FDIC v. Aetna Casualty and Surety Co., 947 F.2d 196, 209 (6th Cir. 1991). Despite the strong similarities between the two doctrines, case law indicates that the "alter ego" defense may be more difficult to establish than the "employee" defense.

While it is well established that a corporation is charged with knowledge of all facts of which its officers or employees receive, the general rule is that if the agent acts adversely or to defraud his corporate principal, the corporation will not be deemed to have knowledge of such facts. See, Maryland Casualty Co. v. Tulsa Industrial Loan and Investment Co., 83 F.2d 14 (10th Cir. 1936). This general rule, however, is not absolute where the corporate agents involved are stockholders, officers and directors. The knowledge of these persons may be imputed to the corporation if they exercise substantial control over the day-to-day activities of the company.

One of the first cases to address the circumstances under which knowledge of wrongdoing may be imputed is Western American

Finance Co. v. Pacific Indemnity Company, 61 P.2d 963 (Cal. 1936). In that case, four individuals, through a chain of corporations, owned a majority of the voting stock in Western American. They were also the sole officers and directors of Western American. They engaged in fraudulent transactions which, of course, they did not disclose to the surety on the bond application. The court held that, given the majority ownership and total control which the individuals exercised over the company, the knowledge of the individuals of their fraudulent actions would be imputed to the company, rendering the policy void. Id. at 968.

An oft-cited case for imputing knowledge is Hartford Accident and Indemnity Co. v. Hartley, 275 F.Supp. 610 (M.D.Ga. 1967). In Hartley, the wrongdoer was a cashier of a bank, who owned the bank in partnership with two others. The two other partners were "silent partners," and the cashier had complete control over the operations of the bank. The bonding company defended the claim by arguing that the cashier's knowledge had to be imputed to the bank, thus rendering the policy void since the dishonest acts were not disclosed on the application.

The court upheld this position, reasoning as follows:

> The general rule . . . cannot apply where, as here, those who in actuality control the day-to-day operations of the corporation (and who, in actuality, are responsible only to themselves) have undertaken a series of transactions designed to defraud the corporation.

Id. at 617. Since the cashier has sole control over the bank's operations, and full knowledge of the dishonest acts, "being himself the perpetrator thereof," his knowledge was imputed to the

bank. Id. at 618. Significantly, his knowledge was imputed despite an explicit provision in the application that the knowledge of the signor would not be imputed. But see, United States Fidelity and Guaranty Co. v. State of Oklahoma, 383 F.2d 417, 419 (10th Cir. 1967)(The provision in the application eliminates any defense to the extent the knowledge sought to be imputed is that of the person signing the application); Phoenix II, infra. (same holding).

In McKee v. American Casualty Co. of Reading, Pa., 316 F.2d 428 (5th Cir. 1963), the wrongdoer was the sole shareholder "and the dominant factor in its (the bankrupt corporation) operation." Under these circumstances, the court ruled that the wrongdoer as a matter of law was the alter ego of the company. His knowledge would be imputed to the company "since there was no adverse interest between [the wrongdoer] and the corporation wholly owned by him." Id. at 430. Since his knowledge was imputed, the insurer was able to establish a defense of untimely notice, as the bank had waited 18 months to notify the insurer.

One of the best explications of the basis for imputing knowledge is found in Phoenix Savings and Loan, Inc. v. Aetna Casualty and Surety Co., 427 F.2d 862 (4th Cir. 1970)(Phoenix II). The trial court had entered a directed verdict in favor of Aetna imputing knowledge of the wrongdoers' fraudulent acts to the bank. Aetna has proven that the wrongdoers controlled approximately 50% of corporate stock, held various high ranking positions as officers (but were not the only ones) and were directors, but not the only

ones. The appeals court noted that "knowledge of officers and directors having substantial control of all activities of a corporation is imputed to the corporation," Id. at 869, but then expounded upon what constitutes "substantial control.

The court relied upon cases imputing knowledge under the "alter ego" doctrine:

> Danziger does hold 90 per cent. of the capital stock of the corporation, is its president, and one of its directors. But those facts do not merge the identity of the corporation with his. It has other stockholders, other directors, and other officers holding common and preferred stock. It was incorporated as an independent entity by the state and functions as such and it is in fact separate and distinct from Danzer as from its other stockholders. There are cases, of course, in which the corporation is used as a mere shield or name for the perpetration of a fraud in which the courts will look beyond the corporate fiction to the realities which it screens but this is not such a case.

Id. at 870 (citation omitted). This is classic "alter ego" doctrine, and it is a difficult, almost impossible burden to meet in most cases. After reviewing West American and Hartley, the court concluded as follows:

> These cases in which knowledge of one or more officers, directors and owners of a business entity was imputed to that entity all involves situations where there existed no real possibility of any corporate control in persons other than the wrongdoers. The district court correctly stated that "[w]here corporate control has been abdicated by those charged with exercising such control and all corporate power is exercised by a few who perform misdeeds, knowledge of those misdeeds must be imputed to the corporation." However, Aetna, which has the burden of proof as to its affirmative defenses, has failed to conclusively establish that such is the case here.

Id. at 870 (citations omitted). The court reversed the directed verdict in Aetna's favor, and remanded for a new trial. Given rigorous standards set forth in Phoenix II, and inherent in the

"alter ego" doctrine, it is not surprising that courts generally have been reluctant to impute a wrongdoer's knowledge to a company except upon the clearest demonstration of the "alter ego" element.

Thus, the Fifth Circuit in FDIC v. Lott, 460 F.2d 82 (5th Cir. 1972) refused to reverse an adverse jury verdict on the imputation issue where the evidence showed only that the wrongdoer owned approximately 50% of the company stock, and was not the sole director. Even where he was the sole controlling officer, the alter ego standards were not satisfied absent clear proof that he had absolute control over the board as well. Id. at 87-88. In United States Fidelity and Guaranty Co. v. State of Oklahoma, 383 F.2d 417, 419 (10th Cir. 1967), the court refused to impute the bank president's knowledge to the bank. Although the president was essentially the sole managing officer, the board of directors was independent and not under his control. Thus, the bond could not be voided on the grounds of fraud in the application. Id. at 419.

B. EQUITY PRECLUDES AN INSURED FROM RECOVERING FOR ITS OWN FRAUD.

Cases uniformly hold that, where the alleged wrongdoer is the controlling shareholder, owner and officer, "there is a public policy against permitting a corporation to collect insurance for the defalcations of its alter ego." California Union Ins. Co. v. American Diversified Savings Bank, 948 F.2d 556, 566 (9th Cir. 1991); FDIC v. Aetna Casualty and Surety Co., 947 F.2d 196, 209 (6th Cir. 1991); City State Bank in Wellington v. U.S.F. & G. Co., 778 F.2d 1103 (5th Cir 1985); FDIC v. Lott, 460 F.2d 82 (5th Cir.

1972); Phoenix Savings and Loan v. Aetna Casualty and Surety Co., 381 F.2d 245, 251 (4th Cir. 1967). The only exception is if the corporation, or the court, is in a position to prevent the wrongdoers from receiving any benefit from the recovery.

In California Union, the wrongdoers were 100% stockholders. The primary reason the court gave for denying the bond claim was that permitting the claim would be tantamount to allowing the individuals to insure themselves against their own fraud, Id. 948 F.2d at 566. The court in Western American Finance Co. v. Pacific Indemnity Company, 61 P.2d 963 (Cal. 1936) reached the same holding for the same reasons.

In FDIC v. Lott, the district court ordered that if any funds were due to the stockholders, those funds which were due to the wrongdoer (55% shareholder) were to be returned to the insurer. The insurer argued on appeal that the equitable defense should bar any recovery. The appeals court, however, held that the district court's order eliminated any equitable concerns and would be upheld. Id. 460 F.2d at 87. In City State Bank, however, the lack of the court's ability to prevent the wrongdoer from sharing in the recovery barred any recovery. In that case, the person who would share was not even the actual wrongdoer, but a bank officer who knew of the fraud and took no steps to prevent it. This person was the bank's sole shareholder at the time, and, although he has sold some of his stock, he contractually retained the right to all proceeds from the bond claim due the shareholders. Under these circumstances, the court could not exclude him from sharing in the

recovery, so recovery as a whole was barred. Id. 778 F.2d at 1110-1111.

Two other courts have specifically recognized that equitable concerns may specifically bar recovery. In Phoenix I, the court expressed "grave concern" that the wrongdoers "should not be allowed under any circumstances to profit from their own reprehensible and criminal conduct." 381 F.2d at 252. The court made it clear that the extent of the wrongdoer's ownership in the company should be determined before any recovery was allowed. FDIC v. Aetna recognized the validity of the defense, but remanded for further proceedings to determine whether the defense would apply under the particular facts of the case.

The equitable defense can be a powerful weapon in defending against bond claims. The primary focus of the defense is the extent of the wrongdoer's ownership of the company at the time of the recovery under the bond. Thus, even if the wrongdoers have been ousted from management, their continued ownership of stock may bar the claim. If they are sole shareholders, there should be a complete defense to any recovery. If they are partial shareholders, the insurer should argue for a reduction in recovery proportionate to the percentage of the wrongdoers' interest. However, if there is no practical way to prevent the wrongdoers from sharing in the recovery, then any recovery should be barred.

PROPER TERMINOLOGY

There has been some confusing terminology used in the cases dealing with coverage defenses based upon ownership and control

over the company. As this paper has demonstrated, there are really four legally distinct theories, all of which might come into play in such circumstances. The courts, however, have not been disciplined in keeping them separate. The most pervasive error has been to lump some or all of them under the rubric of an "alter ego" defense.

As the discussion above shows, "alter ego" is a term of art which refers to a very specific doctrine of corporate and agency law. Although the factual issues in "alter ego" cases are similar to those involved in determining whether an individual is an "employee," the overall standard for establishing "alter ego" is much stricter. Thus, practitioners should be alert to only use the term "alter ego" in those specific and extraordinary situations where the facts justify it. Using "alter ego" to refer to the "employee" defense may result in a higher burden of proof than necessary being placed on the insurer. The discussion in the following section summarizes some of the differences between the two doctrines.

A DISCUSSION OF THE "EMPLOYEE" AND "ALTER EGO" DEFENSES

As the foregoing discussion demonstrates, the defenses with the broadest possible application are the "employee" and the "alter ego" defenses. The "dishonesty" and "equitable" defenses apply only under specifically defined fact situations. The "employee" and "alter ego" defenses, however, may arise under a much greater variety of factual situations. Each of these defenses has advantages and disadvantages under the current state of the case

law. On the whole, however, the "employee" defense appears to be the easier defense to establish, and should be considered as the first line of attack. A comparison of the types of proof required to establish each defense illustrates this point.

Both the "employee" and the "alter ego" defenses focus on issues of control, specifically, control over ownership, control over the board of directors, and control over management. All three types of control must exist before either defense may succeed, but the degree of control necessary to support the "employee" defense appears to be significantly less than that required to support the "alter ego" defense.

CONTROL OVER OWNERSHIP. The "employee" defense cases all require that the wrongdoer exercise some control over the ownership of the company. The cases typically require at least control over a majority of the company's voting stock. The cases discuss this type of control in terms of stock ownership, but other mechanisms, such as control over proxies or some type of influence over other stockholders, might also suffice. Since the corporation's ability to "control" the wrongdoer is the essential focus of the "employee" inquiry, some type of control over the ownership of the company is an essential first step towards establishing the defense.

The type of control required to establish that the wrongdoer is the "alter ego" of the company is much more rigorous. In virtually all cases, 100% stock ownership is required. Since "identity" between the corporation and the wrongdoer is the essential focus of the "alter ego" inquiry, mere majority

ownership, absent some other exceptional circumstance, is not sufficient to establish the first step.

CONTROL OVER THE BOARD OF DIRECTORS. To establish the "employee" defense, the insurer must show that the wrongdoer had sufficient control over the board of directors such that the board had no real control over or check on his actions in operating the company. It is not necessary to show that the wrongdoers comprised the entire board. It is sufficient if the wrongdoers are a majority of the board. It is also sufficient if it can be shown that the wrongdoers had the actual ability to control the board's actions. In this regard, the wrongdoers' ability to appoint or fire directors, the wrongdoers' financial or business relationships with other directors, or the extent to which control over the board has been ceded or abdicated to the wrongdoers are all relevant factors in the inquiry. It is not enough, however, simply to show that the board routinely approved the wrongdoers' actions. Some type of affirmative influence by the wrongdoers must be shown.

Under the "alter ego" doctrine, the wrongdoers' control over the board must be demonstrably absolute. It may be sufficient to defeat an alter ego defense if a few, or even one, directors are independent of the wrongdoers' control. Most cases have required that the wrongdoers in fact comprise the only directors in order to have the requisite degree of control. If the wrongdoers are not the sole directors, the board must be so dominated by the wrongdoers as to be an extension of their identity. This would probably require some showing of collusion with or coercion by the

wrongdoers.

CONTROL OVER MANAGEMENT. Under the "employee" defense, the wrongdoer must have significant control over the day-to-day operations of the business. They do not have to be the only officers of the corporation. Yet, their operational control must be such that no other persons within corporate management have the power to control and direct their actions.

To establish the "alter ego" defense, the insurer must show that the wrongdoers are the only persons with authority to operate the company or act on its behalf, with the possible exception of acting in insignificant matters.

CONCERNS FOR INSURERS

The effectiveness of the "employee" and "alter ego" defenses are threatened by some recent decisions. In particular, the New Hampshire Insurance decision from the Ninth Circuit, is very damaging. By focusing on the list of positions included within the scope of "employee," and not on the definition of "employee" itself, the court has eliminated the defense in any situation involving a policy with the definition of "employee" which does not include a specific reference to the right to "govern and direct" the person. This may include the majority of current fidelity policies. Although the New Hampshire case does not appear to be well decided, it is one of the most recent statements on the issue, and could very well be persuasive in other Circuits. Insurers should consider reinstating the "govern and direct" language into the policy definition of "employee."

Also, the "alter ego" defense is substantially undercut by the generally prevalent clause in the policy application that the knowledge of the signor of his own fraudulent actions will not be imputed to the company. Even if the signor/wrongdoer may be deemed the corporate "alter ego," the "non-imputation clause" will preclude the insurer from raising the defense. The clause reflects the general rule that a corporate agent's knowledge of his own fraud is not imputable to the corporation if the agent is acting adverse to the corporate interest, and, in most cases, insurers are not giving up much by having it in the application. In those rare cases where the signor is also the corporate "alter ego," however, the insurers have deprived themselves of an important defense. Insurers should consider either deleting the clause altogether, thus allowing common law concerning imputed knowledge (including the "alter ego" doctrine) to control, or qualify the clause so that it does not apply in an "alter ego" situation.

Perhaps the best solution to these potential difficulties is for insurers to develop a rider to their fidelity policies to specifically exclude from coverage actions taken by majority shareholders who are also officers and directors, and to specifically provide that knowledge of such persons of their own fraudulent actions will be imputed to the company. Such a rider would eliminate the present judicial threats to the insurers' defenses, and would provide a uniform standard to be followed as opposed to the often erratic approach taken by the case law.