

# ALTER EGO DEFENSE

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## ***I. Introduction***

This article addresses whether a corporation can recover under employee dishonesty coverage for loss caused by a person who has a substantial ownership interest in the insured.<sup>1</sup> Common sense suggests that an insured corporation should not be able to recover loss caused by a person who has a substantial ownership interest in the insured, because the wrongdoer would have in effect insured his own dishonesty, a result that would be inconsistent with settled policy against permitting insurance for intentional wrongdoing.<sup>2</sup> Indeed, one court noted nearly 100 years ago that “insuring a person against his own dishonesty would be, to say the least, a novel and unusual contract.”<sup>3</sup>

But what if the wrongdoer does not directly own the insured, or if the wrongdoer’s spouse owns the insured? What if the insured is insolvent, and a claim is made by a trustee or some other third party acting on behalf of the insured? There are dozens of opinions addressing these and other related scenarios in what is known as the alter ego defense.

Although its name suggests that the defense is based upon the premise that the acts of an owner-wrongdoer are deemed to be the acts of the insured, few cases address that issue.<sup>4</sup> Rather, a majority of cases address whether recovery can be denied on the basis that an owner-wrongdoer is not a covered employee, or on the basis that the insured may be charged with an owner-wrongdoer’s knowledge of his own dishonest conduct for purposes of defenses based upon misrepresentation in the application, late notice or termination of coverage. The type of bond involved in the claim often dictates the way in which an alter ego defense is presented to and analyzed by the courts. This is because commercial fidelity bonds usually contain a relatively

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<sup>1</sup>This issue is addressed under both commercial crime policies as well as under financial institution bonds. An earlier version of this article was presented to the annual meeting of the Surety Claims Institute, Williamsburg, Virginia in June 1996.

<sup>2</sup>Hartford Fire Ins. Co. v. Conestoga Title Ins. Co., 746 A.2d 460 (N.J. Super. Ct. App. Div. 2000).

<sup>3</sup>Farmers’ & Merchants’ State Bank of Verdon v. United States Fid. & Guar. Co., 133 N.W. 247, 249 (S.D. 1911). It has been stated in other contexts that “no one shall be permitted to profit by his own fraud, or to take advantage of his own wrong, or to found any claim upon his own inequity, or to acquire property by his own crime.” Riggs v. Palmer, 22 N.E. 188 (N.Y. 1889).

<sup>4</sup>For that reason, “[a]lter ego’ in a sense is, therefore, a misnomer.” George C. Montgomery, *The Alter Ego Type Defenses Reconsidered*, 13 FORUM 578 (1978).

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specific definition of employee, which is absent from most financial institution bonds, such as the Standard Form 24.

While the alter ego cases can be categorized and analyzed in many ways,<sup>5</sup> this article provides a technical analysis of the cases in five comprehensive categories.

This article first addresses cases involving commercial fidelity bonds, in which the central issue is whether an owner-wrongdoer is an employee of an insured. Second, this article addresses a line of cases involving, for the most part, financial institution bonds (or bankers blanket bonds), in which the main issue is whether an insured should be charged with an owner-wrongdoer's knowledge of his or her own wrongful conduct. When determining the key issues in either situation, courts evaluate the amount of the owner-wrongdoer's ownership interest in the insured and the amount of control exercised by other officers and directors of the insured.

Third, this article addresses several cases mostly involving financial institution bonds in which the central issue is whether the acts of an owner-wrongdoer should be deemed to be an act of an insured. Issues of ownership, control and factors associated with corporate veil-piercing are important in these cases.

Fourth, this article addresses a significant case involving the related issue of whether an owner-wrongdoer can possess the manifest intent to cause his or her own company to suffer a loss. Even though the case does not address the issues normally associated with an alter ego case, such as control, it addresses an important ancillary issue.

Fifth, this article addresses several specific factual scenarios, such as application of the alter ego defense when (1) more than one wrongdoer jointly owns the insured, but only one wrongdoer is an employee of the insured; (2) a wrongdoer owns an insured's parent; (3) recovery is sought by persons other than an insured; (4) a wrongdoer is excluded from participating in a recovery; (5) an owner-wrongdoer

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<sup>5</sup>See, e.g., Guy W. Harrison, *Defenses to Fidelity Bond Claims Based upon the Wrongdoer's Ownership and Control of the Company* (unpublished paper presented to the Fourth Annual Meeting of the Southern Surety & Fidelity Claims Association, Atlanta, Georgia, April 1993); Charles H. Hoens, Jr., *Bankers Blanket Bond - Insuring Agreement "A" - Fidelity: What (Who) is Covered?*, in *BANKERS BLANKET BONDS* (Jack McNeil ed. 1978); John Michael McCormick, *Frauds of the Insured, Imputation of Knowledge and Impleading the Employee in Fidelity Cases*, 4 *FORUM* 204 (1969); George C. Montgomery, *The Alter Ego Type Defenses Reconsidered*, 13 *FORUM* 528 (1978); Armen Shahinian & Scott D. Baron, *Who is a Covered "Employee" Under the Financial Institution Bond?*, in *FINANCIAL INSTITUTION BONDS* (Duncan L. Clore ed., 2d ed. 1998); Frank L. Skillern, Jr., *When Discovery by Officers of Insured Becomes Dishonesty of Insured to Preclude Recovery Under Fidelity Bond*, 5 *FORUM* 235 (1970); R. Earl Welbaum, *Collusion with the Insured*, in *FINANCIAL INSTITUTION BONDS* (Gilbert J. Schroeder ed., 1991); Keith Witten, *"Barn Burning" and What Can Be Done To Prevent It*, 22 *TORT & INS. L.J.* 511 (1987).

is not specifically excluded from coverage; or (6) an insurer has prior knowledge of a wrongdoer's ownership interest.

## II. Analysis

### A. COMMERCIAL FIDELITY BONDS

Typically, a fidelity bond defines "employee" as:

- a. any natural person:
  - (1) While in your service (and for 30 days after termination of service); and
  - (2) Whom you compensate directly by salary, wages or commissions; and
  - (3) *Whom you have the right to direct and control while performing services for you.*<sup>6</sup>

Recently, one court rejected an argument that the "control" language in the definition was intended merely to distinguish covered employees from independent contractors, stating that such an interpretation tortures the language of the policy to the point of absurdity.<sup>7</sup> In addition, a substantial majority of courts addressing the issue has held that a corporation must possess more than a mere theoretical right to control the wrongdoer.<sup>8</sup>

The primary issue in alter ego cases is whether an owner-wrongdoer is an employee of an insured and, thus, whether a loss was caused by "employee" dishonesty. Consequently, the issue of whether a wrongdoer is a covered employee primarily depends upon whether an insured has the right to govern and direct him in the performance of services. In determining whether an insured has the right to control a wrongdoer, courts examine the wrongdoer's ownership interest in the insured and the extent to which the insured has an independent management or board of directors. Courts have taken a broad approach when ascertaining a wrongdoer's ownership interest in an insured, but the fidelity bond cases do not provide much guidance as to the type of evidence which an insurer must produce to prove that a wrongdoer is not controlled or directed by an insured. Although there is no bright-line test, the cases indicate that the greater the ownership interest and the lesser the

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<sup>6</sup>Form CR 10 00 1090 at (c)(1)(a), (Insurance Services Offices, Inc. 1989) (emphasis added).

<sup>7</sup>*Bird v. Centennial Ins. Co.*, 11 F.3d 228, 233 (1st Cir. 1993).

<sup>8</sup>*E.g., In re Payroll Express Corp.*, 216 B.R. 344, 361 (S.D.N.Y. 1997), *aff'd*, 186 F.3d 196 (2d Cir. 1999), *cert. denied sub. nom.*, *Pereira v. Aetna Cas. & Sur. Co.*, 529 U.S. 1019 (2000); *Hartford Fire Ins. Co. v. Conestoga Title Ins. Co.*, 746 A.2d 460, 462 (N.J. Super. Ct. App. Div. 2000); *Conestoga Title Ins. Co. v. Premier Title Agency, Inc.*, 746 A.2d 462, 464-65 (N.J. Super. Ct. App. Div. 2000).

amount of control over the wrongdoer exercised by other officers and directors, the more likely the wrongdoer will not be considered an employee.

First, the fidelity bond cases show courts take a liberal view when determining the amount of a wrongdoer's ownership interest. Courts have pooled the shares owned by more than one wrongdoer,<sup>9</sup> and have considered shares indirectly owned by a wrongdoer, whether owned through a parent corporation<sup>10</sup> or by a spouse.<sup>11</sup>

For example, *Hartford Fire Insurance Co. v. Conestoga Title Insurance Co.*<sup>12</sup> held that the wrongdoer was not an employee as defined in the bond, because his wife was the sole shareholder and sole director of the insured, but had absolutely nothing to do with the insured or its business. Therefore, the wrongdoer was not an employee even though he personally did not own any stock of the insured.

Second, when a wrongdoer is the only officer, director and shareholder of an insured, courts almost uniformly hold that the wrongdoer is not an employee.<sup>13</sup> In most cases involving sole shareholders, there is little discussion of proof of a lack of control exercised by other officers or directors.<sup>14</sup> In one case, the court simply noted that the wrongdoer and his wife were the only directors of the insureds, that they held no meetings, and that the record showed the insureds were completely controlled by the wrongdoer.<sup>15</sup>

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<sup>9</sup>*California Union Ins. Co. v. Am. Div. Sav. Bank*, 948 F.2d 556 (9th Cir. 1991); *Kerr v. Aetna Cas. & Sur. Co.*, 350 F.2d 146 (4th Cir. 1965); *Charm Promo, Ltd. v. Travelers Indem. Co.*, 447 F.2d 607 (7th Cir. 1971), *after remand*, 489 F.2d 1092 (1973); *Payroll Express Corp.*, 216 B.R. at 361-63; *Employer's Admin. Serv., Inc. v. Hartford Acc. & Indem. Co.*, 709 P.2d 559 (Ariz. Ct. App. 1985).

<sup>10</sup>*California Union*, 948 F.2d at 556; *Kerr*, 350 F.2d at 154; *Orleans Parish Sch. Bd. v. Chubb Custom Ins. Co.*, No. 00-2226, 2001 WL 345331 (E.D. La. April 6, 2001). *Cf. West Am. Fin. Co. v. Pac. Indem. Co.*, 61 P.2d 963, 965 (Cal. Ct. App. 1936).

<sup>11</sup>*Bird*, 11 F.3d at 229; *In re World Hospitality Ltd.*, 983 F.2d 650, 651 (5th Cir. 1993); *Payroll Express Corp.*, 216 B.R. at 361-63; *Hartford v. Conestoga*, 746 A.2d at 461.

<sup>12</sup>746 A.2d 460, 461 (N.J. Super. Ct. App. Div. 2000).

<sup>13</sup>*Bird*, 11 F.3d at 229 (wrongdoer was one hundred percent shareholder of one insured and fifty percent shareholder, along with his wife, in another insured, was the only officer of both insureds and he and his wife were the only directors of both insureds); *California Union*, 948 F.2d at 566 (two wrongdoers owned one hundred percent of insured's parent corporation, were principal officers and only directors); *Kerr*, 350 F.2d at 154 (one hundred percent shareholders, sole directors and principal officers), *McKee v. Great Am. Ins. Co.*, 316 F.2d 473, 474 (5th Cir.) (sole owner and principal officer), *cert. denied*, 375 U.S. 830 (1963); *Three Garden Village Ltd. P'ship v. United States Fid. & Guar. Co.*, 567 A.2d 85 (Md. 1989) (sole shareholder, director and officer); *Conestoga v. Premier*, 746 A.2d at 464-65 (sole shareholder, officer and director); *Employer's Admin. Serv.*, 709 P.2d at 561 (sole shareholders, officers and directors).

<sup>14</sup>*Kerr*, 350 F.2d at 146; *McKee v. Great Amer. Ins. Co.*, 316 F.2d at 473; *Three Garden*, 567 A.2d at 85.

<sup>15</sup>*Bird*, 11 F.3d at 229-30.

In one recent case, however, the court examined proof of the wrongdoer's control over the insured by quoting extensively from the wrongdoer's deposition.<sup>16</sup>

The wrongdoer, who owned 100 percent of the insured's parent corporation, testified to firing his own son because he "forgot who the boss was," and testified in response to the question of whether the board of directors ever refused to approve of his actions as: "Are you kidding? No. . . I can't imagine that happening."<sup>17</sup>

On the other hand, one court has held that a one hundred percent shareholder was an employee because he was not the only member of the board of directors, which met regularly and was active in running the affairs of the insured.<sup>18</sup> Another court has stated in dictum that it may have held that wrongdoers were employees of the insured if there was a non-culpable officer or director who exercised control over the affairs of the insured.<sup>19</sup>

Third, when a wrongdoer owns less than one hundred percent of an insured, courts generally require evidence that other officers and directors failed to control the wrongdoer.<sup>20</sup> As noted above, in *Hartford Insurance Co. v. Conestoga Title Insurance Co.*,<sup>21</sup> the court examined the amount of control exercised by the board of directors when determining that the wrongdoer was not an employee, even though he did not own any stock of the insured. The court concluded that the sole shareholder and sole director, the wrongdoer's wife, had "absolutely nothing to do with" the insured or its business.

In another case involving a wrongdoer who was a majority shareholder, president and a director of the insured, the court declined to grant summary judgment in favor of the insurer, citing an absence of proof of a lack of control over the wrongdoer by the insured's board of directors.<sup>22</sup> In a case involving a ninety-five percent shareholder, the court upheld summary judgment in favor of the insurer, but

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<sup>16</sup>*Orleans Parish Sch. Bd. v. Chubb Custom Ins. Co.*, No. 00-2226, 2001 WL 345331, at \*4 (E.D. La. April 6, 2001).

<sup>17</sup>*Id.*

<sup>18</sup>*Seattle Int'l Corp. v. Commerce & Indus. Ins. Co.*, 600 P.2d 612, 614 (Wash. Ct. App. 1979).

<sup>19</sup>*Employer's Admin. Serv.*, 709 P.2d at 564 n.2; *Conestoga v. Premier*, 746 A.2d at 465.

<sup>20</sup>*In re World Hospitality Ltd.*, 983 F.2d 650 (5th Cir. 1993) (ninety-five percent and controlling and dominating shareholder); *Charm Promo., Ltd. v. Travelers Indem. Co.*, 447 F.2d 607 (7th Cir. 1971) (two-third owners of company involved in an insured joint venture), *after remand*, 489 F.2d 1092 (1973); *Ins. Co. of N. Am. v. Greenberg*, 405 F.2d 330 (10th Cir. 1969) (president, secretary and less than majority shareholder); *In re Mechem Fin., Inc.* 167 B.R. 799 (Bankr. W.D. Pa. 1994) (president, majority shareholder and a director); *Hartford v. Conestoga*, 746 A.2d at 461; *Bryan v. Fid. & Cas. Co. of New York*, 9 P.2d 86 (Wash. 1932) (president, secretary, treasurer and eighty percent owner). In *Bryan*, the court held that the president, secretary and treasurer, who owned eighty percent of the insured, which shares were held in escrow, was an employee of the insured because there was no evidence of an absence of meeting by the trustees or directors of the insured and the wrongdoers shares were held in escrow.

<sup>21</sup>746 A.2d at 461.

<sup>22</sup>*Mechem Financial*, 167 B.R. at 802.

described the wrongdoer as a controlling and dominating shareholder.<sup>23</sup> In a case involving an eighty percent shareholder, the court granted summary judgment in favor of the insurer because the insured's trustee in bankruptcy conceded that no one controlled the wrongdoer and because there was no evidence that the insured's board of directors exercised supervisory control over the wrongdoer.<sup>24</sup> Similarly, in three other cases involving wrongdoers who were not sole shareholders, the courts declined to hold that the wrongdoers were not employees because they were not sole or majority stockholders and because there was no proof of a lack of control by other officers and directors of the insureds.<sup>25</sup>

Nonetheless, there are two cases involving majority shareholders who were held not to be employees of the insureds because the wrongdoers possessed the right to elect a majority of the insureds' boards of directors.<sup>26</sup> In one case, the wrongdoers were promoters who obtained all of the voting stock and fifteen percent of the other classes of stock of the insured's parent corporation. They voted themselves officers and directors of the insured, plundered it, and disappeared. The court did not reach the control issue, holding instead that they were never in the service of the insured and were never paid wages.<sup>27</sup> In the other case, the issue was whether a person named as a principal in a fidelity policy was covered by the policy when the principal subsequently acquired a majority ownership interest in the insured. The court held that the wrongdoer was not covered by the policy because as majority owner "he no longer was subject to the restraining influence of efficient supervision."<sup>28</sup> Neither of these cases discusses in any detail evidence of actual lack of control by other officers and directors of the insureds.

There is also one case involving a sixty percent shareholder in which the court held that the wrongdoer was an employee because the insured possessed a theoretical right to control him.<sup>29</sup> The court reasoned that the insured possessed such a right even if the board acted as a rubber stamp.<sup>30</sup> Nonetheless, a substantial majority of courts have declined to interpret the "control" language in the fidelity bond's definition of employee on the basis of the insured's theoretical rights.<sup>31</sup>

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<sup>23</sup>*World Hospitality*, 983 F.2d at 651-52.

<sup>24</sup>*In re Prime Commercial Corp.*, 187 B.R. 785 (Bankr. N.D. Ga. 1995).

<sup>25</sup>*Charm*, 447 F.2d at 612; *Greenberg*, 405 F.2d at 333; *Bryan*, 9 P.2d at 87.

<sup>26</sup>*First Nat'l Life Ins. Co. v. Fid. & Dep. Co. of Maryland*, 525 F. 2d 966 (5th Cir. 1976); *Farmers' & Merchants' St. Bank of Verdon v. United States Fid. & Guar. Co.* 133 N.W. 247 (S.D. 1911).

<sup>27</sup>*First Nat'l Life*, 525 F.2d at 970

<sup>28</sup>*Farmers' & Merchants' St. Bank of Verdon*, 133 N.W. at 249.

<sup>29</sup>*General Fin. Corp. v. Fid. & Cas. Co. of New York*, 439 F.2d 981 (8th Cir. 1971), *rev'g* 311 F. Supp. 353 (D. S.D. 1970).

<sup>30</sup>*Id.* at 984.

<sup>31</sup>*E.g.*, *Bird*, 11 F.3d at 233; *Hartford v. Conestoga*, 746 A.2d at 462; *Conestoga v. Premier*, 746 A.2d at 464-65; *Employer's Admin. Serv.*, 709 P.2d at 562-63.

In summary, in alter ego cases which recovery is sought under a commercial fidelity bond, the primary issue usually is whether an insured has the right to control a wrongdoer in the performance of services and, thus, whether the wrongdoer is a covered employee of the insured. In general, a wrongdoer who is the sole shareholder, officer and director of an insured is not likely to be considered a covered employee. When a wrongdoer is not a sole shareholder, officer and director of an insured, a majority of courts have held that in the absence of proof of a lack of actual control by other officers and directors, such a wrongdoer will be considered an employee of an insured.

## B. FINANCIAL INSTITUTION BONDS

Generally, financial institution bonds define an employee as:

an officer or other employee of the Insured, while employed in, at, or by any of the Insured's offices or premises covered hereunder, and a guest student pursuing studies or duties in any of said offices or premises;<sup>32</sup>

When examined in light of the definition of employee in a commercial fidelity bond, it is apparent that financial institution bonds usually do not limit fidelity coverage to loss caused by persons whom the insured has the right to direct and control on the performance of services.<sup>33</sup> This difference has not gone unnoticed by the courts, which have distinguished commercial fidelity bond cases on the basis that they interpret a more limited definition of employee.<sup>34</sup> In many cases, courts do not discuss whether owner-wrongdoers are exempted from coverage.<sup>35</sup> Consequently,

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<sup>32</sup>Financial Institution Bond, Standard Form No. 24, Definition (g)(1) (revised Jan. 1986), reprinted in THE STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA 1995).

<sup>33</sup>It should be noted, however, that some financial institution bonds contain definitions of "employee" similar to that contained in a commercial fidelity bond. *E.g.* Financial Institution Bond, Standard Form No. 25 (revised Oct. 1987), reprinted in THE STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA 1995) (formerly known as Insurance Companies Blanket Bond); Financial Institution Bond, Standard Form No. 14 (revised Oct. 1987), reprinted in THE STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA 1995) (formerly known as Brokers Blanket Bond).

<sup>34</sup>*E.g.*, FDIC v. New Hampshire Ins. Co., 953 F.2d 478 (9th Cir. 1992) (wrongdoer who was sole shareholder, chairman of the board, and CEO was an employee as defined in a financial institution bond); FDIC v. Kansas Banker's Sur. Co., 17 F.3d 1436, (10th Cir. 1994) (declining to "read-in" control language); SEC v. Credit Bancorp, Ltd, 147 F. Supp. 2d 238 (S.D. N.Y. 2001) (officer of the insured was covered employee within the meaning of the bond, because the bond did not contain a definition of employee that excluded persons the insured did not have the right to direct and control).

<sup>35</sup>*California Union*, 948 F.2d at 556; FDIC v. Lott, 460 F.2d 82 (5th Cir. 1972); United States Fid. & Guar. Co. v. Oklahoma, 383 F.2d 417 (10th Cir. 1967); McKee v. Am. Cas. Co. of Reading, Pa., 316 F.2d 482 (5th Cir. 1963); West Am. Fin. Co. v. Pac. Indem. Co., 61 P.2d 969 (Cal. Ct. App.

in financial institution bond cases, the focus of the alter ego defense often is not whether an owner-wrongdoer is a covered employee, but whether an insured can be charged with the wrongdoer's knowledge of his own misdeeds. In this regard, the alter ego defense usually is interposed in connection with other policy defenses, such as misrepresentation in the bond application,<sup>36</sup> termination of coverage<sup>37</sup> or late notice.<sup>38</sup>

Whether an insured can be charged with a wrongdoer's own knowledge turns upon principles of agency and corporation law. Generally, what an employee learns during the scope of his employment is imputed to the corporation.<sup>39</sup> But a wrongdoer's knowledge of his own culpable conduct may not be imputed to an insured corporation if his infidelity constitutes an act outside the scope of his employment or if his interest is adverse to the corporation's.<sup>40</sup> An exception to this rule, however, is that knowledge possessed by employees having substantial control of all the activities of a corporation can be imputed to the insured corporation.<sup>41</sup>

In determining whether an owner-wrongdoer has substantial control of all of the activities of an insured, courts have examined a wrongdoer's ownership interest in the insured and the amount of control exercised by non-culpable officers and directors. Like the commercial fidelity bond cases, the greater a wrongdoer's ownership interest in an insured and the greater degree of lack of control exercised by non-culpable officers and directors, the more likely the insured will be charged with the wrongdoer's knowledge. Unlike fidelity bond cases, some of the financial institution bond cases give a better insight into the kind of evidence regarding control, or lack thereof, courts evaluate when determining the merits of an alter ego defense.

In one case, a trustee in bankruptcy sought to recover under a commercial blanket bond for the defalcations of the principal officer and sole shareholder of the insured. In a very short opinion, the court reasoned that the insured was charged with

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<sup>36</sup>United States Fid. & Guar. Co. v. Oklahoma, 383 F.2d at 419; Hartford Acc. & Indem. Co. v. Hartley, 275 F. Supp. 610, 616 (M.D. Ga. 1967), *aff'd*, 389 F.2d 91 (5th Cir. 1968).

<sup>37</sup>*In re Lloyd Sec. Inc.*, 153 B.R. 677, 685 (E.D. Pa. 1993).

<sup>38</sup>*Lott*, 460 F.2d at 83.

<sup>39</sup>RESTATEMENT (SECOND) OF AGENCY § 268 (1958).

<sup>40</sup>*Id.* §§ 268 & 282; Phoenix Sav. & Loan v. Aetna Cas. & Sur. Co., 427 F.2d 862 (4th Cir. 1970), *rev'g* 302 F. Supp. 832 (D.C. Md. 1966), *prior appeal*, 381 F.2d 245 (1967), *rev'g* 266 F. Supp. 465 (1966).

<sup>41</sup>*Phoenix*, 427 F.2d at 869; *McKee v. Am. Cas. Co. of Reading, Pa.*, 316 F.2d 428, 430 (5th Cir. 1963); *FDIC v. Am. Sur. Co. of New York*, 39 F. Supp. 551 (W.D. Ky. 1941) (court imputed knowledge of sole actor, who together with family members owned sixty-eight percent of insured); *McIntosh v. Dakota Trust Co.*, 204 N.W. 818 (N.D. 1925) (court imputed knowledge of 80 percent shareholders who comprised the entire board of directors and were in sole control of the insured); *but see* *FDIC v. Nat'l Sur. Corp.*, 281 N.W.2d 816 (Iowa 1979) (refusing to apply "sole actor" exception without evidence of lack of control by insured's board). *See generally* RESTATEMENT (SECOND) OF AGENCY § 282(2) (listing exceptions to adverse interest rule).

the wrongdoer's own knowledge because there was no adverse interest between the wrongdoer and the corporation wholly owned by him.<sup>42</sup> Therefore, the trustee was barred from recovering because the insured failed to comply with the bond's notice provision.<sup>43</sup> More recently, another court upheld a finding that the knowledge of misdeeds committed by a ninety-two percent shareholder who was president, chief operating officer and director of the insured was imputed to the insured, thereby precluding recovery under a financial institution bond.<sup>44</sup> The opinion contains very little factual discussion of a lack of control over the institution by non-culpable officers and directors.

When a wrongdoer owns less than a substantial amount of an insured, application of the alter ego defense has had mixed results. In one case, the court imputed the wrongful knowledge of four wrongdoers who indirectly owned a majority of the insured and comprised a majority of the insured's board of directors, holding that by reason of their ownership interest, the wrongdoers controlled the management, policies, and affairs of the insured and its related corporations.<sup>45</sup> The insured argued that the adverse interest rule precluded imputation of the wrongdoers' knowledge. The court acknowledged the rule, but held that as to third parties, the law presumes that agents communicate their wrongful knowledge to a corporation even if the agent may personally benefit from the frauds.<sup>46</sup> The court held further that since some of the wrongdoers' defalcations occurred prior to the insured's application for the first bond and continued through the issuance of successor bonds, the bonds were unenforceable against the insurers.

In another case,<sup>47</sup> an insured bank sought recovery under a bankers blanket bond for loss caused by its president and cashier, who was also one of three partners of a partnership which owned the bank. It was undisputed that the wrongdoer had complete control of the operations of the insured and that the other partners were

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<sup>42</sup>McKee v. Am. Cas. Co. of Reading, Pa., 316 F.2d at 430

<sup>43</sup>*Id.* The *New Hampshire* case also involved a one hundred percent shareholder, but the court only addressed the issue of whether he was an "employee" under the terms of a financial institution bond and did not address whether the insured should be charged with the wrongdoer's knowledge of his own frauds. As noted above, the court held that the wrongdoer was an employee of the insured because the bond did not contain a limited definition of employee (as found in fidelity bonds); see also *Credit Bancorp*, 147 F. Supp. 2d at 238 (officer of the insured was a covered employee within the meaning of the bond, because the bond did not contain a definition of employee that excluded persons the insured did not have the right to direct and control.).

<sup>44</sup>*Redlake Cty. Bank v. Employer's Ins. of Wausau*, 874 F.2d 546 (8th Cir. 1989). The court did not discuss notice provisions of the bond or misrepresentation in the bond application, but held that since the insured was charged with the wrongdoer's knowledge of his misdeeds, the wrongful acts were committed by the insured rather than by an employee.

<sup>45</sup>*West Am. Fin. Co. v. Pac. Indem. Co.* 61 P.2d 969 (Cal. Ct. App. 1936).

<sup>46</sup>See RESTATEMENT (SECOND) OF AGENCY § 282(2) (1958).

<sup>47</sup>*Hartford Acc. & Indem. Co. v. Hartley*, 275 F. Supp. 610 (M.D. Ga. 1967), *aff'd*, 389 F.2d 91 (5th Cir. 1968).

partners in name only. The court held that the bond was void ab initio because the insured was charged with the wrongdoer's knowledge of his own culpable conduct even in the face of the application, signed by the wrongdoer, which provided "[s]uch knowledge as any officer signing for the Insured may now have in respect to his own personal acts or conduct, unknown to Insured, is not imputable to the Insured bank."<sup>48</sup>

On the other hand, in one recent case the court refused to impute the knowledge of a wrongdoer who owned one third of the insured where there was no evidence that the other shareholder did not exercise control over the insured.<sup>49</sup> The court explained at length the steps the wrongdoer had taken to conceal his conduct from the other, majority, shareholder, and reasoned that knowledge is imputed only when the wrongdoer's amount of control and ownership of the insured is overwhelming.<sup>50</sup>

Two other cases stand for the proposition that absent direct evidence of a lack of control exercised by non-culpable officers and directors, the issue of whether an owner-wrongdoer has substantial control over all of the affairs of an insured is a question which should be decided by the trier of fact.

In *Phoenix Savings & Loan v. Aetna Casualty & Surety Co.*,<sup>51</sup> one of the wrongdoers was the president; the other was the secretary and treasurer of the insured; both of them were also directors and members of the insured's executive committee. Although the number of directors increased during the time the frauds were committed, many of the directors were alleged to have participated in them. Four of five members of the executive committee of the board were accused of participating in the transactions which formed the basis of the bond claim; the fifth member was accused of defrauding the insured. The insured's bylaws were specifically amended to authorize the type of transaction which the insured later claimed to be fraudulent. In granting summary judgment, the district court concluded that the persons who controlled the corporation's day-to-day activities had full knowledge of the nature of the transactions and held that the bonds were

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<sup>48</sup>275 F. Supp. at 610. *But see* United States Fid. & Guar. Co. v. Oklahoma, 383 F.2d 417 (10th Cir. 1967) (similar language in bond application precluded imputation of the wrongful knowledge of the president who signed the application, but who apparently was not a majority shareholder of the insured).

<sup>49</sup>Employers Reinsurance Corp. v. Landmark, 547 N.W. 2d 527 (N.D. 1996)

<sup>50</sup>Interestingly, the insured contended wrongdoer caused the loss because he failed to tell his partner, who then failed to notify the insured's E&O carrier of the wrongdoer's (apparently negligent) failure to procure workers compensation insurance for an important client. It does not appear that the bond contained a standard definition of employee dishonesty, and the court does not specifically address the wrongdoer's conduct in the context of an insuring agreement.

<sup>51</sup>266 F. Supp. 465 (D.C. Md. 1966), *rev'd and remanded*, 381 F.2d 245 (4th Cir. 1967) [hereinafter *Phoenix II*], *after remand*, 302 F. Supp. 832 (1969) [hereinafter *Phoenix III*], *rev'd and remanded*, 427 F.2d 862 (1970) [hereinafter *Phoenix IV*].

unenforceable because the insured made misrepresentations in applying for the bond regarding the faithful performance of its employees.

On appeal, the court in *Phoenix II*<sup>52</sup> held that an issue of fact existed as to whether the wrongdoers had substantial control of the insured. First, the court reasoned that the record was not clear as to whether the wrongdoers owned or controlled a majority of any of the insured's three classes of voting stock during any one period. Second, the court reasoned that the record did not clearly prove that the wrongdoers controlled a majority of the board of directors or had control of all of the affairs of the insured. Consequently, the court reversed and remanded.

In *Phoenix III*,<sup>53</sup> the district court only heard testimony from the insured's expert, as the pretrial order contained 194 stipulations of facts. Thereafter, the court directed a verdict in favor of the insurer. The court reasoned that the wrongdoers elected themselves chief executive officers, ran the day-to-day operations of the insured, and comprised the alter ego of the board of directors and executive committee. Furthermore, the wrongdoers participated in all executive decisions regarding the fraudulent transactions, and handled all of the stock transactions which were placed upon the books and records of the insured. There was no evidence showing any affirmative acts being initiated or carried out by any other members of the board, many of whom never attended meetings and many of whom were appointed by the wrongdoers. With respect to the wrongdoers' ownership interest in the insured, the court assumed that the general public owned a majority of the shares of the insured, since the insured's records were not conclusive on that issue.

In *Phoenix IV*,<sup>54</sup> the court of appeals again reversed on procedural grounds, holding that while the evidence of the wrongdoers' control over the insured was substantial, the facts were susceptible to conflicting inferences. The court reasoned, for example, that even though some of the directors were business associates of or were appointed by the wrongdoers, a jury could infer that "they were honest men despite their connection with rogues."<sup>55</sup> There was no direct evidence that the board failed prudently to consider management reports or failed carefully to consider the proposals made by the wrongdoers. As a result, the court of appeals concluded that the judge should not have taken the case from the trier of fact.

In *FDIC v. Lott*,<sup>56</sup> the Federal Deposit Insurance Corporation<sup>57</sup> sought to recover under a bankers blanket bond for losses allegedly caused by Lott, who was president, a director and fifty-two percent shareholder of the insured. The insured's

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<sup>52</sup>381 F.2d at 249.

<sup>53</sup>302 F. Supp. at 833.

<sup>54</sup>427 F.2d at 868.

<sup>55</sup>*Id.* at 862.

<sup>56</sup>460 F.2d 82 (5th Cir. 1972).

<sup>57</sup>Hereinafter FDIC.

board was comprised of five directors, who with Lott together owned ninety-seven percent of the insured. Among other things, Lott caused the insured to make loans which exceeded the insured's legal lending limit to a company owned by him and another director. The loans were brought to the attention of the board by bank examiners during several meetings. Thereafter, Lott often called board meetings, but would later cancel them and direct a third director to prepare minutes of meetings which were never held. In addition, Lott was required to attend a personal conference with bank examiners, of which he did not inform the members of the board. When Lott received subsequent bank examiners' reports, he read them to the other directors, but often omitted reading critical portions about insider loans. Although the directors were aware of the excessive loans, Lott assured them that he was taking care of the problem.<sup>58</sup>

The a jury found that Lott had committed dishonest, fraudulent, or criminal acts with respect to the loans and that the two outside directors, one of which owned the company which received the illegal loans, did not know or should not have known of Lott's fraudulent acts. The jury also found that the two inside directors failed to properly supervise the insured's business, but that their conduct was not the proximate cause of the loss.

The insurer appealed on the grounds that the directors had knowledge of Lott's fraudulent conduct and that the knowledge was imputed to the bank as a matter of law. Relying on the *Phoenix* cases, the insurer argued that Lott was in sole control of the insured. The court of appeals noted that Lott was not the bank's sole shareholder,<sup>59</sup> and reasoned that while it was true that there was a controlling shareholder who was also an officer who actually ran the insured, it did not necessarily follow as a matter of law that the other directors "abdicated their duties and responsibilities with which they were charged by law."<sup>60</sup> Furthermore, the insured could not be charged with Lott's fraudulent knowledge because his interests were adverse to the bank and because the jury found that the other directors did not know of Lott's fraudulent conduct.<sup>61</sup>

Thus, both *Phoenix* and *Lott* acknowledged the availability of the alter ego defense, but held that when a wrongdoer, or a group of wrongdoers, owns less than a substantial majority of an insured, direct evidence that either other officers or directors completely abdicated their responsibilities or were aware of the wrongdoers' conduct and acquiesced in it is required before a court should decide as a matter of

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<sup>58</sup>460 F.2d at 85.

<sup>59</sup>The court also explained that since the district court's judgment specifically excluded Lott from participating in any recovery, innocent shareholders and creditors of the insured should not have to bear the loss when fraudulent majority shareholder will not himself benefit.

<sup>60</sup>460 F.2d at 88.

<sup>61</sup>*Id.* Citing *Phoenix*, the court said the jury could have inferred the other directors were honest men despite their connection with a rogue.

law that a wrongdoer's own knowledge of his misdeeds is imputed to an insured. The *Phoenix* court so held even though there was evidence that the wrongdoers selected the other directors who were alleged to have participated in the frauds and other directors who apparently did not attend meetings. In *Lott*, the court so held even though one director benefitted from the frauds and another participated in falsifying bank records.

In summary, in alter ego cases involving financial institution bonds, the primary issue usually has been whether an insured should be charged with the wrongful knowledge possessed by an owner-wrongdoer for purposes of a defense based upon misrepresentation in the bond application, termination of coverage or late notice. This, in turn, depends upon whether the wrongdoer has substantial control over all of the affairs of the insured. In determining whether a wrongdoer has substantial control, courts have analyzed the amount of ownership interest in the insured possessed by the wrongdoer and the amount of control, or lack thereof, over the affairs of the insured exercised by non-culpable officers and directors. As in commercial fidelity bond cases, when a wrongdoer owns all or almost all of the shares of an insured, courts require less evidence of an absence of actual control over the affairs of the insured by other officers and directors. When a wrongdoer owns less than substantially all of the insured, courts require direct evidence of a lack of control by other officers and directors before deciding as a matter of law that the insured should be charged with the wrongdoer's knowledge of his or her own misconduct.

### C. CASES INVOLVING WRONGFUL ACTS OF INSUREDS

In addition to the two important lines of cases described above, there are several other financial institution bond cases involving whether an act of an owner-wrongdoer is deemed to be the act of the insured. These cases examine whether the legal separateness between a corporation and those persons that own and control the corporation should be disregarded and the acts of individuals should be deemed to be the acts of the corporation. In this context, courts have also looked to the amount of a wrongdoer's ownership interest in an insured and the control, or lack thereof, exercised by other officers and directors, as well as factors usually considered in corporate-veil-piercing cases. The fidelity cases differ from corporate alter ego cases, however, because in the latter, the objective is to impose upon the individuals who own and control the corporation liability for corporate debts. In fidelity cases, the object is to impose upon the insured corporation responsibility for the actions of its owners or those who control it.

First, *In re Payroll Express Corp.*,<sup>62</sup> the insured sustained a loss caused by husband and wife who owned one hundred percent of the insured. The husband

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<sup>62</sup>216 B.R. 344 (S.D.N.Y. 1997), *aff'd*, 186 F.3d 196 (2d Cir. 1999), *cert. denied sub. nom.*, *Pereira v. Aetna Cas. & Sur. Co.*, 529 U.S. 1019 (2000).

owned fifty percent of the insured and was CEO and president; the wife owned the other fifty percent and was a director and officer. With the assistance of other employees and outside professionals, the happy couple caused the insured to sustain a \$14.5 million loss over five years. As part of the scheme, they engaged in a \$20 million check-kiting scheme which helped conceal their activities. When the scheme ended, the insured had liabilities of \$36.2 million and assets of \$3 million.

The insurers contended that there was no coverage: the acts of the two principal wrongdoers should be deemed to be the acts of this insured because they owned and dominated the insured. In describing the insurer's arguments as the "equitable alter ego doctrine," the court noted that under New Jersey law courts should disregard the corporate entity only when: (1) the stockholders' disregard of the corporate entity make it a mere instrumentality for the transaction of their own affairs; (2) there is such a unity of interest and ownership that the separate personalities of the corporation and the owners no longer exist, and; (3) to adhere to the doctrine of the corporate entity would promote injustice or protect fraud.<sup>63</sup>

After finding that the wrongdoers stole over \$14 million from the insured over five years and engaged in a scheme to systematically hide the fact that the insured's liabilities exceeded its assets by over twelve hundred percent, the court held in favor of the insured's trustee on the equitable alter ego defense. The court reasoned that the insurer failed to show that the insured had no other purpose than to further the interests of the wrongdoers, because the insured had been in business for over twenty years, employed several persons, "kept its own books and appears to have had its own bank accounts, creditors and clients."<sup>64</sup> Even though the wrongdoers systematically looted the insured for their own gain (actually by taking third parties' money), the insured's corporate form appeared to have served a legitimate purpose. The court held that it could not find there was a disregard of the corporate entity or that the insured was a "mere instrumentality" of the wrongdoers. The court did not make any findings with respect to the third basis for disregarding the separate existence of the corporation: that to adhere to the doctrine of the corporate entity would promote injustice or protect fraud.<sup>65</sup>

Second, in *Transamerica Insurance Co. v. FDIC*,<sup>66</sup> an insurer appealed from a summary judgment granted in favor of an insured for reimbursement under a financial institution bond for loss caused by a 93.5 percent owner of the insured who was also president, chief lending officer, a director and chairman of the board. He elected all of the other directors, who served at his pleasure, set his own salary, gave

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<sup>63</sup>216 B.R. at 360.

<sup>64</sup>*Id.*

<sup>65</sup>The court did hold, however, that loss caused by the two owners, and those who acted in collusion with them, was not covered because neither of the owners qualified as covered employees within the meaning of the bond.

<sup>66</sup>489 N.W.2d 224 (Minn. 1992).

himself bonuses, and hired and fired employees. The insurer argued that the alter ego defense stands for the proposition that an owner of a controlling interest in an insured is not an employee covered by a fidelity bond and contended that the trial court confused the distinction between the alter ego defense and corporate-veil-piercing (which results in a court disregarding the existence of a corporation as a separate entity).<sup>67</sup> Noting that the wrongdoer was, as a salaried officer, an employee as defined in the bond, the Minnesota supreme court explained that it had never applied the alter ego doctrine to preclude coverage in a case where the wrongdoing employee was merely a majority stockholder and board member and other directors were not involved in or had knowledge of his dishonesty.

The court reasoned that the insurer had to show not only that the owner-wrongdoer ran the insured and owned almost all of its stock, but also that the board of directors “abdicated its control of the corporation to such a degree that [the owner-wrongdoer] ceased to be its employee.”<sup>68</sup> In applying factors considered in corporate-veil-piercing cases,<sup>69</sup> the court noted that affidavits from the non-culpable members of the board indicated that throughout the wrongdoer’s administration, the board was actually involved in the insured’s affairs, that the trial court found that the board held regular meetings, kept minutes and observed other corporate formalities, and that after the owner-wrongdoer resigned, the board continued to operate the insured and sought a new president, even though the wrongdoer did not sell his stock until several months thereafter. The court reasoned that the fact that the owner-wrongdoer owned 93.5 percent of the stock of the insured and ran it as his own business was insufficient, without more, to show that the board abandoned its responsibility to oversee the insured. The court distinguished several fidelity bond cases on the basis that they involved sole shareholders.<sup>70</sup>

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<sup>67</sup>A distinction recognized by the court in *Payroll Express Corp.*, 216 B.R. at 361-63. *But see* *Redlake Cty. Bank v. Employer’s Ins. of Wausau*, 874 F.2d 546 (8th Cir. 1989) (insured was charged with the wrongdoer’s knowledge of his own misconduct; conduct was, therefore, an act of the insured); *Conestoga v. Premier*, 746 A.2d at 464 (wrongdoer was not an employee within the meaning of what appears to be commercial fidelity bond, because he was the sole shareholder, sole director and sole officer, but the court also concluded wrongdoer was the alter ego of the insured).

<sup>68</sup>*Id.* at 228.

<sup>69</sup>Insufficient capitalization, failure to observe corporate formalities, nonpayment of dividends, insolvency of the debtor corporation at the time of the questioned transactions, siphoning of funds by the dominant shareholder, nonfunctioning of other officers and directors, absence of corporate records, and existence of the corporation as merely a facade for individual dealings.

<sup>70</sup>*Kerr v. Aetna Cas. & Sur. Co.*, 350 F.2d 146 (4th Cir. 1965); *McKee v. Great Am. Ins. Co.*, 316 F.2d 473 (5th Cir. 1962), *United States Fid. & Guar. Co. v. Three Garden Village Ltd. P’ship*, 551 A.2d 881 (Md. Ct. Spec. App. 1989).

Third, in *FDIC v. Aetna Casualty & Surety Co.*,<sup>71</sup> the FDIC sued recover under a bankers blanket bond for loss caused by two brothers who operated and controlled the insured, one of whom was president, chairman of the board, and the largest shareholder of the insured. The insurer argued that the bond only covered losses resulting from the acts of employees, rather than acts by the insured corporation. It argued that the wrongdoer was the alter ego of the insured such that he could not be considered an employee, because he dominated the insured based on the authority derived from his ownership of stock and the offices held. Citing corporate-veil-piercing cases, the court of appeals held that the trial court erred in failing to consider whether the insurer possessed such a defense.<sup>72</sup>

Fourth, in *Drexel Burnham Lambert Group, Inc. v. Vigilant Insurance Co.*,<sup>73</sup> the insured sought indemnification under several brokers and bankers blanket bonds for claims of third parties who suffered as a result of illegal trading activities of the insured and its employees. The court held that the insured was estopped from seeking recovery under the bonds because it had previously pleaded guilty to a federal information involving the same transactions which formed the basis of the bond claims. The court reasoned that because the insured pleaded guilty to knowingly participating in and benefitting from the criminal conduct engaged in by its employees, it was seeking to recover for its own criminal conduct. Although technically not an alter ego case (the wrongdoers were not substantial owners) the principles set forth in *Drexel* dovetail with the alter ego defense.<sup>74</sup>

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<sup>71</sup>947 F.2d 196 (6th Cir. 1991). *Cf.* *Premium Fin. Co., Inc. v. Employers Reinsurance Corp.*, 979 F.2d 1091 (5th Cir. 1992) (one hundred percent owner, COO and one of two directors, along with spouse, was "insured" for purposes of exclusion in liability policy).

<sup>72</sup>947 F.2d at 209-10. It should be also noted that in *Thrift Fed. Sav. & Loan v. Overton*, 563 N.E. 2d 289 (Ohio 1990), the court held that loss caused by an owner-wrongdoer was excluded from coverage after the insured admitted that the wrongdoer was its alter ego. The policy contained a provision specifically excluding loss caused by a fraudulent, dishonest or criminal act of the insured.

<sup>73</sup>595 N.Y.S. 2d 999 (N.Y. Super. Ct. 1993).

<sup>74</sup>*Id.* at 1010. *See also Farmers' & Merchants' State Bank of Pierz v. St. Paul Fire & Marine Ins. Co.*, 242 N.W.2d 840 (Minn. 1976), in which the insured sought to recover under a financial institution bond attorneys' fees incurred in defending an action brought against it by a third party. The third party was a customer of the insured who sued the insured because the insured had purchased property which the customer intended to purchase and for which the customer had sought financing from the insured. The transaction was handled on behalf of the insured by a loan officer and its president, who was also a ninety percent shareholder. The insured's board of directors approved the transaction, although it was fully aware of the conflict of interest. The Minnesota Supreme Court held that the bond did not cover losses suffered by reason of fraud, dishonesty, or breach of fiduciary duty when an insured, through its board of directors, has knowledge of the transaction complained of, appreciated its fraudulent nature, and acquiesced or participated in it. The court reasoned that a wrongful act committed by a majority of the board of directors was attributable to the insured itself on a ratification theory. Consequently, evidence regarding the amount of control, or lack thereof, by an insured's board of directors may not only support a defense based upon imputation, but also upon principles of ratification.

In summary, some courts have recognized that in certain circumstances the wrongful acts of an owner-wrongdoer may be deemed the wrongful act of an insured as opposed to the wrongful acts of an employee. These cases involve the types of issues normally considered by courts when determining whether to impose liability upon a corporation's shareholders. Finally, when examining a potential alter ego situation, a surety claims professional should also determine whether the insured ratified or somehow benefitted from the wrongdoer's conduct.

#### D. MANIFEST INTENT

When analyzing a claim for alter ego issues, one should also keep in mind other policy defenses, particularly lack of manifest intent. In *FDIC v. St. Paul Fire & Marine Insurance Co.*,<sup>75</sup> the wrongdoer was a director and president, and owned a substantial amount of the insured's parent corporation. The insured suffered a loss because the wrongdoer caused the insured to make loans to his associates who invested in companies in which the wrongdoer had a financial interest. These pertinent facts were not disclosed to the insured. The district court entered judgment in favor of the insurer, finding that the wrongdoer did not possess the manifest intent to cause the insured to suffer a loss when he caused the insured to make the loans because doing so would have been a form of financial suicide. The court of appeals held that the district court's finding was not clearly erroneous, reasoning that it was highly unlikely that the wrongdoer had the manifest intent to "cause a significant injury to an entity in which he had a major financial stake."<sup>76</sup> Thus, even though *St. Paul* does not address issues normally associated with alter ego cases, it is apparently the first case to hold that a wrongdoer who owns a significant amount of an insured may not possess the requisite manifest intent to cause the insured to suffer a loss.<sup>77</sup>

#### E. APPLICATION OF THE ALTER EGO DEFENSE TO SPECIFIC FACTUAL CIRCUMSTANCES

##### 1. When More than One Wrongdoer Jointly Owns the Insured, but Only One Wrongdoer Is an Employee of the Insured

In *West American Finance Co. v. Pacific Indemnity Co.*,<sup>78</sup> the wrongdoers consisted of a group comprised of two persons who were officers and directors of the insured and two other persons who were only directors. The court did not distinguish

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<sup>75</sup>942 F.2d 1032 (6th Cir. 1991).

<sup>76</sup>*Id.* at 1037.

<sup>77</sup>As noted above, this may have been a potential issue in *Landmark*. The court may not have addressed it, because the bond apparently did not contain a standard definition of dishonesty. Nonetheless, the wrongdoer mistakenly failed to obtain workers compensation insurance for its biggest client, and then paid resulting losses out of his own pocket. It appears he did not disclose the incident out of embarrassment and in an effort to protect the insured from harm.

<sup>78</sup>61 P.2d 969 (Cal. Ct. App. 1936).

between the two wrongdoers who were only directors, but considered their ownership interests in holding that the knowledge possessed by the four wrongdoers was imputed to the insured.

Similarly, in *In re Payroll Express*,<sup>79</sup> the insured sustained a loss caused by a married couple. The husband, a fifty percent percent shareholder and CEO of the insured, was specifically excluded from coverage. In holding that the wife, herself a fifty percent percent shareholder and officer of the insured, was not a qualified employee within the meaning of the bond, the court considered the husband's ownership interest.

## 2. When a Wrongdoer Indirectly Owns an Insured

Courts can and do consider a wrongdoer's direct and indirect ownership interests. In *West American Finance Co.*,<sup>80</sup> the court reasoned that by virtue of their ownership of one hundred percent of the insured's great-grandparent corporation, four wrongdoers were able to control the affairs of the insured, and held that the insured should be charged with the wrongdoers' knowledge of their own culpable conduct. In *Kerr v. Aetna Casualty & Surety Co.*,<sup>81</sup> the court noted that two wrongdoers directly owned seventy-five percent of the insured and indirectly owned the remaining twenty-five percent through a closely held corporation. The court held that the wrongdoers were not employees of the insured under the terms of a fidelity bond. Recently, in *California Union Insurance Co. v. American Diversified Savings Bank*,<sup>82</sup> the court held that two wrongdoers were not employees as defined in a dishonesty, disappearance and destruction policy because they owned one hundred percent of the insured's parent corporation.

Importantly, courts have also considered the ownership interests of a wrongdoer's relatives or associates in determining whether a wrongdoer is an employee of an insured within the meaning of a bond.<sup>83</sup> As noted above, in *Hartford Fire Insurance Co. v. Conestoga*, the court held that the wrongdoer was not an employer as defined in a commercial fidelity bond, because the wrongdoer's wife owned one hundred percent of the insured and had nothing to do with the insured's affairs. As the court correctly noted,

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<sup>79</sup>216 B.R.344, 361-63.

<sup>80</sup>*Id.*; see also *Orleans Parish Sch. Bd. v. Chubb Custom Ins. Co.*, No. 00-2226, 2001 WL 345331 (E.D. La. April 6, 2001) (wrongdoer owned one hundred percent of insured's parent corporation); but see *Transit Mgt. of Southeast La., Inc. v. Group Ins. Amin., Inc.*, No. 96-1445; 96-3165; 97-1310, 1997 WL 639019 (E.D. La. Oct. 11, 1997) (in a related case, the court noted the wrongdoer owned ninety-five percent of the insured's parent corporation).

<sup>81</sup>350 F.2d at 154.

<sup>82</sup>948 F.2d at 556.

<sup>83</sup>*E.g.*, *Payroll Express*, 216 B.R. at 361-62 (court considered husband's fifty percent ownership when holding wife was not an employee); see also *FDIC v. Am. Sur.*, 39 F. Supp. at 554-56 (wrongdoer and family owned sixty-eight percent of insured);

If we were to permit recovery on the bond in these circumstances, the reality is that a thief who utterly dominated the corporation could wrongfully obtain the benefits of a fidelity bond by placing formal ownership of the company in a spouse or confederate. That is patently inconsistent with the settled policy of not permitting insurance for intentional wrongdoing.<sup>84</sup>

Consequently, courts have considered a wrongdoer's indirect ownership in an insured when determining the merits of an alter ego defense, e.g., the ownership of related companies and the ownership interests of the wrongdoer's spouse and other family members.

### 3. When Recovery is Sought by Persons Other Than the Insured

In cases directly addressing the issue, courts have overwhelmingly applied the alter ego defense to deny coverage to successors in interest to an insured, reasoning that they possess no greater rights than an insured. For example in two recent related cases, the courts applied the alter ego doctrine to deny coverage to a judgement creditor and an assignee of the insured. In *Hartford Fire Insurance Co. v. Conestoga Title Insurance Co.*,<sup>85</sup> the court held a judgment creditor of the insured is essentially in the same position as an assignee, and as such its rights can rise no higher than those of the assignor. The court reasoned that the fact that a judgement creditor was asserting the bond claim did not diminish the force of the policy considerations supporting application of the alter ego defense.

Similarly, in *Conestoga Title Insurance Co. v. Premier Title Agency, Inc.*,<sup>86</sup> the court specifically noted as a preface to its analysis that an assignee's rights are subject to all the equities and defenses that could have been asserted against the assignor. The court concluded the wrongdoer was not an employee within the meaning of what appears to be commercial fidelity bond, because he was the sole shareholder, sole director, and sole officer of the insured.<sup>87</sup>

In addition, in *Bird v. Centennial Insurance Co.*,<sup>88</sup> an assignee of the insureds could not maintain a defense of equitable estoppel, reasoning that the assignee had no greater rights than the insureds, who had unclean hands. In *Employer's Administrative Service, Inc. v. Hartford Accident & Indemnity Co.*,<sup>89</sup> the court reasoned that the receiver for the insured stood in the same shoes as the insured. In

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<sup>84</sup>746 A.2d at 462 (citations omitted).

<sup>85</sup>*Id.*

<sup>86</sup>746 A.2d at 464.

<sup>87</sup>The court also concluded that the wrongdoer was the alter ego of the insured.

<sup>88</sup>11 F.3d at 234.

<sup>89</sup>709 P.2d at 561.

*Three Garden Village Ltd. Partnership v. United States Fidelity & Guaranty Co.*,<sup>90</sup> the court stated that assignees of the insureds had no greater rights than the insured, even under a third-party beneficiary theory. Note, however, that there are several other cases in which alter ego defense has been successfully asserted against a trustee in bankruptcy or other direct successor of an insured which do not contain any discussion of whether they possess more or less rights than an insured.<sup>91</sup>

Despite the aforementioned cases, in some financial institution bond cases, courts have considered whether a wrongdoer's knowledge of his own dishonest conduct should not be imputed to an insured during the period the insured is "adversely dominated" by the wrongdoer. Under this principle, courts consider whether an insured's "discovery" of a loss should be tolled until the insured is notified of the loss by a third party. These cases present a practical problem because adverse domination should be immaterial in a claim by an insured under a financial institution bond for loss caused by the dishonesty of its sole or majority owner. First, adverse domination usually is applied to protect claims made by shareholders of mutual funds against mutual fund companies for the dishonest conduct of fund managers, who are not the funds' sole or majority owners. Second, since financial institution bonds are not a form of liability insurance, adverse domination should not be applied to protect an insured's creditors.

For example, in *In re Lloyd Securities, Inc.*,<sup>92</sup> the trustee of an insured's estate brought an adversary proceeding seeking to recover under a financial institution bond for a loss of funds stolen from the insured's customer-investor accounts. The wrongdoers were the only two officers of the insured and comprised two-thirds of its board of directors. They were also the sole shareholders, directors, and officers of the insured's parent company, of which the insured was a wholly-owned subsidiary.

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<sup>90</sup>567 A.2d at 94 n.7.

<sup>91</sup>*World Hospitality*, 983 F.2d at 650; *Mechem*, 167 B.R. at 799; *California Union*, 948 F.2d at 556; *McKee v. Am. Cas. Co. of Reading, Pa.*, 316 F.2d at 428; *McKee v. Great Am. Ins. Co.*, 316 F.2d at 473; *Payroll Express*, 216 B.R. at 361-62.

It should be noted that in *FDIC v. Oldenburg*, 34 F.3d 1529 (10th Cir. 1994), the Court of Appeals for the Tenth Circuit held that a defense based upon a misrepresentation in a bond application could not be asserted against the FDIC under the doctrine set forth in *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), and its statutory counterpart, 12 U.S.C. § 1823(e). In substance, the statute provides that no agreement which tends to diminish or defeat the interest of the FDIC in an asset acquired under the Federal Deposit Insurance Act is effective unless it is, among other things, in writing. The insurer sought to avoid payment under the bond due to misrepresentations in the bond application, which was not referred to or incorporated by the bond. The court held that to condition payment under a financial institution bond upon the truthfulness of assertions in the bond application was a prohibited agreement under section 1823(e). The court also held that a financial institution bond was an asset under the terms of section 1823(e). *But see* *FDIC v. Aetna Cas. & Sur. Co.*, 947 F.2d 196 (6th Cir. 1991) (holding that bond was not an asset under § 1823(e)).

<sup>92</sup>153 B.R. 677 (E.D. Pa. 1993)

In the bankruptcy court, the insurer moved for summary judgment, claiming, *inter alia*, that the bond terminated immediately after the initial fraud was committed. The wrongdoers' knowledge of their own frauds was imputed to the insured.<sup>93</sup> The court denied the motion, holding that the wrongdoers' knowledge of their frauds could not be imputed to the insured because they were acting outside the scope of their employment. The court also found that discovery of the loss was equitably tolled during the period the insured was adversely dominated by the wrongdoers. The judge reasoned that accepting the insured's argument would preclude the insured from recovering under the bond for conspiratorial fraud by the principal, which in the court's view was a primary risk the bond was intended to insure.

Later, the trustee moved for summary judgment.<sup>94</sup> In recommending that the motion be granted, the bankruptcy judge supplemented his previous holding by finding that the bond was required by the National Association of Securities Dealers and was intended to benefit the public. The court reasoned that the discovery of the loss should be tolled in order to protect the insured's customer-investors.

The district court granted summary judgment in favor of the trustee, finding that the principles of adverse domination and equitable tolling were controlling. Relying primarily upon cases dealing with mutual funds, involving wrongdoers who were not substantial owners of the insureds,<sup>95</sup> the court reasoned that other courts had applied adverse domination principles in the context of fidelity policies and held that discovery of the loss was tolled during the period of time the insured was dominated by the wrongdoers and until such time as the insured was given notice of the loss by a third party.<sup>96</sup>

#### **4. When Innocent Shareholders or Creditors Will Be Affected, or a Wrongdoer Is Excluded from Participating in a Recovery**

Closely related to the identity of the party who is seeking recovery is the issue of whether innocent shareholders or creditors may be affected by a lack of recovery, or whether a wrongdoer will be excluded from participating in a recovery. In the first

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<sup>93</sup>Lloyd Sec. Inc. v. Nat'l Union Fire Ins. Co., No. 91-10905, 1992 WL 119362 (Bankr. E.D. Pa. May 21, 1992).

<sup>94</sup>*Id.*

<sup>95</sup>*E.g.*, Pradis v. Aetna Cas. & Sur. Co., 796 F. Supp. 59 (D. R.I. 1992); Kehoe v. Peerless Ins. Co., No. 74-1905-MC, 1980 WL 1425 (D. Mass. June 20, 1980); Admiralty Fund v. Peerless Ins. Co., 191 Cal. Rptr. 753 (Cal. Ct. App. 1983).

<sup>96</sup>*In re Lloyd Sec., Inc.*, 153 B.R. at 684. The court relied upon *California Union*, 948 F.2d at 565-66, wherein the court applied adverse domination principles, but held that discovery was not equitably tolled under the terms of a financial institution bond because federal regulators, who had been investigating the insured, and other employees of the insured could have discovered the frauds. *Lloyd* also cited *J.I. Corp. v. Federal Insurance Co.*, 920 F.2d 118 (1st Cir. 1990), which declined to hold that discovery was tolled because the sole owner of the insured had control over the insured and the wrongdoers.

instance, at least one court has declined to apply the alter ego doctrine when doing so would have harmed creditors of an insured. In the second instance, several courts have held that the alter ego doctrine does not apply when a wrongdoer will not participate in a recovery, reasoning that public policy does not prevent a recovery when a wrongdoer would not profit from his or her own wrongful conduct.

As previously discussed, in *In re Lloyd Securities, Inc.*,<sup>97</sup> the bankruptcy judge recommended that summary judgment be granted in favor of the trustee on the basis that discovery of the loss should be tolled in order to protect the insured's customer-investors. The district court granted summary judgment in favor of the trustee, reasoning that principles of adverse domination and equitable tolling controlled. Although it stated in dicta that it expressed no opinion as to whether the trustee possessed greater rights than the insured and whether the customers had standing to recover under the bond, the court declined to apply the alter ego defense.<sup>98</sup>

Several courts have declined to apply the alter ego defense when the wrongdoers have been excluded from recovering under the bonds.<sup>99</sup> In *FDIC v. Oldenburg*,<sup>100</sup> the court held that the alter ego doctrine did not apply because it was undisputed that any benefit arising from a payment under the bonds under which recovery was sought would accrue to the FDIC in its corporate capacity and not to the insured, the wrongdoer or any company owned by the wrongdoer.<sup>101</sup> In *FDIC v. Lott*,<sup>102</sup> the court declined to charge the insured with the wrongdoer's wrongful knowledge, reasoning, in part, that since the wrongdoer was specifically excluded from participating in any recovery, innocent shareholders and creditors should not have to bear a loss when the fraudulent majority shareholder will not benefit from his own fraud. In another case in which the court held for an insured, the court reasoned that the wrongdoer would not benefit from his own fraud because the insurer had a right of subrogation against the wrongdoer.<sup>103</sup>

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<sup>97</sup>153 B.R. 677 (E.D. Pa. 1993).

<sup>98</sup>In *Kerr*, 350 F.2d at 144-55, the court stated that a fidelity bond is "intended to protect the corporation from the fraud or dishonesty of its employees, not to protect its creditors from the fraud or dishonesty of its stockholders and directors." In *In re Prime Commercial Corp.*, 187 B.R. 785, 797 (Bankr. N.D. Ga. 1995), the court said that "[c]ases involving fidelity policies are not about balancing the rights of creditors with the interest of an insurer not to pay a thief. They are about interpretation of contracts of insurance." See also *Payroll Express*, 216 B.R. at 360 (distinguishing contractual alter ego doctrine).

<sup>99</sup>See Keith Witten, "Barn Burning" and What Can Be Done About It, 22 TORT & INS. L.J. 511 (1987), for an excellent discussion of the public policy issues relating to the alter ego defense and defenses to other types of insurance policies.

<sup>100</sup>34 F.3d at 1555.

<sup>101</sup>In support, the court characterized the alter ego doctrine as an equitable defense which permits the piercing of the corporate veil where a stockholder and a corporation have not maintained separate identities.

<sup>102</sup>460 F.2d at 87.

<sup>103</sup>*Transamerica Ins. Co.*, 489 N.W.2d at 229 n.7.

This approach has been criticized on the basis that whether a wrongdoer is excluded from participating from a recovery is unrelated to whether a wrongdoer has sufficient control of an insured during the time of the loss.<sup>104</sup>

### 5. When a Wrongdoer Has Not Been Specifically Excluded from Coverage

There are three cases that consider whether an insurer must specifically exclude a substantial owner of the insured to obviate coverage. In two cases the courts held that majority shareholders and principal officers were covered employees of the insureds because they were not specifically excluded from coverage.<sup>105</sup> The courts held that the insurers intended to provide coverage for the wrongdoers because the insurers had specifically excluded them from coverage in prior policies issued between the parties. The cases are unclear as to whether the insurers knew when they issued the policies that the wrongdoers were majority shareholders as well as principal officers of the insureds. In the third, and most recent case, the court held that the insureds sole shareholder, director and officer was not an employee even though he was listed in the insureds application for the bond.

First, in *General Finance Corp. v. Fidelity & Casualty Co. of New York*,<sup>106</sup> the court held that the president, director and majority shareholder was an employee of the insured because the insurer canceled a previous exclusion after the insured requested that the president be covered by the policy. In *In re Leedy Mortgage Co., Inc.*, the court held that a majority shareholder and principal officer was a covered employee under one policy because he was specifically excluded by a rider attached to another policy previously issued to the insured by the same insurer. The court reasoned that the insurer could have specifically excluded the wrongdoer from coverage if it wanted to, as it had in the prior policy.<sup>107</sup>

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<sup>104</sup>Armen Shahinian & Scott D. Baron, *Who is a Covered "Employee" Under the Financial Institution Bond?*, in FINANCIAL INSTITUTION BONDS 103, 131 (Duncan Clore ed., 2d ed. 1998).

<sup>105</sup>*Gen. Fin. Corp. v. Fid. & Cas. Co. of New York*, 439 F.2d 981 (8th Cir. 1971); *In re Leedy Mort. Co., Inc.*, 76 B.R. 440 (Bankr. E.D. Pa. 1987).

<sup>106</sup>439 F.2d at 981.

<sup>107</sup>There are three cases in which the court stated in dicta that if the insurers wanted to exclude majority shareholders from coverage, they should have specifically done so. *Lloyd Sec., Inc.*, 1992 WL 236162, at \*10; *Transamerica Ins. Co.*, 489 N.W.2d at 229 n.7; *Seattle Int'l Corp.*, 600 P.2d at 614. In these cases, there are no discussions as to whether the insurers knew prior to issuing the policies that the wrongdoers were majority shareholders of the insureds. *But see Hartford Acc. & Indem. Co. v. Hartley*, 275 F. Supp. 610 (M.D. Ga. 1967), *aff'd*, 389 F.2d 91 (5th Cir. 1968), in which the court held that a bankers blanket bond was void ab initio due to imputation principles, even though the wrongdoer signed the application for the bond, which stated that the knowledge of the signer would not be imputed to the insured.

Second, in *Conestoga Title Insurance Co. v. Premier Title Agency, Inc.*,<sup>108</sup> the insured's application said that it employed two employees plus the owner also indicated that there was one president, accountant and secretary/receptionist. The insured's assignee apparently contended that the insurer was estopped from denying the wrongdoer's status as an employee, because he was indirectly referenced in the application. The court rejected the contention, reasoning that the application did not refer to coverage, but merely requested the number and titles of the employees. The court noted that the insurer charged the same premium for up to five employees, and because there were less than five employees, the fact that he was listed as president had no effect on the premium.

Further, the court reasoned that there was nothing in the application indicating that the wrongdoer was the sole shareholder and sole director of the insured and that the insured sought to obtain coverage for him even though it had no control over him. The court explained that he might have been a covered employee had the insured had other shareholders and directors through whom the insured could have exercised control over him. The court concludes that even if the application were to be considered as part of the bond, the definition of employee would control whether the wrongdoer was a covered employee.

## **6. When an Insurer Has Prior Knowledge of a Wrongdoer's Ownership Interest in an Insured**

The cases indicate that an insurer's knowledge of a wrongdoer's ownership interest in an insured is another relevant factor in evaluating the merits of an alter ego defense. In one well known case, the court rejected two forms of the alter ego defense after the insured stipulated that it intended to cover the wrongdoer as an employee even though it knew that the wrongdoer was the sole shareholder and dominated the affairs of the insureds. In two other cases, the courts considered whether the insurers were estopped from denying the employee status of the wrongdoers.

In *Fidelity Deposit & Trust Co. of Maryland v. USAFORM Hail Pool, Inc.*,<sup>109</sup> the insureds were four related companies who acted as managers of insurance pools created by insurance companies to cover hailstorm damage to crops owned by insured farmers. In this capacity, they collected premiums for the members of the insurance pools. The receiver for the insureds sought to recover under a bond for losses allegedly caused by a person whom the parties stipulated as a matter of fact and law was the sole stockholder and alter ego of the named insureds.<sup>110</sup> The parties also

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<sup>108</sup>746 A.2d at 463.

<sup>109</sup>318 F. Supp. 1301 (M.D. Fla. 1970), *rev'd on other grounds*, 463 F.2d 4 (5th Cir. 1972), *rev'd after remand*, 523 F.2d 744 (1975), *after remand*, 465 F. Supp. 478 (1979).

<sup>110</sup>318 F. Supp. at 1305.

stipulated as a matter of fact and law that the wrongdoer was a covered employee under the bond and that the bond was in full force and effect at all times material to the suit.<sup>111</sup>

The insurer interposed, inter alia, two variations of the alter ego defense. Relying upon the *McKee* cases,<sup>112</sup> it argued that the bond did not cover loss caused by the wrongdoer because he was the alter ego of the named insureds. Next, the insurer argued that coverage terminated under the knowledge and discovery provisions of the bond because other officers knew of the wrongdoer's wrongful acts.

With respect to the first argument, the court distinguished the *McKee* cases on the basis that under the wording of the bonds, the wrongdoer was himself a named insured, rather than an employee as was the case in the *McKee* cases. Further, the court reasoned the testimony revealed that when it issued the bond, the insurer knew everything about the insured's operation, including the fact that the wrongdoer controlled the insureds.

With respect to the insurer's second argument, the court reasoned that the insurer knew when it wrote the bond that there was no one to whom it could look to or rely upon to give notice of the wrongdoer's misconduct and that the insurer also knew that the wrongdoer was the only person who could steal anything of consequence, namely the premium deposits belonging to the pool participants. The court concluded that the insurer was aware that the wrongdoer was the only person "in authority" as that term was used in the notice provisions of the bond and intimated that the insurer waived the notice and discovery provisions of the bond insofar as the wrongdoer was concerned because the insurer knew that the wrongdoer was the sole stockholder and alter ego of the insureds when it wrote the bond. The court found, however, that there were no other officers, as that term was used in the bond, who could have discovered the wrongful conduct for purposes of the notice and termination provisions of the bond. As a result, the court rejected the insurer's alter ego defenses.<sup>113</sup>

A related issue was addressed in *Employer's Administrative Services, Inc. v. Hartford Accident & Indemnity Co.*,<sup>114</sup> in which the insured argued that the insurer should be estopped from denying the employee status of two wrongdoers who were the sole shareholders, officers and directors of the insured because the insurer

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<sup>111</sup>*Id.*

<sup>112</sup>*McKee v. Great Am. Ins. Co.*, 316 F.2d at 473; *McKee v. Am. Cas. Co. of Reading, Pa.*, 316 F.2d at 428.

<sup>113</sup>*But see, Thrift Fed. Sav. & Loan v. Overton*, 563 N.E.2d 289 (Ohio 1990) (after insured admitted wrongdoer was its alter ego, court held that loss caused by acts of the wrongdoer was not covered due to a provision in the bond excluding loss caused by any fraudulent, dishonest or a criminal act of the insured).

<sup>114</sup>709 P.2d 559 (Ariz. Ct. App. 1985).

represented to third parties that the insured was covered for losses resulting from the dishonest act of its employees, which included the wrongdoers because they were corporate officers. In denying the contention, the court reasoned that there was no evidence that the insurer was aware that the wrongdoers were the sole officers, directors and shareholders of the insured, and noted that neither the insured's application nor subsequent information submitted to the insurer revealed that the wrongdoers were the sole employees of the insured. The court also reasoned that there was no evidence that the insurer issued the policy knowing that it would not cover the fraudulent acts of the wrongdoers.<sup>115</sup>

Recently, in *Bird v. Centennial Insurance Co.*,<sup>116</sup> the insureds' assignee argued that the insurer was estopped from denying coverage under two fidelity bonds on the basis that the insurer allegedly knew of the insureds' corporate structures at the time it issued the policies. The court of appeals reasoned that estoppel was an equitable argument, and held that the assignee was barred from asserting it under the doctrine of unclean hands because the insureds had previously been adjudged liable for the underlying conduct which formed the basis of the bond claims.<sup>117</sup>

Consequently, some courts have applied principles of waiver and estoppel when considering the merits of an alter ego defense. In doing so, courts have examined whether an insurer knew prior to issuing a bond the identity of an insured's major stockholders and the extent to which an insurer was aware of an insured's operations and potential for controlling stockholders to dominate and control the insured.

### ***III. Conclusion***

The alter ego defense has been interpreted in a variety of, and often confusing, contexts. For that reason, the type of bond under which recovery is sought is important because it may dictate the way in which the issue is presented to and analyzed by the court. Commercial fidelity bonds usually contain a specific definition of employee, which, among other things, includes only those persons whom an insured has the right to direct or control in the performance of services. Accordingly, the primary issue in those cases is whether an owner-wrongdoer is controlled by the insured. Thus, in cases involving commercial fidelity bonds, the alter ego defense can be presented by an insurer to show that loss resulting from the acts of an owner-wrongdoer is not a loss caused by a covered employee.

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<sup>115</sup>As noted above, the court in *Conestoga v. Premier*, 746 A.2d at 465, noted that the application did not indicate the wrongdoer was the sole shareholder and director of the insured.

<sup>116</sup>11 F.3d at 234.

<sup>117</sup>The court also characterized the *Hail Pool* case as an estoppel case, and distinguished it on its facts.

This does not mean, however, that the alter ego defense is not applicable to claims involving financial institution bonds. Some financial institution bonds, such as Standard Forms 25 and 14, contain definitions of employee similar to that contained in commercial fidelity bonds. In cases involving Standard Form 24 or similar financial institution bonds, the alter ego defense has been asserted by insurers in support of defenses based upon misrepresentation, termination of coverage or failure to give timely notice. In those cases, the issue generally is not whether an owner-wrongdoer is a covered employee, but whether the insured should be charged with knowledge of the wrongful conduct. Some courts have applied principles of adverse domination in alter ego cases involving financial institution bonds, which could result in a tolling of discovery until an insured is notified of the loss by a third party. Nonetheless, since these cases often involve claims made by or on behalf of creditors of an insured, they can be discredited because the courts often fail to recognize that fidelity coverage is not a form of liability insurance or do not address other cases applying the alter ego defense against creditors or trustees in bankruptcy.

Further, there are some financial institution bond cases in which the courts recognized that in certain circumstances, acts of an owner-wrongdoer may be deemed to be acts of an insured. This argument may be particularly appropriate when the bond involved in the claim contains an exclusion for loss caused by an act of the insured. As a practical matter, when a wrongdoer owns a significant amount of an insured, and exercises a high degree of control over its affairs, these cases may not be substantially different from the cases involving late notice, misrepresentation, or termination of coverage, given that if an insured is charged with committing the wrongful acts, it should be charged with knowledge of them. At least one court has refused to disregard the insured separate corporate identity, while at the same time held that the wrongdoer exercised sufficient control over the insured such that she was not a covered employee. Although not specifically discussed by the courts, it would appear that the evidentiary burden of proof for concluding that a wrongdoer is not an employee, or that the insured should be charged with the wrongdoer's knowledge, would be less than if the court were to disregard the corporate entity altogether.

In a related context, there may be occasions when acts of an owner-wrongdoer who owns less than a significant amount of an insured may be deemed to be acts of the insured, if, for example, the insured's board of directors ratified, benefitted from or accepted responsibility for the owner-wrongdoer's conduct. Thus, in claims involving financial institution bonds, an insurer's arguments may depend upon exclusions contained in the bond, when the acts giving rise to the claim occurred or whether the claim is being made by or on behalf of sympathetic creditors of the insured.

The primary issues considered by courts when evaluating the merits of an alter ego defense are the amount of a wrongdoer's ownership interest in an insured and the

extent to which the wrongdoer controls the management and operations of the insured.

As an ancillary matter, it is important to note that one court upheld a trial court's finding that loss caused by an owner-wrongdoer was not covered because the owner-wrongdoer may not have possessed the requisite manifest intent to cause the insured to suffer a loss. This is significant because it may provide a defense in the absence of other evidence which may support an alter ego defense. For example, a defense based upon lack of manifest intent may be available when an owner-wrongdoer does not own a controlling amount of an insured, but would nonetheless suffer financial ruin if he or she intended the insured to suffer a loss.

In conclusion, the precise nature of any alter ego defense will depend upon the type of bond and nature of the facts involved in the claim. This article provides a meaningful starting point from which one can analyze the legal and factual issues presented by a claim.