

PROPERTY INSURANCE AND THE INNOCENT CO-INSURED: WAS IT ALL PAY AND NO GAIN FOR THE INNOCENT CO-INSURED?

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I. INTRODUCTION

For more than a century, courts have attempted to define the rights of an innocent co-insured when another insured has fraudulently caused a loss under an insurance policy.¹ Early cases denied recovery to an innocent co-insured based on the public policy of preventing a wrongdoer from benefiting from his or her wrong.² Recently, however, the trend has been to allow an innocent co-insured to recover under a policy language analysis.³ This Note briefly discusses property insurance coverage⁴ and examines several theories of recovery as they relate to the innocent co-insured spouse, partner, and corporation.⁵ It concludes with a

1. Ronald A. Hobgood & F. Anthony Lamb, *Recovery by an Innocent Co-Insured*, FOR THE DEFENSE, July 1993, at 3.

2. See, e.g., *Bellman v. Home Ins. Co.*, 189 N.W. 1028 (Wis. 1922), overruled by *Hedtkke v. Sentry Ins. Co.*, 326 N.W.2d 727, 740 (Wis. 1982).

3. See, e.g., *Vance v. Pekin Ins. Co.*, 457 N.W.2d 589 (Iowa 1990).

4. See *infra* part II.

5. See *infra* parts III-IV.

discussion of insurance policy construction principles and a drafting suggestion for insurers.⁶

II. PROPERTY INSURANCE COVERAGE OVERVIEW

The primary purpose of property insurance is to protect persons or other entities "against the risk of loss or damage due to fortuitous circumstances."⁷ The property covered by the insurance policy is the subject matter of the insurance, "but it is apparent that it is the risk of loss or liability for such property that is primarily important."⁸ The insurer has the power to select and control the property risk it is willing to undertake.⁹

Under most policies, the insurer does not cover all risks.¹⁰ Policy conditions or exclusions enable an insurer to limit the risks it undertakes.¹¹ A policy condition may be a condition precedent or a condition subsequent.¹² A condition subsequent "is a condition whose satisfaction suspends or terminates the agreement."¹³ A condition precedent is "either a condition whose satisfaction is necessary for the insurance agreement to become final and binding, or a condition an insured must satisfy in order to recover for a loss under that agreement."¹⁴ A fraud condition, for example, "obligates an insured not to conceal or misrepresent any fact or circumstance relating to the insured property."¹⁵

A policy exclusion refers to risks the insurer does not accept and the policy does not cover.¹⁶ Generally, nonfortuitous losses, such as fraud or misconduct on the part of the insured, are excluded from the policy.¹⁷ For example, an intentional act exclusion bars recovery by an insured who intentionally caused a loss.¹⁸ This exclusion "avoid[s] giving an insured a license to commit wanton and otherwise wrongful acts against the insured property."¹⁹ If an insured's act

6. See *infra* part VI.

7. WARREN FREEDMAN, RICHARDS ON THE LAW OF INSURANCE § 1:56, at 129 (6th ed. 1990). See also MARK A. RHODES, 10A COUCH ON INSURANCE 2D § 42:12, at 159-60 (rev. ed. 1982) (stating "[a] contract of fire insurance is one of indemnity whereby the insurer agrees to protect the insured against certain stated types of loss to the extent of the coverage stipulated in the policy").

8. FREEDMAN, *supra* note 7, at 130.

9. *Id.* at 131.

10. RHODES, *supra* note 7, at 148.

11. Hobgood & Lamb, *supra* note 1, at 3.

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. RHODES, *supra* note 7, at 148.

18. Hobgood & Lamb, *supra* note 1, at 3.

19. *Id.*

or omission violates a policy condition or exclusion, the insured will be precluded from recovery under the policy.²⁰

The presence of an innocent co-insured, however, may allow recovery under the policy even though another co-insured violated a policy condition or exclusion. For example, an innocent co-insured may recover even though another insured intentionally destroyed the property.²¹ Recovery by an innocent co-insured spouse depends on whether the court bases recovery on a theory of property law—reasonable expectations—or the language of the contract.²² Recovery by an innocent co-insured partner also depends on whether a court uses property law principles to find the policy obligations joint or several, or whether it relies on contract language to determine the partner's obligations.²³ Finally, recovery by a corporation turns upon whether the court bases recovery on the amount of stock the wrongdoing shareholder owned, the amount of control the wrongdoing shareholder had over the corporation, corporate assent to the wrongdoing shareholder's acts, or the policy language.²⁴

III. INNOCENT SPOUSE COVERAGE

Whether an innocent spouse may recover under an insurance policy depends upon how the courts decide several factors. Recovery may depend on "a determination of whether the contract interests are joint or severable."²⁵ Another factor is whether the courts use contract or property law to govern the interpretation of the innocent insured's rights under the policy.²⁶ Finally, recovery may depend on how the courts weigh the "desire to avoid a possible benefit to the wrongdoer" against the desire to prevent "the imposition of fraud on an innocent party."²⁷

Over the years, three theories of recovery have emerged. The first theory considers the relationship of the parties and the nature of the property ownership.²⁸ The second theory considers the reasonable expectations of the contracting parties to determine whether an innocent spouse may recover.²⁹ The

20. Hobgood & Lamb, *supra* note 1, at 3-4. For example, the voluntary and intentional burning of insured property by the insured or by another with his authority "does not create a right of recovery upon the policy." 43 AM. JUR. 2D *Insurance* § 493, at 562 (1982). False statements as to material matters will also "preclude any recovery on the policy by the insured." 44 AM. JUR. 2D § 1371, at 299 (1982).

21. 43 AM. JUR. 2D *Insurance* § 493, at 562-63 (1982).

22. *See infra* text accompanying notes 25-97.

23. *See infra* text accompanying notes 98-135.

24. *See infra* text accompanying notes 136-89.

25. Leane English Cerven, *The Problem of the Innocent Co-Insured Spouse: Three Theories on Recovery*, 17 VAL. U. L. REV. 849, 856 (1983).

26. *Id.*

27. *Id.*

28. *Id.* at 855-57; *see infra* text accompanying notes 31-57.

29. Hobgood & Lamb, *supra* note 1, at 9; *see infra* text accompanying notes 58-64.

final theory considers the language of the policy and determines recovery based upon the particular language used to define who is insured.³⁰

A. *Early View: No Recovery Based on Relationship of the Parties and Property Ownership*

Historically, courts have viewed the innocent co-insured spouse's ability to recover in light of the relationship between the insureds and the nature of the property ownership.³¹ Under this theory, courts denied recovery because the policy was joint,³² which created a "joint obligation not to commit fraud."³³ When one insured violated that obligation, the violation was "chargeable to both insureds and preclude[d] recovery by the innocent joint insured."³⁴ Although the courts denied recovery because the contract was joint, they were often "unclear as to how they arrive[d] at this decision."³⁵

"Some courts reasoned that policy rights and obligations were joint because insurance policies were usually written in the names of both spouses."³⁶ For example, in *Rockingham Mutual Insurance Co. v. Hummel*,³⁷ the Virginia Supreme Court considered whether an innocent spouse was entitled to a share of the insurance proceeds when the husband intentionally set fire to the property.³⁸ The court held the legal interest in the property was joint, noting that the property was owned in tenancy by the entirety.³⁹ Further, the court noted the policy was written in the name of both the husband and the wife:

[T]he form of the insurance contract was joint; the "Named Insured" was "Harold Lee and Mildred Hummel." Thus under the policy and as the "insured," each spouse had the joint obligation to use all reasonable means to save and preserve the property. Likewise each spouse had the joint duty to refrain from defrauding the insurer.⁴⁰

30. Cerven, *supra* note 25, at 865-69; see *infra* text accompanying notes 65-97.

31. Cerven, *supra* note 25, at 857-58; see also Hobgood & Lamb, *supra* note 1, at 3-4.

32. Cerven, *supra* note 25, at 858.

33. Marvin L. Karp, *Arson and the Innocent Co-Insured*, 22 SPRING BRIEF 8, 10 (1993), available on WESTLAW.

34. *Id.* (quoting *Klemens v. Badger Mut. Ins. Co.*, 99 N.W.2d 865, 866 (Wis. 1959); see also *Matyuf v. Phoenix Ins. Co.*, 27 Pa. D. & C.2d 351, 365 (1933) (stating "[w]hen two joint owners of property . . . are jointly insured by one policy, it is implied, by the very nature and fundamental purpose of the insurance contract, that a fraudulent and felonious burning by either of the joint owners who are jointly insured is not included within the contemplated risks").

35. Cerven, *supra* note 25, at 858.

36. Hobgood & Lamb, *supra* note 1, at 4.

37. *Rockingham Mut. Ins. Co. v. Hummel*, 250 S.E.2d 774 (Va. 1979).

38. *Id.* at 775.

39. *Id.* at 776.

40. *Id.*

Other courts relied upon the theory that "a married couple constitutes a single entity under the law."⁴¹ The property interests of a husband and wife were regarded as "inextricably intertwined," and contract interests were considered "inseparable."⁴² "[S]uch an argument effectively imputed the wrongdoing of the guilty insured to the innocent co-insured."⁴³

Joint tenancy or tenancy by the entirety also provided support for this position.⁴⁴ "The rationale was that, since the insureds owned the property jointly, the insurable interest in the property was also joint."⁴⁵ In *Jones v. Fidelity & Guaranty Insurance Corp.*,⁴⁶ the innocent co-insured sought to recover on community property that was feloniously burned by her ex-husband.⁴⁷ The divorce decree did not dispose of the property.⁴⁸ The court concluded that, although the parties were divorced, they "did not cease to be joint owners of the insured property."⁴⁹ Joint ownership carried with it the "joint obligation on the part of the owners to save and preserve the property."⁵⁰ Based on this reasoning, the court denied recovery by the innocent co-insured.⁵¹

Finally, courts pointed to the principle that a "wrongdoer should not profit from his or her own wrong" to support the denial of recovery.⁵² Courts feared recovery by the innocent co-insured would directly or indirectly benefit the wrongdoer.⁵³ Thus, to avoid any benefit to the wrongdoing insured, the courts "simply prevented any of the insureds from recovering for the loss."⁵⁴

Other courts have rejected property interests and marital relationships as the basis for denying recovery to an innocent co-insured.⁵⁵

41. Cerven, *supra* note 25, at 861; see also Hobgood & Lamb, *supra* note 1, at 3 (stating courts "relied upon the fictional oneness of a married couple for the proposition that wrongdoing by one spouse precluded recovery by the other spouse").

42. Cerven, *supra* note 25, at 861-62.

43. Hobgood & Lamb, *supra* note 1, at 4.

44. *Id.*; see also Karp, *supra* note 33, at 10; Cerven, *supra* note 25, at 861.

45. Hobgood & Lamb, *supra* note 1, at 4; see also *Cooperative Fire Ins. Ass'n v. Domina*, 399 A.2d 502, 503 (Vt. 1979) (denying recovery because property was owned in tenancy by the entirety); *Rockingham Mut. Ins. Co. v. Hummel*, 250 S.E.2d 774, 776 (Va. 1979) (denying recovery in part because property was owned in tenancy by the entirety).

46. *Jones v. Fidelity & Guar. Ins. Corp.*, 250 S.W.2d 281 (Tex. Civ. App. 1952).

47. *Id.* at 282-83.

48. *Id.* at 281.

49. *Id.* at 282.

50. *Id.* at 282-83 (quoting 45 C.J.S. *Insurance* § 822(a) (1946)).

51. *Id.* at 283.

52. Hobgood & Lamb, *supra* note 1, at 4; see also *Short v. Oklahoma Farmers Union Ins. Co.*, 619 P.2d 588, 590 (Okla. 1980) (determining "[t]o allow recovery on an insurance contract where the arsonist has been proven to be a joint insured would allow funds to be acquired by the entity of which the arsonist is a member and is flatly against public policy").

53. Hobgood & Lamb, *supra* note 1, at 4.

54. *Id.*; see also *Short v. Oklahoma Farmers Union Ins. Co.*, 619 P.2d at 590; Cerven, *supra* note 25, at 862-63.

55. Karp, *supra* note 33, at 10.

[The Old View] has been criticized—we think rightfully so—both on insurance law principles and present day circumstances:

Because an insurance [policy] does not insure the property itself, the analogy drawn between the interests in the property and those under the [policy] is questionable. The proceeds of an insurance [policy] are personalty and are held in the same way as any personal property voluntarily acquired. Although the value of the insurance proceeds and that of the property are similar, the proceeds of an insurance policy are not a substitute for the property. Finally, the reliance on archaic legal fictions, such as the marital "unit" . . . is untenable in light of the Married Women Acts and the insurance changes in the legal treatment of marriage and marital property.⁵⁶

Some courts began to consider other approaches to the innocent co-insured issue and a second theory emerged, which "attempt[ed] to provide a fairer result."⁵⁷

B. Reasonable Expectations Theory

Courts dissatisfied with the early view turned to the reasonable expectations theory to determine the rights of an innocent co-insured spouse. Under this theory, "the test is not what the insurance company intended the words of the policy to mean but what a reasonable person in the position of the insured would have understood them to mean."⁵⁸

[T]his test will best protect the insurance company from fraud while assuring that the insurance company will not be unjustly enriched. It will also permit an innocent victim whose property has been destroyed to collect under an insurance policy for a loss reasonably expected to be covered. This test also avoids the imputation of criminal action to an innocent victim.⁵⁹

Thus, as long as the innocent spouse can show a "sole or major and separable interest in the insured property," the illegal destruction of the property will not bar recovery.⁶⁰

56. *Vance v. Pekin Ins. Co.*, 457 N.W.2d 589, 591 (Iowa 1990); see also *St. Paul Fire & Marine Ins. Co. v. Molloy*, 433 A.2d 1135, 1141 (Md. 1981) (stating whether property is held by the entirety was "of no real significance to the resolution of the issue of whether [the innocent co-insured spouse] may recover"); *Short v. Oklahoma Farmers Union Ins. Co.*, 619 P.2d at 591 (finding "[a] jointly insured party owning property jointly with an arsonist would be precluded from recovery under the contract without regard to his or her status as a spouse"); *American Economy Ins. Co. v. Liggett*, 426 N.E.2d 136, 139-40 (Ind. Ct. App. 1981) (stating to deny recovery based on the fiction of marital "oneness" is "a perversion of this legal fiction, designed to protect the spouses' rights and marital property, to use it to destroy the property rights of an innocent spouse").

57. Cerven, *supra* note 25, at 863.

58. *Hoyt v. New Hampshire Fire Ins. Co.*, 29 A.2d 121, 123 (1941) (citations omitted).

59. *Kulubis v. Texas Farm Bureau Underwriters*, 706 S.W.2d 953, 955 (Tex. 1986).

60. Cerven, *supra* note 25, at 864.

Courts and commentators, however, have criticized the reasonable expectations test. While the marital relationship is no longer important under this approach, the property interest remains material.⁶¹ "If the innocent party cannot prove his or her interest is severable, the wrongful conduct of the other spouse bars the innocent spouse from recovering under the policy. Proving divisibility of property interest may be difficult if not impossible."⁶² Further, commentators argue this theory "ignores the nature and extent of the parties' rights and duties as governed by the insurance contract."⁶³ Instead, it "removes the express intent of the parties from their agreement and substitutes in its place subjective intent, unexpressed by either party and contrary to unambiguous language in the written agreement, based on the 'reasonable expectation' of a hypothetical insured."⁶⁴

C. Current Trend: Policy Language Theory

The current trend allows an innocent co-insured to recover depending upon the policy language. "[R]ecovery depends—not on property rationales or marital relationships—but on a contract analysis of the insurance policy provisions."⁶⁵ Under this theory, "familiar principles of interpretation peculiar to insurance policies apply."⁶⁶ For example, courts will construe ambiguous policy language against the insurer.⁶⁷ If the language is ambiguous, the court will construe the provision in favor of the insured and find the rights and obligations under it are several as to each insured.⁶⁸ Thus, the innocent co-insured is allowed to recover for the loss.⁶⁹ If the language is unambiguous, however, the courts must apply the provision without construing it.⁷⁰ Therefore, if the language is unambiguous and indicates wrongdoing by one insured, which prevents recovery by all

61. *Vance v. Pekin Ins. Co.*, 457 N.W.2d 589, 592 (Iowa 1990); *see also Cerven, supra* note 25, at 865.

62. *Vance v. Pekin Ins. Co.*, 457 N.W.2d at 592 (citations omitted).

63. *Id.*

64. *Hobgood & Lamb, supra* note 1, at 10.

65. *Vance v. Pekin Ins. Co.*, 457 N.W.2d at 592.

66. *Id.*

67. *Id.*

68. *Id.* (citing *Cerven, supra* note 25, at 867-68); *see also Hobgood & Lamb, supra* note 1, at 6 (stating if "the language of the condition of exclusion is ambiguous, the court will construe the provision in favor of the innocent co-insured and allow that party to recover for the loss").

69. *Hobgood & Lamb, supra* note 1, at 6; *see also St. Paul Fire & Marine Ins. Co. v. Molloy*, 433 A.2d 1135, 1142 (Md. 1981).

"[U]nless the terms (of an insurance policy) are plainly to the contrary . . . the obligation of the carrier should be considered several as to each person insured, and the fraud or misconduct of one insured should not bar recovery by the innocent co-insureds to the extent of their respective interests in the property involved."

Id. (quoting *Howell v. Ohio Casualty & Ins. Co.*, 327 A.2d 240, 243 (N.J. Super. Ct. App. Div. 1974)).

70. *Hobgood & Lamb, supra* note 1, at 5-6 (citing *State Farm Fire & Casualty Ins. Co. v. Walker*, 459 N.W.2d 605, 610 (Wis. Ct. App. 1990)).

insureds, the rights and obligations are considered joint and the innocent co-insured cannot recover under the policy.⁷¹

Courts have generally found "the insured" to be ambiguous, possibly referring to either all insureds or only to the insured seeking recovery under the policy.⁷² Use of the term "any insured" has been found "unambiguous and refers to all insureds under the policy."⁷³ Finally, most courts have found that the use of the term "an insured" is unambiguous and refers to all insureds under the policy.⁷⁴

In *Dolcy v. Rhode Island Joint Reinsurance Ass'n*,⁷⁵ the Rhode Island Supreme Court considered whether an innocent, noncollusive spouse could recover under a fire insurance policy issued to both the husband and the wife on property they held as tenants by the entirety.⁷⁶ The wife filed for divorce against the husband and obtained a court order restraining him from interfering with and enjoining him from gaining access to the home.⁷⁷ In violation of the order, and without the wife's consent, the husband entered the home, assaulted the wife, and set fire to the premises.⁷⁸ The court noted the wife "had no control over [the husband's] conduct, had no knowledge of his actions in setting the fire, and did not misrepresent any facts or engage in any fraud in causing or contributing to the subject fire loss."⁷⁹

The insurer denied coverage under the "Intentional Loss" exclusion clause, which stated that no coverage was provided for intentional losses committed "by or at the direction of *an* insured."⁸⁰ The court focused on the term "an insured" in the provision to justify the insurer's denial of coverage:

When the Association states that it does "not insure against loss caused directly or indirectly by . . . an insured" who commits the loss intentionally, we think it clear that if any insured intentionally commits an act causing loss, no insurance is provided for the loss. Although it may sound simplistic to say that this case turns on the use of the article "an" instead of the article "the," when the exclusion is read in full we are bound to find the clause unambiguous.⁸¹

71. *Id.* (citing *Dolcy v. Rhode Island Joint Reinsurance Ass'n*, 589 A.2d 313, 316 (R.I. 1991)).

72. *Id.* at 7.

73. *Id.*; see also *Bryant v. Allstate Ins. Co.*, 592 F. Supp. 39, 41 (E.D. Ky. 1984) (stating such language is as "clear as spring water" and holding it barred recovery by an innocent spouse).

74. *Hobgood & Lamb, supra* note 1, at 7.

75. *Dolcy v. Rhode Island Joint Reinsurance Ass'n*, 589 A.2d 313 (R.I. 1991).

76. *Id.* at 313.

77. *Id.*

78. *Id.*

79. *Id.* at 313-14.

80. *Id.* at 315.

81. *Id.* at 316.

The court concluded both insureds had "a joint obligation to refrain from causing intentional loss because the Association did not insure for such a loss."⁸² Further, it stated the denial of coverage did not violate public policy.⁸³ "Presumably the insurer's lower exposure to liability because of the joint obligations of named insureds is reflected in lower premiums, and if the insured is dissatisfied with the result, he or she is free to purchase another policy naming that person individually as insured."⁸⁴

While the policy language theory "mitigates the harshness and inequities of the other two theories,"⁸⁵ it has been criticized as being "too overprotective of the marital relationship."⁸⁶ Further, it may invite collusion between the husband and wife and "create[] 'the virtually insurmountable obstacle of proving both the arson of one spouse, and the conspiracy between spouses in order to defeat recovery in the first instance.'"⁸⁷ To avoid these problems, one commentator has suggested it may be appropriate "to examine the status of the marriage at the time of the fire."⁸⁸ For example, if the couple is separated or divorced at the time of the fire, this may weaken the suspicion of spousal complicity.⁸⁹ Further, if the wrongdoing spouse dies as a result of the fire, "there is no danger of any subsequent benefit to the wrongdoer if the 'innocent' spouse is allowed to collect the proceeds."⁹⁰

Even if complicity is suspected, however, "the alleged innocence of the 'innocent' spouse will probably go unchallenged unless there is direct proof of collusion."⁹¹ The difficulty of proving spousal complicity and the threat of litigation for a bad-faith refusal to pay a claim encourage the insurer to settle the claim with its insured.⁹² To ease the difficulties faced by insurers under the contract language theory, it has been suggested that "[t]he burden of proof should be shifted to the 'innocent' spouse to establish his or her lack of involvement in the fraudulent acts of the other spouse."⁹³ For example, the Georgia Supreme Court has stated that once the insurer proves arson by one insured, the burden shifts to

82. *Id.*

83. *Id.*

84. *Id.*

85. Cerven, *supra* note 25, at 868.

86. *Id.* at 868-69. The marital relationship may be a factor in some "courts' treatment of the liability for the fraudulent conduct of the guilty spouse. It is at this point that the courts often confuse tort law with contract law principles." *Id.* at 869. In some cases it is unclear whether the court is relying on the liability for fraud or on the nature of the contract rights to determine the innocent spouse's ability to recover. *Id.* "The issue in these actions concerns the nature and extent of the contractual obligations under the insurance policy, not whether the denial of recovery is tantamount to an imputation of vicarious liability based on the marital relationship." *Id.*

87. *Id.* at 869 (quoting Paul B. Butler, Jr. & Bob G. Freemon, Jr., *The Innocent Coinsured: He Burns It, She Claims—Windfall or Technical Injustice?*, 17 FORUM 187, 210 (1981)).

88. *Id.* at 870.

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.* at 870-71.

93. *Id.* at 871.

the other insured to "prove her nonparticipation in the alleged wrongful conduct."⁹⁴

The best solution for the insurers, however, may be to simply revise the policy to include the use of unambiguous language.⁹⁵ If the insurers intend the fraudulent acts of one insured to void the policy as to the innocent co-insured, the policy should be drafted to reflect that intent. Thus, "any" or "an" insured should replace "the" insured in the fraud provision to indicate that the exclusion or condition applies to all insureds under the policy.⁹⁶ If the insurers continue to use "the insured" in the fraud provision, the courts should construe the ambiguity against the insurers and in favor of the insureds.⁹⁷

IV. INNOCENT PARTNER COVERAGE

Recovery by an innocent co-insured partner involves considerations similar to recovery by an innocent co-insured spouse. An early line of cases denied recovery because "all of the partners [are] bound by the fraud of one of the partners in contracts relating to the partnership."⁹⁸ Further, courts argued that to permit recovery would be against public policy because the wrongdoer would benefit from the wrong.⁹⁹ The more recent trend, however, allows innocent co-insured partners to "recover their proportionate interest under a policy for intentional destruction of partnership property by a partner as long as the wrongdoer does not benefit and the act was neither within the wrongdoer's authority nor done in furtherance of partnership business."¹⁰⁰

A. Early View: No Recovery Allowed Based on Joint Obligations of the Partners

Several courts have held "[t]he rule as to partnerships or joint venturers is that innocent partners and joint venturers are also barred from recovery where the

94. *Richards v. Hanover Ins. Co.*, 299 S.E.2d 561, 564 (Ga. 1983).

95. *Cerven*, *supra* note 25, at 872; *see also* *Hobgood & Lamb*, *supra* note 1, at 10.

96. *Cerven*, *supra* note 25, at 872; *see also* *Hobgood & Lamb*, *supra* note 1, at 10.

[T]here is no reason why this implied exception cannot be made an express exception in the policy. It could be written in bold letters and red ink across the face of the policy: IF YOU OR ANY PERSON INSURED BY THIS POLICY DELIBERATELY CAUSES A LOSS TO PROPERTY INSURED THEN THIS POLICY IS VOID AND WE WILL NOT REIMBURSE YOU OR ANYONE ELSE FOR THAT LOSS.

American Economy Ins. Co. v. Liggett, 426 N.E.2d 136, 141 (Ind. Ct. App. 1981).

97. *Hobgood & Lamb*, *supra* note 1, at 10.

98. *Zemelman v. Boston Ins. Co.*, 84 Cal. Rptr. 206, 207 (Cal. Ct. App. 1970).

99. *Bellman v. Home Ins. Co.*, 189 N.W. 1028, 1028 (Wis. 1922), *overruled by* *Hedtcke v.*

Sentry Ins. Co., 326 N.W.2d 727, 740 (Wis. 1982).

100. 5 JOHN A. APPLEMAN & JEAN APPLEMAN INSURANCE LAW AND PRACTICE § 3113, at 60 (Supp. 1994).

arson is perpetrated by a partner or a joint venturer."¹⁰¹ This rule stems from the belief that partnership contracts constitute joint obligations.¹⁰² Because the obligations under an insurance policy were considered joint, one partner's wrongdoing was imputed to all other partners.¹⁰³ Thus, when one partner burned partnership property in violation of a policy term, "it operate[d] to relieve the companies of all liability."¹⁰⁴

Courts have also noted that recovery should be denied as a matter of public policy. To permit recovery when a partner deliberately destroyed the insured property "would reward crime and shock the most fundamental notions of justice."¹⁰⁵ Further, "[t]o permit a recovery by either the partnership or the unoffending partner upon a policy of insurance issued to a partnership, insuring partnership property, where one of the partners has wilfully fired the insured property, is likewise repugnant to an intuitive sense of justice."¹⁰⁶

The early view has been criticized, however, because the cases "implicitly rest on the 'principle of fortuitousness,' that is, that insurance covers fortuitous losses and that losses are not fortuitous if the damage is intentionally caused by the insured."¹⁰⁷ "In *Bellman* the court applied the principle of fortuitousness to include not only the insured who engaged in misconduct, but the innocent insured as well."¹⁰⁸ The principle of fortuitousness, however, actually "require[s] rejection of the rule denying recovery by innocent insureds" because the loss is fortuitous as to the innocent co-insured.¹⁰⁹ By focusing on the policy language rather than the property ownership, courts can prevent the wrongdoer "from reaping financial benefit" from the fraudulent act while achieving a more equitable result.¹¹⁰

Courts following the early view assumed that "if there are several insureds, the joint nature of the insurance contract gives rise to joint interests and obliga-

101. *Erwin-Lawler Enters., Inc. v. Fire Ins. Exch.*, 73 Cal. Rptr. 182, 186 (Cal. Ct. App. 1968); see also *Miller & Dobrin Furniture Co. v. Camden Fire Ins. Co.*, 150 A.2d 276, 283 (N.J. 1959) (holding "[a]n innocent partner cannot recover on an insurance policy on partnership property which has been willfully burned by a co-partner"); *Continental Ins. Co. v. Gustav's Stable Club*, 317 N.W.2d 734, 740 (Neb. 1982) (noting the general rule that innocent partners are barred from recovery where the wrongdoing is perpetrated by a partner).

102. *Bellman v. Home Ins. Co.*, 189 N.W. at 1028; see also *Zemelman v. Boston Ins. Co.*, 84 Cal. Rptr. 206, 207 (Cal. Ct. App. 1970) (stating to reward dishonesty will retard public policy); *Hedtcke v. Sentry Ins. Co.*, 326 N.W.2d 727, 737 (Wis. 1982) (stating recovery turns upon "whether the interests and obligations of the insureds are considered joint or several," and if the interests are considered joint, "the misconduct of one insured is considered the misconduct of the other, and neither may recover under the policy").

103. *Bellman v. Home Ins. Co.*, 189 N.W. at 1028-29.

104. *Id.* at 1029.

105. *Id.* at 1028.

106. *Id.*

107. *Hedtcke v. Sentry Ins. Co.*, 326 N.W.2d 727, 738 (Wis. 1982).

108. *Id.*

109. *Id.*

110. *Id.*

tions on the part of each policyholder."¹¹¹ The modern trend, however, permits courts to "discard this conclusory maxim and turn instead to the language of the policy to determine whether the rights of the insureds are joint or several."¹¹²

Courts following the modern trend recognize the need to deter wrongdoers, "but also recognize the fundamental principle of individual responsibility for wrongdoing."¹¹³ Denying recovery to an innocent partner "implicitly imputes the guilt of the arsonist to the innocent insured."¹¹⁴ Punishing the innocent victim is "contrary to our notions of fair play and justice."¹¹⁵ Further, courts can fashion the modern rule to effectuate public policy and prevent wrongdoers from profiting from their wrong.¹¹⁶

B. Modern Trend: Recovery Permitted Based on Policy Language

Under the common law, "the . . . fraudulent wrongdoing of one partner, not within the scope of his authority or in furtherance of the partnership business, does not subject the other partners (or the partnership) to liability."¹¹⁷ To determine whether an innocent partner may recover under the modern rule, it is necessary to first consider whether the wrongdoing partner was acting outside the scope of his authority.¹¹⁸ If so, the question then involves contract interpretation: does the insurance policy modify the common law rule that the wrongdoing of one partner is not attributable to the other partners?¹¹⁹

Many courts have turned to the policy language to determine the obligations of each insured.¹²⁰ "The question whether two or more promisors have promised a single undivided performance, or have each promised a limited and separate performance, is wholly a problem of interpretation. The question is merely what was the performance promised and who promised it."¹²¹ Further, if the language is ambiguous and susceptible to more than one meaning, some

111. *Id.* at 738-39; *see, e.g.*, *Courts of the Phoenix v. Charter Oak Fire Ins. Co.*, 560 F. Supp. 858, 861 (N.D. Ill. 1983) (noting one line of authority denies recovery to an innocent co-insured "because the agreement of the insureds not to commit fraud is joint, with each promising that he and the other will not commit fraud").

112. *Hedtcke v. Sentry Ins. Co.*, 326 N.W.2d 727, 739 (Wis. 1982).

113. *Id.* at 740.

114. *Id.*; *see also* *Courts of the Phoenix v. Charter Oak Fire Ins. Co.*, 560 F. Supp. at 861 (stating both common law and an Illinois statute provide authority for the proposition that the fraudulent conduct of one partner, acting outside the scope of his authority, should not be attributed to the other partners).

115. *Hedtcke v. Sentry Ins. Co.*, 326 N.W.2d at 740.

116. *Id.*

117. *Courts of the Phoenix v. Charter Oak Fire Ins. Co.*, 560 F. Supp. 858, 860 (N.D. Ill. 1983).

118. *Id.* at 862; *see also* *Hogs Unlimited v. Farm Bureau Mut. Ins. Co.*, 401 N.W.2d 381, 386 (Minn. 1987).

119. *See* *Courts of the Phoenix v. Charter Oak Fire Ins. Co.*, 560 F. Supp. at 862; *see also* *Hogs Unlimited v. Farm Bureau Mut. Ins. Co.*, 401 N.W.2d at 386.

120. *Hedtcke v. Sentry Ins. Co.*, 326 N.W.2d 727, 738-39 (Wis. 1982).

121. *Id.* at 739 (quoting ARTHUR L. CORBIN, 4 CORBIN ON CONTRACTS § 926, at 704 (1951)).

courts interpret the language against the insurer or in accordance with the reasonable expectations of the insured.¹²²

In *Courts of the Phoenix v. Charter Oak Fire Insurance Co.*,¹²³ the court considered whether an innocent limited partnership could recover for a loss caused by the partnership's general partner.¹²⁴ The court found the general partner had acted outside the scope of his authority when he caused the loss.¹²⁵ The question then became whether the insurance policy modified the common law doctrine that wrongdoing by one partner acting outside his scope of authority is not imputed to the other partners.¹²⁶ The policy provision covering damage to the building excluded "loss occurring while the hazard is increased by any means within the control or knowledge of the Insured."¹²⁷ The court held this language was ambiguous and, therefore, was not sufficient to prevent recovery by the limited partners.¹²⁸ The court then examined the personal property provision, which excluded loss caused by "any fraudulent, dishonest, or criminal act or omission done by or at the instigation of any Insured, partner or joint adventurer in or of any Insured."¹²⁹ The personal property provision was "explicit enough to subject the limited partners to responsibility for the wrongful acts of the general partner," and the partnership was denied recovery on its personal property loss.¹³⁰

Another court considered the public policies involved in innocent co-insured issues and noted:

[N]otwithstanding the potential for fraud and profit from wrongdoing, the innocent insureds should not suffer for the aberration of a coinsured, whether a spouse or business colleague. We think this is the better public policy. We think it would be unfair and harsh to extend vicarious liability into this context.¹³¹

The court held an innocent partner is allowed to recover under the insurance policy if the fraud was not within the scope of the wrongdoer's authority nor in furtherance of partnership business and "payment of the insurance proceeds to the innocent partners can be accomplished to deny, in a practical manner, any appreciable benefit to the guilty partner."¹³²

Permitting recovery under the modern rule to the innocent co-insured partner may invite collusion between the partners. "In business ventures particularly

122. *Id.*

123. *Courts of the Phoenix v. Charter Oak Fire Ins. Co.*, 560 F. Supp. 858 (N.D. Ill. 1983).

124. *Id.* at 859.

125. *Id.* at 862.

126. *Id.*

127. *Id.* (quoting Building and Personal Property Special Form, § 1.I.1).

128. *Id.* at 863.

129. *Id.*

130. *Id.*

131. *Hogs Unlimited v. Farm Bureau Mut. Ins. Co.*, 401 N.W.2d 381, 386 (Minn. 1987).

132. *Id.*

in times of failing fortunes, the temptation to collect on insurance covering business assets may be more prevalent and the danger of collusion among investors may be enhanced."¹³³ Thus, the difficulties involved in proving a conspiracy among the partners must be overcome by the insurance company before it can deny recovery.¹³⁴ The best solution may be to revise the contracts to clearly state whether wrongdoing by one partner will void the policy as to the innocent partners.¹³⁵

V. CORPORATIONS

The innocent co-insured situation also surfaces when "the insured is a corporation and the . . . [wrongdoing] was committed or procured by an individual who owned only a portion of the stock."¹³⁶ Generally, "the willful burning of property by a stockholder of a corporation is not a defense against the collection of insurance by the corporation."¹³⁷ Many courts, however, rely on several different factors to deny recovery to a corporation when the property was destroyed by a shareholder or a person acting at the request or with the approval of the corporation.¹³⁸ Some courts pierce the corporate veil and deny recovery based on innocent co-insured partner principles.¹³⁹ Other courts deny recovery if the wrongdoer controlled the affairs of the corporation.¹⁴⁰ A third view denies recovery based on corporate assent or complicity.¹⁴¹ The more recent trend allows recovery based on contract language.¹⁴²

A. Piercing the Corporate Veil and Partnership Principles

When the fraudulent shareholder owns all or substantially all of the stock, "courts have pierced the corporate veil to treat the actions of the individual as those of the corporation."¹⁴³ Under this view, wrongdoing by a controlling shareholder allows the court to disregard the "corporate fiction . . . in order to prevent fraud."¹⁴⁴ Piercing the corporate veil permits the court to consider the corporation as a partnership and deny recovery because "innocent partners and

133. *Id.* at 385.

134. See *supra* text accompanying notes 91-92.

135. See *supra* text accompanying notes 95-97.

136. Karp, *supra* note 33, at 37.

137. 43 AM. JUR. 2D *Insurance* § 494, at 565 (1982); see also RHODES, *supra* note 7, at 482.

138. See *infra* text accompanying notes 143-87.

139. See *infra* text accompanying notes 143-46.

140. See *infra* text accompanying notes 160-65.

141. See *infra* text accompanying notes 168-75.

142. See *infra* text accompanying notes 176-87.

143. *Cora Pub. Inc. v. Continental Casualty Co.*, 619 F.2d 482, 486 (5th Cir.), *reh'g denied*, 629 F.2d 1349 (5th Cir. 1980); see, e.g., *Continental Ins. Co. v. Gustav's Stable Club Inc.*, 317 N.W.2d 734 (Neb. 1982); *Erlin-Lawler Enters., Inc. v. Fire Ins. Exch.*, 73 Cal. Rptr. 182 (Cal. Ct. App. 1968); *Miller & Dobrin Furniture Co. v. Camden Fire Ins. Co.*, 150 A.2d 276 (N.J. 1959).

144. *Miller & Dobrin Furniture Co. v. Camden Fire Ins. Co.*, 150 A.2d at 282.

joint venturers are . . . barred from recovery where the arson is perpetrated by a partner or a joint venturer."¹⁴⁵

The principle that a wrongdoer should not be allowed to benefit by his own wrongdoing also influences the courts. "[N]o one should be allowed to benefit by his own wrongdoing, and therefore the corporation should not be permitted to recover, since the recovery will redound to the benefit of the principal holder of its stock, the incendiary."¹⁴⁶

Piercing the corporate veil, however, has been criticized on several grounds. Although the legal identity of a corporation is separate from that of its stockholders,¹⁴⁷ some courts disregard the corporate entity under certain circumstances.¹⁴⁸ The general rule allows courts to pierce the corporate veil if there is "such a unity of interest and ownership that the separate personalities of the corporation and the individual [shareholders] no longer exist"¹⁴⁹ and if refusing to pierce the corporate veil would produce an inequitable result.¹⁵⁰

This rule, however, "suffers from a number of inadequacies."¹⁵¹ For example, when determining whether to pierce the corporate veil, courts "often focus on factors irrelevant to the substance of the plaintiff's claim,"¹⁵² such as whether the corporation observed the "details of corporate form."¹⁵³ Further, the use of a number of different theories to pierce the corporate veil has also caused confusion.¹⁵⁴

145. *Continental Ins. Co. v. Gustav's Stable Club, Inc.*, 317 N.W.2d at 740; *see also* *Erlin-Lawler Enters., Inc. v. Fire Ins. Exch.*, 73 Cal. Rptr. at 186; *Miller & Dobrin Furniture Co. v. Camden Fire Ins. Co.*, 150 A.2d at 283.

146. *Miller & Dobrin Furniture Co. v. Camden Fire Ins. Co.*, 150 A.2d at 283; *see also* *Continental Ins. Co. v. Gustav's Stable Club, Inc.*, 317 N.W.2d at 738 (holding insured corporation not allowed to recover when incendiary owned half of stock and played dominant role in management).

Likewise, under the principle of law that no one should be allowed to profit by his own wrong, an insured corporation will not be allowed a recovery on fire insurance policies where the incendiary owns all or practically all of the stock in the insured corporation, or is in exclusive management of the corporate property.

43 AM. JUR. 2D *Insurance* § 494, at 565 (1982).

147. Boyce L. Graham, Comment, *Navigating the Mists of Metaphor: An Examination of the Doctrine of Piercing the Corporate Veil*, 56 J. AIR L. & COM. 1135, 1135 (1991); *see also* Patricia A. Carteaux, *Corporations—Shareholder Liability—Louisiana Adopts a Balancing Test for Piercing the Corporate Veil*, 58 TUL. L. REV. 1089, 1091 (1984) ("The concept of a corporation as an entity separate and distinct from its shareholders is a universally accepted legal fiction.").

148. Carteaux, *supra* note 147, at 1092.

149. Michael J. Gaertner, Note, *Reverse Piercing the Corporate Veil: Should Corporation Owners Have It Both Ways?*, 30 WM. & MARY L. REV. 667, 679 (1989).

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.* at 680.

The inconsistent articulation and application of these theories have left the law of piercing the corporate veil in hopeless disarray in many jurisdictions. One writer has observed that "courts espouse numerous tests to justify disregarding corporateness, while at the same time their rationales are frequently devoid of substance and dominated by loaded terminology. Thus, the deciding and differentiating factors used in a piercing . . . case are often impossible to determine."¹⁵⁵

This confusion is increased in situations in which a shareholder, rather than a third party, is seeking to pierce the corporate veil for his or her own benefit.¹⁵⁶

Because of the chaos surrounding veil-piercing, at least one commentator has suggested that when "law or equity provides an adequate remedy without piercing the corporate veil, the courts should refrain from the extraordinary step" of piercing the corporate veil.¹⁵⁷ Several courts have denied recovery to a corporation without resorting to veil-piercing.¹⁵⁸ For example, some courts consider the amount of control the wrongdoing shareholder exercised over the corporation.¹⁵⁹

B. *Extent of Wrongdoer's Control Over Corporation*

A corporation's recovery has been denied when the fraudulent shareholder "is in exclusive management of the corporate property."¹⁶⁰ Because the wrongdoing shareholder dominates the corporate affairs, courts have "imputed the arson of the individual to the corporation, on the ground that when the owners entrust the business to one person, they should be bound by his actions."¹⁶¹

155. Cardeaux, *supra* note 147, at 1092 (quoting Patricia J. Hartman, Comment, *Piercing the Corporate Veil in Federal Courts: Is Circumvention of a Statute Enough?*, 13 PAC. L.J. 1245, 1251 (1982)).

156. Gaertner, *supra* note 149, at 681.

157. Graham, *supra* note 147, at 1182.

158. See, e.g., *United Gratiot Furniture Mart, Inc. v. Michigan Basic Property Ins. Ass'n*, 406 N.W.2d 239, 240-43 (Mich. Ct. App. 1987).

159. See, e.g., *Kimball Ice Co. v. Hartford Fire Ins. Co.*, 18 F.2d 563, 565 (4th Cir. 1927).

160. 43 AM. JUR. 2D *Insurance* § 494, at 565 (1982); see, e.g., *Kimball Ice Co. v. Hartford Fire Ins. Co.*, 18 F.2d at 565; *Vicksburg Furniture Mfg., Ltd. v. Aetna Casualty & Surety Co.*, 625 F.2d 1167 (5th Cir. 1980); *United Gratiot Furniture Mart, Inc. v. Michigan Basic Property Ins. Ass'n*, 406 N.W.2d at 242.

161. *Cora Pub, Inc. v. Continental Casualty Co.*, 619 F.2d 482, 486 (5th Cir. 1980); see also *United Gratiot Furniture Mart, Inc. v. Michigan Basic Property Ins. Ass'n*, 406 N.W.2d at 242-43 ("[T]he value of a noncontrolling interest in a corporation is always largely dependent on the judgments and choices which the controlling faction makes. When those in control make bad decisions, the corporation suffers loss. As a natural consequence, such loss falls upon all shareholders.").

Those in a corporation who have charge of its control are supposed to manage its assets in the way they regard as most advantageous to its welfare. If instead for instance of selling the personal property for a profit, those who do the thinking and planning for the corporation think it best to burn it up and collect much more than its value from an insurance company, in our judgment all that

In *Kimball Ice Co. v. Hartford Fire Insurance Co.*,¹⁶² the actions of a corporate officer who exercised exclusive control and management of the corporate property, although owning only twenty-five percent of the stock, prevented the corporation from recovering under a fire insurance policy.¹⁶³ The court also noted that to allow recovery in that case would be against public policy.¹⁶⁴ "Fraudulent losses are necessarily excepted upon principles of general policy and morals; for no man can be permitted, in a court of justice, to allege his own turpitude as a ground of recovery in a suit."¹⁶⁵

This theory has been criticized on the grounds that the criminal acts of a manager of a corporation's business should not be attributed to the corporation without its knowledge or consent. Since the acts, even though evincing fraud or design, must be connected with the insured, it is not sufficient that they are the wilful and fraudulent acts of his servants or agents, if the insured is neither expressly nor impliedly a party thereto, and the acts have been done without his procurement, privity, and assent.¹⁶⁶

Based on this reasoning, some courts deny recovery only if the wrongdoer acted at the request or with the assent of the insured corporation.¹⁶⁷

C. Corporate Assent or Complicity

Several courts found that "arson may not be attributed to a corporation unless the perpetrator of the arson acted with the corporation's assent."¹⁶⁸ These cases "typically involve closely-held corporations in which principal officers, stockholders or general managers are implicated in the fraud."¹⁶⁹ Circumstantial evidence may be used to show "that an arsonist acted at the request or with the assent of an insured corporation."¹⁷⁰

In *Cora Pub, Inc. v. Continental Casualty Co.*,¹⁷¹ the court noted several factors that indicated the corporation's complicity in the destruction of a restaurant: The corporate owner had attempted to withdraw from the restaurant, there was evidence of intentional destruction of corporate records, and the corporation

need be said about the matter is that such is the manner in which the responsible management deems it best to handle the corporate affairs.

Northern Assurance Co. v. Rachlin Clothes Shop, Inc., 125 A. 184, 190 (Del. 1924).

162. *Kimball Ice Co. v. Hartford Fire Ins. Co.*, 18 F.2d 563 (4th Cir. 1927).

163. *Id.* at 565.

164. *Id.* at 566.

165. *Id.* (quoting *Columbia Ins. Co. v. Lawrence*, 35 U.S. 507, 518 (1836)).

166. *Owl & Turtle, Inc. v. Travelers Indem. Co.*, 554 F.2d 196, 198 (5th Cir. 1977).

167. *See id.*

168. *Mississippi Lofts, Inc. v. Lexington Ins. Co.*, 841 F.2d 251, 253 (8th Cir. 1988); *Cora Pub, Inc. v. Continental Casualty Co.*, 619 F.2d 482, 486 (5th Cir. 1980); *Owl & Turtle, Inc. v. Travelers Indem. Co.*, 554 F.2d at 198.

169. *Cora Pub, Inc. v. Continental Casualty Co.*, 619 F.2d at 487.

170. *Mississippi Lofts, Inc. v. Lexington Ins. Co.*, 841 F.2d at 253. Circumstantial evidence is especially important "where the corporation is closely-held and where principal officers or stockholders are implicated in the act." *Id.*

171. *Cora Pub, Inc. v. Continental Casualty Co.*, 619 F.2d 482 (5th Cir. 1980).

was in financial difficulty.¹⁷² The court stated that the suspected arsonist's position as general manager and secretary-treasurer of the corporation which owned the destroyed property, did not require it to hold, as a matter of law, that "he personified the corporation."¹⁷³ However, "the fact that arson was committed by an agent and officer of the corporation is evidence of the corporation's complicity."¹⁷⁴ Thus, the court denied the corporation recovery under the insurance policy.¹⁷⁵

D. Contract Language Theory

It has been suggested the real solution to the problem of corporate recovery is "to draft an appropriate policy exclusion."¹⁷⁶ Basing recovery upon the contract language avoids the problems of determining whether the corporate veil should be pierced, whether the wrongdoer dominated corporate affairs, or whether the corporation assented to the fraudulent act. For example, in *Minnesota Bond Ltd. v. St. Paul Mercury Insurance Co.*,¹⁷⁷ the court did not reach the issue of "[w]hether under the common law a corporation can be barred from recovery of insurance benefits when a 50 percent shareholder-officer intentionally destroys the corporate property by fire," because it found the specific provisions of the policy precluded recovery by the corporation.¹⁷⁸ The policy excluded damage "'caused by any willful or dishonest act or omission of the Insured or any associate, employee or agent of any insured, while working or otherwise.'" ¹⁷⁹ Because the act of arson was found to be the willful and dishonest act of an employee of the insured corporation, the court denied recovery to the corporation.¹⁸⁰

In *McCauley Enterprises, Inc. v. New Hampshire Insurance Co.*,¹⁸¹ a corporation was permitted to recover under an insurance policy that excluded losses "occurring . . . while the hazard is increased by any means within the control or knowledge of the insured."¹⁸² The court acknowledged "[t]he general rule that an innocent co-insured, whether partner . . . or spouse . . . cannot recover

172. *Id.* at 487.

173. *Id.*

174. *Id.*

175. *Id.*

176. Karp, *supra* note 33, at 38.

177. *Minnesota Bond Ltd. v. St. Paul Mercury Ins. Co.*, 706 P.2d 942 (Or. 1985).

178. *Id.* at 943.

179. *Id.* at 944.

180. *Id.* The court in *State Farm Fire & Casualty Ins. Co. v. Kane* reached a similar result. *State Farm Fire & Casualty Ins. Co.*, 715 F. Supp. 1558, 1561 (S.D. Fla. 1989). The court denied recovery to the corporate insured because the policy excluded loss caused by "any insured, partner, joint venturer, including an officer, director, trustee, employee or agent thereof." *Id.* The court found this language "unambiguous." *Id.* Thus, because the fire was set by the president of the insured corporation, it was found to be "clearly within the intended exclusion." *Id.*

181. *McCauley Enters., Inc. v. New Hampshire Ins. Co.*, 716 F. Supp. 718, 720 (D. Conn. 1989).

182. *Id.*

on a fire insurance policy where the property wilfully was destroyed by the other co-insured.'"¹⁸³ It found the cases following the general rule focused on "the relationship of the co-insureds, i.e., spousal, business, etc., or the underlying property interest, i.e., tenancy by the entirety, joint tenancy, etc."¹⁸⁴ The court declined to focus on those factors, however, and chose instead to "follow the more recent line of cases adopting a contract approach to the doctrine of innocent co-insureds."¹⁸⁵ Turning to the policy language, it found "when read in conjunction with the policy exclusion in issue and in accordance with the court's duty to construe ambiguous terms in favor of coverage, the policy definition of an 'insured' supports the conclusion that the interests of the co-insureds are severable."¹⁸⁶ Thus, the corporation was not barred from recovery by reason of the fraudulent conduct of a co-insured.¹⁸⁷

As with the innocent co-insured spouse and partners, the risk of collusion among shareholders, directors, or officers of corporations, especially closely-held corporations, increases during times of financial difficulties.¹⁸⁸ To avoid the problems associated with proving collusion,¹⁸⁹ it is important for the policy language to be unambiguous when defining whether the fraud provision will exclude coverage by the corporation if a shareholder, director, or officer of the corporation violates the exclusion.

VI. RULES OF CONSTRUCTION AND THE CONTRACT LANGUAGE THEORY

A. Construction and Interpretation of Insurance Policies

The construction rules governing insurance policies build on general contract rules.¹⁹⁰ For example, when the policy language is ambiguous, it should be construed against the party who caused the ambiguity to exist.¹⁹¹ The terms of an unambiguous policy, however, cannot be enlarged or diminished by judicial construction because a court cannot rewrite a policy using express and unambiguous terms.¹⁹² Further, even if the policy "contains harsh or onerous conditions," the court may not rewrite the policy to obtain an equitable result, as the parties were under "no legal compulsion . . . to deal with insurance companies upon the basis of such conditions."¹⁹³

183. *Id.* (quoting *Cooperative Fire Ins. Ass'n v. Domina*, 399 A.2d 502, 502 (Vt. 1979)).

184. *Id.*

185. *Id.*

186. *Id.* at 721.

187. *Id.*

188. *Hogs Unlimited v. Farm Bureau Mut. Ins. Co.*, 401 N.W.2d 380, 385 (Minn. 1987).

189. See *supra* text accompanying notes 91-92.

190. James M. Fischer, *Why are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. ST. L.J. 995, 1001-02 (1992).

191. *Id.* at 1002.

192. 43 AM. JUR. 2D *Insurance* § 271, at 343 (1982).

193. *Id.* § 271, at 344; see also FREEDMAN, *supra* note 7, § 11:2[b], at 244 (stating "[a]bove all, courts cannot, under the guise of construction, make a new contract for the parties"). In *Minnesota Bond Ltd. v. St. Paul Mercury Insurance Co.*, the court noted:

Similarly, the Doctrine of Reasonable Expectations (holding that a court should construe the insurance contract to honor the insured's reasonable expectations of coverage) follows from general rule of contract interpretation that courts: (1) look to the circumstances under which the contract was made; (2) seek to give effect to the mutual intention of the parties as reflected in the purposes of the contract; and (3) endeavor to give the contract a reasonable construction.¹⁹⁴

Again, if the intention of the parties is clear, a court may construe but not change the contract.¹⁹⁵ A court cannot "disregard the express language the parties have used when such language is capable of reasonable interpretation."¹⁹⁶

Some rules of construction, however, are unique to insurance policies.¹⁹⁷ For instance, courts often hold:

1. Contract terms providing coverage will be construed liberally whereas terms restricting coverage (exclusions) will be construed narrowly.
2. The language of the insurance contract is to be construed in accordance with the reasonable understanding of a layperson.
3. If semantically possible, the contract will be construed so as to achieve its objective of securing indemnity to the insured for the losses to which the insurance relates.¹⁹⁸

These three rules vary significantly from general rules of construction in contract law.¹⁹⁹

The rules of insurance policy construction express "a profound pro-insured bias."²⁰⁰ This construction in favor of the insured has been justified on several grounds. For example, an insurance policy is often referred to as an adhesion contract because the stronger party dictates the terms of the contract to the weaker party.²⁰¹ Because the insurer drafts the contract, the terms are often one-sided.²⁰² Thus, courts are willing to interpret ambiguities against the insurance

Although it may have been unwise for this insured to purchase a policy with such a far-reaching exclusion as contained in exclusion No. 4, nevertheless that decision was made by the plaintiff corporation when it chose to insure its property under this policy. The exclusion is clear and unambiguous and fully applicable to this loss.

Minnesota Bond Ltd. v. St. Paul Ins. Co., 706 P.2d 942, 944 (Or. 1985).

194. Fischer, *supra* note 190, at 1002.

195. 43 AM. JUR. 2D Insurance § 272, at 346 (1982).

196. *Id.*

197. Fischer, *supra* note 190, at 1004.

198. *Id.* at 1004-05.

199. *Id.*

200. *Id.* at 1007.

201. *Id.* at 1008-09.

202. FREEDMAN, *supra* note 7, § 11:2[f], at 250.

company as the drafter of the policy.²⁰³ Courts have also pointed to the unequal relationship between the insured and the insurer as a justification for a pro-insured construction.²⁰⁴ Under this view, courts refuse to enforce the contract based on unfairness either in the formation or in the content of the insurance policy.²⁰⁵ Other courts justify the rule by holding that the insurer and the insured have a fiduciary relationship.²⁰⁶ Finally, others point to the insurer's superior position to justify the pro-insured construction rules.²⁰⁷

B. The Contract Language Theory

In an innocent co-insured situation, courts using the contract language view have generally focused on how the policy defines the insured.²⁰⁸ The insured has been held to be ambiguous by a number of courts.²⁰⁹ "The unanimous view appears to be that such language is ambiguous because it is susceptible to more than one reasonable interpretation: 'the insured' could refer only to the insured seeking recovery, or it could refer to all insureds under the policy."²¹⁰ Because the language is considered ambiguous, courts construe the provision in favor of the innocent co-insured.²¹¹

The term "any insured" has also been considered by a number of courts, and the overwhelming majority view is the term is unambiguous and refers to all insureds under the policy.²¹² Under this provision, the rights and obligations of the insured are considered joint.²¹³ As a result, "wrongdoing by one insured violates the joint obligation among all the insureds to refrain from wrongdoing."²¹⁴

203. Fischer, *supra* note 190, at 1009.

204. *Id.* at 1015.

205. *Id.* at 1015-16.

206. *Id.* at 1025.

207. *Id.* at 1047.

208. See, e.g., Dolcy v. Rhode Island Joint Reinsurance Ass'n, 589 A.2d 313, 315-16 (R.I. 1991); Vance v. Pekin Ins. Co., 457 N.W.2d 589, 592-93 (Iowa 1990).

209. Hobgood & Lamb, *supra* note 1, at 7; see, e.g., McCauley Enters., Inc. v. New Hampshire Ins. Co., 716 F. Supp. 718, 720-21 (D. Conn. 1989); Hogs Unlimited v. Farm Bureau Mut. Ins. Co., 401 N.W.2d 381, 384-85 (Minn. 1987); Hedtcke v. Sentry Ins. Co., 326 N.W.2d 727, 739 (Wis. 1982).

210. Hobgood & Lamb, *supra* note 1, at 7.

211. See, e.g., Hogs Unlimited v. Farm Bureau Mut. Ins. Co., 401 N.W.2d at 384 n.3 (citations omitted); Courts of the Phoenix v. Charter Oak Fire Ins., 560 F. Supp. 858, 863 (N.D. Ill. 1983).

212. Hobgood & Lamb, *supra* note 1, at 7; see, e.g., Webb v. American Family Mut. Ins. Co., 493 N.W.2d 808, 812 (Iowa 1992); McCauley Enters., Inc. v. New Hampshire Ins. Co., 716 F. Supp. at 721. But see Ponder v. Allstate Ins. Co., 729 F. Supp. 60, 61 (E.D. Mich. 1990) (holding fire insurance provision stating policy would be void if "any insured" intentionally conceals or misrepresents a material fact did not bar recovery by an innocent co-insured because the provision did not comply with Michigan's mandatory statutory policy language).

213. Hobgood & Lamb, *supra* note 1, at 7.

214. *Id.*; see also Sales v. State Farm & Casualty Co., 849 F.2d 1383, 1385 (11th Cir. 1988) (stating "unlike the phrase 'the insured,' the phrase 'any insured' unambiguously expresses a

"An insured" has also been found unambiguous and refers to all insureds under the policy.²¹⁵ "Such language indicates a contractual intent that the rights and obligations under the exclusion or condition are joint instead of several."²¹⁶ Thus, "wrongdoing by one insured precludes recovery by all insureds."²¹⁷

Clearly, insurers should give careful attention to drafting exclusions and conditions intended to cover the fraudulent conduct of insureds. "Given the trend of the cases in recent years, any insurance company that believes it can rely on common law principles to defeat the claim of an innocent spouse, an innocent partner, or even a corporation owned by two or more unrelated individuals is living dangerously."²¹⁸ Insurers should re-examine policy language and replace ambiguous terms such as "the insured" with terms clearly expressing an intent to deny recovery to all insureds if any insured acts fraudulently.²¹⁹ Despite the improvements over other methods of determining innocent co-insured recovery, the policy language view is not without criticism. For example, the *Dolcy* decision, which adopted a strict contract interpretation approach to find the term "an insured" barred recovery for an innocent co-insured,²²⁰ has been criticized as being too protective of the insurer rather than the innocent co-insured.²²¹ Further, the fear of collusion and the possibility that a wrongdoer may profit from his or her wrong still exist under the contract language approach.²²²

The contract language theory, however, provides the insurer and the insureds with a clearer definition of the insureds' obligations under the policy.²²³ Further, it is more equitable because it avoids imputing the wrongs of one person to an innocent third party.²²⁴ Finally, the court can still avoid benefiting the wrongdoer by permitting the innocent co-insured to recover only if it will not benefit the fraudulent insured.²²⁵ Some courts, for example, allow the innocent co-insured to recover only his or her portion of the interest in the destroyed property.²²⁶

contractual intent to create joint obligations and to prohibit recovery by an innocent co-insured"), *rev'd on other grounds* 902 F.2d 933 (11th Cir. 1990).

215. *Id.*; see, e.g., *Dolcy v. Rhode Island Joint Reinsurance Ass'n*, 589 A.2d 313, 315-16 (R.I. 1991); *Vance v. Pekin Ins. Co.*, 457 N.W.2d 589, 592-93 (Iowa 1990).

216. *Hobgood & Lamb*, *supra* note 1, at 8.

217. *Id.*; see, e.g., *Vance v. Pekin Ins. Co.*, 457 N.W.2d 589 (Iowa 1990).

218. *Karp*, *supra* note 33, at 38.

219. See *Cerven*, *supra* note 25, at 872 (stating insurance companies should redraft their policies to reflect an intent to void the policy as to all co-insureds if one insured acts fraudulently).

220. *Dolcy v. Rhode Island Joint Reinsurance Ass'n*, 589 A.2d 313, 314-15 (R.I. 1991).

221. Michael E. Randazzo, *Topical Survey, Insurance*, 26 SUFFOLK U. L. REV. 552, 556-62 (1992).

222. See *supra* text accompanying notes 91-92.

223. See *Hobgood & Lamb*, *supra* note 1, at 10 (stating "construction of ambiguous policy terms protects insureds when policy language is unclear," but will enforce the terms as written if the language is unambiguous, thus serving "both equity and public policy").

224. *Hedtcke v. Sentry Ins. Co.*, 326 N.W.2d 727, 740 (Wis. 1982).

225. See *Hogs Unlimited v. Farm Bureau Mut. Ins. Co.*, 401 N.W.2d 381, 386-87 (Minn. 1987).

226. E.g., *Republic Ins. Co. v. Jernigan*, 753 P.2d 229, 235 (Colo. 1988); *Lewis v. Homeowners Ins. Co.*, 432 N.W.2d 334, 336-37 (Mich. Ct. App. 1988); see also *Cerven*, *supra* note 25, at 875.

VII. CONCLUSION

The issue of innocent co-insured recovery is by no means a settled area of the law. Various theories govern the recovery of an innocent co-insured spouse, partner, or corporation. The recent trend in case law, however, indicates that more courts are relying on insurance policy language to permit or deny recovery. Use of the term "the insured" has generally been found ambiguous and is construed against the insurer. On the other hand, use of "any insured" or "an insured" has been found clear and explicit, and bars recovery to all insureds should any insured violate a policy provision. Insurers should review their policy language and replace any ambiguous language with language evidencing a clear intent to deny recovery to all insureds if any insured commits a fraud.²²⁷

Courts should also adopt the contract language approach. Use of contract language permits recovery to the innocent co-insured regardless of the underlying property interests or the insureds' relationship to one another. Further, such an approach is equitable because it is within the power of the insurance company to define the coverage terms of the policy in clear and unambiguous language. If an ambiguous term is used, it should be construed against the insurer. Finally, the public policy of preventing a wrongdoer from profiting from his or her wrong can also be advanced by carefully constructing the innocent co-insureds recovery to prevent any benefit to the fraudulent insured. For example, the innocent co-insured may be permitted to recover only his or her interest in the property.

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227. Karp, *supra* note 33, at 38. "[E]very company would be well advised to review (and revise) the language of its policies." *Id.*

