IN FACT AND IN LAW

Insurance Law

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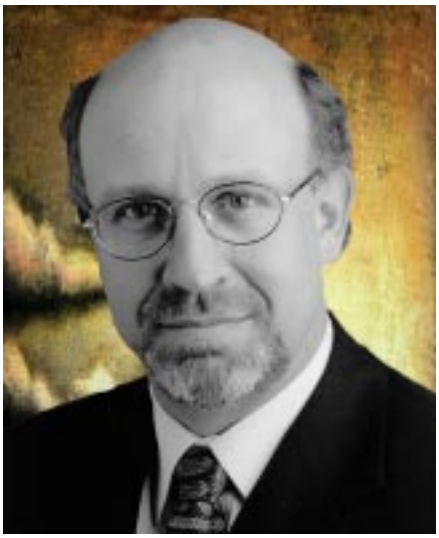
The Wilful Misconduct of a Shareholder
is Imputable to the Insured Company

by Pierre F. Carter

On January 25, 1999, the Court of Appeal, in Miscou Motel *v.* Général Accident, Compagnie d'Assurance du Canada[1]*, rendered a decision on the effect of the voluntary act of a shareholder on the rights of the company and of his fellow shareholder to the insurance indemnity and, secondly, on the effect of a hypothecary guarantee clause stipulated in the insurance contract where there was no hypothec at the time the contract was entered into but where a hypothecary loan was subsequently granted.*

The Facts

A fire completely destroyed the Miscou Motel, which was owned by a company controlled by two shareholders, one of whom was the principal shareholder (66.6%) and the other a minority shareholder (33.4%). The insurance company refused to indemnify the shareholders alleging that the fire was probably started by the criminal act of the minority shareholder.



In addition to claiming the insurance indemnity from the insurer, the shareholders and the company sued the broker, who had failed to add to the insurance contract a hypothecary endorsement in favour of the bank that granted the company a $35,000 loan a few months after the insurance policy was issued. The insurance contract actually included a standard hypothecary clause but the name of the creditor had been left blank because there was no hypothec when the policy was signed.

Although it had been duly advised of the loan by the insured when it was granted, the broker never informed the insurance company, and the latter therefore never accepted the specific hypothecary creditor, nor did it issue an endorsement confirming it. Just before trial, the bank intervened in the case to claim the capital and interest due on its loan from both the insurance company and the broker.

At trial, the Superior Court[2] concluded, based on the evidence, that the fire was intentionally set by the minority shareholder but it ordered the insurer to pay the entire insurance indemnity to the company. The principal shareholder of the company, who had not participated in the crime, should not, according to the judge, be denied coverage as a result of an act he had nothing to do with. In addition, the Superior Court rejected the hypothecary creditor's claim, finding that it was prescribed because it was based on delict and should have been instituted within two years after the fire.

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[1] *Général Accident, Compagnie d'Assurance du Canada v. Miscou Motel et al,* C.A.Q., 200-09-000490-935, 200-09-000467-933 and 200-09-000489-937, January 25, 1999, Justices Dussault, Rousseau-Houle and Robert.

[2] *Miscou Motel inc. et al v. Général Accident, Compagnie d'Assurance du Canada et al,* [1993] R.J.Q. 1928, [1993] R.R.A. 728, J.E. 93-1288 (S.C.), May 28, 1993, Justice René Letarte.

Pierre F. Carter has represented Général Accident, compagnie d'assurance du Canada in this case.

Court of Appeal Decision

The Court of Appeal overturned the Superior Court's decision based on three legal issues which may be summarized as follows:

Wilful Misconduct of the Company and the *Alter Ego* Doctrine

The *alter ego* or «second self» doctrine is often used in law to determine the civil or criminal liability of a company for acts committed by its controlling mind but rarely to determine its contractual rights. The identity of the controlling mind is sometimes difficult to determine but according to both the doctrine and jurisprudence, this concept must be examined based on a person's responsibilities within the company. Since authority can be delegated, there can be more than one controlling mind in the same company.

The Court of Appeal, despite the fact that the guilty shareholder only held a minority position in the company, concluded that the latter was one of the controlling minds of the company in the same way the principal shareholder was, since he was in charge of day-to-day operations of the business and generally responsible for ensuring that it ran smoothly. His wilful misconduct is imputable to the company and the insurer can therefore invoke it against the insured party.

The Court also stated that it is not necessary to prove collusion or conspiracy between the two shareholders for the insured company to lose its right to the insurance indemnity. The act of only one of its shareholders, provided such shareholder is one of the controlling minds of the company, is sufficient to make it lose its right.

Prescription of the Hypothecary Creditor's Recourse

Because the trial judge had found the hypothecary creditor's action to be prescribed, the Court of Appeal examined this question.

The Court declared that the hypothecary creditor's action was based on the insurance contract and that it was prescribed by three years. Prescription started to run at the end of the sixty (60) day period following the filing of the claim. In this case, the fire occurred on January 2, 1990 and the proof of loss was submitted on February 27, 1990; the three-year delay thus started to run on April 27, 1990, so the action taken by the hypothecary creditor on April 26, 1993 was not prescribed. The fact that the insurance company denied the existence of the contract does not alter the nature of the hypothecary creditor's claim, which could only be contractual.

Insurance Company's Absence of Knowledge of Identity of Hypothecary Creditor

The hypothecary creditor's claim is based on the existence of a hypothecary clause automatically included in the insurance contract even though the insurance contract was signed before the deed of loan and the insurance company was never informed of the existence of the hypothecary claim.

The Court of Appeal invoked the doctrine of two separate contracts developed by the Supreme Court[3] and the practice of automatically including a hypothecary clause in fire insurance policies even if there is no hypothec on the property. Justice Robert stated that we cannot automatically conclude from this practice that there are two separate contracts because there can be no common intention between the insurance company and the insured hypothecary creditor since the latter did not exist when the contract with the insured party was formed.

However, the question is still not settled because the mere existence of the hypothecary guarantee clause in the contract constitutes, according to the judge, a «firm offer» by the insurance company to enter into a contract if a hypothecary creditor ever appears. The latter would be entitled to the insurance as of right if it at least

[3] *National Bank of Greece (Canada) v. Katsikonouris* [1990] 2 R.C.S. 1029 and *Caisse Populaire des Deux-Rives v. Société Mutuelle d'Assurance contre l'Incendie de la Vallée du Richelieu [1990] 2 R.C.S. 995.*

brought the existence of the debt and its intention to take advantage of the hypothecary clause to the attention of the insurance company or its representative.

In this particular case, the creditor had actually indicated its intention to take advantage of the insurance company's offer concerning the hypothecary guarantee clause when the hypothecary debtor, mandated by the lender, advised the insurance broker of the existence of the debt and the fact that the bank wanted to take advantage of the hypothecary clause.

As a result, unless it had revoked the clause before the hypothecary creditor accepted it, the insurer was bound by the hypothecary creditor's mere indication of its acceptance.

According to Justice Robert, who wrote for the majority, for such an offer to exist, two conditions must be met from the hypothecary creditor's and the principal insured's point of view:

- the hypothecary deed of loan must contain a clause giving the principal insured a mandate to form a separate contract for the benefit of the hypothecary creditor;
- if the contract contains such a clause, the debtor, on behalf of the creditor, must notify «the insurer or its representative» of his intention to accept the offer.

In this case, the question arose as to whether the broker could be considered «the insurer or its representative». The Court concluded that the broker was the insurer's mandatary to receive such notification and to confirm the acceptance of the offer to enter into a contract. The fact that the broker signed the policy as a «qualified agent» and that one of the general conditions allowed any notice to be given by hand to the agency which had signed the contract lead to the conclusion that there was in fact a mandate. Since the insurer was duly notified by the lender's mandatary of the acceptance of the offer relating to the hypothecary guarantee clause, it is bound by that separate contract and must pay the indemnity owed to the creditor notwithstanding the wilful misconduct which was imputable to the insured company.

Justices Dussault and Rousseau-Houle held otherwise. Although they agree with the doctrine of two separate contracts and acknowledge the requirement for a mandate to the debtor, they are of the opinion that the mere fact that the hypothecary creditor required its debtor to obtain insurance gave effect to the hypothecary clause: "*in order for the second contract resulting from the standard hypothecary clause to be formed, it is not necessary that the debtor, on behalf of the hypothecary creditor, expressly advise the insurer or its representative that he accepts the offer made by the insurance company and wishes to take advantage of the hypothecary clause.*" p.3 (reasoning of Justice Thérèse Rousseau-Houle)

The notice recommended by Justice Robert is thus not an essential condition according to the majority opinion. Two conditions are therefore necessary to give the hypothecary creditor the status of a separate insured party:

- the mandate given to the debtor to insure the hypothecated property in the name and on behalf of the hypothecary creditor.
- the presence of a hypothecary clause in the insurance contract.

Conclusion

The application of the *alter ego* doctrine in insurance claims is, in our opinion, a great step forward in the fight against fraud. However, according to Supreme Court jurisprudence, the rights of the hypothecary creditor will be protected despite the wilful misconduct imputed to the insured company even, and this is new, if the identity of the hypothecary creditor was never revealed to the insurance company because of the practice of automatically inserting a hypothecary guarantee clause in the insurance policy.

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