

Chapter Two

AGENCY

A. INTRODUCTION

The law of agency is the law of delegation—i.e., the legal principles that govern the ability of one person (the principal) to have another person (the agent) act on his behalf. Basic agency relationships underlie virtually all commercial dealings in the modern world. For example, the relationship between a sole proprietor and his employees is governed by the law of agency, as is the relationship between a corporation and its officers. Technically, the agency relationship is not a form of business organization in and of itself; instead, agency is the mechanism by which business organizations function. To take an obvious example, a corporation—an artificial legal construct that has no physical being of its own—can act only through agents for everything it does. Regardless of whether the corporation is writing a check, selling a product, or entering into a multi-billion dollar merger, the law of agency is involved.

Agency concepts explicitly appear in the statutory schemes of many business organizations. In the general partnership, for example, partners are agents with apparent authority to bind the partnership for acts in the ordinary course of the partnership business.¹ While this principle presents itself as a partnership doctrine (it is in the partnership statute after all), and while it could be studied purely as a matter of partnership law, it is far easier to understand the principle if one is familiar with the agency concepts from which the principle derived. Even when the relevant business organization statute does not explicitly incorporate an agency principle, the common law of agency will apply unless it is clearly displaced by the statutory scheme at issue. Section 104(a) of the Revised Uniform Partnership Act, for example, indicates that “[u]nless displaced by particular provisions of this [Act], the principles of law and equity supplement this [Act],” and the comment states that the law of agency is encompassed within these supplementary principles. As a further example, § 301 of the Revised Uniform Limited Liability Company Act explicitly defers to the law of agency. In short, the study of agency law is directly related to the study of modern business organizations.

The principal sources of agency law today are the Second and Third Restatements of Agency. The American Law Institute—an association of lawyers, academics, and judges—authored the Restatements of Agency and, like all Restatements, their text and comments represent an effort to capture the law as developed by the courts. The Second Restatement of Agency was published in 1958, and the Third Restatement of Agency was published in 2006. Although the Restatements are not binding authorities, they are very influential and persuasive to many courts.

Because of the relatively recent publication of the Third Restatement, most of the existing case law deals with the Second Restatement. Nevertheless, the basic principles of the Second and Third Restatements are largely the same. The materials in this Chapter will discuss and cite to both versions.

¹ See, e.g., REV. UNIF. P'SHIP ACT § 301 (1997).

B. THE CREATION OF THE AGENCY RELATIONSHIP

1. DEFINING AGENCY

The Second Restatement defines *agency* as the “fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.”² The person who is acting for another is the *agent*; the person for whom the agent is acting is the *principal*. Parsing this definition reveals three primary elements of an agency relationship: (1) consent by the principal and the agent; (2) action by the agent on behalf of the principal; and (3) control by the principal. These elements reveal the general policy thrust of agency law—if there is mutual consent to an arrangement involving an agent acting to further the principal’s interest and subject to the principal’s control, then it is appropriate to make the principal liable for the agent’s actions.

Consent: Consent of both the principal and the agent is necessary to form an agency relationship. More specifically, both the principal and the agent must consent to the agent acting on the principal’s behalf and subject to the principal’s control. Thus, agency is a consensual relationship in which one person agrees to act for the benefit of, and subject to the control of, another person.

The principal must manifest (or convey) his consent to the agent. This required manifestation of consent may be written, oral, or implied from the parties’ conduct. The agent’s consent may also be established by written or oral statements, or by implication from the parties’ conduct.³ Thus, if *P* asks *A* to complete a task pursuant to *P*’s instructions, and *A* does so, an agency relationship has been created even if *A* did not expressly communicate to *P* his agreement to perform the task.

On behalf of: The agent must be acting on the principal’s behalf. This requirement is generally understood to mean that the agent must be acting *primarily* for the benefit of the principal rather than for the benefit of the agent or some other party.⁴ This element is critical to the agency definition, as it allows courts to distinguish the agency relationship from more garden-variety exchanges of compensation for services where we would not expect an agency relationship to arise. Simply acting in a way that benefits another, in other words, even where there is control, is insufficient to establish an agency relationship; instead, a court must believe that the agent was

² RESTATEMENT (SECOND) OF AGENCY § 1 (1958); *see* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

³*See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 1.03 (2006).

⁴*See* J. DENNIS HYNES & MARK J. LOEWENSTEIN, AGENCY, PARTNERSHIP, AND THE LLC: THE LAW OF UNINCORPORATED BUSINESS ENTERPRISES: CASES, MATERIALS, PROBLEMS 17 (7th ed. 2007) (“‘On the principal’s behalf’ and acting ‘primarily’ for the principal’s benefit are different ways of expressing the same requirement. Merely benefitting another by one’s conduct does not qualify. It is too far removed in degree.”); *cf.* RESTATEMENT (SECOND) OF AGENCY § 13 cmt. a (1958) (“The agreement to act on behalf of the principal causes the agent to be a fiduciary, that is, a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking.”).

acting primarily for the benefit of the other person (the principal).⁵

For example, suppose that a homeowner calls an electrician to install a new chandelier. One might plausibly argue that the electrician has agreed to act subject to the homeowner's control in several respects—e.g., the homeowner has specified the particular task, the homeowner may have required a particular time and date for the service, and the homeowner may want the chandelier hung in a particular manner. Nevertheless, absent extraordinary facts, the electrician's services would be considered primarily for his own benefit, largely because the electrician sets the price for his services and retains the profits from his labor. From a policy standpoint, this conclusion is sensible, as we would not expect an electrician to have a fiduciary duty of loyalty to his customer, or for the customer to be liable for the electrician's negligence, or for any of the other onerous obligations of the agency relationship to apply.⁶

Control: The agent must act subject to the principal's control, but the degree of control exercised by the principal does not have to be significant. As one court observed:

The control a principal must exercise over an agent in order to evidence an agency relationship is not so comprehensive. A principal need not exercise physical control over the actions of its agent in order for an agency relationship to exist; rather, the agent must be subject to the principal's control over the result or ultimate objectives of the agency relationship.

...

In sum, the control a principal exercises over its agent is not defined rigidly to mean control over the minutia of the agent's actions, such as the agent's physical conduct The level of control may be very attenuated with respect to the details. However, the principal must have ultimate responsibility to control the end result of his or her agent's actions; such control may be exercised by prescribing the agents' obligations or duties before or after the agent acts, or both.⁷

⁵ Keep in mind, however, the following words of caution: "While this proposition is well accepted, the task of distinguishing between actions that merely benefit persons and actions taken on behalf of persons is not always easy. It sometimes involves drawing a fine line, subject to debate." HYNES & LOEWENSTEIN, *supra* note 4, at 17.

⁶ Does the fact that an agent is compensated indicate that the agent is acting primarily for his own benefit rather than that of the principal? A paid agent is in some sense acting on his own behalf in order to earn the promised compensation; nevertheless, "compensation is earned by acting in a manner that advances the interest of the principal, and thus the paid agent is considered to be *primarily* acting for the benefit of another." *Id.*

⁷ Green v. H&R Block, Inc., 735 A.2d 1039, 1050-51 (Md. 1999); *see also* RESTATEMENT (SECOND) OF AGENCY § 14 cmt. a (1958) ("The control of the principal does not, however, include control at every moment; its exercise may be very attenuated and, as where the principal is physically absent, may be ineffective.").

Thus, the requisite level of control may be found simply by the fact that the principal has specified the task that the agent should perform, even if the principal has not prescribed the details of how the task should be accomplished.

In addition to these three primary elements, it is important to note that the agency definition uses the term “person” to refer to both agents and principals. Both the Second and Third Restatements define “person” to include individuals as well as organizations.⁸ Thus, agency relationships are not limited to natural persons; indeed, artificial entities such as corporations, trusts, partnerships, or limited liability companies may act as principals or as agents.

Keep in mind that, if the legal definition of agency has been met through satisfaction of the above elements, an agency relationship is present, regardless of whether the parties intended to create such a relationship:

Agency is a legal concept which depends upon the existence of required factual elements: the manifestation by the principal that the agent shall act for him, the agent’s acceptance of the undertaking and the understanding of the parties that the principal is to be in control of the undertaking. The relation which the law calls agency does not depend upon the intent of the parties to create it, nor their belief that they have done so. To constitute the relation, there must be an agreement, but not necessarily a contract, between the parties; if the agreement results in the factual relation between them to which are attached the legal consequences of agency, an agency exists although the parties did not call it agency and did not intend the legal consequences of the relation to follow. Thus, when one who asks a friend to do a slight service for him, such as to return for credit goods recently purchased from a store, neither one may have any realization that they are creating an agency relation or be aware of the legal obligations which would result from performance of the service.⁹

2. DISTINGUISHING AGENCY FROM OTHER RELATIONSHIPS

It is often difficult to distinguish agency relationships from other types of legal relationships. Much turns on the distinction because, as will be discussed, the agency relationship imposes significant burdens and obligations on both agents and principals that are often absent in non-agency settings.

a. AGENCY VS. THE GRATUITOUS BAILMENT¹⁰

⁸ See RESTATEMENT (SECOND) OF AGENCY § 1 cmt. a (1958); RESTATEMENT (THIRD) OF AGENCY § 1.04(5) (2006).

⁹ RESTATEMENT (SECOND) OF AGENCY § 1 cmt. b (1958); see RESTATEMENT (THIRD) OF AGENCY § 1.02 (2006).

¹⁰ A bailment is defined as the “rightful possession of goods by one who is not the owner.” 9 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS 875 (3d ed. 1967). A gratuitous bailment is “the transfer of possession or use of property without compensation.” *Fili v. Matson Motors, Inc.*, 590 N.Y.S.2d 961, 963 (App. Div. 1992).

A law school favorite in this area is *Gorton v. Doty*.¹¹ In *Gorton*, the Soda Springs High School football team was scheduled to play the Paris High School football team on September 21, 1934. Rather than travel by bus, the team was to be taken to the game in private cars. Doty, a teacher at Soda Springs, volunteered the use of her car for transporting some of the players on the condition that Russell Garst, the coach of the football team, drive the car himself. Doty was not paid for the use of her car, and she testified that she merely loaned the car to Garst and that she did not “direct[] his work or his services, or what he was doing.”

Unfortunately, an accident resulted while Garst was driving. Garst was killed, and Richard Gorton, one of the student passengers in the car, was injured. Gorton’s father sued Doty to recover for his son’s injuries on the theory that Garst was acting as Doty’s agent when the accident occurred.¹²

The jury returned a verdict in favor of Gorton on the agency theory, and the Idaho Supreme Court affirmed. As to consent, the court stated that Doty consented to Garst acting as her agent “from her act in volunteering the use of her car upon the express condition that he [Garst] should drive it.” Similarly, the court concluded that Garst consented to act as Doty’s agent “by his act in driving the car.” The court further noted that “[i]t is not essential to the existence of authority that there be a contract between principal and agent or that the agent promise to act as such, nor is it essential to the relationship of principal and agent that they, or either, receive compensation.” Other than mentioning Doty’s “express condition” that Garst should drive the car, the court provided no analysis of the control and “on behalf of” elements of the agency inquiry.¹³

Was Garst the agent of Doty, or was he simply, as the dissent maintained, a “gratuitous bailee?” As in any agency analysis, one should consider the three primary elements of the agency relationship. First, as to consent, the court’s conclusion was based on no more than Doty volunteering the use of her car and Garst driving it in accordance with Doty’s instructions. Nevertheless, consent does not require an explicit verbal or written agreement. As mentioned, the parties’ conduct may imply consent—a principle that supports the court’s conclusion.

Second, as to control, was it enough that Doty conditioned the use of her car on Garst driving it? This evidence was certainly thin, and the dissent downplayed it as “a mere precaution upon her part that the car should not be driven by any one of the young boys—a perfectly natural thing for her to do.”¹⁴ Recall, however, that the degree of control exercised by the principal does not have to be significant, and it can be enough that the principal has specified the task (e.g., drive my car to the football game) that the agent should perform. That said, the imposition of liability upon Doty based on such underwhelming control evidence tends to make students (as well as professors) uneasy.

¹¹ 69 P.2d 136 (Idaho 1937).

¹² See *id.* at 138-41. A principal can be liable for the torts of his agent. See Chapter 2(C)(1).

¹³ See *Gorton*, 69 P.2d at 138, 140, 145.

¹⁴ *Id.* at 146 (Budge, J., dissenting).

What if the evidence of control were much stronger? What if, for example, Doty prescribed the route that Garst must travel, the speed that Garst must average, the rest breaks that Garst must take, etc.? Would that make the agency conclusion in *Gorton* more palatable? These questions are critical because they highlight the third element of the agency relationship—the “on behalf of” element—that the court largely ignored. Even if consent and control were firmly established, in other words, was there any evidence that Garst was acting primarily for the benefit of Doty? The use of Doty’s car benefitted Garst to the extent that he could transport some of his players to the game and could stop looking for alternative vehicles; similarly, it benefitted the school to the extent that public or other private transportation did not have to be provided. But the use of the car appears to have provided no benefit to Doty at all; at the very least, the arrangement was not *primarily* for her benefit. As a result, the court’s agency conclusion seems far off the mark.¹⁵

What are the planning implications of *Gorton*? What should Doty have done to avoid the possibility of a liability finding against her? The court suggested that Doty’s failure to explicitly communicate to Garst that she was “loaning” her car to him made a difference, but that omission should hardly matter. The label that the parties give to their relationship (e.g., lender-borrower) is not controlling for agency purposes. The only question is whether the facts and circumstances surrounding the parties’ arrangement meet the legal definition of agency. Surely it would have helped if Doty had placed no condition on who could drive, but as the dissent indicated, her desire to keep teenagers from driving her car was a sensible precaution. Doty could have, of course, refused to lend her car at all, which in hindsight would have been ideal. If she truly wanted to lend her car, however, perhaps her best course of action would have been to confirm that her auto insurance policy was in good standing, and that it covered accidents caused by persons driving her car with permission.

This last point may explain what the *Gorton* majority was attempting to accomplish by using agency principles to uphold the liability verdict. The court may have believed that automobile owners were in the best position to insure against this type of loss. By using (abusing?) agency principles to impose liability, the court incentivizes vehicle owners to obtain insurance that covers themselves as well as other permitted drivers.

One final point is worth mentioning. Students are often amazed that agency liability can be found when one person is simply doing a favor for another. Notice, however, that if one person consents to doing a favor for the other pursuant to the other’s instructions, it is entirely consistent with an agency relationship—particularly because the person doing the favor (who would be viewed as the agent) is generally doing it for the benefit of the other person (who would be viewed as the principal).¹⁶ After all, that’s what a favor is—something that you do

¹⁵ As the dissent observed, “[Doty] loaned her car to Garst, not for her benefit, but for his benefit or for the benefit of the school district.” *Id.* at 146 (Budge, J., dissenting).

¹⁶ *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 1 cmt. b (1958) (“Thus, when one who asks a friend to do a slight service for him, such as to return for credit goods recently purchased from a store, neither one may have any realization that they are creating an agency relation or be aware of the legal obligations which would result from performance of the service.”).

primarily to help someone else out. The reason that *Gorton* does not fit this explanation, of course, is that the person doing the favor (Doty) is characterized as the principal, even though the favor was being done for the benefit of someone else.

b. AGENCY VS. THE CREDITOR-DEBTOR RELATIONSHIP

A leading case addressing the distinction between agency and the creditor-debtor relationship is *A. Gay Jenson Farms Co. v. Cargill, Inc.*¹⁷ In *Cargill*, Warren Seed & Grain Company operated a grain elevator. The business had several components: (1) Warren purchased grain from local farmers and resold it; (2) Warren stored grain for farmers; (3) Warren sold chemical, fertilizer, and steel storage bins; and (4) Warren operated a seed business which involved buying seed grain from farmers, processing it, and reselling it to farmers and other local grain elevators.

Cargill, Inc. (a large international trader of grain products) provided Warren with working capital financing from 1964 to 1977. Cargill effectively provided a \$175,000 line of credit to Warren that gradually increased over the years to \$1.25 million. Cargill also purchased the majority of Warren's grain for Cargill's own operations. Ultimately, Warren ceased operations in 1977 as a result of mounting financial difficulties. At the time of Warren's collapse, it owed \$2 million to 86 farmers for the purchase of their grain, and it owed \$3.6 million to Cargill.¹⁸

The 86 farmers sued Cargill to recover their \$2 million. They alleged that Warren incurred the debts as an agent of Cargill and that Cargill was therefore liable as a principal for Warren's obligations. After a jury trial, judgment was entered in favor of the plaintiffs.¹⁹ On appeal, Cargill argued that its relationship with Warren was not that of principal-agent, but was instead merely a creditor-debtor arrangement (or, alternatively, a buyer-supplier relationship).

Relying on the Second Restatement of Agency, the Minnesota Supreme Court held that an agency relationship did exist between Cargill and Warren. The court concluded that Cargill interfered with the internal affairs of Warren, "which constituted de facto control of the elevator." According to the court, factors indicating Cargill's control over Warren included the following: "(1) Cargill's constant recommendations to Warren by telephone; (2) Cargill's right of first refusal on grain; (3) Warren's inability to enter into mortgages, to purchase stock or to pay dividends without Cargill's approval; (4) Cargill's right of entry onto Warren's premises to carry on periodic checks and audits; (5) Cargill's correspondence and criticism regarding Warren's finances, officers salaries and inventory; (6) Cargill's determination that Warren needed 'strong paternal guidance'; (7) Provision of drafts and forms to Warren upon which Cargill's name was imprinted; (8) Financing of all Warren's purchases of grain and operating

¹⁷ 309 N.W.2d 285 (Minn. 1981).

¹⁸ *See id.* at 287-90.

¹⁹ It should be noted that Warren was located in the town of Warren, Minnesota and the jury pool was drawn from that community. *See id.* at 288, 295. As mentioned, the plaintiffs were local farmers, while defendant Cargill was a large corporation.

expenses; and (9) Cargill's power to discontinue the financing of Warren's operations." In addition to control, the court concluded that Warren acted on behalf of Cargill "in procuring grain for Cargill as the part of its normal operations which were totally financed by Cargill." In short, the combination of the control by Cargill and the grain supply benefits to Cargill led the court to conclude that an agency relationship had been established.²⁰

The holding of *Cargill* is controversial. With respect to control, when a lender finances a business, it is very common for the lender to impose various conditions on how the money can be used and how the business may run its operations—e.g., the funds can be used for expansion purposes only, liabilities cannot be increased above a certain ratio or amount, decisions to sell key assets require the lender's approval, etc. These conditions give the lender a degree of control over the business, but is that control enough to meet the element of the agency definition? Section 14O of the Second Restatement, which the court cites, provides some general guidance by stating that "[a] creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business." The comment to the section, however, is more helpful:

A security holder who merely exercises a veto power over the business acts of his debtor by preventing purchases or sales above specified amounts does not thereby become a principal. However, if he takes over the management of the debtor's business either in person or through an agent, and directs what contracts may or may not be made, he becomes a principal, liable as any principal for the obligations incurred thereafter in the normal course of business by the debtor who has now become his general agent. The point at which the creditor becomes a principal is that at which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with his debtor may be.

This section and its accompanying commentary highlight the difference between "affirmative" control (i.e., the power to initiate or direct transactions) and "negative" or "passive" control (i.e., the power to limit, block, or veto conduct that is initiated by others). Whereas affirmative control is substantial and generally goes beyond the control that most creditors possess, negative control, such as the ability to veto transactions that substantially threaten the debtor's prospect of repayment is, as previously mentioned, a very common feature of lending arrangements. The

²⁰ See *id.* at 289-91. Cargill's interest in Warren is easier to understand with some historical context:

These events occurred in the midst of the "Great Grain Robbery" that occurred after President Richard Nixon authorized grain sales to the Soviet Union and China. Grain firms like Cargill then sold about 25 percent of America's grain harvest to the Soviet[s], pushing up grain prices to unheard of levels ("beans in the teens") and having widespread effects on nearly every area of the economy. "It was one of those economic events . . . that . . . can truly be said to have changed the world." Dan Morgan, *Merchants of Grain* 121 (1979). Cargill badly needed grain to fulfill the contracts it made with the Soviet Union and other purchasers. It needed Warren's supplies, as well as those of other grain elevators.

commentary to § 14O recognizes this distinction to the extent that it indicates that the mere exercise of a veto power is typically insufficient to create a principal-agent relationship.²¹

Did Cargill exercise more than “negative” control? Cargill’s approval was needed for entering into mortgages, purchasing stock, or paying dividends, but those are just examples of veto power. As mentioned, the court stated that Cargill made “constant recommendations to Warren,” it noted “Cargill’s correspondence and criticism regarding Warren’s finances, officers salaries and inventory,” and it highlighted Cargill’s determination that Warren needed “strong paternal guidance.” Recommendations, correspondence, criticism, and internal determinations, however, are not the same as the existence of an affirmative power to direct the business. After all, a debtor like Warren could just reject the recommendations and criticism and continue to operate its business as it desired. There was some evidence, in fact, that Warren did just that.²² Without evidence that Cargill went beyond recommendations and criticism and actually assumed the power to initiate transactions or to direct changes within Warren, Cargill’s input could have been viewed simply as input, and not as evidence of significant control. Thus, although the *Cargill* court states definitively that “Cargill was an active participant in Warren’s operations rather than simply a financier,” and that “Cargill made the key economic decisions,” the basis for these and related statements would seem to be in question.²³

Even assuming that the control element was met, what about the “on behalf of” element of the agency inquiry? Was Warren acting primarily for the benefit of Cargill? Cargill clearly benefitted from its relationship by receiving interest on the loaned sums as well as a steady supply of grain, but Warren also benefitted by earning money from its grain resale business as well as its other business pursuits.²⁴ When a debtor is attempting to generate income for itself in

²¹ See also RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f (2006) (“The right to veto another’s decisions does not by itself create the right to give affirmative directives that action be taken, which is integral to the right of control within common-law agency. Thus, a debtor does not become a creditor’s agent when a loan agreement gives the creditor veto rights over decisions the debtor may make. Moreover, typically a debtor does not consent to act on behalf of the creditor as opposed to acting in its own interests.”).

²² As the court noted:

Between 1967 and 1973, Cargill suggested that Warren take a number of steps, including: (1) a reduction of seed grain and cash grain inventories; (2) improved collection of accounts receivable; (3) reduction or elimination of its wholesale seed business and its specialty grain operation; (4) marketing fertilizer and steel bins on consignment; (5) a reduction in withdrawals made by officers; (6) a suggestion that Warren’s bookkeeper not issue her own salary checks; and (7) cooperation with Cargill in implementing the recommendations. *These ideas were apparently never implemented, however.*

Cargill, 309 N.W.2d at 289 n.4 (emphasis added).

²³ *Id.* at 291-93.

²⁴ Even though the court noted that Warren was shipping up to 90% of its cash grain to Cargill, Warren was presumably benefitting from those sales by earning the difference between the price at which it purchased the grain from farmers and the price at which it resold that grain to Cargill. Moreover, Warren also benefitted by selling to customers other than Cargill. See *id.* at 289 (noting that Warren was at one

its own business, there is a strong argument that it is operating primarily for its own benefit rather than for the benefit of another.²⁵ (Indeed, the fact that Warren’s officer salaries were high enough to prompt complaint by Cargill suggests that Warren’s officers were primarily running the business for their benefit and not for Cargill’s.) Even if the proceeds from Warren’s sales were largely used to repay the Cargill debt, it is not clear why the court did not view the debt as facilitating Warren’s own business—a business where Cargill happens to be a primary lender and customer, but a business nonetheless. Instead, the court viewed the financial and customer ties between Cargill and Warren as an indication that Warren lacked an independent business all together.²⁶

At bottom, the *Cargill* court seemed to believe that Warren was simply a business being run for Cargill’s advantage. In such circumstances, one can make a basic economic argument for liability: a creditor should be required to internalize all of the costs of a business being run for its benefit. Put differently, the court may have believed that Cargill’s relationship allowed it to

point shipping Cargill 90% of its cash grain, but also stating that “[w]hen Cargill’s facilities were full, Warren shipped its grain to other companies,” and further mentioning that “[a]pproximately 25% of Warren’s total sales was seed grain which was sold directly by Warren to its customers”); *cf. id.* at 288 n.3 (stating that “Cargill hoped that Warren’s profits would be used to decrease its debt balance”).

²⁵ *Cf.* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f (2006) (noting that “typically a debtor does not consent to act on behalf of the creditor as opposed to acting in its own interests”).

²⁶ Cargill alternatively argued that its relationship with Warren was that of buyer-supplier rather than principal-agent. The Second Restatement distinguishes an agent from a supplier by observing that “[o]ne who contracts to acquire property from a third person and convey it to another is the agent of the other only if it is agreed that he is to act primarily for the benefit of the other and not for himself.” RESTATEMENT (SECOND) OF AGENCY § 14K (1958). As mentioned, because Warren was attempting to generate income for itself in its own business, there is a strong argument that it was operating primarily for its own benefit rather than for the benefit of Cargill. Pursuant to § 14K, this would counter an inference of agency.

The commentary to § 14K further observes that “[f]actors indicating that the one who is to acquire the property and transfer it to the other is selling to, and not acting as agent for, the other are: (1) That he is to receive a fixed price for the property, irrespective of the price paid by him. This is the most important. (2) That he acts in his own name and receives the title to the property which he thereafter is to transfer. (3) That he has an independent business in buying and selling similar property.” *Id.* § 14K cmt. a. The *Cargill* court stated that “[u]nder the Restatement approach, it must be shown that the supplier has an independent business before it can be concluded that he is not an agent.” Because the court determined that Warren lacked an independent business, it concluded that “the relationship which existed between the parties was not merely that of buyer and supplier.” *Cargill*, 309 N.W.2d at 292. This conclusion is puzzling. Given that Warren earned money by selling to Cargill as well as other customers, *see* note 24 and accompanying text, it is unclear why the court did not view Warren as an independent business. Moreover, there is nothing in the comment indicating that the “independent business” concept is a *requirement* for supplier status; instead, it is listed only as a factor, and not even as the most important factor.

get the benefits of Warren’s business without the accompanying obligations—a situation that is rectified by holding Cargill liable as a principal for the debts of Warren.²⁷

After *Cargill*, should banks and other lenders have anything to fear? The amici curiae argued in *Cargill* that lenders would decline to make further loans to county elevators if liability on an agency theory were imposed. The *Cargill* court attempted to alleviate such concerns by distinguishing the Cargill-Warren relationship from an “ordinary bank financing, since Cargill was an active participant in Warren’s operations rather than simply a financier.” According to the court, “there was a unique fabric in the relationship between Cargill and Warren which varies from that found in normal debtor-creditor situations.”²⁸ As discussed above, this conclusion is debatable.

Going forward, opinions like *Cargill* would seem to increase the cost of borrowing for debtors. Even if a creditor exercised only negative control over a debtor, *Cargill* suggests that there is some risk of agency liability being imposed. A creditor who appreciates this risk will presumably refuse to make loans that it otherwise would have made or will charge more for the loans to compensate for the increased risk of liability. Another alternative is that a creditor will significantly decrease the level of control exercised over a debtor in an effort to avoid the risk of agency liability. A decrease in control, however, increases the risk of default to the creditor. Correspondingly, the creditor will presumably charge more for the loan to compensate for this heightened default risk.

C. LIABILITY FROM THE AGENCY RELATIONSHIP

What liability is created when an agent interacts with a third party? This is the most common question that arises out of a principal-agent relationship. Because the principal’s liability for an agent’s tortious acts is addressed in many first-year torts courses, most professors give this topic very little coverage (if any) in an upper-level business law class. Instead, a business law course typically focuses on contract liability from the agency relationship. Accordingly, contract liability is emphasized in the materials below, although the basics of tort liability are also discussed.

1. TORT LIABILITY FROM THE AGENCY RELATIONSHIP

a. DISTINGUISHING BETWEEN SERVANTS AND INDEPENDENT CONTRACTORS

²⁷ Indeed, the court noted that “Cargill became, in essence, the owner of the [Warren] operation without the accompanying legal indicia.” See *Cargill*, 309 N.W.2d at 292. Because Cargill did not get the profits from Warren’s operation, however, the court’s conclusion arguably imposes Warren’s costs on Cargill without its benefits. *But see* STEPHEN M. BAINBRIDGE, AGENCY, PARTNERSHIPS & LLCs 28-29 n.30 (2004) (“This analysis, however, overlooks the local monopoly typically enjoyed by grain elevators. Cargill’s relationship with Warren gave it the benefit of Warren’s local monopoly—i.e., sole access to the grain harvested in the area.”).

²⁸ *Cargill*, 309 N.W.2d at 292-93.

A general tenet of agency law is that a principal has the right to control the conduct of an agent with respect to matters entrusted to the agent.²⁹ The principal can determine what the ultimate goal is, and the agent must strive to meet that goal. The degree of control that the principal has over the acts of the agent may vary widely within the agency relationship. In this respect, the Second Restatement distinguishes between a master/servant relationship and an independent contractor relationship.³⁰

A *master* is a principal who "employs an agent to perform service in his affairs and who controls or has the right to control the physical conduct of the other in the performance of the service." A *servant* is an agent so employed by a master.³¹ In some sense, the use of the words master and servant for this relationship is unfortunate because those words may imply servility, household service, or manual labor. The relationship is not so limited; indeed, under these definitions, most employment relationships are technically master/servant relationships.³² An *independent contractor* is a "person who contracts with another to do something for him but who is not controlled by the other nor subject to the other's right to control with respect to his physical conduct in the performance of the undertaking."³³ In general, if a person is subject to the control of another as to the means used to achieve a particular result, he is a servant. By contrast, if a person is subject to the control of another as to his results only (but not over how to achieve those results), he is an independent contractor.

Example: General Motors Corporation employs an individual to serve as head designer of a new automobile. His salary is \$300,000 per year. The designer is a "servant" in the Second Restatement terminology and General Motors is his "master." As evidence, consider this possible scenario: the chief executive officer of General Motors comes to the designer and says, "John, the board of directors liked your sketches for the new convertible. They feel, however, that it looks a little boxy and they think the headlights are too conspicuous. Please streamline it a little more and move the headlights into the front fenders." What should the head designer do? He makes the changes that are requested, thereby indicating that he is a servant.

Example: A builder enters into a contract with the owner of a lot to build a house on the

²⁹ See RESTATEMENT (SECOND) OF AGENCY § 14 (1958); RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

³⁰ See RESTATEMENT (SECOND) OF AGENCY § 2 (1958).

³¹ See *id.* §§ 2, 220(1). Thus, a master is a subcategory of principal, and a servant is a subcategory of agent. See *id.* § 2 cmt. a.

³² See, e.g., *id.* § 220 cmt. a ("The word [servant] indicates the closeness of the relation between the one giving and the one receiving the service rather than the nature of the service or the importance of the one giving it. Thus, ship captains and managers of great corporations are normally superior servants, differing only in the dignity and importance of their positions from those working under them. The rules for determining the liability of the employer for the conduct of both superior servants and the humblest employees are the same . . .").

³³ *Id.* § 2(3).

lot in accordance with certain plans and specifications prepared by an architect. The builder is an independent contractor. He is employed merely to accomplish a specific result and is not otherwise subject to the owner's control.

Example: A broker enters into a contract to sell goods for a manufacturer. His arrangement involves the receipt of a salary plus a commission on each sale, but the broker has discretion as to how to conduct his business. He determines which cities to visit and who to contact. He uses his own automobile to visit prospects. The broker is an independent contractor because the manufacturer does not control the details of how the broker conducts his day-to-day business.³⁴

It is often difficult to determine whether a person is a servant or an independent contractor. The Second Restatement includes a somewhat dated provision that lists the following factors to consider in making the determination:

- (a) the extent of control which, by the agreement, the master may exercise over the details of the work;
- (b) whether or not the one employed is engaged in a distinct occupation or business;
- (c) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;
- (d) the skill required in the particular occupation;
- (e) whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work;
- (f) the length of time for which the person is employed;
- (g) the method of payment, whether by the time or by the job;
- (h) whether or not the work is a part of the regular business of the employer;
- (i) whether or not the parties believe they are creating the relation of master and servant;
and

³⁴ While all servants are agents, an independent contractor may or may not be an agent. *See id.* § 2. In general, a non-agent independent contractor exists when one or more of the basic elements of the agency relationship are absent—e.g., when there is insufficient control over the contractor, or when the contractor is acting primarily in his own interests. *See, e.g.,* *Kemether v. Pa. Interscholastic Athletic Ass'n, Inc.*, 15 F. Supp. 2d 740, 748 (E.D. Pa. 1998) (“Where prerequisites of agency, such as control, are not satisfied, a non-agent independent contractor relationship may exist: A person who contracts to accomplish something for another or to deliver something to another, but who is not acting as a fiduciary for the other is a non-agent contractor. He may be anyone who has made a contract and who is not an agent.” (internal quotation omitted)). In this Chapter, we are concerned only with independent contractors who would also be legally characterized as agents.

(j) whether the principal is or is not in business.³⁵

In which direction do these factors cut? With respect to (a), more control by the principal over the details of the work suggests a servant status. For (b), the presence of a distinct occupation or business for the worker leans toward independent contractor status, as there is some business to conduct outside of the principal's operations. A more substantial degree of supervision in (c) indicates servant status. For (d), work which does not require the services of highly skilled individuals suggests servant status. With respect to (e), the employer providing the materials necessary for the work to be accomplished favors servant status (if provided by the worker, independent contractor status is suggested). A longer length of time of employment in (f) indicates servant status, as independent contractor assignments are often one-time engagements. Payment by time in (g) suggests servant status, while payment by the job suggests independent contractor status. The task being part of the employer's regular business in (h) indicates servant status, as servants typically work on assignments related to the employer's business. For (i), the parties' belief that they are creating a master-servant relationship obviously favors servant status. Finally, with respect to (j), the fact that the principal is in business suggests servant status—presumably because, as in (h), servants typically work on assignments related to the employer's business, but also because an operating business is more likely to have the resources necessary to exercise the degree of control that is required for servant status.

Why does the law care (and why should you care) about whether a person is a servant or an independent contractor? The classification of an agent as a servant or an independent contractor is important primarily because different rules apply with respect to the liability of the principal for harm caused by the agent's tortious conduct. While a master is liable for torts committed by a servant within the scope of his employment, a principal is generally not liable for torts committed by an independent contractor in connection with his work.³⁶ Thus, the determination of whether a person is a servant or an independent contractor can be outcome-determinative in a particular dispute.

Example: *P*, the owner of a successful retail operation with two stores, hires *D* to drive her delivery truck and to deliver goods to her two stores. Before doing so, *P* checks *D*'s driving record and arranges for him to go to a driving school for truck drivers. *D*'s record shows that he has had no accidents for 20 years, and he completes the driving school program without difficulty. Three weeks later, while driving *P*'s delivery truck, *D* is negligent and has a serious accident, injuring *T*. *P* is liable to *T* for his injuries.

In this example, *D* is a servant, and *P*'s liability is independent of whether *P* exercised due care in hiring *D*, or even whether she knew that *D* was her employee at all. *P*'s liability, however,

³⁵ See RESTATEMENT (SECOND) OF AGENCY § 220(2) (1958); see also RESTATEMENT (THIRD) OF AGENCY § 7.07 cmt. f (2006) (listing similar factors). A more modern list might include factors such as whether the employer uses a W-4 form for the employee, or whether the employee is listed as such on insurance forms.

³⁶ See RESTATEMENT (SECOND) OF AGENCY §§ 219, 250 (1958); cf. RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006) (imposing similar liability rules but not using the terms “master,” “servant,” or “independent contractor”).

only applies to actions within the scope of *D*'s employment. *P*'s liability in this situation may be described as "vicarious liability" and the consequence of "respondeat superior." *Vicarious liability* refers to the imposition of liability on one person for the actionable conduct of another. *Respondeat superior* is a Latin phrase that means "let the master respond."

Example: The manufacturer's broker who is selling goods in one of the above examples has an automobile accident while driving his own car to visit a prospect. The manufacturer is not liable for injuries to third persons arising from the accident. The same would be true of a person injured by the builder in the above example while working on the owner's house. Because the broker and the builder are both independent contractors, the general rule of non-liability for the principal applies.

Of course, the broker and the builder themselves would both be personally liable for the injuries that they caused in these examples, as a person is always responsible for his own torts. *D*, the servant in the above delivery truck example, would also be personally liable for *T*'s injuries, since he too is a tortfeasor. This illustrates the difference between direct liability (a person is always responsible for his own torts) and vicarious liability (a person is sometimes, but not always, responsible for the torts of another).³⁷

The Third Restatement does not use the terms "master," "servant," or "independent contractor." Instead, the Third Restatement simply defines an "employee" as "an agent whose principal controls or has the right to control the manner and means of the agent's performance of work," and it provides that "[a]n employer is subject to vicarious liability for a tort committed by its employee acting within the scope of employment."³⁸ Under the Third Restatement, therefore, there are "employee agents" and "nonemployee agents," with the latter term analogous to the "independent contractor" language of the Second Restatement.

b. LIABILITY FOR THE TORTS OF SERVANTS

As mentioned, the general rule is that a master is liable for the torts committed by a servant within the scope of the servant's employment. What is the rationale for this rule of vicarious liability? One basis for its application is that the servant may be judgment proof and have no insurance of his own. As a consequence, the injured party's only recourse is against the principal. As further justification for the doctrine, consider the following:

What has emerged as the modern justification for vicarious liability is a rule of policy, a deliberate allocation of a risk. The losses caused by the torts of employees, which as a practical matter are sure to occur in the conduct of the employer's enterprise, are placed upon that enterprise itself, as a required cost of doing business. They are

³⁷ See RESTATEMENT (SECOND) OF AGENCY § 343 (1958); RESTATEMENT (THIRD) OF AGENCY § 7.01 (2006). Similarly, while agency concepts may make a principal vicariously liable for the acts of an agent, the principal may also be directly liable for the principal's own tortious behavior (e.g., negligent hiring or negligent supervision). See, e.g., RESTATEMENT (SECOND) OF AGENCY § 213 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 7.03(1), 7.05 (2006).

³⁸ RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006).

placed upon the employer because, having engaged in an enterprise, which will on the basis of all past experience involve harm to others through the torts of employees, and sought to profit by it, it is just that he, rather than the innocent injured plaintiff, should bear them; and because he is better able to absorb them, and to distribute them, through prices, rates or liability insurance, to the public, and so to shift them to society, to the community at large. Added to this is the makeweight argument that an employer who is held strictly liable is under the greatest incentive to be careful in the selection, instruction and supervision of his servants, and to take every precaution to see that the enterprise is conducted safely.³⁹

The principal is only liable when the servant acts within the scope of his employment. This “scope of employment” restriction is the subject of numerous published decisions. According to § 228(1) of the Second Restatement, a servant’s conduct is within the scope of employment “if, but only if . . . (a) it is of the kind he is employed to perform; (b) it occurs substantially within the authorized time and space limits; (c) it is actuated, at least in part, by a purpose to serve the master, and (d) if force is intentionally used by the servant against another, the use of force is not unexpected by the master.”⁴⁰ Notice that, as subsection (d) suggests, even an intentional tort committed by an employee can be viewed as within the scope of employment.⁴¹

With respect to subsection (c), it should be noted that many courts have found that the servant was acting with a purpose to serve the master on very tenuous facts. In *Nelson v. American-West African Line*,⁴² for example, a drunken boatswain (the foreman of the crew) started a fight with (and injured) a crew member who was trying to sleep in his bunk. Although Judge Learned Hand acknowledged that “unless there was some evidence that he supposed himself engaged upon the ship’s business, the ship was not liable,” he concluded that the

³⁹ W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 69, at 500–01 (5th ed. 1984) (footnote omitted).

⁴⁰ For additional guidance on whether a servant/employee’s actions are within the scope of his employment, see RESTATEMENT (SECOND) OF AGENCY §§ 229-237 (1958). The Third Restatement’s formulation of the scope of employment doctrine is stated in more general terms: “An employee acts within the scope of employment when performing work assigned by the employer or engaging in a course of conduct subject to the employer’s control. An employee’s act is not within the scope of employment when it occurs within an independent course of conduct not intended by the employee to serve any purpose of the employer.” See RESTATEMENT (THIRD) OF AGENCY § 7.07(2) (2006).

⁴¹ See, e.g., RESTATEMENT (THIRD) OF AGENCY § 7.07 cmt. c (2006) (“Intentional torts and other intentional wrongdoing may be within the scope of employment. For example, if an employee’s job duties include determining the prices at which the employer’s output will be sold to customers, the employee’s agreement with a competitor to fix prices is within the scope of employment unless circumstances establish a departure from the scope of employment. Likewise, when an employee’s job duties include making statements to prospective customers to induce them to buy from the employer, intentional misrepresentations made by the employee are within the scope of employment unless circumstances establish that the employee has departed from it.”).

⁴² 86 F.2d 730 (2d Cir. 1936).

boatswain might have thought that he was acting in the interest of the ship. As the court noted, “[i]f he really meant to rouse the plaintiff and send him upon duty, if he really meant to act as boatswain and for the ship, however imbecile his conduct it was his master’s.”⁴³

c. LIABILITY FOR THE TORTS OF INDEPENDENT CONTRACTORS

As mentioned, a principal is not generally liable for torts committed by an independent contractor in connection with his work. In *Anderson v. Marathon Petroleum Co.*,⁴⁴ the Seventh Circuit explained the rationale for this rule:

Generally a principal is not liable for an independent contractor’s torts even if they are committed in the performance of the contract and even though a principal is liable under the doctrine of respondeat superior for the torts of his employees if committed in the furtherance of their employment. The reason for distinguishing the independent contractor from the employee is that, by definition of the relationship between a principal and an independent contractor, the principal does not supervise the details of the independent contractor’s work and therefore is not in a good position to prevent negligent performance, whereas the essence of the contractual relationship known as employment is that the employee surrenders to the employer the right to direct the details of his work, in exchange for receiving a wage. The independent contractor commits himself to providing a specified output, and the principal monitors the contractor’s performance not by monitoring inputs—i.e., supervising the contractor—but by inspecting the contractually specified output to make sure it conforms to the

⁴³ *Id.* at 731-32. In *Ira S. Bushey & Sons, Inc. v. United States*, 398 F.2d 167 (2d Cir. 1968), the court went even further by holding the employer liable on a foreseeability theory even though the employee concededly had no purpose to serve the employer. *See id.* at 170-72; *see also* RESTATEMENT (THIRD) OF AGENCY § 7.07 cmt. b (2006) (criticizing a foreseeability approach).

Many cases involving the scope of employment concern whether an employee was on a “frolic” (an act of the employee outside the scope of employment because it was done for the employee’s own benefit) or whether the conduct should simply be viewed as a “detour” (an act usually considered to be within the scope of employment because it is only a minor deviation from the employee’s task). As one authority explains:

Take an employee who is told to drive a truck from city A to city B, fifty miles away. The employee drives thirty miles out of his way to visit a friend in city C and negligently injures someone while engaged in this digression. If the deviation from the assigned route is considered sufficiently great to be classified as a “frolic” on the part of the employee, the employer may not be liable for the accident in these circumstances. But as the relative extent of the deviation diminishes, so that the digression becomes a mere “detour,” the chances of the employer being held liable increase.

GEORGE C. CHRISTIE ET AL., CASES AND MATERIALS ON THE LAW OF TORTS 401 (3d. ed. 1997); *see also* KEETON ET AL., *supra* note 39, § 70, at 505 (“Essentially the question is one of major and minor departures, having always in mind that the employer is to be held liable for those things which are fairly to be regarded as risks of his business.”).

⁴⁴ 801 F.2d 936 (7th Cir. 1986).

specifications. This method of monitoring works fine if it is feasible for the principal to specify and monitor output, but sometimes it is not feasible, particularly if the output consists of the joint product of many separate producers whose specific contributions are difficult (sometimes impossible) to disentangle. In such a case it may be more efficient for the principal to monitor inputs rather than output—the producers rather than the product. By becoming an employee a producer in effect submits himself to that kind of monitoring, receiving payment for the work he puts in rather than for the output he produces.

Since an essential element of the employment relationship is thus the employer's monitoring of the employee's work, a principal who is not knowledgeable about the details of some task is likely to delegate it to an independent contractor. Hence in general, though of course not in every case, the principal who uses an independent contractor will not be as well placed as an employer would be to monitor the work and make sure it is done safely. This is the reason as we have said for not making the principal vicariously liable for the torts of his independent contractors.⁴⁵

Despite this general rule, there are circumstances where liability is imposed on a principal for the torts of an independent contractor. Examples of such circumstances include non-delegable duties (such as duties associated with abnormally dangerous activities), torts that are authorized by the principal, and fraud or misrepresentation (in some situations) by the agent.⁴⁶

2. CONTRACT LIABILITY FROM THE AGENCY RELATIONSHIP

A contractual transaction between an agent and a third party may impose liability upon the principal, the third party, and/or the agent. This liability inquiry is often affected by the type of principal that is present in the transaction: (1) a “disclosed” principal; (2) a “partially disclosed” principal; or (3) an “undisclosed” principal.

A principal is *disclosed* if, at the time of the agent's transaction, the third party has notice that the agent is acting for a principal and has notice of the principal's identity.⁴⁷ It may be, of course, that in a specific situation, a third person does not actually know who the principal is, but should be able to reasonably infer the identity of the principal from the information on hand. This is still a disclosed principal situation.⁴⁸

⁴⁵ *Id.* at 938-39.

⁴⁶ *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY §§ 212, 214-216, 250-267 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 7.03-7.06, 7.08 (2006). For additional information, see KEETON ET AL., *supra* note 39, § 71, at 509-16 (discussing exceptions to the general rule of non-liability for the conduct of independent contractors).

⁴⁷ *See* RESTATEMENT (SECOND) OF AGENCY § 4(1) (1958); RESTATEMENT (THIRD) OF AGENCY § 1.04(2)(a) (2006).

⁴⁸ *See* RESTATEMENT (SECOND) OF AGENCY § 9(1) (1958); RESTATEMENT (THIRD) OF AGENCY § 1.04(4) (2006).

A principal is *partially disclosed* if, at the time of the agent's transaction, the third party has notice that the agent is or may be acting for a principal, but has no notice of the principal's identity.⁴⁹

Example: A offers to sell goods to T, truthfully advising T that A is the manufacturer's representative for a well-known manufacturer. The identity of the manufacturer is not disclosed. The manufacturer is a partially disclosed principal.

A principal is *undisclosed* if, at the time of the agent's transaction, the third party has no notice that the agent is acting for a principal.⁵⁰ In effect, the third party is dealing with the agent as though the agent is the real party in interest.

a. LIABILITY OF THE PRINCIPAL TO THE THIRD PARTY

A principal will be liable on a contract between the agent and a third party when the agent acts with actual authority, apparent authority, or inherent authority. Even when the agent lacks one of these three types of authority, the principal may be liable under the doctrines of estoppel or ratification.

(1) Actual Authority

Actual authority (often described as *express authority* or simply by the words "authority" or "authorized") arises from the manifestation of a *principal to an agent* that the agent has power to deal with others as a representative of the principal. An agent who agrees to act in accordance with that manifestation has actual authority to so act, and his actions without more bind the principal.⁵¹ Put differently, if the principal's words or conduct would lead a reasonable person in the agent's position to believe that the agent has authority to act on the principal's behalf, the agent has actual authority to bind the principal.

Example: P, the owner of two retail stores, employs C to serve as credit manager. P has orally given C the authority to review and approve requests from customers for the extension of credit. C reviews the application of Y and approves him for the extension of credit. C has actual authority to approve Y, and P is bound by C's decision.

Example: P goes to an office where, as he knows, several brokers have desks, and leaves upon the desk of A, thinking it to be the desk of X, a note signed by P, which states: "I authorize

⁴⁹ See RESTATEMENT (SECOND) OF AGENCY § 4(2) (1958). Instead of the term "partially disclosed" principal, the Third Restatement uses the term "unidentified" principal. See RESTATEMENT (THIRD) OF AGENCY § 1.04(2)(c) (2006).

⁵⁰ See RESTATEMENT (SECOND) OF AGENCY § 4(3) (1958); RESTATEMENT (THIRD) OF AGENCY § 1.04(2)(b) (2006).

⁵¹ See RESTATEMENT (SECOND) OF AGENCY §§ 7, 26, 32-34, 144, 186 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 2.01-2.02, 3.01, 6.01-6.03 (2006).

you to contract in my name for the purchase of 100 shares of Western Union stock at today's market." Unaware of the mistake, *A* comes to work, finds the note, and makes a contract with *T* in *P*'s name for the purchase of the shares. *A* has actual authority to make the contract, and *P* is bound by *A*'s action.

Actual authority may be *express* (e.g., oral or written statements, including provisions in the company's organizational documents) or *implied* (e.g., inferred from words used, from custom, or from the relations between the parties).⁵²

Example: *P* is an elderly person living alone. He is befriended by *A*, a neighbor. *A* does errands for *P*, going to the store, helping *P* go to the doctor, and so forth. *P* has long had a charge account at a local grocery store that *A* has used frequently to charge groceries for *P*. The approval by *P* of *A*'s prior transactions would lead a reasonable person in *A*'s position to believe that he had authority to buy groceries for *P* in the future. This is implied actual authority based on *P*'s acceptance of the groceries in the past.⁵³

A common type of implied actual authority is incidental authority. *Incidental authority* is simply authority to do incidental acts that are related to a transaction that is authorized. As the Third Restatement explains:

If a principal's manifestation to an agent expresses the principal's wish that something be done, it is natural to assume that the principal wishes, as an incidental matter, that the agent take the steps necessary and that the agent proceed in the usual and ordinary way, if such has been established, unless the principal directs otherwise. The underlying assumptions are that the principal does not wish to authorize what cannot be achieved if necessary steps are not taken by the agent, and that the principal's manifestation often will not specify all steps necessary to translate it into action.⁵⁴

⁵² See RESTATEMENT (SECOND) OF AGENCY § 7 cmt. c (1958) ("It is possible for a principal to specify minutely what the agent is to do. To the extent that he does this, the agent may be said to have express authority. But most authority is created by implication. . . . [Such authority may be] implied or inferred from the words used, from customs and from the relations of the parties. [It is] described as 'implied authority.'"); RESTATEMENT (THIRD) OF AGENCY § 2.02(1) (2006) (noting that an agent has actual authority "to take action designated or implied in the principal's manifestations to the agent").

⁵³ Cf. RESTATEMENT (SECOND) OF AGENCY § 43(2) (1958) ("Acquiescence by the principal in a series of acts by the agent indicates authorization to perform similar acts in the future."); RESTATEMENT (THIRD) OF AGENCY § 2.02 cmt. f (2006) ("On prior occasions the principal may have affirmatively approved of the agent's unauthorized act or silently acquiesced in it by failing to voice affirmative disapproval. This history is likely to influence the agent's subsequent interpretation of instructions. If the principal's subsequent instructions do not address the history, the agent may well infer from the principal's silence that the principal will not demand compliance with the instructions to any degree greater than the principal has done in the past.").

⁵⁴ RESTATEMENT (THIRD) OF AGENCY § 2.02 cmt. d (2006); see also *id.* § 2.02(1) (stating that "an agent has actual authority to take action . . . necessary or incidental to achieving the principal's objectives"); RESTATEMENT (SECOND) OF AGENCY § 35 (1958) ("Unless otherwise agreed, authority to conduct a transaction includes authority to do acts which are incidental to it, usually accompany it, or are reasonably

Example: *P* authorizes *A* to purchase and obtain goods for *P* but does not give *A* money to pay for them. Without an arrangement that *A* is to supply the money or is to buy upon his own credit, *A* has authority to buy upon *P*'s credit.

Example: *P* directs *A* to sell goods by auction although, as *P* and *A* know, a statute forbids anyone but a licensed auctioneer from conducting sales by auction. Nothing to the contrary appearing, *A*'s authority includes the authority to employ a licensed auctioneer.

(2) Apparent Authority

Apparent authority arises from the manifestation of a *principal to a third party* that another person is authorized to act as an agent for the principal. That other person has apparent authority and an act by him within the scope of that apparent authority binds the principal.⁵⁵ Put differently, if the principal's words or conduct would lead a reasonable person in the third party's position to believe that the agent (or other person) has authority to act on the principal's behalf, the agent (or other person) has apparent authority to bind the principal.⁵⁶

Apparent authority commonly arises when a principal creates the impression that broad authority exists in an agent when in fact it does not. The theory is that if a third party relies on the appearance of authority, the third party may hold the principal liable for the action of the agent. As mentioned, the principal is bound by the agent's conduct within the scope of the agent's apparent authority, even though the conduct was not actually authorized by the principal.

Example: *P* gives *A*, an agent who is authorized to sell a piece of property on behalf of *P*, specific instructions as to various terms of the sale, including the minimum price (\$300,000) *P* is willing to accept. *P* informs possible buyers that *A* is his selling agent but obviously does not communicate *A*'s specific instructions to anyone but *A* (because to do so would be a virtual

necessary to accomplish it.”).

⁵⁵ See RESTATEMENT (SECOND) OF AGENCY §§ 8, 27, 49, 159 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 2.03, 3.03, 6.01-6.02 (2006).

⁵⁶ Why the use of the phrase “the agent (or other person)” in the text? The simple answer is that apparent authority can exist even in the absence of a principal-agent relationship. For example, apparent authority can arise when a person falsely represents to a third party that someone else is his agent. See, e.g., RESTATEMENT (THIRD) OF AGENCY § 2.03 (2006) (“Apparent authority is the power held by an agent *or other actor* to affect a principal's legal relations with third parties when a third party reasonably believes *the actor* has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations.”); *id.* § 2.03 cmt. a (“The [apparent authority] definition in this section does not presuppose the present or prior existence of an agency relationship The definition thus applies to actors who appear to be agents but are not, as well as to agents who act beyond the scope of their actual authority.”); see also RESTATEMENT (SECOND) OF AGENCY § 27 (1958) (describing apparent authority and noting that it is created by the principal's conduct “which, reasonably interpreted, causes the third person to believe that the principal consents to have the act done on his behalf by *the person* purporting to act for him” (emphasis added)).

blueprint to possible buyers as to how to buy the property as cheaply as possible). *A* has actual authority only to enter a contract to sell the property at a price equal to \$300,000 or more. *A* has apparent authority, however, to sell the property at any price given that *P* has represented to possible buyers that *A* is his selling agent.

Example: *A* signs a contract on behalf of *P* to sell *P*'s property to *T* for \$275,000. *P* is bound on that contract because the action was within *A*'s apparent authority. Nevertheless, *A* has violated his instructions and is liable to *P* for the loss incurred.⁵⁷

As the above text emphasizes, apparent authority is based on the principal's manifestations to a third party. Thus, apparent authority cannot be created by the mere representations of an agent or other actor. Not even the most convincing and persuasive person can create an agency or apparent agency relationship entirely on his own.⁵⁸

Example: John is a smooth-talking con man. He becomes friends with *X* and represents to *X* that he is an agent for General Motors seeking possible owners of new car franchises. John is very convincing, showing forged letters on GM letterhead, a forged identification card, and so forth. He persuades *X* that he will obtain a franchise for *X* if *X* will pay \$250,000. *X* does so. John disappears with *X*'s money. General Motors is not obligated to grant a franchise to *X* and is not otherwise liable for *X*'s loss.

Apparent authority may be established through an agent's title or position. Indeed, it is somewhat common for a third party to argue that an agent's title or position, which was given to him by the principal, created a reasonable belief in the third party that the agent was authorized to act for the principal in ways that are typical of someone who holds that title or position. This notion that title or position conveys authority can also be used to establish actual authority to the extent that the agent reasonably believes that he has authority to act based on the title or position given to him by the principal.

For example, if *P* appoints *A* as "Treasurer," and nothing more is stated, *A* will reasonably believe that he has the authority that treasurers typically have, and third parties who deal with *A* (and are aware of his position) will reasonably believe the same. If *P* tells *A* that he will not have authority to write checks on the company's account, *A* will not have actual authority to do so. Assuming that a treasurer typically has the power to write company checks, however, *A* will have apparent authority to write checks with respect to third parties who are aware of his position but are unaware of the limitation on his authority.⁵⁹

⁵⁷ See Chapter 2(D)(1).

⁵⁸ Interestingly, the Second Restatement states that the manifestation by the principal required for apparent authority can be established by the principal "authorizing the agent to state that he is authorized." RESTATEMENT (SECOND) OF AGENCY § 8 cmt. b (1958). Thus, an agent's representation to a third party—one made with the consent of the principal—should not be considered to be solely an act of the agent that is insufficient for apparent authority.

⁵⁹ See, e.g., RESTATEMENT (SECOND) OF AGENCY § 27 cmt. a (1958) ("[A]s in the case of authority, apparent authority can be created by appointing a person to a position, such as that of manager or treasurer, which carries with it generally recognized duties; to those who know of the appointment there is

The major difference between apparent authority and actual authority is that actual authority flows from the principal to the agent, while apparent authority flows from the principal to the third party. As previously mentioned, if the principal's words or conduct would lead a reasonable person in the *agent's* position to believe that the agent has authority to act on the principal's behalf, the agent has actual authority, but if the principal's words or conduct would lead a reasonable person in the *third party's* position to believe that the agent (or other person) has authority to act on the principal's behalf, the agent (or other person) has apparent authority.⁶⁰

In some circumstances, the scope of an agent's apparent authority will be equivalent to the scope of the agent's actual authority. For example, when a principal sends identical letters describing an agent's authority and its limits to both the agent and the third party, actual and apparent authority are co-extensive (assuming no other facts). As the above examples indicate, however, the scope of actual and apparent authority will not always be the same. It is, therefore, important to distinguish between the concepts and to recognize that liability for a principal may arise from statements or other manifestations made by the principal to an agent (actual authority), and/or from statements or other manifestations made by the principal to a third party (apparent authority).⁶¹

An excellent example of apparent authority, as well as its relationship to actual authority, is

apparent authority to do the things ordinarily entrusted to one occupying such a position, regardless of unknown limitations which are imposed upon the particular agent.”); *id.* § 49 cmt. c (“Acts are interpreted in the light of ordinary human experience. If a principal puts an agent into, or knowingly permits him to occupy, a position in which according to the ordinary habits of persons in the locality, trade or profession, it is usual for such an agent to have a particular kind of authority, anyone dealing with him is justified in inferring that he has such authority, in the absence of reason to know otherwise. The content of such apparent authority is a matter to be determined from the facts.”).

⁶⁰ Apparent authority cannot arise in an undisclosed principal situation. After all, when a principal is undisclosed, the third party has no idea that a principal is involved in the transaction. See notes 77-78 and accompanying text.

⁶¹ Apparent authority (as well as other agency rules) can be justified through a “least cost avoider” concept. The concept is based on the notion that, in many situations, it makes sense to impose liability on the party who could have taken precautions against the loss in the least expensive manner. By imposing such liability, the party who could most easily and cheaply prevent the loss is incentivized to do so. As an example, recall the hypothetical where *P* appoints *A* as “Treasurer” but prohibits *A* from writing company checks. Assuming that treasurers typically have the power to write such checks, *P*'s prohibition is unusual. One could argue that it will be cheaper for *P*, and the relatively few idiosyncratic principals like *P*, to take precautions against *A* acting beyond his actual authority (such as by providing *A* with a different title or with no title at all) than to require all potential third parties to investigate *A*'s authority to write checks. If this argument is credited, it is appropriate to impose liability on *P* when *A* acts with apparent (but without actual) authority. Indeed, the principal is often the least cost avoider because principals have many tools to control agents acting beyond their actual authority (e.g., better monitoring, clearer instructions, greater care in the selection of agents). For more on the relationship between agency rules and the least cost avoider concept, see generally Eric Rasmusen, *Agency Law and Contract Formation*, 6 AM. L. & ECON. REV. 369 (2004).

provided by *Essco Geometric v. Harvard Industries*.⁶² Harvard manufactured chairs and sold them to private and public entities. Diversified (Essco's trade name) sold foam that Harvard used in its chairs. Frank Best was Harvard's purchasing manager for over twenty years. During that time, Best cultivated a close business relationship with Edsel Safron, the president of Diversified. When Best retired, Michael Gray, the former purchasing agent, became the new purchasing manager for Harvard.

In 1989, Ed Kruske, the president of Harvard, issued two internal memoranda. The first directed that all purchase orders be initialed by Kruske prior to being sent out to a vendor. The second stipulated that all requisitions of fifty dollars or more have both the department manager's approval and Kruske's approval, unless an emergency arose. Gray received both of these directives, but no one outside of Harvard was notified of these changes in internal operating procedures.

In early 1990, Gray and Safron signed a letter that they believed represented an exclusive multi-million dollar contract between Harvard and Diversified for all of Harvard's foam needs over a two-year period. The agreement was different from prior practice to the extent that Harvard had ordinarily issued cancellable purchase orders whenever it needed foam. The letter agreement, however, purported to be an exclusive and non-cancellable requirements contract. Kruske refused to honor the agreement. As a result, Diversified sued Harvard for breach of contract on the grounds that Gray had actual or apparent authority to bind Harvard to the agreement. A jury found for Diversified, and Harvard appealed.⁶³

Did Gray have actual authority to bind Harvard to the agreement? The court noted that there was a lack of evidence on express actual authority, as no job description outlined the nature of Gray's responsibilities or the scope of his authority. Nevertheless, the court found sufficient evidence of implied actual authority to support the jury finding. First, Gray testified that he believed that he had the authority to enter into the transaction because of his job as the purchasing manager of the company. Second, in Gray's October 1989 performance evaluation, Harvard encouraged him to take a more active role in managing his department and reducing costs. Thus, Gray could have reasonably believed that he was authorized to act in ways that furthered those objectives (such as entering into a contract with a less expensive supplier like Diversified). Third, the court cited the custom and practice at Harvard and within the industry. Gray testified that, for approximately fifteen years, he had observed Harvard's former purchasing manager selecting vendors for the company. Other witnesses similarly testified that purchasing managers within the industry customarily made unsupervised decisions as to who would be their company's suppliers.

Notice that much of the evidence relied upon by the court focused on Gray's title or position. Because Harvard had given Gray the title of purchasing manager, he believed that he was authorized to enter into an agreement with Diversified. Why? Because Gray knew that Harvard had allowed the prior purchasing manager to enter into agreements with vendors, and because Gray was presumably aware that persons with the title of purchasing manager throughout the industry had similar authority. As a result, Gray could have reasonably believed that his title or position

⁶² 46 F.3d 718 (8th Cir. 1995).

⁶³ *See id.* at 720-23.

gave him the authority to enter into an agreement with Diversified.⁶⁴

On the other hand, was it reasonable for him to believe that purchasing managers at Harvard could enter into non-cancellable agreements when that had not been the practice in the past? The court noted that, when Harvard selected a vendor, it usually sent between 60% and 70% of its foam needs to that vendor. Moreover, Harvard cancellations were “few and far between.” In practice, therefore, the court did not seem to view the non-cancellable nature of the Diversified contract as significantly different from the agreements that Harvard purchase managers had entered into in the past. Thus, it was not necessarily unreasonable for Gray to believe that he had authority to enter into the non-cancellable Diversified contract. This was likely a very close call, however, as even the court admitted that “cancelable purchase orders constitute the daily and weekly routine,” and that “an exclusive, non-cancelable requirements contract differs materially from a standard purchase order.”⁶⁵ The procedural posture of the case becomes important here. Because the jury found that Gray was authorized, and because the court on appeal was simply looking to see if there was sufficient evidence to have submitted the case to the jury, close calls favored Diversified.

What about the two Harvard internal memoranda that seemed to restrict the authority of Harvard employees? Was it reasonable for Gray to think that he had authority to enter into the Diversified contract in light of these restrictions? The court noted that Kruske’s directives were issued because he wanted to cut costs and maintain high quality controls. Because Gray believed that Diversified was an inexpensive and high-quality vendor, the court observed that “[a] reasonable jury could thus conclude that Gray’s decision to sign the letter [agreement] fully comported with the purpose behind the directives.”⁶⁶ Thus, the court accepted a “spirit over letter” argument—i.e., the requirement of Kruske’s approval was simply to insure that a contract furthered the company’s interests. Because there was evidence suggesting that the Diversified contract did further Harvard’s interests, a jury could find that Gray was reasonable in believing that he had complied with the directives. One would think, however, that the Kruske memoranda were issued so that he (rather than the employees) could determine if the company’s contracts were beneficial, and that the requirement for his approval was not simply a formality that employees could decide to ignore. Once again, this was likely a close call.

What about Gray’s apparent authority? Was it reasonable for Diversified to believe that Harvard had given Gray the authority to enter into the letter agreement? The court observed that, for over twenty years, Harvard had allowed its former purchasing manager (Frank Best) to select vendors for Harvard. When Gray replaced Best, the court noted that “no one ever advised Diversified that Harvard had instituted new internal operating procedures or that the purchasing manager would have less authority to negotiate on behalf of the company.”⁶⁷ Thus, Harvard’s

⁶⁴ *Cf. id.* at 724 (“Thus, evidence that an agent historically engaged in related conduct, without limitation, would be enough to support a jury question on the issue of actual authority.”).

⁶⁵ *Id.* at 724-25.

⁶⁶ *Id.* at 725.

⁶⁷ *Id.* at 726.

acceptance of its purchasing manager's contracts over the years—a course of conduct that Diversified was aware of—reasonably suggested to Diversified that Harvard's purchasing manager had the authority to bind the company. Even though Diversified knew that Harvard had never entered into a non-cancellable requirements contract, the court cited testimony that industry custom presumed without question that the person in the position of purchasing manager possessed the authority to bind the company. Based on this custom, it was not unreasonable for Diversified to believe that the person designated by Harvard as purchasing manager did have authority to enter into a non-cancellable requirements contract, even though such contracts had not been the prior practice between the parties.⁶⁸ The court concluded that, “[a]s with actual authority, the evidence and inferences therefrom led to differing conclusions, and were matters for resolution by the jury.”⁶⁹

Why were Kruske's internal memoranda not mentioned by the court in its apparent authority discussion? Recall that apparent authority addresses a principal's manifestations and how they affect the reasonable beliefs of a third party. Because Diversified knew nothing about the internal memoranda, they are not relevant to an apparent authority analysis.

Why was the evidence of industry custom regarding the authority of a purchasing manager mentioned in the court's actual authority and apparent authority discussions? Recall that when a principal gives a title or position to an agent, that action can establish actual authority by creating a reasonable belief in the agent that he is authorized to act in ways that are typical of someone in the industry who holds that title or position. Similarly, that action can establish apparent authority by creating a reasonable belief in a third party that the agent is authorized to act in ways that are typical of someone in the industry who holds that title or position.

Going forward, what should Harvard do to protect itself from employees binding it to unwanted contracts? First, to combat actual authority, Harvard should make it very clear that the employees do not have authority to enter into contracts without Kruske's express permission, and that the employees have no discretion to waive or modify this requirement. It would likely help to further convey that this is a change from prior practice and that such prior practice is no longer valid. Second, to combat apparent authority, Harvard should convey this same information to its existing and prospective suppliers. This will help defeat an argument that a third-party supplier reasonably believed that a Harvard employee had the authority that is typically possessed by a person in the industry with that position. The goal, of course, is to influence the reasonable beliefs of both the employees (actual authority) and the third-party suppliers (apparent authority).

(3) Inherent Authority

According to the Second Restatement, the term “inherent agency power” (typically referred to as *inherent authority*) is used to describe “the power of an agent which is derived not from

⁶⁸ Moreover, the court cited testimony from Safron that Diversified had entered into similar contracts with some of its other customers. *See id.* at 727. This testimony was presumably relevant because it suggested that the Harvard-Diversified contract was not so extraordinary that it would have been unreasonable for Diversified to believe that the Harvard purchasing manager could enter into it.

⁶⁹ *Id.*

authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent.”⁷⁰ That definition indicates that inherent authority is a distinct type of authority, but it says very little about when it arises.

Later sections, however, provide further guidance. A general agent⁷¹ for a disclosed or partially disclosed principal has inherent authority to bind the principal “for acts done on his [the principal’s] account which usually accompany or are incidental to transactions which the agent is authorized to conduct if, although they are forbidden by the principal, the other party reasonably believes that the agent is authorized to do them and has no notice that he is not so authorized.”⁷²

Example: *P* hires *A* to manage a branch store of *P*’s retail operations. *A* has authority to manage the store on a day-to-day basis but is told expressly that he has no authority to mark down the prices of goods without the prior approval of *P*. *A* nevertheless marks down slow-moving goods which are sold to third persons. There is no actual authority, but *P* is bound by inherent authority if the act of marking down prices usually accompanies managerial duties, and if a third party reasonably believed that *A* was authorized to do such an act.

In the above example, can an argument be made that there was apparent authority? The principal gave *A* the position of “manager,” and it may be reasonable for third parties who know that *A* is a manager to believe that he has the authority to mark down prices.⁷³ In situations involving a disclosed or partially disclosed principal, therefore, the concepts of apparent authority and inherent authority typically overlap.

A further illustration is provided by the facts of *Kidd v. Thomas A. Edison, Inc.*⁷⁴ Edison engaged singers for “tone test” musical recitals which were designed to show the accuracy with which the singer’s voice was reproduced by the record albums made by the company. An Edison employee named Maxwell engaged Fuller to retain the singers. The plaintiff was one of the hired singers who apparently was not paid. She sued Edison for breach of contract. After a jury finding for the plaintiff, Edison moved to set aside the verdict. Maxwell testified that Fuller was authorized to retain singers, but only for performances where record dealers had agreed to pay the singer’s fee. Fuller, in other words, was not authorized to enter into contracts where Edison had the primary obligation to pay.⁷⁵

⁷⁰ RESTATEMENT (SECOND) OF AGENCY § 8A (1958).

⁷¹ A “general agent” is “an agent authorized to conduct a series of transactions involving a continuity of service.” *Id.* § 3(1).

⁷² *Id.* § 161.

⁷³ See Chapter 2(C)(2)(a)(2).

⁷⁴ 239 F. 405 (S.D.N.Y. 1917).

⁷⁵ See *id.* at 405-06.

In denying Edison’s motion, Judge Learned Hand observed that “while . . . the ‘tone test’ recitals were new, in the sense that no one had ever before employed singers for just this purpose of comparing their voices with their mechanical reproduction, they were not new merely as musical recitals; for it was, of course, a common thing to engage singers for such recitals.” More importantly, Judge Hand noted that “[w]hen . . . an agent is selected, as was Fuller, to engage singers for musical recitals, the customary implication would seem to have been that his authority was without limitation of the kind here imposed, which was unheard of in the circumstances.”⁷⁶

Given this analysis, Edison could be held liable on inherent authority grounds because (1) Fuller, its general agent, was authorized to engage singers for musical recitals, (2) the payment of the singer’s fees by the engager usually accompanied such authority, (3) the plaintiff reasonably believed, based upon the first two factors, that Fuller was authorized to bind Edison to payment, and (4) the plaintiff had no notice that Fuller’s authority in this regard had been curtailed. Notice, however, that these circumstances would also establish apparent authority by virtue of Fuller’s position. That is, Edison placed Fuller in the position of engaging singers for musical recitals. According to Judge Hand, it was reasonable for third parties such as the plaintiff to believe that a person in that position had the customary authority of persons in that position—notably, the ability to bind the engager to payment. Because the plaintiff was unaware that Fuller’s authority was more restricted, Fuller still had apparent authority to bind Edison. In short, *Edison* reiterates that in situations involving a disclosed or partially disclosed principal, the concepts of apparent authority and inherent authority typically overlap.

In an undisclosed principal situation, however, inherent authority has independent significance. After all, apparent authority involves a third party who reasonably believes, based on a *principal’s* manifestations, that another person was authorized to act on the *principal’s* behalf.⁷⁷ In an undisclosed principal situation, therefore, there can be no apparent authority, as the third party has no idea that a principal is involved in the transaction. Stated differently, in an undisclosed principal situation, a third party does not believe that the agent or other person is acting on behalf of someone else—a belief that is necessary for apparent authority. To the third party, the agent or other person appears to be acting for himself.⁷⁸ Nevertheless, even in the absence of actual and apparent authority, an undisclosed principal can still be bound via inherent authority.

⁷⁶ *Id.* at 406.

⁷⁷ *See* Chapter 2(C)(2)(a)(2).

⁷⁸ *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 194 cmt. a (1958) (“Since apparent authority is the power which results from acts which appear to the third person to be authorized by the principal, if such person does not know of the existence of a principal there can be no apparent authority.”); RESTATEMENT (THIRD) OF AGENCY § 2.03 cmt. f (2006) (“In contrast, apparent authority is not present when a third party believes that an interaction is with an actor who is a principal. . . . If a third party believes that an actor represents no one else’s interests, the third party does not have a reasonable belief in the actor’s power to affect anyone else’s legal position.”).

The case of *Watteau v. Fenwick*⁷⁹ is illustrative. In *Watteau*, the defendants were a group of brewers who purchased a “beerhouse” known as the Victoria Hotel from a man named Humble. For reasons that are not explained, the defendants wanted to conceal the fact that they now owned the pub. As a result, although Humble remained employed as the pub’s manager, he was also held out as the pub’s owner.⁸⁰

With the exception of bottled ales and mineral water, the defendants required Humble to purchase all of the goods needed for the pub from them. Over a period of years, however, Humble violated these instructions by purchasing on credit, in his own name, “cigars, bovril [a non-alcoholic drink], and other articles” from the plaintiffs. Apparently unpaid, the plaintiffs sued the defendants to recover. After finding for the plaintiffs, the defendants appealed.⁸¹

Did Humble have actual authority as the pub manager to buy the cigars and other items? Clearly not. Despite his position as manager, he was explicitly forbidden by the defendants from purchasing those goods from outsiders. Did Humble have apparent authority to engage in the purchases? This too is a dead-end. The plaintiffs had no idea that a principal-agent relationship was even involved in the transaction; they thought that Humble was buying for himself.⁸² Nevertheless, the court held the defendants liable:

[O]nce it is established that the defendant was the real principal, the ordinary doctrine as to principal and agent applies—that the principal is liable for all the acts of the agent which are within the authority usually confided to an agent of that character, notwithstanding limitations, as between the principal and the agent, put upon that authority. It is said that it is only so where there has been a holding out of authority—which cannot be said of a case where the person supplying the goods knew nothing of the existence of a principal. But I do not think so. Otherwise, in every case of undisclosed principal, or at least in every case where the fact of there being a principal was undisclosed, the secret limitation of authority would prevail and defeat the action of the person dealing with the agent and then discovering that he was an agent and had a principal.⁸³

This holding in *Watteau* is reflected in § 194 of the Second Restatement: “A general agent for an undisclosed principal authorized to conduct transactions subjects his principal to liability for acts

⁷⁹ [1893] 1 Q.B. 346 (Eng.).

⁸⁰ *See id.* at 346. The court noted that “[a]fter the transfer of the business, Humble remained as defendants’ manager; but the licence was always taken out in Humble’s name, and his name was painted over the door.” *Id.*

⁸¹ *See id.*

⁸² As the court noted, “[t]he plaintiff gave credit to Humble, and to him alone, and had never heard of the defendants.” *Id.* at 348; *see id.* at 349 (“There was no holding out, as the plaintiff knew nothing of the defendant[s].”).

⁸³ *Id.* at 348-49.

done on his account, if usual or necessary in such transactions, although forbidden by the principal to do them.”⁸⁴ Humble was authorized to manage the bar for the defendants. Purchasing cigars, non-alcoholic drinks, and similar items for patrons can be viewed as “usual or necessary” actions in carrying out the management of a bar. Thus, even though Humble was forbidden to make such purchases, the defendants are still liable for Humble’s actions.⁸⁵

What is the rationale for inherent authority? The Second Restatement bases the doctrine on the notion that, as between a principal who benefits from an agent’s actions and an innocent third party, it is more appropriate for the principal to bear the costs of the agent’s conduct:

The principles of agency have made it possible for persons to utilize the services of others in accomplishing far more than could be done by their unaided efforts. . . . Partnerships and corporations, through which most of the work of the world is done today, depend for their existence upon agency principles. The rules designed to promote the interests of these enterprises are necessarily accompanied by rules to police them. It is inevitable that in doing their work, either through negligence or excess of zeal, agents will harm third persons or will deal with them in unauthorized ways. It would be unfair

⁸⁴ See also RESTATEMENT (SECOND) OF AGENCY § 195 (1958) (discussing the inherent authority of manager-agents in an undisclosed principal situation); cf. RESTATEMENT (THIRD) OF AGENCY § 2.06(2) (2006) (preserving what is effectively inherent authority (although not designated as such) in undisclosed principal situations).

⁸⁵ A more modern application of inherent authority in the undisclosed principal setting is addressed in *Morris Oil Co. v. Rainbow Oilfield Trucking, Inc.*, 741 P.2d 840 (N.M. 1987). Dawn, the holder of a certificate of public convenience and necessity, was engaged in the oilfield trucking business. Rainbow was permitted to use Dawn’s certificate in order to operate a trucking enterprise in Hobbs, New Mexico. Dawn and Rainbow entered into several contracts giving Dawn control over Rainbow’s operations and a share of Rainbow’s gross receipts. See *id.* at 842.

Rainbow contracted in its own name to buy diesel fuel from defendant Morris. When Rainbow did not pay, Morris discovered Dawn’s relationship with Rainbow and ultimately sued Dawn. See *id.* at 842-43. The court held for Morris on several grounds, including the fact that Dawn was bound by Rainbow’s inherent authority at the time of the Rainbow-Morris contract. According to the court, Dawn (the undisclosed principal) entrusted Rainbow (the agent) with the management of Dawn’s enterprise in Hobbs. Because purchasing fuel for a trucking enterprise was “in the usual course of business engaged in by the agent,” the court found that inherent authority existed. See *id.* at 843-44.

Two peculiarities in *Morris Oil* are worth mentioning. First, the dispute could have been resolved on actual authority grounds. The court explicitly noted that “the agreement [between Dawn and Rainbow] specifically states that Rainbow may create liabilities of Dawn in the ordinary course of business of operating the terminal,” and it observed that “[t]here is no question that the liability to Morris was incurred in the ordinary course of operating the trucking business.” *Id.* at 843. Second, there is some question as to whether Rainbow was Dawn’s agent at all. Dawn collected all fees for transportation services conducted by Rainbow, deducted a \$1,000 per month clerical fee and a percentage of the gross receipts, and remitted the balance to Rainbow. See *id.* at 842. This arrangement could be viewed as Rainbow simply paying a fee to Dawn for the use of Dawn’s certificate (particularly if the share of gross receipts retained by Dawn was relatively small). With respect to the “on behalf of” element of the agency inquiry, therefore, Rainbow may have been acting primarily for its own benefit rather than for the benefit of Dawn. See Chapter 2(B)(1).

for an enterprise to have the benefit of the work of its agents without making it responsible to some extent for their excesses and failures to act carefully. The answer of the common law has been the creation of special agency powers or, to phrase it otherwise, the imposition of liability upon the principal because of unauthorized or negligent acts of his servants and other agents. These powers or liabilities are created by the courts primarily for the protection of third persons, either those who are harmed by the agent or those who deal with the agent. In the long run, however, they [i]nure to the benefit of the business world and hence to the advantage of employers as a class, the members of which are plaintiffs as well as defendants in actions brought upon unauthorized transactions conducted by agents.⁸⁶

The Third Restatement does not recognize inherent authority as an independent concept:

The term “inherent agency power,” used in Restatement Second, Agency, and defined therein by § 8A, is not used in this Restatement. Inherent agency power is defined as “a term used . . . to indicate the power of an agent which is derived not from authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent.” Other doctrines stated in this Restatement encompass the justifications underpinning § 8A, including the importance of interpretation by the agent in the agent’s relationship with the principal, as well as the doctrines of apparent authority, estoppel, and restitution.⁸⁷

Despite this position, § 2.06(2) of the Third Restatement preserves what is effectively inherent authority (although not designated as such) in undisclosed principal situations: “An undisclosed principal may not rely on instructions given an agent that qualify or reduce the agent’s authority to less than the authority a third party would reasonably believe the agent to have under the same circumstances if the principal had been disclosed.”

(4) Estoppel

Section 8B of the Second Restatement describes the doctrine of estoppel in the following manner:

(1) A person who is not otherwise liable as a party to a transaction purported to be done

⁸⁶ RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958); *see also id.* § 161 cmt. a (“The basis of the [inherent authority] liability stated in this Section is comparable to the liability of a master for the torts of his servant. . . . In the case of the master, it is thought fair that one who benefits from the enterprise and has a right to control the physical activities of those who make the enterprise profitable, should pay for the physical harm resulting from the errors and derelictions of the servants while doing the kind of thing which makes the enterprise successful. . . . Commercial convenience requires that the principal should not escape liability where there have been deviations from the usually granted authority by persons who are such essential parts of his business enterprise. In the long run it is of advantage to business, and hence to employers as a class, that third persons should not be required to scrutinize too carefully the mandates of permanent or semi-permanent agents who do no more than what is usually done by agents in similar positions.”).

⁸⁷ RESTATEMENT (THIRD) OF AGENCY § 2.01 cmt. b (2006).

on his account, is nevertheless subject to liability to persons who have changed their positions because of their belief that the transaction was entered into by or for him, if

(a) he intentionally or carelessly caused such belief, or

(b) knowing of such belief and that others might change their positions because of it, he did not take reasonable steps to notify them of the facts.⁸⁸

Estoppel is closely related to the doctrine of apparent authority. Both doctrines focus on holding the principal responsible for a third party's belief that a person is authorized to act on the principal's behalf. The doctrines, however, are distinct. Apparent authority holds the principal responsible for a third party's belief because of the principal's manifestations of authority to the third party. By contrast, the doctrine of estoppel can apply when the principal has not made any manifestations of authority to the third party at all. Instead, the principal is held responsible because the principal contributed to the third party's belief or failed to dispel it:

The [estoppel] doctrine is applicable when the person against whom estoppel is asserted has made no manifestation that an actor has authority as an agent but is responsible for the third party's belief that an actor is an agent and the third party has justifiably been induced by that belief to undergo a detrimental change in position. Most often the person estopped will be responsible for the third party's erroneous belief as the consequence of a failure to use reasonable care, either to prevent circumstances that foreseeably led to the belief, or to correct the belief once on notice of it. . . .⁸⁹

Thus, the estoppel doctrine can apply when apparent authority is unavailable. Consider the following example:

P has two coagents, *A* and *B*. *P* has notice that *B*, acting without actual or apparent authority, has represented to *T* that *A* has authority to enter into a transaction that is contrary to *P*'s instructions. *T* does not know that *P*'s instructions forbid *A* from engaging in the transaction. *T* cannot establish conduct by *P* on the basis of which *T* could reasonably believe that *A* has the requisite authority. *T* can, however, establish that *P* had notice of *B*'s representation and that it would have been easy for *P* to inform *T* of the limits on *A*'s authority. *T* detrimentally changes position in reliance on *B*'s representation by making a substantial down payment. If it is found that *T*'s action was

⁸⁸ RESTATEMENT (SECOND) OF AGENCY § 8B (1958); *see also* RESTATEMENT (THIRD) OF AGENCY § 2.05 (2006) (substantially the same). The Third Restatement makes it clear that the estoppel doctrine protects third parties who “justifiably” rely on a belief that an actor is an agent, and who act on that belief to their detriment. Although the Second Restatement lacks the “justifiably” term, the courts often impose a justifiable reliance requirement. *See, e.g.,* McNeil Real Estate Fund XXVI, L.P. v. Matthew's, Inc., 112 F. Supp. 2d 437, 443 (W.D. Pa. 2000).

⁸⁹ RESTATEMENT (THIRD) OF AGENCY § 2.05 cmt. c (2006); *see also id.* § 2.05 cmt. d (“The doctrine stated in this section may estop a person from denying the existence of an agency relationship with an actor when the third party would be unable to establish either the existence of a relationship of agency between the actor and the person estopped . . . or a manifestation of authority sufficient to create apparent authority . . .”).

justifiable, *P* is estopped to deny *B*'s authority to make the representation.⁹⁰

Apparent authority and estoppel also differ to the extent that apparent authority may be created without the need for a third party to establish a detrimental change in position. By contrast, estoppel requires such a showing.⁹¹ The requisite change in position can be demonstrated through “payment of money, expenditure of labor, suffering a loss or subsection to legal liability.”⁹²

How does estoppel differ from inherent authority? First, inherent authority only applies when a principal-agent relationship has been established. By contrast, estoppel can apply even when a principal-agent relationship is absent.⁹³ (The discussion of *Koos Bros.* below illustrates this point.) Second, while inherent authority can apply in undisclosed principal situations,⁹⁴ estoppel requires the third party to believe that the transaction was entered into on behalf of a purported principal.⁹⁵ In disclosed or partially disclosed principal situations, however, the doctrines likely cover similar ground.⁹⁶ Third, as with apparent authority, inherent authority may

⁹⁰ *Id.* § 2.05 illus. 1.

⁹¹ *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 8B cmt. b (1958); RESTATEMENT (THIRD) OF AGENCY § 2.03 cmt. e (2006).

⁹² RESTATEMENT (SECOND) OF AGENCY § 8B(3) (1958).

⁹³ *Compare* RESTATEMENT (SECOND) OF AGENCY §§ 161, 194 (1958) (establishing inherent authority in relationships between a “general agent” and its “principal”), *with id.* § 8B (describing estoppel more generically as a doctrine that can subject “[a] person who is not otherwise liable as a party” to liability for transactions believed to have been entered into “by or for him”), *and* RESTATEMENT (THIRD) OF AGENCY § 2.05 cmt. d (2006) (noting that the estoppel doctrine can apply “when the third party would be unable to establish . . . the existence of a relationship of agency between the actor and the person estopped”).

⁹⁴ *See* Chapter 2(C)(2)(a)(3).

⁹⁵ *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 2.05 (2006) (defining estoppel as involving “a person,” “an actor,” and “a third party,” and noting that liability can be imposed on the “person” when the third party believes that a transaction done by the “actor” was on the “person’s” account).

⁹⁶ If a disclosed or partially disclosed principal restricts an agent from performing acts that usually accompany transactions that the agent is authorized to conduct, the principal’s failure to inform third parties of this atypical restriction should give rise to inherent authority. *See* Chapter 2(C)(2)(a)(3). Moreover, the failure to inform third parties could give rise to estoppel on the grounds that the principal “carelessly caused” a third party’s belief that the agent had the typical scope of authority, or that the principal, “knowing of such belief . . . did not take reasonable steps to notify” the third party of the restriction. Technically, however, the doctrines of estoppel and inherent authority will never both apply to a particular situation, as the presence of inherent authority (or any type of authority) precludes the application of the estoppel doctrine. *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 8B (1958) (stating that estoppel only applies to a person “who is not otherwise liable as a party to a transaction”); RESTATEMENT (THIRD) OF AGENCY § 2.05 (2006) (stating that estoppel only applies to a person “who has not made a manifestation that an actor has authority as an agent and who is not otherwise liable as a party to a transaction”).

be created without the need for a third party to establish a detrimental change in position.

*Hoddeson v. Koos Bros.*⁹⁷ nicely illustrates the independent significance of the estoppel doctrine. Mrs. Hoddeson went to the Koos Bros. furniture store to purchase some bedroom furniture. Upon entering the store, she was “greeted by a tall man with dark hair frosted at the temples and clad in a light gray suit.” The man asked if he could be of assistance, and he guided Hoddeson to the furniture that she wanted. He informed Hoddeson that, other than the display models, her desired items were not in stock, but they would be delivered to her in a few weeks. Hoddeson paid him \$168.50 in cash—the amount calculated by the man as the purchase price—and she departed the store. After not receiving the furniture, she contacted Koos Bros. to inquire. To her dismay, she discovered that there was no record of her order, as the man was simply an imposter who was not affiliated with Koos Bros. She sued Koos Bros. to recover her \$168.50, and a jury found in her favor.⁹⁸

On appeal, Koos Bros. reiterated that the salesman was an imposter who was not affiliated with the store. Obviously, there was no actual authority that could bind Koos Bros. to the sale. What about apparent authority? While apparent authority can be established in the absence of a principal-agent relationship, the doctrine requires the principal—by words, conduct, or other manifestations—to “hold out” another person as someone authorized to act for the principal.⁹⁹ The imposter lacked apparent authority, therefore, because there were no manifestations by Koos Bros. indicating that the imposter had authority to act for it. The mere fact that the imposter purported to exercise authority on Koos Bros.’ behalf was insufficient.¹⁰⁰ Finally, although the court did not discuss it, inherent authority was inapplicable given the absence of a principal-agent relationship between Koos Bros. and the imposter.

Despite this absence of authority, the court ordered a new trial on the question of whether Koos Bros. could be liable under the doctrine of estoppel:

Our concept of the modern law is that where a proprietor of a place of business by his dereliction of duty enables one who is not his agent conspicuously to act as such and ostensibly to transact the proprietor’s business with a patron in the establishment, the

⁹⁷ 135 A.2d 702 (N.J. Super. Ct. App. Div. 1957).

⁹⁸ *See id.* at 703-05.

⁹⁹ *See* Chapter 2(C)(2)(a)(2).

¹⁰⁰ As the court observed:

The point here debated is whether or not the evidence circumstantiates the presence of apparent authority, and it is at this very point we come face to face with the general rule of law that the agency and appearance of authority must be shown to have been created by the manifestations of the alleged principal, and not alone and solely by proof of those of the supposed agent. Assuredly the law cannot permit apparent authority to be established by the mere proof that a mountebank in fact exercised it.

Hoddeson, 135 A.2d at 706; *see also* Chapter 2(C)(2)(a)(2) (discussing apparent authority).

appearances being of such a character as to lead a person of ordinary prudence and circumspection to believe that the impostor was in truth the proprietor's agent, in such circumstances the law will not permit the proprietor defensively to avail himself of the impostor's lack of authority and thus escape liability for the consequential loss thereby sustained by the customer.¹⁰¹

Using the language of the Second Restatement, if Hoddeson demonstrated at a new trial that Koos Bros. did not take sufficient steps to prevent imposters from posing as salesmen in its store, Koos Bros. would presumably be liable because it "carelessly caused [her] belief" that the impostor had the authority to act for the store. Alternatively, to the extent that Koos Bros. was aware that it had a problem with imposters, Hoddeson could argue that Koos Bros. knew that customers were being fooled into thinking that imposters acted for the store, but it "did not take reasonable steps to notify [the customers] of the facts."

(5) Ratification

Even if an agent acts without authority, a principal will be liable to a third party if (1) the agent purports to act (or, under the Third Restatement, acts) on the principal's behalf, and (2a) the principal affirmatively treats the agent's act as authorized (*express ratification*), or (2b) the principal engages in conduct that is justifiable only if the principal is treating the agent's act as authorized (*implied ratification*).¹⁰² Express ratification most commonly occurs through oral or written statements (e.g., a company resolution).¹⁰³ Implied ratification most commonly occurs when the principal has knowledge of an unauthorized transaction entered into purportedly on his behalf, but the principal nevertheless accepts the benefits of the transaction.¹⁰⁴

Example: *P* owns an advertising agency and employs *A* to service existing accounts by purchasing space in advertising media. *A* does not have authority to set terms with clients. *A* executes an agreement with *T* that commits *P* to develop a new advertising campaign for *T*. *P* learns of the agreement and then accepts and retains advance payment made by *T* for the new advertising campaign. By accepting and retaining the payment, *P* has ratified the unauthorized agreement made by *A*.

¹⁰¹ *Hoddeson*, 135 A.2d at 707; *see also id.* ("Certainly the proprietor's duty of care and precaution for the safety and security of the customer encompasses more than the diligent observance and removal of banana peels from the aisles. Broadly stated, the duty of the proprietor also encircles the exercise of reasonable care and vigilance to protect the customer from loss occasioned by the deceptions of an apparent salesman.").

¹⁰² *See* RESTATEMENT (SECOND) OF AGENCY §§ 82-83, 85, 100, 143 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 4.01-4.03 (2006).

¹⁰³ *Cf.* RESTATEMENT (SECOND) OF AGENCY § 93 (1958); RESTATEMENT (THIRD) OF AGENCY § 4.01(2) (2006).

¹⁰⁴ *Cf.* RESTATEMENT (SECOND) OF AGENCY §§ 98-99 (1958); RESTATEMENT (THIRD) OF AGENCY § 4.01 cmt. g (2006) ("A person may ratify an act . . . by receiving or retaining benefits it generates if the person has knowledge of material facts . . . and no independent claim to the benefit.").

A further illustration of both express and implied ratification occurred in *Evans v. Ruth*.¹⁰⁵ Homer Ruth was awarded a contract to provide crushed stone to certain state highways in Pennsylvania. One of Ruth's foremen, allegedly without authority, hired James Evans to haul stone. After the work was completed, Evans presented his bills to Ruth, who stated: "Well, I see you finished the work for me. . . . If you will have a sworn affidavit to that statement, I will pay you." Evans furnished the affidavit, but Ruth refused to pay. The court stated that Ruth "affirm[ed] [the contract] by stating that the work was done for him and that he would pay for it provided an affidavit was furnished." Even without this express ratification, Ruth probably would have been liable via implied ratification, as he received "weigh slips" from haulers, including Evans, indicating the weight of stones that had been hauled. Ruth submitted these weigh slips to the state in order to get himself paid. The weigh slips were evidence, in other words, that Ruth was aware of the contract with Evans, and his submission of those slips to the state for payment suggested that he knowingly accepted the benefits of his contract with Evans.¹⁰⁶

Ratification has occurred as soon as the principal objectively manifests his acceptance of the transaction, even if the fact of ratification is not communicated to the third party, the agent, or any other person.¹⁰⁷ When ratification occurs, the effect is to validate the contract as if it were originally authorized by the principal. Thus, ratification imposes liability upon a principal in the same manner as if the principal had actually authorized the contract in the first place.¹⁰⁸

Ratification, however, is subject to several restrictions. First, ratification is ineffective unless the principal, at the time of the ratification, was fully aware of all of the material facts involved in the original transaction.¹⁰⁹ Second, ratification must occur before the third party has withdrawn from the transaction.¹¹⁰ This rule reduces the risk that the principal will use ratification to speculate at the expense of the third party. We do not want the principal waiting to see if the deal works out to his advantage—ratifying the transaction if it does, and repudiating the transaction if it does not. Third, ratification is ineffective if it would be unfair to the third party

¹⁰⁵ 195 A. 163 (Pa. Super. Ct. 1937).

¹⁰⁶ *See id.* at 164-65.

¹⁰⁷ *See* RESTATEMENT (SECOND) OF AGENCY § 95 (1958); RESTATEMENT (THIRD) OF AGENCY § 4.01 cmt. d (2006) ("Ratification requires an objectively or externally observable indication that a person consents that another's prior act shall affect the person's legal relations. To constitute ratification, the consent need not be communicated to the third party or the agent. This is so because the focal point of ratification is an observable indication that the principal has exercised choice and has consented.").

¹⁰⁸ *See* RESTATEMENT (SECOND) OF AGENCY §§ 82, 100, 143 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 4.01(1), 4.02(1) (2006).

¹⁰⁹ *See* RESTATEMENT (SECOND) OF AGENCY § 91 (1958); RESTATEMENT (THIRD) OF AGENCY § 4.06 (2006).

¹¹⁰ *See* RESTATEMENT (SECOND) OF AGENCY § 88 (1958); RESTATEMENT (THIRD) OF AGENCY § 4.05 (2006).

as a result of changed circumstances.¹¹¹ Finally, ratification cannot operate to prejudice the rights of intervening persons—i.e., persons who are not parties to the transaction, but who acquired rights or other interests in the subject matter of the transaction before the ratification occurred.¹¹²

Example: Without authority to bind *P*, *A* purports to rent machinery from *T* for *P*. *A* delivers the machinery to *P*, representing that *T* has loaned the machinery to *P* without requiring compensation. *P* uses the machinery. There is no ratification by *P* because he was unaware of the material facts related to the rental transaction.

Example: *P* retains *A* to identify properties that *P* might purchase. Lacking actual or apparent authority to do so, *A* enters into a contract that purports to commit *P* to purchase Blackacre, which is owned by *T*. *T* notifies *P* that *T* withdraws from the transaction. If *P* subsequently affirms the contract made by *A*, ratification will not have occurred. *T* is not bound by the transaction because his withdrawal preceded *P*'s attempt to ratify.

Example: Purporting to act for *P* but without power to bind him, *A* contracts to sell Blackacre with an existing house to *T*. The next day the house burns to the ground. *P*'s later ratification does not bind *T*, as a material change in circumstances (the house burning) prior to the ratification makes it inequitable to bind *T*. *T*, however, may elect to be bound by the contract if he chooses.

Example: Purporting to act for *P* but without power to bind him, *A* makes a contract for the sale of *P*'s land to *T*. *B*, not knowing this, offers *P* a lower price than that called for by *T*'s contract. *P* accepts *B*'s offer. *P* then learns of the contract with *T* and attempts to ratify it. *B* is entitled to the land because *B* acquired his rights to the land before *P*'s attempt to ratify.¹¹³

As mentioned, ratification requires an agent to purport to act on a principal's behalf. Under the Second Restatement, therefore, there can be no ratification by an undisclosed principal. By definition, in an undisclosed principal situation, a third party has no notice that the agent is acting for a principal; thus, the agent is not purporting to act on a principal's behalf. The Third Restatement changes this rule and allows ratification by an undisclosed principal by stating that a person may ratify an act "if the actor *acted or purported to act* as an agent on the principal's

¹¹¹ See RESTATEMENT (SECOND) OF AGENCY § 89 (1958); RESTATEMENT (THIRD) OF AGENCY § 4.05 (2006).

¹¹² See RESTATEMENT (SECOND) OF AGENCY § 101(c) (1958); RESTATEMENT (THIRD) OF AGENCY § 4.02(2)(c) (2006).

¹¹³ Can a principal ratify part of a transaction and repudiate other aspects of it? For example, assume that *A*, acting without authority, purports to enter into a contract on behalf of *P* for the sale of land to *T*. The contract price is for \$300,000, and the sale is set to close at the end of next month. Can *P* ratify the price aspect of the transaction because *P* is pleased with the \$300,000 sum, but reject the closing date because *P* wishes to finalize the sale earlier? Unfortunately for *P*, ratifying only part of a single transaction is impermissible. An effective ratification must encompass "the entirety of an act, contract, or other single transaction." RESTATEMENT (THIRD) OF AGENCY § 4.07 (2006); see RESTATEMENT (SECOND) OF AGENCY § 96 (1958).

behalf.”¹¹⁴ Because an agent for an undisclosed principal acts on the principal’s behalf (even though he does not purport to do so), ratification by an undisclosed principal is permissible under the Third Restatement.

What function does ratification serve? Consider the following:

Ratification often serves the function of clarifying situations of ambiguous or uncertain authority. A principal’s ratification confirms or validates an agent’s right to have acted as the agent did. That is, an agent’s action may have been effective to bind the principal to the third party, and the third party to the principal, because the agent acted with apparent authority. If the principal ratifies the agent’s act, it is thereafter not necessary to establish that the agent acted with apparent authority. Moreover, by replicating the effects of actual authority, the principal’s ratification eliminates claims the principal would otherwise have against the agent for acting without actual authority. The principal’s ratification may also eliminate claims that third parties could assert against the agent when the agent has purported to be authorized to bind the principal but the principal is not bound. . . .¹¹⁵

(6) Summary

What was the point of walking through these authority and related doctrines? (By now, you may have forgotten.) Recall that a principal will be liable on a contract between an agent and a third party when the agent acts with actual authority, apparent authority, or inherent authority. Even when the agent lacks one of these three types of authority, the principal may be liable under the doctrines of estoppel or ratification. Thus, the authority and related doctrines are important because, when they are established, the principal will be liable to a third party for contracts entered into by an agent.

b. LIABILITY OF THE THIRD PARTY TO THE PRINCIPAL

When an agent makes a contract for a disclosed or partially disclosed principal, the third party is liable to the principal if the agent acted with authority (actual, apparent, or, under the Second Restatement, inherent), so long as the principal is not excluded as a party by the form or terms of the contract.¹¹⁶ When an agent makes a contract for an undisclosed principal, the third party is liable to the principal if the agent acted with authority (actual or, under the Second Restatement, inherent), so long as the principal is not excluded by the form or terms of the contract, the existence of the principal is not fraudulently concealed, and there is no set-off or

¹¹⁴ RESTATEMENT (THIRD) OF AGENCY § 4.03 (2006) (emphasis added).

¹¹⁵ RESTATEMENT (THIRD) OF AGENCY § 4.01 cmt. b (2006) (citation omitted).

¹¹⁶ See RESTATEMENT (SECOND) OF AGENCY §§ 292-293 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 6.01(1), 6.02(1) (2006). Because ratification functions as a substitute for actual authority, ratification by the principal would also seem to bind the third party. See RESTATEMENT (SECOND) OF AGENCY § 292 cmt. a (1958); RESTATEMENT (THIRD) OF AGENCY § 6.03 cmt. c (2006); see also Chapter 2(C)(2)(a)(5) (discussing ratification).

similar defense against the agent.¹¹⁷ In most situations, therefore, one can generally assert that a third party will be liable to the principal in circumstances where the principal is liable to the third party.¹¹⁸

Example: *A* is a general agent for *P* who manages *P*'s business. With *P*'s consent, the business is conducted in *A*'s name. *A* enters into a contract in his own name to buy goods from *T* which are suitable for the business. The purchase has been authorized by *P*. If *T* fails to deliver the goods, *P* can maintain an action against *T* for such failure because *A* had actual authority to enter into the contract with *T*.

Example: *P* authorizes *A* to buy Blackacre from *T*. *A* goes to *T*, who refuses to deal with *P* in any manner. Although *T* realizes that *A* is acting in *P*'s interest, it is stated in the written agreement that the contract is made solely between *A* and *T* and that *P* is not a party to the agreement. *P* has no cause of action against *T* on the contract because the terms of the agreement exclude *P*.

Example: *P* is the undisclosed principal of *A*. Pursuant to *P*'s instructions, *A* enters into a stock purchase agreement with *T* Corporation on behalf of *P*. The agreement contains a representation made by *A* that *A* acts solely for *A*'s account and that no other person will have any interest in the securities that *A* will acquire from *T* Corporation. *P* cannot enforce the agreement against *T* Corporation because the terms of the agreement exclude *P*.

Example: *P*, who owns a farm, engages *A* to sell cattle owned by *P*. *P* tells *A* to contract in *A*'s own name. *A* sells cattle to *T* for \$10,000 (with *T* having no notice that *A* is acting as an agent). At the time of the sale, *A* also independently owes \$4,000 to *T*. *P* demands payment of the \$10,000 from *T*. Because *A* had actual authority to enter into the contract with *T*, *T* is liable to *P*. *T*'s liability to *P*, however, is only \$6,000. *T* is entitled to set off the \$4,000 amount that *A*

¹¹⁷ See RESTATEMENT (SECOND) OF AGENCY §§ 302-304, 306, 308 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 6.03, 6.06, 6.11(4) (2006). As mentioned, apparent authority is inapplicable in an undisclosed principal situation. See Chapter 2(C)(2)(a)(3). Once again, because ratification functions as a substitute for actual authority, ratification by the principal would also seem to bind the third party. See Chapter 2(C)(2)(a)(5).

¹¹⁸ See Chapter 2(C)(2)(a) (discussing when a principal is liable to a third party). This general notion of reciprocal liability does not seem to apply when the principal is liable to the third party on the grounds of estoppel. See, e.g., RESTATEMENT (SECOND) OF AGENCY § 8B cmt. b (1958) ("However, contrary to the rule as to apparent authority, one who is estopped to deny liability upon a contract which was purportedly made for him does not thereby have a right of action against the other party. He may, however, gain rights by ratification if he satisfies the requirements as to formalities." (citation omitted)). Moreover, while the Third Restatement does preserve a vestige of inherent authority in undisclosed principal situations, see RESTATEMENT (THIRD) OF AGENCY § 2.06(2) (2006), this provision only makes the principal liable to a third party. For the third party to be liable to the principal, the principal must bind itself through actual authority or ratification. See RESTATEMENT (THIRD) OF AGENCY § 6.03 cmt. c (2006) ("If an agent acts without actual authority in making a contract on behalf of an undisclosed principal, the principal may be subject to liability as stated in § 2.06. A principal in such a case may acquire rights against the third party by ratifying the agent's conduct as stated in § 4.03.").

owes *T*.

The fraudulent concealment exception merits some additional discussion. When an agent contracting on behalf of an undisclosed principal falsely represents that he is acting solely for himself (i.e., falsely represents that he is not acting on behalf of a principal), the Second and Third Restatements both provide that the third party can avoid the contract if the principal or the agent had notice that the third party would not have dealt with the principal.¹¹⁹

Example: *P* is *A*'s undisclosed principal. With authorization from *P*, *A* contacts *T* and offers to sell and deliver to *T* 1,000 shares in a corporation. Neither *P* nor *A* has notice that *T* would be unwilling to deal with *P*. In response to a question by *T*, *A* falsely represents that he is not acting on behalf of a principal. *A* and *T* then enter into a contract for the sale of the shares. *P* can enforce this contract.

Example: Same facts as above, except that *A* has notice that *T* would not enter into any contract if *T* knew that *P* was the principal. *P* cannot enforce the contract if *T* elects to rescind. The same result occurs if *A* had no notice that *T* would be unwilling to deal with *P*, but *P* did have such notice.

This fraudulent concealment exception can be confusing. After all, doesn't an agent contracting on behalf of an undisclosed principal always represent that he is acting solely for himself and not on behalf of a principal? While an agent acting on behalf of an undisclosed principal certainly represents that he is acting for himself, he does not represent that he is acting *solely* for himself—unless that particular representation is affirmatively made in some manner. Thus, the fraudulent concealment exception applies only if the agent does something more than simply sign his name to a contract. In the above examples, the agent does something more by affirmatively denying the existence of a principal.¹²⁰

*Hirsch v. Silberstein*¹²¹ discusses the fraudulent concealment exception in circumstances suggesting racial discrimination. The Hirsches sold a lot next to their home to the Silbersteins

¹¹⁹ See RESTATEMENT (SECOND) OF AGENCY §§ 9, 304 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 1.04(4), 6.11(4) (2006). Mere doubts or suspicions about the third party's willingness to deal with the principal do not satisfy this "notice" standard. See, e.g., RESTATEMENT (THIRD) OF AGENCY § 6.11 cmt. d (2006).

¹²⁰ See, e.g., RESTATEMENT (THIRD) OF AGENCY § 6.11 cmt. d (2006) ("When an agent deals with a third party on behalf of a principal but does not disclose the principal's existence, the agent does not impliedly represent that the agent does not act on behalf of a principal. . . . If a third party wishes certainty that the party with whom it deals will be the only party with rights and liabilities under the contract . . . [t]he third party may also ask the person with whom it deals whether that person acts as agent for an undisclosed principal. . . . If the agent answers the third party's question falsely, the agent has made a false representation to the third party. This is a basis on which the third party may avoid a contract made with the agent on behalf of the undisclosed principal if the agent had notice that the third party would not have dealt with the principal.").

¹²¹ 227 A.2d 638 (Pa. 1967).

for \$10,000. Apparently the Silbersteins had represented that they intended to build their own home on the lot and to live there as neighbors of the Hirsches. Mr. Hirsch personally inspected Mr. Silberstein's place of work and investigated Mr. Silberstein's credit. As a result of these investigations, he concluded that the Silbersteins would make desirable neighbors, and he agreed to sell them the lot. The Silbersteins, however, were acting as a "straw party" for the Crosses, an African-American family, and the Silbersteins conveyed the property to the Crosses as soon as they acquired it. The Hirsches sued for rescission, and Mr. Hirsch claimed that he "would not have entered into the agreement of sale had he known that there had been any misrepresentation with reference to who was going to occupy the land." The court rejected the claim, noting that "[t]he Silbersteins were under no legal duty to reveal the existence of their undisclosed principals." According to the court, "[w]hile the instant record may indicate a representation by Silberstein that he was not acting on behalf of a principal, it is nonetheless barren of any evidence that appellants would not have dealt with the Crosses had their existence been known."¹²² Although an admission of racial prejudice might have caused the Hirsches difficulties under a variety of civil rights laws, such prejudice, if brought to the attention of the Silbersteins or the Crosses before the contract was entered into, presumably would have been a sufficient basis for rescission under the fraudulent concealment exception.¹²³

Despite the general rules stated above, an undisclosed principal cannot bind a third party to a contract if the principal's role in the contract substantially changes the third party's rights or obligations:

The nature of the performance that a contract requires determines whether performance by an undisclosed principal will be effective as performance under the contract and whether an undisclosed principal can require that the third party render performance to the principal. Performance by an undisclosed principal is not effective as performance under a contract if the third party has a substantial interest in receiving performance from the agent who made the contract. This limit corresponds to the limit on delegability of performance of a duty The nature of the performance that a contract requires from a third party determines whether an undisclosed principal is entitled to receive that performance. An undisclosed principal may not require that a third party render performance to the principal if rendering performance to the principal would materially change the nature of the third party's duty, materially increase the burden or risk imposed on the third party, or materially impair the third party's chance of receiving return performance. These limits correspond to the limits imposed on

¹²² *Id.* at 639.

¹²³ The purchase agreement between the Hirsches and the Silbersteins included an anti-assignment clause. The court held that the clause was not violated because the agreement of sale was not assigned; instead, the Silbersteins conveyed the property in an entirely separate transaction to the Crosses. If the Silbersteins were agents on behalf of an undisclosed principal (the Crosses), however, it is more accurate to say that the Crosses themselves were parties to the original purchase agreement because the Silbersteins had actual authority to enter into the agreement on behalf of the Crosses. *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 6.03 (2006) (noting the general rule that "[w]hen an agent acting with actual authority makes a contract on behalf of an undisclosed principal, . . . unless excluded by the contract, the principal is a party to the contract"). Thus, no assignment (or further conveyance) was necessary.

assignment of a contractual right.¹²⁴

Example: *T* enters into a contract with *A* in which *A* promises to manage *T*'s investment portfolio. *A* does not disclose that *A* makes the contract on behalf of *P*. *P* offers to manage *T*'s portfolio. *T* is free to accept or reject *P*'s offer of performance. *P*'s offer does not constitute an offer of performance of the contract made by *A*. *T* has a substantial interest in receiving investment-management services from *A*.

Example: *T* enters into a contract to purchase a quantity of coal of a specified kind from *A*. *A* does not disclose that *A* makes the contract on behalf of *P*. *P* tenders coal to *T* of the specified kind and quantity. *P*'s tender has the effect of a tender by *A* because *T* has no substantial interest in receiving the coal from *A*.

Example: *T* agrees to work as a nanny for *A*. *P*, *A*'s undisclosed principal, cannot require *T* to work as a nanny for *P*. The contract between *T* and *A* requires that *T* render personal services in an ongoing close association. Requiring *T* to render the services to *P* would materially change the nature of *T*'s duties.

Example: *T* agrees to sell Blackacre in exchange for cash to *A*, who acts on behalf of *P*, *A*'s undisclosed principal. *P* may require performance from *T* (assuming that neither *P* nor *A* had notice that *T* would not have dealt with *P*). The contract made by *A* requires only the payment of money in exchange for Blackacre.

c. LIABILITY OF THE AGENT TO THE THIRD PARTY

If an agent contracts with a third party on behalf of a disclosed principal, the general rule is that the agent is not a party to the contract and is not liable to the third party.¹²⁵ This result is consistent with the third party's expectations—i.e., the third party expected that he was entering into a contract with the principal and not with the agent.

Example: *P* instructs *A* to purchase a computer on *P*'s behalf. *A* goes to *T*'s computer store and represents to *T* that he is buying for the account of *P*. A contract is entered into. *P* is liable on the contract, but *A* is not.

If an agent contracts with a third party on behalf of a partially disclosed or undisclosed principal, the general rule is that the agent is a party to the contract and is liable to the third party (regardless of whether the principal is also liable to the third party).¹²⁶ The third party's right to

¹²⁴ RESTATEMENT (THIRD) OF AGENCY § 6.03 cmt. d (2006); see RESTATEMENT (SECOND) OF AGENCY §§ 309-310 (1958).

¹²⁵ See RESTATEMENT (SECOND) OF AGENCY § 320 (1958); RESTATEMENT (THIRD) OF AGENCY § 6.01(2) (2006).

¹²⁶ See RESTATEMENT (SECOND) OF AGENCY §§ 321-322 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 6.02(2), 6.03(2), 6.09 (2006). If an agent becomes a party to a contract under the general rule, and if the

hold the agent responsible on contracts with partially disclosed principals is based on the common sense notion that a third party normally would not agree to look solely to a person whose identity is unknown for performance of the contract. If the third party does not know the identity of the principal, the third party cannot investigate the solvency and reliability of the principal; thus, the third party probably expected the agent to be liable.¹²⁷ Similarly, the third party's right to hold the agent responsible on contracts with undisclosed principals is also consistent with the third party's expectations—i.e., the third party expected the agent to be a party to the contract because the agent presented the deal as if he were acting for himself. Moreover, if the third party is unaware of the principal's existence, the third party must be relying on the agent's solvency and reliability when entering into the contract.

Example: *P*, a well-known manufacturer, instructs *A* to offer to sell goods on *P*'s behalf to *T* without revealing *P*'s identity. *A* makes the offer and truthfully advises *T* that *A* is making the offer on behalf of a well-known manufacturer. *A* does not disclose *P*'s identity. *T* accepts the offer. Both *P* and *A* are liable on the contract. *P* is liable because *A* acted with actual authority in entering into the transaction. *A* is liable because he is an agent acting on behalf of a partially disclosed principal.

Example: Same facts as above, but *A* offers to sell the goods to *T* without disclosing that they are *P*'s goods and that he is selling the goods on *P*'s behalf. *T* accepts the offer. Both *P* and *A* are liable on the contract. *P* is liable because *A* acted with actual authority in entering into the transaction. *A* is liable because he is an agent acting on behalf of an undisclosed principal.

An agent who purports to act on behalf of a principal makes an implied warranty of authority to a third party. If the agent lacks the power to bind the principal, the agent is liable to the third party for breach of the implied warranty (unless the agent conveyed that he was not making such a warranty or the third party knew that the agent had no authority).¹²⁸ The agent may also be liable to the third party under a theory that he has tortiously misrepresented his authority.¹²⁹

third party breaches the contract in some manner, the third party may be liable to the agent. *See, e.g.,* RESTATEMENT (THIRD) OF AGENCY § 6.03 cmt. e (2006) (“As a party to a contract made on behalf of an undisclosed principal, an agent may sue the third party in the agent’s own name.”).

¹²⁷ In *Van D. Costas, Inc. v. Rosenberg*, 432 So. 2d 656 (Fla. Dist. Ct. App. 1983), the president of Seascape Restaurants, Inc. signed a contract with his name and the trade name of the restaurant—“Jeff Rosenberg, The Magic Moment.” The court cited authority for the proposition that the use of a trade name is not a sufficient disclosure of the identity of the principal to create a disclosed principal situation (which would eliminate the liability of the agent). Instead, Rosenberg was held liable as an agent for a partially disclosed principal. *See id.* at 657-59.

¹²⁸ *See* RESTATEMENT (SECOND) OF AGENCY § 329 (1958); RESTATEMENT (THIRD) OF AGENCY § 6.10 (2006). The Third Restatement explicitly indicates that the agent is not liable for breach of the implied warranty if the principal ratified the agent's conduct. *See id.* § 6.10(1).

¹²⁹ *See* RESTATEMENT (SECOND) OF AGENCY § 330 (1958); RESTATEMENT (THIRD) OF AGENCY § 6.10 cmt. a (2006) (“An agent who falsely warrants authority may be subject to liability for fraud or negligent misrepresentation.”).

Example: A, a mortgage broker claiming to act as agent for P Corporation, makes an oral contract to sell mortgage-backed securities owned by P Corporation to T Bank. A acted without actual, apparent, or inherent authority. A is subject to liability to T Bank for loss to T Bank resulting from T Bank's reliance on A's implied representation that A had the power to bind P Corporation.

D. DUTIES OF THE AGENT AND THE PRINCIPAL TO EACH OTHER

1. THE AGENT'S DUTIES TO THE PRINCIPAL

An agency relationship has the important characteristic of being a *fiduciary* relationship—i.e., an agent is a fiduciary with respect to matters within the scope of his agency.¹³⁰ This effectively means that an agent is held to a very high standard of conduct in carrying out tasks for the principal. An agent's fiduciary duties require the agent to act *loyally* and *carefully* when acting within the scope of the agency. Some examples of this loyalty obligation include the following: (1) an agent is accountable to the principal for any profits arising out of the transactions he is to conduct on the principal's behalf;¹³¹ (2) an agent must act solely for the benefit of the principal and not to benefit himself or a third party;¹³² (3) an agent must refrain from dealing with his principal as an adverse party or from acting on behalf of an adverse party;¹³³ (4) an agent may not compete with his principal concerning the subject matter of the agency;¹³⁴ and (5) an agent may not use the principal's property (including confidential information) for the agent's own purposes or a third party's purposes.¹³⁵ In general, these prohibitions on an agent's behavior can be trumped by

¹³⁰ See RESTATEMENT (SECOND) OF AGENCY § 13 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 1.01, 8.01 (2006).

¹³¹ See RESTATEMENT (SECOND) OF AGENCY § 388 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 8.02, 8.06.

¹³² See RESTATEMENT (SECOND) OF AGENCY § 387 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 8.01, 8.06 (2006).

¹³³ See RESTATEMENT (SECOND) OF AGENCY §§ 389, 391 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 8.03, 8.06 (2006).

¹³⁴ See RESTATEMENT (SECOND) OF AGENCY § 393 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 8.04, 8.06 (2006).

¹³⁵ See RESTATEMENT (SECOND) OF AGENCY §§ 395-396, 398, 402, 404, 422-423 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 8.05, 8.06, 8.12 (2006). An interesting application of this principle is found in *Reading v. Attorney General*, [1948] 2 K.B. 268 (Eng.). While in uniform, a British soldier stationed in Cairo helped escort a smuggler's trucks through police checkpoints. Because of the presence of the soldier, the trucks were allowed to pass without being inspected. The smuggler paid the soldier approximately 20,000 pounds, but the army discovered his actions and seized the funds. See *id.* at 269-70. The soldier sued to recover his money, but the court rejected the claim. As the court indicated, where "the wearing of the King's uniform and his position as a soldier is the sole cause of his getting the money, and getting it dishonestly, that is an advantage which he is not allowed to keep." *Id.* at 277. The soldier's official uniform and position can be viewed as property of the principal that the soldier improperly exploited for his

agreement. If a fully informed principal consents to the behavior, in other words, there is usually no problem.¹³⁶

The decision of *Tarnowski v. Resop*¹³⁷ involves the agent's duty of loyalty. The plaintiff engaged the defendant as his agent to locate a route of coin-operated music machines that was suitable for purchase. The defendant allegedly investigated a business owned by the sellers and proposed that the plaintiff purchase the business. After the plaintiff did so, he discovered that the defendant had misrepresented the extent of his investigation and had passed along false statements of the sellers. The plaintiff sued the sellers for fraud and received a judgment for \$10,000 (which largely served as a return of the \$11,000 that the plaintiff had paid for the business). The plaintiff then sued the defendant agent for a \$2,000 commission the defendant had received from the sellers, as well as for various amounts of damages.¹³⁸

With respect to the recovery of the \$2,000 commission, the court noted that all profits made by an agent in the course of an agency belong to the principal "whether they are the fruits of performance or the violation of an agent's duty." According to the court, "[i]t matters not that the principal has suffered no damage or even that the transaction has been profitable to him." Moreover, the principal's right "is not affected by the fact that the principal, upon discovering a fraud, has rescinded the contract and recovered that with which he parted." The plaintiff had an "absolute right" to the \$2,000 commission "irrespective of any recovery resulting from the action against the sellers for rescission."¹³⁹ The strictness of this rule is premised on the basic notion that we want the agent committed fully to the principal's interests; correspondingly, we do not want that commitment diluted by the agent's efforts to seek profits for himself. As a consequence, there is a strict rule of disgorgement of profits by the agent.

The plaintiff also sought to recover damages for losses suffered in the business prior to rescission, loss of time devoted to the operation, and the expenses and attorneys' fees incurred in connection with the suit against the sellers. The court allowed the plaintiff to recover all of these damages. Citing agency principles, the court noted that when an agent receives a benefit as a result of violating his duty of loyalty, the principal is entitled to recover that benefit as well as the amount of damages caused by the breach. Citing tort principles, the court observed that a wrongdoer is

own personal purposes. *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 404 illus. 3 (1958) ("A soldier uses his official uniform and position to smuggle forbidden goods into a friendly country and thereby makes large profits. The country by which he is employed is entitled to the profits.").

¹³⁶ For example, why are waiters, bartenders, and other service personnel allowed to retain tips from customers? As agents, they are accountable to the principal for all profits received in the course of the agency relationship. Nevertheless, in most service industries, the principal implicitly or explicitly consents to the agent keeping the tips. *Cf.* RESTATEMENT (SECOND) OF AGENCY § 388 cmt. b (1958) ("An agent can properly retain gratuities received on account of the principal's business if, because of custom or otherwise, an agreement to this effect is found.").

¹³⁷ 51 N.W.2d 801 (Minn. 1952).

¹³⁸ *See id.* at 802.

¹³⁹ *Id.* at 802-03.

liable for all of the foreseeable injuries resulting from his tortious acts.¹⁴⁰

When all was said and done, the plaintiff had recovered (1) almost all of the purchase price that he had paid the sellers; (2) damages caused by the agent's misconduct; and (3) the \$2,000 commission the sellers paid to the agent. In other words, the plaintiff was made more than whole—he recovered his losses *and* was allowed to recover the agent's \$2,000 profit. What justifies this result? As the court observed, “[f]idelity in the agent is what is aimed at.”¹⁴¹ It bears repeating that, in order to ensure that an agent does not put his interests before those of the principal, the law requires the agent to disgorge all of his ill-gotten gains, regardless of whether the principal has been made whole. If an agent was allowed to retain profits made in the scope of the agency, the agent may be tempted to advance his own interest in maximizing personal profits rather than the interests of the principal.¹⁴² Because motivating fidelity in the agent is of paramount importance, the law is not particularly bothered if the principal receives a windfall along the way.

As mentioned, the agency relationship requires an agent to act carefully as well. An agent “has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances.”¹⁴³ Moreover, “[i]f an agent claims to possess special skills or knowledge, the agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge.”¹⁴⁴ Although the *Tarnowski* court did not focus explicitly on the agent's duty of care, the defendant agent likely breached that duty by conducting only a superficial investigation into the sellers' business and the accuracy of their representations.¹⁴⁵

In many circumstances, an agent also has a duty to disclose information to the principal. The agent must “use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.”¹⁴⁶ This disclosure

¹⁴⁰ *See id.* at 803-04.

¹⁴¹ *Id.* at 803.

¹⁴² For example, on the facts of *Tarnowski*, we do not want the agent thinking something along the lines of “Maybe I won't investigate the sellers' representations too much because I won't get the commission if this deal falls through.”

¹⁴³ RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006); *see* RESTATEMENT (SECOND) OF AGENCY § 379 (1958).

¹⁴⁴ RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006); *see* RESTATEMENT (SECOND) OF AGENCY § 379 (1958).

¹⁴⁵ *See Tarnowski*, 51 N.W.2d at 802.

¹⁴⁶ RESTATEMENT (SECOND) OF AGENCY § 381 (1958); *see id.* § 390 (imposing a duty to disclose on an agent who acts as an adverse party with the principal's consent); RESTATEMENT (THIRD) OF AGENCY §§ 8.06, 8.11 (2006).

obligation between parties in a fiduciary relationship differs dramatically from the lack of a duty to volunteer information in an arm's length transaction.

Example: *M* is looking for a site for his plant. He learns that *O* has a site for sale. The asking price is \$250,000. *M* and *O* negotiate and agree upon a price of \$247,500. In this negotiation, *O* does not disclose that he purchased the site for \$150,000 a few days before—information that would have been relevant to *M*'s decision to agree to the \$247,500 price. *O*'s failure to disclose this information is not a breach of any duty and *M* may not rescind the transaction.

Example: *P* retains *A* to purchase a suitable manufacturing site for him. *A* owns a suitable site which he offers to *P* for \$250,000, a fair price. *A* tells *P* all of the relevant facts, but he fails to disclose that he purchased the site for \$150,000 a short time ago. *A* has breached his duty and the transaction may be rescinded by *P*.

An agent also has a duty to act only as authorized by the principal.¹⁴⁷ It should come as no surprise, therefore, that an agent acting without actual authority is liable to his principal for any loss suffered by the principal (e.g., if an agent lacking actual authority binds the principal via apparent authority).¹⁴⁸

Example: *A* acts as *P* Insurance Co.'s agent for purposes of issuing policies of workers' compensation insurance. *A* issues a binder policy to *T*. *A* acts with apparent authority in issuing this policy but *A* issues it in a manner clearly prohibited by *A*'s agency agreement with *P* Insurance Co. *E*, an employee of *T*, suffers a job-related injury. *P* Insurance Company must pay the claim even though *A* exceeded *A*'s actual authority in issuing the insurance policy to *T*. *A* is subject to liability to *P* Insurance Co. for the amount of *E*'s claim against *P* Insurance Co. *A* is also subject to liability for any costs *P* Insurance Co. incurs in opposing *T*'s claim.

2. THE PRINCIPAL'S DUTIES TO THE AGENT

A principal's duties to an agent are not fiduciary in nature as fiduciary responsibilities run only from the agent to the principal.¹⁴⁹ Nevertheless, a principal has several obligations to an agent. For example, a principal must perform his contractual commitments to the agent, must not unreasonably interfere with the agent's work, and must generally act fairly and in good faith towards the agent.¹⁵⁰ In addition, if an agent incurs expenses or suffers other losses in carrying out

¹⁴⁷ See RESTATEMENT (SECOND) OF AGENCY §§ 383, 385 (1958); RESTATEMENT (THIRD) OF AGENCY § 8.09 (2006).

¹⁴⁸ See RESTATEMENT (SECOND) OF AGENCY §§ 399, 401 (1958); RESTATEMENT (THIRD) OF AGENCY § 8.09 & cmt. b (2006).

¹⁴⁹ See Chapter 2(D)(1).

¹⁵⁰ See RESTATEMENT (SECOND) OF AGENCY §§ 432-437 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 8.13, 8.15 (2006).

the principal's instructions, the principal has a duty to indemnify the agent.¹⁵¹ Perhaps most importantly, unless the circumstances indicate otherwise, it will be inferred that the principal agreed to compensate the agent for his services.¹⁵²

E. TERMINATION OF THE AGENT'S POWER

As previously discussed, the relationship between an agent and a principal is a consensual one.¹⁵³ Actual authority from that relationship terminates when the objective of the relationship has been achieved, when the principal or the agent dies, and in a variety of other circumstances.¹⁵⁴ Actual authority also terminates when the principal revokes it or the agent renounces it.¹⁵⁵ If the agency relationship is based on contract, however, the decision to terminate actual authority may result in a breach of that contract. Nevertheless, actual authority has ended, even though contractual liability may exist for its termination.¹⁵⁶ Stated differently, a principal or an agent always has the power to terminate actual authority, but he may not have the right.¹⁵⁷

Example: *P*, who owns a hotel, retains *A Corp.* to manage it. *P* and *A Corp.* enter into an agreement providing that, in exchange for *A Corp.*'s management services, *A Corp.* will receive a commission equal to five percent of the hotel's gross revenues. The agreement further provides that *A Corp.*'s authority shall be irrevocable by *P* for a period of 10 years. Two years later, *P* revokes *A Corp.*'s authority. *A Corp.*'s actual authority is terminated, although *A Corp.* may sue

¹⁵¹ See RESTATEMENT (SECOND) OF AGENCY §§ 438-440 (1958); RESTATEMENT (THIRD) OF AGENCY § 8.14 (2006).

¹⁵² See RESTATEMENT (SECOND) OF AGENCY §§ 441, 443 (1958); RESTATEMENT (THIRD) OF AGENCY § 8.13 cmt. d (2006) ("Unless an agreement between a principal and an agent indicates otherwise, a principal has a duty to pay compensation to an agent for services that the agent provides.").

¹⁵³ See Chapter 2(B)(1).

¹⁵⁴ See RESTATEMENT (SECOND) OF AGENCY §§ 105-124 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 3.06-3.10 (2006).

¹⁵⁵ See RESTATEMENT (SECOND) OF AGENCY § 117-119 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 3.09-3.10 (2006).

¹⁵⁶ See RESTATEMENT (SECOND) OF AGENCY § 118 (1958); *id.* § 118 cmt. b ("The principal has power to revoke [authority] and the agent has power to renounce [authority], although doing so is in violation of a contract between the parties and although the authority is expressed to be irrevocable. A statement in a contract that the authority cannot be terminated by either party is effective only to create liability for its wrongful termination."); RESTATEMENT (THIRD) OF AGENCY § 3.10(1) & cmt. b (2006).

¹⁵⁷ The rationale for this proposition is that an agent can impose tort and contract liability upon a principal. This potential for liability can only be avoided if the principal retains the ability to terminate an agent's authority. Thus, the law always leaves the principal with a termination power, although its exercise may result in a breach of contract. Similarly, an agent who no longer wishes to serve a principal needs a mechanism for ridding himself of the fiduciary obligations imposed by the agency relationship. As a result, the law always allows the agent to renounce his authority, although such a renunciation may result in a breach of contract.

P for breach of contract.

Because an inference of apparent authority may be based on the existence of prior actual authority, the termination of actual authority does not itself eliminate the apparent authority of an agent. It may be necessary to give notice of termination to third parties who dealt with the agent or who otherwise continue to believe that the principal has authorized the agent to act.¹⁵⁸

¹⁵⁸ See RESTATEMENT (SECOND) OF AGENCY §§ 124A, 125 (1958); RESTATEMENT (THIRD) OF AGENCY § 3.11 (2006).