

# Agency Law

## AGENCY CREATION

An agency is a fiduciary relationship—that is, the agent holds a position of trust, manages the principal's affairs or funds, and has a duty to the principal to act in a trustworthy manner. In insurance, producers may act as the agents of either insurers or insureds. Understanding how the agency relationship is created is essential to knowing whether a purported agent actually has the authority to make legally binding agreements on behalf of the principal.

The parties to an **agency** are the **agent** and the **principal**. Although many agency relationships involve contracts, a contract is not essential to form an agency. The agency relationship is consensual rather than contractual, and that consent can be written or oral, express or implied.

An agency relationship can be established in three ways:

- By appointment
- By estoppel
- By ratification

## Appointment

The usual method of creating an agency is by express appointment. That is, Anita authorizes Brian to act in her behalf, and Brian assents to the appointment. The agent must consent to the relationship because agency law requires the agent to assume fiduciary duties (those involving trust).

As in contract formation, the principal's proposal can make a communicated acceptance unnecessary. If the principal asks another to act and indicates that no further communication is necessary, and the other person acts, the agency relationship arises. For example, Margaret writes to Joe, a real estate broker, and asks him to purchase a particular piece of real property for her in his name. Joe purchases the property in his own name and then refuses to convey it to Margaret. The circumstances indicate an implied agreement to form an agency relationship. Joe purchased the property on Margaret's behalf and must transfer it to her.

A principal can extend additional power to an agent through **power of attorney**. If an agent contracts to sell a principal's real estate, the principal must sign the deed. Otherwise, unless the agent has a power of attorney, the agent's signature on a deed has no effect. A power of attorney can be specific, such as

### Principal

The party in an agency relationship that authorizes the agent to act on that party's behalf.

### Agent

In the agency relationship, the party that is authorized by the principal to act on the principal's behalf.

### Agency

A legal, consensual relationship that exists when one party, the agent, acts on behalf of another party, the principal.

### Power of attorney

A written document that authorizes one person to act as another person's agent or attorney-in-fact.



a power to sell real estate, or it can be general, giving the agent power over all of the principal's property.

### Estoppel

If a principal's words or conduct cause a third person to reasonably believe that an agency exists and to rely on that representation in dealing with the supposed agent, the principal is estopped (prevented) from denying the agency, resulting in **agency by estoppel**. For example, if an insurer's owner allows a customer service representative to find insurance coverage for applicants, the owner has created an agency by estoppel and cannot deny coverage placed by the employee. The reason for agency by estoppel is that one should be bound by one's words and conduct if another person materially relies on them.

Because the principal has given the agent no actual authorization, an agency by estoppel is not a genuine agency in the sense that agency by appointment is. The practical legal effects, however, are the same to the third party as if the principal had appointed the agent. The acts of the apparent agent bind the principal.

No agency by estoppel is formed if the person for whom the act is performed (who would be the principal if an agency relationship existed) is unaware of the supposed agent's action. For example, Bob has created the appearance that he is Paul's agent by printing stationery that falsely implies an agency relationship. As long as Paul neither knows nor should know of Bob's deception, Paul can deny the agency. Anyone relying on the deceptive stationery relies on appearances that Bob, not Paul, created. Therefore, Paul would not be liable for Bob's actions as an alleged agent.

However, a person who knowingly permits another person to represent that an agency exists can be estopped from denying the agency. For instance, Paul owns a jewelry store and permits his friend, Anne, to display and sell her handcrafted jewelry in his store. Their businesses are separate, but customers could reasonably believe that Anne works for Paul. Although Paul and Anne are not principal and agent, any customer who deals with Anne and believes her to be Paul's agent can hold Paul liable as principal if the customer has suffered loss in reasonable reliance on that belief.

What if Anne has falsely represented that Paul is her principal? Must Paul disavow the relationship? Can his silence create agency by estoppel? The answer is not certain. A court would consider Paul's silence in relation to what a reasonable person would do to disavow the relationship. Clearly, if Paul were to come face-to-face with a person who believes that Anne is Paul's agent, he must disavow the agency relationship. Suppose, however, that Anne advertises the purported agency in newspapers in a distant city where Paul does no business? Although the legal question concerns what a reasonable person would do, it is doubtful that a court would submit this question to a jury in the absence of unusual circumstances.

#### Agency by estoppel

An agency relationship created by a principal's words or conduct that cause a third party to reasonably believe that an agency exists.



## Ratification

If a person acts as agent for one who has given no actual consent or authority, the purported principal has two options:

- Ratify or confirm the transaction
- Refuse to approve the purported agent's unauthorized acts

When an agency relationship is created by **ratification**, the agent's authority comes into existence, and a contract arises between the principal and the third party.

A ratification must meet four conditions to be effective:

- The agent must have purported to act for the principal. If the agent failed to disclose a principal's existence, then ratification by the undisclosed person will not create an agency relationship. The purported agent need not identify the principal but must purport to act for someone.
- The principal must ratify the entire transaction, not just the favorable parts.
- The principal must ratify the agreement before the third party elects to withdraw from the agreement. If the third party has withdrawn, died, or become incompetent to contract before the principal ratifies the agreement, the ratification is ineffective.
- The principal must have all material facts available before the ratification is binding.

Ratification establishes the agency relationship. In contrast, an estoppel does not create an agency relationship but only protects the third person from a loss that would result if the agency were denied. In both agency by estoppel and agency by ratification, the legal effect to the third party is the same. The third party has an enforceable contract with the principal.

Rather than ratification, a purported principal may refuse to approve the acts of a person who has claimed to be an agent. See the exhibit "Ratification or Refusal."

### Ratification

Creation of an agency relationship resulting when a principal adopts the act of another who has purported to act for the principal and has neither power nor authority to perform the act for the principal.

### Ratification or Refusal

Steve is an agent for Movers Insurance Company, which has given him authority to bind coverage for up to \$200,000 for cargo policies. Steve issues a transit certificate to Planes Inc. for \$500,000 for the transportation of a shipment from Florida to California. The tractor-trailer hauling the cargo overturns, destroying the cargo.

Planes Inc. files a claim for the \$500,000. Movers Insurance has a problem: Steve had authority to write a policy up to only \$200,000, and he violated his agency authority in writing the \$500,000 transit certificate. Movers can ratify Steve's actions by accepting the loss and paying the \$500,000, or it can refuse to approve Steve's actions and deny the claim.



## AGENT'S AUTHORITY

Agents must generally act within the scope and limitations of the authority specifically granted them by the principal. However, in some situations, even if the agent acts outside of that authority, the principal may still be bound to a third party by the agent's actions.

From the perspective of a third party, an agent's authority can be either actual authority or apparent authority. Actual authority can be either express or implied. The scope of an agent's authority depends on which type of authority the agent has.

### Scope of Authority

A court analyzing a question about an agent's authority first determines whether the agent was acting under actual authority. If no actual authority exists, the court should determine whether the agent had apparent authority.

### Actual Authority

**Actual authority** can be express or implied.

**Express authority** applies not just to carrying out the principal's specific instructions, but also to performing acts incidental to carrying out those instructions. To determine the scope of express authority, courts examine the goals of the agency in light of all surrounding circumstances. For example, the power to sell generally includes authority to collect payment and to make customary warranties. However, a sales agent who has no possession or indication of ownership has no authority to collect the purchase price. In most commercial situations, the agent has authority only to solicit orders or to produce a buyer with whom the principal can deal.

Custom is the most common source of **implied authority**. Agents can reasonably infer that they have authority to act according to prevailing custom unless the principal gives different instructions. Without different instructions, an agent's authority extends to, and is limited to, what a person in this agent's position usually does.

Implied authority can also apply when an agent acts beyond the usual scope of authority in an emergency. If the agent needs to act to protect or preserve the principal's property or rights but is unable to contact the principal, and if the agent reasonably believes that an emergency exists, he or she has authority to act beyond, or even contrary to, the principal's instructions.

An agent who acts reasonably in an emergency has authority to act even if the agent is mistaken about the necessity for the actions or is at fault in creating the emergency. The agent, however, can be liable to the principal for any expenses resulting from the agent's wrongful conduct.

#### Actual authority

Authority (express or implied) conferred by the principal on an agent under an agency contract.

#### Express authority

The authority that the principal specifically grants to the agent.

#### Implied authority

The authority implicitly conferred on an agent by custom, usage, or a principal's conduct indicating intention to confer such authority.



## Apparent Authority

Unlike actual authority, a principal neither confers **apparent authority** on an agent nor creates it. Apparent authority is based on appearances and includes all the authority that a reasonable person, acquainted with the customs and nature of the business, could reasonably assume the agent has. It generally arises in one of two overlapping circumstances:

- A principal grants less authority than agents in the same position in that business usually have.
- The method of operation of the principal's business differs from that of other businesses of the same kind in the principal's area.

For example, principal Paul instructed agent Ann not to sell goods on credit if the total credit to a customer exceeds \$200, an unusual restriction in Paul's business. Ann sold goods on credit to Lee for \$250 with no actual authority to do so. Lee, however, neither knew nor had reason to know of the restriction. A third party could have reasonably believed that Ann had the usual authority in that situation. The authority was apparent, and Paul cannot deny it.

As a second example, Paul puts Ann in charge of a jewelry store and instructs her not to stock or sell watch batteries. All other jewelry stores in that area do stock and sell watch batteries. Ann contracts with Larry to purchase a supply of watch batteries. Ann has apparent authority to do this as long as Larry is unaware of the restriction on Ann's authority.

## Duty to Ascertain Scope of Authority

A principal's representation to a third party—that is, the appearance the principal has created—determines the existence and the scope of an agent's apparent authority. A third person is not entitled to rely on an agent's statements about the scope of the agent's authority. Only the actual authority the principal has given, or the apparent authority the principal has manifested to the third party, controls the extent of the agent's authority. If an agent acts in a way adverse to the principal's best interests, the third party has notice that the agent might be exceeding his or her authority. The third party must ascertain the scope of the agent's authority by a direct inquiry to the principal. If the third party fails to inquire, and the agent does not have authority, the transaction in question does not bind the principal.

## AGENT'S DUTIES AND REMEDIES

In an agency relationship, the principal and agent have specific obligations to each other. If either party fails to fulfill these obligations and thereby harms the other party, legal remedies are available to allow the injured party to recover.

### Apparent authority

A third party's reasonable belief that an agent has authority to act on the principal's behalf.



An agent's duties to a principal include loyalty, obedience, reasonable care, accounting, and information. If the agent fails to fulfill these duties, the principal can sue the agent to recover any resulting loss or damage.

The principal's duties to the agent include an agreed-on period of employment, compensation, reimbursement for expenses, and indemnity for losses. If the principal breaches these duties, the agent can sue or can retain the principal's property until the principal has paid the amounts due.

### **Agent's Duties to Principal**

An agent's implied fiduciary duties to a principal include these:

- Loyalty
- Obedience
- Reasonable care
- Accounting
- Information

Violation of any of these duties subjects the agent to discharge and to liability for any damages to the principal even if the agency contract does not expressly state these duties.

A subagent, who is the agent of an agent, owes the same duties to the principal that the original agent owes. An original agent is responsible to the principal for any subagent's violation of duty, even if the agent has exercised good faith in selecting the subagent. Further, a subagent owes the agent who did the hiring substantially the same duties.

If a subagent is employed without a principal's authority, no agency relationship arises between the principal and the subagent. The principal is not liable to third parties for an unauthorized subagent's acts. At the same time, the unauthorized subagent owes no duties to the principal.

### **Loyalty**

One of the agent's most important duties is loyalty to the principal's interests. The agent must not undertake any business venture that competes with or interferes with the principal's business.

The principal can claim any profits the agent realizes in dealing with the principal's property. For example, any gift the agent receives from a third party while transacting the principal's business belongs to the principal. The duty of loyalty, however, does not obligate the agent to shield a principal who is acting illegally or dishonestly. To illustrate, Jo learns that her principal, Pete, cheated Tom on various contracts that Jo had arranged between Pete and Tom. Jo can disclose Pete's actions to Tom. If Tom obtains a judgment against Pete for his improper dealings, Pete cannot recover from Jo for breach of the



duty of loyalty. Jo's duty does not extend to concealing Pete's dishonest acts from persons those actions affect.

## Obedience

An agent owes a duty to obey a principal's lawful instructions. If the agent disobeys a reasonable instruction, the principal can sue for any resulting damages and can also terminate the relationship. Generally, the agent cannot challenge the instruction, unless it calls for illegal or immoral acts.

The agent owes a duty to perform according to the principal's instructions. If the principal has given ambiguous instructions, the agent owes the duty to exercise his or her best judgment in carrying them out. However, if harm to the agent is possible, or if an emergency arises, the agent might be justified in disobeying the principal's instructions.

An agent cannot delegate the authority granted by a principal to another person. The principal selects the agent because of personal qualifications. However, three exceptions apply to the nondelegation rule:

- **Ministerial duties**—If certain tasks do not require judgment or discretion, an agent can delegate their performance.
- **Customary appointments**—If custom and usage of a particular business involve the delegation of authority, the agent can delegate.
- **Emergency appointments**—In an emergency that requires the appointment of another to protect the principal's interests, the agent can make an emergency appointment.

### Ministerial duties

The routine or mechanical tasks performed by agents.

## Reasonable Care

An agent must exercise the degree of care and skill that a reasonable person would exercise under the same or similar circumstances. An agent with special skills or training is held to the standard of care of a reasonable person possessing those skills. Thus, a real estate broker employed to sell property must exercise the reasonable care of any real estate broker dealing with similar property.

An agent's failure to act when action is reasonably required also constitutes a breach of this duty. An agency contract carries an implied promise that the agent will carry out the duties of the agency with reasonable care to avoid injury to the principal. To illustrate, Charles asks Marcie, an insurance broker, to obtain an automobile insurance policy with collision coverage for his car. Marcy obtains a policy and delivers it to Charles, but the policy does not include collision coverage. After Charles has an accident, he learns that no collision coverage is in force. Charles may have a cause of action against Marcie for breach of the duty of reasonable care.

Reasonable care is required whether or not the agent is paid for the services. Unpaid agents cannot be compelled to perform duties, but once they begin



performance, they are held to the standard of reasonable care. For example, real estate broker Betty gratuitously promises to act as Clark's agent in the sale of his real estate. Clark cannot sue Betty for her failure to try to sell the property. However, suppose Betty convinced Tony to purchase Clark's property and failed to have Tony sign a binding sales agreement. If Tony later declined to proceed with the purchase, Clark could sue Betty for negligence for her failure to exercise the degree of reasonable care.

An agent and a principal can agree that the agent is not to be liable to the principal for ordinary negligence. An agent, however, cannot evade liability for gross negligence. To limit the agent's liability for gross negligence would be against public policy.

### **Accounting**

An agent must account to the principal for all the principal's property and money that come into the agent's possession. As part of this duty, the agent must keep the principal's property, including money, separate from the agent's. If the agent commingles the property or money, then the law assumes that it all belongs to the principal unless the agent clearly proves otherwise.

Money held by the agent should be deposited in a separate bank account in the principal's name. If the agent deposits it in his or her own name and the bank then fails, the agent is liable for any loss the principal sustains. The agent should account promptly for any of the principal's money held. Failure to do so makes the agent liable for interest payments to the principal.

### **Information**

An agent owes a duty to keep the principal informed of all facts relating to the agency. Therefore, if a principal authorizes an agent to sell property for a specified amount and the agent later learns that the property's value has materially changed, then the agent must give the principal that information. Generally, the agent owes a duty to make reasonable efforts to provide the principal with information relevant to the affairs entrusted to the agent. Failure to perform this duty makes the agent liable to the principal for any resulting loss.

The law imputes the knowledge an agent obtains during the course of performing a principal's business to the principal and therefore imposes on the agent the duty to give the information to the principal. Most courts do not impose a duty to communicate information that the agent obtains outside the scope of the agent's employment. Additionally, if an agent acts adversely to the principal's interest, by colluding with a third party to defraud the principal, for example, that knowledge will not be imputed to the principal.





## Principal's Remedies

Depending on the offense, a principal can sue an agent for breach of the agency contract or in tort for harm done. Remedies include requiring the agent to transfer improperly held property, pay the value of the benefit the agent received, or pay damages for negligence or tort.

If the agent is insolvent, the principal's best remedy is a suit to transfer the property. If the agent has personally profited from the transaction, then a suit for the value of the benefit the agent received represents the principal's best alternative. In other cases, a suit for breach of agency contract may be preferable to a suit in tort because the statute of limitations is generally longer for contract suits than for tort suits.

In still other cases, the principal can sue for an injunction prohibiting the agent from revealing trade secrets obtained during the course of employment or from competing with the principal in violation of a noncompetition agreement after termination of employment.

## Principal's Duties to Agent

The principal owes these duties to the agent:

- Agreed-on period of employment
- Compensation
- Reimbursement for expenses
- Indemnity for losses

## Agreed-On Period of Employment

Either party can terminate an employment contract at will unless the contract specifies a fixed period of employment. A contract to pay a salary by the month or year does not necessarily indicate that employment is guaranteed for the stated period.

A contract with a fixed period of employment makes the parties liable for any breach of their contract within that period. Because the agency relationship is consensual, the parties can refuse to continue the relationship during the contractual period, but they are subject to damages for breach of the contract.

When an employment contract provides for a specified period of employment and the principal's business terminates during the period, the agency also terminates because of changed conditions.

## Compensation

The principal must pay the agent the agreed-on compensation for the services performed. If no compensation agreement exists, the agent is entitled to the reasonable value of the services rendered. If the contract does not mention



compensation but an agent under similar circumstances would receive compensation for services, compensation is required for the reasonable value of the services. However, an agent who breaches agency duties is not entitled to compensation.

A principal is not responsible for a subagent's compensation if the agent was given no authority to hire subagents. Likewise, if the agent has the authority merely to delegate duties to a subagent, the agent, not the principal, is responsible for compensation.

### **Reimbursement for Expenses**

A principal must reimburse an agent for any expenses necessarily incurred for the discharge of agency duties. For example, if the agent must incur travel and advertising expenses to accomplish agency purposes, the principal must reimburse these expenses. The agent must spend the money reasonably. If the agent's negligent conduct results in unnecessary expense, the agent bears the expense rather than the principal.

### **Indemnity for Losses**

The principal owes a duty of indemnity, or reimbursement, for any losses or damages the agent has suffered because of the agency and incurred through no fault of the agent. If a principal directs an agent to commit a wrong against a third party, and the agent does not know that the act is wrongful, the agent is entitled to indemnity for the amount paid as a result of a lawsuit arising from the act. To illustrate, a principal directs an agent to cut down and sell trees on land that the principal incorrectly believes he owns. The landowner sues the agent to recover damages for loss of the trees. The agent is entitled to indemnity by the principal.

A principal must indemnify an agent for the expenses incurred in defending any lawsuits resulting from the agent's authorized acts. If the expense resulted from the agent's own intentional or negligent conduct, even though the principal directed the act, the agent is usually not entitled to indemnification. To illustrate, Paul promises to reimburse his sales representative, Anne, for money she pays out in illegal gratuities to purchasing agents to whom she sells goods. Anne is not entitled to indemnification from Paul for money she pays illegally.

An agent who makes payments or becomes subject to liability to third persons because of a subagent's authorized conduct has the same right to indemnity from the principal as if the conduct were the agent's. Because a subagent is both the agent's and the principal's agent, the subagent is entitled to indemnity from either of them.



## Agent's Remedies

An agent can sue for compensation, indemnity, or reimbursement and can also obtain a court order requiring an accounting from the principal. An agent discharged by a principal during a specified employment period can sue for compensation for the remainder of the period.

An agent can also exercise a lien, or right to retain possession of the principal's goods, until the principal has paid the amounts due. Some agents, such as attorneys, bankers, and stockbrokers, can enforce a general lien against the principal; that is, they can hold the principal's goods and papers until all accounts are settled. The general lien is not limited to the immediate transaction between the parties but to all transactions between the agent and principal. Many other kinds of agents can assert only a special lien, which allows retention of the principal's property until the account for the immediate transaction between the principal and agent is settled.

## AGENCY TERMINATION

Parties often find it more difficult to terminate an agency relationship than to enter into one. Wrongful termination is a breach of contract, and the terminating party can be liable. Understanding the ways an agency can legally be terminated protects both parties from liability.

If an agency is "at will," either the principal or the agent can terminate the agency at any time without legal liability. If, however, the agency is to continue for a certain period or until accomplishment of a specific purpose, then both the principal and the agent have the power, but not the right, to terminate the agency. Termination can be accomplished in one of several ways:

- Just cause
- Lapse of time
- Accomplishment of purpose
- Revocation
- Renunciation
- Death or incapacity
- Changed circumstances

### Just Cause

An agency can be terminated for just cause. Examples of just cause include fraud, criminal activity, and flagrant violations of agency contracts. If an agency is at will, it can be terminated without cause.



## Lapse of Time

Lapse of time can also terminate an agency. Authority granted to an agent for a specified period terminates at the expiration of that period. If the parties forming the agency specify no time, lapse occurs after a reasonable period, depending on the circumstances. For example, if Margaret authorized Joe to sell her property five years ago and they have not communicated since, the agency has probably terminated through lapse of time. If, however, Joe made occasional reports to Margaret about prospective buyers and Margaret gave no indication that the agency was terminated, Joe would continue to have authority to sell.

## Accomplishment of Purpose

Many agencies are terminated when their purpose has been accomplished. If the agent has the authority to accomplish a particular purpose, that authority terminates upon its accomplishment. This is the case even if the purpose is accomplished by another agent or by the principal. The agency usually continues until the agent has received notice that the agency's purpose has been accomplished. To illustrate, Paul has given authority to two separate agents, Anne and Betty, to lease or sell Paul's house. With Anne's knowledge, Betty leases the house to Terry. Anne's authority to lease or sell the house ends, as does Betty's.

## Revocation

A principal may terminate an agency through revocation. To revoke an agency, the principal notifies the agent, by word or act, that the agent no longer has authority. A contract provision requiring revocation in a specific manner does not always prevent agency termination in another manner. The principal always has the power to terminate the agency, although the agent can sue for damages if the termination violates the agency contract.

If the principal appoints another agent to accomplish the authorized purpose, and if the new appointment conflicts with the first, the original agent's authority is terminated. For example, if a client engages a new attorney to try a case with the knowledge of the original attorney, the original attorney's agency ends because the two agency relationships conflict.

However, appointment of a second agent does not always terminate the first agency. For example, the mere fact that a second agent is given authority to sell the same property as a first agent is not sufficient to terminate the original agency. Unless the first agent has an exclusive right to sell property, the principal reserves the right to sell or to authorize another agent to sell. The appointments are consistent and the first agent who sells gets the benefit.



## Renunciation

An agent's termination of the agency relationship is a "renunciation of authority." The renunciation is effective even if it breaches the contract that binds the agent to perform. For example, Lyle, an actor, hired Rachel to represent him as his agent for two years. After one year, Rachel resigned. Although Rachel may be liable under contract to Lyle for the cost of finding a replacement, Rachel's renunciation has terminated her authority as his agent and ended the agency relationship.

## Death or Incapacity

Death or incapacity can terminate an agency in three ways:

- The death of either principal or agent terminates the agency.
- The incapacity of the principal terminates the agency.
- The principal has the right to terminate the agency upon learning of the agent's incapacity.

Agency termination occurs upon a principal's death even though the agent or third party has no actual notice of death. Death is a matter of public record, so the law assumes that the public has notice of death. However, courts have found that the necessities of modern banking and commerce require relaxation of this rule. For example, until a bank receives actual notice of a depositor's death, the bank has authority to pay checks drawn on the depositor's account.

A principal can also become incapacitated. Courts generally treat a principal's incapacity in the same manner as they treat a principal's death. Because the agent acts in the principal's place and the principal cannot act, agency authority ends during incapacity. Incapacity that terminates agents' authority can occur when principals are declared legally incompetent. This can occur, for example, when a principal is declared mentally incompetent because of the inability to understand the consequences of his or her actions.

An agent does not need capacity to contract to be an agent. The principal's capacity is the determining factor, not the agent's. A mentally incompetent agent may represent a principal, and the agent's contract binds the principal unless a party involved in the contract knows of the incompetency.

To illustrate, Paul authorizes Anne to sell his property. Anne contracts to sell the property to a buyer, who does not know that Anne is under the influence of drugs. Anne's contract binds Paul to sell the property to the buyer. Paul can terminate the agency upon learning of Anne's incompetency.



## Changed Circumstances

Changed circumstances can terminate an agency. If, because of a substantial change in circumstances, the agent should reasonably infer that the principal would not want the agency to continue, authority to act terminates.

For example, if Paul has authorized Anne to sell his land for \$100,000 and Anne learns that the discovery of oil on the land has increased its value to \$5 million, Anne's authority to sell the land for \$100,000 terminates. An agent can exercise authority only with a reasonable belief that the principal still wants that authority exercised.

The principal's bankruptcy is a changed circumstance that usually terminates the agent's authority with respect to all assets under a bankruptcy court's control. In bankruptcy, the principal's assets and the power to deal with those assets pass to a trustee in bankruptcy, even without notice to the agent. Ordinarily, the principal's mere inability to pay bills is not sufficient to terminate the agent's authority.

If an agent's bankruptcy affects the agent's ability to perform the agency's purpose, or the principal's business standing, the agency terminates.

## CONTRACTUAL RIGHTS AND LIABILITIES

Agency contract liability deals with situations in which parties to a contract fail to fulfill their obligations. When this occurs, the party that suffers a resulting loss has a right of recovery against the party in breach. Agency contract liability focuses on these respective rights:

- A third party's rights against a principal
- A principal's rights against a third party
- An agent's liability to a third party
- An agent's rights against a third party

A contract establishes rights and duties of the various parties to it. For example, in a sales contract, the seller agrees to supply goods and the purchaser agrees to pay a specified amount for those goods. If either party breaches the contract, the other party has the right to seek damages or to seek to have the contract enforced. In addition, some transactions can create implied warranties, breach of which can also create a right of recovery. In contracts arranged by agents, third parties may have rights of recovery against both the principal and the agent, and both the principal and the agent may have rights of recovery against third parties. In determining these rights, courts examine both the agent's authority to act and the status of the principal.



## Third Party's Rights Against a Principal

The rights a third party has against a principal for an agent's properly authorized and executed contracts depend on the principal's status. There are three types of principals: **disclosed principals**, **partially disclosed principals**, and **undisclosed principals**.

In contracts involving partially disclosed principals and undisclosed principals, third parties enter into the agreements largely on the strength of the agent's credibility. The agent is liable for agreements made until the third party elects to hold the principal liable. The third party, on learning of the principal's existence or identity, can elect to enforce the contract against the principal rather than against the agent.

An undisclosed principal is responsible for all contracts the agent enters into within the scope of the agent's actual authority, and the third party can sue the principal when the principal's existence becomes apparent. Being unknown to the third party, the principal could not have created any apparent authority. Therefore, liability is limited to the agent's actual authority.

The right to sue an undisclosed principal on a contract is subject to these exceptions:

- A third party cannot sue the principal for nonpayment under a contract if the principal has made a good-faith settlement of the account with the agent. For example, when an undisclosed principal has supplied an agent with money to purchase goods, but the agent purchases the goods on credit and keeps the money, a settlement has occurred. The principal is not liable to the creditor for a second payment. The settlement can occur before or after the formation of the contract with the third party, but it must occur before disclosure of the principal to the third party.
- A third party cannot sue the principal if, having learned of both the principal's existence and the principal's identity, the third party expresses the intention to hold the agent liable for the contract. Election of the agent discharges the principal. However, this does not apply if the principal is only partially disclosed. The third party can obtain a judgment against either the agent or the partially disclosed principal without discharging the right against the other.

### Disclosed principal

A principal whose existence and identity are known to the third party dealing with the agent.

### Partially disclosed principal

A principal whose existence is known, but whose identity is not known, to the third party dealing with the agent.

## Principal's Rights Against a Third Party

If a contract binds a principal to a third party, it also binds the third party to the principal. It is immaterial whether the third party knew nothing of the principal's existence and thought the contract was formed with the agent alone. In transactions between a third party and an agent of a disclosed principal or a partially disclosed principal, the principal has rights against the third party to the same extent as if the principal had conducted the transaction.



When undisclosed principals are involved, their rights against third parties can be limited in four situations:

- If an agent has fraudulently represented to a third party that the contract is on the agent's behalf alone or that the agent represents someone other than the real principal, the third party has the right to rescind the contract. If the agent or principal knows or should know that the third party is unwilling to deal with the principal, the principal's identity becomes a material fact. Misrepresentation of a material fact by the agent allows the third party to void the contract. If the agent does not actively misrepresent the principal's identity, but knows that the third party would not agree to contract with the principal, the agent has a duty to disclose the principal's identity to the third party.
- An undisclosed principal cannot enforce a contract against a third party if enforcement would impose a substantial additional burden on the third party. For example, Sophie, an agent, contracts to purchase from Kate "all of the oil that Sophie requires." Kate is unaware that Sophie represents Will, whose oil requirements are substantially greater than Kate knows or is able to meet. Under the circumstances, Will cannot enforce the contract against Kate.
- If a contract specifies the agent's personal performance, the principal cannot substitute his or her own performance in fulfillment of the contract. For example, Peter is an undisclosed principal and Daniel is his agent. Daniel contracts to personally paint Kyle's house. Peter cannot do the painting; it must be done by Daniel. Once Daniel completes the painting, Peter can demand payment from Kyle under the contract.
- When a third party sues an agent for breach of a contract with an undisclosed principal, a judgment against the agent destroys the principal's right of recovery against the third party. However, a judgment either for or against the agent obtained by the third party after the principal's identity becomes known does not necessarily diminish the rights of a principal who took no part in the suit.

## Agent's Liability to a Third Party

Generally, an agent is not liable to a third party under a contract made on a disclosed principal's behalf. The principal alone is liable. Six situations represent exceptions to that rule:

- When an agent acts on a principal's behalf, the agent warrants by implication that he or she has actual authority to do so. If the agent is not authorized to act on the principal's behalf or exceeds the authority granted by the principal, the agent breaches that implied warranty of authority. The agent is liable to the third party for that breach. The agent may also be liable for fraud if he or she intentionally misrepresents the existence or extent of authority. However, if the third party knows or has reason to suspect that the agent lacks authority, the agent is not liable





for breach of warranty. Full disclosure to the third party of all facts relating to the agent's authority protects the agent against suits for breach of warranty. Also, the agent's liability for breach of warranty terminates if the principal ratifies the contract before the third party withdraws from it. However, ratification that occurs after the third party withdraws due to the agent's lack of authority or sues the agent for breach of warranty is ineffective in discharging the agent's liability to the third party.

- If an agent acts on behalf of a minor or a mentally incompetent person, the agent is personally liable for breach of the warranty of authority if the third party was not aware of the principal's incapacity. Part of the agent's implied warranty of authority is that the principal can be legally bound under the contract.
- If a third party has intended to contract with the agent and the agent purported to act personally and not for a principal, to avoid personal liability on a contract with the third party the agent must disclose both the existence and identity of the principal. It is not sufficient that the third party knows facts that could disclose the principal's identity.
- The third party can ask the agent to agree to personally guarantee the contract. An agent who voluntarily assumes responsibility for performing the agreement is liable for the principal's nonperformance. The principal is liable on the contract, and the agent is liable on the guaranty.
- If a third party pays money to an agent who has no authority to collect it and the agent does not turn the money over to the principal, the third party can sue the agent for the money. The agent cannot avoid liability by subsequently paying wrongfully collected funds to a principal. In addition, a third party can recover payments made to an agent resulting from the agent's mistake or misconduct even though the agent has turned the funds over to the principal.
- An agent is liable for fraudulent or malicious acts that harm a third party. That the agent was acting in good faith under the principal's direction is not a defense against personal tort or criminal liability. An agent who wrongfully injures a third party or is guilty of theft is personally liable.

## Agent's Rights Against a Third Party

A third party is usually not liable to an agent for breach of contract between the agent and the third party on behalf of a disclosed principal. However, the third party can be liable to the agent if the agent intended to be bound or if the principal is undisclosed or partially disclosed.

- An agent can sue a third party for breach of contract if both the agent and the third party have agreed that the contract obligates the agent. For example, if the principal's credit standing is unacceptable to the third party, the agent can become an actual party to the contract. In this case,



the agent is potentially liable but also has the right to sue the third party for breach of contract.

- An agent can sue a third party for breach of contract entered into without the third party's knowledge of the principal's existence and identity. However the principal can also sue, and the principal's right to sue the third party is superior to that of the agent.
- An agent who falsely represents authority to act on a principal's behalf and who, therefore, fails to bind the principal to the contract cannot later sue under the contract. The agent cannot prove the existence of the alleged contract.
- In a suit by a third party against an agent concerning a contract entered into on a principal's behalf, the agent can set up personal defenses as though the agent were the sole contracting party. These defenses include that the principal or agent performed the contract; that the third party failed to perform the contract; or that the statute of frauds or statute of limitations precludes recovery.
- With the disclosed or partially disclosed principal's consent, the agent can assert the principal's defenses or counterclaims against the third party. The third party cannot, therefore, be in a better position by suing the agent than by suing the principal because defenses that are purely personal to the principal become available to the agent.

## TORT LIABILITY OF PRINCIPAL AND AGENT

Generally, principals and agents are liable to third parties for their own torts. However, in several situations, a principal may be held liable for torts committed by an agent.

### Employee

A person hired to perform services for another under the direction and control of the other party, called the employer.

### Independent contractor

A person (or organization) hired to perform services without being subject to the hirer's direction and control regarding work details.

Agents can be **employees** of the principal or they can be **independent contractors**. The distinction between employees and independent contractors is important in agency relationships, because the extent to which the principal is liable for an agent's torts depends on the relationship between the agent and the principal. Although it can sometimes be difficult to determine whether an individual is an employee or an independent contractor, the most important distinguishing factor is the extent to which the principal controls the details of the work being done.

## Principal's Liability for Agent's Torts

As a principal's authorized representative, an agent can bind the principal to contracts and complete transactions on the principal's behalf. If, in the course of the agency, an agent commits a tort against a third party, to what extent, if any, is the principal liable for that tort? Although individuals are generally liable for their own torts, in several circumstances, a principal becomes liable for an agent's torts.



## Respondeat Superior Liability

If an agent commits a tort, the principal may be held liable for that tort under the doctrine of **respondeat superior**. *Respondeat superior* means “let the master answer,” and it attributes vicarious liability to a principal for the torts of an agent when two conditions are met:

- The agent must be an employee of the principal.
- The tort must be committed while the agent is acting within the scope of his or her employment.

Employers often grant their employees authority to act as their agents. For example, a manufacturer’s management might authorize an employee in the purchasing department to contract with raw materials suppliers on the company’s behalf.

In most cases, determining whether an agent is an employee or an independent contractor is relatively easy. Determining whether an employee was acting within the scope of his or her employment when a tort was committed can be more challenging. Generally, agents are considered to be acting in the scope of employment if they are performing work assigned by the employer or undertaking activities subject to the employer’s control. The critical element is that the employer controls or has the right to control how the agent performs the assigned work. If an agent undertakes activities independently with no intention of serving the employer’s interests, the agent is not considered to be acting in the scope of employment.<sup>1</sup>

If an agent is an employee, the principal and agent may have **joint and several liability** for any tort committed, and an injured third party may elect to sue the principal, the agent, or both to recover damages.

## Direct Liability

A principal who commits a tort against a third party is directly liable to that party for any resulting harm.

A principal may be directly liable to a third party for an agent’s tort that is committed at the specific direction of the principal. For example, a landlord (principal) who directs a property manager (agent) to unlawfully evict a tenant is liable for any harm or damage to the tenant.

A principal may also be directly liable to a third party for an agent’s tort if the principal has been negligent in hiring, training, or supervising the agent. The principal is responsible for selecting appropriate individuals as agents; giving them clear instructions; providing them with appropriate tools, equipment, or materials; monitoring their performance; and discharging those that do not perform appropriately.

### Respondeat superior

The legal principle under which an employer is vicariously liable for the torts of an employee acting within the course and scope of employment.

### Joint and several liability

The liability of multiple defendants either collectively or individually for the entire amount of damages sought by the plaintiff regardless of their relative degree of responsibility.



### **Liability for Independent Contractor's Torts**

Generally, a principal is not liable for the torts of agents that are independent contractors. This is because the principal does not have authority to specify the way in which the agency is to be performed. However, this general rule has three exceptions:

- A principal who negligently enters into an agency with an independent contractor that is unsuitable or incompetent can be held liable for resulting harm to third parties. For example, if a mall owner contracts a security firm, knowing that the firm's employees all have several previous convictions for assault and battery, and a security guard attacks and injures a mall patron while on duty, the mall owner may be held liable to the injured party.
- Certain duties are considered so important that responsibility for them cannot be delegated to another party. For example, a municipality has a duty to keep public roads in good repair. While the municipality can delegate the repair work to an independent contractor, it cannot delegate responsibility for ensuring that the work is done, and done in an acceptable manner. If a principal hires an independent contractor to perform one of these important duties and the contractor fails to perform or performs inadequately, the principal may be liable for any resulting harm or damage to third parties.
- A principal who hires an independent contractor to perform highly dangerous activities, for example building demolition, must ensure that the contractor takes appropriate safety precautions. If the independent contractor negligently fails to do so, the principal may be held liable to third parties for any resulting harm or damage.

### **Liability for Agent's Misrepresentations**

When an agent makes a material misrepresentation to a third party in a transaction, the third party can rescind (avoid) that transaction. Alternatively, the third party may elect to recover in tort for any harm resulting from the misrepresentation. A principal may be liable to a third party for misrepresentations by an agent in two situations:

- If a principal intended that an agent make a misrepresentation during a transaction, the principal is directly liable for that misrepresentation. In some states, a principal may also be directly liable for negligently allowing a misrepresentation by an agent.
- When an agent has actual or apparent authority to make true statements about a particular subject, the principal is vicariously liable for any misrepresentations made by the agent even if the principal did not direct or condone the misrepresentation. For example, a real estate agent could have actual or apparent authority to make true statements about a property for sale. If the real estate agent misrepresents details about the property to a third party, the principal could be held liable.



In an attempt to relieve themselves of liability for agents' misrepresentations, principals may include an exculpatory clause in the contracts agents make with third parties. An exculpatory clause limits the principal's liability for statements made to only statements that are specifically included in the contract. Such a clause may protect a principal against tort liability resulting from misrepresentation by an agent, but a third party injured by the misrepresentation can still choose to rescind the transaction.

## Agent's Liability for Own Torts

Even when they are acting on behalf of a principal, agents are generally liable for their own torts. For example, an agent who slanders or libels a third party while performing acts related to the agency is liable for his or her actions. However, this rule has four exceptions:

- If a principal has been granted permission to do something, the principal's agent is considered to have the same permission. For example, if a neighboring business allows a construction company to park its heavy equipment in the neighbor's parking lot overnight, the construction company's agent may also park the company's equipment there without committing a trespass. The scope of the agent's permission is strictly limited to that granted to the principal.
- If a principal is legally entitled to take action to defend his or her person or property, the principal's agent may take similar action in protection of the principal. For example, a principal who is attacked can use physical force to defend against the attacker; the principal's agent can also use physical force against the attacker to protect the principal.
- An agent who makes misrepresentations in a transaction is not liable if the agent did not know, and had no reason to know, that the statement was a misrepresentation. For example, if the principal misrepresented information to the agent and the agent, in good faith, relayed that misinformation to a third party, the agent is not liable to the third party for any resulting harm or damage.
- If a principal supplies defective tools or instruments to the agent and a third party is injured because of the defect, the agent is not liable if he or she did not know or have reason to know that the tool or instrument was defective.

## SUMMARY

The usual method of creating an agency is by express appointment. A principal can extend additional power to an appointed agent through power of attorney.

In agency by estoppel, if the principal's words or actions lead a third person to believe that an agency exists, the principal cannot subsequently deny the agent's authority to act on the principal's behalf. Although agency by estoppel is not a genuine agency, it protects third parties from potential loss that could result if the agency were denied.



In agency by ratification, if a person acts as an agent without the principal's consent or authority, the principal can choose to ratify the transaction, and an agency is created. Alternatively, the principal could choose to refuse to approve the purported agent's unauthorized actions.

An agent's authority can be either actual authority or apparent authority. An agent's actual authority can be express or implied. Apparent authority generally occurs when a principal grants less authority than agents usually have, or when the principal's business operates differently from similar businesses in the area.

A third party cannot rely on an agent's statements about the scope of the agent's authority, but must ascertain it by direct inquiry to the principal.

Principals and agents owe different obligations to each other. An agent's duties to a principal include loyalty, obedience, reasonable care, accounting, and information. The principal has four remedies for an agent's default or wrongdoing. The principal can sue to require the agent to transfer improperly held property to the principal; sue for the value of the benefit the agent received; sue for breach of agency contract; or sue in tort for harm done.

A principal has the duty to provide the agent with an agreed-on period of employment, compensation, reimbursement for expenses, and indemnity for losses. If the principal breaches any of these duties, the agent can sue for compensation, indemnity, or reimbursement; alternatively, the agent can retain possession of the principal's goods until the principal has paid any amounts due.

Agency can terminate for just cause, lapse of time, accomplishment of purpose, revocation by the principal, renunciation by the agent, death or incapacity, and changed circumstances.

To determine the rights and liabilities of principals, agents, and third parties in breach of contract cases, courts must answer questions about the existence of the agency, the extent of the agent's authority, and the extent to which the principal's existence and identity were disclosed.

A principal can be held vicariously liable for the torts of an agent under the doctrine of *respondeat superior*. A principal can also be directly liable for an agent's torts if they were committed at the principal's direction or if the principal has been negligent in selecting or managing the agent. Although principals are not generally liable for the torts of independent contractors, they can be under certain circumstances. A principal can also be liable for an agent's misrepresentations. In addition, although agents are generally liable for their own torts, in some situations they can be relieved of that liability.

## ASSIGNMENT NOTE

1. Restatement (Third) of Agency § 707 (2006).

