

A THEORY OF AGENCY LAW

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ABSTRACT

Despite the ubiquity of agents in the modern world, agency law does not have a coherent explanation or unified theory. The Restatement (Third) of Agency updates and attempts to explain the law, but its explanations are limited in scope and at times unpersuasive. Like other contemporary commentary on agency law, the Third Restatement draws from contract and tort theory, an approach which ignores the unique features of agency law. Agency law enables principals to act through agents; it also ensures that principals using agents do not thereby escape liability or other consequences of their choices. This paper develops a theory to fit agency law. The “cost-benefit internalization theory” is based on the simple premise that the principal, who has chosen to conduct her business through an agent, must bear the foreseeable consequences of that choice. Conversely, as the bearer of the risks, the principal is entitled to receive the benefits created by the agency relationship. The cost-benefit internalization theory explains and illuminates virtually all agency law doctrine.

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I. INTRODUCTION

It would be difficult to function in a modern economy for more than a few hours without interacting with an agent of some kind. The atmosphere is so thick with agents that most people rarely think about them; I willingly hand money to a stranger I meet in a store and carry away goods without questioning whether a sale has occurred. Despite the fact that agency is indispensable to even the simplest functions of modern life, the law of agency is in a sad state. It has been largely abandoned by legal scholars and it is, as a discrete body of law, under-theorized. Its basic tenets, its *modus operandi*, and its theoretical foundations are a mystery to lawyers, judges, and legal scholars. Current thinking about agency law relies on the principles of tort and contract law to provide a basis for the principal's liability for her agent's contracts and torts, but those principles are unable to explain the law fully. The principal's decision to operate through an agent in the first place creates a unique set of conditions and must be addressed by an independent set of principles. The doctrines that address that decision comprise agency law. This Article develops and applies the principles that support those doctrines.

Stated briefly, the purpose of agency law is to restore the status quo after a person chooses to use an agent. The foundational principle of agency law is that the principal, who has chosen to conduct her business through an agent, must bear the foreseeable consequences created by that choice. Conversely, as the bearer of the risks, the principal is entitled to receive the benefits created by the agency relationship. This set of principles, which I call the cost-benefit internalization theory,¹ explains current agency law doctrine in a way other explanations and theories cannot.

Part II of this Article considers the nature and purposes of agency law in light of the fundamental feature of agency—the principal's decision to employ an agent—and describes the cost-benefit internalization theory as an explanation of agency law. Part III describes the use of contract theory to explain agency and its inability to address a variety of agency problems. Part

1. The word "theory" can mean a number of different things in legal scholarship. It can mean a general approach to looking at legal problems, as in "Feminist Legal Theory"; it can mean a rather narrow way of looking at a specific doctrinal problem, as in the lien theory of mortgages; and it can mean many things in between. In this Article, I use the word "theory" to describe a set of principles that is general enough to have application to an entire field of law, but specific enough to be able to support discrete legal rules. In developing the cost-benefit internalization theory, I argue here that agency law serves a unique purpose. To put it simply, the "theory" explains the legal rules; the purpose explains the theory.

IV similarly describes the use and inadequacies of tort theory in agency law. Part V describes various other attempts that have been made to explain agency law, including references to its supposed history. Part VI concludes with a catalogue of the most common doctrines of agency law, some of the problems they raise, and their explanation and solution under the cost-benefit internalization theory.

II. THE COST-BENEFIT INTERNALIZATION THEORY

The best explanation for agency doctrine is based on the moral and economic principle that a person must bear the foreseeable consequences of her voluntary actions. Thus, the principal must bear the consequences of hiring an agent to the extent it is foreseeable that harm might result from the agent's unauthorized acts. For example, it is foreseeable that harm will result from unauthorized contracts when the contract is one that a third party is likely to enter into with the agent given the circumstances of the agent's employment. It is appropriate that the principal bear these losses not only because she voluntarily created the risks, but also because she is receiving the benefit of the act that created the risk: the hiring of the agent. I refer to this principle as the cost-benefit internalization theory to emphasize that it is based not only on an economic cost-internalization principle, but also on the moral principle that a person cannot justly retain the benefits of her actions while refusing to pay the costs, and on the principle of both justice and efficiency; that a person who has willingly undertaken certain risks should retain the benefits of the risky activity.

The premise of the cost-benefit internalization theory is that agency law has a single underlying policy goal: to mitigate the effects of using an agent. Agency is a technology that enables increased or more productive activity, but the use of that technology has certain effects. Without technology, an individual's activities and their consequences are limited by her personal abilities; the use of an agent enhances a person's ability to act in the world. Like any technology, agency alters the natural state of affairs. Without agency law, the consequences of an agent's acts would naturally fall on the agent, except to the extent they are externalities. The law changes that situation by restoring the consequences of an agent's act to their originating source—the principal.² In other words, agency law ensures that the use of technology does

2. The law often seeks to restore a prior state of affairs following a bad act by putting the parties as nearly as possible in the position they would have been in had the bad act not occurred. Agency is

not alter the legal consequences of an actor's behavior.³ It does this by treating acts accomplished through the use of the agent as if they were accomplished by the principal's faculties alone.⁴ Without the restoration of the status quo provided by agency law, the use of agents would be either pointless or extremely expensive: principals would not have any assurance that they would receive the benefits of their agent's actions, and third parties would be unwilling to deal with anyone other than someone who was provably a principal.⁵

A. Responsibility

The cost-benefit internalization theory, at its most general, holds that a principal should be responsible for the foreseeable consequences of her use of an agent. Several aspects of this general principle should be clarified before addressing its more specific applications. First, the principal's responsibility derives from fundamental legal and moral principles. For some, moral responsibility derives from reason and free will;⁶ for others, it is a principle

different in that it seeks not to remedy a bad act, but to enable a useful act.

3. The law of search and seizure is another area of the law that refers to the pre-technology, natural, state. In some cases, the warrantless use of a sense-enhancing technology is permitted under the Fourth Amendment if surveillance without the technology would not require a warrant. *See* *United States v. Dunn*, 480 U.S. 294, 305 (1987) (flashlight); *Dow Chem. Co. v. United States*, 476 U.S. 227, 238 (1986) (high-resolution aerial camera); *United States v. Jacobsen*, 466 U.S. 109, 122–26 (1984) (chemical test); *Texas v. Brown*, 460 U.S. 730, 739–40 (1983) (flashlight); *United States v. Place*, 462 U.S. 696, 706–07 (1983) (dog's nose); *United States v. Knotts*, 460 U.S. 276, 284–85 (1983) (beeper tracking device); *Smith v. Maryland*, 442 U.S. 735, 744–46 (1979) (pen register recording dialed numbers); *United States v. Lee*, 274 U.S. 559, 563 (1927) (searchlight). *See generally* David E. Steinberg, *Making Sense of Sense-Enhanced Searches*, 74 MINN. L. REV. 563 (1990).

4. The so-called identification doctrine is a simple rendering of this idea. The identification doctrine uses a legal fiction—that the agent has no separate identity—to treat the agent as if she were the principal. *See* Oliver Wendell Holmes, Jr., *Agency [Part I]*, 4 HARV. L. REV. 345, 345, 363, 364 (1891); Oliver Wendell Holmes, Jr., *Agency [Part II]*, 5 HARV. L. REV. 1, 18 (1891). The fiction was widely criticized by the legal realists, *see, e.g., id.*, and has no supporters today.

5. Agency law also facilitates the use of agents by regulating the relationship between the principal and the agent. The default terms that agency law provides for the interaction between principal and agent help to reduce transaction costs not only by reducing the need for individual contracting but also by standardizing the terms of the principal-agent relationship and thereby permitting interchangeable agents. The cost-benefit internalization theory is particularly apt because it explains not only the principal's liability for the agent's contracts and torts, but also the rules governing the relationship between the principal and agent.

6. *See* J.M. FINNIS, *NATURAL LAW AND NATURAL RIGHTS* 90 (1980) (discussing Sartre); *CATECHISM OF THE CATHOLIC CHURCH* ¶ 1734 (“Freedom makes man responsible for his acts to the extent that they are voluntary.”); ARISTOTLE, *NICHOMACHEAN ETHICS* Bk. III ¶ 5; P.S. ATIYAH, *THE RISE & FALL OF FREEDOM OF CONTRACT* 348–49 (1979) (quoting SIR ARTHUR BRYANT, *THE AGE OF ELEGANCE* 290).

of equality that derives from the need to treat like cases alike.⁷ The principal's responsibility may also derive from the fact that the principal is receiving the benefits of the agency relationship,⁸ or from economic principles requiring an actor to internalize all the costs of her activities.⁹ Whatever its source, the existence of responsibility is probably not controversial. There is also an important corollary to the principal's responsibility: The principal is entitled to receive and retain the benefits created by her use of an agent because she is made to bear the burden of responsibility.¹⁰

B. Use of an Agent

It is not controversial to assert that a principal is responsible for the foreseeable consequences of her acts. The more difficult question involves the identification of the foreseeable consequences of the principal's use of an agent in her business. It will be helpful, in answering that question, to clarify first what is meant by "using an agent in her business." An agent is a person who has agreed to "act on the principal's behalf and subject to the principal's control."¹¹ The agent must "hold power" to affect the principal's affairs in some way, although it is not necessary that the agent have the power to enter into contracts for the principal. An agent may only have authority to negotiate or transmit or receive information; but it is the essence of agency that the

7. See ARTHUR RIPSTEIN, *EQUALITY, RESPONSIBILITY & THE LAW* 265 (1999).

8. See Paula J. Dalley, *All in a Day's Work: Employers' Vicarious Liability for Sexual Harassment*, 104 W. VA. L. REV. 517, 536–40 (2002); ATIYAH, *supra* note 6, at 177–78. The receipt of a benefit was, at one time, the basis for liability in contract. *Id.* at 177, 487. *Cf.* Shelley's Case, 1 Co. Rep. 93b, 99a, 76 E.R. 203, 223 (K.B. 1579–81) ("*qui sentit onus, sentire debet et commodum*"). It continues to be a basis for liability in restitution and other areas of the law. See ATIYAH, *supra* note 6, at 767, 768–70. See also HERBERT BROOM, *A SELECTION OF LEGAL MAXIMS* (R.H. Kersley ed., 10th ed. 1939) ("*Qui sentit commodum, sentire debet et onus*"). One strain of thought argues that receipt of a benefit alone should create an obligation to pay for it. See LAWRENCE C. BECKER, *RECIPROCITY* 124–30 (1986); Richard Arneson, *The Principle of Fairness and the Free Rider Problem*, 92 ETHICS 616 (1982); S.F.C. MILSOM, *HISTORICAL FOUNDATIONS OF THE COMMON LAW* 260 (2d ed. 1981). Another argues that there is no such obligation unless the beneficiary requested the benefit. See J.H. Baker, *The History of Quasi-Contract in English Law*, in *RESTITUTION PAST, PRESENT AND FUTURE* 37, 46, 48 n.51 (W.R. Cornish et al. eds., 1998); ATIYAH, *supra* note 6, at 483; A.L. GOODHART, *ENGLISH LAW AND THE MORAL LAW* 130 (1953); *Indiana Lumbermens Mut. Ins. Co. v. Reinsurance Results, Inc.*, 513 F.3d 652, 656 (7th Cir. 2008).

9. *Cf.* Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, 514, 543–45 (1961).

10. *Cf.* Pierre Samuel Du Pont de Nemours, *On the Origin and Progress of a New Science* 573–74 (1768), in *COMMERCE, CULTURE AND LIBERTY* 564 (Henry C. Clark ed., 2003) (explaining that the "natural" result of a person using another's resources in cultivation is an agreement by which each would "enjoy a portion of the produce proportionate to his work and expense").

11. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

agent is to deal with a third party in some way.¹² Agency is a consensual,¹³ although not necessarily contractual,¹⁴ relationship. Thus, except in cases of estoppel,¹⁵ the use of an agent by a principal will always be voluntary even if any particular act of an agent is not authorized or permitted. While instances will occasionally arise when the existence of an agency relationship is in doubt, the legal concept is clear and long-standing and does not require further explication here.

C. The Principal's Business

It is more difficult to define what is meant generally by “the principal’s business,” although it is not usually a difficult question as a practical or legal matter. Many, if not most, businesses have a scope that is informally defined by the principal. Any such business will also have a penumbra of related activities that a principal may or may not claim to be within her business depending on the purpose for which the question is asked. The law is asked to address the scope of a business in a number of contexts, of which the corporate opportunity doctrine is perhaps the most clearly defined.¹⁶ In general, the identification of the parameters of the business should be based on the intent of the principal or principals, as objectively manifested. It will often be difficult to determine the precise boundaries of any business, but this also is not a novel issue peculiar to agency law that must be addressed in general here. It does, however, present a particular problem in the context of a principal’s vicarious liability for torts, which is discussed below.

D. Reasonable Foreseeability

Whether and when a principal is using an agent in her business is not usually a difficult question; the difficulty lies in identifying the foreseeable consequences of the use of the agent. The principal’s responsibility is limited to foreseeable consequences consistent with both moral and economic reasoning. Because moral responsibility is based on the exercise of reason and

12. *See id.* § 1.01 cmt. c.

13. *See id.* § 1.01.

14. *See* Warren A. Seavey, *The Rationale of Agency*, 29 YALE L.J. 859, 863 (1919).

15. *See infra* Part VI.A.3.

16. An officer or director has a duty to offer an opportunity to the corporation if the opportunity is in the corporation’s line of business. *See* Guth v. Loft, 5 A.2d 503, 513 (Del. 1939). Partners’ and agent’s duties of loyalty are similarly limited. *See* Meinhard v. Salmon, 164 N.E. 545, 548 (N.Y. 1928); RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. c.

free will, it extends only to consequences that are reasonably foreseeable and therefore available to be considered by a free, reasoning actor.¹⁷ From the economic perspective, a person cannot take into consideration costs that she could not reasonably foresee.¹⁸ As is true elsewhere in the law, the standard for foreseeability is reasonableness. This comports with moral norms¹⁹ and, because the standard is the same in like cases, with an equality norm.²⁰ The law is practiced in dealing with questions of reasonableness in torts and, as discussed below, in agency law. The application of a reasonable person standard will bring within the range of foreseeable consequences those outcomes that depend on the reasonable behavior of third parties and the normal operation of the natural world, because those factors are foreseeable. Normatively, those outcomes should be included in the consequences borne by the principal because agency law specifically addresses the principal's use of the agent to interact with third parties and with the natural world.

E. Causation

The final piece of the cost-benefit internalization theory asks which outcomes can be said to be consequences of the principal's use of the agent. In other words, does the principal's responsibility depend on her having "caused" an outcome, and if so, what account of causation does the law use in this context? The cost-benefit internalization theory is based on a view of moral responsibility that includes causation,²¹ but it is a broad concept of causation. Any particular outcome is caused by a variety of acts and occurrences, and several of those will be more proximate to the outcome than the principal having appointed an agent in the first place.²² One objection to

17. See Edward C. Lyons, *Balancing Acts: Intending Good and Foreseeing Harm—The Principle of Double Effect in the Law of Negligence*, 3 GEO. J. L. & PUB. POL'Y 453, 461 (2005); GEORGE SHER, DESERT 40 (1987).

18. See RIPSTEIN, *supra* note 7, at 105. It does not increase efficiency to require a person *ex post* to internalize a cost she could not have foreseen *ex ante*, because efficiency depends on an *ex ante* cost-benefit analyses, but only if the cost is likely to recur, which is simply a different way to assess foreseeability.

19. See Lyons, *supra* note 17, at 461–63.

20. See RIPSTEIN, *supra* note 7, at 6–9.

21. See JOEL FEINBERG, *DOING & DESERVING: ESSAYS ON THE THEORY OF RESPONSIBILITY* 32–33 (1970). An alternative view of moral responsibility holds an actor responsible only for what she intends. See RIPSTEIN, *supra* note 7, at 16–18.

22. Note, moreover, that it is the principal's act of appointing an agent in general that triggers responsibility; responsibility is not based on the principal's choice of any particular person to serve as an agent.

the cost-benefit internalization theory may be that its idea of causation is too broad. In philosophical terms, the existence of the agency relationship is more like a background condition than a voluntary act.²³ Nevertheless, the principal's original appointment of an agent is the appropriate trigger for the application of the cost-benefit internalization theory for a number of reasons. First, the principal's use of an agent is an abnormal background condition.²⁴ As noted above, the use of the agent alters the natural state of things in a single predictable way: the agent is now interacting with the world where, in a world without agency, the principal would have been acting herself. Moreover, that alteration of the natural state of things is itself a legal effect with a legal cause. Regardless of future events or outcomes, the law of agency must intervene if the appointment of the agent is to have any effect at all. At the highest level of generality, the law enables the appointment of an agent to have an effect in the world, and the need for adjustments to counteract the effect of the law also arises at that level of generality.

As noted above, the use of an agent, combined with agency law, has a series of identifiable and predictable effects. First, the principal's enterprise will expand. Second, the enterprise will face greater risk of failure because the agent, not the owner, is operating some part of it and will not have the same incentives to work. This is a so-called agency cost to the enterprise. Third, the enterprise poses increased risks to the public because of its increased activity. Those risks are different in degree, but not in kind, from the baseline risks of the enterprise before the appointment of the agent. Fourth, the enterprise poses increased risks to the public because an agent may do things an owner would not. Those risks are different in kind from the basic risks of the enterprise. Fifth, the enterprise incurs the incidental costs of the agency relationship. The various doctrines of the law of agency address all these effects. The first, third and fourth effects are external: the use of an agent directly or indirectly increases the risks to third parties from the baseline risk created by the enterprise before it used an agent. The second and fifth effects are internal; they are risks or costs to the principal and the enterprise. All these risks are general risks of the use of an agent, and the use of the agent "causes" them for the purposes of the cost-benefit internalization theory.

23. See FEINBERG, *supra* note 21, at 27. Hart and Honoré argue that a background condition can never be a cause. See H.L.A. HART & TONY HONORÉ, *CAUSATION IN THE LAW* 33–35 (2d ed. 1984). See also FEINBERG, *supra* note 21, at 154.

24. See FEINBERG, *supra* note 21, at 166–67 (arguing that an unusual background condition counts as a cause).

Many other factors affect how the general risks of the use of an agent actually affect third parties, and the other branches of the law, as well as the law of agency, address those factors. Questions of causation, in the sense of legal or proximate cause, continue to be relevant to underlying questions of liability. Thus, the principal will be liable for her agent's negligent driving only if the negligence was the proximate cause of the third party's injury. A principal will be liable for an agent's contract only if there is consideration. The law of agency operates at a higher level of generality. While the specific negligence of the agent must be a legal cause of a specific injury, the general use of the agent is sufficient cause for the general responsibility of the principal. The specific doctrines of agency law serve to limit that general responsibility, but the principal's responsibility, as a preliminary matter, is based on the general increased risks that the use of the agent creates.

F. The Cost-Benefit Internalization Theory and Agency Law, Part One

Part VI of this Article contains an application of the cost-benefit internalization theory to specific agency law doctrines. This section serves as an introduction to the cost-benefit internalization theory in action. As noted above, the cost-benefit internalization theory holds that the principal is responsible for the foreseeable consequences of her acts, which in this case means *the use of an agent in this way in this business*. This principle requires the law to answer two questions: what are the foreseeable consequences of the use of an agent in this way in this business, and what is the "business" in question. Different doctrines of the law address those questions. With respect to an agent's contracts, the principal is liable to the extent that it is foreseeable that a third party would rely upon the agent's having authority to enter into a particular contract. That foreseeable reliance exists when the third party's reliance is reasonable in light of the principal's behavior, either based on specific conduct of the principal²⁵ or based on the principal's use of the agent in a specific context with customary norms.²⁶ Note that it is not the fact that the third party relied on the agent's authority that leads to the principal's liability. Rather, it is the fact that the third party's reliance is a foreseeable consequence of the principal's actions that leads to liability.

With respect to an agent's torts, the principal is liable when an agent commits a tort that is a foreseeable consequence of the use of the agent in this

25. This is the doctrine of apparent authority.

26. This is the doctrine of inherent agency power.

way in the principal's business. The principal is not liable if the tort is not foreseeable in light of the way the principal operates this business, or if the tort is a consequence of someone else's business, not the principal's. "The way the principal operates this business" is a very general concept. It does not include decisions about the amount of training to provide or whether to conduct background checks. It asks instead how agents are integrated into the business. For example, if the principal uses agents to interact with customers but deals personally with suppliers, that is a feature of her operation that must be taken into account in identifying foreseeable consequences. The scope of employment requirement of *respondeat superior*, properly understood, restricts the principal's liability to torts that are foreseeable consequences of the principal's acts. The independent contractor exception restricts the principal's liability to torts that are consequences of the principal's business, not of someone else's. Thus, the reasonableness requirement in the doctrine of apparent authority, the limitation to customary authority in the doctrine of inherent agency power, the "causal nexus" and similar requirements in the definition of the scope of employment, and the features of the independent contractor exception are specific instances of the general rule that limits the principal's liability to foreseeable consequences.

The cost-benefit internalization theory goes further than explaining and limiting a principal's liability to third parties, however. It also explains and limits the principal's liability to the agent and the agent's liability to the principal. The law requires that the principal bear the foreseeable costs of her business; that applies to costs incurred by the agent as well as to costs borne by third parties. Thus, a principal is obligated to indemnify the agent for expenses incurred in the process of producing profits for the principal's business, to the extent it is reasonably foreseeable that the agent will incur those costs. In the indemnification context, the foreseeability limitation appears in the requirement that the principal bear expenses that are necessary²⁷ or that "fairly should be borne by the principal."²⁸ Conversely, the duty of loyalty imposed on the agent seeks to prevent the agent from misappropriating the benefits from the principal's use of the agent in her business.

27. *Admiral Oriental Line v. United States*, 86 F.2d 201, 202 (2d Cir. 1936).

28. RESTATEMENT (THIRD) OF AGENCY § 8.14(2)(b) (2006).

III. THE LIMITS OF CONTRACT

The authors of the Restatement (First) of Agency (*the First Restatement*) felt the need to defend the existence of a separate set of agency principles, because many of the rules they were dealing with seemed to be part of the law of contracts or torts.²⁹ Seventy-three years later, in the Foreword to the Restatement (Third) of Agency (*the Third Restatement*), the Director of the American Law Institute congratulated the Reporter for having “convinced most of those who have engaged with her work that there *is* an independent law of Agency.”³⁰ Ironically, however, the first sentence of the Introduction to the Third Restatement borrows language straight out of the Restatement of Contracts: The law of agency “encompasses the legal consequences of consensual relationships in which one person (the principal) manifests assent that another person (the agent) shall, subject to the principal’s right of control, have the power to affect the principal’s legal relations through the agent’s acts and on the principal’s behalf.”³¹ *The Third Restatement* does not attempt to describe a basis for the law of agency beyond the contractual one just noted, although it does describe rationales for individual doctrines. Those rationales, most of which are contract-based, have a long, if not distinguished, ancestry. It is difficult, however, to justify the principal’s liability for the agent’s torts using a contract theory. *The Third Restatement* does not address this problem; the sections dealing with liability for torts do not contain “rationale” comments.³²

Contract principles, which broadly speaking, are based on the parties’ consent to be bound,³³ can generally explain a principal’s liability for her

29. See Deborah A. DeMott, *The First Restatement of Agency: What Was the Agenda?*, 32 S. ILL. U. L.J. 17, 29–30 (2007).

30. RESTATEMENT (THIRD) OF AGENCY vol. 1, at XI (2006).

31. *Id.* at 3.

32. See RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006) (stating rule for vicarious tort liability). The Reporters’ Notes observe that vicarious tort liability has traditionally been based on the principal’s right to control the agent, although, as I have observed elsewhere, the control theory has weaknesses. See Dalley, *supra* note 8, at 535–36. The Restatement (Third) tries to minimize the problem of vicarious tort liability by describing in detail the many ways that a principal can be liable directly, not vicariously, in connection with an agency relationship. See RESTATEMENT (THIRD) OF AGENCY §§ 7.04–7.06, § 7.07 cmt. e (2006). Because direct liability is based entirely on the principal’s own activities, it really is not agency liability at all.

33. The Restatement (Second) of Contracts describes the current, “bargain,” theory of contracts as follows: “[T]he formation of a contract requires a bargain in which there is a manifestation of mutual assent to the exchange and a consideration.” RESTATEMENT (SECOND) OF CONTRACTS § 17(1) (1981).

agent's contracts. *The Third Restatement* observes that the liability of a disclosed principal for her agent's contracts reflects the "bargain principle" of "contemporary contract law,"³⁴ because both the principal and the third party to the contract have manifested their assent to be bound.³⁵ Even critics of agency law concede that it makes sense for a principal to be liable when she specifically consented to agent's actions.³⁶ In the vast majority of real-world agency relationships, the principal not only consents, but affirmatively desires, to be bound by the acts of her agent, and the role of agency law is to effectuate the result everyone desires. Agency law goes beyond this, however, and holds principals liable even when they have not actually consented to a particular transaction. Promissory theories of contract can be used to explain that result as well. The doctrine of apparent authority, which makes a principal a party to the agent's contract even when the principal did not actually authorize the agent to make the contract, is based on manifestations by the principal to the third party that the agent is authorized.³⁷ Under the Restatement (Second) of Agency (*the Second Restatement*), this doctrine was generally held to require that the principal manifest consent to the transaction, rather than consent to the acts making the principal "responsible" for the third party's belief that the agent was authorized.³⁸

Agency law only becomes interesting, however, when it imposes liability on a clearly non-consenting principal, and commercial expediency requires that the law hold principals liable even when they could not possibly have

34. RESTATEMENT (THIRD) OF AGENCY § 6.01 cmt. b (2006). As discussed below, the Third Restatement's definition of "manifestation of assent" is so broad that it is difficult to square the liability it creates with the bargain principle. The Third Restatement also reiterates its devotion to the "bargain principle" with respect to the liability of unidentified principals by noting that the agent and the third party both manifest assent to the contract. *Id.* § 6.02 cmt. b. The unidentified principal, however, becomes a party to a contract without any manifestation of assent. According to the Third Restatement, the unidentified principal becomes a party to the contract because the agent "acts on behalf of a principal" and because "ordinarily" the third party wants the "liability of the person on whose behalf the agent contracts." *Id.* This rationale hardly comports with the bargain principle.

35. See RESTATEMENT (THIRD) OF AGENCY § 6.01 cmt. b (2006). See also *id.* § 6.02 cmt. b. If the principal's liability is based on her manifestations of assent to be bound, the agency relationship is essentially irrelevant, except insofar as it replaces consideration.

36. Holmes, *Agency [Part I]*, *supra* note 4, at 347; John H. Wigmore, *Responsibility for Tortious Acts: Its History*, 7 HARV. L. REV. 315, 317 (1894). See also Gerard McMeel, *Philosophical Foundations of Agency Law*, 116 L.Q. REV. 387, 402 (2000) (arguing that agency liability arose in the 18th century based largely on the consent of the principal and the induced-reliance theory discussed below).

37. See RESTATEMENT (SECOND) OF AGENCY § 8 (1958).

38. See Steven A. Fishman, *Inherent Agency Power—Should Enterprise Liability Apply to Agents' Unauthorized Contracts?*, 19 RUTGERS L.J. 1, 40–41 (1987). Cf. RESTATEMENT (SECOND) OF AGENCY § 27 cmt. a (1958) ("[E]ither the principal must intend to cause the third person to believe that the agent is authorized to act for him, or he should realize that his conduct is likely to create such belief.").

consented to specific transactions. To some degree, the objective theory of contracts provides a solution to the non-consenting principal problem; if the principal *appears* to have consented to the transaction, contract theory is satisfied. *The Second Restatement's* version of apparent authority is therefore consistent with the bargain theory of contracts. *The Third Restatement's* approach to apparent authority, on the other hand, may be better explained by a reliance theory of contract.³⁹ Under *the Third Restatement*, apparent authority exists where the third party reasonably believes the agent has authority and “that belief is traceable to the principal’s manifestations.”⁴⁰ The definition of “manifestation” has been broadened to include types of conduct not generally viewed as communicative. First, placing an agent in a position that carries “specific functions or responsibilities” constitutes a manifestation of assent to acts by the agent that are “requisite to fulfilling the specific functions or responsibilities.”⁴¹ Second, placing an agent in a “position . . . or setting in which holders of the position customarily have authority of a specific scope” constitutes a manifestation of assent to acts within that scope.⁴² Finally, failure to express dissent will be taken as a “manifestation of affirmance” when a reasonable person would speak up to rebut an inference of authority.⁴³

The Third Restatement's broad definition of “manifestations of assent” allows the old doctrines of apparent authority, estoppel,⁴⁴ and inherent agency power⁴⁵ to be subsumed into a broader concept of apparent authority. That broader version of apparent authority appears to be contractual, because it requires that the principal engage in some voluntary conduct that constitutes

39. The reliance theory is embodied in Section 90 of the Restatement (Second) of Contracts: A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise.

RESTATEMENT (SECOND) OF CONTRACTS § 90 (1979). Despite the requirement of a promise, the detrimental reliance theory of contracts is not consent-based because the focus of the inquiry is on the effect of the obligor’s actions on the behavior of the obligee. Under Section 90, the action that induces the obligee’s reliance is the promise, which will virtually always be voluntary, but the resulting obligation on the contract need not be voluntary at all.

40. RESTATEMENT (THIRD) OF AGENCY § 2.03 (2006).

41. *Id.*

42. *Id.*

43. *Id.*

44. See RESTATEMENT (THIRD) OF AGENCY, topic 4, intro. note at 143 (2006) (stating that estoppel “protects justifiable and detrimental reliance,” noting that the word “reliance” can refer to any behavior induced by a manifestation, but stating that liability in estoppel is distinguished by its requirement that the third party has changed her position).

45. See *infra* text accompanying notes 50–56.

a “manifestation,” but under *the Third Restatement’s* broad definition of manifestation that conduct need not come anywhere near expressing consent. Rather, the principal’s liability appears to be based on the fact that the principal did something that induced the third party to rely on the agent.⁴⁶ The reliance theory appears in *the Second Restatement* in the doctrine of estoppel. When a principal unreasonably permits a third person to rely on authority that does not exist, the principal will be estopped from denying that authority even if the principal never manifested assent to be bound and was not responsible for the appearance of authority.⁴⁷ In such a case, however, there is no contract formed; rather, the principal is liable only for actual damages resulting from the third party’s change of position. Estoppel is thus purely reliance-based, but it does not create a binding contract because there is no promise or other conduct by the principal that induced the reliance.

Neither the bargain theory nor the reliance theory is able to explain the liability of an undisclosed principal for her agent’s contracts.⁴⁸ The undisclosed principal doctrine provides that a contract arises between a principal and a third party even when the third party is not aware that the agent is acting as an agent at all. In such a case there is no way to find a manifestation of assent to a contract with the principal by the third party and often no manifestation of assent to the specific transaction by the principal.⁴⁹ The reliance theory of contracts also does not explain the doctrine; a third party cannot possibly rely upon the authority of an agent to bind a principal when the party is not aware that the agent is an agent at all.⁵⁰

Agency law’s response to the undisclosed principal problem has been the doctrine of “inherent agency power.” Inherent agency power is an agent’s power to bind the principal in contract solely as a result of the agency relationship.⁵¹ The principal creates the power by appointing the agent, and the agent’s inherent power is limited to the powers such an agent would

46. Reliance is said to have been the basis for Roman law’s imputation of liability to the *paterfamilias* and to commercial principals. See J. INST. 4.7.pr.-1.

47. RESTATEMENT (SECOND) OF AGENCY § 8B (1958).

48. See Randy E. Barnett, *Squaring Undisclosed Agency Law with Contract Theory*, 75 CALIF. L. REV. 1969 (1987) (explaining the undisclosed principle doctrine based on a “consent theory of contract”).

49. See RESTATEMENT (THIRD) OF AGENCY § 6.03 cmt. b (2006).

50. As noted below, in some cases the third party is induced to enter into a contract with the agency in reliance on other facts, such as the fact that the agent is the owner of assets actually owned by the principal. That reliance might create estoppel of another kind; the principal might be estopped from denying that the agent owned the assets.

51. See RESTATEMENT (SECOND) OF AGENCY § 8A (1958).

customarily have.⁵² Inherent agency power was much criticized under *the Second Restatement*, and *the Third Restatement* was determined to get rid of it. Without inherent agency power, however, some principals would be relieved of liability in situations where they “should” be liable. The classic example of this problem is *Watteau v. Fenwick*,⁵³ in which an undisclosed principal placed unusual restrictions on the agent’s authority. Because the principal in *Watteau* was completely concealed, there were no manifestations to support apparent authority, and the principal could not be estopped from denying liability because the third party did not rely on the principal’s existence at all.⁵⁴ Rather, the third party relied on the appearance that the agent was a principal and therefore the owner of the business. To permit the principal to avoid liability in such a case would, in essence, provide asset protection to undisclosed principals without subjecting them to the requirements of the law relating to limited liability entities.⁵⁵ As the court in *Watteau* recognized, inherent agency power⁵⁶ solved the problem.

The Third Restatement addressed the *Watteau* problem by replacing inherent agency power with the extended doctrine of apparent authority described above. Placing an agent in “a position or setting” in which “holders of the position customarily have authority of a specific scope” constitutes a manifestation of assent to acts within that scope and therefore can create apparent authority. An example based on *Watteau* is used to illustrate that feature of apparent authority. This broadening of the definition of “manifestation” takes the doctrine out of contract theory where the principal is undisclosed. Neither the bargain theory nor the reliance theory of contract holds a promisor to a contract if the third party does not accept or rely on the promise. In the absence of an acceptable contract-based justification, *the Third Restatement* does not even attempt to explain why an undisclosed principal is liable; it observes that the doctrine is “well-settled doctrine” and commercially necessary.⁵⁷

52. *Id.*

53. *Watteau v. Fenwick*, [1893] 1 Q.B. 346 (Eng.).

54. *Id.*

55. The most important such requirement is that the entity’s name includes some indication that it has limited liability. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(a)(1) (2008); UNIFORM LIMITED LIABILITY COMPANY ACT § 108 (2006); MODEL BUS. CORP. ACT ANN. § 4.01(a)(1) (4th ed. 2008).

56. The court did not use this term. Rather, it referred to the “ordinary doctrine as to principal and agent . . . 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 . . .” *Watteau*, [1893] 1 Q.B. at 348–49.

57. *See* RESTATEMENT (THIRD) OF AGENCY § 6.03 cmt. b. The endnotes to that section cite *Scrimshire v. Alderton*, (1743) 93 Eng. Rep. 1114 (K.B.); 2 (2006) *Strange* 1182. Ironically, a later

IV. THE LIMITS OF TORT

Although contract theories do a fair job of explaining most of a principal's liability for her agent's contracts, they are generally incapable of explaining the principal's liability for her agent's torts,⁵⁸ also known as *respondeat superior*.⁵⁹ This may explain why the principal's vicarious liability for torts has drawn more criticism than vicarious liability for contracts. Tort theories, on the other hand, do a better job of explaining agency law doctrines, and the cost-benefit internalization theory is, in part, based on principles that underlie tort liability. Commentators on the law of torts recognize the extent to which theories of tort liability explain *respondeat superior*, but they have not extended that analysis to agency law generally, and commentators on agency law tend to ignore theories derived from tort law. When one examines the principles underlying tort law, one discovers that those principles have only limited explanatory power for agency law. The inability of tort principles to explain agency law is not surprising, considering that tort law and agency law serve different functions.

Common law torts are usually divided according to their bases for liability: intentional torts, negligence, and liability without fault, otherwise known as strict liability or, simply, causation. Not surprisingly, each basis of liability has its own theoretical justification, and those justifications have varied over time. Liability for intentional torts and negligence is based on the tortfeasor's fault; in the case of negligence, liability is based on the tortfeasor's failure to conform her conduct to a social norm. Liability for negligence is also justified by the need to create incentives for actors to take an appropriate amount of care, and liability may be imposed on the person who could have avoided the accident most easily or at least expense. Liability

commentator reportedly observed that the case contained "particular circumstances" because the "agent" had agreed to pay the owner of the goods, thus making him a purchaser and not an agent at all. *See id.* at 1115. *See also* Holmes, *Agency [Part I]*, *supra* note 4, at 349.

58. If agency law does not exist—that is, if the principal's liability in contract is a contract law doctrine, and her liability in tort is a tort law doctrine—then the lack of a single explanation for contract and tort liability is not surprising. But as explained below, the existence of a separate body of agency law satisfies social needs that cannot be met by standard contract and tort law alone. *See infra* notes 73–78 and accompanying text.

59. Wigmore asserted that the principal's implied consent was the basis for *respondeat superior* liability in Norman law (replacing the Anglo-Saxon concept of control discussed below). *See* Wigmore, *supra* note 36, at 332.

without fault has provided greater theoretical challenges.⁶⁰ Such liability has been justified by the fact that the actor created a danger that was “especially great” and the number of its victims “especially numerous,” and on the fact that the actor “introduced a danger not common in the community.”⁶¹ Liability without fault has also been justified because the actor was in a “peculiarly advantageous position” to spread the loss, and on the fact that “the person carrying on the activity is greatly benefited therefrom in comparison to the loss to the injured persons.”⁶² These justifications correspond to the often-stated goals of tort law: compensating victims, preventing accidents, punishing fault, spreading losses, and forcing actors to internalize the costs of the accidents caused by their activity.

The underlying premises of tort law do not translate well to agency law. Concepts of fault do not apply to most agency law problems. A principal who intends or authorizes the agent’s tortious conduct, even if she does not know it will be tortious, is liable directly in tort; similarly, a principal who is negligent in choosing or supervising an agent is directly liable in tort for negligence. Agency law is not necessary or relevant to either situation. Concepts of liability derived from the need to reduce the incidence and cost of accidents are based on the policy concerns of the law of torts, not the law of agency. Liability based on ability to spread losses, or, more crudely, on the ability to pay, has been suggested as an explanation for *respondeat superior*.⁶³ Such a justification assumes that the principal, rather than the third party, will have the deep pocket, which will often not be the case. A policy aimed at spreading losses would be better served by placing losses on the best loss-spreader, as tort law attempts to do, rather than by using the extremely imprecise proxy of an actor’s position as a principal. It is also unclear why the law of agency, which is directed at ameliorating the effects of using an agent, would have loss spreading as its goal.⁶⁴

60. It has been suggested that at one time liability was premised only on causation. See 2 HARPER & JAMES, THE LAW OF TORTS § 14.1, at 212 n.2 (1956).

61. *Id.* at 215.

62. *Id.*

63. The argument was not usually stated as baldly as, “let the richer person pay,” although that was not unknown. See T. BATY, VICARIOUS LIABILITY 154 (1916); Glanville Williams, *Vicarious Liability and the Master’s Indemnity*, 20 MOD. L. REV. 220, 232 (1957). Rather, the argument was that the risks of modern society should be borne by corporations, which had all the money and created all the problems, and that vicarious liability provided a legal basis for holding corporations liable. See Harold J. Laski, *The Basis of Vicarious Liability*, in FOUNDATIONS OF SOVEREIGNTY AND OTHER ESSAYS 250, 259, 268, 274–79, 288–89 (1922); BATY, at 65–72; Wigmore, *supra* note 36, at 405 n.1.

64. See *Ira S. Bushey & Sons, Inc. v. United States*, 398 F.2d 167, 171 (2d Cir. 1968). *But see* *Lisa M. v. Henry Mayo Newhall Memorial Hosp.*, 907 P.2d 358, 366 (Cal. 1995) (referring to “policy goals”

The cheapest-cost-avoider theory of tort law can be applied to agency law in a superficially satisfactory way.⁶⁵ The cheapest-cost-avoider theory places a loss upon the actor who could have avoided the risk of injury at the least cost. If that person is the injured party, then the putative tortfeasor is not liable.⁶⁶ Because the principal makes all the decisions about the agency—whether to hire an agent, whom to hire, how much training and supervision to provide, and how to use the agent in her enterprise—the principal is often the one in the best position to reduce the risk that the agent will injure someone. But here too the liability would be based on the principal’s fault. Cheapest-cost-avoider analysis cannot explain the principal’s liability generally, but only the principal’s liability with respect to a particular tort.⁶⁷

Although the direct application of tort principles to agency law has been only sporadic and incomplete, tort principles are the unspoken basis for the most popular theory of agency liability: the principal’s control of the agent and, consequently, her ability to prevent the agent’s wrongdoing.⁶⁸ This control-based explanation for *respondeat superior* is frequently asserted and is said to have existed for millennia.⁶⁹ The control theory probably grew from, and accounts for, the fact that control is an important element in agency doctrine. Control is often used to determine which of two employers is liable for the torts of a borrowed servant,⁷⁰ for example, and control over the manner

of “preventing future injuries, assuring compensation to victims, and spreading the losses caused by an enterprise equitably”).

65. See William A. Klein, *The Story of Martin v. Peyton: Rich Investors, Risky Investment, and the Line Between Lenders and Undisclosed Partners*, in *CORPORATE LAW STORIES* 77, 97–98 (J. Mark Ramseyer ed., 2009) (discussing liability of undisclosed principal).

66. Theoretically, cheapest-cost-avoider analysis merely identifies negligence: a party has failed to exercise due care if she was the cheapest-cost avoider and the accident nevertheless occurred.

67. In torts, cheapest-cost-avoider analysis is used to determine liability on a case-by-case basis, not to identify an entire class of actors as permanent loss-bearers.

68. Liability for negligence is said to arise from the tortfeasor’s failure to prevent, or try to prevent, a recognizable or foreseeable harm. See OLIVER WENDELL HOLMES, JR., *THE COMMON LAW* 75–77 (1963).

69. See Laski, *supra* note 63, at 265–66; BATY, *supra* note 63, at 41. Wigmore observed that the liability of the master for his slave in Anglo-Saxon law was directly analogous to the owner’s liability for injuries caused by his animals. See Wigmore, *supra* note 36, at 330–31. *But see* P.S. ATIYAH, *VICARIOUS LIABILITY IN THE LAW OF TORTS* 41–47 (1967) (arguing that vicarious tort liability is not about control). On the other hand, as discussed below, in Roman law the owner was liable for the torts of his slave, although he could absolve himself of liability by turning the slave over to the victim of the tort. J. INST. 4.8. *Justinian’s Institutes* states that if a slave commits a tort and is then sold, the new owner, rather the owner at the time of the tort, bears the liability. *Id.* at 4.8.5. It is difficult to square this doctrine with a theory that depends on the owner’s control over the slave or ability to avoid the risk.

70. See RESTATEMENT (THIRD) OF AGENCY § 7.03 cmt. d(2) (2006). See also *Responsibility of the Hirer of a Post-Chaise*, 10 AM. JURIST & L. MAG. 256 (1833) (arguing that the hirer of a horse and carriage

in which the agent performs her tasks is usually said to be the determinative difference between an employee and an independent contractor.⁷¹ *The Third Restatement* even makes control the determining fact for the scope of employment.⁷² Although courts and commentators make much of the fact of control, it is difficult to see why the principal's right of control should be relevant to agency law. If control is important because it means the principal could have, and should have, avoided the occurrence of a tort, then the relevant theory is ordinary negligence: a principal who fails to exercise due care in selecting or supervising an agent will be directly liable in tort. Similarly, if a principal unreasonably fails to control an unauthorized agent and a third party relies on the agent to her detriment, the principal will be liable under estoppel principles. More fundamentally, agency law is aimed at the use of agents generally: the relationship between the principal and agent, the principal's and third party's ability to do business through agents, and the externalities created by the principal's choice to operate through an agent. The principal's control is one factual aspect of that relationship; the more salient fact, however, is that the principal is receiving the benefit of the use of the agent.

Although ideas of liability premised on reducing losses are not convincingly applied to agency law, principles from the law of torts are part of the cost-benefit internalization theory. It cannot be argued that the use of an agent is unusual or especially dangerous today, but, as I argue above, the use of an agent creates a special kind of risk, in part as a result of legal facts, and the principal's liability should be based on the fact that she created that risk, combined with the fact that she, because of the operation of the law, benefits from the relationship. The idea that an actor should be forced to internalize the costs of her activities, an idea that has found its home in the tort law, is especially relevant to the law of agency. A few commentators on tort law have recognized this coincidence by identifying *respondeat superior* as

has the power to cause the driver to drive recklessly, and therefore the hirer, not the owner, should be liable for the driver's "rashness or . . . negligence"). The 1833 editorialist also notes that the carriage may be hired for a long time or for a long distance, and the injured person should not have to pursue the now-remote owner for injuries caused by the hirer and driver. *See id.* at 258. This argument seems to be based on some other rationale than the hirer's control, perhaps on the fact that the hirer's activity created the risk.

71. Compare RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006) (describing control as the distinguishing feature), with *id.* at § 2.04 cmt. b (describing the principle underlying the employee/independent contractor distinction). Because a principal is not liable for an independent contractor's torts, control is therefore ultimately determinative of liability. *See also infra* Part VI.B.2.

72. *See* RESTATEMENT (THIRD) OF AGENCY § 7.07(2) (2006).

a kind of enterprise liability.⁷³ Not surprisingly, they have not extended the cost-internalization principle to other areas of agency law.

V. OTHER (UNSATISFACTORY) EXPLANATIONS

Commentators have occasionally proposed explanations for agency law that are not derived from contract or tort principles. This Section describes those explanations and shows that, while they have certain merits, they are unable to explain the doctrine in a useful and coherent way.

A. Policy

Doctrines of agency law that cannot be explained by reference to tort or contract principles are often said to be based solely on policy considerations. The principal's liability for an agent's torts, for example, was tolerated because it provided a way to reach corporations.⁷⁴ The policy most often used to justify agency law liability, however, is the unspecified needs of commerce.⁷⁵ Commerce requires the use of agents, and the use of agents requires that third parties be willing to rely on them. Commerce therefore requires that principals be liable for their agent's contracts at least within the ordinary operation of the business. This was the argument used by Learned Hand to explain inherent agency power in a leading American case on that doctrine.⁷⁶ In *the Second Restatement*, inherent agency power was described as a doctrine existing "for the protection of third persons." *The Third Restatement* grudgingly includes the undisclosed principal doctrine despite the fact that it has no theoretical (i.e. contractual) basis because business seems to need the concept.⁷⁷ Commerce seems less dependent on the liability of a principal for the agent's torts, but it would probably be bad policy in a different sense to allow a principal to escape the risk of liability for accidents by operating through agents. Occasionally, the principal's liability for her

73. Enterprise liability treats the agent's torts as a risk of the business that should be borne by the principal. See Dalley, *supra* note 8, at 534–35. See also RESTATEMENT (SECOND) OF TORTS § 519 cmt. d (1997) ("The defendant's enterprise, in other words, is required to pay its way by compensating for the harm it causes, because of its special, abnormal and dangerous character.")

74. See *supra* note 63.

75. See McMeel, *supra* note 36, at 390, 400; Seavey, *supra* note 14, at 859; WILLIAM BLACKSTONE, 1 COMMENTARIES 418 (1765).

76. Kidd v. Thomas A. Edison, Inc., 239 F. 405, 407, 408 (S.D.N.Y. 1917). See also *Watteau*, [1893] 1 Q.B. at 349 (noting that "mischievous consequences" would result if the principal were not liable).

77. See RESTATEMENT (THIRD) OF AGENCY § 6.03 cmt. b (2006).

agent's actions is said to be required by "justice."⁷⁸ The justice referred to in these situations is presumably related to the cost-benefit internalization theory.⁷⁹

B. Status and the Identification Fiction

It has been argued that agency law derives from archaic notions of status, and many early agency relationships were status relationships.⁸⁰ Tapping Reeve's early American treatise covered "baron and femme," parent and child, guardian and ward, and master and servant. Shakespeare's *Henry V* provides an example of a status relationship with a whiff of vicarious liability.⁸¹ In Act IV, Scene 1, a soldier argues that the king will have to make a "heavy reckoning" for the fate of those who "do not die well" in the upcoming battle.⁸² The disguised King rejects this view: The men in his service come to him with their previous sins upon them. If they die in battle and as a result must pay for those sins before God, it is their own responsibility. As another soldier puts it, "'Tis certain, every man that dies ill, the ill upon his own head—the king is not to answer for it." This passage has been said to be one of the earliest uses of the language of master-and-servant, and Henry's rejection of vicarious liability—"[the masters] purpose not their [servants'] death when they purpose their services"—has been said to be a rejection of *respondeat superior* liability. This misreads the passage, however. Henry is not rejecting responsibility for the lives of his men, but only for the state of their souls when they die. The fact that the soldier makes the argument at

78. An example of this appears in *Reading v. Attorney-General*, in which a sergeant in the Army sued to recover unauthorized profits seized by the Crown. [1951] A.C. 507, 514–15 (H.L.). The court was at a loss to explain why the Crown should be entitled to the money, although it was clear that he should not be allowed to retain money that he had acquired by the use of the Crown's property. One commentator has observed that the "true moral basis on which the claim is based is clear and uncontroversial." GOODHART, *supra* note 8, at 129–30.

79. See Dot Reid, *Thomas Aquinas and Viscount Stair: The Influence of Scholastic Moral Theology on Stair's Account of Restitution and Recompense*, 29 J. LEG. HIST. 189, 192–93 (2008) (observing that the maxim of Pomponius in the *Digest* that no one should be enriched at the expense of another is a principle of justice, not a rule of law); GOODHART, *supra* note 8, at 127–28.

80. Buckland argues that the Roman status relationships of guardian and ward, common owners, and *heres* and legatee are explained by the fact that the agent holds property for the principal. See W.W. BUCKLAND & ARNOLD D. MCNAIR, *ROMAN LAW AND COMMON LAW: A COMPARISON IN OUTLINE* 332–33 (F.H. Lawson ed., 2d ed. 1952).

81. See Wigmore, *supra* note 36, at 393 n.1 (discussing view that the scene provides an early example of the control-based nature of vicarious liability).

82. WILLIAM SHAKESPEARE, *THE LIFE OF KING HENRY THE FIFTH*, act 4 sc. 1.

all—that the lord must answer to God when his men die in “irreconciled iniquities”—illustrates the bond a status relationship could have.

Even if agency law has its origins in status relationships, that origin does not, in itself, tell us much about agency law. What are the features of status relationships, and which of those features illuminates agency law and how? Status relationships can be based on property, as in bailment and the Roman family, or on affective ties as in the modern family, or on a combination of both as in feudal relationships. Are those differences important, and if so, where does agency fit? Is agency doctrine really “a survival from ideas of status,”⁸³ or did it merely develop in the context of status relationships? Status relationships are an interesting subject in their own right, but they are embedded in specific social arrangements. Even if we understood all the contours of status relationships and the rules that should apply to them, they could not provide guidance in a world where social interactions are organized very differently. Thus, the fact that agency once existed in status relationships, and perhaps still does, does not shed much light on the law.

As status relationships declined in importance in more modern economies, commerce would nevertheless continue to require that a principal be a party to contracts made on his behalf. Commercial practice, custom, and the intent of the parties would all support the principal’s becoming a party to the contract, but the formalities of the common law needed something more. The law, which at that time made frequent use of fictions, reached for yet another legal fiction: the agent *was* the principal when the agent was acting on the principal’s behalf.⁸⁴ As an explanation for the principal’s liability, the identification doctrine⁸⁵ is perfect, and although it is clearly a fiction, it may

83. *Kidd*, 239 F. at 407 (S.D.N.Y. 1917).

84. The standard maxim of vicarious liability is *qui facit per alium, facit per se*, which means approximately “he who acts through another acts himself.” This maxim appears in BLACKSTONE, 1 COMMENTARIES 429, and is discussed in Holmes, *Agency [Part II]*, *supra* note 4, at 20. It first appeared in the *Liber Sextus* of Pope Boniface VIII, dated approximately 1298. *Regulae Iuris in VI Decretalium Bonifaci VIII*, INTERNET SERV., <http://web.infinito.it/utenti/i/interface/Regulae3.html?a> (last visited Dec. 27, 2010). Boniface’s maxim, however, is *qui facit per alium est perinde ac si faciat per seipsum*, which is closer to “when one acts through another it is as if he acted himself.” *Id.* The change in the maxim suits the identification theory nicely.

85. The agent is subsumed into the identity of the principal. Holmes was outraged by this fiction: A judge would blush to say nakedly to a defendant: “I can state no rational ground on which you should be held liable, but there is a fiction of law which I must respect and by which I am bound to say that you did the act complained of, although we both know perfectly well that it was done by somebody else whom the plaintiff could have sued if he had chosen, who was selected with the utmost care by you, who was in fact an eminently proper person for the employment in which he was engaged, and whom it was not only your right to employ, but much to the public advantage that you should employ.”

reflect a long history of convention in pleading in the common law. It is possible that many cases involving the actions of a servant or bailiff were pleaded as if the actor were the principal.⁸⁶ That fact would only be revealed if the opposing party thought it was worth arguing about.⁸⁷ Once legal fictions became suspect, the identification doctrine fell out of favor and it is not a useful doctrine today. It is worth noting however, that the identification doctrine explains only the principal's liability to third parties; it is irrelevant to the relationship between the principal and the agent.

C. Historical Explanations

1. Roman Law

At the turn of the twentieth century, commentators began to seek explanations for agency law in Roman law.⁸⁸ The emphasis on Roman law presumably reflects the state of the historical sources. Few early common law cases mentioning agents of any kind have been identified.⁸⁹ It is generally believed that commercial law prior to the 18th century was buried in the proceedings of merchants' courts, and the law of commercial agents would therefore be less accessible than other common law doctrines. Agency law matters involving fiduciary duties might arise in chancery⁹⁰ or ecclesiastical

Holmes, *Agency [Part II]*, at 22 (1891), reprinted in 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 368, 413 (Assoc. of Am. L. Schools ed., 1909).

86. See Anon., Y.B. Mich. 30 Edw. 3, fol. 18 (1356) (Eng.), reprinted in J.H. BAKER & S.F.C. MILSOM, SOURCES OF ENGLISH LEGAL HISTORY: PRIVATE LAW TO 1750, at 213 (1986) (observing that a count that "my servant sold them" was not an appropriate count for an action against the buyer. Rather the count should be that "you yourself sold the wools."). See also *Stockbridge v. Bradford*, 103 SELDEN SOCIETY 237 (K.B. 1333) (holding master liable for trespass committed by servant at command of master without discussion).

87. An early example of a dispute over representation by an agent appears in a 1311 case from the fair at St. Ives. See *Fulham v. Francis*, 1 SELECT CASES CONCERNING THE LAW MERCHANT 89–90 (Charles Gross ed., Selden Society 23, 1908) (Fair Ct. of St. Ives 1311), quoted in Stephen E. Sachs, *From St. Ives to Cyberspace: The Modern Distortion of the Medieval Law Merchant*, 21 AM. U. INT'L. L. REV. 685, 757–58 (2006). In that case, two servants tried to claim ownership on behalf of their master, but the defendant objected that the master must claim ownership himself. The judge observed that it would be "hard and inconsistent with right" not to allow a servant to represent a master this way. The court convened all the merchants of the fair, who agreed with the first judge. See *id.*

88. See generally J.M. KELLY, A SHORT HISTORY OF WESTERN LEGAL THEORY 323–25 (1992).

89. For a review of the English case law, see Wigmore, *supra* note 36, at 332–37, 384–91, 394–97, 400–04.

90. A significant part of Chancery's jurisdiction involved claims by beneficial owners of property against feoffees or trustees who refused to carry out their instructions regarding land which they legally owned.

courts. The merchants' courts, chancery, and the ecclesiastical courts were all heavily influenced by Roman law, so perhaps it makes sense to look to Roman sources for the antecedents of agency law.

As many commentators have pointed out, Roman law contains a variety of institutions that at least superficially resemble modern agency law. The most obvious of these is the family. The family in Rome was a unit consisting of the *paterfamilias* and all those in *patria potestas* (which we might broadly translate as "power of the father"). Those in power included the wife, children, grandchildren, adopted children and grandchildren, and slaves of the *paterfamilias*. All property was owned by the *paterfamilias*, and if a member of the family engaged in a business that generated profit, that profit also belonged to the *paterfamilias*. Although it was a maxim of Roman law that one could not act through another,⁹¹ actions by slaves were binding on the *paterfamilias*. A slave could acquire property for the *paterfamilias* and could in some circumstances bind the *paterfamilias* to a contract. Furthermore, if a member of the family caused damage, the *paterfamilias* was often responsible for the damage.⁹² Thus, the sons (adopted and natural) and slaves of the family bear some resemblance to agents of the *paterfamilias*.⁹³ The common custom of conducting business through slaves reflects this.⁹⁴

In addition to family members, Roman law recognized a variety of agent-like characters, such as fiduciaries, procurators, and mandators. The fiduciary was a straw man used to satisfy formalities in sales transactions, including transactions necessary to free a son from *patria potestas*.⁹⁵ The obligations of the Roman fiduciary were not legally enforceable, although at some point the praetor began to enforce those obligations as a requirement of good faith.⁹⁶ In the contract of mandate, a person (the mandator) designated someone (a mandatary or procurator) to act on his behalf.⁹⁷ The contract of mandate was required to be gratuitous.⁹⁸ The mandatary's authority was limited to his

91. See David Johnston, *Limiting Liability: Roman Law and the Civil Law Tradition*, 70 CHI-KENT L. REV. 1515, 1515 (1995).

92. Alternatively, where the damage was caused by a slave, the *paterfamilias* could turn over the slave to the victim. This "noxal liability" permitted the *paterfamilias* to limit his liability to the value of the slave. See *id.* at 1525.

93. See BARRY NICHOLS, AN INTRODUCTION TO ROMAN LAW 201 (1962).

94. See F.H. LAWSON, THE ROMAN LAW READER 133–34 (1969); WILLIAM L. BURDICK, THE PRINCIPLES OF ROMAN LAW AND THEIR RELATION TO MODERN LAW 425–26 (photo. reprint 1989) (1938).

95. See ALAN WATSON, CONTRACT OF MANDATE IN ROMAN LAW 10–11 (1961).

96. See *id.*

97. See W.W. BUCKLAND, A TEXT-BOOK OF ROMAN LAW FROM AUGUSTUS TO JUSTINIAN 519 (1932).

98. See J. INST. 3.26.

express mandate,⁹⁹ and he, rather than the mandator, was bound by and able to enforce the contract.¹⁰⁰

Procurators were used as general managers for businesses,¹⁰¹ but the exact extent of their powers and liabilities is uncertain.¹⁰² The causes of action known as the *actio institoria* and the *actio exercitoria* are Roman legal institutions that seem more closely related to our idea of business practice, although we do not have directly analogous causes of action.¹⁰³ The former action provided a remedy against a principal¹⁰⁴ when the principal put someone (the *institor*) in charge of a business. The principal was liable for the acts of the *institor* within the scope of the business.¹⁰⁵ The *actio exercitoria* permitted a similar claim against a shipowner for actions of the captain.¹⁰⁶

These historical instances of agency-like relationships are not explanations for our law. For one thing, the social and legal institutions of ancient Rome are so dissimilar to our institutions that it would be absurd to retain legal rules based on it. This was the gist of Holmes's critique of agency law.¹⁰⁷ Also, even if Roman law included concepts exactly like our agency law, there is no reason to believe, based on existing evidence that our law descended from its Roman predecessor.¹⁰⁸

99. See BUCKLAND, *supra* note 97, at 516.

100. See BURDICK, *supra* note 94, at 427. In later times, equitable actions were permitted between the mandator and third parties. See *id.* at 460.

101. See WATSON, *supra* note 95, at 6–9.

102. See *id.* at 7.

103. The closest analogue is our concept of inherent agency power.

104. “Principal” is not a Roman word.

105. See Johnston, *supra* note 91, at 1516.

106. See J. INST. 4.7.2.

107. See Holmes, *Agency [Part I]*, *supra* note 4, at 355.

108. It is perhaps worth noting at this point that, while our agency law probably does not directly descend from Roman law, our partnership law may. From an early date Roman law recognized the *societas*, which was a general form of co-ownership. Although they were liable to each other, partners in a *societas* (unlike our partnership) were not vicariously liable for the acts of their partners. See NICHOLS, *supra* note 93, at 185–87. Another medieval form of partnership that resembles our partnership in some respects is the *commenda*, a standardized form of doing business developed in the pre-Islam Arab world but used across Europe. See Ron Harris, *The Institutional Dynamics of Early Modern Eurasian Trade: The Commenda and the Corporation* at 14–15 (SSRN); MAX WEBER, *THE HISTORY OF COMMERCIAL PARTNERSHIPS IN THE MIDDLE AGES* 66–68 (Lutz Kaelber trans., 2003). The *commenda* was a bilateral contract between an investor and a traveling agent who typically did not invest capital but instead provided his labor and expertise; the profits were commonly shared. See *id.* See also *id.* at 68–71 (describing the *societas maris*, an innovation on the *commenda*). Sources of our partnership law in the 19th century drew heavily on civil law inheritors of the Roman law. See, e.g., JOSEPH STORY, *COMMENTARIES ON THE LAW OF PARTNERSHIP* (4th ed. 1855) (regularly citing Justinian and the French jurist Robert Pothier). Thus, although partnership is said to be mutual agency, See *Cox v. Hickman*, 11 Eng. Rep. 431, 446 (H.L. 1860), the historical explanation for partnership law may differ from the historical explanation for agency law.

2. English Law

We have little understanding of the history of English agency law and, to this author's knowledge, no one has suggested an explanation of agency law based on Anglo-American legal history.¹⁰⁹ One apparent forerunner of our law appears in the "Statute of the Staple" of 1353,¹¹⁰ which limited a master's liability for a servant's torts to acts within the scope of employment. The statute deals primarily with commercial law, but the provision limiting liability does not apply only to merchants.¹¹¹ Non-commercial agency relationships also existed, of course. Estate management from medieval times, if not earlier, was performed by stewards, bailiffs, and reeves, who were responsible for holding the manor court in the lord's absence,¹¹² for taking accounts from underlings, for managing and accounting for farm activity, and for overseeing laborers. The bailiff could bind the lord to a lease or alienation in fee of the lord's land,¹¹³ and the sheriff could attach the bailiff if he could not attach the lord.¹¹⁴ Although the authority of the bailiff and other feudal agents had fairly clear limits, their powers illustrate that the law recognized, even in medieval times, that a man could be bound by and therefore liable for, the acts of another man.¹¹⁵

The relationship between bailiff and lord appears to have been connected to the bailiff's custody of the lord's property.¹¹⁶ Borough customs from the

109. At the conclusion of his historical study, Wigmore provides a defense of the doctrine based on policy. *See* Wigmore, *supra* note 36, at 405 n.1.

110. Statute of Staple, 1353, 27 Edw. 3, c. 19 (Eng.).

111. *Id.* ("[N]o merchant nor other, of what condition that he be, shall lose or forfeit his goods nor merchandises for the trespass and forfeiture of his servant, unless he do it by the commandment or procurement of his master, or that he hath offended in the office in which his master hath set him, or in other manner, that the master be holden to answer for the deed of his servant by the law-merchant, as elsewhere is used.").

112. The bailiff acted as prosecutor in the lord's court, and the steward acted as judge. *See* T.F.T. Plucknett, *The Medieval Bailiff*, in *STUDIES IN ENGLISH LEGAL HISTORY*, at V.9, V.11. *See also* Magna Carta cl. 38 (Eng. 1215).

113. Plucknett, *supra* note 112, at V.16.

114. *Id.* at V.14.

115. According to Professor Plucknett, these rules were based on the status of the bailiff and the relationship among the lord, the bailiff, and the land. *Id.* at V.15–16. Medieval statutes expanded and increased the liability of the bailiff to the lord and provided and clarified remedies for both the lord and the bailiff relating to claims between them. *See id.* at V.23–28. The legal power to bind was based not on any affirmative delegation (i.e. consent) from the lord but rather on the agent's role in the lord's affairs. *See id.* at V.15–16.

116. The bailiff as the temporary holder of the land was in effect, a bailee. *See id.* at V.2.

twelfth century describe a rule that a principal's goods in the hands of an agent are not subject to seizure for the agent's wrong.¹¹⁷ This rule might be read to indicate a rejection of vicarious liability. Alternatively, it may reflect the property-based nature of the relationship. Factors, for example, held title to the goods they held by virtue of their status as factors.¹¹⁸ The principal thus gave the factor power to bind the principal by appointing him as factor and giving him power over the goods, not by granting authority to perform certain transactions. Religious houses, like other corporations, necessarily acted through agents and were liable, for example, to pay for goods purchased without authorization, but only if the religious house received the benefit of the goods.¹¹⁹

As the foregoing discussion illustrates, the history of the treatment of agents by English law is a complex subject that has not been fully explored. But even if we had a complete historical explanation of agency, that explanation would be unable to help us develop the doctrine today. The fact that a doctrine is old suggests, in the law, that it should not be jettisoned lightly,¹²⁰ but it cannot explain the doctrine for modern times¹²¹ or provide a basis for deciding difficult cases. In the words of Learned Hand, "[t]he responsibility of a master for his servant's act . . . is a survival from the law of status . . . preserved now from motives of policy."¹²² That motive of policy is the cost-benefit internalization theory, which explains the survival and evolution of the doctrine—whatever its origins—and guides its application to difficult new cases.

VI. THE COST-BENEFIT INTERNALIZATION THEORY AND AGENCY LAW, PART TWO

My claim is that the cost-benefit internalization theory, unlike the other theories described above, explains virtually all agency law. Both to test that

117. See 1 *BOROUGH CUSTOMS* 221–22, (Mary Bateson ed., Selden Society 18, 1904).

118. See Plucknett, *supra* note 112, at V.30. This legal rule was not changed until 1733, and the modern law of agency only began to develop thereafter. See *id.*

119. See MILSOM, *supra* note 8, at 260.

120. One of the assumptions of the common law is that legal doctrines improve as they develop over time and accrete the experience of generations of lawyers.

121. See OLIVER WENDELL HOLMES, JR., *The Path of the Law*, in *COLLECTED LEGAL PAPERS* 167, 186–87 (1920).

122. *Thomas A. Edison, Inc. v. Kidd*, 239 F. 405, 407 (S.D.N.Y. 1917). See also Holmes, *Agency (Part II)*, *supra* note 4, at [last page] (“whenever a rule of law is in fact a survival of ancient traditions . . . it has to be reconciled to present notions of justice and policy, or to disappear”).

theory and to guide those using agency law, this Section reviews the major doctrines of agency law as described by *the Second Restatement*.¹²³

A. Principal's Liability for an Agent's Contracts

1. Authority

The clearest basis for a principal's liability for an agent's contracts under the cost-benefit internalization theory is inherent agency power.¹²⁴ As noted above, this doctrine has been heavily criticized and most courts, and no doubt parties, prefer to base contractual liability on actual authority or apparent authority. Under current law, a true contract is formed between a principal and a third party when an agent acts with actual or apparent authority in making the contract.¹²⁵ Actual authority is based on the principal's manifestations to the agent (and the reasonable implications thereof) that the principal consents to be bound by the contract.¹²⁶ Apparent authority is based on the principal's manifestations to the third party, directly or indirectly, that the principal consents to be bound by the contract.¹²⁷ Apparent authority only exists, however, when the third party subjectively believes that the principal consented to the contract and where that belief is reasonable considering the principal's manifestations.¹²⁸ Because authority is based on the principal's manifestations, it is the doctrine best explained by contract theory.¹²⁹

Authority can also be explained by a more specific version of the cost-benefit internalization theory. The cost-benefit internalization theory holds the principal responsible for the foreseeable consequences of using an agent, and a principal's manifestations to the agent or third parties will help to determine what consequences are reasonably foreseeable. If the agent or third party is not reasonable in relying on the principal's manifestations, then the injury is not adequately foreseeable.¹³⁰ The principal's liability is "based" on her

123. I rely on the Second Restatement to provide a description of the law as it currently exists because courts have been consulting the Second Restatement for guidance since 1957.

124. The "rationale" for inherent agency power described in the Second Restatement contains an argument very similar to the argument of this Article. See RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958).

125. See *id.* § 140.

126. See *id.* § 7.

127. See *id.* § 8.

128. See *id.*

129. See *supra* Part III.

130. For the purposes of the cost-benefit internalization theory, foreseeability is defined by the

manifestations not because they indicate assent but because they create foreseeable consequences. Also, the principal's manifestations to third parties are often necessary for the principal to get the benefit of the use of the agent because the manifestations enable the agent to interact with the third party. Note that this benefit is separate from any benefit that the principal receives from the contract.

The liability supported by the cost-benefit internalization theory is not contractual, but a true contract is nevertheless formed between the third party and the principal when an agent acts with actual or apparent authority. Both the principal and the third party presumably want to create a true contract between them, and therefore both the cost and the benefit to be borne by the principal are best captured by the creation of a true contract. Agency law, under the cost-benefit internalization theory, supplies the link between the third party and the principal that binds the principal to the contract. Any result other than creation of a contract would not fully place on the principal the consequences of her actions.

2. *Inherent Agency Power*

Inherent agency power is a surprisingly controversial doctrine that existed before *the Third Restatement* sought its destruction.¹³¹ The doctrine states that a general agent¹³² has the power to bind her principal to contracts that are within the authority that an agent of that kind customarily has.¹³³ Other theories of agency law are unable to explain inherent agency power; it does not require control of the agent by the principal and it is based only on the broadest possible definition of consent to be bound.¹³⁴ In the absence of other theoretical explanations, courts applying the doctrine have expressly relied on

reasonable expectations of persons interacting with the principal, including the agent and members of the public. *See supra* Part II.D.

131. *See, e.g.,* Thomas A. Simpson, *A Comment on an Inherently Flawed Concept: Why the Restatement (Third) of Agency Should Not Include the Doctrine of Inherent Agency Power*, 57 ALA. L. REV. 1163 (2006); John Dwight Ingram, *Inherent Agency Powers: A Mistaken Concept Which Should Be Discarded*, 29 OKLA. CITY U. L. REV. 583 (2004); Matthew P. Ward, Note, *A Restatement or a Redefinition: Elimination of Inherent Agency in the Tentative Draft of the Restatement (Third) of Agency*, 59 WASH. & LEE L. REV. 1585 (2002); Kornelia Dormire, Comment, *Inherent Agency Power: A Modest Proposal for the Restatement (Third) of Agency*, 5 J. SMALL & EMERGING BUS. L. 243 (2001).

132. A general agent is an agent generally employed in the enterprise, as opposed to a special agent who is appointed for a specific purpose or task.

133. *See* RESTATEMENT (SECOND) OF AGENCY § 8A (1958).

134. *See supra* note 40–42 and accompanying text.

the cost-benefit internalization theory.¹³⁵ The principal has sought to benefit the enterprise by creating the agency relationship with the foreseeable and probably desired consequence that third parties will deal with her agent in the customary way. Thus, she is bound when they do so. Inherent agency power does not require a manifestation of assent to be bound; the principal's creation of the relationship is not a manifestation in any usual sense of the term. But, as in the case of actual and apparent authority, under the cost-benefit internalization theory the law creates a true contract between the principal and the third party because that is the desired consequence.

In one respect, inherent agency power doctrine does not comport with the cost-benefit internalization theory. Under the Second Restatement, only a general agent can have inherent agency power.¹³⁶ A special agent, who is an agent appointed for a single transaction or series of transactions, can only have authority created by the principal's manifestations.¹³⁷ Given that inherent agency power is limited to the customary powers of agents of the appropriate kind, there is no reason to limit inherent agency power to general agents. It is only when a principal's instructions are out of the ordinary that an agent's customary power will exceed her actual authority; in such a case the principal should bear the risks of any secret unusual restrictions she chooses to place on the agent. The analysis is the same whether the agent is the manager of a store or a realtor hired to help sell a house; only the scope of the power should differ.

3. Estoppel

The fourth doctrine creating liability for the principal based on her agent's contracts is estoppel. Estoppel is not an agency law doctrine; it exists for the protection of third parties in a wide variety of contexts.¹³⁸ In the agency context, a principal who intentionally, recklessly, or negligently permits a third party to rely on an agent's authority is liable to a third party for damages

135. See *Kidd v. Thomas A. Edison, Inc.*, 239 F. 405, 408 (S.D.N.Y. 1917) ("The very purpose of delegated authority is to avoid constant recourse by third persons to the principal . . . [That purpose] demands the possibility of the principal's being bound through the agent's minor deviations.").

136. See RESTATEMENT (SECOND) OF AGENCY § 8A cmt. b (1958). This restriction disappeared along with the inherent agency power doctrine in the Third Restatement.

137. See RESTATEMENT (SECOND) OF AGENCY § 3 (1958). The distinction between general and special agents was originally based on "similar grounds of policy" to the distinction between servants and independent contractors. See Restatement of Agency § 3 cmt. a (1933). I argue below that the independent contractor exception is superfluous under the cost-benefit internalization theory. See *infra* Part VI.B.2.

138. See *id.* § 8B cmt. a.

resulting from the third party's change of position.¹³⁹ Estoppel does not create a binding contract between the principal and the third party. Rather, it imposes damages for an injury caused by wrongful conduct.¹⁴⁰ As a fault-based remedy, estoppel is probably best explained by tort principles.¹⁴¹ Because estoppel is useful primarily when the principal fails to act and ordinary authority cannot exist, the cost-benefit internalization theory is not applicable. One could say the principal, by choosing to remain silent, has sought a benefit and created costs to third parties that she should be required to bear. But the cost-benefit internalization theory, unlike tort theory, does not explain why the principal's liability in estoppel, unlike liability under authority doctrine, is limited to the third party's out-of-pocket damages. The failure of the cost-benefit internalization theory to fully explain estoppel does not detract from the theory's power with respect to agency law. As noted above, estoppel applies in a variety of non-agency contexts and does not depend upon the existence an agency relationship.

4. Ratification

A principal is also bound to a contract when the principal, knowing its terms, chooses to accept the benefits of the contract.¹⁴² The doctrine is commonly used to permit a principal to retain the advantages of a contract that, for some reason, was not authorized at the time it was formed. The doctrine prohibits a principal from accepting the benefits of a contract while avoiding its burden,¹⁴³ and thus it is easily explained by a more specific version of the cost-benefit internalization theory. Like inherent agency power, ratification does not require a manifestation of assent by the principal at the time of formation of the contract. Nevertheless, a true contract may exist following ratification based on a theoretical assignment of the contract from the agent to the principal. Whether or not the requirements of contract law are satisfied is irrelevant, however. The doctrine permits a principal who has created an agency relationship, and subjected herself to the risks it creates, to capture the benefits created¹⁴⁴ by the agent's unauthorized interactions with

139. *See id.* § 8B.

140. *See id.* § 8B cmt. b & c.

141. *See id.* § 8B cmt. a.

142. *See id.* §§ 82–83, 91.

143. *See id.* § 82 cmt. d.

144. In this respect ratification is similar to some of the requirements of the duty of loyalty. *See infra* Part VI.C.

third parties, where allowing the principal to do so does not injure the third party.¹⁴⁵

B. Vicarious Liability for Agent's Torts

The literature suggests that the principal's liability for her agent's torts is the most difficult doctrine to justify.¹⁴⁶ Under current law a principal is liable for the torts of her servant, but not an independent contractor, when the servant is acting within the scope of employment.¹⁴⁷ Both the definition of "independent contractor" and the definition of "scope of employment" have presented difficulties.

1. Scope of Employment

The Second Restatement states that a servant's conduct is within the scope of employment if "(a) it is of the kind he is employed to perform; (b) it occurs substantially within 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."¹⁴⁸ *The Second Restatement* further states that "[t]o be within the scope of employment, conduct must be of the same general nature as that authorized, or incidental to the conduct authorized," and it includes a list of factors to be used in determining whether conduct is sufficiently similar to authorized conduct to be within the scope of employment.¹⁴⁹ Courts applying these rules and their predecessors have used the famous "frolic and detour" language—a servant who is merely on a detour from her usual duty is within the scope of employment, but a servant who is "on a frolic of [her] own" is outside the scope of employment. A few courts have rejected *the Second Restatement's* formulation and have adopted a test based on whether the tort was "typical of or broadly incidental to the enterprise" or "engendered by the employment."¹⁵⁰

145. Because ratification is used where the third party believed the agent was authorized, it cannot, by definition, change the third party's burden of performance from what was expected.

146. *Respondeat superior* liability has been criticized as contrary to common sense, Holmes, *supra* note 4, at 14; and tantamount to theft, Williams, *supra* note 63, at 232. See also BATY, *supra* note 63, at 154.

147. See RESTATEMENT (SECOND) OF AGENCY § 219(1) (1958).

148. *Id.* § 228.

149. *Id.* § 229.

150. *Lisa M. v. Henry Mayo Newhall Mem'l Hosp.*, 907 P.2d 358, 362 (Cal. 1995). See also

The scope of employment doctrine has proved difficult to apply in a number of not uncommon situations. One class of cases involves a servant who, while on a business errand, deviates from her route for a personal reason. Courts have based the master's liability on rather arbitrary criteria such as whether the employee was travelling towards or away from the business location and whether the servant was on the same street she would have been on had she been conducting business. The other difficult class of cases involves intentional assaults, including sexual assault and sexual harassment.¹⁵¹ Under *the Second Restatement's* test for scope of employment, which requires that conduct be "actuated, at least in part, by a purpose to serve the master," masters will not be liable for most intentional torts committed by their servants. Because intentional torts sometimes are closely related to a servant's work, it is usually in the context of intentional torts that courts have rejected *the Second Restatement* formulation in favor of a test that considers whether the employment caused the tort or substantially increased the risk that the tort would occur.¹⁵²

The cost-benefit internalization theory easily explains the master's liability for a servant's torts, and as various courts have recognized, also provides a sensible way to define the scope of employment. As explained above, the use of agents increases the risk that torts will occur both because it increases the scope of the enterprise and because agents are more likely to commit torts than owners. Because the cost-benefit internalization theory holds a principal liable for risks created by the use of agents, it explains the rule that principals are liable for their agent's torts. "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."¹⁵³ Because the master has entered into an enterprise and hired agents to advance that enterprise in the hope of profit, "it

Rodebush v. Oklahoma Nursing Homes, Ltd., 867 P.2d 1241, 1245 (Okla. 1993); *Hinman v. Westinghouse Elec. Co.*, 471 P.2d 988, 990 (Cal. 1970) (master should bear risks "that may fairly be regarded as typical of or broadly incidental to the enterprise he has undertaken"); *Ira S. Bushey & Sons v. United States*, 398 F.2d 167, 171-72 (2d Cir. 1968) (master liable for risks "which arise 'out of and in the course of' his employment of labor") (quoting *HARPER & JAMES*, *supra* note 60, at 1377-78 (1956)).

151. The U.S. Supreme Court has weighed in on the latter problem, adopting a test for vicarious liability under Title VII which, although purportedly based on state common law, is not necessarily consistent with state law. *See Dalley*, *supra* note 8, at 552.

152. *See Lisa M.*, 907 P.2d at 361; *Ira S. Bushey & Sons*, 398 F.2d at 170.

153. *Hinman*, 471 P.2d at 990 (quoting W. PROSSER, *LAW OF TORTS* 471 (3d ed. 1964)).

is just that he, rather than the innocent injured plaintiff, should bear” the risks of that enterprise.¹⁵⁴ This is the essence of cost-internalization.

The cost-benefit internalization theory holds the principal responsible only for the foreseeable consequences of hiring an agent. Certain risks are inherent in any enterprise and those are the risks, the foreseeable consequences that a principal must bear. Thus, the scope of employment should be defined to include risks that are a foreseeable outgrowth of or incident of the enterprise. As commentators have observed, “what is reasonably foreseeable in this context . . . is quite a different thing from the foreseeably unreasonable risk of harm that spells negligence. . . . The foresight that should impel the prudent man to take precautions is not the same measure as that by which he should perceive the harm likely to flow from his long-run activity in spite of all reasonable precautions on his part.”¹⁵⁵ *The Second Restatement’s* definition of the scope of employment, which focuses on the nature of the servant’s conduct, is not supported by the cost-benefit internalization theory, which instead focuses on the nature of the master’s enterprise and the risks it entails.

The most direct application of the cost-benefit internalization theory concerns situations in which the principal uses the agent to perform a task or errand that the principal would otherwise have to perform herself. The principal must, at a minimum, be liable in those circumstances as if she had, in fact, performed the task. This is the case where an agent is actually engaged in the principal’s business when the tort occurs. Because it is reasonably foreseeable that an agent will deviate to some degree from her instructions, the principal is also liable for those deviations when they result in torts, just as she is when they result in unauthorized contracts. The principal’s liability in both cases is limited by the foreseeability of the deviation. In contracts, the measure of foreseeability is the reasonableness of the third party’s belief in the agent’s authority; in torts the measure of foreseeability is the principal’s expectations.

Torts that are reasonably foreseeable consequences of the use of an agent fall into two categories: those that are inherent in the operation of the business, and those that are caused by the business.¹⁵⁶ Ordinary traffic accidents fall into the former category while traffic accidents involving agents pressured to meet tight deadlines fall into the latter category. The parameters of both categories will involve questions of fact. With respect to ordinary

154. *Id.*

155. *Ira S. Bushey & Sons*, 398 F.2d at 171 (quoting *HARPER & JAMES*, *supra* note 60, at 1377–78).

156. The latter category will often, but not always, be a subset of the former.

business operations, whether the agent's deviations from instructions and from the exercise of due care are reasonably foreseeable will depend on the distance and extent of the deviation. With respect to caused torts, the existence of causation will depend on the nature of the business and, in general, how it is operated. Thus, a repossession service that sends agents to seize vehicles from debtors will foreseeably cause assaults that would not, perhaps, be caused by a repossession service that disables vehicles using a remote disabling device.¹⁵⁷ It should be noted, however, that the former business is liable for its agents' assaults not because it has breached a duty of care in carrying on its business this way, but because its business foreseeably causes a certain kind of tort. The questions of foreseeability and causation required by this analysis will often be difficult, but they are typical of questions that the legal system must address in a variety of contexts.¹⁵⁸

This approach to the scope of employment answers some of the continuing questions of *respondeat superior*. For example, a traffic accident that occurs while an agent is off-route will be within the scope of employment if the agent's deviation from route is sufficiently minor to be foreseeable by the principal. An accident that occurs while the agent is going to or coming from work ordinarily does not subject the principal to liability under the "going and coming" rule. That rule can continue to apply under the cost-benefit internalization theory because accidents before and after work, while foreseeable in a general sense, are not risks created by the employment.¹⁵⁹ The agent is not acting as an agent once she has left her employment. If, however, the principal assigns the agent tasks during that time, the agent has not left the employment and the risks of some kinds of accidents will continue to be foreseeable consequences of the employment. This would be true, for example, when an employee is conducting business on a mobile phone while driving to or from work.

157. See Jonathan Welch, *Late on a Car Loan? Meet the Disabler*, WALL ST. J., Mar. 25, 2009, at D1, available at <http://online.wsj.com/article/SB123794137545832713.html>.

158. As in other such questions, the determination will be subject to hindsight bias, but that problem, too, is not unique to agency law.

159. This might be said to be an arbitrary distinction. The employment requires that the agent get to work. The same might be said of other activities: the employment may require that the agent purchase certain clothes, that the agent get up at a certain time in the morning, and so forth. All these features are also foreseeable from the principal's perspective. There are two responses to this objection. First, a principal is not liable for activities that an agent would undertake even if the agent were not employed by the principal. Second, while the principal cannot escape liability that foreseeably arises from her business, she should be permitted to limit that liability by removing the agent from her operations either temporarily or permanently.

The cost-benefit internalization theory analysis applies more dramatically to liability for intentional torts. Under the Second Restatement's definition of scope of employment, an employer is not liable when an agent steals a third person's property, even when the agent has access to the property because of the agent's employment.¹⁶⁰ The cost-benefit internalization theory results in a different rule. Where a business places its agents in situations where it is reasonably foreseeable that the agents will engage in intentional torts, the business should bear the risk. Thus, apartment or hotel maintenance crews, airline baggage handlers, and utility service personnel should expose their employers to liability for theft.¹⁶¹ The principal's liability for the agent's sexual torts presents a closer question. There may be cases where the employment actually causes the tortious behavior; in those cases the principal's liability is clear.¹⁶² Far more often, however, the employment has no connection to the tort or the employment's only connection to the tort is that it brings the victim and tortfeasor together. In those cases, the question is whether the sexual behavior is a risk of the principal's business rather than simply a "background" risk that arises from life in general. Life in society creates a risk of sexual assault that, although not borne equally by everyone, does not depend on a person's business or employment. A business that merely brings people together does not increase the risk of sexual assault; the incidence of sexual torts in that business should not be any greater than the incidence of such torts in the general public. Such cases are different from thefts committed by employees whose job substantially enhances their temptations and opportunities for theft. An employee who sexually assaults someone in an insurance agency has not committed a tort that is a risk of the business, although it might in some sense be foreseeable, because it is just as likely and just as foreseeable that the employee would commit the assault elsewhere.

A further question arises about businesses, such as schools, that provide their employees access to a particular kind of victim and, perhaps, to an environment in which the victims are more vulnerable because of the employees' position of authority. Those businesses have increased the likelihood that a tort will occur, even if they have not increased the likelihood

160. See *Bremen State Bank v. Hartford Accident & Indem. Co.*, 427 F.2d 425, 428 (7th Cir. 1970).

161. The business could avoid this liability by not using agents. If it seems unreasonable to expect the business to operate that way, then it is clear that the business is benefiting from—in fact, dependent on—the use of agents and should therefore accept the risks corresponding to that benefit.

162. See *Simmons v. United States*, 805 F.2d 1353, 1364–65, 1371 (9th Cir. 1986). See also Dalley, *supra* note 8, at 565–66.

that a particular person will commit a tort.¹⁶³ Is the risk of a sexual tort in such a business analogous to the risk of theft in apartment maintenance? In fact, the use of maintenance personnel by an apartment building increases the risk of both theft and sexual assault. Should the business be liable for only one of those torts? The cost-benefit internalization theory suggests that the business should be liable where the commission of a sexual tort is a reasonably foreseeable consequence of the operation of the business, and that would include businesses that provide special access to vulnerable populations. Although this result is counter to the law and perhaps to intuition, it is consistent with a principle that requires a business to bear the risks it creates.¹⁶⁴

2. Independent Contractor Exception

A principal is only liable for an agent's torts when the agent is a "servant" or, in the language of *the Third Restatement*, an "employee." *The Second Restatement* defines a servant as "a person employed to perform services in the affairs of another and who with respect to the physical conduct in the performance of the services is subject to the other's control or right to control."¹⁶⁵ An agent who is not a servant is an independent contractor.¹⁶⁶ *The Second Restatement* also provides a list of ten factors to be considered in determining whether an agent is a servant.¹⁶⁷ As the Comments note, however, it is difficult to define generally the difference between a servant and an independent contractor. Both *the Second* and *Third Restatements* emphasize the extent of the principal's control over the means by which the agent performs her work.¹⁶⁸ Where the agent retains control over the manner in

163. Under *Lisa M. v. Henry Mayo Newhall Mem'l Hosp.*, 907 P.2d 358, 361 (Cal. 1995), the principal in such a case would not be liable because there is no causal nexus between the tort and the employment. The impulse to commit the tort does not arise from the employment but rather from the employee's personal characteristics.

164. Note that the risk of sexual assault will often not be reasonably foreseeable *in light of the business*. If the risk of assault in connection with the business is no different from the risk of assault elsewhere, then it is not a foreseeable risk of the business. Thus, the types of businesses that would be required, under the cost-benefit internalization theory, to bear the costs of sexual assaults would be limited.

165. RESTATEMENT (SECOND) OF AGENCY § 220(1) (1958).

166. In this context, "independent contractor" has a technical meaning: an agent who is not a servant. *See id.* § 220 cmt. e. The term is used in other contexts to mean other things and can sometimes refer to a person who is not an agent at all.

167. *Id.* § 220(2).

168. § 220 cmt. f (2006); RESTATEMENT (SECOND) OF AGENCY § 220 (1958).

which the specified result is to be accomplished, the agent is an independent contractor.¹⁶⁹ *The Second Restatement* provides additional explanation, however. The word “servant” “indicates the closeness of the relation” between the principal and agent;¹⁷⁰ a servant is someone whose “physical activities and his time are surrendered to the control of the master.”¹⁷¹ Even more generally, a servant is “an integral part of his master’s establishment,” whereas an independent contractor “aids in the business enterprise but is not a part of it.”¹⁷²

The emphasis on control in the Restatement definitions of servant and independent contractor suggest that the principal’s liability for the agent’s torts in general is based on the principal’s control.¹⁷³ As I have argued elsewhere, however, the emphasis on control in the definition of a servant is misleading. The real distinction between a servant and an independent contractor is that the servant is part of the master’s enterprise and the independent contractor is engaged in an enterprise of her own. The distinction is both consistent with and explained by the cost-benefit internalization theory. The cost-benefit internalization theory requires that a principal internalize the costs created by her use of agents in her enterprise. But that liability only extends to the risks of *her* enterprise, not the risks of an enterprise owned by someone else. The factors set forth in the Restatement¹⁷⁴ attempt to capture whether the agent is operating her own business. Thus, the factors ask whether the agent owns her own tools, her own place of business, her own time, and her own livelihood. The amount of control a principal has over an agent is a very good indicator of whether or not the agent is in business for herself, and it is probably the case that most principals use servants, rather than independent contractors, precisely because they want the control that they gain once the agent is woven into the fabric of the principal’s enterprise. Control is an important fact, but it is important because it identifies the owner of the enterprise, and in the context of vicarious liability for torts

169. *Id.* § 220 cmt. e.

170. *Id.* § 220 cmt. a.

171. *Id.* § 220 cmt. e. *See also* Seavey, *supra* note 14, at 866 (noting that the key to servant status is the “grant of control over the servant’s time”).

172. RESTATEMENT (SECOND) OF AGENCY ch. 7, topic 2, tit. B, introductory note (1958).

173. *See supra* Part IV.

174. The factors are part of the black-letter law in the Second Restatement, *see* RESTATEMENT (SECOND) OF AGENCY § 220(2) (1958), and are included in the comments in the Third Restatement, *see* RESTATEMENT (THIRD) OF AGENCY § 7.07 cmt f. (2006).

an owner is only liable for the risks created by her use of agents in her enterprise.¹⁷⁵

It should also be observed, as a corollary of the limitation of the principal's liability, that the principal has foregone considerable benefits by hiring an independent contractor instead of a servant. The independent contractor is not at the principal's beck and call. She is not accountable for her time and she can complete the principal's work at her own pace and in her own way. She is often able to work for others in her spare time and she, rather than the principal, will usually capture the benefits of her productivity gains. For this reason, the independent contractor will have an incentive to improve the way in which she completes her tasks, but the principal may not reap the rewards of that improvement.¹⁷⁶

The cost-benefit internalization theory casts the relationship between the independent contractor exception and the scope of employment doctrine into an interesting light. If the scope of employment is defined to capture risks that are caused by or inherent in the principal's use of agents in her business, and the independent contractor exception is defined to exclude risks that are not properly risks of the principal's business, then the independent contractor exception is superfluous; acts by an independent contractor can never be within the scope of employment properly understood. The doctrines do not completely overlap, however. The independent contractor exception asks whether the agent is in general, a part of the principal's business, while the scope of employment doctrine asks whether the particular act of the agent is sufficiently connected to the principal's business. Thus, a servant who is by definition within the business, may nevertheless act outside the business on some occasions. Acts by an independent contractor, on the other hand, are

175. Another problem with a control-based definition of independent contractors is that it is ill-equipped to explain the liability of a corporation for the torts of corporate officers. A corporation, as principal, is unable to control anyone. The board of directors has the legal power to exercise means-and-method control over the corporate executives, although that power is rarely exercised. The Third Restatement seems to struggle with this idea, however. It provides the following illustration of the board's control: The board of directors learns that the CEO is experiencing vision problems and requires the CEO to use a driver on company business. "[The CEO] is an employee of [the] Corporation for this purpose." RESTATEMENT (THIRD) OF AGENCY § 7.07 cmt. f, illus. 15 (2006). The illustration does not explain a corporation's liability for its officers, however. Corporate officers are servants for *all* business purposes and therefore must be under the control of the board for all business purposes, as the text of the comment recognizes: "[A]ll employers retain a right of control, however infrequently exercised." *Id.* cmt. f. If the definition of "employer" is based on control, that reasoning is circular. The better explanation for executives' status as servants is that control is not the determinative factor in identifying a servant.

176. Theoretically, improvements in productivity will be reflected in the price negotiated by the principal and independent contractor.

never within the business. The formulaic *Second Restatement* versions of the doctrines do not necessarily intersect in the same way; the separate belt-and-suspenders doctrines supplement each other to ensure that the principal's liability for the agent's torts is limited to the risks of the principal's business.

The intersection of the two doctrines explains why there is no independent contractor exception for a principal's liability for an agent's contracts. The authority and inherent agency power doctrines serve the same purpose as the scope of employment and independent contractors doctrines; they require, in different ways, that the risk of an unauthorized contract be connected to the principal's business. The authority doctrines, which inquire about the reasonable implications of a principal's manifestations, connect the contract to the business through the principal's acts and the third party's reasonable belief. The identification of the business determines the foreseeability of the third party's reliance on the agent's authority. Inherent agency power doctrine, which inquires whether the agent's act was customary, connects the contract to the business through both the nature of the agent and the agent's act. The identification of the business and the agent's role in it, determines the extent of the agent's customary authority. Thus, consideration of both the specific act, which is covered by the scope of employment, and of the nature of the agent, which is covered by the independent contractor doctrine, are built into the authority and inherent agency power doctrines.

3. Section 261 Torts

Section 261 of the *Second Restatement* provides that a principal is subject to liability when she puts an agent "in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons."¹⁷⁷ More generally, Section 265 provides that a principal is liable *in tort* when a third party relies upon an agent's apparent authority. These provisions seem to contradict the general rule that a principal is only liable for torts of servants, and only within the scope of employment. Apparent authority is a doctrine governing the principal's liability for an agent's contracts; how can it create liability in tort? These and other sections of the Restatement reflect the difficulty presented by fraud and other torts¹⁷⁸ where the tort is

177. RESTATEMENT (SECOND) OF AGENCY § 261 (1958). The rule applies whether or not the agent is a servant.

178. The examples given by the Second Restatement are an agent with apparent authority who directs other agents to commit trespass, and a defamatory statement by an agent that is published because the publisher believed it was made with the principal's authority. *Id.* § 265 illus. 1, 2.

effective only because the agent acted with apparent authority.¹⁷⁹ Under the cost-benefit internalization theory, however, the distinction between the principal's liability in tort and her liability in contract drops away. Regardless of the basis for the underlying obligation incurred by the agent, the principal is liable because she has chosen to use agents to conduct her enterprise. The agent's torts and the agent's unauthorized contracts are equally foreseeable consequences of her choice, and to the extent a particular tort or contract is within the range of foreseeability, the principal is liable.

C. Fiduciary Duty

Because it seeks to ensure that a principal internalize the costs and benefits of her decision to use an agent in her enterprise, whatever the source, the cost-benefit internalization theory explains the relationship between the principal and the agent as well as relations between the principal and third parties. The relationship between the principal and the agent is regulated primarily by the fiduciary duties of the agent to the principal on the one hand, and the principal's duty to indemnify the agent, on the other.

The Second Restatement describes the agent's duties in considerable detail, but they fall into a few broad categories.¹⁸⁰ First, the agent owes the principal a duty to perform with "standard" care and otherwise to act to advance the principal's business.¹⁸¹ The agent also has a duty to give to the principal all relevant information which the principal is likely to want, no matter how the agent acquired the information.¹⁸² These duties, which control the performance of the agent's functions for the principal and seek to ensure that the principal receives the services from the agent that the principal sought, can be said to comprise the duty of care.

179. Analogously, section 219(2)(d) provides that a master is liable when a servant is able to commit a tort because the servant has some power or instrumentality by virtue of her employment. *Id.* § 219(2)(d).

180. Fiduciary duties are often described as the duty of care and the duty of loyalty. It has been argued that the duty of care is not a fiduciary duty. A so-called fiduciary duty of good faith occasionally appears in the literature, but good faith is more properly either a component of the duty of loyalty, *see* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006), or an implied covenant in contracts, *see* Paula J. Dalley, *The Law of Partner Expulsions: Fiduciary Duties and Good Faith*, 21 CARDOZO L. REV. 181, 197 (1999).

181. A paid agent must act with "standard" care; a gratuitous agent is held to the same standard of care as non-agents performing similar acts. *See* RESTATEMENT (SECOND) OF AGENCY § 379 (1958). The agent must also obey the principal, *id.* § 385, keep and render accurate accounts, *id.* § 382, act only as authorized, *id.* § 383, and generally maintain "good conduct," *id.* § 380.

182. *See id.* § 381.

A second set of duties generally described as the duty of loyalty seek to ensure that the principal, not the agent, receives and retains the benefits of the principal's business. The basic formulation of the duty of loyalty in *the Second Restatement* is that the agent must act "solely for the benefit of the principal in all matters connected with his agency."¹⁸³ Thus, the agent must account for all profits received in the performance of the principal's business;¹⁸⁴ must refrain from dealing as, or on behalf of, a party adverse to the principal;¹⁸⁵ must refrain from competition with the principal "concerning the subject matter of the agency";¹⁸⁶ and must refrain from acting for someone with conflicting interests.¹⁸⁷ The agent must avoid commingling of assets¹⁸⁸ and must disgorge any profits or proceeds the agent receives as a result of a breach of duty.¹⁸⁹

With respect to information, an agent is not permitted to use or disclose confidential information¹⁹⁰ that the agent received from the principal or from the agency relationship if the use or disclosure would injure the principal, whether or not the use or disclosure is in a transaction related to the agency.¹⁹¹ On the other hand, if the agent receives a profit from the use of information acquired from the agency relationship, the agent must disgorge that profit even if the use of the information has not injured the principal.¹⁹² The duty to protect confidential information continues after the termination of the agency relationship, unlike the agent's other duties.¹⁹³

183. *Id.* § 387.

184. *See* RESTATEMENT (SECOND) OF AGENCY § 388 (1958).

185. *See id.* §§ 389, 391. Even where the agent has the principal's consent to act as an adverse party, the agent is subject to a duty to deal fairly with the principal and to disclose material information. *See id.* §§ 390, 392.

186. *Id.* § 393.

187. *See id.* § 394.

188. *See id.* § 398.

189. *See id.* §§ 403–404, 404A.

190. The prohibition does not apply to information that is a matter of general knowledge. *See id.* § 395.

191. *See id.*

192. *See id.* § 388 cmt. c. The Third Restatement's provisions on the use of information are similar but stated more clearly. Section 8.05 prohibits the use of the principal's property or confidential information for the agent's own purposes, as well as disclosure of the principal's information. The duty applies whether or not the information is connected with the subject matter of the agency relationship. *See* RESTATEMENT (THIRD) OF AGENCY § 8.05 cmt. c (2006). It is not clear whether the prohibition applies only to information acquired in the course of the agent's employment. The Comment refers to the acquisition of "confidential information about a principal or otherwise in the course of an agency relationship," but provides as an example "information about the principal's health, life history, and personal preferences," *id.*, which would not necessarily be acquired in the course of the agency relationship.

193. *See* RESTATEMENT (SECOND) OF AGENCY § 396 (1958).

The agent's fiduciary duties are consistent with the cost-benefit internalization theory because they ensure that the principal receives the benefits that accrue from the principal's hiring of an agent. The duty of care ensures that the principal receives the benefit of the agent's efforts, and the duty of loyalty ensures that the principal receives the benefits that arise from the principal's business but naturally or intentionally come to the agent rather than the principal. The various provisions of the duty of care relate to the agent's work as an agent: her competence and diligence, her record-keeping, her obedience to the principal's commands, and her public conduct. These matters can be governed by express or implied contract; in most cases the agent has agreed to provide and the principal has bargained to receive these benefits. But as we have noted repeatedly, the principal's hiring of the agent, without any additional agreement between them, constitutes her choice to operate her enterprise in a particular way. Under the cost-benefit internalization theory, she is responsible for the costs that choice entails, and she is also entitled to the benefits. The business benefits arising from the use of the agent are, presumably, the basis for the principal's decision to use an agent at all, but those business benefits arise only when the agent behaves in accordance with expectations. Thus, the agent's failure to act appropriately—in other words, her breach of the duty of care—is a potential cost of the use of the agent¹⁹⁴ that is naturally “internalized” by the principal in the normal course of business. The cost-benefit internalization theory provides a corresponding benefit in the principal's power to require the agent's good behavior and enforce the duty of care.

The various branches of the duty of loyalty are also directed at agency costs, although in this case at opportunistic behavior rather than shirking. The duty of loyalty permits a principal to capture benefits that an agent might otherwise be able to “externalize” from the principal. This is clearest in the rules requiring an agent to disgorge profits arising from the agent's employment, even if the profit was something, such as a kickback, not anticipated by the principal. If the principal is bearing the risks of the business, all the benefits from whatever source should also belong to her. An agent's competition with the principal also risks the agent's use of a benefit of the enterprise or relationship that should belong to the principal. The restriction on the agent's acting as an adverse party is also a way of protecting the principal's ownership of the benefits of the agency relationship.

194. This includes the agency cost economists call “shirking.”

Because information is an asset of the business and its use can produce profit, the rules governing information operate to ensure that valuable information generated by the agent is delivered to the principal and that proceeds from the use of information by the agent are returned to the principal just as other profits are. The provision of *the Second Restatement* that restricts an agent's use of information only where the principal is injured is therefore inconsistent with the cost-benefit internalization theory. But because profits from information derived from the agency are always returned to the principal, the overall treatment of information is consistent with the cost-benefit internalization theory.¹⁹⁵ It is appropriate that those provisions have been clarified in *the Third Restatement*. On the other hand, where an agent receives information outside the agency relationship and uses that information to produce a profit in a transaction unrelated to the agency relationship, the profit cannot be said to be a benefit of the principal's enterprise or of her use of an agent in that enterprise, and the agent should be permitted to keep that profit even if the information is related to the agency relationship in subject matter.

Two provisions of *the Second Restatement* are worth noting separately. First, unless there is a contrary agreement, an agent employed to do "noninventive" work is entitled to retain any patent arising from her work, even if she used the principal's time and facilities to develop the invention.¹⁹⁶ An agent employed to invent is not entitled to retain her patents.¹⁹⁷ This rule violates the principles of the cost-benefit internalization theory and seems to be based squarely on contractual principles. A principal who hires someone to invent things presumably expects her agent to generate patents and would therefore contract to retain those patents; while a principal who does not expect her agent to generate patentable inventions would be unlikely to bargain to receive those benefits and therefore, should not receive them. The patent-retention provision was not retained in *the Third Restatement*. One can argue that if a principal is liable only for the foreseeable consequences of her acts, she should similarly be entitled only to the foreseeable benefits of her activities, and a patent is not a foreseeable benefit of hiring a "noninventive" agent. However, the other provisions of *the Second Restatement* relating to the duty of loyalty ensure that a principal receives all the benefits of her enterprise, whether she expected them or not, and the patent-retention provision is unjustifiable under the cost-benefit internalization theory.¹⁹⁸

195. See Du Pont de Nemours, *supra* note 10.

196. See RESTATEMENT (SECOND) OF AGENCY § 397 (1958).

197. See *id.*

198. The patent-retention rule appears to be based, at least in part, on the idea that a person's ideas

The second noteworthy provision of *the Second Restatement* concerns purported agents, that is, those who are not agents but who claim or pretend that they are. Such persons are liable to their putative principals only to the extent that other third parties would be liable, which is for losses caused by the conduct of the “agents” or by their misuse of property.¹⁹⁹ If the principal ratifies the person’s agency, on the other hand, the now-actual agent becomes liable just as other agents are liable.²⁰⁰ This provision cannot be explained by a contractual theory, but makes sense under the cost-benefit internalization theory. A person who has taken it upon herself to pretend to be an agent can be said to have consented to the burdens as well as the benefits of agency, and it would make sense to hold her liable for all the obligations of an agent, consistent with her own choice. That is not the rule, however. Agency law considers the costs and benefits to the principal, not to the agent, because the principal is the owner of the enterprise and the originator of the activity. Thus, the benefits of the agent’s service, including the agent’s duties and liabilities to the principal, belong to the principal only if the principal has agreed to hire an agent in the first place.

D. Indemnification

A principal must indemnify her agent for payments by the agent that are authorized or necessary for the principal’s business, as well as for other payments that benefit the principal.²⁰¹ Under *the Second Restatement*, the principal must also indemnify the agent for losses which, “because of their relation, it is fair that the principal should bear.”²⁰² The Comment explains

are her own as a kind of mental property. *See* *United States v. Dubilier Condenser Corp.*, 289 U.S. 178, 188 (1933) (“[Invention] is the result of an inventive act, the birth of an idea and its reduction to practice; the product of original thought; a concept demonstrated to be true by practical application or embodiment in tangible form. Though the mental concept is embodied or realized in a mechanism or a physical or chemical aggregate, the embodiment is not the invention and is not the subject of a patent. This distinction between the idea and its application in practice is the basis of the rule that employment merely to design or to construct or to devise methods of manufacture is not the same as employment to invent.”).

199. *See* RESTATEMENT (SECOND) OF AGENCY § 430 (1958).

200. *See id.*

201. *See id.* § 438(2). A principal need not indemnify an agent who has been “officious,” even if the principal benefits from the payment. *See id.* *Cf. supra* note 8. The agent also has a right to be reimbursed for amounts paid or losses suffered in authorized transactions, unless the agent was at fault. *See* RESTATEMENT (SECOND) OF AGENCY § 438 cmt. b. (1958). Of course, a principal must pay for expenses that she has agreed to pay in her agreement with the agent. *See id.* § 438(1). The Second Restatement elevates that obligation to a duty enforceable by damages for a tort. *See id.* § 438 cmt. a.

202. RESTATEMENT (SECOND) OF AGENCY § 438(2)(b) (1958). At common law, the principal’s duty to indemnify an agent did not extend to liability for injuries suffered by the agent as a result of her

further that there are some losses that the principal should bear as “incidental losses” because “the agent was performing the principal’s business.”²⁰³ *The Third Restatement* continues this rule and uses similar language.²⁰⁴ The use of the concept of fairness in the indemnification provisions of the Restatement illustrates the difficulty of defining the parameters of the obligation; all one can say about it is that it is based on the fact that the agent is acting on the principal’s behalf, but industry custom can help determine fairness.²⁰⁵ This concept of fairness is an instance of the cost-benefit internalization theory appearing in the black-letter law. But the cost-benefit internalization theory looks beyond the principal’s benefit from any specific expenditure by the agent; rather, it considers that the principal is receiving the benefit of all the business conducted by the agent, and she should therefore indemnify the agent for all expenses related to the business. Here, the cost to be internalized is a cost that would otherwise fall on the agent.

In addition to costs incurred on behalf of the principal, an agent also often incurs costs to be an agent. One can say that, the agent is in the business of being an agent, and that the agent, not the principal, must bear those costs. For example, an agent may need a business wardrobe, she must get to and from work each day, and she may have spent resources to acquire expertise or education.²⁰⁶ Stated as a general principle, this sounds like hair-splitting, but industry custom and common social practices suggest that the distinction is real and in most cases can be determined by reference to custom and practice. The cost-benefit internalization theory requires that the owner of a business bear its costs, and thus requires a definition of the business in question which will occasionally raise difficult questions of fact. Those thorny fact questions exist in the law under any theory,²⁰⁷ the cost-benefit internalization theory explains them and provides a vantage point from which to consider them.

performance of the principal’s business. Such injuries are now covered by workers’ compensation laws. *See id.* cmt. a.

203. *Id.* § 438 cmt. a.

204. *See* RESTATEMENT (THIRD) OF AGENCY § 8.14 (2006).

205. *See id.* § 8.14 cmt. b.

206. An agent’s education that permits her to be an agent in a particular field, such as law school, is to be distinguished from education made necessary by the principal’s business, such as research on a client matter.

207. The need for a definition of the scope of the principal’s business appears in the doctrines of inherent agency power, scope of employment, independent contractor, indemnification for expenses, corporate opportunity and its unincorporated analogues, and other aspects of the duty of loyalty.

E. Compensation

A principal is not required under agency law to compensate her agent. Usually, there is a contractual obligation to pay the agent;²⁰⁸ there can be an implied contract to pay an agent who undertakes a task for the principal in circumstances where both parties reasonably should expect that the principal would compensate the agent;²⁰⁹ and a principal may be contractually bound to pay compensation if the principal acts in bad faith.²¹⁰ But in the absence of an express or implied contract, the principal need not pay the agent.²¹¹ A principal is also not obligated to pay compensation to her subagent, even where the intermediate agent has agreed to pay the subagent.²¹² Why is a principal required to pay an agent's expenses but not to compensate her in the absence of contract? The cost of compensating the agent would seem to be a cost of hiring an agent for the business that should be borne by the principal. Other such costs, such as providing additional workspace and equipment, are ordinarily borne by the principal. One explanation for this gap in the law is that there is no agency-based measure of what fair compensation would be. The principal cannot be required to pay the agent based on the benefit the principal received from the agent's labor—that benefit is by definition, under the cost-benefit internalization theory, the principal's. Nor would it make sense to require the principal to pay the agent's cost of being an agent; under the cost-benefit internalization theory, that is an expense of the agent's business and is borne by the agent unless it is passed through to the principal by agreement. Every likely measure of compensation is based on a bargain between the principal and the agent; even compensation based on custom is based on prior negotiations between other principals and agents. Thus, while the cost-benefit internalization theory suggests that the principal should be required to compensate her agents and subagents, we currently have no way to measure that liability other than by agreement between the parties.

208. See RESTATEMENT (SECOND) OF AGENCY § 441 (1958).

209. See *id.* § 441 cmt. c.

210. See *id.* § 454. This rule applies, for example, where an agent to be paid on commission is terminated when the transaction is nearly complete. See *id.*

211. See *id.* § 441 cmt. a.

212. See *id.* § 458.

F. Termination upon Death of the Principal

One of the most difficult rules of agency law has been the rule governing the termination of an agent's apparent authority upon the death of the principal. The death of the principal obviously terminates the agency relationship, because the agent can no longer work on behalf of the principal and subject to her control. The difficult question concerns the agent's lingering apparent authority. The traditional rule held that the agent's apparent authority was also terminated by the principal's death, whether or not the agent or the third party knew of the death.²¹³ Not surprisingly, this rule created difficulties in application, especially when the principal was in business and her agents were numerous and far-flung. The most plausible alternative rule is that the agent's apparent authority continues for a reasonable time based on the nature of the business and of the agent's role. The problem is that after principal's death, it will probably take some time for someone to take over her affairs, identify pending business, and determine whether to re-appoint the agent to act on behalf of the estate. During that time, the estate is unable to protect itself from the unauthorized acts of the agent in the way that a principal who knows the risks of her business can.

The cost-benefit internalization theory suggests that the agent should continue to have inherent agency power for a reasonable period following the principal's death. The principal's business, like a terminating partnership, must be wound up; the benefits of outstanding business accrue to the estate and it is appropriate that the estate should bear the risk that an agent will make unauthorized contracts in connection with the business. The usual limits on inherent agency power would apply—the agent's power would be limited by the custom of the industry and the nature of the agent's job. The same analysis can be applied to argue that apparent authority should continue for a reasonable time after the principal's death, within the limits of the manifestations that created the apparent authority because a person's estate will reap some of the benefits of communications she made before death. Apparent authority would also exist in the case of special agents, who cannot under existing law have inherent agency power.²¹⁴ The important feature of post-death powers is that they be restricted to the scope of the principal's

213. The identification doctrine, *see supra* notes 85–86 and accompanying text, perfectly explains this not-very-practical rule. *See* Vernon V. Palmer, *The History of Privity—The Formative Period (1500–1680)*, 33 AM. J. LEG. HIST. 3, 30 (1989).

214. As I argue above, however, special agents should also have inherent agency power.

business and the scope of the agent's position because that is the extent of the estate's potential benefit.

G. Undisclosed Principals

As noted above, the law governing undisclosed principals creates special problems for other theories of agency law,²¹⁵ but it is easily explained by the cost-benefit internalization theory. Agency law treats all principals the same, whether they are disclosed or not.²¹⁶ A few special rules apply when the principal is undisclosed but those rules derive from other areas of the law. For example, when an agent misrepresents the fact that she is acting for a principal, the contract will be voidable if the existence or identity of the principal was a material fact.²¹⁷ The identity of the principal will be material if the third party would not have agreed to do business with the principal. Therefore, when an agent misrepresents or fails to disclose the existence or identify of the principal in those circumstances, the contract is voidable.²¹⁸ This is basic contract law, modified only slightly in that it applies to the agent's failure to disclose as well as her affirmative misrepresentation.²¹⁹ In addition, a third party can avoid a contract made for an undisclosed principal when the contract is for personal services or another obligation that, under contract law, must be performed by the original party and may not be delegated to another.²²⁰ The third special rule applicable to undisclosed principals is that the third party is permitted to enforce the contract against either the principal or the agent.²²¹ This is also properly identified as a doctrine from contract law not agency. The law of contracts provides that the parties to a contract are bound where the requirements of formation are met, and where the principal is undisclosed, the contract on its face binds the agent. Where the third party knows she is dealing with an agent, the contract is usually not intended to bind the agent and therefore does not.

215. *See supra* Part III.

216. *See* RESTATEMENT (SECOND) OF AGENCY § 186 (1958).

217. *See id.* § 304 cmt. a. In addition, a third party is not bound to a contract that specifically excludes the principal or any undisclosed principal. *See id.* § 303.

218. *See id.* § 304.

219. *See* RESTATEMENT (SECOND) OF CONTRACTS § 164 (1981).

220. *See* RESTATEMENT (SECOND) OF AGENCY §§ 309, 310 (1958). *See also* RESTATEMENT (SECOND) OF CONTRACTS § 318 cmt. c (1981).

221. *See* RESTATEMENT (SECOND) OF AGENCY §§ 210, 210A (1958). The Third Restatement has modified the rule to provide that the third party may proceed against both the principal and the agent until the obligation has been satisfied. *See* RESTATEMENT (THIRD) OF AGENCY § 6.09 cmt. c (2006).

When the ordinary doctrines of contract law are removed from the picture, the law of undisclosed principals is not very interesting. An undisclosed principal is bound when the agent is actually authorized, of course, but an agent for an undisclosed principal cannot have apparent authority because an undisclosed principal cannot manifest to a third party her assent to be bound to a contract by her agent.²²² The principal is bound, however, by the agent's inherent agency power, which exists when the agent's position is one in which agents ordinarily have the power to make contracts of that sort.²²³ In the absence of fraud or the special circumstances noted above, the third party is bound to the contract with the principal despite the fact that the third party had no idea that she was dealing with someone other than the agent.²²⁴ These agency law rules relating to undisclosed principals are explained and required by the cost-benefit internalization theory. An undisclosed principal has created costs and anticipates benefits just as any other principal does, and those costs should be, and are, treated the same as the costs created by a disclosed principal. An undisclosed principal is bound to contracts made by her agent when the creation of those contracts is a reasonably foreseeable consequence of her appointment of the agent, which is the case when there is actual authority or inherent agency power. The undisclosed principal is similarly liable when the use of the agent results in a tort if the occurrence of the tort is a foreseeable consequence of the use of the agent. The corollary of those liabilities is that the principal is entitled to keep the benefits created by the use of the agent; thus, the undisclosed principal is entitled to enforce her agent's contracts.

H. Authority of Corporate Officers

One of the innovations of *the Third Restatement* is its inclusion of provisions applying agency law to organizations: partnerships, corporations, and limited liability companies.²²⁵ Organizations present two complications that are worth examining here. First, the law generally provides that the principal in an organization is the organization itself. In the case of limited liability entities, it is the entity that constitutes the enterprise and, at least

222. See RESTATEMENT (SECOND) OF AGENCY § 194 cmt. a (1958).

223. See *id.* § 194 cmt. a.

224. See *id.* § 302.

225. I have argued elsewhere that agency is a poor fit for organizational law, but we are stuck with it for now. See Paula J. Dalley, *Imagining Business Associations Without Agency Law*, 11 TRANSACTIONS: TENN. J. BUS. L. 77 (2009).

initially, receives the benefits and creates the costs addressed by the cost-benefit internalization theory. The fact that owners of the enterprise are not liable for the costs of the activity although they ultimately receive its benefits, does not violate the cost-benefit internalization theory if the entity is forced to internalize all the costs of the activity before the owners are permitted to receive the benefits. Recognition of this principle may provide a way to conceptualize the doctrine of piercing the corporate veil: The separate existence of the entity should be disregarded when the owners have drained off the benefits of the activity before the entity has borne its internal and external costs. A full exploration of the application of the cost-benefit internalization theory to issues created by limited liability is beyond the scope of this Article, however.

A more germane issue, applicable to organizations concerns the authority of corporate officers. Corporate officers have actual authority to the extent the corporation, through its board of directors, has manifested its assent that the officer enter into a contract. The board of directors, acting for the principal, can similarly create apparent authority by creating manifestations of assent that are available to third parties, such as public statements or certified board resolutions. Express authority can also be created by the certificate of incorporation or, more commonly, the bylaws. Corporate statutes create a variety of authority as well. Statutory authority is not based on a manifestation of assent by the principal, except in the extenuated sense that someone consented to forming the organization subject to the statute, and therefore, statutory authority should not be understood as actual authority. Rather, it is a form of inherent agency power because it exists solely by virtue of the agency relationship. The principal, by placing the person in this office, has conferred upon her all the powers that similarly situated agents usually have. The same is true of partners and other agents with statutory authority. The more difficult question about corporate officers, in practice, concerns authority that is not specified at all. In other words, what other customary authority is included in an officer's inherent agency power, and what are the reasonable implications of a manifestation consisting of the grant of a recognized title? These are factual questions that are not inherently different from the factual questions raised in other contexts.

VII. CONCLUSION

Theory can explain and illuminate the law and provide insights that are useful in solving legal problems. Legal problems are practical problems, however, and theory alone cannot solve legal problems. Agency law has

developed to address the practical problems created by an essential feature of human interaction, and it has developed into a remarkably coherent body of law despite the fact that it has not been subject to a governing theory. Prior attempts to explain agency law doctrines have failed, and those failures have resulted in calls for the abolition of doctrines that cannot be adequately explained by the failed theories. This has been the fate of the much-maligned doctrine of inherent agency power. The liability of the undisclosed principal and the liability of a principal for the torts of her servant have both defied explanation and have survived only because they are essential to the function of a modern society. The cost-benefit internalization theory, which provides a coherent explanation for those troublesome doctrines as well as for the rest of agency law, addresses this problem. Clothed with an explanatory theory, the essential doctrines of agency law can appear in courtrooms without shame. More importantly, an understanding of the fundamental purposes of agency law and of the explanation for the law that those purposes suggest can guide judges as they apply the battle-worn but victorious doctrines of agency law to new legal problems.