A COMMENT ON AN INHERENTLY FLAWED CONCEPT: WHY THE RESTATEMENT (THIRD) OF AGENCY SHOULD NOT INCLUDE THE DOCTRINE OF INHERENT AGENCY POWER

SUMMARY

The doctrine of inherent agency power first appeared in the Restatement (Second) of Agency (Second Restatement). The doctrine applies to situations involving overzealous or careless agents and unsuspecting third parties. Basically, the doctrine maintains that a principal will be liable for an unauthorized contract entered into by its agent if the other party to the contract reasonably relies on the unauthorized agent's claims of authority. Hence, inherent agency power can bind a principal to a contract that the principal never would have agreed to had the principal been aware of the circumstances.

The rationale underlying inherent agency power existed before the Second Restatement, but the restatement's drafters coined the phrase "inherent agency power" to aid courts in applying the concept. The drafters viewed the newly named doctrine as a way to protect "innocent" third parties. However, the Reporter for the Restatement (Third) of Agency (Third Restatement) eliminated the term "inherent agency power" from the latest restatement, viewing the doctrine as both confusing and unnecessary.

Few commentators have analyzed the Third Restatement's elimination of inherent agency power. Of those who have, few agree with the Reporter. These commentators raise two concerns. First, they argue that the Reporter effects a substantive change of agency law, not just a restatement. Second, they feel that excising inherent agency power from the Restatement will harm innocent third parties currently protected under the Second Restatement.

This Comment defends the Third Restatement's approach. The language and rationale of the Third Restatement show that eliminating inherent agency power is a practical adjustment that embodies current caselaw and reflects how reasonable people behave when dealing through agents. The result is a clearer, more useful restatement.

I. INTRODUCTION

This Comment is divided into three parts. Part I outlines the importance of agency law and explains some essential concepts and terms. The second part discusses the situations under which the Second Restatement will hold

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a principal liable for her agent's actions. It briefly describes specific rules in the Second Restatement and discusses the rationale supporting each rule. The third part describes the Third Restatement's approach, details how it differs from the Second Restatement, and answers questions raised by commentators skeptical of the Third Restatement's approach.

A. The Importance of Agency Law

Before examining the Third Restatement's elimination of inherent agency power, it is necessary to define and explain some basic concepts of agency law. Most rules governing principal-agent relations are simply a generic set of "off the rack" rules that mimic what a reasonable principal and a reasonable agent would have agreed to if they sat down and entered into negotiations.[1] This "majoritarian default" approach allows the principal and agent to form a relationship without incurring steep bargaining costs.[2] The "majoritarian default" is generally cheaper for the parties since they will likely adopt such rules instead of haggling over the specific terms of each agency relationship.[3] Still, most agency laws are flexible and allow the parties to adjust the "majoritarian default" terms to meet their specific needs.[4]

The Second Restatement defines agency as the relationship that forms when two parties agree that one of them will act on behalf of the other and will be subject to the other's control.[5] Discussion of agency law involves three parties: a principal, an agent, and a third party. The principal directs the agent, and the agent, according to the Second Restatement, follows the principal's directions.[6] The third party is the person who deals with the principal through the agent.[7]

Agency is the most common business relationship recognized by law.[8] Agency law covers a broad spectrum of relationships, ranging from the employees of a small business to the president of a multinational corporation.[9] Although it is no longer a part of the typical first-year law school curriculum, agency law was held in such high esteem by the American Law Insti-

1. *See* STEPHEN M. BAINBRIDGE, AGENCY, PARTNERSHIPS, & LLCS 45 (2004).
2. *Id.*
3. *Id.*
4. *Id.*
5. *See* RESTATEMENT (SECOND) OF AGENCY § 1 (1958).
6. MELVIN ARON EISENBERG, AN INTRODUCTION TO AGENCY, PARTNERSHIPS, AND LLCS 6 (3d ed. 2000).
7. *See* Eric Rasmusen, *Agency Law and Contract Formation*, 6 AM. L. & ECON. REV. 369, 370 (2004).
8. *See* BAINBRIDGE, *supra* note 1, at 2. Agency relationships are not limited to business situations. Anytime a person agrees to act on behalf of and subject to the control of someone else, agency law governs the resulting relationship. There is neither a requirement that the parties enter into a formal agreement nor a need for the parties to realize that they have formed an agency relationship; they need only act in a way that is consistent with the definition of agency. *See, e.g.*, Gordon v. Doty, 69 P.2d 136 (Idaho 1936) (finding an agency relationship where a schoolteacher allowed a football coach to use her car to transport football players to an out-of-town football game).
9. BAINBRIDGE, *supra* note 1, at 2.

HeinOnline -- 57 Ala. L. Rev. 1164 2005-2006

tute that the Restatement (First) of Agency was the second restatement compiled (after the Restatement (First) of Contracts).[10]

A unique aspect of agency law is that it shares features of both contract and tort law. Contract law governs the principal-agent relationship.[11] The agent can bind the principal to a contract. But, the legal disputes arising from an agent's interactions with a third party typically resemble tort law insomuch as the dispute normally results from unintentional actions and involves a principal and a third party who did not deal with each other in person.[12] The Second Restatement's rationale for inherent agency power is based, in part, on the tort-contract hybrid aspect of agency law.[13]

B. Parties Relevant to the Agency Relationship

Principals can be one of three types: disclosed, partially disclosed, or undisclosed. A disclosed principal is a principal whose identity is known to the third party when the third party transacts with the principal's agent.[14] A principal is partially disclosed if the third party knows that the agent is acting for a principal but is unaware of the principal's identity.[15] A principal is undisclosed if the third party believes the agent is acting for himself and is unaware of the principal's existence.[16] This Comment only discusses agency relationships involving disclosed and partially disclosed principals.[17]

Typically, the principal delegates some decisionmaking authority to the agent.[18] The ability to delegate decisionmaking authority to agents allows for the creation and management of complex business enterprises that one person acting alone could never control.[19] As the Third Restatement notes, "The ability to delegate with a reasonably reliable sense of the legal consequences is the essence of corporate management."[20] When parties choose to delegate, agency law governs the legal consequences of the delegation.[21] As a result, modern business organizations rely on clear agency principles.[22]

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10. *See id.* at iii; RESTATEMENT (FIRST) OF AGENCY (1933).

11. *See* Rasmusen, *supra* note 7, at 379.

12. *Id.* (noting that when two parties interact through an agent, the problems arising from the agent's lack of care are similar to negligence, a tort law principle).

13. *See* discussion *infra* Part I.E.5 (explaining the supporting rationale for inherent agency power).

14. *See* EISENBERG, *supra* note 6, at 9.

15. *See id.*

16. *See id.*

17. This Comment does not address the Third Restatement's treatment of unauthorized contracts involving undisclosed principals. Although the draft version of the Third Restatement completely eliminates the phrase "inherent agency power," the Third Restatement addresses cases involving undisclosed principals through a different rule—estoppel of an undisclosed principal. *See* RESTATEMENT (THIRD) OF AGENCY § 2.06 (Tentative Draft No. 2, Mar. 14, 2001).

18. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

19. *See* RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958).

20. RESTATEMENT (THIRD) OF AGENCY § 1.03 cmt. c (Tentative Draft No. 2, Mar. 14, 2001).

21. *See* DAVID EPSTEIN ET AL., BUSINESS STRUCTURES 37 (2002).

22. *See* RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958); EPSTEIN ET AL., *supra* note 21, at 37; Deborah Demott, *A Revised Prospectus for a Third Restatement of Agency*, 31 U.C. DAVIS L. REV. 1035, 1039 (1998) ("In some industries . . . the legal characterization of behavior based on agency doc-

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C. The Multiple Benefits of the Agency Relationship

A principal's ability to delegate tasks to an agent benefits both of the parties involved and society as a whole. Principals benefit because they can accomplish more by acting through others.[23] Agents benefit because, in most cases, the principal compensates them for their efforts.[24] Third parties also benefit because principal-agent relationships allow them to carry on their affairs without incurring the time and resource costs of verifying all transactions with the principal.[25]

Problems may arise, however, if the agent and principal have diverging interests because the agent may choose to gratify his own interests at the principal's expense.[26] The principal then suffers a loss.[27] If it suffers enough losses, the principal may decide to stop acting through agents or may be forced to monitor agents more closely, and the economy will lose the low transaction costs that motivate principals to use agents in the first place.[28]

The principal can, however, structure the relationship to minimize the agent's incentives to deviate. First, the principal can train the agent to follow directions.[29] Second, the principal can monitor the agent's activities and reward the agent's obedience.[30] Third, the principal can make the agent pay bonding costs.[31] And fourth, the principal may be able to recover damages from the agent when the agent's actions harm the principal.[32]

No principal, however, can ensure that the agent will always follow instructions, so the agency relationship carries some costs that cannot be eliminated. The total costs the principal incurs to monitor, compensate, and recover lost value from the agent are called agency costs.[33] Agency costs cannot be eliminated—they are inherent in the principal-agent relationship. However, agency costs can be reduced by providing efficient rules for determining who bears the costs when the agent's deviations harm the principal, the third party, or both.[34] An efficient rule will require both the principal and the third party to act with appropriate care (i.e., not wasteful or unreasonable) when dealing through agents. For the reasons outlined below,

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trine affects basic business practices.").

23. *See* Rasmusen, *supra* note 7, at 377-78.
24. *Id.* at 377.
25. *Id.*
26. *See* Jensen & Meckling, *supra* note 18, at 308 ("If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.").
27. *Id.*
28. *Cf. id.*
29. *See* Rasmusen, *supra* note 7, at 376.
30. *See* Jensen & Meckling, *supra* note 18.
31. *Id.* Jenson and Meckling define bonding costs as the resources an agent expends "to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions." *Id.*
32. *See* RESTATEMENT (SECOND) OF AGENCY § 401 (1958).
33. Jensen & Meckling, *supra* note 18.
34. *See* Rasmusen, *supra* note 7, at 376.

HeinOnline -- 57 Ala. L. Rev. 1166 2005-2006

the Third Restatement's elimination of inherent agency power nudges agency law toward more efficient results.[35]

D. Problems with the Second Restatement

The Second Restatement is the leading authority on agency law,[36] but it has been criticized extensively—Judge Richard Posner once referred to it as an "antiquated screed."[37] In fact, the Reporter for the Third Restatement, Deborah Demott, cites the Second Restatement's age as a primary justification for drafting the Third Restatement.[38]

Besides addressing changes resulting from the passage of time, a key innovation of the Third Restatement is its recognition of the agent as an independent actor. In contrast to the Second Restatement, which treats agents as simple-minded facilitators of the principal's will (like a tool in a mechanic's hand), the Third Restatement analyzes court opinions and agency doctrines in light of the fact that agents sometimes prefer their own goals over those of the principal.[39] Consequently, the elimination of inherent agency power reflects Demott's broader goal of restating the law to reflect how reasonable people expect agents to behave, without unduly complicating the determination of liability when an agent departs from the principal's instructions.[40]

E. Types of Authority

The Second Restatement identifies five ways in which an agent can bind its principal to a contract. In essence, these five ways are simply a way of classifying the proof that a third party must show to bind a principal.[41] These five ways are: (1) actual authority, (2) apparent authority, (3) inherent agency power, (4) agent by estoppel, and (5) ratification.[42] Though these concepts overlap and there is uncertainty over the parameters of each doctrine, any of the five doctrines will bind a principal to a contract.[43] Only three of the five types of authority bear directly on this Comment's discussion: actual authority, apparent authority, and inherent agency power.

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35. *See* discussion *infra* Part III.
36. *See, e.g.*, EPSTEIN ET AL., *supra* note 21, at 37 ("In 'doing' agency law, courts rely heavily on the Restatement (Second) of Agency . . . .").
37. Jansen v. Packaging Co., 123 F.3d 490 (7th Cir. 1997) (Posner, J., dissenting).
38. *See* Demott, *supra* note 22, at 1035.
39. *See id.* at 1057.
40. *See id.* at 1035.
41. EPSTEIN ET AL., *supra* note 21, at 35.
42. *See* EISENBERG, *supra* note 6, at 10.
43. BAINBRIDGE, *supra* note 1, at 33.

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1. Actual Authority

Under the Second Restatement,[44] actual authority exists when an agent reasonably believes that the principal has authorized a particular course of conduct.[45] There are two types of actual authority: express actual authority and implied actual authority. Express actual authority results when a principal gives an agent a direct authorization to act.[46] For example, if a principal instructs her agent to purchase a plane ticket, the agent has express, actual authority to purchase the plane ticket.[47]

Implied actual authority results when an agent can reasonably infer from the principal's instructions that the principal has acquiesced to a certain action.[48] Thus, if a principal instructs her agent to make intercontinental travel arrangements, the agent has implied authority to buy plane tickets as part of the trip.[49] Most actual authority is created by implication.[50] Even if the principal errs when creating authority (for instance, the principal wanted to travel by sea) a grant of express authority is binding on the principal.[51] Also, the third party's belief as to the agent's authority is irrelevant because actual authority results from a manifestation between the principal and agent. If actual authority exists, the principal is bound even if the third party doubted the agent's actual authority.[52]

2. Apparent Authority

Under the Second Restatement, "[a]pparent authority is created by the same method as that which creates [actual] authority, except that the manifestation of the principal is to the third person rather than to the agent."[53] Apparent authority focuses on what a third party reasonably believes about the agent's authority.[54] It is the product of a principal's "holding out" of an

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44. "[The Second Restatement] uses the term 'authority' to mean what is conventionally called 'actual authority.'" EISENBERG, *supra* note 6, at 8 n.1.

45. BAINBRIDGE, *supra* note 1, at 35; *see also* RESTATEMENT (SECOND) OF AGENCY §§ 7, 26 (1958).

46. *See* EPSTEIN ET AL., *supra* note 21, at 38.

47. *Id.*

48. *Id.*

49. *Id.* at 39.

50. *See* EISENBERG, *supra* note 6, at 11.

51. *See, e.g.*, BAINBRIDGE, *supra* note 1, at 36 ("[I]f Mary wants to buy Blackacre but mistakenly tells Paul to buy Whiteacre on her behalf, Paul has actual express authority to buy Whiteacre . . . .").

52. Matthew P. Ward, Comment, *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, 1589 (2002).

53. RESTATEMENT (SECOND) OF AGENCY § 27 cmt. a (1958); *see also* RESTATEMENT (SECOND) OF AGENCY § 27 (1958) ("[A]pparent authority to do an act is created as to a third person by written or spoken words or any other conduct of the principal which, reasonably interpreted, causes the third person to believe that the principal consents to have the act done on his behalf by the person purporting to act for him.").

54. *See* RESTATEMENT (SECOND) OF AGENCY § 8 (1958) ("Apparent authority is the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons.").

HeinOnline -- 57 Ala. L. Rev. 1168 2005-2006

agent as having certain authority and the third party's belief that such authority exists.[55] An agent can hold apparent authority even if the principal makes no express grant of authority.[56]

To create apparent authority, two elements must be present: (1) the principal's manifestation (2) must cause a third party to reasonably believe the principal has consented to "have the act done on his behalf by the person purporting to act for him."[57] For instance, apparent authority can result from a direct manifestation by the principal to the third party.[58] The Second Restatement, however, fails to define what constitutes a "manifestation." The lack of a clear definition has proven problematic; because the types of conduct that constitute a manifestation cannot be clearly identified without a clear definition, courts have struggled to decide when to apply apparent authority and when to apply inherent agency power.[59]

Apart from a direct communication, the principal's "holding out" of an agent to third parties can also be non-verbal[60] and can occur without action on the part of the principal.[61] Apparent authority from inaction can arise when an agent and principal interact with a third party. If the agent, while in the principal's presence, tells the third party that she has authority to act on the principal's behalf and the principal does nothing to deny the agent's assertion of authority, the agent has apparent authority and can bind the principal in contract.[62] Also, the requisite manifestation can be found where the principal authorizes the agent to state that he is authorized[63] or where the parties' behavior in prior transactions suggests that the agent is authorized.[64]

For purposes of this Comment, the most important type of apparent authority relates to customary powers. Apparent authority based on an agent's customary powers springs from the principal's placement of an agent in a position that carries generally recognized duties.[65] A court may determine

55. *See* K & G Farms v. Monroe County Serv. Co., 134 S.W.3d 40, 43 (Mo. App. E.D. 2003).

56. *See id.*

57. *See* RESTATEMENT (SECOND) OF AGENCY §§ 8, 27 (1958); *see also* BAINBRIDGE, *supra* note 1, at 40 ("The basic rule is that apparent authority exists only when two criteria are satisfied. First, the principal must in some way hold out the agent as possessing certain authority. Second, the third party must reasonably believe the agent has such authority.").

58. *See* BAINBRIDGE, *supra* note 1, at 40.

59. *See* Demott, *supra* note 22, at 1047.

60. Ward, *supra* note 52, at 1591.

61. *See* BAINBRIDGE, *supra* note 1, at 41.

62. *See id.*

63. *See id.* The manifestation required to create apparent authority differs from the manifestation required to create actual authority. Under actual authority, the relevant manifestation is from the principal to the agent. Under apparent authority, the relevant manifestation is from the principal to the third party. If a third party can establish apparent authority, the agent's actual authority is irrelevant. This is important because a devious principal could (1) authorize an agent to tell another person that the agent holds broad authority while (2) explicitly limiting the agent's actual authority. If the principal, through the agent, manifests that the agent has broad authority, then any undisclosed limitation on the agent's actual authority will not keep the principal from being responsible for an unauthorized contract.

64. *See id.* at 42.

65. *See* BAINBRIDGE, *supra* note 1, at 42; Essco Geometric v. Harvard Indus., 46 F.3d at 726 (8th Cir. 1995) ("If a principal allows an agent to occupy a position which, according to the ordinary habits of people in the locality, trade or profession, carries a particular kind of authority, then anyone dealing with

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that an agent holds apparent authority based on customary powers regardless of any undisclosed limits the principal imposed on the agent's actual authority.[66]

There are two criteria for showing apparent authority based on custom: "[f]irst, the third party must know that the principal . . . placed the agent in a certain position. Second, it must be customary for an agent in that position to [hold the authority to make the agreement.]"[67] Positions such as manager and treasurer are examples of positions with customary powers.[68] Thus, if a third party knows that a principal placed the agent in the position, the principal has made the requisite manifestation.[69] Under the Second Restatement, the principal is bound if the third party reasonably relies on the principal's manifestation—even if the third party lacks familiarity with the industry or the powers that normally accompany a person in the agent's position.[70]

Apparent authority based on customary powers is illustrated in *Essco Geometric v. Harvard Industries*.[71] In *Essco Geometric*, the defendant, a manufacturer of office chairs, had purchased foam from the plaintiff to use in its office chairs for thirty years.[72] The defendant had employed the same purchasing manager for over twenty years. The purchasing manager had authority to contract on behalf of the manufacturer.[73] When the manager retired, however, his replacement was required to seek upper management approval before issuing any new purchase orders, but the supplier was not informed of the policy change.[74] When the new purchasing manager signed a contract with the supplier without receiving upper management's approval, the defendant sought to void the contract, claiming the purchasing manager lacked authority to bind the company.[75] The court found that the purchasing manager held apparent authority because of the prior relationship between the supplier and the manufacturer and because of the industry custom that "the purchasing manager possessed the authority to bind the company."[76]

Despite the placement of the agent in a position conferring customary authority, the third party's belief about the agent's authority must still be reasonable.[77] In *Hamilton Hauling, Inc. v. GAF Corp.*,[78] the court defined third party reasonability as "that which a reasonably prudent man, using

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the agent is justified in inferring that the agent has such an authority.").

66. BAINBRIDGE, *supra* note 1, at 42.
67. *Id.*
68. *See* Hamilton Hauling, Inc. v. GAF Corp., 719 S.W.2d 841, 847 (Mo. App. 1986) (citing section 8 of the Second Restatement).
69. *See* BAINBRIDGE, *supra* note 1, at 41.
70. RESTATEMENT (SECOND) OF AGENCY § 27 cmt. d (1958).
71. 46 F.3d 718 (8th Cir. 1995).
72. *Id.* at 720.
73. *Id.* at 721.
74. *Id.* at 722.
75. *Id.* at 723.
76. *Id.* at 727.
77. *See* BAINBRIDGE, *supra* note 1, at 43.
78. 719 S.W.2d 841, 846 (Mo. App. 1986) (citations omitted).

HeinOnline -- 57 Ala. L. Rev. 1170 2005-2006

diligence and discretion, in view of the principal's conduct would suppose the agent to possess."[79]

3. *Rationale for Apparent Authority*

The Second Restatement's rationale for apparent authority is rooted in the same rationale as the "objective theory of contracts."[80] This theory provides that a person—the offeror—who manifests to another—the offeree—that she is willing to contract upon specific terms will be bound to those terms if the offeree accepts the offer, regardless of the offeror's subjective intentions.[81] Also, when a principal represents that another is authorized to act on her behalf, the situation is the same as if the principal were interacting directly with the third party.[82] If not, the principal could avoid being bound by an agreement by disclaiming the agent's authority.[83] Allowing the principal to hide behind its agent "would result in uncertainty in a large number of commercial transactions."[84] This uncertainty is likely to reduce the willingness of third parties to deal with agents.

Some commentators find apparent authority unfair.[85] After all, apparent authority allows an agent to bind a principal even when the agent violates the principal's explicit commands.[86] Despite the risk that the agent will deviate from the principal's instructions, the long-term benefits that delegation to agents provides to both principals and third parties probably justifies much of this risk. But, it is important to remember that, like principals, third parties also benefit from agency relationships. Like other forms of agency, agency based on apparent authority allows third parties to negotiate and contract without requiring the principal's direct, explicit approval of every transaction—so long as the third party's belief in the agent's stated authority is reasonable.[87] Thus, the delegation of authority to agents reduces transaction costs not only for the principal, but also for the third party.[88]

Unfortunately, agents sometimes enter into contracts that exceed the authority actually conferred upon them by their principals, while not exceeding the authority that a third party could reasonably expect the agent to hold.[89] In this situation, either the principal will be forced to honor a contract that it did not authorize or the third party will lose the effort it invested

79. *Id.*
80. RESTATEMENT (SECOND) OF AGENCY § 8 cmt. d (1958).
81. *See id.*
82. *See* RESTATEMENT (SECOND) OF AGENCY § 8 reporter's notes (1958).
83. *See id.*
84. *Id.*
85. *See* BAINBRIDGE, *supra* note 1, at 44.
86. *Cf. id.*
87. *See id.* at 44-45.
88. *See supra* text accompanying note 23.
89. *See, e.g.*, Kidd v. Thomas A. Edison, Inc., 239 F. 405 (S.D.N.Y. 1917) (ordering damages for plaintiff where defendant principal had instructed agent to book singers for one show only, and agent instead booked a female singer for an entire tour).

HeinOnline -- 57 Ala. L. Rev. 1171 2005-2006

in the making the agreement.[90] Consequently, the transaction cost savings offered by agency law would be lost.[91]

This loss is not limited to the parties to the agreement. Society as a whole loses because one of the "innocent" parties will be forced the pay for losses that would not have occurred if both the principal and the third party had been aware of the transaction's specific terms.[92] When this type of unwanted transaction occurs, "society wants to reduce the . . . losses in the cheapest possible way."[93] The cheapest way is often found by placing the loss on the party that could have most easily avoided the loss—the least-cost avoider.[94]

The least-cost avoider rationale appears in apparent authority. This seems fair because it places the loss on the party who could have prevented the loss at the lowest cost to society. It gives that party an incentive to take precautions, while minimizing the cost of those precautions.[95] Since the principal selects the agent, gives the agent instructions, and monitors the agent, the principal is often the least-cost avoider.[96] Accordingly, the Second Restatement places liability on the principal when an apparent agent exceeds his or her authority.[97]

4. Inherent Agency Power

According to the Second Restatement, "[i]nherent agency power . . . indicate[s] the power of an agent which is derived not from [actual] authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent."[98] Unfortunately, this definition does no defining.[99] It tells us that inherent agency power differs from actual and apparent authority. It offers a justification for why inherent agency power should be recognized. But it never says what inherent agency power is.[100]

Section 161 of the Second Restatement provides some help for situations involving disclosed and partially disclosed principals. It states that disclosed or partially disclosed principals are responsible for their agent's acts, even when the principal prohibits the act, if "(i) the act usually accompanies or is incidental to transactions that the agent is authorized to conduct, and (ii) the third person reasonably believes the agent is authorized to do the

90. *See* LARRY RIBSTEIN, UNINCORPORATED BUSINESS ENTITIES 32 (3d ed. 2004).
91. *See id.* at 33.
92. *See id.* at 32; BAINBRIDGE, *supra* note 1, at 45.
93. BAINBRIDGE, *supra* note 1, at 45.
94. *See* RIBSTEIN, *supra* note 90; BAINBRIDGE, *supra* note 1, at 45.
95. BAINBRIDGE, *supra* note 1, at 45.
96. RIBSTEIN, *supra* note 90, at 33.
97. *See* RESTATEMENT (SECOND) OF AGENCY § 8 (1958).
98. *Id.* § 8A.
99. *See* EISENBERG, *supra* note 6, at 11.
100. *See id.*

HeinOnline -- 57 Ala. L. Rev. 1172 2005-2006

act."[101] Section 161 is particularly applicable where the third party lacks familiarity with the agent's customary powers and where the principal did not authorize the agent to hold himself out as having any binding authority.[102] Otherwise, the practical impact of inherent agency power seems indistinguishable from that of apparent authority.[103] The Second Restatement distinguishes inherent agency power from actual and apparent authority on the basis that inherent agency power does not rest upon the principal's manifestations; instead, it springs from the relationship between principal and agent.[104] Thus, the term "power" is used instead of "authority."[105]

In a contract setting, the Second Restatement applies inherent agency power to three situations: (1) where the agent does something he appears to have authority to do, but doing so violates the principal's orders; (2) where the agent acts for his own purposes by entering into a transaction that he otherwise would not be authorized to enter; and, (3) where the agent "is authorized to dispose of goods and departs from the authorized method of disposal."[106]

Judge Learned Hand laid the foundation for inherent agency power in *Kidd v. Thomas A. Edison, Inc.*[107] In that case, Edison's agent, Fuller, was authorized to book singers for "tone recitals" designed to show off the recording quality of Edison's phonographs.[108] The tone recitals were to take place in record stores. Though the industry custom was for recital singers to be signed for an entire tour,[109] Fuller's authority was limited; he could book singers, including the plaintiff, only for those recitals that record dealers agreed to pay for, with Edison guaranteeing the dealers' payment.[110] For reasons not stated in the opinion, Fuller exceeded his actual authority and booked Kidd for an entire singing tour.[111] When the trial court found that Fuller had authority to bind Edison to the contract, Edison appealed and argued that Fuller lacked authority to bind it to the contract's terms.[112] In his opinion affirming the lower court, Judge Hand explained that "[t]he scope of any authority must . . . be measured . . . not alone by the words in which it is created, but by the whole setting in which those words are used, including the customary powers of such agents."[113] The kind of limitation placed

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101. *See id.*
102. *See* BAINBRIDGE, *supra* note 1, at 50.
103. *See id.*
104. RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958) ("Because such a power is derived solely from the agency relation and is not based upon principles of contracts or torts, the term inherent agency power is used to distinguish it from other powers of an agent which are sustained upon contract or tort theories.").
105. *Id.*
106. *Id.* § 8A cmt. b.
107. Kidd v. Thomas A. Edison, Inc., 239 F. 405 (S.D.N.Y. 1917).
108. *Id.* at 406.
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.*

on Fuller was unheard of in the context of music recitals, though the specific context of a "tone test" was new. Judge Hand reasoned:

> The responsibility of a master for his servant's act is . . . *preserved . . . from motives of policy*. . . . If a man select[s] another [man] to act for him with some discretion, *he has by that fact vouched to some extent for his reliability*. . . . The very purpose of delegated authority is to avoid constant recourse by third persons to the principal, which would be a corollary of denying the agent any latitude beyond his exact instructions.[114]

Thus, inherent agency power protects third parties from agents who act "either through negligence or excess of zeal."[115] The Second Restatement reasons that "[i]t would be unfair for an enterprise to have the benefit of the work of its agents without making it responsible to some extent for their excesses and failures to act carefully."[116] The Second Restatement further notes that, although the immediate benefit of the doctrine of inherent agency power flows to third parties harmed by an agent's unauthorized actions, the doctrine ultimately benefits all businesses since employers will inevitably be litigants in cases involving their agents' unauthorized transactions.[117]

As with apparent agency, inherent agency power requires that the third party *reasonably* believe the agent is authorized. In determining the reasonableness of the third party's belief, courts probe whether the agent's acts are a continuation of her prior authorized acts, whether a relationship of trust already existed between the parties, and whether any of the agent's actions make the belief unreasonable.[118]

5. Rationale for Inherent Agency Power

The Second Restatement created inherent agency power to provide a rationale for cases where neither apparent nor actual authority seemed to apply, but the court nevertheless found the agent's actions binding upon the principal.[119] Consequently, inherent agency power functions as a catchall for situations where intuition dictates that the principal ought to be bound, but neither apparent nor actual authority applies.[120]

Therefore, the doctrine appears to be a gap-filler born of the interdependency among agency, contract, and tort law that existed when the Second

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114. *Id.* at 407-08 (emphasis added).
115. EISENBERG, *supra* note 6, at 11 (quoting RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958)).
116. *Id.* (quoting RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958)).
117. *Id.* at 12 (quoting RESTATEMENT (SECOND) OF AGENCY § 161 cmt. a (1958)).
118. Ward, *supra* note 52, at 1595.
119. *See* BAINBRIDGE, *supra* note 1, at 46.
120. *See id.* at 46.

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Restatement was drafted.[121] Where actual or apparent authority exists, the principal and third party are bound to the transaction because the principal manifested his will to the third party through an appropriate channel—an agent.[122] The perceived need for inherent agency power arises when an agent exceeds his actual authority, when the principal has not communicated the agent's authority to the third party, or both.[123] In this situation, the Second Restatement finds no actual authority since the agent is acting outside of his instructions.[124] It finds no apparent authority because the principal has not held the agent out as having authority.[125] However, "[a] principle which will explain such cases can be found if it is assumed that a power can exist purely as a product of the agency relation."[126] If these assumptions are true, the principal cannot be liable on contract law principals because he has made no communication to the third party by authorized means.[127] And the principal cannot be liable under tort law because he has committed no wrong.[128] Thus, inherent agency power presents an equitable doctrine that bridges the gap between the apparent lack of tort and contract law liability and the intuition that the principal, rather than an "innocent" third party, should bear the costs of his agent's misdeeds. The doctrine's logic mirrors that of respondeat superior in tort law.[129]

Like respondeat superior, the Second Restatement justifies using inherent agency power to hold a principal liable for an unauthorized contract by noting that the agent is trusted and controlled by the principal, owes a fiduciary duty to the principal, and typically acts for the benefit of the principal.[130] Because of the nature of the principal-agent relationship, the Second Restatement reasons that it is more just to place the losses resulting from the agent's unauthorized contracts on the principal than to allow the third party to be harmed by the agent's unauthorized actions.[131]

In situations involving principals that are businesses, some proponents of inherent agency power further justify the doctrine by arguing that busi-

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121. *See* RESTATEMENT (SECOND) OF AGENCY § 8A cmt. b (1958).
122. *See id.*
123. *See id.*
124. *See id.*
125. *See id.*; *see also* Steven A. Fishman, *Inherent Agency Power—Should Enterprise Liability Apply to Agents' Unauthorized Contracts?*, 19 RUTGERS L.J. 1, 6 (1987) (arguing that an unduly strict reading of the term manifestation in the Second Restatement has led to the need for the doctrine of inherent agency power).
126. RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958).
127. *Id.* § 161 cmt. a.
128. *See id.* § 8A cmt. b ("The liability of the master in such cases cannot be based upon any ordinary tort theory, since in many cases the employment is not a causative factor in any accepted sense."). However, common law developments since the Second Restatement was drafted have accepted a much broader concept of what falls under one's scope of employment. *See, e.g.*, Ira S. Bushey & Sons, Inc. v. United States, 398 F.2d 167 (2d Cir. 1968) (finding that an intoxicated member of the U.S. Coast Guard was an agent of the U.S. Government where the drunken sailor's actions caused severe damage to the plaintiff's drydock).
129. EISENBERG, *supra* note 6, at 12.
130. *See* RESTATEMENT SECOND OF AGENCY § 8A cmt. b (1958).
131. *See id.*

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nesses should absorb the harm caused by their agent's unauthorized contracts because businesses are in a better position to spread the risk of harm through price increases and insurance.[132] This gives greater assurance that the third party will receive the benefit of its bargain[133] and treats the loss as a cost of doing business.[134] Viewed in this light, inherent agency power forces a principal to internalize all of its business costs instead of shifting some of its costs onto third parties who would be harmed if the principal could simply void the contract any time the agent lacked actual authority.[135] The claim is that this method results in a more efficient allocation of economic resources.[136]

Additionally, some commentators view inherent agency power as a way to hold principals accountable for reasonable third-party expectations that arise when principals act through agents.[137] After all, most agents, despite their best intentions, will sometimes deviate from their principals' instructions.[138] For example, an agent may forget or misinterpret one of the principal's instructions or may sincerely believe that the principal would approve of his or her conduct if the principal were aware of all the facts surrounding the situation.[139] For instance, the agent may sincerely believe that the principal would approve of an unauthorized contract if a third party needed to strike a deal quickly and would look elsewhere if the agent did not commit the principal to the contract right away, leaving no time for the agent to contact the principal about the deal's terms.[140] After all, situations like this are why principal-agent relationships require the principal to delegate at least some decisionmaking authority to the agent.[141] Thus, under a "reasonable expectations" rationale, inherent agency power seems justified because "it is or should be foreseeable to a principal, when he appoints an agent, that as a practical matter the agent acting in good faith for the benefit of the principal is likely to deviate occasionally from instructions."[142]

Finally, like apparent authority, inherent agency power is also grounded in the least-cost avoider concept.[143] As with apparent authority, conventional wisdom holds that the principal is typically in a better position to control the agent.[144] Thus, when the agent enters into an unauthorized contract, it is fairer to place the resulting damages on the principal because it could have avoided the harm by exercising greater control over the agent, while

132. EISENBERG, *supra* note 6, at 12-13; Fishman, *supra* note 125, at 48.
133. *Cf.* EISENBERG, *supra* note 6, at 12.
134. *Id.*; Fishman, *supra* note 125, at 48.
135. *See* ALAN C. STOCKMAN, INTRODUCTION TO MICROECONOMICS 472-79 (2d ed. 1999).
136. *See id.*
137. *See* EISENBERG, *supra* note 6, at 12.
138. *See id.* at 12-13.
139. *See id.*
140. *See id.* at 12-13.
141. Jensen & Meckling, *supra* note 18.
142. EISENBERG, *supra* note 6, at 13.
143. *See* BAINBRIDGE, *supra* note 1, at 48.
144. *Cf.* Fishman, *supra* note 125, at 35.

HeinOnline -- 57 Ala. L. Rev. 1176 2005-2006

the third party, who does not control the agent's actions or training, is "innocent."[145]

II. CRITICISMS OF INHERENT AGENCY POWER

Several commentators have questioned the usefulness of inherent agency power in situations involving disclosed principals.[146] This part outlines three of those criticisms.

A. The Supporting Rationales for Inherent Agency Power Are Flawed

At first glance, the least-cost avoider and loss-spreading rationales supporting inherent agency power appear sound. Nevertheless, they fail to justify inherent agency power because they oversimplify the nature of a principal-agent relationship by failing to appreciate the extent to which a third party can influence the agent's behavior.

The least-cost avoider rationale is limited because it is not clear that the principal is always the least-cost avoider. The principal typically controls the agent more than the third party, but this control is limited because the principal is not present when the transaction occurs.[147] The third party deals through the agent voluntarily, and in a contract situation (unlike a tort), the third party can verify all of the facts relating to the transaction.[148] But, if a third party knows that the agent's principal will bear the costs of the agent's mistakes, then third parties have an incentive to take less than optimal care in dealing with the agent.[149] In these situations, the third party—not the principal—may be in the best position to question the agent's authority to make a contract that includes terms that may be disadvantageous to the principal.[150] Eventually, the costs that the principal incurs in screening, training, and monitoring its agents to ensure that the agents do not exceed their authority will outweigh the costs a third party would incur by simply pausing to question whether a person in the agent's position normally has the authority claimed by the agent.[151] Furthermore, if the third party bears no risk for the unauthorized contract, the risk faced by the principal could even be amplified if the third party possesses greater bargaining power.[152] Thus, instead of remedying one of its chief concerns—allowing a principal to avoid any contract it deems unbeneficial by simply hiding behind its

145. *See* BAINBRIDGE, *supra* note 1, at 48.
146. *See, e.g.*, *id.* at 48, 50-51; Fishman, *supra* note 125, at 13; EISENBERG, *supra* note 6, at 11.
147. *See* Fishman, *supra* note 125, at 50.
148. *Id.* at 49.
149. *See* Rasmusen, *supra* note 7, at 378; *see also* Lincoln Bank v. Nat'l Life Ins. Co., 476 F. Supp. 1118, 1123 (E.D. Pa. 1979) ("Where both the principal and the third party are equally innocent, Section 161 will place the burden upon the principal, since he is in the better position to supervise the agent's actions.").
150. *See* Fishman, *supra* note 125, at 50.
151. *See id.*
152. *See id.*

HeinOnline -- 57 Ala. L. Rev. 1177 2005-2006

agent and crying that the agent lacked authority—inherent agency power may force an unauthorized contract upon the principal, although the third party may have avoided the problem by asking the agent for evidence of authority.[153]

Also debatable is the desirability of using inherent agency power to force a principal to spread the costs of unauthorized contracts through pricing and insurance. First, the price of the principal's goods and services bears directly on how much of that good or service the principal will produce and how much the public will buy.[154] If so-called "cost spreading" compels a principal to raise its prices in order to shift onto consumers any costs that the third party could have more easily avoided, the principal will produce less of that good or service,[155] and society will miss out on whatever quantity of that good or service the principal would have produced had the legal rule not required it to pass the costs of its agent's unauthorized contracts onto its consumers.[156] A better rule would require the principal to include in its prices only those costs that result directly from its activities. Furthermore, the idea that principals can use insurance to reduce the risk of unauthorized contracts is erroneous because the "risks from unauthorized contractual acts of an agent are frequently uninsurable."[157] Hence, any justification that forces the principal to bear the risk-spreading burden rests on flawed logic, especially in situations involving two parties of equal bargaining strength who voluntarily agree to deal with one another through an agent.[158]

B. Confusion Between Apparent Agency and Inherent Agency Power

An additional problem with inherent agency power is that its boundaries are unclear.[159] Courts have struggled to use the doctrine as envisioned by the Second Restatement's drafters and frequently cite apparent authority when inherent agency power would apply.[160] In *Kidd v. Edison, Inc.*—a case frequently cited to explain the policy justifications for inherent agency power—Judge Learned Hand used the term "apparent agency" when speaking of inherent agency power.[161] Even the Second Restatement admits that courts have often applied apparent authority in situations for which inherent

153. *See id.* This does not mean that the least-cost avoider concept is not useful or that the benefits of acting through agents are illusory. It simply means that the Second Restatement's approach incorrectly assumes that the principal is always in the best position to avoid the harm caused by unauthorized contracts. "The courts should be wary of adopting a rule that goes too far in protecting a party who appears to have been wronged if the result is to protect parties who are in a position to protect themselves." *Id.*

154. *See* STOCKMAN, *supra* note 135, at 75, 83, 93.

155. *Id.*

156. *Id.* at 218-19.

157. *See* Fishman, *supra* note 125, at 49.

158. *See id.*

159. EISENBERG, *supra* note 6, at 11.

160. *See* BAINBRIDGE, *supra* note 1, at 33.

161. 239 F. 405, 406 (S.D.N.Y. 1917) ("The point involved is the scope of [the agent]'s 'apparent authority' . . . .").

HeinOnline -- 57 Ala. L. Rev. 1178 2005-2006

agency power seems to fit.[162] Because courts apply the agency doctrines inconsistently,[163] it seems they reach a conclusion based on intuition and then look for the agency doctrine that squares best with that intuition.[164] The "variety of doctrines is a bad sign for clear decision making, not a good one."[165] Furthermore, even if the doctrines were readily distinguishable, in cases involving disclosed principals it is not clear that inherent agency power adds any substance to apparent authority by virtue of custom.[166]

C. Both Principals and Third Parties Benefit from Agency Relationships

In the comments following section 8A, the Second Restatement justifies binding a principal to an unauthorized contract made on its behalf by its agent on the respondeat superior rationale that it would be unfair to allow the principal to benefit from the agent's services without making the principal responsible for the agent's harms. Yet, respondeat superior is not a clean fit for unauthorized contracts because the third party also benefits from the agency relationship. An agent provides an efficient way to bring principals and third parties together in *mutually* beneficial interactions.[167] Without an agent, the interaction would be either more expensive or impossible. Thus, justifying the rule on the basis that the principal receives the benefit from the agent is only half correct: Both parties benefit from the agency relationship because the agent reduces transaction costs for both parties.[168] Therefore, the notion that a principal should bear all costs associated with an agent's unauthorized contract is inaccurate because it does not consider the real nature of an agency relationship.

III. THE RESTATEMENT THIRD APPROACH: ELIMINATE INHERENT AGENCY POWER

In her prospectus, the Reporter for the Third Restatement argues that the Second Restatement, though useful, is too specific to provide the flexibility needed in an evolving business climate.[169] While it offers an extensive, de-

162. *See* RESTATEMENT SECOND OF AGENCY § 8A cmt. b (1958).

163. *See, e.g., In re* Lernout & Hauspie Sec. Litig., 230 F. Supp. 2d 152, 173 n.17 (D. Mass. 2002) ("Plaintiffs make no argument that the 'status' of the various KPMG member entities vis a vis KPMG International should give them inherent agency powers (i.e., implied authority) to bind the entire association for their individual misstatements.").

164. *See* Rasmusen, *supra* note 7, at 375.

165. *Id.*

166. *See* EISENBERG, *supra* note 6, at 11 ("But this leaves open the issue, under what circumstances is a third person reasonable in believing that an agent has authority that, by hypothesis, is beyond the agent's apparent authority?").

167. *See* Rasmusen, *supra* note 149, at 377 ("The agent reduces transaction costs, to the benefit of both parties, and both parties should be interested in a legal rule that encourages efficient monitoring. When the principal hires the agent he does not just help himself. A reduction in transaction costs helps the third party, too.").

168. *See id.*

169. Demott, *supra* note 22, at 1040 ("For example, in contrast to 1958, much of today's business activity implicates large organizations, including for-profit business corporations and not-for-profit

HeinOnline -- 57 Ala. L. Rev. 1179 2005-2006

tailed analysis of a how to apply agency law to specific situations, the Reporter laments how the Second Restatement's rules and examples involve individual principals—not organizational principals, which are more common.[170] According to the Reporter, the focus on individual principals and specific rules stifles the formation of generally applicable agency law principles.[171] Thus, in drafting the Third Restatement, the Reporter strives to restate agency law based on broad principles that courts use, instead of the fact-specific situations presented in the Second Restatement.[172] The Reporter also shifts the Restatement's focus away from "individual principals to a broader focus on corporate and organizational principals."[173]

A. Elimination of Inherent Agency Power

The Third Restatement does not include the doctrine of inherent agency power. The Reporter notes both the Second Restatement's failure to clearly define inherent agency power and the confusion that exists over the doctrine's applicability.[174] Specifically, the Reporter claims that many courts already apply apparent authority to situations where the Second Restatement would apply inherent agency power.[175] As a result, apparent agency "may have overtaken the doctrine of inherent agency power."[176] Accordingly, for situations involving disclosed or partially disclosed principals, the Reporter expands the definition of apparent authority to cover situations that the Second Restatement would have included under inherent agency power.[177]

Under the Third Restatement, apparent authority still relies on a manifestation from the principal to a third party.[178] Unlike the Second Restate-

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organizations like universities. *Restatement (Second)* does not devote specific attention to the agency problems created by the corporate form or by organizations in general. *Restatement (Second)* reflects a simpler business world dominated by smaller business enterprises that effected transactions through nonemployee-representatives and brokers, a world additionally in which large-scale franchising did not play a significant role in structuring business activity. Further, *Restatement (Second)* pays only glancing attention to the agency dimensions of partnership as a form of business organization, one in which perennial disputes arise over the scope of partners' agency authority and fiduciary duty. Even if the popularity of limited liability companies eclipses that of limited and general partnerships, the underlying agency problems will remain.") (footnote omitted).

170. *Id.* at 1041-43.

171. *Id.* at 1041-42 ("[The Second Restatement] emphasizes detailed treatment at the occasional expense of a general articulation of principles. This propensity may at times sacrifice the opportunity that generalization presents to explore underlying rationales more fully.").

172. *Id.*

173. *Id.* at 1043 ("By paying explicit attention to the applications of agency doctrine when the principal is an organization, one enhances the prospect of successful generalization. In varying degrees of tightness, one can discover links between agency's internal concern with the principal-agent relationship and its external concern with the consequences of an agent's interactions with third parties.").

174. *Id.* at 1047.

175. *Id.* at 1047, 1050 ("It is open to question whether this distinction [between apparent authority and inherent agency power] is sustainable in light of the definition of apparent authority applied in many recent cases.").

176. *Id.* at 1047.

177. Ward, *supra* note 52, at 1586.

178. *See* RESTATEMENT (THIRD) OF AGENCY § 2.03 (Tentative Draft No. 2, Mar. 14, 2001) ("Apparent authority is the power held by an agent or other actor to affect a principal's legal relations with third

HeinOnline -- 57 Ala. L. Rev. 1180 2005-2006

ment, however, the Third Restatement defines manifestation.[179] The definition is intentionally broad: "A person manifests assent or intention through written or spoken words or other conduct."[180] The comments to the definition stipulate that the term "manifestation" encompasses more than mere oral communication and includes basically any conduct "observable by others, that expresses meaning."[181] Instead, either nonverbal communication or the placing of an agent in "a position or office with specific functions or responsibilities, from which third parties will infer that the principal assents to acts by the person requisite to fulfilling the specific functions or responsibilities."[182] The expansion of apparent authority is justified. As noted by the Reporter, "many cases define apparent authority itself more broadly than does the black letter formulation in *Restatement (Second)*, requiring less specificity and focus in the principal's representations to third parties."[183] Often, the agents in these cases occupy defined roles within an organization.[184]

The elimination improves agency law for three reasons: (1) in situations involving a disclosed or partially disclosed principal, expanding the scope of apparent authority by defining manifestation broadly reflects the intuitive notion that there is no substantive difference between inherent agency power and apparent authority; (2) the expansion of tort law and contract law has filled the gap previously occupied by inherent agency power; and (3) the Third Restatement approach furthers a primary goal of agency law: reducing the transaction costs and uncertainties that arise when principals delegate decisionmaking authority to their agents.

B. No Practical Difference Between Apparent Authority and Inherent Agency Power

The Third Restatement's approach follows common-sense notions of parsimony. Parsimony refers to adopting "the simplest assumption in the formulation of a theory."[185] By recognizing that apparent authority and inherent agency power are practically the same doctrine, the Third Restatement makes agency law easier to understand and to follow.

Under section 161 of the Second Restatement, inherent agency power relies on the third party's reasonable belief that the agent is authorized to contract and whether such contracts are incidental to the agent's typical duties.[186] Apparent authority, as outlined in section 2.03 of the Third Re-

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parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations.").

179. *Id.* § 1.03.
180. *Id.*
181. *Id.* § 1.03 cmt. b ("It is a broader concept than communication.").
182. *Id.*
183. Demott, *supra* note 22, at 1051.
184. *Id.* at 1052.
185. THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (4th ed. 2000).
186. *See* BAINBRIDGE, *supra* note 1, at 50.

HeinOnline -- 57 Ala. L. Rev. 1181 2005-2006

statement, follows the same rationale by examining whether a third party reasonably can conclude that an agent holds authority to enter into a given transaction on her principal's behalf.[187]

Though the conclusion is the same under both the Second and Third Restatement, each restatement differs starkly in how it reaches its result. Under the Second Restatement, the principal's liability is based on a "power" emanating from the principal-agent relationship.[188] If the third party's reliance is reasonable, then the principal, by virtue of its status as master of the agent, is liable for its agent's unauthorized contracts.[189] As one commentator noted, "[Inherent agency power] would, if broadly applied, substitute the general principle of *respondeat superior* for the more carefully drawn rules of agency law."[190]

Instead of relying on a "power" emanating from the principal-agent relationship, the Third Restatement binds a principal to its agent's unauthorized contracts if the principal placed the agent in a position of power. A position of power is a position that typically endows the agent with the authority to bind the principal to transactions that relate to the agent's duties or apparent scope of authority.[191] The "placement" of the agent in a "defined position" constitutes a manifestation to the third party that the agent holds authority to bind the principal.[192] But remember, the result and consequences are the same under either rule: the third party can bind a principal to a transaction if the third party reasonably believes the agent's position provides for such authority.[193] The similar rationales cause confusion because in cases involving similar facts, some courts apply inherent agency power while others apply apparent authority.[194]

By reducing the number of doctrines that bind a principal to a transaction (and, therefore, the number of assumptions underlying those doctrines), the Third Restatement eliminates needless redundancy and confusion. It also addresses Judge Frank Easterbrook's concern that a party could use inherent agency power to "bootstrap" liability onto a principal who has expressed limitations on an agent's authority to the third party.[195]

Besides steering away from the murky concept of "power," the Third Restatement improves agency law by underscoring the need for a third party's reliance on the agent's authority to be reasonable. Recall that under

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187. *Id.* at 40.

188. *See* RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958) ("A principle which will explain [inherent agency power] cases can be found if it is assumed that a power can exist purely as a product of the agency relation. . . . [S]uch a power is derived solely from the agency relation . . . .").

189. *See id.*

190. Browne v. Maxfield, 663 F. Supp. 1193, 1200 n.6 (E.D. Pa. 1987).

191. *See* BAINBRIDGE, *supra* note 1, at 50-51.

192. RESTATEMENT (THIRD) OF AGENCY § 3.03 cmt. b (Tentative Draft No. 2, Mar. 14, 2001) ("A principal may also make a manifestation by placing an agent in a defined position in an organization or by placing an agent in charge of a transaction or situation.").

193. *See* BAINBRIDGE, *supra* note 1, at 50-51.

194. *Id.*

195. *See* Cange v. Stotler & Co., 826 F.2d 581, 598 (7th Cir. 1987) (Easterbrook, J., concurring).

HeinOnline -- 57 Ala. L. Rev. 1182 2005-2006

the Second Restatement apparent authority stemming from the customary powers associated with an agent's position did not require that the third party actually know what powers typically accompany the position.[196] If the power was there, then the third party's reliance was dubbed reasonable, regardless of the third party's actual knowledge.[197] The Third Restatement requires both custom and the third party's knowledge of the custom.[198] Since a third party cannot reasonably rely on powers she does not know exist, the Third Restatement approach is more reasonable.[199]

Nevertheless, the Third Restatement approach maintains the least-cost-avoider concept—i.e., it places a burden on the principal to select and train agents carefully and to control public perceptions regarding an agent's authority[200]—while confining the principal's liability to those transactions in which the third party reasonably believed the agent was authorized to enter.[201]

C. Expanding Concepts of Tort Law and Contract Law May Justify Expanding the Definition of Manifestation and Eliminating Inherent Agency Power

The Second Restatement used the inherent agency power to fill a perceived gap in contract and tort law liability.[202] But when the transaction involves a disclosed or partially disclosed principal, inherent agency power is an unnecessary gap-filler because contract law has expanded since the Second Restatement's adoption; as a result, the gap in which inherent agency power purported to fill no longer exists.

To determine if two partners assented to a contract, contract law looks to the parties' objective manifestations of intent. When the Second Restatement was drafted, courts took a narrow view of objective manifestation.[203] Because the Second Restatement treats agents as mere extensions of their principals (not as independent actors), the narrow view of objective manifestation espoused by the courts when the Second Restatement was drafted essentially required a principal to issue a direct manifestation to a third party before apparent authority could exist.[204] By contrast, contemporary

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196. BAINBRIDGE, *supra* note 1, at 43 n.33.
197. *Id.*
198. *Id.*
199. *Id.*
200. *See id.* at 51.
201. *See* RESTATEMENT (THIRD) OF AGENCY § 2.03 (Tentative Draft No. 2, Mar. 14, 2001).
202. RESTATEMENT (SECOND) OF AGENCY § 161 cmt. a (1957).
203. *See, e.g.*, LON L. FULLER & MELVIN ARON EISENBERG, BASIC CONTRACT LAW 360-63 (6th ed. 1996) (explaining how classical contract law looked at standardized and objective factors evidencing a party's assent, while modern contract law focuses on more individualized and subjective factors indicating assent, thereby focusing more on the each party's legitimate expectations); *see also* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 1-2, at 28-29 (5th ed. 2000) (explaining the expansion of contract law since the inception of the Uniform Commercial Code).
204. Even where the Second Restatement recognizes that placing a person in a position of recognized authority can be a manifestation, the positions mentioned are authoritative positions like managers and treasurers. *See* RESTATEMENT (SECOND) OF AGENCY § 8 (1958).

HeinOnline -- 57 Ala. L. Rev. 1183 2005-2006

contract law requires courts to examine all of the circumstances surrounding a party's manifestation of intent.[205]

An application of the "surrounding circumstances" approach to the interaction of contract and agency law suggests that inherent agency power is unnecessary. A determination of whether a third party reasonably relied on a disclosed or partially disclosed principal's manifestation can be examined in light of the circumstances surrounding the transaction, without resorting to a gap-filler. The result is that apparent authority can be inferred from the circumstances surrounding the principal's manifestations, thereby addressing the situations that the Second Restatement's drafters, relying on a strict reading of contract law, felt would not be covered by apparent authority under the Second Restatement.[206]

Even if contract law had not filled the gap, the Third Restatement approaches the principal-agent relationship more realistically. Both tort and contract law focus on the conduct of immediate actors.[207] Contract law looks to the parties' manifestations of intent, and tort law examines whether or not a legal duty was breached.[208] Finding a principal liable for the agent's conduct simply because the parties are associated—the Second Restatement's approach—oversimplifies the relationship by neglecting to recognize that an agent may have motivations and interests distinct from the principal or third party.[209] To this end, the Restatement Third's requirement that the principal make some type of manifestation to the third party,[210] coupled with the need for reasonable reliance by the third party,[211] balances the burden to monitor the agent between the principal and third party. The result is that neither party can use the rule of law to shift transaction costs to the other party.

In conclusion, the Third Restatement's approach creates a more workable judicial framework. Given the more frequent use of apparent authority, courts may find it easier to apply apparent authority. Also, because inherent agency power is rarely applied, the practical impact of the Third Restatement's approach will be small. Nevertheless, the removal of inherent agency power is important because it increases agency law's efficiency while addressing Judge Easterbrook's "bootstrapping" concern.[212]

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205. *Cf.* BRIAN A. BLUM, CONTRACTS: EXAMPLES AND EXPLANATIONS 52-53 (2d ed. 2001) (explaining the difference between a strict and relative objective approach).

206. *See* RESTATEMENT (SECOND) OF AGENCY § 161 cmt. a (1958) (stating that inherent agency power is necessary because no contract or tort theory offers a viable ground for holding the principal liable).

207. DeMott, *supra* note 22, at 1038.

208. *Id.*

209. *Id.*

210. *See* RESTATEMENT (THIRD) OF AGENCY §§ 2.03, 3.03 (Tentative Draft No. 2, Mar. 14, 2001).

211. *Id.*

212. *See* Cange v. Stotler & Co., 826 F.2d 581, 598 (7th Cir. 1987) (Easterbrook, J., concurring) (refusing to acknowledge that a third party can escape the fact that he knew of limitation on agent's actual authority by appealing to the agent's inherent authority).

HeinOnline -- 57 Ala. L. Rev. 1184 2005-2006

D. Concerns

Because the absorption of inherent agency power into apparent authority is a new approach, few articles address the subject. Of the articles that do exist, most do not support eliminating inherent agency power. Generally, they share two concerns: (1) that the Third Restatement is making law, not restating law;[213] and (2) that the elimination of inherent agency power will harm third parties.[214] The worries are unjustified. A fair reading of the Third Restatement's definitions of apparent authority and manifestation address both of these concerns.

Taken literally, the elimination of inherent agency power indisputably changes existing law. This raises the concern that any change could lead to unnecessary confusion.[215] Thus, critics view eliminating inherent agency power as an unwarranted and unnecessary change to existing law.[216] This analysis oversimplifies the purpose of a restatement.

A restatement is not a recitation. It is an attempt to provide a unifying rationale for how courts make decisions.[217] The rationale of some cases may be cast aside if a clearer rationale would provide the same result.[218] The goal is to establish the best rule,[219] thereby gaining wide acceptance.[220] A restatement, if widely accepted, provides certainty. So, the Third Restatement's clear definition of manifestation and its accompanying expansion of apparent authority, if taken as an attempt to reconcile cases that disagree over inherent agency authority, is appropriate for a restatement.

Some commentators are also concerned that apparent agency power as defined by the Third Restatement will not protect third parties to the same extent as inherent agency power.[221] The argument proceeds as follows: (1) the Third Restatement claims to eliminate the need for inherent agency power by "broadening" the scope of principal actions that constitute a "manifestation" sufficient to create apparent authority;[222] (2) the definition of apparent authority based on customary powers (as outlined by the Second Restatement) treats nonverbal communications and appointments to a position of authority as a manifestation from the principal to a third party;[223]

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213. *See, e.g.*, Ward, *supra* note 52.
214. *See, e.g.*, *id.*
215. *Id.* at 1627.
216. *Id.*
217. Kornelia Dormire, *Inherent Agency Power: A Modest Proposal for the Restatement (Third) of Agency*, 5 J. SMALL & EMERGING BUS. L. 243, 243 (2001).
218. *Id.* at 247.
219. *See id.*
220. *Id.*
221. Ward, *supra* note 52, at 1600.
222. *Id.* at 1599 ("Rather than retain inherent agency, the reporter instead attempts to expand the definition of 'manifestation' for apparent authority purposes to include situations without verbal communications, such as appointments of agents to certain positions." (citing RESTATEMENT (THIRD) OF AGENCY, at xiii, xvi (Tentative Draft No. 1, 2000))).
223. *Id.*

HeinOnline -- 57 Ala. L. Rev. 1185 2005-2006

therefore, (3) the Third Restatement's "expansions" of apparent authority effect no real change in the scope of apparent authority.[224]

Consequently, since the Second Restatement's version of inherent agency power requires no manifestation to hold a principal responsible for an agent's acts,[225] but a manifestation from a principal to a third party is required to find apparent authority,[226] eliminating inherent agency power strips protections currently available to third parties who have not received a direct manifestation from the principal and who have reasonably relied on an unauthorized agent's representations of authority.[227]

The case of *Croisant v. Watrud*[228] illustrates this argument. In *Croisant*, the principal was an accounting firm. The agent was a partner in the firm, and the third party was a client.[229] The client initially engaged the firm for income tax counseling and preparation. But, when the client sold her business, the agent collected payments on the sale, made disbursements from the client's account, kept financial records, and prepared tax returns.[230] The client received all of these services from the agent; none of the firm's other partners or employees advised the client.[231] The agent made unauthorized payments from the client's account, including one payment to himself. When the agent died in a hunting accident, the client sought to hold the agent's accounting firm liable for the misappropriated funds.[232] Although the partnership never approved the non-tax related services, it did collect payment for them.[233]

Since the partnership never expressly approved any services other than tax preparation, and it never approved of the unauthorized disbursements, no actual authority existed.[234] The court did not find apparent authority based on customary powers because it lacked sufficient information to determine whether the collection and disbursement arrangement was common in the accounting profession.[235] Instead, the court imposed liability on the basis of inherent agency power because (1) the acts in question were a continuance of prior accounting services, (2) the services gave rise to a trust relationship, and (3) the agent had done nothing to convey a lack of authority to the third party.[236] One critic of the Third Restatement argues that the new approach would change the outcome in *Croisant* because the principal made no manifestation that the agent could assume the non-tax related du-

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224. *Id.* at 1599-1600.
225. *Id.* at 1600.
226. *Id.* at 1598-1601.
227. *Id.* at 1601.
228. 432 P.2d 799 (Or. 1967).
229. *Id.* at 800.
230. *Id.* at 800-01.
231. *Id.* at 800.
232. *Id.*
233. *Id.* at 801.
234. Ward, *supra* note 52, at 1608.
235. *Croisant*, 432 P.2d at 802.
236. Ward, *supra* note 52, at 1608.

HeinOnline -- 57 Ala. L. Rev. 1186 2005-2006

ties and there was no evidence that these duties were commonly performed by accounting firms in the area.[237] Hence, the Third Restatement's manifestation requirement would torpedo the plaintiff's claim.

The Restatement Third explicitly addresses this situation. The comments to section 3.03 state that "[a] third party may reasonably believe that the partnership has acquiesced or consented to a partner's expansion of the nature of 'the business of the partnership' if the third party observes dealings or a pattern of conduct between the individual partner and the partnership supportive of that belief."[238] Applying the Third Restatement version of apparent authority, the accounting partnership in *Watrud* would be liable for the agent's actions under a theory of apparent authority because it acquiesced to the additional services because the acquiescence would function as a manifestation.[239]

IV. CONCLUSION

The Reporter for the Third Restatement acknowledges that the Second Restatement uses inherent agency power to protect third parties who deal through agents.[240] But, as the Reporter also notes, this characterization is incomplete. Accordingly, the Third Restatement incorporates the notion that agency law recognizes the rights of both third parties and principals.[241] Both parties benefit from the agent's services and have enforceable rights stemming from agent-brokered transactions.[242] Because agency law protects both principals and third parties, the rationale for inherent agency power is questionable, and folding the doctrine into apparent authority trims transaction costs for both principals and agents.[243] Because all types of authority grant equally enforceable rights, the shift to apparent authority will still "protect third parties when a disclosed agent's assertion of authority is plausible in light of the agent's evident position or prior relationship with the third party."[244] Thus, the reasonable expectations of both third parties and principals will be protected.

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237. *Id.* at 1601.
238. RESTATEMENT (THIRD) OF AGENCY § 3.03 cmt. e(2) (Tentative Draft No. 2, Mar. 14, 2001).
239. The Third Restatement not only addresses this situation, but it also uses the situation as an example of applying apparent agency. *See* RESTATEMENT (THIRD) OF AGENCY § 3.03 illus. 8 (Tentative Draft No. 2, Mar. 14, 2001) ("A, a partner in P, an accounting firm, regularly prepares tax returns for T, who receives bills from P for A's services. At T's request, A agrees to collect accounts receivable and make cash disbursements for businesses owned by T. Accountants do not ordinarily perform such work for clients. T receives bills from P, prepared by P's central billing office, that include a specifically itemized charge for A's collection and disbursement work. A disburses cash to persons to whom T does not owe money. P is liable to T for loss caused T by A. It is reasonable for T to believe that P has authorized A to undertake the work in the course of P's business.").
240. Demott, *supra* note 22, at 1048.
241. *Id.*
242. *Id*
243. *Id.*
244. *Id.* at 1047.

HeinOnline -- 57 Ala. L. Rev. 1187 2005-2006

In the end, supporters of inherent agency power either fail to appreciate the broad definitions of apparent agency and manifestation as outlined by the Third Restatement, or they do not trust that courts will apply them correctly. Nevertheless, the broadened definitions allow courts to stretch the doctrine of apparent authority enough to protect third parties, while eliminating the problems "inherent" to inherent agency power.

Thomas A. Simpson

HeinOnline -- 57 Ala. L. Rev. 1188 2005-2006