

Principal's Contract Liability

by Sophia



WHAT'S COVERED

In this lesson, you will learn how a principal can be held liable for contracts made by an agent. Specifically, this lesson will cover:

1. Role of Authority in Determining Liability

When the agent makes a contract for his principal or commits a tort in the course of his work, is the principal liable?

The key to determining whether a principal is liable for contracts made by his agent is authority: Was the agent authorized to negotiate the agreement and close the deal?

➞ **EXAMPLE** Obviously, it would not be sensible to hold a contractor liable to pay for a whole load of lumber merely because a stranger wandered into the lumberyard saying, “I’m an agent for ABC Contractors; charge this to their account.”

To be liable, the principal must have authorized the agent in some manner to act on his behalf, and that authorization must be communicated to the third party by the principal.

2. Types of Authority

There are three types of authority:

- Express
- Implied
- Apparent

We will consider each in turn.

2a. Express Authority

The strongest form of authority is that which is expressly granted, often in written form. The principal consents to the agent’s actions, and the third party may then rely on the document attesting to the agent’s authority to deal on behalf of the principal.

One common form of **express authority** is the standard signature card on file with banks allowing corporate

agents to write checks on the company's credit. The principal bears the risk of any wrongful action of his agent.

CASE STUDY: *Allen A. Funt Productions, Inc. v. Chemical Bank*

Allen Funt (1914–99) was an American television producer, director, and writer, best known as the creator and host of *Candid Camera* from the 1940s to 1980s, which was broadcast as either a regular show or a series of specials. Its most notable run was from 1960 to 1967 on CBS. In fact, for several years the accountant embezzled money from the company by writing checks to himself and depositing them in his own account. The company sued its bank, charging it with negligence, apparently for failing to monitor the amount of money taken by the accountant.

But the court dismissed the negligence complaint, citing a state statute based on the common-law agency principle that a third party is entitled to rely on the express authorization given to an agent; in this case, the accountant drew checks on the account within the monetary limits contained in the signature cards on file with the bank.

Allen A. Funt Productions, Inc. v. Chemical Bank, 405 N.Y.S.2d 94 (1978).

Letters of introduction and work orders are other types of express authority.



TERM TO KNOW

Express Authority

Authority given to an agent that is directly granted in clear terms.

2b. Implied Authority

Not every detail of an agent's work can be spelled out. It is impossible to delineate step-by-step the duties of a general agent; at best, a principal can set forth only the general nature of the duties that the agent is to perform.

Even a special agent's duties are difficult to describe in such detail as to leave him without discretion. If express authority were the only valid kind, there would be no efficient way to use an agent, both because the effort to describe the duties would be too great and because the third party would be reluctant to deal with him.

But the law permits authority to be "implied" by the relationship of the parties, the nature and customs of the business, the circumstances surrounding the act in question, the wording of the agency contract, and the knowledge that the agent has of facts relevant to the assignment.

The general rule is that the agent has implied or "incidental" authority to perform acts incidental to or reasonably necessary to carrying out the transaction.

➞ **EXAMPLE** If a principal instructs her agent to "deposit a check in the bank today," the agent has the authority to drive to the bank unless the principal specifically prohibits the agent from doing so.

The theory of **implied authority** is especially important to business in the realm of the business manager, who may be charged with running the entire business operation or only a small part of it. In either event, the business manager has a relatively large domain of implied authority. He can buy goods and services; hire, supervise, and fire employees; sell or junk inventory; take in receipts and pay debts; and in general, direct the

ordinary operations of the business.

The full extent of the manager's authority depends on the circumstances— what is **customary** in the particular industry, in the particular business, and among the individuals directly concerned.

On the other hand, a manager does not have implicit authority to undertake unusual or extraordinary actions on behalf of his principal. In the absence of express permission, an agent may not sell part of the business, start a new business, change the nature of the business, incur debt (unless borrowing is integral to the business, as in banking, for example), or move the business premises.

➞ **EXAMPLE** The owner of a hotel appoints Andy as manager; Andy decides to rename the hotel and commissions an artist to prepare a new logo for the hotel's stationery. Andy has no implied authority to change the name or to commission the artist, though he does have implied authority to engage a printer to replenish the stationery supply— and possibly to make some design changes in the letterhead.

Even when there is no implied authority, in an emergency the agent may act in ways that would in the normal course require specific permission from the principal. If unforeseen circumstances arise and it is impracticable to communicate with the principal to find out what his wishes would be, the agent may do what is reasonably necessary in order to prevent substantial loss to his principal.

CASE STUDY: *G. H. Mumm Champagne v. Eastern Wine Corp.*

During World War II, Eastern Wine Corporation marketed champagne in a bottle with a diagonal red stripe that infringed upon the trademark of a French producer. The French company had granted licenses to an American importer to market its champagne in the United States. The contract between producer and importer required the latter to notify the French company whenever a competitor appeared to be infringing upon its rights and to recommend steps by which the company could stop the infringement. The authority to institute suit was not expressly conferred, and ordinarily the right to do so would not be inferred.

Because France was under German occupation, however, the importer was unable to communicate with the producer, its principal. The court held that the importer could file suit to enjoin Eastern Wine from continuing to display the infringing red diagonal stripe, since legal action was “essential to the preservation of the principal's property.”

G. H. Mumm Champagne v. Eastern Wine Corp., 52 F.Supp. 167 (S.D.N.Y. 1943).

The rule that a person's position can carry with it implied authority is fundamental to American business practice. But outside the United States, this rule is not applicable, and the business executive traveling abroad should be aware that it is customary in civil-law countries to present proof of authority to transact corporate business— usually in the form of a power of attorney.

This is not always an easy task. Not only must the power of the traveling executive be shown, but the right of the corporate officer back in the United States to delegate authority must also be proven.



TERMS TO KNOW

Implied Authority

A part of the actual authority of an agent that includes doing what is necessary to accomplish the agent's responsibilities.

Customary

A description of business practices and usage that are considered normal, ordinary, and habitual.

2c. Apparent Authority

In the agency relationship, the agent's actions in dealing with third parties will affect the legal rights of the principal. What the third party knows about the agency agreement is irrelevant to the agent's legal authority to act.

That authority runs from principal to agent. As long as an agent has authorization, either express or implied, she may bind the principal legally.

➔ **EXAMPLE** The seller of a house may be ignorant of the buyer's true identity; the person he supposes to be the prospective purchaser might be the agent of an **undisclosed principal**.

Nevertheless, if the agent is authorized to make the purchase, the seller's ignorance is not a ground for either seller or principal to void the deal.

But if a person has no authority to act as an agent, or an agent has no authority to act in a particular way, is the principal free from all consequences? The answer depends on whether or not the agent has apparent authority— that is, on whether or not the third person reasonably believes from the principal's words, written or spoken, or from his conduct that he has in fact consented to the agent's actions.

Apparent authority is a manifestation of authority communicated to the third person; it runs from principal to third party, not to the agent. Apparent authority is sometimes said to be based on the principle of **estoppel**. Estoppel is the doctrine that a person will not now be allowed to deny a promise or assertion she previously made where there has been detrimental reliance on that promise or assertion.

Estoppel is commonly used to avoid injustice. It may be a substitute for the requirement of consideration in contract (making the promise of a gift enforceable where the donee has relied upon the promise), and it is sometimes available to circumvent the requirement of a writing under the Statute of Frauds.

Consider what the Restatement (Third) of Agency states in Section 2.05:

§ 2.05 Estoppel to Deny Existence of Agency Relationship

"A person who has not made a manifestation that an actor has authority as an agent and who is not otherwise liable as a party to a transaction purportedly done by the actor on that person's account is subject to liability to a third party who justifiably is induced to make a detrimental change in position because the transaction is believed to be on the person's account, if:

1. the person intentionally or carelessly caused such belief, or
2. having notice of such belief and that it might induce others to change their positions, the person did not take reasonable steps to notify them of the facts."

Apparent authority can also arise from prior business transactions.

CASE STUDY: *Meggs v. Central Supply Co.*

On July 10, 1974, Meggs sold to Buyer his business, the right to use the trade name Rose City Sheet Metal Works, and a list of suppliers he had used. Three days later, Buyer began ordering supplies from Central Supply Company, which was on Meggs's list but with which Meggs had last dealt four years before. On September 3, Central received a letter from Meggs notifying it of Meggs's sale of the business to Buyer. Buyer failed to pay Central, which sued Meggs. The court held that Rose City Sheet Metal Works had apparent authority to buy on Meggs's credit; Meggs was liable for supplies purchased between July 10 and September 3.

Meggs v. Central Supply Co., 307 N.E.2d 288 (Ind. App. 1974).

In such cases, and in cases involving the firing of a general manager, actual notice should be given promptly to all customers.



TERMS TO KNOW

Undisclosed Principal

A principal unknown to a third party at the time that a transaction is conducted by the principal through an agent.

Apparent Authority

Authority that an agent has as communicated by the principal, or authority that a reasonable person using diligence and sound discretion would assume the agent to have.

Estoppel

A doctrine stating that a person will not be allowed to deny a previously made promise or assertion when there has been detrimental reliance on that promise or assertion.

3. Ratification

Even if the agent possessed no actual authority and there was no apparent authority on which the third person could rely, the principal may still be liable if he ratifies or adopts the agent's acts before the third person withdraws from the contract.

Ratification usually relates back to the time of the undertaking, creating authority after the fact as though it had been established initially. Ratification is a voluntary act by the principal. Faced with the results of action purportedly done on his behalf but without authorization and through no fault of his own, he may affirm or disavow them as he chooses.

To ratify, the principal may tell the parties concerned or by his conduct manifest that he is willing to accept the results as though the act were authorized. Or by his silence, he may find under certain circumstances that he has ratified.

Note that ratification does not require the usual consideration of contract law. The principal does not need to be promised anything extra for his decision to affirm to be binding on him. Nor does ratification depend on the position of the third party; for instance, a loss stemming from the party's reliance on the agent's representations is not required.

In most situations, ratification leaves the parties where they expected to be, correcting the agent's errors harmlessly and giving each party what was expected.



TERM TO KNOW

Ratification

The confirmation or adoption by the principal of a previous act done by the agent, even if, when such act was done, it was not legally binding.



SUMMARY

In this lesson, you learned about the **role of authority in determining liability**. The principal is liable on an agent's contract only if the agent was authorized by the principal to make the contract. The three **types of authority** are express, implied, or apparent.

Express authority is granted in oral or written words. **Implied authority** means the agent has authority to perform acts incidental or reasonably necessary to carrying out the transaction for which he or she has express authority. **Apparent authority** arises where the principal gives the third party reason to believe that the agent had authority. The reasonableness of the third party's belief is based on the circumstances. Even if the agent has no authority, the principal may still be liable if he or she **ratifies the contract** made by the agent.

Best of luck with your learning!

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