

Community College of Rhode Island

Law of Business Organizations

Instructor: Dr. Daniel J. Donovan

THE LAW OF AGENCY

Introduction

To understand the present law dealing with agency and business organizations, some understanding of the origin and development of the law is helpful and perhaps necessary. The system of laws in the United States is based upon the law that the 13 original English colonies brought with them. Modern English legal history started with the Norman Conquest in the year 1066 and the law developed slowly as society and the economy grew and changed. This is generally referred to as the Common Law of England and this law is still with us today unless changed by judicial decisions or through legislative action.

Law of Agency In General: The law of agency generally concerns itself with the legal ramifications of one person working for another. These legal ramifications may include duties and responsibilities between the persons, but are more frequently concerned with the legal ramifications when third persons are involved. When can a business (or the owners of the business) be liable to a third person for the torts (civil wrongs that cause damage or injury) that are committed by a person who works for the business? When is the business bound by or liable on contracts (legally enforceable agreements) that a person who works for the business makes with a third person? These are the primary questions that arise under the law of agency. The terms used in the law of agency can be confusing, especially since courts and legal writers can use a term broadly or narrowly without alerting you to the change in how a term is used. Hopefully, by the end of this introduction, you will be able to deal with the concepts involved without getting confused by the terminology.

Although this course is a study of the law relating to "business organizations", one cannot thoroughly understand how business organizations work without understanding the law of agency. The

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three major forms of business organizations are the sole proprietorship, the partnership, and the corporation. The corporation is a legal entity which essentially exists only on paper until natural individuals organize and operate it. A corporation can only act through agents and in no other way. A partnership is a combination of two or more owners. Under partnership law, each partner is an agent of the other partners. Some courts have said that partnership law itself is just a branch of the law of agency, but whether that it is true or not, certainly agency law is an important part of any study of partnerships. The sole proprietor may be the only business form in which agency is not an integral part, but once the sole proprietor starts to expand his or her business beyond what they are capable of accomplishing by their own efforts, the law of agency enters the picture. And, even if the sole proprietor never expands, he or she must deal with other business organizations which more than likely will be operating through agents.

Master and Servant: The first relationship for which the law recognized that one person may be liable for the torts of another person was that of master and servant, where the servant was working for a lord or other noble in the lord's personal household. Since these personal servants could come into contact with the public and cause physical injury to other people or damage to property, the common law early on had to address the problem of liability. In most cases the "servant" did not have the financial means to compensate the injured party for the loss that he or she caused. Initially, the law found the master liable only for torts that the master had actually commanded the servant to commit. Later, however, this liability was expanded to include the negligent torts of the servant (accidental injury or damage). The theory behind making the master liable for torts of his servant was known as "**respondeat superior**" (let the master answer). This theory was based upon the fact that the master could control the physical conduct or activities of his servant. Therefore, the master who controls the physical conduct should be liable for the physical damage or injury caused by the servant. Another name for this liability of the master is "**vicarious liability**", by which a person may be liable to a third person due to a relationship and not because that person was personally at fault or did something wrong.

As society progressed and the economy moved from one based primarily on agriculture to one comprising other types of businesses, the master employed his personal servants in the operation of the business as well as the home. When questions of liability arose out of this "business" servant performing tasks (making a delivery, for example) that caused a physical injury or damage, the law applied the same rules as it had applied when the tasks of the servant were personal to the master. The master, now a proprietor, was liable for his business servant's torts on the same basis as before - **the master had control of the physical conduct or activities of the servant.**

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Scope of Employment: Later on in history, the persons working in the businesses were no longer personal servants who were simply moved over to the shop or store, but were persons having lives independent of the master. To determine the liability of this servant, the law had to distinguish now when this business servant's activities would make the master liable and when it would not. The concept of "**scope of employment**" developed to deal with this change in society. This new concept meant that first it must be determined that a person was the servant of another, and second whether, at the time of the tort was committed, was the person acting within the "scope" of his or her employment. If both these questions were answered in the affirmative, then the master was liable to the third party for the tort.

Liability for Intentional Torts: The courts were able to fairly easily apply the doctrine of vicarious liability when the torts involved were so-called "negligent" torts, that is when the servant accidentally injured a third party or damaged someone else's property. The courts had a harder time dealing with the area of what is called "willful" or "intentional" torts, whereby the injury is done on purpose and not accidentally. At first, the common law courts did not hold the master liable for such intentional torts such as assault on a person or willful destruction of property. But eventually the courts focused on the reason the tort was committed as a basis for liability. If the intentional tort was committed for personal reasons of the servant, such as personal grudge between the servant and a person the servant came in contact with, the master was not held liable for the tort. If, however, the servant thought that he or she was furthering the master's business by committing the tort, then the master was held liable. Common situations in which a master could be liable for the intentional torts (usually assaults) of the servant are bouncers in nightclubs and persons employed to repossess property such as cars.

Employer and Employee: In general usage today we have abandoned the terms "master" and "servant" and substituted the terms "employer" and "employee", but the concepts remain essentially the same. The modern day employer does not have the same kind of control over the physical activities that the old English master had, but the question comes down to whether the employer has control over, or at least a right to control, the physical activities of the employee. Some legal texts and some courts still use the old terms "master" and "servant" when dealing with the issue of whether an employer is liable to a third party for the torts of the employee. This staying with this old, archaic terminology is partly due to the conservative traditional nature of the law, but is also due to the fact the word "employee" as used in many federal and state statutes today (for example, workers' compensation laws or the Internal Revenue Code) may be much broader than the old common law "servant".

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Employer and Independent Contractors: In the course of history, some business servants developed a great deal of expertise and skill, and they started to work for more than one master. The law then had to address the question of whether these types of persons would make the master liable under the doctrine of vicarious liability. In response to this development, the law created a new category of persons known as "independent contractors". The distinction made between "servants" and "independent contractors" was based upon the reason behind the master's liability in the first place - the control of the physical activities of the servant by the master. The law thus recognized that one person could still be employed by another, but not be subject to the control of his or her physical conduct by the employer. The **control of the employer over the independent contractor was in the area of results** only and not how the results were obtained. In the relationship of employer and independent contractor then, the rule was applied that an employer was not liable for the torts of an independent contractor. In time, however, courts felt it necessary to carve out exceptions to this rule. Two primary exceptions still alive today involve situations where the work for which the independent contractor is hired is considered "inherently dangerous" and where the employer is under a legal duty or obligation to perform the work for which the independent contractor is hired.

Principal and Agent: As the economy of England continued to change, more trading took place with other nations and merchants would appoint traders to take their goods for sale throughout the Mediterranean Sea and attend various "trading fairs" that would be held in continental Europe. The English common law did not yet recognize that one person could appoint another to make contracts on behalf of the first person, but this was what was taking place at these trading fairs. The merchants and traders involved in this new economy wanted to make the system work, despite the lack of recognition in the common law for what they were doing. Starting in Europe and eventually spreading to England, the merchants started to hold their own courts at these "fairs" to resolve disputes. The law that was applied at these merchant courts became known as the "**law merchant**" and this law recognized that one person could contract on behalf of another. The terms used for this relationship were "principal" and "agent". The word "agent" comes from the Latin word "agere" which means "to act for".

In determining whether a principal would be liable on the contracts made by an agent, the law merchant used the concept of "**authority**". Such an agent under the law merchant was a person who had authority to act on behalf of another. Recognizing that there were a number of different acts for which an agent could be authorized or given power to conduct by the principal, the law merchant also developed the concept of "**scope of authority**" (similar to the development of scope of employment), and held that a principal was liable on contracts made by an agent with a third party when the agent was acting within the scope of his or her authority. Since this authority had to come from the principal, the

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burden was placed on the third party suing under a contract to prove that the agent in fact had authority from the principal to make the contract.

Merger of Common Law and Law Merchant: As the activities and the power of the merchant courts grew, the common law courts of the English government decided to take over the disputes that had been previously decided at these courts and make them part of the common law of England. Instead of starting from scratch in developing this new part of the common law, the English courts simply borrowed the terminology and concepts developed by the law merchant and merged them in with the old common law concepts involving master and servant. Both parts are now generally studied together and considered parts of the law of agency, but the separate origins of the two parts of the law still shows up today in the terminology used and concepts applied. For the most part, when the question to be answered involves an issue of torts, the common law rules of master and servant are applied. When the question to be answered involves an issue of contracts, then the law merchant rules of principal and agent are applied.

There has been some mixing of the two basic concepts, but essentially they remain the same today as they were hundreds of years ago. Modern law has recognized that there are some torts not involving physical injury or damage for which a principal should be held liable. Thus a court today might find a principal liable for torts involving fraud or misrepresentation that are committed by an agent who does not meet the definition of a common law servant. In addition, we have recognized that there are some agents who may not have authority to enter into contracts on behalf of a principal, but have some lesser "authority" in dealing with third persons that may affect the principal's relationship or liability.

There are three basic relationship that came out of the history that has just been covered: master and servant (employer and employee); employer and independent contractor; and principal and agent. An employee (one subject to control of his or her physical activities) may in fact be an agent, and in many cases employees do have some authority to bind an employer. Obviously the chief executive officer of a corporation (who is an employee subject to the control of the Board of Directors) would have a great deal of authority, whereas a janitor would have little (charging janitorial supplies perhaps) or no authority to bind his employer. An independent contractor on the other hand is by definition the opposite of an employee, so one could not be an employee and an independent contractor at one and the same time. However, an independent contractor, although not an employee, may or may not be an agent in the sense that he or she has authority to bind the employer to a contract of some nature.

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Different Uses of the Label "Agent": Because of the merger of the common law and the law merchant as previously mentioned, writers in the law and courts will frequently use the word "agent" in different ways and this can lead to confusion on the part of the reader of a text or court decision who is not aware of a shift in the way the word is used. Basically, there are three ways in which the word "agent" is used. The broadest use of the term "agent" is when it is used to mean any person who works for another (servant, independent contractor, or contracting agent). Thus a court decision or legal text may use the word "agent" when discussing the liability of a principal for the physical torts (whether negligent or intentional) of another, which historically came under the category of master and servant.

The most specific use of the term "agent" is when it is used to mean only someone who has authority to bind the principal to a contract with a third party. This is the way the term was first used in the law merchant and hinges on the concept of authority. This is sometimes called a **“contracting agent.”** A third and intermediate way in which the term "agent" is used comes about when the writer means a person who represents another with third persons, but not necessarily those who have authority to make contracts. This use of the term would exclude mere employees and independent contractors who have no authority whatsoever to deal with third persons, but would include persons who may represent a principal with the public but have no authority to bind the principal to a contract. This intermediate use of the term "agent" would also include all **“soliciting agents”** who can deal with the public by taking orders and offers, but can not make the actual contract.

Real estate agents are one example of a soliciting agent, since the real estate agent must submit any offers to buy to the seller who alone can enter into the contract to sell the real estate. Frequently insurance agents are only soliciting agents who take insurance applications, but have no authority to "bind" the insurance coverage. People like lawyers and accountants also come within this intermediate use of the term "agent" since they do not have authority to enter into contracts on behalf of the principal, but they usually do have some "authority" to deal with the public or third parties on behalf of the principal, and thus may affect their principal's liability to third persons by statements or representations made. For example, a statement made by a lawyer in a court document may be held to be an "admission" of the client and thus affect the results of the client's litigation, or representations by a real estate agent as to the boundaries of a piece of property being sold may later subject the seller to liability if the boundaries are not as represented. In conclusion, if a person is aware of the various ways in which the word "agent" may be used (as it often is in the business law textbook), the reader is less likely to be misled by labels and can look behind the labels to the legal concepts that are being applied.