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A LENDER'S LIABILITY FOR AGENT MISDEEDS

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"The rich ruleth over the poor; and the borrower is servant to him that lendeth."¹

I. Introduction

One of the fastest growing areas of litigation in the 1980s was lender liability.² During that decade, borrowers and third-party creditors began relying upon securities law and other statutory remedies to recover damages they suffered as a result of lender miscon-
duct. When statutory remedies were not available, borrowers and third-party creditors turned to common law theories to hold lenders liable.

A. Common Law Theories

Many common law theories were developed and applied in the area of lender liability. These theories included breach of contract, breach of fiduciary duty, breach of duty of good faith and fair dealing, actual fraud, constructive fraud, duress, tortious interference.
with contractual and business relations,\textsuperscript{10} negligent misrepresentation,\textsuperscript{11} and excessive control.\textsuperscript{12}

This article discusses the use of agency principles\textsuperscript{13} in the context of two of these common law actions by a borrower against its lender. Specifically, the article analyzes the law of interference—particularly interference with corporate governance, the newest theory of lender liability\textsuperscript{14}—and excessive control, which is often styled as an action for equitable subordination.\textsuperscript{15} The article advocates an approach to interference and control liability that would provide a remedy to a borrower for damages suffered as a result of a lender’s wrongful interference and control of the borrower. These theories have been applied through the use of ordinary “tort analysis.”\textsuperscript{16} In other words, a lender would be liable to a borrower for interference and control if the lender takes some action from which it is reasonably foreseeable that damage will result.\textsuperscript{17}

This article explores the concept of holding a lender vicariously liable for the acts of individuals who further the aims of the lender.

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\textsuperscript{10} Melamed v. Lake County Nat’l Bank, 727 F.2d 1399, 1403 (6th Cir. 1984); \textit{State Nat’l Bank}, 678 S.W.2d at 698.


\textsuperscript{13} Agency is defined in the Restatement as “the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.” \textit{Restatement (Second) of Agency} § 1(1) (1958). ‘Agency’ is a consensual, fiduciary relationship between two legal entities created by law by which the principal has the right to control the conduct of the agent and the agent has the power to effect the legal relations of the principal.” 1 I.L.P. \textit{Agency} § 2 (1988) (citing Gunther v. Commonwealth Edison Co., 467 N.E.2d 1104 (Ill. App. Ct. 1984); Milwaukee Mut. Ins. Co. v. Wessels, 449 N.E.2d 897 (Ill. App. Ct. 1983)). The word “agent” comes from the Latin verb “ago, agere” and the noun “agens, agentis,” which means one who acts, a doer, force or power that accomplishes things. \textit{Harold G. Reuschlein & William A. Gregory, Agency and Partnership} 1 (1979).

\textsuperscript{14} Agency theory is intended to “enable a person, through the services of another, to broaden the scope of his activities and receive the product of another’s efforts, paying such other for what he does but retaining for himself any net benefit resulting from the work performed.” \textit{Id.}

\textsuperscript{15} \textit{See infra} text accompanying notes 19-29.

\textsuperscript{16} \textit{See infra} text accompanying notes 31-33.

through some misconduct that results in damage to the borrower. In doing so, the article scrutinizes the law of agency and provides new definitions of several key terms. It is suggested that the reason agency concepts have not often been applied in lender liability cases is that the courts are frequently confused about the terms “master,” “servant,” “independent contractor,” and “nonservant agent.”

By categorizing and defining when an individual falls into one of these categories, the theories of lender liability based upon interference and control become much simpler to apply and are more fair to both the lender and the borrower.

1. Interference

Interference with contractual relations is a common law tort theory that has existed since at least the First Restatement of Torts. A newer breed of this tort is tortious interference with corporate governance. Both actions may provide a basis for the application of agency principles if a lender “interferes” by “placing” an agent in the borrower’s operations.

   a. Tortious Interference with Contractual Relations

The Restatement (Second) of Torts defines the four elements of an action sounding in tortious interference with contractual relations. First, there must be a valid contract that is subject to interference. Second, there must be a willful and intentional act of interference. Third, the act must proximately cause the plaintiff some damage. And fourth, the plaintiff must suffer some actual loss or damage. Interference may be justified under certain circumstances, but there is no absolute privilege to interfere with another’s contractual relations. Privilege exists only when there is a legitimate economic

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19. Restatement of Torts § 766 (1939); see also Fowler V. Harper, Interference with Contractual Relations, 47 Nw. U. L. Rev. 873 (1953); Charles E. Carpenter, Interference with Contractual Relations, 41 Harv. L. Rev. 728 (1928).
21. Id. at 684.
22. Restatement (Second) of Torts § 766A (1979).
23. Id.
24. See id. § 767 (including a disinterested desire to protect the obligor, an act done in order to further public morality, and an attorney advising a firm to breach an existing contract).
25. See Frank Colson, Inc. v. General Motors Corp., 488 F.2d 202, 206 (5th Cir. 1974).
interest that can only be protected by the particular interference. In addition, the assertion of privilege requires the interfering party to act fairly.

b. Tortious Interference with Corporate Governance

While tortious interference with a contract or contractual relations usually involves interference by a defendant with a relationship between a plaintiff and a third party, tortious interference with corporate governance applies when a lender interferes directly with the management and control of a borrower's business operation. The concept of direct interference with a borrower's business was developed in the case of *State National Bank v. Farah Manufacturing Co.*

This new tort is further examined in this article. Special emphasis will be placed on the role that agency law and *respondeat superior* play in alleging interference with corporate governance by a lender.

2. Excessive Control

Excessive control of a borrower by its lender is not a tort per se. Rather, lenders have been sued upon theories which allege that the borrower became the mere instrumentality or alter ego of the lender. These cases are often filed by other creditors of the borrower who argue that certain debts should be subordinated to others. Usually

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27. See, e.g., Services, Inc. v. Control Data Corp., 759 F.2d 1241, 1249 (5th Cir. 1985) (requiring fair competition even when privilege is claimed).

28. E.g., *Restatement (Second) of Torts* § 766. The Restatement provides:

One who intentionally and improperly interferes with the performance of a contract . . . between another and a third person by inducing or otherwise causing the third person not to perform the contract, is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to perform the contract.

*Id.*


30. See discussion infra part III.A.

such a case involves a lawsuit by another creditor who has been frustrated in its attempt to collect from the debtor. These cases are described as equitable subordination cases.

This article, however, is directed at something different. The factual scenario discussed here involves a lender who forces certain personnel upon the borrower. These individuals are selected by the lender and cause damage to the borrower’s business. The borrower complains that such control over it by the lender is wrongful and that the lender is liable for the damage caused by the personnel forced upon the borrower. Once again, agency law will be key to holding the lender responsible.

B. The Need for the Application of Agency Principles to Lender Liability

While many would argue that the world contains too many theories of lender liability already, there are circumstances under which lender misconduct may not be actionable without an application of agency principles. In the hypothetical that follows, without the application of agency principles, the borrower is left with a much weaker case and depending upon the jurisdiction, is not likely to recover. However, if the hypothetical borrower can successfully argue that the lender controlled and interfered with the borrower’s business through the lender’s agents, the lender may be held liable by the doctrine of respondeat superior under the definitions and concepts provided in this article.

C. A Hypothetical Problem

Suppose a lender has made a sizable loan to a developer for the construction of a hotel. The developer hires a general contractor and

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33. See, e.g., Pepper v. Litton, 308 U.S. 295 (1939); In re Mobile Steel Co., 563 F.2d 692, (5th Cir. 1977).
34. See, e.g., Swartz, supra note 2, at 1A.
begins the project. For a time, everything is fine, and the lender promptly funds each draw requested by the developer. At some point, the project falls behind schedule. Construction delay is typically a technical event of default as defined in most loan agreements. The developer may also fail to provide updated financial statements, another event of default under most construction loan agreements.

The lender, feeling insecure (whether reasonable or not), informs the borrower that it is dissatisfied with the present management of the project. It points out that the loan is technically in default and threatens to foreclose the property unless the borrower agrees to hire a specified individual in a high-ranking capacity, such as Chief Financial Officer. This individual is to have complete authority over the project. The borrower, afraid now that the project may be lost if it does not comply, hires the identified individual, with the lender actively participating in the negotiation of the employment contract. The individual essentially takes over the project.

The individual does not receive any remuneration from the lender. His or her salary and benefits are paid by the borrower. Of course, this salary is covered by the borrower’s draw requests, which are funded by the lender. That is, if the loan does not fund, no employee of the borrower gets paid. The new-hire does not speak with the lender on a daily basis and in general, attempts to run the project in a profitable manner. Nevertheless, the individual makes decisions that result in mechanic’s liens and lawsuits being filed against the borrower and other resultant defaults. The lender eventually decides that it has had enough, accelerates all outstanding monies to be immediately due and owing, and files a foreclosure action. The borrower wishes to counterclaim under some type of lender liability theory for the lender’s seemingly wrongful interference and excessive control. How the issues in this hypothetical would be resolved is unclear under the present agency precedents. Agency law is archaic—with nary a treatise written in almost thirty years—and, due to numerous convoluted opinions, agency law seems unable to maintain precise definitions or enable one to predict legal outcomes with any certainty.

This article advocates a simple solidification of these slippery


definitions and concepts, with the result that the above hypothetical could be easily resolved by a factfinder. Quite simply, the individual selected by the bank may be the lender's agent. If the individual is the agent of the lender, he or she may further be a servant, a nonservant, or a nonservant-independent contractor. The individual may also be an independent contractor who bears no agency relationship to the lender. The decision of which category to place the individual in will depend upon the amount of control the lender exercises over the individual at the inception of the relationship. Liability will then be imputed to the lender through the concept of vicarious liability, depending upon the precise nature of the wrongdoing engaged in by the individual as applied to the tests that accompany each agency definition. In other words, were the individual a servant, nearly any act undertaken by the individual would impute liability. On the other hand, were the individual a nonservant agent-independent contractor, the principal would only be liable for those acts that are within the "inherent scope of the agency relationship."

This may not seem to be a radical view of agency law, and indeed it is not. Nevertheless, the law and commentary on agency leaves much of this analysis open to question. Hopefully, courts will begin to adopt a more coherent framework of agency law that will assist borrowers in their attempts to hold lenders liable for the misconduct of lender-appointed individuals who interfere with the borrower's business and cause the borrower damages.

II. AGENCY FRAMEWORK AND DEFINITIONS

A. Establishment of an Agency Relationship

The creation of an agency relationship has three distinct elements. First, there must be a communication between the principal and the agent and possibly, third parties. Second, there must be mutual assent to create the agency. And third, the parties must

37. See discussion infra part II.C.
38. Under the definitional structure provided in this article, an "independent contractor" may or may not have an agency relationship with the other contracting party. Where an agency relationship exists, the contractor is referred to as a "nonservant agent-independent contractor."
39. See discussion infra part II.C.
understand that the principal controls the relationship.42

When the principal communicates to another person that the person is to act on the principal’s account and subject to the principal’s orders, the principal satisfies the only element “required for authority to do acts or conduct transactions” in an agency relationship.43 “Authority to act as agent . . . can be created in a great variety of ways; any conduct of the principal communicated directly or indirectly to the agent is sufficient. Like offers of a contract, the interpretation may result in an agency not intended by the principal.”44

Although an agency relationship is often created by a communication directly from the principal to the agent, it may also be created by a communication between the principal and a third person.45 This is called “apparent authority.”46 “There is apparent authority to those who, relying upon conduct for which the principal is responsible, reasonably believe in the existence of the authority.”47

Mktg., 545 F. Supp. at 266-67; Seavey, supra note 40, §§ 3, 18.
42. Goodway Mktg., Inc., 545 F. Supp. at 266-67; see Seavey, supra note 40, § 3, at 5.
43. Veeberd, 720 F. Supp. at 848 (quoting Seavey, supra note 40, § 18); see Hayes v. Lincoln Gen. Ins. Co., 899 F.2d 684, 687 (7th Cir. 1990) (“It is essential that there be some form of communication, direct or indirect, by the principal . . .”); Moreau v. James River-Otis, Inc., 767 F.2d 6, 9-10 (1st Cir. 1985) (explaining that apparent authority “must be established by proof of something said or done by the principal on which a third person reasonably relied”); see also Restatement (Second) of Agency § 8 (1958).
45. Seavey, supra note 40, § 18, at 33.
46. Id. § 18, at 33-34; see, e.g., Essex Crane Rental Corp. v. Weyher/Livesey Constructors, 940 F.2d 1253, 1257 (9th Cir. 1991) (stating that it is essential that there is a communication by the principal that instills a reasonable belief in the mind of a third party); Todd Farm Corp. v. Navistar Int’l Corp., 835 F.2d 1253, 1256 (8th Cir. 1987) (explaining that apparent authority would have existed if the principal had acted in a manner that would lead to a reasonable belief that the agent had authority to act on the principal’s behalf).
Placing an individual into a position in which the acts or representations of that individual would appear reasonable to a third party is sufficient to create an agency relationship. On the other hand, the statements of an individual regarding his or her authority are inadmissible as evidence of his or her authority unless he or she was in fact authorized to make such statements.

In addition to a communication, an agent must accept what amounts to an offer by the principal. This is akin to the contract concept of "mutual assent." Agency requires consent of both the agent and the principal. However, regardless of how the parties define their relationship, and even if both deny the existence of the relationship, an agency will be found to exist when the evidence indicates one.

The most critical element in the creation of an agency is that the parties understand that the principal is to be in control of the undertaking. Control defines whether the principal may be simultaneously described as a "master." The element of control is not relevant to the question of whether a principal is liable for the acts


55. Reuschlein & Gregory, supra note 13, at 3. Note that the distinction between "master" and "principal" is now largely irrelevant. 3 Am. Jur. 2d Agency § 280 (1986); see discussion infra part II.C.2.a.
of an agent nor is the element of control necessary to prove the ongoing agency relationship.\textsuperscript{56} The concept of control is only relevant at the inception of the relationship to determine whether an agency relationship exists at all, and if so, whether the agent will be defined as an agent, a servant, or an independent contractor.\textsuperscript{57}

Agency may also be further broken down into two sub-defin-itions of “general agent” and “special agent.” A general agent is authorized to conduct an ongoing series of transactions to further the interests of the principal.\textsuperscript{58} A special agent, on the other hand, is only authorized to conduct a single transaction “or a series of transactions not involving continuity of service.”\textsuperscript{59}

This distinction is important because while the principal may not be held liable for the unauthorized acts of a special agent,\textsuperscript{60} the principal will remain liable for acts of a general agent, even when unauthorized, so long as those acts are “acts which general agents usually perform.”\textsuperscript{61} This power is referred to as “inherent agency power.”\textsuperscript{62} The scope and extent of the agency are determined by the intentions of the parties and by the circumstances surrounding the relationship.\textsuperscript{63} These topics are discussed later in this article.\textsuperscript{64}

\begin{footnotesize}
\begin{enumerate}
\item See infra text accompanying notes 57-76.
\item Cf. Third Fed. Sav. & Loan Ass’n v. Fireman’s Fund Ins. Co., 548 F.2d 166, 170 (6th Cir. 1977) (explaining that the mode and manner of control must be examined to define a relationship as principal and agent or master and servant as opposed to employer and independent contractor).
\item City of St. Louis v. Praprotnik, 485 U.S. 112, 172 n.22 (1988) (Steven, J., dissenting); Flintridge Station Assocs. v. American Fletcher Mortg. Co., 761 F.2d 434, 439 (7th Cir. 1985); Donroy, Ltd. v. United States, 301 F.2d 200, 205 (9th Cir. 1962); Anthony P. Miller, Inc. v. Needham, 122 F.2d 710, 712 (3d Cir. 1941); Restatement (Second) of Agency § 3 cmt. c (1958); Reuschlein & Gregory, supra note 13, at 14.
\item Restatement (Second) of Agency § 3 (1958); see Voorhees-Jontz Lumber Co. v. Bezek, 209 N.E.2d 380, 387 (Ind. Ct. App. 1965).
\item Voorhees-Jontz Lumber Co., 209 N.E.2d at 387.
\item Reuschlein & Gregory, supra note 13, at 15. The Restatement defines “inherent agency power” as follows:
\begin{quote}
Inherent agency power is a term used in the restatement of this subject to indicate the power of an agent which is derived not from 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.
\end{quote}
\end{enumerate}
\end{footnotesize}
Although many elements of the agency relationship mirror those required for a valid contractual relationship (offer, acceptance and mutual assent), there is one key difference: No consideration is necessary for the creation of an agency relationship. "One who voluntarily acts at the direction of another is an agent, although nothing is received by the actor."  

B. Continuation or Termination of the Relationship

Once an agency is shown to exist, that agency will be presumed to continue until proven otherwise. Agency can be proven to have been terminated either expressly, as where notice is given by the principal to the agent that the agency is terminated, or implicitly, such as when the undertaking is obviously complete and the agent should know that the principal no longer wishes him to act.

1. Express Termination

A principal may terminate the agency relationship by revoking the agent's power to act. Such a revocation must be expressly made known to the agent.

2. Implicit Termination

"As in the making of an offer, authority is created by a unilateral act and continues to exist as long as the one upon whom it is conferred has reason to believe the other desires him to act, if the other retains capacity." The agency relationship will usually termi-
nate when the agent should realize that the principal does not wish for the agent to act on the principal's behalf any longer, or, if the principal knew the facts, would no longer wish the agent to act on the principal's behalf. The agency relationship will also terminate upon completion of the "undertaking." Lapse of time may also act to terminate an agency relationship. However, termination by lapse of time is highly dependent upon the type of transaction involved. Additionally, an agency relationship may terminate if there is a change in circumstances such that the agent should be aware that the principal no longer wishes the agent to act.

The continued existence of the agency relationship is a preliminary fact that will be assumed by the court unless proven otherwise. Just because the agency relationship continues to exist, however, does not mean that the principal will therefore be liable for all the acts of the agent. Rather, the doctrine of respondeat superior must be applied to determine whether the principal will be liable. As we shall see, where the existence of the agency relation turns primarily upon the control of the principal over the agent, the imputation of liability turns primarily upon whether the actions of the agent are within the scope of the employment.

C. Vicarious Liability and Respondeat Superior

"Looking for a 'deep pocket'? If so, you may be in luck."

The first step in analyzing the concept of vicarious liability must be to compartmentalize agency law and the liability of a principal for the acts of an agent into the categories of contract liability or tort liability. While the standards by which a principal's liability will be imputed overlap, it is useful to consider each basis of liability separately.

73. Id. § 42, at 81.
74. Id. § 42, at 82.
75. Id. § 44, at 83.
76. Id. § 45, at 84.
78. See, e.g., Brady v. Roosevelt S.S. Co., 317 U.S. 575, 581 (1943) ("The principal is not liable for every negligent act of his agent.").
80. See discussion infra part II.C.2.c.
1. **Contract Liability**

When a question is presented in which a third party wishes to hold the principal liable for a contract that was executed by the agent, the court will examine the actual or apparent authority of the agent.\(^8\) The general rule is that for the principal to be held liable for such contracts, the contract must have been entered into on the principal’s behalf, and the contract must be within the actual or apparent authority of the agent.\(^8\)

\[\text{a. Actual Authority}\]

Actual authority can be broken down into express authority and implied authority.\(^8\) Obviously, a principal may expressly communicate to an agent that the agent has the power to take a specific action. The agent here has actual and express authority. But in a commercial setting it will be impossible for the principal to express all of the kinds of authority the agent will need to complete the required task. Therefore, implied authority is said to exist.

Implied authority is found by examining the facts of the particular case, defining the expressed authority and then asking whether or not a reasonable person familiar with the customs and ways of dealings of agents in the particular line of business could believe that the agent had the authority to act.\(^8\)

Implied authority is, therefore, a subset of actual authority and can only exist if it is reasonably necessary to carry out the expressed objective for which actual authority was granted.\(^8\)

\[\text{b. Circumstantial Authority}\]

A second category of authority can be described as “circumstantial authority,” which can be broken down further into “apparent authority,” “estoppel,” and “inherent authority.”\(^8\) “[C]ircumstantial authority is a subset of actual authority and can only exist if it is reasonably necessary to carry out the expressed objective for which actual authority was granted.\(^8\)

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84. *Wolfe & Naffziger, supra* note 66, at 84.
85. *Id.*
86. *Id.*
87. *Id.* at 90.
authority is defined by asking what measure of authority could a third party reasonably believe the agent to have under the circumstances.\textsuperscript{88} The Restatement defines “apparent authority” as “the power to affect the legal relations of another person by transactions with third [parties], professedly as agent for the other, arising from and in accordance with the others manifestations to such third [party].”\textsuperscript{89} Thus, there are two required elements for apparent authority to exist. First, circumstances must be created by the principal that could reasonably result in a third party believing that the agent is authorized.\textsuperscript{90} Second, there must be actual and reasonable reliance by the third party upon these circumstances.\textsuperscript{91}

In some cases the doctrine of estoppel applies to bar the principal from denying liability for the contracts of the agent. “[E]stoppel is appropriately argued when there have been: 1.) circumstances created by the principal which 2.) cause a third-party to reasonably believe the agent has authority (these two elements are identical to the elements for apparent authority) and 3.) the third-party has changed his position.”\textsuperscript{92} An agency by estoppel occurs if a principal communicates solely with the agent in terminating the agent’s authority, and the principal fails to inform third parties.\textsuperscript{93}

“Inherent agency power is a term used in the Restatement to indicate the power of an agent which is derived not from authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with . . . an agent.”\textsuperscript{94} The common law developed the law of inherent authority to apply in situations such as where a “breach of duty may look like one of the generally recognized torts but it is not.”\textsuperscript{95} This stems from a belief that it would be unfair for a corporation to obtain the benefits of agency law without bearing the responsibility for the agent’s acts.\textsuperscript{96} “The doctrine of inherent authority is another example of courts’ recognition that it is vital to protect the reasonable
expectations of businessmen.”97 “Inherent authority may exist when the principal has expressly forbidden the agent to act in certain matters, yet failed to take measures to inform third parties of this limitation causing them to reasonably believe the position of the agent carried with it the authority asserted.”98

A party may argue in any given factual situation that all three of the circumstantial authority concepts—apparent, estoppel, and inherent—apply at the same time. “There is no inconsistency in this.”99

2. Tort Liability

“Respondeat superior”100 is the term used to describe the liability of a principal for the unauthorized or disobedient acts of an agent when those acts are conducted in connection with the interests of the principal.101 “The well-settled general rule is that a principal is liable civilly for the tortious acts of his agent which are done within the course and scope of the agent’s employment.”102 A principal may be liable for the tort of an agent when the principal has created a situation that allows the agent to commit the tort.103 This is aggravated (or enhanced) when the agent commits the tort with the intention of furthering the interests of the principal.104


A distinction in terms is often found in agency cases. The terms

97. Wolfe & Naffziger, supra note 66, at 98.
98. Id.; see also Steven A. Fishman, Inherent Agency Power—Should Enterprise Liability Apply to Agents’ Unauthorized Contracts?, 19 Rutgers L.J. 1, 3-4 (1987).
102. 3 Am. Jur. 2d Agency § 280 (1986); see Estate of Mathes v. Ireland, 419 N.E.2d 782, 786 (Ind. Ct. App. 1981) (“[T]he touchstone for the principal’s liability for the tortious acts of his agent is merely whether they are done within the course and scope of the employment.”).
103. Seavey, supra note 40, § 87, at 148.
104. Id.
105. “When I use a word,” Humpty Dumpty said in a scornful tone, “it means just what I choose it to mean—neither more nor less.” “The question is,” said Alice, “whether you can make the words mean so many different things.” “The question is,” said Humpty Dumpty, “which is the master—that’s all.” Lewis Carroll, Through the Looking Glass (1977).
"master and servant" are often seen along with "principal and agent." In some English cases, the distinction among terms was based upon the amount of control the master or principal held over the servant or agent. However, this distinction has not generally been maintained, thus, allowing the categories of agents and servants to be coextensive as far as the question of control by the employer is concerned. There is no difference in the liability of a principal for the tortious act of an agent and a master for the tortious act of the servant. In both cases, the tort liability is based on the master and servant, rather than agency, principle. In other words, although control is relevant for establishing the relationship, the question of liability will turn upon whether the agent or servant was acting in the scope of his or her employment.

The Restatement defines "master and servant" as a subset of "principal and agent." Despite the legal insignificance of the difference in terms, some cases and commentators continue to draw a limited distinction. Seavey defines a "servant" as "one who gives personal service as a member of a business or domestic household, and subject to control by the employer as to his physical activities." He also cautions that this statement cannot give an "accurate picture" of

106. See, e.g., Merton Ferson, Bases for Master's Liability and for Principal's Liability to Third Persons, 4 Vand. L. Rev. 260 (1951).


108. 3 Am. Jur. 2d Agency § 280 (1986); see also Alfred Conard, What's Wrong with Agency?, 1 J. Legal Educ. 540, 553-54 (1949) (discussing the debate over whether "servants" should be a subcategory of "agents" in drafting the Restatement).


110. Id.


112. This definition is as follows:

1. A master is a principal who employs an agent to perform service in his affairs and who controls or has the right to control the physical conduct of the other in the performance of the service.

2. A servant is an agent employed by a master to perform service in his affairs whose physical conduct in the performance of the service is controlled or is subject to the right of control by the master.

3. An independent contractor is a person who contracts with another to do something for him but who is not controlled by the other nor subject to the other's right of control with respect to his physical conduct in the performance of the undertaking. He may or may not be an agent.

what the courts mean when they use the term. The distinction is relevant for negligent physical acts of an agent, for which the principal will not ordinarily be liable. However, the principal will be liable for the negligent physical acts of a servant. A distinction is often drawn by examining the task with which the agent is assigned. A servant sells or gives time, while a nonservant agent is paid for a result.

A principal is liable to third persons for the other torts of any agent, whether or not a servant; (a) if the act was authorized, or, as to one relying upon the relation, was apparently authorized; or (b) if the tort was committed within the agent's inherent powers; or (c) if the agent's position enabled him to commit the tort.

Thus, on this analysis, the servant-agent distinction is only relevant where the principal is to be held liable for a physical injury caused by the servant or agent.

However, in Green v. Perry, the court held that no respondeat superior liability exists for tortious acts committed by "non-servant agents." In Green, the plaintiff was a delivery man for the co-defendant company. The co-defendant Perry was also a delivery man for the company. The company asked Perry to drive Green home one day after work in a company van. Perry did so, and on the way home he was involved in an accident in which Green

114. Seavey, supra note 40, § 84, at 141.
115. Blanchard v. Ogima, 215 So.2d 902, 906 (La. 1968) (quoting Restatement (Second) of Agency § 250 (1958)).
117. Seavey, supra note 40, § 84, at 142.
118. Id. § 91, at 161.
121. Id. at 389 (citing Burkett v. Crulo Trucking Co., 355 N.E.2d 253 (Ind. Ct. App. 1976)).
122. Id. at 386.
123. Id.
124. Id.
was injured. Green argued that Perry was an employee of the company and that the company was, therefore, responsible for Perry's tortious actions. The company argued that Perry was an independent contractor and that they were, therefore, not responsible for his actions.

The court began with a correct analysis of the law of *respondeat superior*. That is, the court demonstrated that it was looking for the degree of control over Perry by the company to decide whether or not an agency relationship existed: “Control is the key factor in determining the existence of an employment relationship. Control means direction and control over the employee’s work; however, control refers to the right to control, rather than its actual exercise.” The court even went so far as to recognize that an “independent contractor” may also share an “employment relationship” with the company such that the company would be liable for the torts of the independent contractor. “While parties may be designated as ‘independent contractors,’ as opposed to ‘employees,’ an employer-employee relationship may still be found if enough of the indicia of an employment relationship exists.”

The company did not pay Perry a salary or hourly wage, rather, he was paid by the job. No taxes or social security were withheld, and no benefits were provided. On this evidence, the court held that it was undisputed Perry was an independent contractor. However, there was also evidence that Perry had just accepted a position with the company as a sales representative. As a sales representative, Perry would be paid on a per-day basis, would receive benefits, and would have his expenses paid. This raises an inference of a “master-servant” relationship, according to the court. The court wrote that “[t]here is no *respondeat superior* liability for principals whose non-servant agents commit tortious acts.”

125. *Id.*  
126. *Id.* at 387.  
127. *Id.* Note that the Restatement provides that an independent contractor may simultaneously be an agent. See definition *supra* note 112.  
129. *Id.* (citing *Swanson v. Wabash College*, 504 N.E.2d 327 (Ind. Ct. App. 1987)).  
130. *Id.*  
131. *Id.* (citing *Furr v. Review Board*, 482 N.E.2d 790 (Ind. Ct. App. 1985)).  
132. *Id.*  
133. *Id.*  
134. *Id.*  
135. *Id.*  
136. *Id.*  
137. *Id.* at 389 (citing *Burkett v. Crulo Trucking Co.*, 355 N.E.2d 253 (Ind. Ct. App. 1976)).
language is unfortunate and inappropriate.

Upon analysis, Green may have been using incorrect designations. That is, what Green refers to as a "nonservant agent" may actually be an independent contractor who has no agency relationship with the other contracting party. In fact, it is clear that Green correctly analyzed the problem, for in the next paragraph the court comments: "If the Greens are to prevail on their claim, they must establish a master-servant relationship whether that be as employer-employee, master-gratuitous servant, or principal-agent. There is no free-standing theory of relief based upon an agency relationship." Unilaterally stating that no liability can attach for a "nonservant agent" is a mistake. This mistake was made in the earlier case of Burkett v. Crulo Trucking Co., where the court referred to a "nonservant agent" as an "independent contractor" without realizing the distinction between the two. Green relied on Burkett in making its erroneous statement.

The Burkett case did not lead to an inconsistent result because in that case the "nonservant agent" had caused a harm through physical negligence. In Burkett, the plaintiff's decedent was killed when he was rear-ended by a dump truck owned by the defendant. The driver of the dump truck leased it from the company and then hauled stone for the company. At the time of the accident, the defendant was on his way to pick up a load of stone for the company. The issue was, therefore, whether the company should be held liable for the driver's tort.

The Burkett court recognized at the outset that "[t]here is a semantic problem." Unfortunately, Burkett does not resolve the problem but only makes it worse.

Employees, servants, and independent contractors, as well as other categories of persons, may, in the proper circumstances, be described as agents. Professor Seavey classifies all agents as either servants or non-servants and designates the latter as a type

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138. Id. (emphasis added).
140. Id. at 261.
141. Green, 549 N.E.2d at 389.
143. Id. at 254.
144. Id.
145. Id.
146. Id. at 258.
147. Id. at 261.
of independent contractor. While "employee" and "servant" may have variant connotations, modern case law tends to treat the words as virtually synonymous in agency applications. Although Burkett seems to view "agent" and "independent contractor" as mutually exclusive descriptions, they are not. An independent contractor may well be an agent.\footnote{148}

This passage from the Burkett decision correctly states the law. The Burkett court makes its mistake in applying its own recognition of the somewhat "liquid" definitions. The court holds that "nonservant agent" and "independent contractor" are synonymous and that respondeat superior will not impute liability to a principal for such a person's acts.\footnote{149} The court recognized that Professor Seavey defines nonservant agents as "a type of" independent contractor.\footnote{150} However, this does not mean that all independent contractors are nonservant agents. More importantly, even an independent contractor can subject the principal to liability if the principal exhibits enough control over the contractor's actions.\footnote{151}

The cases and commentary indicate that a principal may be held responsible for the acts of an independent contractor.\footnote{152} Sometimes the terms "nonservant agent" and "independent contractor" overlap, and whether or not liability for the acts of such a person exists depends upon whether the tort was committed within the inherent scope of the employment.\footnote{153} This was the deficiency in Burkett. The Burkett court did not consider the scope of employment issue. The Burkett court made the mistake of deciding that once an agent was defined as a "nonservant," that made the agent an "independent contractor," and that was the end of the story—no further analysis was required. Burkett should have decided that once the agent was classified as a "nonservant" or "independent contractor," the principal would only be liable for acts committed during the scope of employment, with the existence of such employment depending upon the right to control.

The most important distinction is between an agent and an independent contractor who is not also acting as an agent.\footnote{154} Principals

\begin{footnotes}
\item[148] Id. (citation omitted) (citing Seavey, supra note 40, § 6).
\item[149] Id.
\item[150] Id.
\item[151] See Seavey, supra note 40, § 82, at 137-40.
\item[152] See id.
\item[153] See Wolfe & Naffziger, supra note 66, at 129.
\item[154] As mentioned earlier, these concepts may overlap. This is consistent with the definition of an independent contractor found in the Restatement, which provides that an independent contractor may or may not be an agent. Restatement (Second) of Agency § 2
\end{footnotes}
are generally not responsible for the acts of an independent contractor.\textsuperscript{158} "One who employs an independent contractor suffers \textit{no liability based upon respondeat superior for this agent's torts!}\textsuperscript{158} "An independent contractor agrees to accomplish certain results . . . , but such contractor is not controlled in the details, manner, or particular method of performing the task. An agent, on the other hand, is subject to the control of the principal with respect to the details of the work."\textsuperscript{187} Thus, in determining whether a relationship is based upon agency or independent contract, the court must inquire as to the control of the principal over the other party.

It is the "right to control" that is most significant in determining whether the relationship is one based upon agency or independent contract.\textsuperscript{188} Here again, as with the distinction between agent and servant, the "control" element is only relevant to establish the relationship, not to impose liability. Once the relationship is determined to be an agency relationship, the scope of employment determines liability. If the control element is considered and found insufficient to support an agency relationship, then the "agent" is actually an independent contractor, and the principal will not ordinarily be liable for his or her acts. However, an independent contractor may still be an agent. While this confuses the terms, and as \textit{Burkett} aptly recognized: "There is a semantics problem,"\textsuperscript{189} the analysis nevertheless remains the same. Step one is whether there is a right to control. Step two is whether the action was in the scope of employment. If both steps are satisfied, then the principal will be liable whether the relationship is deemed an agency or an independent contractor. In other words, how a court labels the relationship is less important than the analysis in which the court engages.

\textsuperscript{155} A principal may be held liable for the actions of the independent contractor if the activity engaged in was ultrahazardous or if the principal exercised control and direction over the contractor. \textit{See} \textit{Wolfe \\& Naffziger, supra} note 66, at 125-30.

\textsuperscript{156} \textit{Id.} at 126.

\textsuperscript{157} \textit{Western Adjustment \\& Inspection Co. v. Gross Income Tax Div.}, 142 N.E.2d 630, 634 (Ind. 1957).


\textsuperscript{159} \textit{See supra} text accompanying note 147.
b. How Much Control Is Necessary for the Acts of the Agent to Bind the Principal?

The right to control is the key to finding an agency relationship from which liability may be imputed under the doctrine of respondeat superior. The right to control must exist for the creation of an agency relationship, and an agency relationship must exist for liability to be imputed under the doctrine of respondeat superior.  

Bear in mind that actual control need not be shown. It is the existence of the right to control that will result in a characterization of the relationship as one of principal and agent. As one commentator has stated:

Though "control" is an important factor, and in some cases still a decisive factor, it is wrong to overestimate its value. Furthermore, in applying the control test, the question is not whether in practice the work was done subject to a direction and control exercised by an actual supervision or whether an actual supervision was possible, but whether ultimate authority over the man in the performance of his work resided in the employer so that he was subject to the employer's orders and directions.

In determining whether the principal has employed an agent who will act on the principal's behalf and subject the principal to liability or an independent contractor who will not, the Restatement has provided courts with four considerations:

1. The extent of control the principal may exercise over the details of the agent's work;
2. Whether or not the agent is engaged in a generally recognized occupation of his own in which he exercises his own independent skill and judgment;
3. Whether the principal or the agent supplies the instrumentalities, tools and place of work; and
4. The method of payment, whether by time or by the job.

Thus, it can be said that generally if the action to be taken is to

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160. It is merely the right to control and not actual control that is essential. Liability may still be found even if the principal exercised no control whatsoever, so long as the principal had the right to control the agent. Seavey, supra note 40, § 84, at 142.
accomplish a physical result, such as painting a house, and the principal is to direct the work, then a master-servant relationship exists. If, however, the actions to be taken are more abstract, such as "negotiating, contracting, auditing, etc., then chances are that a principal-independent contractor relationship exists."\textsuperscript{164}

For example, in most service station cases the service station operator is held to be an independent contractor and not an agent of the oil company.\textsuperscript{165} In Smith v. Cities Service Oil Co.,\textsuperscript{166} a typical case, the operator purchased supplies from other suppliers from which the oil company received no profit, fixed the hours of the station, hired his own attendants, fixed the salaries and conditions of employment, and kept his own books and records.\textsuperscript{167} The only indicia of an agency relationship was that the defendant's brand signs were displayed, the operator accepted the defendant's credit cards, and from time to time the defendant suggested methods for the operation of the station.\textsuperscript{168} The court found that this did not amount to an agency relationship.\textsuperscript{169} This is to be distinguished from Gizzi v. Texaco, Inc.,\textsuperscript{170} wherein the court found the oil company held itself out to the public as vouching for the abilities of the operator's mechanics and, thereby, exposing itself to liability on an "apparent authority" agency relationship.\textsuperscript{171}

Cases such as Green and Burkett indicated that there was no distinction and that if a person was an independent contractor or nonservant agent, there could be no liability based upon respondeat superior.\textsuperscript{172} Wolfe and Naffziger indicate that this may not be true

\textsuperscript{164}. Wolfe & Naffziger, supra note 66, at 126.
\textsuperscript{165}. See, e.g., Smith v. Cities Serv. Oil Co., 346 F.2d 349 (7th Cir. 1965); Texas Co. v. Higgins, 118 F.2d 636 (2d Cir. 1941); Nelson v. Cities Serv. Oil Co., 146 N.W.2d 261 (Iowa 1966); Reynolds v. Skelly Oil Co., 287 N.W. 823 (Iowa 1939).
\textsuperscript{166}. Smith v. Cities Serv. Oil Co., 346 F.2d 349 (7th Cir. 1965).
\textsuperscript{167}. Id. at 352.
\textsuperscript{168}. Id.
\textsuperscript{169}. Id.
\textsuperscript{171}. See id. at 310; Dickey, supra note 162, at 257; see also Lafayette Bank & Trust Co. v. Price, 440 N.E.2d 759, 761-62 (Ind. Ct. App. 1982).
\textsuperscript{172}. Commentators indicate that in a lender-borrower control relationship there will "rarely, if ever, be a master-servant relationship. Few creditors will immerse themselves so deeply into the debtor's business that they exercise actual physical control. The controlling creditor may be able to characterize the relationship as an 'independent contractor-agency' and thereby avoid compensating the debtor's tort victims." Dan S. Schechter, The Principal Principle: Controlling Creditors Should Be Held Liable for Their Debtor's Obligations, 19 U.C. Davis L. Rev. 875, 914 (1986). This author was referring to third parties suing the creditor for torts of the debtor, which is distinguishable from our hypothetical. Additionally, Schechter is not completely correct. If the relationship is one in which there is sufficient control by the
and that liability will attach if there is an agency relationship and the activity was within the scope of employment.\textsuperscript{178}

Although a relationship may be characterized as an independent contractor relationship rather than a master-servant relationship, this does not mean that the independent contractor cannot take actions that will result in liability for the principal. In a few instances, a nonservant agent or independent contractor may create tort liability for the principal based upon \textit{respondeat superior} or a doctrine very similar to it. These instances are the commission of a tort within the \textit{inherent scope of the agency}; that is, those torts committed during the very act for which the agent was employed. Since most nonservant agents in lender-appointed individual scenarios such as the earlier hypothetical are hired to achieve a legal or rather abstract, non-physical result, the torts creating the principal’s liability are those of a non-physical nature. The torts that most often arise in the lender-borrower relationship are misrepresentation, fraud, deceit, conversion, and interference with contractual relations.\textsuperscript{174}

c. Was the Act Committed in the Scope of the Employment?

If an agency relationship is shown to exist, then the critical element necessary for holding a principal liable for the torts of an agent is whether the tortious acts were done within the scope of the employment.\textsuperscript{178} Some courts hold that liability under the doctrine of \textit{respondeat superior} is not based upon the agency relationship but rather an employer-employee relationship and that the “touchstone” for liability is that the acts be committed in the course and scope of the employment.\textsuperscript{176} This seems to be in serious conflict with opinions such as \textit{Carver v. Crawford}\textsuperscript{177} and \textit{Delk v. Board of Commissioners},\textsuperscript{178} which hold that the agency relationship is the key to \textit{respondeat superior}.

\textsuperscript{173} See infra Appendix for a chart detailing this proposition.
\textsuperscript{174} \textsc{Wolfe} \& \textsc{Naffziger}, supra note 66, at 127.
This apparent conflict is explained in *American Jurisprudence*:

Fundamentally, and according to both the Restatement and the American courts, there is no distinction to be drawn between the liability of a principal for the tortious act of his agent and the liability of a master for the tortious act of his servant. In both cases, the tort liability is based on the master and servant, rather than any agency, principle; the liability for the tortious act of the employee is grounded upon the maxim of "*respondeat superior*" and is to be determined by considering, from a factual standpoint, the question whether the tortious act was done while the employee, whether agent or servant, was acting within the scope of his employment.\(^{179}\)

Once again the point is made that the distinction between an agent and a servant is in fact irrelevant, despite the incorrect designations by the court in *Green*.\(^{180}\) It is the distinction between independent contractor and other agents that is important. The independent contractor, *if he or she is also an agent*, will bind the principal if the tort is committed "during the very act for which the agent was employed,"\(^{181}\) while a servant will bind the principal so long as the act is committed in the *scope* of the employment. It appears that the *Green* and *Burkett* courts have failed to draw a distinction between the terms "nonservant agent" and "independent contractor."

Wolfe and Naffziger indicate that it is possible for a nonservant agent to be an independent contractor.\(^{182}\) The resulting analysis requires a determination of whether an independent contractor does in fact have an agency relationship with the principal. In other words, under the Wolfe and Naffziger analysis, the two are not mutually exclusive. There will be no liability of the principal if there is no agency relationship. However, if there is an agency relationship, it may still be characterized as a "nonservant/independent contractor" relationship.\(^{183}\) Here, the analysis diverges from the holding in *Green*. While the nonservant agent relationship may be characterized as an "independent contractor," liability will be imputed for the acts of the independent contractor if they are done in the scope of the employment.\(^{184}\) However, not all independent contractors are nonservant agents, so there is a second category of independent contrac-

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180. See supra text accompanying notes 128-41.
182. Id. at 125-30.
183. Id.
184. Id.
tors whose acts the principal will not be responsible. The proper analysis, no matter how the agent is characterized, is to resolve the issue of “scope of employment” to determine whether liability exists. For an employment relation to exist, there must be an agency relationship.

"Conduct of a servant is within the scope of his employment if it is not a serious departure from authorized conduct in manner or space, [and] is actuated in part by a motive to serve the master . . . ." The most basic element is the intent by the agent to act for the principal. However, even this element is not absolutely necessary for a finding of liability.

i. "On a Frolic of His Own"

Generally, the principal will not be responsible for the acts of the agent when the agent acts in his or her personal rather than representative capacity. However, disobedient acts of an agent may still be attributed to the principal even when the agent acts in his or her own interest, so long as he or she also advances the interests of the principal.

For example, in Horn v. Duke Homes, the plaintiff alleged that she had been wrongfully discharged as a result of her refusal to engage in sexual relations with her supervisor and sought damages under Title VII of the Civil Rights Act of 1964. The defendant alleged that it was entitled to judgment as a matter of law because the superior to the defendant’s supervisor had neither approved nor had knowledge of the misconduct. It was the defendant’s position

185. Wolfe and Naffziger proclaim: “Adopting an iron clad rule in this matter is impossible.” Id. at 128. For an excellent illustration of the Wolfe and Naffziger analysis, see infra Appendix.
187. Id. § 426.
188. Seavey, supra note 40, § 87, at 148.
189. See id.
190. See id.
191. The liability of a principal is severed if the tortious act occurred while the agent was “on a frolic of his own.” See Young B. Smith, Frolic and Detour, 23 COLUM. L. REV. 444 (1923). Smith states that “[i]t was Baron Parke who uttered the classic phrase that a master is not responsible for injuries caused others by his servant’s unauthorized negligence while ‘on a frolic of his own.’” Id. at 444 (citing Joel v. Morison, 6 C & P 501, 503 (1834)).
193. See Seavey, supra note 40, § 87, at 150; see also Smith, supra note 191, at 448-49.
196. Horn, 755 F.2d at 603.
that such misconduct was "wholly unconnected to the well-being of the employer" and that, therefore, the supervisors acts were outside the scope of employment. However, the court held that "by delegating power to [the supervisor] the "employer" and [the supervisor] essentially merged; as long as the tort complained of was caused by the exercise of this supervisory power, [the supervisor] should be . . . held liable for the tort."

This analysis seems to indicate that the principal will be held liable for all acts of an agent who is given discretionary power over a situation and then uses that discretionary power to commit the tort. The idea is that the agent could not have committed the tort but for the principal's action in putting the agent in the position and delegating the power that allows the agent to take the action.

This analysis was not followed in *Columbia Plaza Corp. v. Security National Bank,* however, where a lender was found not to be liable for negligent administration of a construction loan. In that case, the bank's officer was negligent in accepting a bribe, but accepting the bribe was an act solely for the benefit of the officer and not the bank. Therefore, the bank was not liable.

The cases that allow egregious conduct by agents to be considered within the scope of employment may be making a "cost-spreading" consideration. Some commentators indicate that the courts need to spread the costs of the activity among the persons connected with it.

ii. The Concept of Ratification.

It is generally acknowledged that a principal may not retain the benefits of unauthorized acts of an agent if the principal has knowledge of them without imputation of liability to the principal. Al-
though the case may be such that the principal, under the general rule, is not charged in the first instance with the knowledge of an agent who is acting adversely to him, or fraudulently or illegally,

[the doctrine of imputed knowledge may be invoked where the principal fails to disavow what was assumed to be said and done in his behalf by the agent; and if the principal learns the facts before his position has changed and still knowingly retains a benefit obtained through the act of the agent which he would not have received otherwise, he cannot escape responsibility.]

Thus, although the agent may take unauthorized actions outside the scope of his or her employment that would not ordinarily subject the principal to liability, liability may still attach if the principal knowingly accepted the benefits of the unauthorized act. This describes the concept of ratification.

The Restatement defines ratification as "the affirman by a person of a prior act which did not bind him but which was done professedly on his account, whereby the act, as to some or all persons, is given effect as if originally authorized by him." Ratification is an important concept because it does not rely upon either actual or circumstantial authority. Rather, it is simply an act that could have been authorized and was done on the principal's behalf. All that is left for liability to attach is an affirmation by the principal. This affirmation can take the form of either actual or implied knowledge by the principal of the action. Affirmation will usually be a negative, that is, the failure of the principal to act—thereby tacitly approving of the action taken by the agent.

A ratification will only apply if an agent takes some unauthorized acts that would otherwise not subject the principal to liability, but the principal opens himself to liability by affirming the actions or authorizing them after the fact. As discussed above, it is not 

representation made in the scope of the agency will result in liability of the principal on the theory that where both the principal and the third party are innocent, it is better to place the burden upon the principal than the third party. Bischoff Realsy, Inc. v. Ledford, 562 N.E.2d 1321, 1324 (Ind. Ct. App. 1990); see also Steven N. Bulloch, Fraud Liability Under Agency Principles: A New Approach, 27 William & Mary L. Rev. 301, 303-07 (1986).

204. 3 AM. JUR. 2D Agency § 291 (1986) (citations omitted).
207. Seavey, supra note 40, § 36 at 65.
209. E.g., Shearson Hayden Stone, Inc. v. Leach, 583 F.2d 367, 369 (7th Cir. 1978); Arthur Gregory, Note, Agency—Ratification of an Unauthorized Act, 19 S.C. L. Rev. 788,
necessary that the principal expressly affirm or ratify the action; silence will act as a ratification if the principal knowingly accepts the benefits of the unauthorized acts. The knowledge element requires that the principal be aware of all material facts for the ratification to expose the principal to liability. Similarly, the third party must not be aware of a limit on the agent’s power, or the principal cannot ratify an act in contravention of that power.

The cases do indicate that for ratification to apply, the agent must act for or on behalf of the principal. It is unclear what the result would be if the agent were acting in the interest of himself and the principal.

d. **Application of Apparent Authority to Tort Liability**

The concept of apparent authority was examined earlier in the context of a principal’s liability for contracts entered into by the agent. "The concept is growing and changing not only a principal’s liability for an agent’s contracts but, just as important, it is imposing new types of liability on the principal for the agent’s tortious conduct." This doctrine usually applies in situations in which the principal has made representations about an independent contractor that would lead the third party to reasonably believe that the independent contractor is actually an agent of the principal.

The most common examples of this are the service station cases. In these cases, typified by *Gizzi v. Texaco, Inc.*, persons injured by operators of service stations sue major oil companies. The oil companies defend by claiming that they are not responsible for the actions of the operators, who are independent contractors. This defense will work, so long as the oil company has not held the operator out to be a “servant” of the oil company, and, thereby, cloaking the

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789-91 (1967).


214. *See supra* text accompanying notes 45-47.


operator with apparent authority. In the Gizzi case, the Texaco slogan was, "Trust your car to the man who wears the star." The Third Circuit decided that this advertising had given the public the impression that Texaco operators were the servants of Texaco and that Texaco was vouching for their competence as auto mechanics, thereby accepting responsibility for the acts of the operators. When a man had his brakes repaired by a Texaco mechanic, and the brakes later failed, Texaco was held liable for the resulting injuries.

**e. Serving Two Principals and the Resultant Liability**

An agency relationship may arise out of "an agreement to employ the agent of another, such person then becoming the agent of the first party." Thus, it is possible for an agent to represent the interests of two separate principals in conducting a single act. This raises the difficult issue of which principal should be held liable for the act of the agent when the act is tortious.

Ordinarily, where the agent serves two principals, each with the knowledge and consent of the other, neither will be liable to the other for the tortious acts of the agent if the principal did not participate in the tortious acts in any way. Since the principals are under an equal duty to supervise the agent and protect their own interests, the agent’s misconduct is not imputed to any principal who is not actually at fault.

On the other hand, a principal may be held liable to the other

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217. See sources cited supra note 165.
218. Gizzi, 437 F.2d at 310.
219. Id.
220. Id.; see also Dickey, supra note 162; Robert N. Davis, Comment, Service Station Torts: Time for the Oil Companies to Assume Their Share of the Responsibility, 10 Cal. W. L. Rev. 382 (1975); Thomas Toner, Comment, Liability of Oil Companies for the Torts of Service Station Operators, 7 Land & Water L. Rev. 263 (1972).
221. 1 I.L.P. Agency § 3 (1988) (citing Andrews v. Votaw, 240 Ill. App. 311 (1926), in which the employee of the maker of a note to whom the note was given for safe-keeping by an agreement between the maker and the payee became an agent of the payee).
223. 3 C.J.S. Agency § 430 (1973) (citing Ringer v. Wilkin, 183 P. 986 (Idaho 1919); Boss v. Tomaras, 232 N.W. 229 (Mich. 1930); Rodgers v. Ward, 8 N.Y.S.2d 167, aff’d, 11 N.Y.S.2d 240 (1939); United Ass’n of Journeymen v. Borden, 328 S.W.2d 739 (Tex. 1959); Anderson v. Brotherhood of Painters, 330 S.W.2d 541, aff’d in part, rev’d in part on other grounds, 338 S.W.2d 148 (Tex. 1960)).
principal where he is directly connected with the tort committed by the agent, as where there was collusion with the agent, active participation in the wrongful act, or the wrongful act is otherwise authorized or ratified.\textsuperscript{226}

While it may be unfair to hold a principal liable to the other for the tortious acts of their mutual agent, one principal may be held liable if that principal was involved in, was connected to, or had some responsibility for the agent’s tortious acts.

f. Subagency

Where there is more than one possible level of agency, the doctrine of subagency is brought up.\textsuperscript{226} “A subagent is a person appointed by an agent empowered to do so, to perform functions undertaken by the agent for the principal, but for whose conduct the agent agrees with the principal to be primarily responsible.”\textsuperscript{227} A subagent serves two principals, and can create tort liability for both. This is somewhat different from the hypothetical, where the two principals are the lender and the borrower, rather than the principal and the appointing agent, but the important concept is that two parties may share liability for the actions of a single agent.

In order to impose liability on the agent for the tortious conduct of a sub-agent, the same type of analysis we used when presenting the respondeat superior doctrine must be utilized. The relationship between agent and sub-agent must be properly classified as a master-servant one if a tort within the scope of (or incidental to the purpose of) the agency has been committed.\textsuperscript{228}

Thus, if a subagent commits a tort within the scope of the employment, the principal will be liable for that tort.

III. Control and Interference Actions Using the Agency Theory

With the foregoing harmonization of agency law, holding a lender liable for actions in which the lender wrongfully takes control of a borrower becomes easier to understand. The agency principles

\begin{itemize}
\item 225. Id. citing United Ass'n v. Borden, 328 S.W.2d 739 (Tex. 1959); Anderson v. Brotherhood, 330 S.W.2d 541, aff'd in part, rev'd in part on other grounds, 338 S.W.2d 148 (Tex. 1960).
\item 227. Restatement (Second) of Agency § 5(1) (1958).
\item 228. Wolfe & Naffziger, supra note 66, at 169.
\end{itemize}
discussed above may be applied primarily in two ways. First, a borrower may proceed on a straight *respondeat superior* theory. The trouble the borrower will face if it chooses to follow this path is that there is case law which essentially holds that a lender must practically step into the shoes and become the "alter ego" of the borrower. Other cases require a showing that the lender use the borrower as a mere instrumentality to accomplish the lender's ends. But these cases usually involve an action by one creditor against another, and not a direct action by the borrower against the lender. When a borrower sues directly, seeking recovery for damages it has suffered as a result of the actions of the lender's agents, the analysis should be different. Here we scrutinize the lender's right to control the agent at the inception of the relationship, whether that relationship was ever terminated, and the acts of the agent which caused damage to the borrower. If the agent's acts were within the scope of employment then the lender should be held responsible.

The second theory a borrower may proceed on is interference with corporate governance through the lender's agents. "A lender may expose itself to liability by interfering with the borrower's corporate governance . . ." This interference is properly described as "tortious" when a creditor exercises an inordinate amount of control over its debtor.

Despite which theory the borrower proceeds on, it must initially be understood that control alone is not bad or improper, nor does it result in liability standing alone. In an article appearing in the

233. Lawrence, supra note 232, at 1388.
Yale Law Journal, Oliver Williamson argues that lenders in certain situations should be represented on a debtor's board of directors. In fact, in many early “lender liability” cases, courts held that the “installation of an officer of the creditor may be proper as ‘a legitimate and customary practice of keeping an oversight . . . over the business, management and operations of a debtor of doubtful solvency.’” Such bank representatives were sometimes even allowed to participate in the day-to-day management of their debtors’ businesses, especially when the arrangements were voluntarily agreed to by the debtor. The existence of an agency relationship, which in turn relies on the control, may also open the door to liability. “[I]t would seem easy to apply agency law to the typical creditor control fact pattern. It is surprising, therefore, that so few courts or litigants have done so.”

It is not proposed that installment of an officer of the creditor into the business of the debtor is wrong—some control of a borrower by its lender may be a good thing. Rather, it is proposed that if a lender chooses to install “hand picked minions” into the borrower's operation, the borrower should be able to look to the lender for compensation when those individuals cause damage to the borrower.

A. Agency and Tortious Interference with Corporate Governance

The leading case on the issue of tortious interference with corporate governance is State National Bank v. Farah Manufacturing Co. This section of the article will discuss the finer points of the Farah Manufacturing Co. opinion that discuss this new theory of liability.

In the Farah Manufacturing Co. case, the Texas Appellate Court found evidence sufficient to support a verdict that was based

236. Id. at 69-70 (citing Lawrence v. Muter Co., 171 F.2d 380 (7th Cir. 1948); American S. Trust Co. v. McKee, 293 S.W. 50 (Ark. 1927)).
238. Schechter, supra note 172, at 915.
240. For good background on the Farah Manufacturing Co. case, see Ebke & Griffin, supra note 237 at 777-82. When a LEXIS search was run using the term “tortious interference with corporate governance,” the computer located no cases, state or federal. By slightly modifying the search, the computer located only Farah Manufacturing Co. This case has also been Shepardized ad nauseam, but has not been cited very often.
in part upon "interference with business relations." The court stated that "[i]nterference with another's business relations with a third-party is actionable only if the interference is motivated by malice and no useful purpose of the inducing party is subserved."\textsuperscript{241} At first blush, it looks as if \textit{Farah Manufacturing Co.} is using the "tortious interference with contractual relations" that is discussed in so many cases. However, the court was actually extending the concept of "tortious interference with business relations" to cover an interference with the management of the corporation itself.\textsuperscript{242} In doing so, the court contradicted itself.

The court first set up the requirements for an action based on interference: "To maintain the action for interference with the contract, it must be established that (1) there was a contract subject to interference, (2) the act of interference was willful and intentional, (3) such intentional act was a proximate cause of Plaintiff's damage, and (4) actual damage or loss occurred."\textsuperscript{243} The Bank argued that on this statement of the law, it had not interfered "with an existing or reasonably probable future contract or business relation."\textsuperscript{244} The court admitted that "actionable interference has traditionally been found to fall within one of these two categories."\textsuperscript{245} However, in the next two paragraphs, the court seems to ignore the requirement of a contract as an essential element of the tort of interference:

The central theme of FMC's case is that the lenders interfered with FMC's \textit{own business relations and protected rights}. Although the lenders may have been acting to exercise legitimate legal rights or to protect justifiable business interests, their conduct failed to comport with standards of fair play. Upon consideration of the private interests of the parties and of the social utility thereof, the social benefits derived from permitting the lenders' interference are clearly outweighed by the harm to be

\textsuperscript{241} \textit{Farah Manufacturing Co.}, 678 S.W.2d at 688.

\textsuperscript{242} The tort of "tortious interference with corporate governance" can legitimately be considered to have been born in the \textit{Farah Manufacturing Co.} case. Unfortunately, the case has not been applied or interpreted by many courts in the years that followed its publication. The commentators have analyzed it extensively, but unfortunately, we are without much precedent. Lenders are advised to proceed cautiously, however. See Richard Greene, \textit{The Judge Hates a Bossy Lender}, \textit{FORBES}, Oct. 10, 1983, at 102. "Years ago the banks could say, 'Your Comptroller's an idiot, you've got to get rid of this guy.' Now he says, 'There seems to be some trouble in your comptroller's department, you should look at some things for possible change.' You hope he gets the idea." \textit{Id.} (quoting an attorney representing lenders).

\textsuperscript{243} \textit{Farah Manufacturing Co.}, 678 S.W.2d at 689 (quoting Armendariz v. Mora, 553 S.W.2d 400, 404 (Tex. Civ. App. 1977)).

\textsuperscript{244} \textit{Id.} at 690.

\textsuperscript{245} \textit{Id.}
expected therefrom.

In view of the foregoing principles, the evidence is legally sufficient that the lenders interfered with FMC's business relations, its election of directors and officers and its protected rights. FMC was entitled to have its affairs managed by competent directors and officers who would maintain a high degree of undivided loyalty to the company.\(^\text{246}\)

The court essentially re-drafted the elements of "interference" that it reiterated earlier. Under the court's holding in *Farah Manufacturing Co.*, it is no longer necessary that there be a contract with a third party that is interfered with. Rather, the willful interference with the election of officers and directors is sufficient. *Farah Manufacturing Co.* justifies this holding on policy grounds.\(^\text{247}\)

The holding in *Farah Manufacturing Co.* has been called "unprecedented."\(^\text{248}\) It is clear that the *Farah Manufacturing Co.* court expanded the concept of the tort of interference, which prior to that time had only existed for an interference with contractual relations. The Restatement defines the tort of interference as the following:

One who intentionally and improperly interferes with the performance of a contract . . . between another and a third person by inducing or otherwise causing the third person not to perform the contract, is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to perform the contract.\(^\text{249}\)

"Although some courts have held that the theory of interference will protect ordinary business relations, the *Farah Manufacturing Co.* court expanded the theory of interference beyond mere business relations to afford legal protection to the corporate governance rights of debtor corporations and their shareholders."\(^\text{250}\) Ebke & Griffin state that "*Farah Manufacturing Co.* will serve . . . as a legal catalyst in an increasingly liability oriented environment."\(^\text{251}\)

It is interesting to note that one of the defenses raised by the lender was that once its chosen officers were inserted onto the FMC board, it no longer dictated their actions. In response to this argu-

\(^{246}\) *Id.* (emphasis added) (citations omitted).
\(^{247}\) The court stated, "the social benefits derived from permitting the lenders' interference are clearly outweighed by the harm to be expected therefrom." *Id.*
\(^{248}\) Ebke & Griffin, supra note 237, at 788.
\(^{249}\) *RESTATEMENT (SECOND) OF TORTS* § 766 (1977).
\(^{250}\) Ebke & Griffin, supra note 237, at 788.
\(^{251}\) *Id.* at 800.
ment, the court wrote that "the acts of the lenders . . . set in motion a chain of foreseeable events from which FMC sustained injury and for which State National may be held accountable." Thus, Farah Manufacturing Co. dispenses with an agency analysis, and simply uses the ordinary tort standard of foreseeability.

Farah Manufacturing Co.'s expansion must be balanced against the earlier case of Del State Bank v. Salmon. There, the Oklahoma Supreme Court reversed a jury award of damages for a bank's wrongful interference with the borrower's employment contract. The court felt that a lender is privileged to interfere in its borrower's affairs so long as its motivation for doing so is "to better its financial position with respect to the loans and not to wrongfully harm the borrower." Farah Manufacturing Co. is thus a significant departure from the holding in Del State Bank.

Is this departure from precedent really necessary? Ebke and Griffin do not think so. "Under Farah Manufacturing Co.'s unprecedented expansion of the interference theory the establishment of a specific contract or prospective contractual relationship does not seem to be essential to an actionable claim for interference in a debtor's corporate governance." Farah Manufacturing Co. ultimately rests upon a straight tort analysis. The bank took some action which it should have foreseen would result in damage to the borrower. Because the Farah Manufacturing Co. court had determined that a fiduciary duty existed between the bank and the borrower, this action was improper.

The problem with this "straight tort" analysis of Farah Manufacturing Co. is two-fold. First, the theory has not been widely embraced. While Farah Manufacturing Co. is cited often in Texas, it is rarely cited elsewhere. This may be the result of a conception that Texas is an overly protective state for debtors. The second

252. Farah Manufacturing Co., 678 S.W.2d at 692.
253. See Prosser, supra note 17, at 288-309.
255. Id. at 1028.
256. Lawrence F. Flick & Dennis Replansky, Liability of Banks To Their Borrowers: Pitfalls and Protections, 103 Banking L.J. 220, 238 (1986); Del State Bank, 548 P.2d at 1027.
257. Ebke & Griffin, supra note 237, at 788-89.
258. According to the authors' research, the Farah Manufacturing Co. opinion had been cited 31 times by Texas courts but only 48 times altogether as of this article's publication date.
259. See In re Fernandez, 855 F.2d 218, 221 (5th Cir. 1988); Armour Fertilizer Works v. Sanders, 63 F.2d 902 (6th Cir. 1933); In re Baker, 182 F. 392, 394 (6th Cir. 1910) ("It has been the policy of the State of Texas in its Constitution and legislation, as construed by the
problem with Farah Manufacturing Co. is that the analysis would seem to sweep extremely broadly. That is, any time a lender exercises control over a borrower, it is foreseeable that some damage may be suffered by the borrower. In this sense, the Farah Manufacturing Co. opinion could be analyzed to be a “strict liability” for lenders case. An application of agency theory, however, would eradicate these problems while achieving the same result.

The foregoing analysis demonstrates that the key to finding liability on an interference claim is control.260 “Because the theory of agency embodies fiduciary principles, . . . a controlling creditor may owe a fiduciary duty to its debtor.”261 In other words, if the lender has placed an agent into the operation of its borrower, it has interfered with the borrower's corporate governance and may have incurred a fiduciary obligation. “The consequences of finding such a fiduciary relationship are dramatic because the lender must put the borrower’s interests first.”262 Finally, “it appears that no simple rule or formula of what constitutes control exists because the existence of a control relationship ‘necessarily depends upon the cumulative impact of the facts and circumstances of the particular case.’”263

In Credit Managers Association v. Superior Court, a California appellate court found that where a bank threatened to call a loan unless the borrower hired a business consultant, the borrower had a cause of action.264 The consultant in that case had “supplanted and overruled the board of directors.”265 The court found that it was the placement of a person into the borrower’s operation whose allegiance was primarily to the lender was improper.


260. “Control may be manifested in several ways. A lender may obtain voting control, participate on the debtor’s board of directors, gain control of management, exert financial control, or interfere with the borrower’s other contractual relationships.” Cassedy, supra note 222, 170-72 (footnotes omitted).

261. Ebke & Griffin, supra note 237, at 794 (footnote omitted).

262. Cassedy, supra note 222, at 182.


265. Cassedy, supra note 222, at 179.
However, a borrower may not be forced to rely upon the uncertain expansion of interference by *Farah Manufacturing Co.* Rather, the borrower may be successful in arguing that the bank controlled the borrower through an agent, and therefore must bear the responsibility for bad acts done by the agent in the scope of the relationship.

**B. Control of the Borrower by the Bank**

Traditionally banks have been held liable for inordinate levels of control of a borrower on a variety of theories including "instrumentality," "alter ego," and "equitable subordination."

These cases are somewhat similar to the *Farah Manufacturing Co.* case in that they often turn upon the finding of a fiduciary relationship between the bank and its borrower.

Ordinarily there is no fiduciary relationship between a bank and its borrower. "The finding of a fiduciary relationship turns upon whether 'such control over the decision-making process of the debtor . . . amounts to a domination of its will . . ." Absent the court's finding of such a fiduciary relationship in *Farah Manufacturing Co.*, there would have been no liability. For example, in the factually similar case of *In re Prima*, no liability resulted where a fiduciary relationship was not found. The *Prima* and *Badger* opinions are cited below as examples of the level of control necessary.


268. Jeremy W. Dickens, *Note, Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control"*, 65 TEX. L. REV. 801, 835 (1987) (citing Anaconda-Ericsson, Inc. v. Hessen (*In re Teltronics Servs., Inc.*), 29 B.R. 139, 170 (Bankr. E.D.N.Y. 1983)). The term "fiduciary" means "a person holding the character of a trustee . . . in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires." *BLACK'S LAW DICTIONARY* 563 (5th ed. 1979). A fiduciary "relationship exists when there is a reposing of faith, confidence and trust, and the placing of reliance by one upon the judgment and advice of the other." *Id.* The Restatement of Trusts states that a fiduciary "is under a duty to act for the benefit of the other as to matters within the scope of the relation." RESTATEMENT (SECOND) OF TRUSTS § 2 cmt. b (1959). "A fiduciary relationship exists whenever any person acquires a power of any type on condition that he also receive with it a duty to utilize that power in the best interests of another, and the recipient of the power uses that power." J.C. SHEPHERD, *THE LAW OF FIDUCIARIES* 96 (1981).


to incur lender liability for damages resulting from that control.

1. **Prima & Badger**

The *Prima* case involved a company that claimed it was forced into bankruptcy by the wrongful control and mismanagement of the company by its lender. Prima was a brewery that was operating prior to prohibition. During prohibition, Prima manufactured near-beer and ginger ale, and was one of only five breweries in Chicago to survive prohibition. Upon the repeal of prohibition, Prima made a calculated estimate that sales of beer would increase significantly, and that most sales would be in bottles. This was an incorrect assumption, as bottled beer sales quickly peaked and then dropped (beer sold in barrels met with more success). The company had invested heavily in bottles and bottling equipment, and subsequently lost a great deal of money. Prima did its banking with Harris Trust & Savings, who became dissatisfied with Prima's management. Harris therefore "suggested" the employment of Garnett C. Skinner as manager. Skinner was thereupon employed under an employment contract with Prima.

The trial court realized that the company had a reasonable fear that if they did not comply with the bank's suggestion that Skinner be employed the loan would be called and they would be out of business. The court referred to Skinner as both an "agent" and an "instrumentality" of the bank. Unfortunately, the Seventh Circuit disagreed.

The Court of Appeals found that "[t]he relation between the debtor and appellants was solely that of debtor and creditor, and it was not found that at any time there was a fiduciary relation between them." The court also noted that the bank allowed Prima to suggest its own manager, but that the corporation had suggested no one, because they did not wish to "discharge their old manager

272. *Id.* at 960-61.
273. *Id.* at 960.
274. *Id.*
275. *Id.* at 961.
276. *Id.*
277. *Id.*
278. *Id.*
279. *Id.* at 962.
280. *Id.* at 964.
281. *Id.*
who had been with them for many years.\textsuperscript{282} The court went on to find that there was no threat or inducement by the bank to execute the contract with Skinner, and that the bank was not present when the contract was executed.\textsuperscript{283} It was merely the belief of the debtor that led to the execution of the contract.\textsuperscript{284} This would be sufficient if the debtor were somehow inexperienced or easily influenced, but these facts were not present.\textsuperscript{285}

With the failure of their argument that forcing Skinner into their business was tortious, Prima turned to the acts of Skinner once he was in control. To support this argument, the company tried the agency theory. They argued that the terms of the employment agreement with Skinner placed "complete domination and control" in the hands of the bank, and "that for this purpose Skinner became their agent, and they were liable for his acts of mismanagement."\textsuperscript{286} The bank countered that the contract merely prevented a change of management without their consent, and did not put the operation of the business within their "complete domination and control."\textsuperscript{287} The court agreed, finding it significant that the company had retained Skinner as manager for a period of ten years under a second contract that was not known or approved by the bank.\textsuperscript{288}

In addition to these facts, the Court of Appeals noted that the company never complained about Skinner's management or criticized him.\textsuperscript{289} The court felt that if Skinner were truly engaging in mismanagement as an agent of the bank, the company would have called the bank to complain.\textsuperscript{290} The court also found that even if the contract had been procured by undue influence, the company later ratified it by keeping Skinner once it learned of the influence and not complaining to the bank.\textsuperscript{291}

As stated above, the most significant aspect of \textit{Prima} is that no fiduciary relationship was found. The opinion can be criticized for its "non-analysis" of the agency issue.\textsuperscript{292} That is, the court should

\begin{itemize}
  \item \textsuperscript{282} \textit{Id.}
  \item \textsuperscript{283} \textit{Id.} at 964.
  \item \textsuperscript{284} \textit{Id.} at 964.
  \item \textsuperscript{285} \textit{Id.} at 965.
  \item \textsuperscript{286} \textit{Id.} at 966.
  \item \textsuperscript{287} "Financial arrangements of a debtor that benefit the creditor to the debtor's detriment constitute circumstantial evidence of the creditor's control and domination." Douglas-Hamilton, \textit{supra} note 235, at 73.
  \item \textsuperscript{288} \textit{Prima}, 98 F.2d at 966.
  \item \textsuperscript{289} \textit{Id.}
  \item \textsuperscript{290} \textit{Id.}
  \item \textsuperscript{291} \textit{Id.} at 967.
  \item \textsuperscript{292} "Curiously, virtually all cases and treatises focus exclusively on control as the test
have considered how much control the bank exercised over Skinner at the time Skinner was being retained as the manager of Prima. The holding would be the same if the court determined that the bank exercised no control over Skinner. It is also important to realize that the court was looking at the relationship between the lender and the borrower, and not the lender and its chosen individual, Skinner.

The absence of a fiduciary duty was again the key to the ruling of Judge Schmetterer of the United States Bankruptcy Court for the Northern District of Illinois in *In re Badger Freightways, Inc.* In *Badger*, a trucking company alleged that its lender, Continental Bank, "suggested" the employment of a former Continental employee as the chief operating officer of Badger. The bank allegedly told Badger that it "should" let the new officer and another person selected by the bank run the business, and that Badger's current officers "should not" involve themselves in the day-to-day management of the business.

In its bankruptcy, Badger alleged that these two individuals engaged in improper conduct, including the failure to properly keep accounting records and make income tax payments on time. Badger fired one of them, and the other left without notice upon the firing. Badger alleged in its bankruptcy case that these two individuals were the agents of Continental.

Badger filed an adversary action in the bankruptcy court seeking equitable subordination of Continental's claims, based upon the alleged improper acts of Continental. The court recognized that usually a financial institution does not have a fiduciary relationship of agency, without discussing whether the agent had been acting both under the principal's control and on the principal's behalf, as is required by section 1(1) of the Second Restatement. The *Prima* opinion not only does not consider whether the "agent" was acting on the principal's behalf, but does not even engage in a control analysis. The *Prima* case is thus a good example of how the same facts can come out differently depending on whether a court analyzes the case under the "instrumentality rule" or under agency principles.

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294. *Id.* at 973, 978-79.
295. *Id.* at 973.
296. *Id.*
297. *Id.* at 973.
298. *Id.*
299. The complaint sought the determination of lien priority and included a preference action. These are core matters over which the bankruptcy court has jurisdiction by reference from the district court. However, on the "breach of asserted duty" count in the complaint, the bankruptcy judge did not have jurisdiction to enter a final order. This was a non-core action, and as such would be reviewed de novo by the district court, after proposed findings of fact and conclusions of law by the bankruptcy court.
An exception to this general rule exists when the lending institution exerts "dominion and control" over its customer. The rationale behind this exception is significant. If the lending institution usurps the power to make business decisions from the customer's board of directors and officers, then it must also undertake the fiduciary obligation that the officers and directors owe the corporation (and its creditors). This reasoning also dictates the scope of the term "control." What is required is operating control of the debtor's business, because only in that situation does a creditor assume the fiduciary duty owed by the officers and directors.

The court noted that "close monitoring of the debtor's finances" and "making business recommendations" were inadequate to establish control.

Thus, the court held that on the motion to dismiss by Continental, Badger had to show facts that would support both the existence and breach of a fiduciary duty owed to Badger by Continental, or gross misconduct by Continental. The court found that neither existed, and therefore granted the motion to dismiss. Although the court recognized not only that notice pleading is to be construed liberally, and that this is enhanced by the fact that the action is for equitable subordination, which is even more liberal, it nevertheless held that Badger had not alleged enough facts to support its cause. Badger argued that all of the previous control and mismanagement cases had been decided after evidentiary hearings, and argued that it should be provided with such a hearing at which it could present evidence that would support its allegations. The judge declined to grant them this opportunity. He felt that Badger had shown only that Continental recommended they hire the two managers, that there was a "close relationship" between one of the managers and Continental, that the management of the business was turned over to

301. Id. at 977.
303. Id. at 976-77.
304. Id. at 977.
305. Id.
306. Id. at 977-78.
307. Id. at 978.
them on Continental’s recommendation, and that Continental benefited from the actions of the managers. 308 “Without factual allegations showing the existence of an arrangement to control Badger, it is clear that Continental’s recommendation of these two men and their subsequent management of Badger does not by itself establish control and dominion.” 309

The court drew an analogy to Prima, quoting that portion of the Prima opinion that held that the debtor’s acquiescence in the bank’s recommendations was insufficient to constitute domination. 310 Without the existence of a fiduciary relationship, the debtor was unable to show any actionable misconduct by the bank.

The decisions of the courts in Prima and Badger may be criticized on two grounds. First, they properly sought to ascertain whether a fiduciary relationship existed, but they focused on the relationship between the bank and the borrower, rather than on the relationship between the bank and the individual acting on the bank’s behalf. Second, they failed to consider that if those individuals were found to be the agents of the bank, then a fiduciary relationship did exist, as between the bank and the agent. Therefore, when the agent took action that was within the scope of that relationship, and that action resulted in damage to the borrower, the bank could be held liable on a respondeat superior theory. On the other hand, these cases involved actions for equitable subordination, rather than damages.

As shown by Farah Manufacturing Co., Prima, and Badger, liability may be proven if the debtor can successfully plead and argue that a fiduciary relationship existed between the bank and the debtor. This may be established if it can be shown that the bank controls the borrower by placing an agent into the borrower’s operations. “It is the fact of control . . . that creates the fiduciary obligation.” 311

2. Using Agency Theory In Control Cases

It would seem that one could simply apply straight agency theories, as discussed in the first half of this article, 312 to hold banks liable for wrongful control borrowers. “It is surprising, therefore,

308. Id. at 978.
309. Id. at 978.
310. Id. (citing Prima, 98 F.2d at 965).
312. See supra part II.
that so few courts or litigants have done so." In fact, few courts have done so. *Prima* used the instrumentality theory, requiring complete domination and control of the debtor such that the debtor and the creditor were for all intents and purposes the same entity. Somewhat less control than required by the *Prima* court was required for the court in *A. Gay Jenson Farms Co. v. Cargill, Inc.*, holding that recommendations on how to run the business, a right of first refusal, veto power over contracts and dividends, right to entry of premises for audits, control of finances, salaries, etc. all amounted to a fiduciary relationship. And, according to *Farah Manufacturing Co.*, the installation of management personnel into an operation will result in a fiduciary relationship, yet even *Farah Manufacturing Co.* does not apply agency theory.

In *Cargill*, agency theory was used in an attempt to show that the borrower itself was the agent of the lender. There the following actions by the creditor amounted in a finding of control by the principal sufficient to subject the principal liable for the agent’s acts:

1. A number of suggestions were made about the day to day operation of the business.
2. The creditor contacted the debtor daily.
3. The creditor’s headquarters told the regional office that the creditor had the power to make critical decisions regarding the debtor’s use of funds.
4. The creditor told several third-parties that there would be no problem receiving payment from the debtor.
5. An officer of the creditor was sent to the debtor’s business to “supervise” its operation.

The court cited the Restatement of Agency in deciding that these factors amounted to improper control of the debtor.

A contrary case is *Buck v. Nash-Finch Co.* In *Buck*, the creditor insisted on the use of its own accountant by the debtor; the cred-

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313. Schechter, supra note 172, at 915.
314. *In re Prima Co.*, 98 F.2d 952, 966 (7th Cir. 1938).
316. *Id. at 291; see also* Ebke & Griffin, supra note 237, at 793; Brian L. Becker, *Note, Agency—Creditors and Buyers as Principals: Beware of Too Much Control*, 32 KAN. L. REV. 499 (1984) (discussing *A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285 (Minn. 1981)).
318. *Cargill*, 309 N.W.2d at 290.
319. *Id. at 289.
320. *Id. at 291-92.
itor visited the debtor weekly to give advice, the creditor installed a “store manager,” and demanded the firing of certain employees of the debtor. Buck held that the creditor cannot be liable unless it was in direct control over the specific activity of the agent giving rise to the action. This is a ridiculous holding. Once the agency was established, the only remaining question should have been whether the actions were within the scope of the employment. If the creditor has sufficient control over the debtor, any act of the agent within the scope of the agency may be imputed to the principal. By requiring minutely particularized control as a precondition of liability, the Buck court has blurred the distinction between master/servant relationships, which involve tight control, and ordinary agency.

But here again, both Cargill and Buck were focused upon equitable subordination, and did not involve actions against the lender by the borrower. What this section of the article has shown, however, is that a lender who has subjected its borrower to control through the insertion of unwanted personnel may face a cause of action against the lender for wrongful control on the principles of respondeat superior.

IV. CONCLUSION

This article set out to accomplish two things in four sections. The intention was to first explain and discuss agency law and the concept of respondeat superior. This was done by providing definitions for terms such as “master,” “servant,” “nonservant agent,” and “independent contractor.” Next, these concepts were applied to the theory of respondeat superior to determine when a principal will be held liable for actions of an agent. The article concluded that the question of “control” is not important for imputing liability, but only for determining whether the individual controlled is an agent. More importantly, the article concluded that control is only relevant at the inception of the agency relationship. Thereafter, in applying the concept of respondeat superior, courts should only concentrate upon whether the actions taken by the agent were within the scope of employment.

322. Id. at 86-87.
323. Id. at 90-91.
324. Schechter, supra note 172, at 921. Schechter also discusses the Chicago Mill & Lumber v. Boatmen's Bank case, which basically held that there could be no agency liability absent an express agency agreement between the bank and the borrower. Schechter concludes that “Chicago Mill is such a great departure from traditional agency law that it should be given no weight.” Schechter, supra note 172, at 922.
The second thing this article set out to accomplish was an application of these agency principles to lender liability. This was also done in two sections. First, the relatively new tort of “tortious interference with corporate governance” was discussed. Such a cause of action may be relied upon by a borrower who has had individuals “forced” upon it by its lender. Lenders may be dissatisfied with the management or governance of a corporate borrower, and may therefore seek to supplant the borrower’s personnel with “hand-picked minions” of their choosing. When these “minions” make poor decisions or take other actions that result in damage to the borrower, the borrower may sue the lender on a theory of interference.

Because the expansion of the tort of interference has not been widely recognized, the article has suggested that the borrower may proceed directly on a theory of respondeat superior based upon the lender’s improper control of the borrower. The article examined and rejected several other “control” cases, which mainly involved actions by third parties seeking to hold a lender responsible for a debt owed the third party by the borrower. These cases were criticized and distinguished as improperly applying agency law and/or being irrelevant to a direct action by the borrower against its lender.

In summary, the article addresses the situation where a lender forces a borrower to accept an individual as a high ranking director or officer and who subsequently causes damage to the borrower. Without some clarification of agency principles, the borrower is left without a remedy for improper conduct by the bank. Essentially, a bank who forces an individual into a borrower’s operation must be willing to accept the responsibility for that individual’s mistakes or misconduct. Without the harmonization of agency law as described in this article, borrowers are left only with a “control” test that courts developed to deal with cases involving equitable subordination. This test is inadequate to address the legitimate concerns of borrowers who are mistreated by their lenders.
APPENDIX

<table>
<thead>
<tr>
<th>SERVANT</th>
<th>INDEPENDENT CONTRACTOR IS NON-SERVANT AGENT</th>
<th>INDEPENDENT CONTRACTOR NON-AGENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Physical Result is contemplated</td>
<td>- Abstract or legal result contemplated</td>
<td>- Independent contractor works for employer using his own skill and judgment: I/C can not bind employer contractually</td>
</tr>
</tbody>
</table>

INCREASING CONTROL

- Full control over Physical conduct
- May be minimum control over Physical conduct
- No control over physical conduct

Legal Result: Principal - Master LIABLE for unintentional torts of servant within scope of agency — includes torts incidental to scope of agency.

Legal Result: Principal NOT liable for unintentional torts of non-servant agent (independent contractor) unless tort was committed within inherent scope of employment.

Legal Result: Employer NOT liable for torts of I/C, unless task assigned I/C was ultra-hazardous or P interfered with the work of the I/C.

325. Wolfe & Naffziger, supra note 66, at 129.