Fraud Liability Under Agency Principles: A New Approach

Steven N. Bulloch
FRAUD LIABILITY UNDER AGENCY PRINCIPLES: A NEW APPROACH

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I. INTRODUCTION

The law of agency is unique because it encompasses two separate bodies of law: first, the law governing the vicarious liability of one person for the torts of another; and second, the law governing the contractual rights and obligations created for one person by the actions of another. These two bodies of law developed separately, and the concept of one person's authority to enter into contractual relations on behalf of another evolved long before the concept of vicarious tort liability.1 The theoretical justifications underlying these bodies of law also are totally distinct from each other.2 Although the two bodies of law generally are treated under the broad heading of "agency law," they are best approached as two separate branches.

One question of agency law which is not approached in the expected manner is the potential liability of one person for fraud committed by another. Because fraud is a tort,3 one would assume that the potential liability of one person for the fraudulent conduct of another should be analyzed under the vicarious tort liability branch of agency law. Surprisingly, however, courts customarily

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1. The concept of one person's authority to enter into contractual relations on behalf of another was recognized fully under English common law by the end of the thirteenth century. See 8 W. Holdsworth, A History of English Law 222-23 (3d ed. 1926). Vicarious tort liability did not emerge, however, until the seventeenth or eighteenth century. See W. Keeton, D. Dobbs, R. Keeton & D. Owen, Prosser and Keeton on the Law of Torts § 69, at 500 (5th ed. 1984) (concept of vicarious tort liability began to crystallize after 1700); Ferson, Bases for Master's Liability and for Principal's Liability to Third Persons, 4 Vand. L. Rev. 260, 262-64 (1951) (vicarious liability doctrine established about 1800).

2. See infra notes 5-29 & 33-46 and accompanying text.

have analyzed questions of fraud under the authority branch of agency law.\(^4\)

This Article examines, as its central question, whether the customary analysis of fraud using authority principles is the correct way to analyze one person's liability for another's fraud, or whether typical vicarious tort liability principles should be applied. The examination begins with a general discussion of the theoretical justifications supporting vicarious liability for torts other than fraud. Next, the Article discusses authority principles and how they are applied to fraud. The Article then examines the results reached by analyzing fraud cases under vicarious liability principles and compares them to the results of fraud cases analyzed under traditional authority principles. Finally, the Article examines and resolves the central question, concluding that the customary analysis of fraud under authority principles leads to correct results in some, but not all, cases. To reach appropriate results in all instances, the Article suggests that potential fraud liability should be tested using both authority and vicarious liability principles.

II. TYPICAL VICARIOUS LIABILITY ANALYSIS

One person's liability for the torts of another generally is analyzed under concepts involving "masters" and "servants." For vicarious liability\(^5\) to exist, the tortfeasor must be a servant of the person to be held vicariously liable (the master) and the servant must have committed the tort while acting within the scope of employment.\(^6\) The key questions are who is a servant and when does the servant act within the scope of employment. The Restatement (Second) of Agency provides the generally accepted definitions of "master" and "servant:"

(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

\(^4\) See infra notes 47-51 and accompanying text.
\(^5\) Courts often use the phrase "respondeat superior" to describe the branch of agency law relating to the liability of one person for the torts of another. This Article, however, uses the synonymous phrase "vicarious liability" throughout.
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 to control by the master.\textsuperscript{7}

Under the Restatement definition, servants are a subcategory of agents.\textsuperscript{8} As a result, the definition of "servant" is not complete until "agent" also has been defined.

According to the Restatement:

(1) Agency is 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.

(2) The one for whom action is to be taken is the principal.

(3) The one who is to act is the agent.\textsuperscript{9}

This definition indicates that, for an agency relationship to exist, one person must have consented to act on behalf of and subject to the control of another. A servant, therefore, is an agent whose physical conduct at work is controlled by a principal (the master). If a servant commits a tort, the master is liable vicariously as long as the tort is committed within the scope of the servant's employment.

The justifications for holding a master vicariously liable for the torts of a servant can be categorized according to three theories: the "prevention" theory, the "loss spreading" theory, and the "allocation of resources" theory. The prevention theory\textsuperscript{10} is based on

\textsuperscript{7} Restatement (Second) of Agency § 2(1) (1958) [hereinafter cited as Restatement].

\textsuperscript{8} As the inclusion of servants as a subcategory of agents illustrates, the Restatement does not separate agency into two branches. The decision not to divide agency law occurred after some debate. See Conard, What's Wrong With Agency?, 1 J. Legal Educ. 540, 553-54 (1949). This approach has contributed to the confusion concerning agency questions because it calls for the application of a single definitional structure to concepts with separate theoretical justifications. For example, under the Restatement both the principal-agent relationship and the master-servant relationship require "control." Restatement, supra note 7, §§ 1-2. Control, however, serves no function in the creation of a principal-agent relationship and should not be necessary for this relationship to exist. See infra note 63.

\textsuperscript{9} Restatement, supra note 7, § 1.

\textsuperscript{10} The prevention theory sometimes is referred to as the "private policeman" theory. See Laski, The Basis of Vicarious Liability, 26 Yale L.J. 105, 114 (1916).
the assumption that if the tortfeasor is a servant and the tort is committed within the scope of employment, no one, other than the tortfeasor himself, is in a better position than the master to prevent the occurrence of the tort. Consider a typical situation. An employee, making a delivery to a customer in his employer’s truck, runs a red light and injures a pedestrian. In this situation, the employer, as well as the employee, inevitably will be held liable to the pedestrian for the pedestrian’s injuries. Liability will attach regardless of the level of care the employer exercised in choosing the employee to drive the truck and in taking precautions to ensure the safe performance of the employee’s duties. Simply put, this employer is liable even if he is totally without fault. The prevention theory reaches this result because the employer is in the best position to prevent such accidents. Proponents of the theory reason that the employer could have directed the employee to follow a particular route and to take certain safety precautions, or could have disciplined the employee via suspension or discharge for failing to take proper precautions. Strict liability for an employee’s torts, according to the theory, will encourage employers to take additional precautions to ensure that these torts will not occur.

The ability to take additional precautions is premised upon the employer’s right to control how employees perform their work. The Restatement definition of “servant” squares with this theory because it focuses on the master’s control of the servant’s activities. The master’s “right to control the physical conduct of the [servant] in the performance of the service” enables the master to take appropriate steps to prevent the servant from causing additional injuries.

11. The distinction between a master’s vicarious liability for his servant’s torts and a master’s liability for breach of a duty owed to a third person should be kept in mind. For instance, a master will incur liability if he hires an incompetent servant whom he should have known was incompetent and if that servant’s incompetence causes injury to a third person. Cf. Dempsey v. Walso Bureau, Inc., 431 Pa. 562, 568, 246 A.2d 418, 420 (1968) (noting the rule, but affirming the trial court’s decision in favor of the employer on other grounds). A master also will incur liability if he fails to supervise his employee properly and if this failure results in injury to a third person, regardless of whether the employee is characterized as a servant. See, e.g., Darling v. Charleston Community Memorial Hosp., 33 Ill. 2d 326, 211 N.E.2d 253 (1965), cert. denied, 383 U.S. 946 (1966). In these situations, liability is not “vicarious” because the master is the actual tortfeasor.


13. Restatement, supra note 7, § 2(1).
injuries. Control is thus an essential ingredient of the master-servant relationship under the prevention theory, and it explains the employer's liability for the employee's torts in the previous example and in similar situations.\textsuperscript{14}

Although prevention once was the leading justification for the imposition of vicarious liability, courts have utilized other justifications in more recent cases.\textsuperscript{15} Many courts and commentators now believe that these new theories are more persuasive than the prevention theory.\textsuperscript{16} Two of the leading modern theories are the "loss spreading" and "allocation of resources" theories.

\begin{itemize}
\item \textsuperscript{14} In Shedd Brown Mfg. v. Tichenor, 257 S.W.2d 894 (Ky. Ct. App. 1953), the court stated:

\begin{quote}
Charging one with the negligent acts of another, under the doctrine of respondeat superior, is an arbitrary rule based on public policy, and its justification is that the employer should be vigilant in supervising those in his employ to protect the public generally. It would be an unfair application of the rule if the "employer" had no way of guarding against liability by having some control over, or right to control, the particular act or instrumentality which causes the injury.
\end{quote}

Id. at 895-96 (citations omitted). Commentators have echoed this reasoning:

\begin{quote}
[The significance of the right of control] lies not in any connection between control and fault but rather in its bearing on the possibility of accident prevention. There is little doubt that employers of labor are among those strategically placed to promote accident prevention in connection with their operations. . . . It is . . . clear that one of the main reasons why the employer is in this strategic position is his general right of control over his employees while they are engaged about his business. . . . Pressure of legal liability on the employer therefore is pressure put in the right place to avoid accidents.
\end{quote}


\item \textsuperscript{16} See Lange v. National Biscuit Co., 297 Minn. 399, 403, 211 N.W.2d 783, 785 (1973) (stating that the most frequently stated justification is loss spreading; prevention is only a secondary justification); W. Keeton, D. Dobbs, R. Keeton & D. Owen, supra note 1, § 69, at 500 & nn.8-9. In Prosser and Keeton on the Law of Torts, the authors state:

\begin{quote}
What has emerged as the modern justification for vicarious liability is a rule of policy, a deliberate allocation of a risk. . . . [Losses] are placed upon the employer because . . . he is better able to . . . distribute them . . . to the public. . . . Added to this is the makeweight argument that an employer who is held strictly liable is under the greatest incentive . . . to take every precaution to see that the enterprise is conducted safely.
\end{quote}
\end{itemize}
The loss spreading theory was introduced by Young B. Smith in his classic article *Frolic and Detour*.\(^{17}\) In that article, Smith stated that the master of a tortfeasor, as opposed to the victim of the tort, should bear the cost of the injury because the master is a better "loss spreader."\(^{18}\) Smith and his followers suggest that, through the mechanisms of insurance, profit reduction, wage reduction, and price increases, an enterprise could spread the loss efficiently among diverse groups including employees, customers, and other producers of similar products. The injured person, on the other hand, could not so spread the loss, according to the theory.\(^{19}\) The theory rests on the premise that the injured party is not in a position to spread the loss caused by the injury, but rather will have to bear the entire loss if the master is not called upon to absorb it.\(^{20}\) Underlying this premise is the assumption that insurance against the injury is not available to the victim or that its cost is too great to warrant its purchase.\(^{21}\)

The other modern justification for vicarious liability is the allocation of resources theory espoused by Guido Calabresi.\(^{22}\) Calabresi bases his theory on the assumption that price is the key ingredient in determining how an efficient society should operate.\(^{23}\) According to the theory, the world is composed of rational persons who make buying decisions based on price,\(^{24}\) and society will allocate resources properly if the price of each good or service fully reflects

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\(^{17}\) Id. § 69, at 500; see also Note, *Respondeat Superior and the Intentional Tort: A Short Discourse on How to Make Assault and Battery a Part of the Job*, 45 U. CIN. L. Rev. 235 (1976) (suggesting that spreading the costs of the activity is the underlying rationale for vicarious liability).


\(^{19}\) Id. at 457-58.

\(^{20}\) Id.

\(^{21}\) Id. at 458.


\(^{23}\) Id. at 502.

\(^{24}\) Id.
all the costs attributable to it. As the cost of a particular good or service increases, the probability that a particular consumer will buy it decreases correspondingly, and vice versa. Calabresi postulates that the cost of producing goods should include not only labor and material costs, but also the social costs associated with injuries related to the enterprise. Unless the price of more hazardous activities includes these social costs, goods and services produced through these activities will be overproduced and under-priced. As a result, according to the theory, the economic system will suffer from a misallocation of resources. To prevent these problems, Calabresi suggests that any harm attributable to an enterprise or activity should be included as a cost of production in the price of the goods or services produced by the enterprise.

The loss spreading and allocation of resources theories do not depend upon the master's control over the servant, a factor that is critical to the operation of the prevention theory. These two theories can be applied in situations in which control is nonexistent, including the independent contractor situation. All three theories, however, potentially are useful in considering the proper scope of one person's liability for another's fraud. After considering the current status of fraud liability under authority concepts, this Article returns to these theories in considering a new approach to fraud liability.

25. Id. at 503.
26. Id.
27. Id. at 544.
28. Id.
29. Id. At least one commentator has argued, however, that liability rules have no effect on the allocation of resources in a world of costless transactions because individuals are able to adjust the relative costs of their activities by agreement. Coase, The Problem of Social Cost, 3 J. L. & Econ. 1, 6-8 (1960). Calabresi responds that the "Coase theorem" operates correctly only in a world with no transaction costs or legal impediments to bargaining, and where people act rationally. Calabresi concludes that these three conditions do not exist in the real world. Calabresi, Transaction Costs, Resource Allocation and Liability Rules—A Comment, 11 J. L. & Econ. 67, 68-69 (1968). Calabresi also states that the role of the law is to make rules that approximate the results in Coase's utopia as closely and cheaply as possible. Id. at 69; see also Sykes, The Economics of Vicarious Liability, 93 Yale L.J. 1231, 1241 (1984) (arguing that vicarious liability will affect the allocation of resources, particularly when the transaction costs of allocating liability by private agreement between the employer and the tortfeasor are high or when the tortfeasor is judgment proof).
30. See supra notes 13-14 and accompanying text.
31. See infra notes 71-80 and accompanying text.
III. Present Treatment of Fraud

As stated in the introduction, liability for the fraud of another generally has been treated differently from liability for other torts committed by another. Courts have not analyzed fraud cases using master-servant concepts. Instead, they have applied concepts related to the authority branch of agency law, the branch usually concerned with the ability of one person, the agent, to represent another, the principal, and to enter legal relationships on behalf of the other. This branch of agency law is approached under the theory that courts should determine the scope of an agent's authority based on the objective manifestations which emanate from the principal to the agent or the third party—a theory akin to the objective theory of contracts.

The authority branch of agency law employs the concepts of actual and apparent authority. Actual authority is divided into two classes: express authority and implied authority. Communication of exact instructions from the principal to the agent concerning the agent's duties creates express actual authority. Implied actual authority, on the other hand, is based on the reasonable implications of the principal's manifestations to his agent. In contrast to both forms of actual authority, apparent authority is created by communications from the principal to a third party and "results from

32. See supra notes 3-4 and accompanying text.
33. Restatement, supra note 7, § 1(3).
34. Id. § 1(2).
35. Although the authority branch of agency law generally concerns the ability of an agent to enter into contracts on behalf of a principal, its scope is broader. The authority branch also covers an agent's ability to make representations that are binding on a principal in other contexts, such as the granting of licenses to use real property. See Antrim Iron Co. v. Anderson, 140 Mich. 702, 704, 104 N.W. 319, 320 (1905).
37. "Apparent authority is based upon the principle which has led to the objective theory of contracts, namely, that in contractual relations one should ordinarily be bound by what he says rather than by what he intends." Restatement, supra note 7, § 8 comment d; see Makousky, Inc. v. Stern, 285 Minn. 202, 172 N.W.2d 317 (1969).
statements, conduct, lack of ordinary care, or other manifestations of the principal's consent, whereby third persons are justified in believing that the agent is acting within his authority.\textsuperscript{40}

Apparent authority\textsuperscript{41} must be discussed to demonstrate how and why a principal becomes liable for an agent's fraud. The following examples illustrate apparent authority and its application to fraud cases. The first example involves a small town retailer who purchases many of his products from a nearby wholesaler. Suppose that the retailer instructed a new employee to go to the wholesaler and purchase twelve dozen widgets, provided that they cost no more than one dollar per dozen. The retailer also telephoned the wholesaler to tell him that he was sending the employee to purchase widgets in the next day or two and that the employee has authority to purchase the widgets only if they cost no more than one dollar per dozen. The next day, when the retailer noticed that widget prices were dropping, he instructed the employee to pay the wholesaler no more than ninety cents per dozen for the widgets. The employee went to the wholesaler later that day and saw that widgets were priced at ninety-five cents per dozen. The employee purchased the widgets anyway, believing they were a good buy, even though the purchase violated the retailer's instructions.

In this example, the retailer is obligated to pay for the widgets even though the employee did not have actual authority to

\textsuperscript{40} McGee v. Breezy Point Estates, 283 Minn. 10, 22, 166 N.W.2d 81, 89 (1969); see System Inv. Corp. v. Montview Acceptance Corp., 355 F.2d 463 (10th Cir. 1966).

Another concept closely related to apparent authority, which courts sometimes use in the context of principal-agent relations, is estoppel. The chief difference between estoppel and apparent authority is that estoppel requires a change of position by a third party in reliance on the communication from the principal, while apparent authority does not. See Restatement, supra note 7, § 8 comment d. The two concepts also yield different results in certain cases. The concept of apparent authority establishes the rights and duties of both the principal and the third party because the agent and the third party have formed a contract. See infra notes 41-44 and accompanying text. The concept of estoppel, however, establishes only the duties of the principal and only the rights of the third party because the principal is estopped from denying the natural consequence of his manifestation to the third party. Under estoppel, the third party is not bound unless he so chooses. Orcutt v. Tucson Warehouse & Transfer Co., 83 Ariz. 200, 318 P.2d 671 (1957).

\textsuperscript{41} The concept of apparent authority is not co-extensive with actual authority, and apparent authority may exist when actual authority does not. See supra note 40 and accompanying text.
purchase widgets for more than ninety cents per dozen. The retailer is obligated because, under the concept of apparent authority, a contract was made. The retailer manifested to the wholesaler over the telephone that the employee had authority to purchase widgets on his behalf for one dollar per dozen. Although the retailer later revoked the employee's actual authority to purchase widgets for one dollar per dozen, he never revoked the apparent authority created by the telephone call to the wholesaler. Because the wholesaler still believed that the agent had authority to purchase widgets for one dollar a dozen, a contract was made when the employee offered to purchase the widgets for ninety-five cents per dozen and the wholesaler accepted.

Most types of apparent authority are more subtle than the type just illustrated. The first example involved the simplest form of apparent authority, in which a principal directly communicated an agent's authority to a third party. A more complex type of apparent authority arises when a principal places an agent in a position that customarily involves certain powers. Suppose that, in Florida, sales representatives for swimming pool equipment manufacturers customarily have the authority to enter into contracts on behalf of their principals. Unaware of this local custom, a swimming pool equipment manufacturer from California hired a sales representative to sell his swimming pool equipment in Florida. The manufacturer gave the representative printed stationery and cards indicating that the representative was his exclusive sales agent, but the manufacturer told the representative that the home office in California must approve all orders before they become binding. The representative, in an attempt to obtain a commission, purported to make a contract for the sale of equipment to a third party on behalf of the California manufacturer without the manufacturer's approval. The manufacturer learned of the contract and considered the terms unfavorable.

Because sales representatives in Florida customarily have authority to enter into contracts on behalf of their principals, under

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42. The retailer's instruction to pay no more than ninety cents per dozen expressly revoked the employee's actual authority to purchase the widgets at one dollar per dozen.
the concept of apparent authority, the California manufacturer would be bound contractually even though the sales representative violated the manufacturer's instructions. Although the manifestation from the manufacturer to the third party regarding the representative's authority to contract was more subtle than the telephone call in the first example, a manifestation nevertheless occurred. By placing the representative in a position in which persons customarily have the power to contract, the manufacturer communicated to the third person, albeit indirectly, that his agent had such authority.44

These two examples demonstrate the fundamental premise underlying the concept of apparent authority. When the conduct of a principal creates in a third party reasonable expectations that the agent has the authority to enter into a particular contract, the third party should be allowed to enforce that contract against the principal if it was negotiated through the agent.

Another justification, however, underlies apparent authority. Both principals and third parties arguably benefit from a rule contractually binding principals when apparent authority exists because the rule promotes business expediency and ensures the free flow of commerce by enabling third parties to rely on what appears to be the authority of agents.45 For instance, the commercial transaction discussed in the first example above would not have moved as efficiently if the wholesaler had been required to contact the retailer to ensure the new employee's continuing authority to buy widgets for one dollar per dozen. Similarly, a requirement that the


45. In American Soc'y of Mechanical Eng'rs v. Hydrolevel Corp., 456 U.S. 556 (1982), the Supreme Court, considering whether the American Society of Mechanical Engineers (ASME) was liable for its agents' statements, stated:

Behind the principal's liability under an apparent authority theory, then, is business expediency—the desire that third persons should be given reasonable protection in dealing with agents. . . . The apparent authority theory thus benefits both ASME and the public whom ASME attempts to serve through its codes. It is . . . for the ultimate interest of persons employing agents, as well as for the benefit of the public, that persons dealing with agents should be able to rely upon apparently true statements by agents who are purporting to act and are apparently acting in the interests of the principal.

Id. at 567 (citations omitted).
swimming pool equipment purchaser in the second example call the manufacturer in California to ensure that the Florida sales representative had the powers customarily given to persons in his position in Florida would have impeded the free flow of commerce. Such requirements not only would place an additional burden on third parties, but also would impose upon principals the inconvenience of constantly having to confirm the scope of their agents' authority. If the concept of apparent authority did not exist, principals frequently would have to deal directly with persons with whom they had hired agents to deal—which would defeat the very purpose for appointing an agent.46

The fraud rule developed out of the same type of apparent authority analysis, and the application and underlying justifications are the same. For example, recall the swimming pool equipment manufacturer and his agent, and envision a situation in which a third party questioned the agent about the expected life of a chlorinator. Suppose that the agent told the third party that the chlorinator's expected life was twenty years when it actually was only five years. Suppose further that the agent made this representation knowingly and with the intent to induce the third party to buy the equipment, and that the third party did buy the equipment in reasonable reliance on the agent's misrepresentation.

Even assuming that the manufacturer did not authorize the agent's misrepresentation, and in fact told him always to be truthful with potential customers, the manufacturer still would be liable

46. Another concept, inherent agency power, also is predicated on business expediency. See Restatement, supra note 7, § 8A. Courts sometimes employ inherent agency power to bind the principal when the principal did not manifest assent to the third party—in other words, when apparent authority did not exist.

The best known case involving inherent agency power was decided by Judge Learned Hand. See Kidd v. Thomas A. Edison, Inc., 239 F. 405 (S.D.N.Y. 1917). Because apparent authority was not available in Kidd as a basis for the decision, Judge Hand employed a theory that borrowed from vicarious liability concepts. He ruled that the principal in Kidd was in a good position to prevent violations of his instructions by the agent, and therefore that the principal should be bound by the agent's actions even though the agent violated the principal's instructions. Judge Hand justified this result by noting that the third party had acted reasonably in believing that the agent had authority to enter into the contract in question. Id. at 406-07. According to Judge Hand, both the principal and the third party would benefit from the rule developed in Kidd because the rule would "avoid constant recourse by third persons to the principal, which would be a corollary of denying the agent any latitude beyond his exact instructions." Id. at 408.
if the third party brought a common law fraud action against him.\textsuperscript{47} The court would determine liability under an authority analysis, applying the general rule that an innocent principal is liable for an agent’s misrepresentations if the misrepresentations fall within the general class of statements that the principal apparently authorized the agent to make.\textsuperscript{48} The ultimate question would be whether the manufacturer apparently authorized the agent to make statements about the characteristics of the equipment. If so, the innocent manufacturer would be liable for the agent’s fraud.\textsuperscript{49}

\textsuperscript{47} The first step in determining a principal’s liability is to ascertain whether the principal’s agent has committed fraud. Unless the agent has acted fraudulently, no wrong exists for which the principal can be held liable vicariously. In this example, a court would find that the agent’s actions were fraudulent under any definition of fraud. Other cases, however, may not be as clear.

Under the conventional view, the essential elements of fraud are: (1) a misrepresentation of a material fact relating to the past or present; (2) knowledge or recklessness with respect to the misrepresentation; (3) an intent to induce reliance on the misrepresentation; (4) reasonable reliance upon the misrepresentation by the plaintiff; and (5) resulting injury to the plaintiff. Midland Nat’l Bank of Minneapolis v. Perranoski, 299 N.W.2d 404, 411 (Minn. 1980). In some jurisdictions, negligent misrepresentations, as well as knowing or reckless misrepresentations, are actionable. Gediman v. Anheuser Busch, Inc., 299 F.2d 537, 543 (2d Cir. 1962); Sult v. Scandrett, 119 Mont. 570, 178 P.2d 405 (1947). The Restatement (Second) of Torts even takes the position that innocent misrepresentations are actionable. RESTATEMENT (SECOND) OF TORTS § 552C (1977).

\textsuperscript{48} See, for example, J.C. Millett Co. v. Park & Tilford Distillers Corp., 123 F. Supp. 484, 495-96 (N.D. Cal. 1954), in which the court noted:

\begin{quote}
In a very real sense [the agent’s] authority did not extend to making the fraudulent statements but that is not required. The question is whether the statements were made in relation to the subject matter or business dealing in which the agent had authority. The principal is liable for placing his agent in a position which enables the agent while apparently acting within the scope of his authority to commit a fraud.
\end{quote}

Sometimes courts phrase the question in terms of whether the misrepresentation was apparently authorized. See Amen v. Black, 234 F.2d 12, 20 (10th Cir. 1956); RESTATEMENT, supra note 7, § 257(b); see also Bankers Life Ins. Co. v. Scurlock Oil Co., 447 F.2d 997, 1007 (5th Cir. 1971) ("[I]f the agent uses [his apparent] powers in a deceitful manner, it is not the innocent third party who should suffer, but the principal who inflicted the deceitful agent upon the public in the first place."). Regardless of how the issue is framed, however, the result will be the same.

Some courts have extended liability to the principal not only for misrepresentations within the class of statements that the principal apparently authorized, but also for misrepresentations within the class of statements that the principal actually authorized. Such an extension of liability, however, is unwarranted. See infra note 51.

\textsuperscript{49} Even if the court did not find the manufacturer liable for the agent’s fraudulent misrepresentations, the third party still could seek rescission of the contract under the equitable doctrine that a principal is not allowed to retain the “fruits” of his agent’s fraudulent
The justification for the fraud rule, like the justification underlying the concept of apparent authority to enter into contracts, is business expediency. Commerce flows much more smoothly when third parties are permitted to act upon reasonable representations made by an agent on behalf of a principal and when third parties need not inquire into the agent's authority to make such statements. Without the rule, the Florida swimming pool equipment purchaser in the previous example would have had to call the principal in California to verify that the expected life of the chlorinator was twenty years. Such a requirement would be just as time-consuming and burdensome to commerce as a requirement that third parties confirm agents' authority to enter into legal relations on behalf of their principals. In short, the concept of apparent authority serves the same purpose whether it is applied to a principal's liability for contracts made by a disobedient agent or to an innocent principal's liability for an agent's fraud.

50. See supra note 45 and accompanying text; Ricketts v. Pennsylvania R.R., 153 F.2d 757 (2d Cir. 1946).

51. Some courts extend a principal's liability to instances in which the misrepresentation falls within the general class of statements that the principal actually authorized the agent to make, even if no apparent authority existed to make the particular class of statements. See, e.g., Watson v. Yasunaga, 73 Wash. 2d 325, 438 P.2d 607 (1968); see also Loma Vista Dev. Co. v. Johnson, 142 Tex. 686, 180 S.W.2d 922 (1944) (stating the general rule, but holding for the defendant principal).

In Watson, the court held that the innocent principal's liability depended on whether the agent had "implied or apparent authority" to make the general class of statements in question. 73 Wash. 2d at 330, 438 P.2d at 610 (emphasis added). In Loma Vista, the court noted that an innocent principal's liability depended on whether the agent had "the implied authority to make representations as to the quality of the real estate"—the general class of statements within which the misrepresentation in Loma Vista fell. 142 Tex. at 689-90, 180 S.W.2d at 924 (emphasis added).

The use of actual authority as a basis for holding an innocent principal liable for his agent's fraud, however, is unwarranted. Under authority analysis, an innocent principal is held liable for his agent's fraud because third parties view the agent's apparently authorized statements as made on the principal's behalf, pursuant to his authorization. As a result, third parties justifiably form expectations as to the accuracy of the agent's statements. See supra notes 47-50 and accompanying text. Because actual authority is unconcerned with the effect of a principal's behavior on third parties, however, the justification for using authority analysis to analyze fraud cases does not extend to the concept of actual authority.
IV. ANALYSIS OF FRAUD UNDER VICARIOUS LIABILITY PRINCIPLES

Although courts traditionally have applied principles of apparent authority to determine when they should hold an innocent person liable for another's fraud, nothing precludes courts from applying conventional vicarious liability rules. In fact, a determination based upon vicarious liability principles would be particularly logical in fraud cases because this approach would be consistent with the treatment of all other torts. The following discussion describes how courts could apply vicarious liability concepts to determine one person's liability for another's fraud. Because analyses based upon the three distinct justifications for vicarious liability—prevention, loss spreading and allocation of resources—may lead to different results, this Article undertakes a separate analysis using each justification.

As discussed previously, the prevention theory imposes vicarious liability on masters for their servants' torts because masters have the right to control the conduct of their servants' work. Because of this control, proponents of the prevention theory argue, masters are in the best position to prevent servants from committing torts. The prevention theory in its present form is not applicable to fraud cases, however, because "servant" is defined narrowly as one "who is employed by a master to perform service in his affairs whose physical conduct in the performance of the service is controlled or subject to the right to control by the master." This definition renders the master-servant concept inapplicable to fraud cases because the ability to control the physical conduct of

52. See supra notes 10-29 and accompanying text.
53. See supra notes 10-14 and accompanying text.
54. RESTATEMENT, supra note 7, § 2(2) (emphasis added).
55. See id. § 2 comment a ("The words 'master' and 'servant' are herein used to indicate the relation from which arises . . . the liability of an employer for the physical harm caused to third persons by the tort of an employee."). This narrow concept of the master-servant relationship makes sense. The Restatement is not concerned with a master's right to control a servant's communications and to prevent fraud because it adopts the generally accepted approach to fraud, which applies authority principles instead of vicarious liability principles. See id. § 257 comment a ("For [misrepresentations], the principal's liabilities do not depend upon the theory of respondeat superior but upon the reason underlying liability upon authorized or apparently authorized contracts.").
another will not necessarily help the defendant to prevent fraud. Instead, because fraud is caused by inaccurate communications, the defendant must be in a position to control communications by the tortfeasor to the plaintiff in order to prevent fraud.

Courts could apply the prevention theory to fraud cases, however, by expanding the definition of “control” to include control over activities other than physical conduct. The expanded prevention theory would be based on the same assumption that underlies the present application of the prevention theory to tortious physical conduct—the assumption that, through control of an employee’s activities, an employer is in the best position to prevent the employee from committing fraud.

The loss spreading theory, instead of focusing on the employer’s control, focuses on whether the employer is in a better position than the victim to spread the loss incurred because of the employee’s conduct. The result under the loss spreading theory does not depend on the type of tort involved, but instead depends on the characteristics of the employer and the victim in the particular case. In a case involving an employer that is a large firm with numerous employees and customers and easily obtainable insurance versus a victimized consumer, vicarious liability is justified under the loss spreading theory. In a case involving an individual with few employees and customers versus a large business as a victim, vicarious liability is not justified. The inquiry under the loss spreading theory, however, is the same whether the case involves fraud or any other tort. Nothing suggests, therefore, that the theory of loss spreading could not be applied to fraud just as successfully as it is applied to other torts.

The allocation of resources theory also could be applied to fraud. Although a fraud victim suffers economic rather than physical harm, society still suffers a loss due to the employer’s activity. To insure the proper allocation of resources, the price of the employer’s product should reflect the cost of compensating the victim for that loss.

56. See supra notes 17-21 and accompanying text.
57. See United States v. Ridglea State Bank, 357 F.2d 495, 499 (5th Cir. 1966) (principal’s liability for agent’s fraud justified by the principal’s ability to spread losses).
58. See supra notes 22-29 and accompanying text.
In summary, each of the theories justifying vicarious liability could be applied to fraud cases. Whether application of these theories to fraud cases would yield better results, however, is another question. The following discussion compares the outcomes of two fraud cases analyzed under the traditional authority approach with the outcome of those same cases analyzed under a vicarious liability approach.

V. COMPARISON OF VICARIOUS LIABILITY AND AUTHORITY APPROACHES TO FRAUD CASES

A. The California Manufacturer Revisited

The first fact situation used to compare the two approaches to fraud involves the hypothetical California swimming pool equipment manufacturer discussed above, as well as the sales representative hired to distribute the manufacturer's equipment in Florida. Suppose that the manufacturer and the sales representative entered into an agreement granting to the sales representative the authority to enter into contracts on the manufacturer's behalf, provided that the contract price exceeded an agreed minimum. Suppose further that the representative was to be paid a commission rather than an hourly wage, that the manufacturer authorized the representative to sell other equipment and products, and that the manufacturer authorized the representative to sell the pool equipment whenever and wherever he chose. Finally, suppose that the sales representative committed fraud by misrepresenting the normal life expectancy of the chlorinator.

1. Authority Approach

Under a traditional authority analysis, a principal is liable for an agent's fraud if the misrepresentation falls within the general class of statements that the principal apparently authorized the agent to make on the principal's behalf. In the present example, the manufacturer would be liable if he apparently authorized the representative to make statements about the characteristics of his equipment because this would constitute the general class of statements

59. See supra text preceding note 44; supra notes 47-51 and accompanying text.
60. See supra notes 47-49 and accompanying text.
within which the misrepresentation would fall. A selling agent customarily has authority to make statements about the products he sells. Any restriction on this authority would interfere greatly with, if not totally frustrate, the representative’s sales efforts. The fraudulent statement concerning the life of the chlorinator, therefore, would fall within the general class of statements that the representative was apparently authorized to make, and the manufacturer would be liable for the representative’s fraud.

61. See supra note 49 and accompanying text.

62. See Watson v. Yasunaga, 73 Wash. 2d 325, 330, 438 P.2d 607, 610 (1968) (innocent principals held liable for sales agent’s fraudulent statements because “even if [the agent] lacked express authority to make the misrepresentations, the defendant sellers nevertheless are accountable for his actions on the basis of either implied or apparent authority”).

63. A threshold question that sometimes arises under an authority approach is whether the individuals involved ever entered into an agency relationship. If no agency relationship ever existed, the putative principal would not incur liability because, under an authority analysis, an agency relationship is essential to hold an innocent person liable for another's fraud. See, e.g., Arthur Murray, Inc. v. Smith, 124 Ga. App. 51, 183 S.E.2d 66 (1971) (franchisor who was sued for fraudulent misrepresentations of a franchisee absolved because the franchisor and franchisee never entered into an agency relationship).

In the present example, the manufacturer and sales representative assented to a relationship under which the representative had the authority to make contracts on the manufacturer’s behalf. Such agreements are the primary foci of principal-agent relationships. See Kerney v. Aetna Casualty & Sur. Co., 648 S.W.2d 247, 252 (Tenn. Ct. App. 1982). Most courts and commentators, however, also consider control a necessary element of an agency relationship because they require proof that the parties assented to a relationship in which the putative agent would act subject to the putative principal’s control, as well as on behalf of the putative principal. See, e.g., RESTATEMENT, supra note 7, §§ 1, 14. In the present example, the only control the manufacturer exerted over the representative was in setting the minimum price for the equipment below which the representative agreed not to sell the equipment.

Whether control should be necessary to a principal-agent relationship is debatable. When vicarious liability questions are approached under the prevention theory, control serves an important function because prevention is difficult without control. See supra notes 11-14 and accompanying text. Control serves no function in the authority branch of agency law, however, because the authority of an agent is based on communications from a principal to an agent or third party, and not on the principal’s ability to prevent harm. See supra notes 33-40 and accompanying text. The generally accepted notion that a principal must have control over a person before he is bound by that person’s acts probably resulted from the improper merger of two separate branches of agency law, with separate theoretical justifications, under a single definitional framework. See RESTATEMENT, supra note 7, §§ 1, 2.

Courts handle other aspects of agency law without any reliance upon control by a principal. For example, courts and commentators uniformly agree that agents owe a fiduciary duty to their principals. See, e.g., Pollock v. Lytle, 120 Cal. App. 3d 931, 940, 175 Cal. Rptr. 81, 85 (1981); Miller v. Berkoski, 297 N.W.2d 334, 339 (Iowa 1980). This fiduciary duty exists not because of any control that the principal has over the agent, but because the agent has
2. Vicarious Liability Approach

a. Prevention

Under the prevention theory, a defendant is liable for another's fraud only if the defendant has the right to control the conduct of the tortfeasor's work. In the example currently under consideration, the manufacturer probably would not be liable because the representative was an independent contractor—a person "who contracts with another to do something for him but is not controlled by the other nor subject to the other's right to control." The sales representative is likely to be accorded this status because he received a commission instead of an hourly wage, because he was authorized to sell products other than the manufacturer's swimming pool equipment, and because he was allowed to choose which customers he would see and when he would see them. Taken together, these factors are thought to indicate that the representative would have been unresponsive to any attempt by the manufacturer to control how he performed his work. The sales representative was an independent operative who contracted with the manufacturer to deliver finished products, namely signed sales


In the present example, the relationship between the manufacturer and the sales representative should be classified as an agency relationship because the representative was employed to act on the manufacturer's behalf. No control requirement should be imposed. Even if a control requirement were imposed, the control evidenced by the representative's agreement to sell the manufacturer's equipment for no less than a set price should be sufficient to meet a "control" requirement.

64. RESTATEMENT, supra note 7, § 2(3).

65. Payment for a completed job, as opposed to payment by the hour, indicates independent contractor status. McGregor v. Heitzman, 98 Ohio App. 473, 477, 129 N.E.2d 845, 847 (1953); RESTATEMENT, supra note 7, § 220(2)(g); see Smith v. Gennett, 385 S.W.2d 957, 959 (Ky. Ct. App. 1964).


contracts for swimming pool equipment, in return for commission payments.\textsuperscript{68}

Assuming that the sales representative were characterized as an independent contractor, prevention theory advocates would not find the manufacturer liable for fraud because he had so little control over the performance of the representative's work that the manufacturer could not have prevented the representative from committing torts.\textsuperscript{69} Even if the prevention theory were expanded to make it suitable for fraud analysis in the manner proposed earlier in this Article,\textsuperscript{70} the manufacturer still would not be liable. Not only was the manufacturer's control over the physical movements of the representative extremely limited, but the manufacturer also did not have a relationship with the representative that allowed him to control the agent's communications to third parties about the manufacturer's products. Because the representative engaged in business for himself, sold other product lines, and chose his own customers, he was unlikely to respond to the manufacturer's directions concerning the manner of presenting and selling the manufacturer's products.

\textbf{b. Loss Spreading}

Unlike the prevention theory, the loss spreading theory does not depend on the element of control. As long as a defendant can spread the loss, that defendant is a good candidate for vicarious liability under the loss spreading theory, even when control over the tortfeasor's actions does not exist and the tortfeasor would be characterized as an independent contractor. Because independent contractors often can spread losses resulting from their torts just as well as those who contract with them, however, the loss spreading theory generally permits a contractee to escape liability for an


\textsuperscript{69} See Harold A. Newman Co. v. Nero, 31 Cal. App. 3d 490, 496, 107 Cal. Rptr. 464, 467 (1973) ("The doctrine of nonliability 'is founded on the principle that one person should not be compelled to answer for the fault or neglect of another over whom he has no control. . . .'"); see also Wells, Inc. v. Shoemake, 64 Nev. 57, 64, 177 P.2d 451, 455 (1947) (holding that a tortfeasor is a servant, and not an independent contractor, when subject to the defendant's control; defendant liable because "responsibility is placed where the power exists").

\textsuperscript{70} See supra text following note 55.
independent contractor’s torts.\textsuperscript{71} Unlike run-of-the-mill hourly employees, independent contractors are likely to be entrepreneurs with customers and employees to whom losses can be spread.\textsuperscript{72} If these loss spreading mechanisms are available, the loss spreading theory dictates that a contractee should not be liable for an independent contractor’s fraud or other torts. On the other hand, if these loss spreading mechanisms are not available to the independent contractor, liability should attach. Neither situation requires any reference to the amount of control the contractee exerts over the independent contractor. The sole focus of the theory is the ability to spread losses.

In the example involving the California manufacturer and the Florida sales representative, the manufacturer would be liable if the representative did not have the ability to spread the loss through insurance or through recoupment of his loss from increased prices or decreased salaries. In this case, the representative probably cannot obtain insurance\textsuperscript{73} and, as an individual with no employees and a limited pool of customers, he has minimal loss spreading potential. In contrast, the manufacturer is a business enterprise with employees, customers, and readily available insurance. Because the representative is not a good loss spreader and the manufacturer is, the manufacturer must shoulder liability for the sales representative’s fraud.

c. Allocation of Resources

If the allocation of resources theory were applied, the hypothetical California manufacturer might escape liability.\textsuperscript{74} The allocation

\begin{footnotesize}
\begin{enumerate}
\item Smith, supra note 17, at 461.
\item Id.
\item Insurance probably would not be available to the representative because most jurisdictions do not allow insurance against an individual’s own fraud. See 9 G. Couch, Cyclopaedia of Insurance Law § 39:14-15 (2d ed. 1982) (“Any insurance which purports to protect the insured against any loss . . . which may arise from his immoral, fraudulent or felonious conduct is void as against public policy.”); see also Central Dauphin School Dist. v. American Casualty Co., 271 Pa. Super. 218, 227, 412 A.2d 892, 897 (1979) (noting the general rule, but holding that the particular action insured against was taken in “the utmost good faith”), rev’d on other grounds, 493 Pa. 254, 426 A.2d 94 (1981). The representative, therefore, probably would be limited to loss spreading through recoupment of the loss from customers and employees.
\item See Calabresi, supra note 22, at 545-47.
\end{enumerate}
\end{footnotesize}
of resources theory, like the loss spreading theory, is not concerned with the defendant's ability to control the tortfeasor's actions. Instead, the allocation of resources theory looks at the parties' ability to treat tort liability as an inevitable cost of doing business and to include this cost in the price of products and services. If the tortfeasor is an independent contractor, as opposed to an hourly employee, he presumably will pass on the cost of tort liability to the contractee in the price charged for his services. The contractee, in turn, will pass on these costs to his customers in the form of higher prices. In such situations, the allocation of resources theory will work properly even though the contractee is not held liable.

If the representative were aware of his potential liability for fraud and chose to insure against it or set up a reserve for this contingency, the sales representative would have been likely to pass on the cost of potential liability to the manufacturer by demanding a higher price for his services, with the manufacturer, in turn, passing on the cost to consumers by charging more for the company's pool products. If the representative anticipated liability in this manner, only the representative need be held liable under

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75. *Id.* at 545. Guido Calabresi, the primary advocate of the allocation of resources theory, distinguishes between independent contractors and hourly employees based on certain assumptions. He assumes that independent contractors consider the risk of tort liability in determining their prices. *Id.* In contrast, according to Calabresi, typical hourly employees are less likely to factor in such risks because they do not foresee the possibility that they will cause injuries for which they may be liable. *Id.* at 543.

Calabresi also points out that if individual employees insured against the risk, the aggregate of their premiums would exceed the premium the employer would have paid for the aggregated risk. *Id.* at 544. Even assuming that the employer would increase wages to reflect the cost of the employees' insurance premiums and would pass on this cost to consumers, the increase in cost would be higher than necessary and would cause the price of the employer's goods to be overstated. *See id.* These artificially high prices would cause consumers to purchase too few of the employer's goods, thereby resulting in a misallocation of resources. Because premiums paid by independent contractors presumably would not be fractionalized, the allocation of resources problem would not exist if an independent contractor, rather than an hourly employee, were involved.

76. *See id.* at 546. According to the allocation of resources theory, these costs should be passed on to consumers so that they can make their buying decisions based upon a price that reflects all true costs associated with the product. *See supra* notes 22-29 and accompanying text.

77. *See Calabresi,* supra note 22, at 545-46.

78. Because most jurisdictions do not permit insurance against an individual's own fraud, the representative probably could depend only upon self-insurance. *See supra* note 73.
the allocation of resources theory and the innocent manufacturer would escape liability.79

If the representative did not consider the cost of potential fraud claims, however, proper operation of the allocation of resources theory would hold the manufacturer, as well as the sales representative, liable for the fraud. The representative would not have passed on the cost of liability to the manufacturer in the price charged for his services and, in turn, the manufacturer would not have passed on these costs to the consumer by charging higher prices for his equipment. The price of the equipment would be artificially low, and a misallocation of resources would occur, unless the manufacturer, by shouldering direct liability for the representative's fraud, were forced to include these costs in the prices charged to consumers.80

79. This situation is analogous to the situation under the loss spreading theory in which the defendant is absolved from liability because the tortfeasor has loss spreading mechanisms available—a situation which occurs most often when the tortfeasor is an independent contractor. See supra notes 71-73 and accompanying text.

80. Becker v. Interstate Properties, 569 F.2d 1203 (3d Cir. 1977), cert. denied, 436 U.S. 906 (1978), illustrates the need to hold a contractee liable for the torts of an independent contractor if the independent contractor failed to protect against losses through insurance or other mechanisms, as allocation of resources and loss spreading theorists assume that an independent contractor will. In Becker, the plaintiff sought to recover from a general contractor for injuries caused by an employee of an underinsured and undercapitalized subcontractor. Id. at 1205. Because the general contractor had little control over how the subcontractor conducted his actual work, the subcontractor's status as an independent contractor was obvious. The court nevertheless allowed the plaintiff to bring the action against the general contractor for three reasons. First, the court stated that the general contractor was a better loss spreader than the victim because the contractor easily could obtain insurance for accidents such as the one in question. Id. at 1210. Second, the court reasoned that the general contractor should not “obtain the advantage of lowered operating costs,” passed on to him by a subcontractor in the form of reduced prices, “without liability for the decision to expose third parties to the risk of uncompensated losses.” Id. at 1212. On its face, this reason seems to be in line with the allocation of resources theory, although it may represent only an ethical judgment concerning which of two innocent parties should bear the loss. Third, the court stated that, even though the general contractor had too little control over the subcontractor to prevent the accident, the general contractor might have prevented the victim from sustaining an uncompensated loss. For example, the general contractor could have hired only subcontractors that were financially capable of responding to tort claims by requiring subcontractors to obtain adequate liability insurance. Id. at 1211. Becker indicates that some courts will apply the loss spreading and allocation of resources theories to hold defendants vicariously liable in situations in which they would not find liability under strict application of the prevention theory.
B. The Used Car Dealer

A second example also illustrates how the two approaches could be applied to fraud cases that involve agency principles. Suppose that a used car dealer regularly purchased cars from individuals who were selling them through advertisements in a local newspaper. The purchases were made by an hourly employee of the dealer who, when transacting business with the sellers, purported to purchase the cars on his own behalf. In other words, the dealer was acting as an undisclosed principal.\(^8\) Suppose further that the employee frequently made fraudulent statements to the sellers, such as citing imaginary statistical data to indicate that the seller's asking price was substantially inflated or that the market for used cars had declined. A particular seller discovered that the statements were false and that the used car dealer was the real purchaser. This seller sued the dealer for the employee's fraud.

1. Authority Approach

If the question of liability were approached solely under an apparent authority analysis, the dealer would not be liable.\(^8\) No communication, either direct or indirect, emanated from the dealer to the seller concerning the authority of the employee to make statements on his behalf relating to the value of used cars. At the time of the transaction between the employee and the seller, the seller did not even know the dealer's identity. As a result, the dealer could not have manifested to the seller that the employee was authorized to speak on his behalf.\(^8\)

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81. For a discussion of the rights and duties of undisclosed principals, see W. Sell, Agency §§ 79-85 (1975).
82. An actual authority analysis would not be relevant except under a rule making innocent principals liable for misrepresentations that fall within the general class of statements that their agents actually, as well as apparently, were authorized to make. Although some courts do follow such a rule, it is not justified. See supra note 51. If the rule were followed, however, the used car dealer would be liable under the authority approach.
When the dealer directed the employee to purchase used cars for him, the dealer implicitly authorized the employee to discuss the characteristics and value of the automobiles with sellers. Because the employee could not have bargained effectively with sellers without this implicit authority, the employee reasonably would have assumed that he had authority to discuss such matters with sellers.
83. The one instance in which an innocent undisclosed principal ought to be liable for his agent's fraud under an authority analysis occurs when the principal places the agent in a
2. Vicarious Liability Approach

In contrast to the results reached under an authority analysis, the dealer would be liable if vicarious liability theories were utilized. Because of the relationship between the employee and the dealer, the dealer was in a good position to prevent fraud. The employee, as a full-time hourly worker, presumably would have responded to the dealer's directions and orders concerning communications with the sellers. As a result, dealer liability would be appropriate under the prevention theory. The dealer also would be a good candidate for liability under the loss spreading theory because he has the typical loss spreading mechanisms available to him. Application of the allocation of resources theory also would make the dealer liable because the employee could not pass on the cost of liability to the dealer. Only direct dealer liability would cause the costs to be passed on to consumers, resulting in the proper allocation of resources.

C. Summary and Comparison

In the first example considered in this section, the results reached under the two competing approaches were similar. The position of apparent ownership and the agent makes fraudulent statements that a third party generally would expect an owner to make. Courts have used this concept of apparent ownership to hold an undisclosed principal liable for unauthorized contracts made by his agent. See, e.g., Herkert & Meisel Trunk Co. v. Duncan, 141 Kan. 564, 42 P.2d 587 (1935). No reason exists not to apply this concept to fraud cases. In Herkert & Meisel, the defendant, who was an undisclosed principal, placed two agents in a position that made them appear to own the undisclosed principal's store. The agents entered into a contract with the plaintiff for the purchase of certain goods on credit, even though the defendant had instructed them to make only cash purchases. Id. at 565-66, 42 P.2d at 588-89. The court found the defendant liable for the purchases because he had placed the agents in a position that made them appear to own the store and because owners of such stores ordinarily purchased goods on credit. Id. at 567-68, 42 P.2d at 589-90.

The apparent ownership concept also should apply to hold an undisclosed principal liable for his agent's fraud. For example, if an undisclosed principal placed an agent in a position that made him appear to own a store, and the agent made a fraudulent statement about goods sold in the store, the undisclosed principal should be liable for the agent's misrepresentation because third parties should be able to assume that persons who appear to be storeowners will make reliable statements about the store's goods.

84. See supra notes 53-55 and accompanying text.
85. See supra notes 56-57 and accompanying text.
86. See supra note 58 and accompanying text.
major discrepancy involved application of the prevention theory, under which the defendant would escape liability. 7 In the second example, the two competing approaches yielded contrary results. Under the apparent authority analysis traditionally applied to fraud cases, the defendant would not have been liable. 8 Under each of the vicarious liability analyses, however, the defendant would have been liable for the employee's fraud. 9 As a result, this Article now must consider which approach should be adopted.

VI. A Hybrid Resolution

The correct resolution of the question is not to adopt one approach exclusively, but to use the two approaches together. A defendant should have to withstand scrutiny under both approaches in order to avoid liability.

Vicarious liability principles should be applied first. Vicarious liability analysis enables courts to determine which of two innocent parties—the defendant or the third party—should bear the loss resulting from the tortious conduct. Courts could apply any of the three vicarious liability justifications 90 or they could look at all of them. If application of all three theories leads to the same result, no further analysis is necessary. If no uniform result emerges, the result backed by the most compelling theoretical justification should be adopted. 91 If the defendant escapes liability under vicarious liability principles, authority concepts should be applied. An authority analysis enables courts to protect any reasonable expectations that a defendant may have created in the minds of third

87. See supra notes 59-80 and accompanying text.
88. See supra notes 82-83 and accompanying text.
89. See supra notes 84-86 and accompanying text.
90. See, e.g., Chevron Oil Co. v. Sutton, 85 N.M. 679, 515 P.2d 1283 (1973) (applying only the prevention justification in a two-step analysis involving both vicarious liability and apparent authority principles); infra notes 92-98 and accompanying text.
91. For a demonstration of how an analysis involving all three vicarious liability justifications would work, see Becker v. Interstate Properties, 569 F.2d 1203, 1214 (3d Cir. 1977), cert. denied, 436 U.S. 906 (1978). In Becker, the court chose to analyze the case using the loss spreading and allocation of resources theories and a variation of the prevention theory. These theories all pointed toward holding the defendant liable, supporting the court's decision to reverse the trial court's grant of summary judgment to the defendant. See supra note 80.
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parties. A defendant should prevail only if he can withstand scrutiny under both tests.

The decision in *Chevron Oil Co. v. Sutton*, although it involved tortious physical conduct, illustrates the proper procedure for courts to follow. In *Chevron*, an employee of an independently-owned Chevron station improperly repaired the wheel on the plaintiff’s car, causing an accident in which the plaintiff’s wife was killed. In considering the plaintiff’s claim against Chevron, the court enunciated two separate theories under which it could hold Chevron liable. First, the court noted that it could apply traditional vicarious liability principles to the case. Under this analysis, the central question was whether Chevron had sufficient control over the operator of the service station. Second, the court stated that Chevron might be liable under apparent authority principles, even if Chevron did not have the requisite control to be considered a master under vicarious liability principles. According to the court, liability under apparent authority principles could be based on certain facts such as representations in Chevron’s telephone directory advertisements “that its station performed auto repairs, and that its repairmen were skillful.” If Chevron had communicated to the plaintiff through these actions that the service station operator was its servant, Chevron would be liable. The use of apparent authority concepts protected the plaintiff’s reasonable expectations that the service station employee was more reliable because he was controlled by Chevron. The application of apparent authority principles also promoted the efficient flow of commerce by allowing the plaintiff to rely safely on the employee’s apparent status, rather than requiring the plaintiff to contact Chevron for confirmation that the employee really was its servant.

93. Id. at 681, 515 P.2d at 1285.
94. Id.
95. Id. at 682, 515 P.2d at 1286.
96. Id. at 683, 515 P.2d at 1287.
97. Id.
98. As *Chevron* demonstrates, the two-step approach could be applied to cases involving torts other than fraud. Although *Chevron* is an exception, the addition of an apparent authority analysis would be unlikely to render the defendant liable in a case involving tortious physical conduct. Apparent authority is based on communications from the defendant to a third party that create certain expectations by the third party. It is premised on the
The examples of the California pool equipment manufacturer and the used car dealer analyzed above provide good illustrations of how the two-step approach would be applied to a fraud case. In the example involving the California manufacturer, the manufacturer was not in a good position to prevent fraud. He did have the characteristics of a good loss spreader, however. He also was a good candidate for liability under the allocation of resources theory, assuming that the representative’s commission failed to reflect the cost of potential fraud claims. The liability of the manufacturer for the sales representative’s fraud using vicarious liability inefficiencies that would occur if these expectations were not protected. See supra notes 45-46 and accompanying text. Torts involving physical conduct generally do not involve communications to third parties creating expectations that need protection. For example, when an employee runs over an unwary pedestrian, the pedestrian generally has no unfulfilled expectations concerning the employee's status that should be protected by holding the employer liable. Only a few instances of tortious physical conduct, such as the situation considered in Chevron, involve communications creating expectations that should be protected. Fraud cases, on the other hand, often involve communications by principals to third parties that create reasonable expectations concerning the reliability of an agent’s statements. As a result, application of the concept of apparent authority frequently will render the defendant liable.

Similarly, if apparent authority is applied in cases involving communicative torts other than fraud, its application often will cause the defendant to be held liable. These other communicative torts, however, currently are analyzed only under vicarious liability principles. For instance, although the Restatement takes the position that defamation should be analyzed under authority principles, see Restatement, supra note 7, §§ 247, 254, most courts analyze defamation cases strictly under vicarious liability principles. See, e.g., Martin Marietta Corp. v. Evening Star Newspaper Co., 417 F. Supp. 947, 961-62 (D.D.C. 1976); Hunt v. Liberty Lobby, 720 F.2d 631, 648-49 (11th Cir. 1983). In both Martin Marietta and Hunt, the defendant newspapers escaped liability for defamatory statements because they were written by free-lance writers who were held to be independent contractors.

Application of the two-step approach proposed in this Article would have changed the results of both Martin Marietta and Hunt, and possibly would change the results of other similar cases. The newspapers involved in Martin Marietta and Hunt clearly would have been liable under apparent authority concepts. By publishing the stories in question, these newspapers communicated to their readers that they stood behind the stories and they increased the reliability of the stories in their readers' minds. The newspapers should not have been able to escape the consequences of this communication by arguing that the stories were written by independent contractors. A requirement that readers must contact newspapers to insure that they stand behind the stories they publish would be inefficient, if not absurd. Both newspapers implicitly communicated an endorsement to their readers merely by publishing the stories.

99. See supra notes 59-89 and accompanying text.
100. See supra notes 64-70 and accompanying text.
101. See supra notes 71-73 and accompanying text.
102. See supra notes 74-80 and accompanying text.
principles, therefore, would depend on the theory chosen, on the sales representative's loss spreading capabilities, and on whether the representative had included the cost of potential fraud claims in his commission. The outcome of the vicarious liability analysis need not be decided, however, because even if the manufacturer survived application of the vicarious liability principles, he would be liable under apparent authority concepts. Liability would attach because the manufacturer, through his actions, communicated to the purchaser that the representative had authority to make statements concerning the manufacturer's products.¹⁰³

Application of the same two-step approach to the used car dealer example also would render the defendant liable, but for a different reason. The used car dealer would not withstand the threshold analysis under vicarious liability principles because he was a good preventer and loss spreader, and because only direct dealer liability would achieve the proper allocation of resources by forcing prices to reflect the actual cost of doing business.¹⁰⁴ The issue of liability under an apparent authority analysis never would be reached.¹⁰⁵

VII. Conclusion

Most courts and commentators currently agree that an innocent principal's liability for an agent's fraud is determined by application of authority concepts. Although this approach sometimes operates correctly, it does not function properly in all cases. The unsatisfactory result reached when traditional apparent authority principles were applied to the used car dealer example discussed in this Article evidences this deficiency.

The concept of apparent authority protects the reasonable expectations of third parties and promotes the efficient flow of commerce. It does not, however, resolve the problem presented when one of two innocent parties must bear a loss caused by another's torts. Only the application of vicarious liability principles can achieve this goal. By applying a new, two-step approach to fraud

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¹⁰³ See supra notes 60-63 and accompanying text.
¹⁰⁴ See supra notes 84-86 and accompanying text.
¹⁰⁵ If the issue were reached, the defendant would escape liability. See supra notes 82-83 and accompanying text.
cases involving principals and agents, courts can both protect the reasonable expectations of third parties and ensure that losses caused by an agent's fraud are borne by the proper party.