DISLOYAL AGENTS

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I. INTRODUCTION

This Article examines the nature and consequences of fiduciary duties of loyalty within the context of common law agency. My central claim is that duties of loyalty have distinctive functions and consequences, ones distinct from duties and consequences defined by other bodies of law. Within common law agency, an agent owes the principal fiduciary duties of loyalty as well as duties of performance. Although an agent owes both types of duties, distinctive legal consequences follow a breach of a duty of loyalty. These include but are not limited to an enhanced range of remedies available to the principal. The distinctive consequences triggered by an agent's breach of a duty of loyalty are a helpful vantage point from which to assess whether and how an agent's fiduciary duties of loyalty are themselves distinct from duties defined by other bodies of law—in particular, contract law and tort law principles. I argue that an agent's fiduciary duties of loyalty serve functions related to but distinct from the agent's duties of performance and that these functions, in turn, assist in identifying how best to resolve questions about the consequences that should follow an agent's breach of a duty of loyalty. These questions are prominent in recent cases from the United States and England.

It is helpful to begin with a brief discussion of how the common law defines "agency," in part because its definition is somewhat at odds with definitions used in contemporary social science and philosophy. Common law agency, significant in itself, also furnishes an inescapable backdrop for statutory interpretation and for the specification of agents' duties within complex regulatory structures, points beyond the scope of this Article.[1] The Article then develops a typology of an agent's duties of loyalty as distinct from duties of performance, using a range of contemporary and historical

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1. For discussion, see Deborah A. DeMott, *Statutory Ingredients in Common Law Change: Issues in the Development of Agency Doctrine*, *in* COMMERCIAL LAW AND COMMERCIAL PRACTICE 57, 57-83 (Sarah Worthington ed., 2003), and RESTATEMENT (THIRD) OF AGENCY, introduction at 6-10 (2006).

examples of forms of disloyalty. The Article turns next to the consequences of an agent's breach of a duty of loyalty, which are more complex than may initially appear to be the case. Additionally, the consequences of an agent's disloyalty include those that follow when an agent itself is an organization in which individual employees commit fiduciary transgressions in the course of their work for the organization.

Legal theorists differ on how best to characterize fiduciary duty; to some, it's best understood as a consequence of contract—as a set of default terms to which parties would agree, had they the benefit of unlimited resources. An implied—but not much analyzed—consequence of this view is that contract law does or should determine the consequences of breach of fiduciary duty.[2] However, this implication is not borne out by cases that assign consequences to agents' breaches of the fiduciary duty of loyalty. In several respects, their outcomes are inconsistent with what one would predict were contract law, as applicable in other contexts, to govern. Moreover, cases that assign consequences to breaches of the fiduciary duty of loyalty are not entirely captured by tort law concepts and standards. A more complex doctrinal and normative vocabulary is required.

In many ways, the law both reflects and reinforces the widely shared belief that betrayal by one subject to a duty to act loyally represents more than the disappointment that follows any legally cognizable harm or breach of duty, including those stemming from duties defined by contract and tort law.[3] The relatively ferocious consequences that the law ascribes to an instance of disloyalty by an agent to which the principal has not consented reflect the distinctive legal consequences triggered by disloyalty.

II. Common Law Agency and Agents' Duties

A. Agency Defined

The common law defines agency as the "fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."[4] The term "agent" is used more broadly in economics literature to mean any relationship in which one person engages another to perform a

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2. A recent characterization of this view is that "[a] large body of literature contends that fiduciary duties are barnacles on the ship of contract, default contractual terms to which the parties would agree if they had the benefit of unlimited resources." Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 Am. U. L. Rev. 75, 76 (2004). To be sure, one might proceed on the assumption that proponents of the "contractualist" view of fiduciary duty may also use "contract" in a non-legal, unexamined, or nontechnical sense. For present purposes, more analytic traction follows if we assume that accepting a contractualist account of fiduciary duty would also trigger the remedial and other consequences of contract law as generally understood by lawyers.

3. For further elaboration, see Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 Ariz. L. Rev. 925 (2006).

4. Restatement (Third) of Agency § 1.01 (2006).

service under circumstances that involve delegating some discretion over decision-making to the service-performer.[5] This includes actors who would not be agents under the common law definition, for example, garage mechanics and architects. The common law definition, in contrast, means by "on behalf of" that an agent acts with power to affect the principal's legal relations by creating rights or obligations applicable to the principal or by acquiring knowledge of facts with which the principal is charged. The central idea is that an agent serves a representative function and does not simply provide a service. Thus, agents for purposes of common law agency include lawyers, real estate brokers, stock brokers, officers of legal entities of all sorts, and employees. The vocabulary of "agency" within contemporary philosophy and literary studies reflects other concerns, in particular the capacity of an actor to assert control over the actor's own intentions, desires, and decisions.[6] The point is determining or characterizing an actor's autonomy, as opposed to the consequences of an actor's relationships with others. These are not necessarily inconsistent, though; contemporary accounts of common law agency address the significance of the agent status as a distinct person and do not rest on simple identification of an agent with the principal.[7]

A defining characteristic of relationships that are ones of agency under the common law is the principal's power to give interim instructions to the agent although principal and agent have previously agreed the principal will not give such instructions, and although, in giving them, the principal breaches a contract with the agent. This power is a crucial aspect of the principal's position of control over the agent, itself necessitated by the agent's power to subject the principal to liability to third parties.[8] Thus, within U.S. corporate law, a corporation's shareholders do not have a relationship of common law agency with the corporation's directors. To be sure, directors owe fiduciary duties to the corporation and its shareholders, but

5. The classic definition as stated in Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976): "We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."

6. On usage within contemporary philosophy, see 1 CHARLES TAYLOR, HUMAN AGENCY AND LANGUAGE: PHILOSOPHICAL PAPERS 98-99 (1985), stating, "What is crucial about agents is that things matter to them. We thus cannot simply identify agents by a performance criterion . . . [t]o say things matter to agents is to say that we can attribute purposes, desires, aversions to them in a strong, original sense."

7. Earlier accounts of common law agency, in contrast, relied heavily on identifying the agent with the principal. The leading example is OLIVER WENDELL HOLMES, JR., THE COMMON LAW 180-83 (1923).

8. A principal's power to structure its own organization and to define how work should be done within the organization enables the principal to create an identification between the organization and those who work on its behalf that may supplement monetary compensation as an inventive device. *See* George A. Akerlof & Rachel E. Kranton, *Identity and the Economics of Organizations*, 19 J. ECON. PERSP. 9 (2005). Akerlof and Kranton suggest that "the legal concept of a *fiduciary*" can be represented "by modeling an employee's attachment to a firm and motivations to act in the firm's interest" but leave the specifics for further development. *Id*. at 28.

directors, once elected, hold powers of management that are not delegated powers comparable to a common law agent's authority. Likewise, although a trustee unquestionably owes fiduciary duties to the beneficiaries of a trust, the trustee is not subject to the control of either the beneficiaries or the settlor, except as provided in the terms of trust.[9]

B. Agents' Duties

It's conventional to distinguish among an agent's duties. Restatement (Third) of Agency uses the terminology of duties of performance[10] and duties of loyalty. An agent's duties of performance include the duty to act only as authorized by the principal;[11] to fulfill any obligations to the principal defined by contract;[12] to act with the competence, care, and diligence normally exercised by agents in similar circumstances;[13] and to use reasonable effort to provide the principal with facts material to the agent's duties to the principal.[14] An agent's duties of performance are often defined by agreement between principal and agent.

An agent's duties of loyalty stem from the agent's basic obligation to act loyally for the principal's benefit in matters connected with the agency relationship.[15] An agent's more specific duties of loyalty include a duty not to acquire a material benefit from a third party in connection with transactions or other actions taken on behalf of the principal or otherwise through the agent's use of position;[16] a duty not to deal with the principal as or on behalf of an adverse party;[17] a duty not to compete with the principal or assist the principal's competitors during the duration of the agency relationship;[18] and a duty not to use property of the principal, and not to use or communicate confidential information of the principal, for the agent's own purposes or those of a third party.[19] A principal may consent to conduct by the agent that would otherwise breach a duty of loyalty, but in obtaining the principal's consent, the agent must act in good faith and fully disclose material information to the principal. Although open-ended advance consents to disloyal conduct are not effective,[20] the fact that a principal may consent to conduct that would otherwise breach an agent's duties of loyalty mitigates the stringency associated with the fiduciary regime of remedies and other

9. *See* RESTATEMENT (THIRD) OF TRUSTS § 5 cmt. e (2003).
10. In Restatement (Second) of Agency, these were termed "duties of service and obedience." RESTATEMENT (SECOND) OF AGENCY, ch. 13, tit. B (1958). The term "duties of performance" is used in FRANCIS M.B. REYNOLDS, BOWSTEAD AND REYNOLDS ON AGENCY, ch. 6, § 1 (17th ed. 2001).
11. RESTATEMENT (THIRD) OF AGENCY § 8.09 (2006).
12. *Id*. § 8.07.
13. *Id.* § 8.08.
14. *Id*. § 8.11.
15. *Id.* § 8.01.
16. *Id.* § 8.02.
17. *Id.* § 8.03.
18. *Id.* § 8.04.
19. *Id.* § 8.05.
20. *Id.* § 8.06.

consequences that follow breach, as does the agent's power to terminate the relationship.

C. A Typology of Disloyalty

In assessing an agent's duties of loyalty more broadly, it's helpful to identify the forms that disloyal action ordinarily assumes and then assess what remains. Most typically, an agent's disloyal action stems either from (1) a conflict between the principal's interests and the agent's pursuit of the agent's own interests or (2) a conflict between or among the interests of multiple principals represented by the same agent. Consider first a classic illustration of a conflict between an agent's pursuit of self-interest in conflict with the interest of the agent's principal, taken from the recently published memoir of Warren A. Seavey, the Reporter for Restatement (Second) of Agency. Seeking a larger house in 1926 in Lincoln, Nebraska, for his growing family, Professor Seavey identified a suitable property and "made an offer to the real estate man handling the deal."[21] However, "unknown to us," (the Seaveys) his offered price exceeded by $500 the owner's reservation price, that is, the minimum price that the owner told her agent would be acceptable to her.[22] The agent accepted Professor Seavey's offer and his payment and then, "[w]ith the ethics of the usual real estate dealer," pocketed the $500 difference between the price Seavey paid and the seller's reservation price.[23]

However the agency relationships among the three parties may have been structured, the agent's conduct was disloyal. If the "real estate man" served solely as the seller's agent—the conventional structure in residential real estate transactions—the agent's self-interested retention of the $500 conflicts with the seller's interest in receiving all proceeds (net of the agent's commission) from the sale of her property. The agent's self-interest in retaining the $500 also conflicts with the agent's duty to disclose to the seller the material fact that the purchaser offered to pay more than her reservation price for the property. If the "real estate man" represented both buyer and seller, even assuming effective consent by both to dual representation despite the evident conflict between their interests, the agent disserved both buyer and seller by retaining money the buyer wished to pay to the seller. And if the "real estate man" represented only Professor Seavey as a buyer's

21. WARREN A. SEAVEY & DONALD B. KING, A HARVARD LAW SCHOOL PROFESSOR: WARREN A. SEAVEY'S LIFE AND THE WORLD OF LEGAL EDUCATION 58 (2005). At the time, Professor Seavey served as Dean of the law school at the University of Nebraska. *See id.* at 53.

22. *Id.*

23. *Id.* Professor Seavey reports: "Later, he was chagrined when I charged him with it and was angered when I told him he had forfeited his commission and owed $500 to [seller] and $500 to me. He was willing to settle for $500 for both and out of consideration for his family I didn't sue, as that would have ruined him." *Id.* It is not evident on this account on what basis the agent would be subject to liability to both seller and buyer. Perhaps the agent misrepresented the seller's reservation price to the buyer, or the agent represented both parties to the transaction. In any event, the agent's reaction implies that his conduct was inconsistent with local norms.

agent, he appears to have withheld material information to facilitate his retention of the $500. Indeed, as this initial example illustrates, disloyalty often motivates or at least accompanies compromised performance in other respects, as the "real estate man" withheld material information from the parties to the transaction.

Moreover, an agent may act disloyally to the interests of one principal by representing another principal whose interests conflict, even when the agent does not additionally pursue an individual interest in conflict with the principals' interests. In a recent case from the House of Lords, *Hilton v. Barker Booth & Eastwood*, a firm of solicitors represented both a property developer and the firm's long-standing client, the prospective purchaser of a site owned by the developer.[24] The firm represented both in the developer's sale of the site but did not inform the developer that it had advanced to the purchaser the entire amount of the deposit on the purchase price. Nor did the firm inform the developer that the purchaser had only recently been released from prison following his previous conviction for fraud, which perhaps explained the practical necessity that his solicitors lend him the amount of the deposit![25]

As the Lords acknowledged, had the firm of solicitors disclosed the purchaser's criminal record to the seller, it would have jeopardized the firm's own interest in recovering the amount of the deposit the firm lent to the purchaser. Moreover, and distinct from its self-interest in recovering the amount lent to the purchaser, the firm assumed irreconcilable duties to both its long-term client, the purchaser, and its new client, the developer; "[t]he solicitor's duty of single-minded loyalty to his client very frequently makes it professionally improper and a breach of his duty to act for two clients with conflicting interests in the transaction in hand."[26] To fulfill its duty of disclosure to the developer as seller would require action by the firm—disclosure of "discreditable facts" about the purchaser—that would breach the firm's duty of loyalty to him.[27]

Most instances of disloyal action by agents can be subsumed into these two basic categories of action clouded either by a conflicting interest on the part of the agent or by conflicting interests among multiple principals.[28] However, not all instances of disloyalty are obviously captured by these two categories. For example, an agent may breach the agent's duty of loyalty by obtaining a material benefit in connection with a transaction undertaken on behalf of the principal or otherwise through the agent's use of position. Al-

24. [2005] UKHL 8, 1 W.L.R. 567, 567 (Eng.).
25. The firm had represented the purchaser in the prior criminal fraud proceedings against him. *Id.* at 572.
26. *Id.* at 576.
27. *Id.* at 577. Although the fact of the purchaser's criminal conviction was a matter of public record, and thus did not constitute confidential information about a client, disclosing the fact to the seller would breach the firm's duty to the purchaser. *See id*.
28. *See* Matthew Conaglen, *The Nature and Function of Fiduciary Loyalty*, 121 L.Q.R. 452, 465 (2005).

though such action by the agent could be characterized as stemming from a conflict between the agent's interests and those of the principal, the conflict may be much less salient than those discussed above. Thus, had the "real estate man" through whom Professor Seavey bought his house represented only him, the agent's retention of the $500 in excess of the seller's reservation price is not obviously in conflict with Professor Seavey's manifest wish to acquire the seller's house at the price he wished to pay. However, had the agent fulfilled the agent's duty to disclose the material fact known to the agent—the amount of the seller's reservation price—one's hunch is that Professor Seavey may have offered less. The conflict is between the agent's self-interest and the agent's duty to disclose material facts to the principal.

Moreover, an agent's receipt of material benefit may breach the agent's duty of loyalty even when the agent's financial interests appear aligned with those of the principal. Consider in this light an Illustration from Restatement (Third) of Agency:

> P, who owns a racehorse, Grace, engages A, a jockey, to ride Grace in an upcoming race. P agrees to pay A a fee of $500. T, who has made a large bet that Grace will win the race, promises to pay A $5000 if Grace wins the race. . . . Neither A nor T tells P about T's promise. Grace, ridden by A, wins the race. T pays A $5000.[29]

A's receipt of the $5000 breaches an agent's duty of loyalty to the principal although A's interest that Grace win the race appears to be completely aligned with P's interest as the racehorse's owner. But A's perspective is not identical to P's. A's interest in spurring Grace on to victory may shape how A interprets instructions received from P, who, although not wishing that Grace be hobbled in the particular race, may also wish that Grace not be extraordinarily taxed so that she may compete more effectively in other races in the near future.

In more general terms, only the principal can assess how best to further the principal's own interests and objectives. The prospect of acquiring a side benefit may distract the agent from focusing on accomplishing the principal's objectives by biasing how the agent interprets instructions received from the principal and understands what the principal wishes to achieve. This is so even when the side benefit received by the agent does not come at an explicit cost to the principal. If the agent, in contrast, duly discloses the prospect of the side payment, in determining whether to consent, the principal may assess how the payment may compromise or aid the agent's performance.

29. RESTATEMENT (THIRD) OF AGENCY § 8.02 illus. 1 (2006).

III. CONSEQUENCES OF AN AGENT'S DISLOYALTY

A. Remedies for Breach of an Agent's Duty of Loyalty

1. Remedies in General.

It is helpful, for starters, to note how broad a principal's remedies may be when an agent acts disloyally. These remedies reflect a rich mixture derived from contract law, tort law, and restitution and unjust enrichment. An agent's breach subjects the agent to liability to the principal for loss that the breach causes the principal.[30] To establish such loss, it is not necessary for the principal to establish a "but-for" causal relationship between its loss and the agent's misconduct, only that the misconduct was a substantial factor in an outcome adverse to the principal.[31] The "substantial factor" standard for loss causation has been explicitly characterized as a "prophylactic rule intended to remove all incentive to breach—not simply to compensate for damages in the event of a breach."[32]

A breach of fiduciary duty may also subject the agent to liability for punitive damages when the circumstances satisfy general standards for their imposition. Indeed, a breach of fiduciary duty has long been actionable as a tort within U.S. tort law.[33] The availability of punitive damages is, of course, not consistent with contract law theories of damage. Moreover, the law of restitution and unjust enrichment also creates a basis for an agent's liability to a principal. If, through the breach, the agent has realized a material benefit, the agent has a duty to account to the principal for the benefit, its value, or its proceeds. An agent must also account to the principal for the agent's use of the principal's property when the use violates the agent's duty to the principal, although the principal cannot establish loss stemming from the use. A principal may also be able to avoid a transaction with the agent or a third party that stems from the agent's breach of duty.

2. The Character and Functions of Duties of Loyalty

These consequences, ones that conventionally and uncontroversially follow an agent's breach of a duty of loyalty, provide some insight into the character and functions of the underlying duties themselves. The remedies available to a principal do not map neatly onto the contours of either contract law or tort law principles and remedies. For example, remedies that

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30. *Id.* § 8.01 cmt. d(1).

31. *See* ABKCO Music, Inc. v. Harrisongs Music, Ltd., 722 F.2d 988, 996 (2d Cir. 1983).

32. *See* Milbank, Tweed, Hadley & McCloy v. Boon, 13 F.3d 537, 543 (2d Cir. 1994) (quoting *ABKCO Music*, 722 F.2d at 995-96) (internal quotation marks omitted).

33. RESTATEMENT (SECOND) OF TORTS § 874 (1979) ("One standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation."). On the rationale for and consequences of treating breach of fiduciary duty as a tort, see DeMott, *supra* note 3, at 927-34.

have the consequence of stripping profit or benefit from the agent do not necessarily approximate the amount of harm that a principal either has suffered or would be able to prove or the benefit that the principal expected to realize through the transaction conducted by the agent.

As a consequence, fiduciary doctrine as a whole is often characterized as prophylactic, geared to discourage breach by persons subject to fiduciary duties. Thus, a breach of a duty of loyalty triggers remedies and other consequences, distinct from whether the person protected by the duty can establish that the breach in fact led to injury or in fact stemmed from disloyal motives on the part of the fiduciary.[34] It's no defense to a fiduciary who self-deals or otherwise breaches a duty of loyalty that the beneficiary of the duty in some sense benefited through the fiduciary's conduct.[35] Fiduciary doctrine's stringency reflects pragmatic concerns. These include the difficulties inherent in judicial second-guessing of decisions that are often discretionary, as well as the ease with which a disloyal fiduciary may often conceal misconduct.[36] Fiduciary doctrine's stringency may also respond to the risk that a fiduciary, aware of an opportunity to self-deal in a manner that may or may not risk injury to the principal, might be tempted to take the opportunity by the prospect that no provable harm to the principal will follow.

An agent's duties of loyalty are also tied in many ways to duties of performance that the agent owes the principal, as the initial examples discussed above illustrate. The "real estate man" who represented the seller of the house purchased by Professor Seavey owed his principal, the seller, a duty to disclose the purchaser's willingness to pay more than her reservation price for the house. The duty of loyalty that the agent owed the seller as his principal—not to take an unconsented-to material benefit in connection with a transaction on her account—undergirds or supports the agent's duties of performance. Likewise, the firm of solicitors in *Hilton* owed each of their clients duties of disclosure and of effective representation, and had the firm not breached its duties of loyalty to both clients, it is much more likely that the firm would not also have failed to fulfill its duties of performance. Even the jockey who rode Grace in the race, dazzled by the prospect of a large payment promised by a third party, may disregard or misinterpret the instructions provided by Grace's owner, the jockey's principal.

A possible generalization is that duties of loyalty play an exclusively subsidiary function, which is to assist in securing the performance of other duties. More specifically, duties of loyalty perform an insulation role that attaches adverse legal consequences to conduct by an agent or other fiduci-

34. *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1054 (1991).

35. For this point in trust law, see RESTATEMENT (THIRD) OF TRUSTS § 78(2) (Tentative Draft No. 4, 2005), stating, "Except in discrete circumstances, the trustee is subject to a strict prohibition against engaging in transactions that involve self-dealing or . . . create a conflict between the trustee's fiduciary duties and personal interests."

36. *Id.* cmt. b.

ary who undertakes a distracting interest or influence.[37] Although this generalization helps explain much about the consequences that follow breaches of duties of loyalty, its explanatory force has limits. For example, it is not a defense to an agent who breaches a duty of loyalty that the agent can establish that other duties owed the principal were performed with good outcomes for the principal. That is, if duties of loyalty have purely subsidiary functions, it's odd that the common law consistently denies the agent an affirmative defense of establishing due performance of the agent's duties of performance.[38]

Moreover, agency law, at least in the United States, requires explicitly that an agent act "loyally for the principal's benefit" in all matters connected with the agency relationship.[39] A principal may reasonably expect loyal service, not simply the due performance of the agent's other duties. Moreover, as illustrated later in this Article, a principal's expectation of loyal service, if disappointed by the agent, triggers rights in the principal that extend beyond protecting its expectation of due performance by the agent of its other duties.

Finally, and more generally, at least some of the reasons why the law ascribes an independent significance to loyalty can be illustrated by a hypothetical.[40] Suppose you, as a principal, must choose between two agents—Agent A or Agent B—to act as your investment manager. Suppose further that Agent A will "borrow" from your account and use the money for A's own purposes without your consent but, before you are due an accounting, will replace the amount borrowed with interest. In contrast, Agent B will indulge in no "borrowing" at all. Wouldn't you choose to be represented by Agent B? To be sure, we know with the benefit of hindsight that Agent A replaced the value "borrowed" from your account with interest. But Agent A's removal of your assets for A's own interim use created a risk to which you did not consent, which is that A would be unable to replace the value (let alone with interest) at the relevant later time. And Agent A's "borrowing" and use of your assets disregarded your ownership of them. Although your account, if managed by Agent B, will have the same end balance, you will not have borne the interim risk of possible consequences created by Agent A's disloyalty. But now suppose further that Agent A will additionally pay a premium into your account to compensate you for the additional risk you've borne. Agent A has still imposed that risk on you without your prior consent, and you might well wonder how (and by whom) an adequate

37. As Matthew Conaglen characterizes this function, fiduciary duties of loyalty seek "to insulate fiduciaries against situations where they might be swayed away from providing such proper performance." Conaglen, *supra* note 28, at 473-74.

38. It has been argued that trust law should embrace such an affirmative defense, which it presently does not. *See* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 988 (2005).

39. RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006).

40. Many thanks to Richard E.V. Harris for this example.

risk premium might be computed. Life with Agent B seems less fraught with complications, some of which will be unanticipated.

3. Forfeiture of Compensation.

Consider against this background a recent case involving an especially ferocious additional remedy that may be available to a principal—forfeiture of compensation otherwise paid or payable to the agent. In *Phansalkar v. Andersen Weinroth & Co.*, the plaintiff was a banker employed as an advisor and deal facilitator by the defendant, an investment bank.[41] The bank compensated the banker by paying him a fixed annual salary plus an amount determined by the bank on the basis of its annual profitability.[42] Without the knowledge or consent of his superiors at the bank (or of anyone else there, for that matter) during his last year and a half at the bank, the banker accepted for his own account personal investment opportunities—including stock options—from three clients with whom he worked on transactions on the bank's account.[43] So, to accept material benefits on the side breached the banker's duty of loyalty to his employer, the bank.[44] Interestingly, though, the banker also worked on a fourth transaction in which he acted loyally, accepting no side benefit from the client.[45]

The court held that the banker was subject to liability to the bank for the profits that he made, or the property that he obtained, through his receipt of material benefits from clients.[46] More controversially, the court also held that all of the banker's compensation for the year and a half—the period of disloyalty—could be forfeited to the bank.[47] Although the banker acted loyally in connection with one transaction out of four during this interval, the bank did not compensate him on a transaction-by-transaction basis.[48]

A question raised by *Phansalkar* is whether a disloyal agent should be entitled to receive or retain compensation to the extent that the agent's work generated net benefits for the principal. The banker in *Phansalkar* argued that, overall, the transactions for which he had responsibility were profitable for the bank, which received fees from its clients plus equity interests in their businesses.[49] The rule applied by the court, which denies a disloyal agent a defense based on showing that the principal overall suffered no damage from the disloyal conduct, has the consequence of enabling the principal to retain the benefit of the agent's work without paying compensation for it![50] Other cases condition the principal's right to forfeiture on

41. 344 F.3d 184, 187 (2d Cir. 2003).
42. *Id.* at 190.
43. *Id.* at 190-91.
44. *Id.* at 203.
45. *See id.* at 193.
46. *Id.* at 211.
47. *Id.* at 199-200.
48. *See id.* at 191.
49. *See id.* at 201.
50. *See id.* at 208.

showing net injury stemming from the agent's disloyalty or permit a disloyal agent to limit forfeiture by establishing that the value of work performed exceeded the damage done.[51]

Which approach is preferable? Requiring that a principal establish damage is inconsistent with a basic premise of remedies available for breach of fiduciary duty, which is that a principal need not establish harm resulting from an agent's breach to require the agent to account. That is, the agent's duty in *Phansalkar* to account to the bank for the material benefits the agent secretly received from clients—stock options, yachts, whatever—does not turn on whether the principal can establish that the agent's receipt of such benefits injured its business, or even its reputation. But forfeiture of compensation is not identical to accounting for a benefit received. Forfeiture is a separately available remedy, one that seems more geared to deterrence and to assuring that some remedy will be available against a disloyal agent even when the agent has realized no material benefit for which the agent must account. Moreover, requiring that the principal establish damage may tempt an agent to engage in conduct that breaches the agent's fiduciary duties in the hope that no harm will befall the principal or that, if it does, the principal will be unable to establish it or unwilling to expend the resources required to litigate the question.

Likewise, it is inconsistent with these basic points to permit an agent an offset for benefits that the agent's work during the period of disloyalty generated for the principal. For one thing, the benefits generated by a disloyal agent may be difficult to quantify, especially when incentives created by the agent's disloyalty reshape how the agent performs assigned work. For example, an agent attracted by side benefits furnished by third parties with whom the agent deals on the principal's behalf may be tempted to reallocate effort toward those clients, ignoring others who do not furnish comparable enticements. This prospect undercuts a fundamental element in an agency relationship, which is the principal's ability to control the agent and focus the agent's attention on doing the work assigned by the principal. A principal may seek to effect its control in many ways, among them the compensation and other incentive structures applicable to the agent, as well as instructions furnished the agent. Side enticements undermine the efficacy of these measures.

These arguments are not inconsistent with retaining some degree of judicial discretion in assessing an appropriate amount of forfeiture. For example, in *Bank of Tokyo-Mitsubishi, Ltd. v. Malhotra*, a bank employee who pleaded guilty to criminal fraud charges was not required by the court to disgorge to the bank all the half-million dollars paid by the bank as compen-

51. *See, e.g.*, Chem-Trend, Inc. v. Newport Indus., Inc., 279 F.3d 625, 630 (8th Cir. 2002) (applying Michigan law); Walsh v. Atl. Research Assocs., 71 N.E.2d 580, 585 (Mass. 1947); Burg v. Miniature Precision Components, Inc., 330 N.W.2d 192, 195 (Wis. 1983) (burden on employee resisting forfeiture to show value of services exceeded damage done by disloyalty).

sation and fringe benefits during his nine years of employment.[52] Instead, the court limited forfeiture to $22,360 that the employee received as bonuses over the nine years, noting that the employee also was subject to a restitution order in the amount of his fraudulent depredations from the bank.[53] Applying Illinois law, the court characterized forfeiture as a form of "punitive damages" within a court's equitable discretion, not a nondiscretionary remedy.[54]

More fundamentally, the approach to remedies for disloyal conduct by an agent that *Phansalkar*—and many other cases—represents is inconsistent with attempting to capture fiduciary duties of loyalty within contract law. *Phansalkar* represents an entitlement on the part of the principal to loyal service from an agent that operates independently of contract law norms. Enforcing this entitlement also reinforces other basic elements of an agency relationship, including the principal's ability to control the agent's conduct.

Indeed, the gentler alternative rule limiting forfeiture when a disloyal agent's work generates net benefit for the principal doesn't correspond with contractual measures of damages.[55] It is unknowable what measure of damages would place the principal in as good a position as loyal service by the agent would have done. Likewise, the reduced forfeiture measure doesn't correspond to a measure of loss caused the principal by reliance on the agent nor does it represent a measure of benefit that the principal has conferred on the agent. Instead, the reduced forfeiture measure seems more like a tort law measure of damages, one geared toward compensating the principal for harm done while acknowledging that such harm cannot be precisely quantified.[56]

B. An Agent's Duty to Disclose a Prior Breach of Duty

An agent's breach of duty—here, not necessarily confined to a breach of the agent's duties of loyalty—triggers a further distinctive consequence, which is the agent's duty to disclose the *breach* and other relevant information to the principal. Recent cases are instructive on the content and implications of this duty, which is not mandated by general contract law.

First, suppose the agent's breach of duty concerns only what I have classified as a duty of performance. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, a stockbroker ignored a customer's instructions and overbought the customer's account.[57] After overbuying the account, the broker told the customer about the misadventure and that the securities pur-

52. 131 F. Supp. 2d 959, 961-62 (N.D. Ill. 2000) (applying Illinois law).
53. *Id.* at 962.
54. *Id.* at 961.
55. *See* RESTATEMENT (SECOND) OF CONTRACTS § 344 (1981) (summarizing purposes of the law of contract remedies).
56. *See* RESTATEMENT (SECOND) OF TORTS § 901 (1979) (stating general principles of measures of damages in tort).
57. 901 F.2d 1124, 1126-27 (D.C. Cir. 1990).

chased—stock options—had since declined in market value, which had the effect of creating a debit in the customer's account with the firm because it was a margin account.[58] The broker also told the customer that his firm was still keen on the investment, believing that it would do well, and that there were two things the customer could do: either (1) sell the options; or (2) keep the options and send in more money to cover the debit in the customer's account.[59] Not enough, responded the court—the broker's duty to the client obliged the broker to disclose all material information, including information about courses of action open to the customer.[60] In particular, the broker neglected to tell the customer that the customer had the right to reject the unauthorized option purchases.[61]

Thus, although it may not be in an agent's self-interest to do so, an agent's duty to the principal requires disclosure of an unauthorized transaction and of the principal's right (when present) to avoid it. To be sure, the principal's rights against the agent are not unbounded. Although the principal has a right to be indemnified by the agent against losses stemming from the agent's unauthorized transaction, the principal's indemnity claim does not extend to loss the principal could have avoided.[62]

An agent's duty of disclosure complements the principal's basic right to determine, as between agent and principal, what actions the agent will have authority to take on the principal's behalf. Common law agency does not require a principal, like the customer in *Cheng*, to detect unauthorized action taken by the agent and to risk losing rights against the agent if an unauthorized transaction eludes monitoring by the principal. Agency relationships involve delegation by the principal to the agent; what the agent in fact does may often be undetectable by the principal for some period of time. Indeed, agency relationships would become cumbersome if a principal's right to authorize what the agent may rightfully do on the principal's account came coupled with a requirement that the principal itself monitor the agent's conduct, lest the principal lose its rights against an agent stemming from unauthorized action by the agent.

An agent's duty to disclose prior breaches of duty also encompasses the agent's duties of loyalty, although fewer cases illustrate the point. A recent example comes from the English Court of Appeal, *Item Software (UK) Ltd. v. Fassihi*.[63] Mr. Fassihi was the sales and marketing director of a company that distributed software products. His employment contract ran for an indefinite period and was terminable on three months notice. Mr. Fassihi

58. *Id.*
59. *Id.*
60. *Id.* at 1128.
61. *Id.*
62. RESTATEMENT (THIRD) OF AGENCY § 8.09 cmt. b (2006). In *Cheng*, the broker's failure to disclose that the customer had the right to reject unauthorized transactions meant that the customer's ability to mitigate loss was limited to the two alternative routes suggested by the broker, which had the consequence of enhancing the losses recoverable by the customer.
63. [2004] EWCA (Civ) 1244 (U.K.), *available at* 2004 WL 2077421.

wished to establish his own company. While still employed, he approached his employer's chief supplier with his own proposal, while encouraging his employer's managing director to press the supplier for more favorable terms. Upon discovery, Mr. Fassihi was summarily dismissed. Attempting to lure away the supplier to his own company-in-development breached Mr. Fassihi's duty of loyalty to his principal.

Separately, though, did Mr. Fassihi breach his fiduciary duty by failing to disclose his breach to his principal? If so, his breach presumably relieved the principal of its duty to provide three months notice prior to termination, a point to which I return later. The Court of Appeal held that Mr. Fassihi's failure to disclose his breach constituted a separate breach of his fiduciary duty of loyalty, noting that the absence of such a duty "would mean that the company has to expend resources in investigating his conduct and that the enforcement of a liability to compensate the company for misconduct depends on the happenchance of the company finding out about the impropriety."[64] This rationale turns explicitly on the concern that an agency relationship not condition the effectiveness of an agent's obligations on the effectiveness with which the principal monitors the agent, the same rationale I have suggested for the outcome in *Cheng*. Instead, both *Cheng* and *Fassihi* facilitate a principal's control over its agents by explicitly imposing duties of disclosure on agents concerning their own conduct.

The question addressed by *Fassihi* also comes into play when an employee or other agent negotiates a severance contract with the principal—or a favorable modification to the original contract—while the principal remains ignorant of the agent's breach of duty. Should the principal be able to avoid the contract as a remedy for the agent's breach of a duty to disclose the prior breach? On this question, U.S. authority appears to be more protective of the principal than are English cases. In *Hadden v. Consolidated Edison Co.*, a company's officer negotiated a favorable severance package, having assured his superiors that there was no truth in rumors that he had been a participant in a kickback scheme.[65] The court held that the officer's denials, which were false, constituted fraudulent misstatements that entitled the company to avoid the severance deal struck with the executive.[66] In dictum, the court went further, stating that the officer's failure to disclose his wrongdoing itself constituted a breach of fiduciary duty that would make the severance deal avoidable by the company.[67]

64. *Id.* ¶ 65. For agreement with the court's analysis in *Fassihi*, see John Armour & Matthew Conaglen, *Directorial Disclosure*, [2005] C.L.J. 48, 51, stating, "A director's duty of loyalty is subjective because the director, rather than the court, is normally better placed to determine where the company's interests lie. The fact that directors will rarely be shown to have breached this duty is no basis for not applying it; such cases will, by definition, be the most egregious examples of misconduct and should carry liability."

65. 382 N.E.2d 1136, 1138 (N.Y. 1978).

66. *Id.* at 1139.

67. *Id.*

In contrast, two English cases that preceded *Fassihi* are more restrictive. In *Bell v. Lever Brothers Ltd.*, the House of Lords held that a parent corporation could not avoid severance contracts entered into with employees of a subsidiary although the employees did not disclose that they had breached their duties by profiting through secret deals on their own account.[68] In particular, two of the Lords stated that an employee owed no "superadded duty to confess,"[69] either when committing a wrongful act or when receiving payment from the employer. More recently, the Court of Appeal extended the logic of *Bell* to company directors who enter into agreements for increased remuneration or for severance pay.[70] One explanation may be that the English cases assume that negotiating a severance agreement or another variation to an existing employment contract should be a salient point for the employer or other principal, such that is it not unreasonable to expect that the principal would do as the principal did in *Hadden* and make an affirmative inquiry of the agent. In contrast, the dictum in *Hadden* may assume that the ongoing fiduciary relationship between a principal and an agent entitles the principal to expect that the agent will be loyal, an expectation that runs counter to assuming that the principal will affirmatively interrogate the agent prior to notice of disloyal conduct.

C. The Impact of Breaches of Fiduciary Duty on Contractual Provisions

A related question deserving at least brief mention is the impact that an agent's disloyalty should have on rights and obligations previously articulated in a contract between agent and principal, for example, on the three-month notice requirement for termination specified in Mr. Fassihi's contract. At this point, a full account requires consideration of contract law principles. Under basic contract law, a material failure of performance on the part of one party constitutes the nonoccurrence of a constructive condition on the other party's remaining duties of performance under the contract and justifies suspension of performance under the contract.[71] Beyond suspension of performance, termination of the contract may also be justified.[72]

Clearly these basic rules apply to contracts between agents and principals. But suppose that a contract between an agent and a principal contains an explicit provision requiring that, prior to termination of the contract, the principal give the agent notice of and an opportunity to cure any breaches. Does a "notice and cure" provision require a principal to continue a rela-

68. [1932] A.C. 161, 223 (U.K.). *Bell* is best known for its treatment of mistake in contract law. For a nuanced account of the underlying events and business history in *Bell,* see Catharine MacMillan, *How Temptation Led to Mistake: An Explanation of* Bell v. Lever Brothers, Ltd., 119 L.Q.R. 625 (2003).

69. *Bell*, [1932] A.C. at 228.

70. Horcal Ltd. v. Gatland, [1984] 1 B.C.C. 99089 (U.K.), *available at* 1984 WL 282917.

71. *See* RESTATEMENT (SECOND) OF CONTRACTS § 237 (1981).

72. *See* E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 8.18 (3d ed. 2004) (discussing circumstances under which termination is justified).

tionship with a disloyal agent—an agent whose breaches of duty go beyond defaults in performing duties of performance?

Although notice and cure provisions create the theoretical prospect of a turf battle between contract law and fiduciary duty, in practice, courts resolve the impasse by determining that notice and cure provisions are inapplicable unless an agent's breach is curable. Fiduciary norms thus appear to dominate as a consequence. For example, in *Larken, Inc. v. Larken Iowa City Limited Partnership*, the owner of a hotel entered into a management contract with a hotel manager containing a notice and cure requirement.[73] The court held that the provision did not restrict the owner's right to terminate the contract with the manager when the manager engaged in a series of self-dealing transactions "so serious that they frustrated one of the principal purposes of the management agreement, which was to manage the hotel in the best interests of the owner and to be honest and forthright in its dealings."[74] Many breaches of the fiduciary duty of loyalty thus are likely to be incurable because they contravene the principal's expectation of faithful service by the agent. To the extent the law attaches operational consequences to this expectation, an agent's duties of loyalty appear to have functions beyond affording subsidiary assistance toward assuring due performance of an agent's other duties.

D. Disloyal Actors Within Organizational Agents

Many agents are organizations that carry out their work on behalf of principals through employees and other agents of the organization itself. Among the agents discussed so far in this Article, Merrill Lynch in *Cheng* and the firm of solicitors in *Hilton* themselves undertook to act as agents on behalf of client-principals, including the plaintiff in each case. Necessarily the work of each organization was performed by individuals acting on its behalf. In both cases, as in many agency cases, it's likely that breaches of duty on the part of individual actors, if intentional, were motivated by a concern to further the interests of the firm, however misguided the actor's conduct may appear to be. That is, by failing to inform his customer that he had the right to reject an unauthorized purchase, the individual Merrill Lynch broker in *Cheng* may well have sought to protect the firm's position.

73. 589 N.W.2d 700, 700 (Iowa 1998).

74. *Id*. at 704; *accord* Union Miniere, S.A. v. Parday Corp., 521 N.E.2d 700, 703 & n.4 (Ind. Ct. App. 1988) (agent engaged to manage mining business acted affirmatively to undermine principal's business by attempting to dissuade state department from renewing principal's mining permit—agent's conduct "of a nature not easily curable"). A separate question is the weight to be placed on contractual silence about the consequences of an agent's disloyalty. *Union Miniere* was distinguished by *Mor-Cor Packaging Prods. v. Innovative Packaging Corp*., 328 F. Supp. 2d 857, 864 (N.D. Ill. 2004) on the basis that under Wisconsin law, it is "not clear that a material breach necessarily relieves a party of its obligations to comply with a contract's notice and cure provision prior to termination." Although *Mor-Cor* noted that the contract made exceptions to the notice and cure provision for circumstances other than breach of fiduciary duty, it also found that "[m]ore importantly . . . the alleged breach in the instant case appears to have been curable." *Id*. at 864.

In *Hilton*, the individual solicitors who failed to disclose adverse facts about one client to another may well have been motivated to further the firm's interest in recovering the deposit money lent on the firm's behalf to one client.

More challenging questions arise when an individual actor's breach of a duty of loyalty represents a frolic and detour of the individual's own, neither motivated by nor consistent with the interests of the organization. In particular, is an organizational agent itself accountable for—and thus subject to the remedies and other consequences that stem from—an individual actor's breach of a duty of loyalty? If the question is framed as an inquiry dominated by tort law, then it may be determinative of the outcome whether the actor's conduct falls within the scope of employment for purposes of the employer's vicarious liability under the respondeat superior doctrine. In most jurisdictions, an employee who intentionally acts in a wrongful manner and with no purpose of serving the employer's interests is characterized as having acted outside the scope of employment,[75] which would mean that an organizational agent would not itself be accountable for a significant class of fiduciary transgressions on the part of its own employees and other agents.

Common law agency, however, frames the inquiry otherwise. An organizational agent's employees assigned to work on matters for principals whom the organization itself represents are classified as subagents. Common law agency defines a subagent as "a person appointed by an agent to perform functions that the agent has consented to perform on behalf of the agent's principal."[76] A subagent acts subject to the control of the appointing agent and owes an agent's duties—including duties of loyalty—to both the appointing agent and the principal. An appointing agent is responsible to the principal for the subagent's conduct, subject to the terms of any agreement between the appointing agent and the principal.[77] The appointing agent's responsibility stems from its delegation to the subagent of functions and duties that, as an agent, it owes to the principal.

Significant consequences follow from attributing individual actors' breaches of the duty of loyalty to the organizational agent on whose behalf the individual actors work. Attribution creates incentives for an organizational agent to use care in selecting and monitoring the individual actors who carry out its work. Attribution also eliminates what would otherwise be gaps in the enforcement regime for duties of loyalty. These gaps stem from the relative positions of organizational agents and subagents as well as from the structure of remedies for breach of duties of loyalty. It is likely that an appointing agent will be more readily located than a misbehaving subagent and that the appointing agent's assets will provide more ample resources from which to compensate a principal against losses. Additionally, any con-

75. *See* RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006).
76. *Id.* § 3.15(1).
77. *Id.* cmt. d.

tractual relationship is likely to be between the principal and the organizational agent; attributing subagents' breaches of duty of loyalty to their appointing organizational agent is essential to effective recognition of the impact of the disloyal conduct on the principal's rights and liabilities as defined by the contract. Relatedly, if the principal has paid or agreed to pay a commission or other compensation for services to be rendered by an organizational agent, it is the organization against whom forfeiture should operate because the right to receive or retain the compensation is the organization's. Finally, an appointing agent's accountability for disloyal conduct by its subagents reduces the temptation, otherwise present to an unscrupulous agent, to structure its dealings with principals through a specially created vehicle to which the agent transfers assets and which appoints the agent its subagent.[78]

IV. CONCLUSION

The common law of agency has not always attracted the degree of academic interest that's warranted by its ubiquity, as well as its theoretical interest and practical significance. The issues explored in this Article illustrate various dimensions of only a portion of agency's intellectual richness and challenge—what consequences should follow an agent's disloyalty and how best to justify those consequences. In assigning consequences to an agent's disloyalty, it is important to be mindful of distinctive aspects of agency relationships and of an agent's duties of loyalty. The functions served by these duties are related to, but distinct from, the duties of performance that an agent also owes to a principal. An agent's duties of loyalty also operate with consequences not captured by contract law and tort law principles, consequences that both define and reinforce a principal's entitlement to faithful service from its agents.

78. For further elaboration on remedial consequences for an appointing agent when a subagent's conduct is disloyal, see DeMott, *supra* note 3, at 956.