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Marin R. Scordato

EVIDENTIARY SURROGACY AND RISK ALLOCATION: UNDERSTANDING IMPUTED KNOWLEDGE AND NOTICE IN MODERN AGENCY LAW

Marin R. Scordato[*]

There are powerful benefits available to a principal who enters into an agency relationship. The law allowing authorized agents to act as legal representatives of another permits the person on whose behalf the agent is acting to extend her legal personality beyond its natural limits and to do business on a scale far beyond her personal capacity. The law of agency also makes the world of purely legal persons, such as corporations and governments, possible.

Problems with agents acting on behalf of principals, especially corporate principals, have attracted serious and sustained attention in the last few years. Simply to say the names of Tyco, Enron, WorldCom, Arthur Andersen, and Waste Management now conjures up an image of agent misbehavior on a grand and costly scale. This recent history has served to focus popular and political attention on the possibilities for renewed reform of corporate governance and more aggressive regulation of the agents that serve corporations. Inevitably, such an effort must engage, and build upon, the most basic doctrines of agency law. Are such doctrines ready to provide the necessary support?

Along with the powerful benefits available through agency, so too comes significant risk and exposure. An agent may bind a principal to an unwanted contract with another.[1] The principal may be liable to third

[*] Associate Professor of Law, Columbus School of Law, The Catholic University of America; B.A. Haverford College, 1979; J.D. University of Virginia School of Law, 1983. I would like to thank Paula Monopoli, Frank Scordato, Roger Hartley and David Lipton for their willingness to read and comment on earlier drafts of this article. I am grateful for the financial support of this research by the Columbus School of Law at The Catholic University of America. I also appreciate the work of David Aaronson and Maximilian Bercovicz.

1. RESTATEMENT (SECOND) OF AGENCY §§ 8A, 8A cmt. a (1958); Fedders Corp. v. Taylor, 473 F. Supp. 961 (D. Minn. 1979); Lee v. YES of Russellville, Inc., 784 So.

parties for torts inflicted upon them by the agent.[2] Also, a principal may be deemed to have legally received certain knowledge or notice that has, in fact, been received only by the agent.[3] This last possible consequence of an agency relationship resides at the very heart of agency law, and it is the focus of this article.[4]

2d 1022 (Ala. 2000); Reuter v. Middlebrook, 131 N.W.2d 817 (Iowa 1964); Hooper v. Merchants' Bank & Trust Co., 130 S.E. 49 (N.C. 1925); Texas Conservative Oil Co. v. Jolly, 149 S.W.2d 265 (Tex. Civ. App. El Paso 1941); *See* WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 57 (3d ed. 2001).

2. RESTATEMENT (SECOND) OF AGENCY § 219 (1958); Gleason v. Seaboard Air Line Ry. Co., 278 U.S. 349 (1929); United Mine Workers of America v. Patton, 211 F.2d 742 (4th Cir. 1954); Scott v. Ross, 140 F.3d 1275 (9th Cir. 1998) (applying Washington law); Girard v. Trade Prof'l, Inc., 13 Fed. Appx. 865 (10th Cir. 2001) (applying Kansas law); Ex parte Wild Wild West Social Club, Inc., 2001 WL 700606 (Ala. 2001); St. Joseph's Reg'l Health Ctr. v. Munos, 934 S.W.2d 192 (Ark. 1996); Otis Elevator Co. v. First Nat'l Bank of San Francisco, 124 P. 704 (Cal. 1912); Dis. of Columbia v. Hampton, 666 A.2d 30 (D.C. 1995); Woods v. Cole, 693 N.E.2d 333 (Ill. 1998); Oliphant v. Town of Lake Providence, 192 So. 95 (La. 1939); DiCentes v. Michaud, 719 A.2d 509 (Me. 1998); Shafer v. Bull, 194 A.2d 788 (Md. 1963); Semrad v. Edina Realty, Inc., 493 N.W.2d 528 (Minn. 1992); McHaffie By and Through McHaffie v. Bunch, 891 S.W.2d 822 (Mo. 1995); H-D Irrigating, Inc. v. Kimble Props., Inc., 301 Mont. 34 (2000); Ashby v. First Data Res., Inc., 497 N.W.2d 330 (Neb. 1993); Wright v. State, 778 A.2d 443 (N.J. 2001); Nowack v. Metro. St. Ry. Co., 60 N.E. 32 (1901); W.R. Grace & Co. v. Strickland, 124 S.E. 856 (N.C. 1924); Doan *ex rel.* Doan v. City of Bismarck, 632 N.W.2d 815 (N.D. 2001); Dorsey v. Morris, 611 N.E.2d 509 (Ohio 1992) (holding that the agent's action was not within the scope of the agent's employment); State *ex rel.* Oklahoma Bar Ass'n v. Taylor, 4 P.3d 1242 (Okla. 2000); Travelers Cas. & Sur. Co. v. Castegnaro, 772 A.2d 456 (Pa. 2001); Baptist Mem'l Hosp. Sys. v. Sampson, 969 S.W.2d 945 (Tex. 1998), reh'g of cause overruled, (July 3, 1998); Jones v. Mut. Creamery Co., 17 P.2d 256 (Utah 1932); Courtless v. Jolliffe, 507 S.E.2d 136 (W. Va. 1998); Hamilton v. Natrona County Educ. Ass'n, 901 P.2d 381 (Wyo. 1995).

3. RESTATEMENT (SECOND) OF AGENCY § 268, 272, 278 (1958); WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP §§ 57, 59 (3d ed. 2001); Anderson v. Walthal, 468 So. 2d 291, 294 (Fla. Dist. Ct. App. 1985) ("it is equally settled that knowledge of, or notice to, an agent is imputed to the principal when it is received by the agent while acting within the course and scope of employment . . ."); Ouachita Equip. Rental Co. v. Trainer, 408 So. 2d 930, 935 (La. Ct. App. 1981) ("The knowledge of the agent is imputed to the principal even if the agent neglects to specifically convey that information to the principal.").

4. *See* Deborah A. DeMott, *When Is A Principal Charged With An Agent's Knowledge?*, 13 Duke J. Comp. & Int'l L. 291, 291 (2003) ("[I]mputation is central to the bases on which agency ascribes responsibility for one person's actions to another

Generally known as the "imputed knowledge rule" this aspect of agency law legally charges the principal with information obtained by the agent within the scope of the agent's service for the principal.[5] The law will treat the principal as having actually received the information in question, even if it is clear from the facts of the case that the agent failed

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person and thus to agency doctrine as a whole.").

5. Curtis, Collins & Holbrook Co. v. U.S., 262 U.S. 215 (1923); Apollo Fuel Oil v. U.S., 195 F.3d 74 (2d Cir. 1999); Martin Marietta Corp. v. Gould, Inc., 70 F.3d 768 (4th Cir. 1995) (applying Maryland law); Metro. Wholesale Supply, Inc. v. M/V Royal Rainbow, 12 F.3d 58 (5th Cir. 1994) (applying Louisiana law); Aetna Cas. and Sur. Co. v. Leahey Const. Co., 219 F.3d 519 (6th Cir. 2000) (applying Ohio law); Employers Ins. of Wausau v. Banco De Seguros Del Estado, 199 F.3d 937 (7th Cir. 1999), reh'g and reh'g en banc denied, (Jan. 19, 2000) and cert. denied, 530 U.S. 1215 (2000) (applying Wisconsin law); Tonelli v. U.S., 60 F.3d 492 (8th Cir. 1995); Morrow Crane Co. v. Affiliated FM Ins. Co., 885 F.2d 612 (9th Cir. 1989); Cronin v. Washington Nat. Ins. Co., 980 F.2d 663 (11th Cir. 1993) (applying Massachusetts law); Pfenninger v. Hunterdon Central Regional High School, 770 A.2d 1126 (N.J. 2001); Morgan v. Jackson, 63 So. 2d 597 (Ala. 1953); Manley v. Ticor Title Ins. Co. of California, 816 P.2d 225 (Ariz. 1991); Standard Motors Fin. Co. v. Mitchell Auto Co., 293 S.W. 1026 (Ark. 1927); Clark Equip. Co. v. Wheat, 92 Cal. App. 3d 503 (Cal. 1st Dist. 1979); Reardon v. Mut. Life Ins. Co. of N.Y., 86 A.2d 570 (Conn. 1952); Ruotal Corp., N. W., Inc. v. Ottati, 391 So. 2d 308 (Fla. Dist. Ct. App. 4th Dist. 1980); Chicagoland Vending, Inc. v. Parkside Center, Ltd., 454 S.E.2d 456 (Ga. 1995); U.S. Cold Storage Co. v. Central Mfg. Dist. Bank, 175 N.E. 825 (Ill. 1931); Wyckoff v. A & J Home Benev. Ass'n of Creston, Iowa, 119 N.W.2d 126 (Iowa 1962); United Fuel Gas Co. v. Jude, 355 S.W.2d 664 (Ky. 1962); Weingart v. Delgado, 16 So. 2d 254 (La. 1943); Tracey v. Standard Acc. Ins. Co., 109 A. 490 (Me. 1920); Duckworth v. Bernstein, 466 A.2d 517 (Md. 1983); Miller v. Mooney, 725 N.E.2d 545 (Mass. 2000); Pearson v. Sullivan, 176 N.W. 597 (Mich. 1920); Packard Mfg. Co. v. Indiana Lumbermens Mut. Ins. Co., 203 S.W.2d 415 (Mo. 1947); Kaeding v. W.R. Grace & Co.—Conn., 961 P.2d 1256 (Mont. 1998); Selig v. Wunderlich Contracting Co., 69 N.W.2d 861 (Neb. 1955); Taylor v. Metro. Life Ins. Co., 214 A.2d 109 (N.H. 1965); Ford v. Grand Union Co., 197 N.E. 266 (N.Y. 1935); Am. Export & Inland Coal Corp. v. Matthew Addy Co., 147 N.E. 89 (Ohio 1925); Aetna Cas. & Sur. Co. of Hartford, Conn. v. Local Bldg. & Loan Ass'n, 19 P.2d 612 (Okla. 1933); State Farm Fire & Cas. Co. v. Sevier, 537 P.2d 88 (Or. 1975); Hicks v. Am. Natural Gas Co., 57 A. 55 (Pa. 1904); De Ford v. Nat'l Life & Acc. Ins. Co., 185 S.W.2d 617 (Tenn. 1945); Preston Farm & Ranch Supply, Inc. v. Bio-Zyme Enterprises, 625 S.W.2d 295 (Tex. 1981); Macris v. Sculptured Software, Inc., 24 P.3d 984 (Utah 2001); Agency of Natural Resources v. Towns, 724 A.2d 1022 (Vt. 1998); Boice v. Fin. & Guar. Corp., 102 S.E. 591 (Va. 1920); Bollong v. Corman, 217 P. 27 (Wash. 1923); Fritsch v. St. Croix Cent. School Dist., 515 N.W.2d 328 (Wis. Ct. App. 1994).

to transmit the information to the principal, and therefore clear that the principal never actually possessed it.[6]

For example, imagine an owner of an apartment building who has engaged a property manager to operate the leasing of the apartment units on her behalf. Standard leases for the units in the building provide to the tenant an opportunity to extend the current leasehold on the unit for an additional year with a rent increase of no more than 5% if the tenant formally notifies the landlord of her intention to extend the lease no later than two months prior to the end of the current lease term. A particular tenant delivers to the property manager the proper notification of her intent to extend her current lease before the deadline. The property manager carelessly loses the notification prior to making a record of its receipt and thus incorrectly informs the landlord that the unit is available for re-lease at a rent increase of more than 5%. When the landlord offers to the tenant a new lease at a rent increase of 10%, the tenant could effectively bind the landlord to the 5% limit promised by the prior lease, even if the landlord did not ever personally possess any knowledge of the tenant's exercise of the lease provision. This result would be the same no matter how blameless the landlord was in her failure to receive the tenant's prior notice.

This is the imputed knowledge rule in action. Receipt of the notice by the authorized agent results in the legal receipt by the principal, regardless of whether or not the principal actually received the notice from the agent.[7]

There are two well recognized exceptions in agency law to the imputed knowledge rule. One is that a principal will not be imputed with knowledge possessed by an agent when the agent obtained the information from a third party to which the agent owes a duty of

6. New York Marine & Gen. Ins. Co. v. Tradeline (L.L.C.), 266 F.3d 112 (2d Cir. 2001) (applying New York law); Columbia Pictures Corp. v. De Toth, 197 P.2d 580 (Cal. 1948); Farnsworth v. Hazelett, 199 N.W. 410 (Iowa 1924); New England Trust Co. v. Bright, 174 N.E. 469 (Mass. 1931); Westinghouse Electric & Mfg. Co. v. Hubert, 141 N.W. 600 (Mich. 1913); Cox v. Pearce, 20 N.E. 566 (N.Y. 1889); Gibson Oil Co. v. Hayes Equip. Mfg. Co., 1933 OK 142; Hurst Boillin Co. v. Jones, 279 S.W. 392 (Tenn. 1926); Agency of Natural Res. v. Towns, 724 A.2d 1022 (Vt. 1998).

7. WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 59 (3d ed. 2001) (citing Thomason v. Miller, 555 S.W.2d 685 (Mo. App. 1977)); RESTATEMENT (SECOND) OF AGENCY §§ 268, 272 (1958).

confidentiality.[8] For example, suppose that a certain physician works as an employee for a particular hospital. In the course of her work for the hospital, the physician sees an individual as a patient, examines the individual, and diagnoses him as suffering from a serious medical condition. Some time later, the same individual applies for and secures a job at the hospital and, in the process of completing employment and insurance application forms, fails to disclose the existence of the medical condition diagnosed by the physician. The group health insurance company for the hospital subsequently seeks to reject claims for coverage of treatment of the individual's (now employee's) medical condition on the grounds that the physician was aware of the existence of the individual's medical condition at the time of initial employment, and that therefore the hospital was legally aware of the condition pursuant to the imputed knowledge rule. If the insurance company can show that the hospital was legally in possession of the information, then it can argue that the hospital breached the conditions of insurance coverage by failing to disclose the existence of the condition to the insurance company at the time of the individual's initial employment. While otherwise sound, the insurance company's argument is not likely to prevail in this circumstance because the physician obtained the information in question within the scope of a legally confidential relationship or transaction with the individual, and thus the usual operation of the imputed knowledge rule is abated.

The second exception to the imputed knowledge rule applies when the agent, whose knowledge a third party is seeking to impute to the principal, has acted adversely to the principal during the transaction in

8. WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 62 (3d ed. 2001); RESTATEMENT (SECOND) OF AGENCY § 281 (1958); TTT Stevedores of Texas, Inc. v. M/V Jagat Vijeta, 696 F.2d 1135 (5th Cir. 1983); Imperial Fin. Corp. v. Fin. Factors, Ltd., 490 P.2d 662 (Haw. 1971); Farnsworth v. Hazelett, 199 N.W. 410 (Iowa 1924); Puffer v. Badley, 181 P. 1 (Or. 1919); Melms v. Pabst Brewing Co., 66 N.W. 518 (Wis. 1896). *See* Citizens Nat'l Bank v. Lineberger, 45 F.2d 522, 531 (4th Cir. 1930) ("[T]he bank is not chargeable with the knowledge which the attorney acquired in the transaction of the business of his clients."); *See generally* Florence v. Carr, 148 So. 148 (Ala. 1933); Rushville Nat'l Bank v. State Life Ins. Co., 1 N.E.2d 445, 450 (Ind. 1936) ("Knowledge upon the part of its agent and examining officer cannot be imputed to the company . . .").

question.[9] For example, imagine that in the course of a sales transaction, a car salesman working for a dealership learns from a potential customer that the customer must receive a certain minimum amount in trade for his current car in order to be willing to purchase a new car from the dealership through the salesman. Upon direct inspection, the salesman learns of defects in the customer's current car that would make it impossible to give the customer the minimum trade-in value that he seeks. Nevertheless, badly wanting the commission on the sale, the salesman prepares a report of the inspection as if the defects did not exist and credits the customer the desired amount of value in trade for his current car. When the dealership subsequently seeks a remedy against the customer for failing to fully disclose defects in the car of which the customer was aware at the time of the transaction as required by the sales contract, the customer is not likely to be able to employ the imputed knowledge rule to bind the dealership to the knowledge of the salesman regarding the condition of the car, because the agent, the salesman, was operating adversely to the interests of the principal, the dealership, in the transaction in question. This is an illustration of the so-called "adverse agent exception" to the imputed knowledge rule.

MUNROE V. HARRIMAN

Over the years, the adverse agent exception to the imputed knowledge rule has generated significant controversy and attendant litigation. One reasonably well known example of this litigation is the case of *Munroe v. Harriman*.[10] Decided by the United States Court of

9. WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 59 (3d ed. 2001); RESTATEMENT (SECOND) OF AGENCY §§ 268, 271, 282 (1958); Evanston Bank v. Conticommodity Servs., Inc., 623 F.Supp. 1014, 1036 (N.D. Ill. 1985) ("However, knowledge is normally not imputed when an agent is acting adversely to the principal and for his own or another's benefit. Since the agent then has a motive for concealing the information, one can no longer assume that he will fulfill his duty to speak."); In re Investors Funding Corp. of N.Y. Sec. Litigation, 523 F.Supp 533, 541 (S.D.N.Y. 1980) ("However, when an agent is acting adversely to the interest of the principal, his knowledge and conduct are not imputed to the principal."); Duckworth v. Bernstein, 466 A.2d 517, 523 (Md. 1983) ("Where an agent acquires knowledge in the course of his agency, and has no personal interest in the transaction adverse to the interest of the principal, the agent's knowledge is ascribed to the principal.").

10. 85 F.2d 493 (2d Cir. 1936).

Appeals for the Second Circuit on August 10, 1936,[11] the case arose from a series of transactions among Charles Munroe, the plaintiff, Joseph Harriman, the defendant, and Harriman National Bank & Trust Company of The City of New York, a co-defendant.[12] As is indicated in its name, Joseph Harriman played a prominent role in the management and operation of the Harriman National Bank & Trust Company of The City of New York. The court finds that, "Harriman was president of the bank and dominated its other employees."[13]

On June 14, 1932, Munroe lent to Harriman personally, and not to the bank, certain securities owned by Munroe.[14] Munroe's agreement to lend to Harriman the securities was obtained by fraud on the part of Harriman and it is undisputed by the parties that the fraud engaged in by Harriman provided Munroe with the legal basis for rescission of the transaction and return of the securities.[15] However, before Munroe could seek return of the securities from Harriman, Harriman had transferred possession of the securities to the bank so that they could serve as part of the collateral for a loan of $380,000 (subsequently increased to $394,000) from the bank to a corporation personally owned and controlled by Harriman (the M.H.O. Corporation, characterized by the court as, "one of his [Harriman's] dummy corporations.").[16] The loan to M.H.O. Corporation was approved by the loan committee of the bank and, "[n]one of the officers or employees of the bank who took part in the making of the loan, other than Harriman, were aware that the pledged securities had been procured from Munroe by fraud."[17]

So Munroe had a clear right to repossess the securities from Harriman, but Harriman no longer had possession of the securities.[18] The bank, which clearly had possession of the securities, had no direct participation in, nor knowledge of, the fraud that gave rise to Munroe's repossession right.[19] One obvious response by Munroe to this dilemma

11. *Id.* at 493.
12. *Id.* at 494-95.
13. *Id.* at 494.
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*

would be to argue that Harriman was acting as the agent of the bank when he engaged in the fraud, thus tainting the bank with Harriman's fraudulent acts. The court, however, rejected this approach, finding that, "Munroe did not deal with Harriman as an agent of the bank. Harriman's request was that the securities be lent to him personally, and so they were. . . . Hence his fraudulent representations in procuring them cannot be attributed to the bank."[20]

Another approach available to Munroe was to argue that while Harriman's fraudulent acts were not engaged in directly on behalf of the bank by Harriman, Harriman certainly had knowledge of his own fraudulent acts in obtaining the securities from Munroe at the time the securities were offered to the bank as collateral for the loan to M.H.O. Corporation.[21] Thus, applying the basic imputed knowledge rule, it could be said that the bank should be charged with the knowledge of its agent Harriman regarding the legally tainted source of the securities, and that Harriman clearly had this knowledge prior to the bank's receipt of the securities as collateral for the loan.[22] If this is the correct characterization of events, then the bank does not enjoy the status of a bona fide purchaser for value without knowledge at the time that it takes possession of the securities and Munroe's claim to possession is superior to that of the bank.[23]

The bank's response to this line of attack by Munroe is an invocation of the adverse agent exception to the imputed knowledge rule, claiming that with respect to the use of the securities by Harriman as collateral for a loan from the bank to him, Harriman stood on the opposite side of the transaction from the bank and thus had interests with respect to the transaction that were in conflict, or adverse, to those of the bank.[24] Therefore, the bank argues, Harriman operated as an adverse agent when he provided the securities to the bank as collateral for the loan and, as a result, pursuant to the adverse agent exception to the imputed knowledge rule, Munroe may not subsequently impute Harriman's knowledge of the fraudulent origin of the securities to the bank.[25]

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20. *Id.*
21. *See id.* at 494-95.
22. *Id.*
23. *Id.*
24. *Id.* at 495-96.
25. *Id.* at 495.

The court in *Munroe* accepts this line of analysis, as far as it goes, but pushes further to try to determine from the evidence presented whether Harriman operated as the "sole representative" of the bank in accepting the tainted securities as collateral for the loan.[26] After reviewing the facts, the court concludes that:

> [Harriman's] will alone caused the making of the loan and the acceptance of the collateral. Therefore he should be treated as the sole actor on behalf of the bank as fully as though he had physically placed the borrower's note and securities in the bank's vault and paid over the borrowed money without the knowledge of any other officer.[27]

What difference does it make that Harriman is characterized as the "sole actor" on behalf of the bank in the making of the loan? All the difference, according to the court. It rules that, "In such [a] case, as already pointed out, the corporation can claim title only by virtue of the sole actor's act and must accept it burdened with his knowledge of the defect in title."[28] The court is not willing to allow the bank in this circumstance to both accept possession of the tainted securities solely as a result of Harriman's actions on its behalf and at the same time to disclaim the knowledge that Harriman possessed regarding the securities because he had interests in the transaction that were adverse to the bank.[29] In other words, the court in this case fashions an exception to the adverse agent exception to the imputed knowledge rule, holding that a principal will in fact have the knowledge possessed by even an adverse agent if it can be shown that the adverse agent was the sole actor or representative for the principal with respect to the transaction in question.[30]

The *Munroe* case is not exceptional. One reason it probably appears in law school casebooks[31] is that it represents an embrace of a

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26. *Id.* at 496.
27. *Id.* at 496.
28. *Id.*
29. *See id.*
30. *See id.*
31. *See, e.g.*, WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 62, n.18 (3d ed. 2001); WARREN A. SEAVEY, STUDIES IN AGENCY 179 (1949); WARREN A. SEAVEY, HANDBOOK OF THE LAW OF AGENCY 177 (1964).

sole actor exception to the adverse agent exception to the imputed knowledge rule that is recognized by cases in a large number of U.S. jurisdictions.[32]

FARR V. NEWMAN

A second well-known case that is illustrative of another line of interesting analysis regarding the adverse agent exception to the imputed knowledge rule is *Farr v. Newman*.[33] This case involves a fairly simple real estate transaction and an all-too-common occurrence of a dual agency.[34] The plaintiff in the case, Franz Farr, sought to purchase a piece of real property from Newman for $3,000.[35] Both Farr and

32. Curtis, Collins & Holbrook Co. v. U.S., 262 U.S. 215 (1923); Stone & Webster Eng. Corp. v. Hamilton Nat'l. Bank, 199 F.2d 127 (6th Cir. 1952); Connecticut Fire Ins. Co. v. Commercial Nat'l. Bank, 87 F.2d 968 (5th Cir. 1937); Maryland Cas. Co. v. Queenan, 89 F.2d 155 (10th Cir. 1937); Queenan v. Mays, 90 F.2d 525 (10th Cir. 1937); Skud v. Tillinghast, 195 F. 1, 7 (6th Cir. 1912) and cases cited therein; Kean v. Nat'l. City Bank, 294 F. 214, 224 (6th Cir. 1923); Wasmann v. City Nat'l. Bank, 52 F.2d 705 (6th Cir. 1931); Schneider v. Thompson, 58 F.2d 94, 97 (8th Cir. 1932); Anderson v. Missouri State Life Ins. Co., 69 F.2d 794 (6th Cir. 1934); Nissen v. Nissen Trampoline Co., 39 N.W.2d 92 (Iowa 1949); Nat'l Turners Bldg. & Loan Ass'n v. Schreitmueller, 285 N.W. 497 (Mich. 1939); Blumberg v. Taggart, 5 N.W.2d 388 (Minn. 1942); Newco Land Co. v. Martin, 213 S.W.2d 504 (Mo. 1948); Aetna Cas. & Sur. Co. of Hartford, Conn. v. Local Bldg. & Loan Ass'n, 19 P.2d 612 (Okla. 1933); State *ex rel.* Clarke v. Ripley Sav. Bank & Trust Co., 160 S.W.2d 189 (Tenn. 1941); Puget Sound Nat'l. Bank v. St. Paul Fire and Marine Ins. Co., 645 P.2d 1122 (Wash. Ct. App. 1982); Knobley Mountain Orchard Co. v. People's Bank, 129 S.E. 474 (W. Va. 1925); State v. Candler, 728 S.W.2d 756, 759 (Tenn. Crim. App. 1986); Martin v. First Nat'l. Bank, 51 F.2d 840 (D. Minn. 1931); Irving Trust Co. v. State Bankers' Financial Corp., 40 F.2d 88 (S.D.N.Y. 1930); First Nat'l. Bank v. Blake, 60 F. 78 (C.C.D.Or. 1894); Tatum v. Commercial Bank & Trust Co., 69 So. 508 (Ala. 1915); First Nat'l. Bank v. Town of New Milford, 36 Conn. 93, 101 (1869); Founche v. Merchants' Nat'l. Bank, 36 S.E. 256 (Ga. 1900); Taylor v. Felder, 59 S.E. 844 (Ga. Ct. App. 1907); Newell v. Hadley, 92 N.E. 507 (Mass. 1910); Tremont Trust Co. v. Noyes, 141 N.E. 93, 98 (Mass. 1923); Holden v. New York & Erie Bank, 72 N.Y. 286 (1878); Farmers' & Traders' Bank v. Kimball Co., 47 N.W. 402 (S.D. 1890); Black Hills Nat'l. Bank v. Kellogg, 56 N.W. 1071 (S.D. 1893); Barry v. Hensley, 98 S.W. 2d 102 (Tenn. 1936); Vogel v. Zipp, 90 S.W. 2d 668 (Tex. Civ. App. 1936). *See also*, Warren A. Seavey, *Notice Through an Agent*, 65 U. PA. L. REV. 1, 16-20 (1916).

33. 199 N.E.2d 369 (N.Y. 1964).

34. *See id.*

35. *Id.* at 370-71.

Newman executed a written memorandum recording the transaction.[36] The memorandum was not in a form that could have been recorded in the appropriate county office, and it in fact was not recorded.[37]

Subsequent to the execution of the agreement with Farr, Newman learned of an opportunity to sell the same piece of property to another person, Elbert Hardy, for $4,000.[38] Newman apparently approached Farr and asked him to match the $4,000 offer and suggested that he would sell the property to Hardy if he failed to do so.[39] Farr refused to increase his price for the property and threatened to sue if Newman conveyed the property to anyone but him.[40] Undeterred, Newman took $4,000 in cash from Hardy and transferred ownership of the property to him, properly recording the conveyance.[41] Farr made good on his threat and filed suit against Newman and Hardy, seeking specific performance of the earlier agreement and a forced conveyance of the property from Hardy to him.[42]

At this point, without more, Hardy would be in a strong position in the suit brought against him by Farr. Hardy paid cash to Newman for the property, he properly recorded his interest, and he had no reason to believe prior to the purchase that there existed any other colorable claim.[43] He could have been a classic bona fide purchaser for value without knowledge.

However, Hardy, presumably in an effort to save money and simplify the transaction, used for the property purchase the same attorney as did Newman, a lawyer named Cash.[44] It was to this attorney that Farr communicated his belief that his prior agreement with Newman was enforceable and delivered his threat to sue if the property were conveyed to anyone else.[45] Attorney Cash, apparently believing that the written memorandum executed by Farr and Newman was not legally

36. *Id.*
37. *Id.* at 371, 374.
38. *Id.* at 374.
39. *Id.*
40. *Id.*
41. *Id.*
42. *See id.*
43. *Id.* at 371, 374.
44. *Id.* at 374.
45. *Id.* at 371.

enforceable, did not tell Hardy anything about it or about Farr's asserted prior claim to the property or threat to sue.[46]

Now, with these additional facts, Farr is able to argue that while Hardy himself had no knowledge of Farr's prior claim to the property, attorney Cash certainly did. Thus, by invocation of the imputed knowledge rule, Farr could impute the attorney's knowledge, and the notice that Farr provided to him, directly to Hardy and thereby defeat Hardy's claim to have been a bona fide purchaser for value without actual notice of Farr's prior claim. As noted, under the imputed knowledge rule, Hardy would be charged with the notice delivered to attorney Cash even if Hardy could conclusively establish that Cash never actually passed that notice or knowledge on to him.[47]

Hardy's response to Farr's use of the imputed knowledge rule was to point out that attorney Cash represented both himself and Newman in the sale of the property from Newman to Hardy, and that as a result Cash, as a classic dual agent, faced an inevitable conflict of interest as the agent for Hardy.[48] In fact, as the dissent in the case notes, "It would be hard to discover a clearer case of an attorney's representing interests which conflicted at the very point where one client was being lulled into security in the interest of the other client."[49] Thus, Hardy argues, as an agent possessing interests adverse to his, the adverse agent exception to the imputed knowledge rule should prevent Farr from imputing the knowledge and notice possessed by Cash to Hardy, thereby preserving Hardy's status as a bona fide purchaser for value without knowledge and maintaining the superiority of Hardy's claim to the property.[50]

Again, just as in the *Munroe* case, traditional imputed knowledge rule doctrine stops here, accepting the validity of Hardy's analysis and awarding him the superior right to the property.[51] But again, just as in the *Munroe* case, the court does not stop here.[52] Without disputing that Cash was in fact an adverse agent to Hardy and that the adverse agent

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46. *Id.*

47. RESTATEMENT (SECOND) OF AGENCY § 268(1) (1958); WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 59 (3d. 2001).

48. *Farr*, 199 N.E.2d at 371-72.

49. *Id.* at 375 (Van Voorhis, J., dissenting).

50. *Id.* at 371.

51. *See id.* at 371-73.

52. Munroe v. Harriman, 85 F.2d 493, 496 (2d Cir. 1936); *Farr*, 199 N.E.2d at 372-73.

exception to the imputed knowledge rule works in the way that Hardy suggests, the court focuses on the fact that one of the primary functions of an attorney agent in a real estate transaction is to gather knowledge, and receive notice, of possible conflicting claims to the property.[53]

The court writes, "[Hardy's] appointment of an attorney to represent him in the acquisition of this real property, and, incidentally, to receive notice of any outstanding equity, was also an invitation to the public to give such notice to the attorney."[54] A few sentences later the court states:

> Nothing can alter the fact that the attorney was held out as a proper person to whom notice of outstanding equities was to be given, and that his receipt of such notice from plaintiff [Farr] was within his authority, both as actually conferred and as apparent to others.[55]

The court seems bothered by a disposition of the case that would, in effect, permit a buyer to be represented by an attorney in a real estate transaction, an attorney among whose primary functions is the identification of possible conflicting claims to the land, and to allow that attorney to in fact be clearly notified of the existence of a prior conflicting claim, without there following the normal legal consequence to the buyer.[56] While avoiding this phrasing directly, the court seems to imply that there is at most something fraudulent, and at least something inherently unfair to third parties possessing conflicting claims, for the buyer to be able to hold out to them an agent who is especially authorized to collect such claims on behalf of the buyer, to have the third parties provide this agent with full notice, and then to have the usual consequence of that notice negated as a result of a feature of the relationship between the buyer and his agent.[57] Why should the third party necessarily suffer because the agent has interests adverse to the principal?

The court concludes:

> A diversity of interest on the part of the agent is of no significance to

53. *Farr*, 199 N.E.2d at 372-73.
54. *Id.* at 371.
55. *Id.* at 373.
56. *See generally id.* at 372-73.
57. *See generally id.* at 372-73.

> third persons, such as plaintiff, unless it placed the agent's act beyond his authority. Nothing can alter the fact that the attorney was held out as a proper person to whom notice of outstanding equities was to be given, and that his receipt of such notice from plaintiff was within his authority, both as actually conferred and as apparent to others. . . . Once the attorney received plaintiff's notification, as authorized by defendant, even a fraudulent or self-serving concealment of that fact from the defendant would no more extinguish plaintiff's protection than would a debtor's debt be revived where he had paid his creditor's authorized agent for collection, who thereafter embezzled the money collected [citations omitted].[58]

Thus, in the *Farr* case, Farr is determined to have the superior claim to that of Hardy.[59] Hardy is denied the status of a bona fide purchaser for value without knowledge because the knowledge of Farr's prior claim was possessed by Hardy's agent, attorney Cash, and that knowledge is legally imputed to Hardy despite the undisputed fact that Cash was a dual, and thus in this case an adverse, agent.[60] Hardy suffers the consequences of the notice given to his adverse agent, and never actually received by him, regardless of the existence of the adverse agent exception to the imputed knowledge rule.[61]

One can think of the *Farr* case as representing an "agent for notice" exception to the adverse agent exception to the imputed knowledge rule, holding that the knowledge or notice of even an adverse agent will be imputed to the principal if one of the primary duties to be performed by the agent for the principal is the collection of just such knowledge or notice. Alternatively, the *Farr* case can be read as creating a "dual agent" exception to the adverse agent exception to the imputed knowledge rule, holding that notice to or knowledge of a dual agent is imputed to the principals regardless of the fact that the dual agent is adverse to them.[62] Either way, the *Farr* case, just like the *Munroe* case,

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58. *Id.* at 372-73.

59. *Id.* at 373.

60. *Id.*

61. *Id.*

62. Astor v. Wells, 17 U.S. 466 (1819); Brown v. Jefferson County Nat'l Bank, 9 F. 258 (C.C.N.Y. 1881); Mittendorf v. J. R. Williston & Beane, Inc. 372 F. Supp. 821 (S.D.N.Y. 1974); Carter v. Town of Ottawa, 24 F. 546 (N.D. Ill. 1885); Emmons v. Ingebretson, 279 F. Supp. 558 (N.D. Iowa 1968); Manley v. Ticor Title Ins. Co. of CA., 816 P.2d 225 (Ariz. 1991); McHugh v. Duane, 53 A.2d 282 (D.C. 1947); Carlton v.

clearly represents a significant exception to the adverse agent exception to the imputed knowledge rule.

UNDERLYING RATIONALES

Munroe and *Farr* are not alone. They are not odd, isolated, carefully selected instances of courts finding a reason not to apply the adverse agent exception to the imputed knowledge rule in a straightforward manner.[63] This means that the imputed knowledge rule, accurately summarized, includes, at least, the basic rule itself,[64] the confidential agent exception to the rule,[65] the adverse agent exception to the rule,[66] and a list of specific, more or less ad hoc, exceptions to the adverse agent exception to the rule.[67] This is an unusually complicated

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Moultrie Banking Co., 152 S.E. 215 (Ga. 1930); Taylor v. Felder, 59 S.E. 844 (Ga. Ct. App. 1907); Herron v. Interstate Life & Accident Co., 190 S.E. 631 (Ga. Ct. App. 1937); Haas v. Sternbach, 41 N.E. 51 (Ill. 1894); J. & G. Lippman v. Rice Millers' Distrib. Co., 100 So. 685 (La. 1924); Meier v. Goebel-Reid Grocery Co., 20 S.W.2d 605 (Mo. Ct. App. 1929); Barth v. Haase, 139 S.W.2d 1058 (Mo. Ct. App. 1940); Losey v. Simpson, 11 N.J. Eq. 246 (N.J. Ch. 1856); Turner v. Kuehnle, 64 A. 478 (N.J. Ch. 1906); Glen Oaks Club v. Glen Oaks Holding Co., 86 N.Y.S.2d 568 (N.Y. Sup. Ct. 1948), *aff'd* 88 N.Y.S.2d 257 (N.Y. App. Div. 1949); Cmty. Sav. & Loan Ass'n. v. Lubbock Sav. & Loan Ass'n., 509 S.W.2d 448 (Tex. Civ. App. 1974); Foster v. Blake Heights Corp., 530 P.2d 815 (Utah 1974); Melms v. Pabst Brewing Co., 66 N.W. 518 (Wis. 1896); Ross v. Northrup, King & Co., 144 N.W. 1124 (Wis. 1914); Johnson v. Blumer, 197 N.W. 340 (Wis. 1924).

63. *See, e.g.,* Dillon v. Berg, 326 F. Supp. 1214, 1224 (D. Del. 1971); Ctr. v. Hampton Affiliates, Inc., 66 N.Y.2d 782, 799-800 (1985); Blumberg v. Taggart, 5 N.W.2d 388, 393-95 (Minn. 1942); Willcox v. Goess, 92 F.2d 8, 10-11 (2d Cir. 1937); Eitel v. Schmidlapp, 459 F.2d 609, 615-16 (4th Cir. 1972); Matanuska Valley Bank v. Arnold, 223 F.2d 778, 781-82 (9th Cir. 1955). *See also* the cases cited supra notes 9, 32 and 62.

64. RESTATEMENT (SECOND) OF AGENCY § 268 (1958).

65. RESTATEMENT (SECOND) OF AGENCY § 281 (1958).

66. RESTATEMENT (SECOND) OF AGENCY §§ 279, 282 (1958).

67. *See* WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP §§ 59, 62, 64 (2001); *see also* 3 AM JUR 2D. AGENCY § 280, 2 (2004)

> The rule that the knowledge of an agent acting adversely to the principal will not be imputed to the latter may also not apply if the failure of the agent to act upon or to reveal the information results in a violation of a contractual or relational duty of the principal to a person harmed thereby (citing State Farm Fire & Cas. Co. v. Sevier, 537 P.2d 88 (Ore. 1975) and City of Fort Worth v. Pippen, 439 S.W.2d 660 (Tex. 1969)).

and unwieldy structure for a doctrine of the common law, one of whose traditional characteristics is its relative elegance.[68] What could explain this phenomenon?

The unusual complexity and lack of elegance in the structure of the imputed knowledge rule can be traced to a deep, underlying tension between competing rationales supporting the rule itself. These independent rationales for the rule are in harmony supporting the existence of the imputed knowledge rule and the confidential relationship exception to the rule. They diverge markedly, however, with respect to the existence and nature of the adverse agent exception.

Why should there exist an imputed knowledge rule in agency law at all? Why should the law ever formally pretend that a principal has received knowledge or notice of a particular matter based only upon evidence that an agent of the principal has received it? Why not simply require the party seeking to charge the principal with the knowledge or notice to establish directly that the principal actually received it?

THE EVIDENTIARY SURROGACY RATIONALE

One possible, and entirely plausible, reason to impute knowledge to a principal without direct evidence thereof is that, in the face of evidentiary uncertainty, the assumption that the agent in fact passed relevant knowledge on to her principal gets it factually right more often than assuming that the agent failed to do so.[69] This could be called the

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68. *See* DeMott, *supra* note 5, at 291 ("Imputation has been characterized as a disorderly doctrine that is difficult to rationalize and to justify or explain in any satisfying way.") (citing F.M.B. Reynolds, BOWSTEAD AND REYNOLDS ON AGENCY 441 (17th ed. 2001); *see also* Peter Watts, Imputed Knowledge in Agency Law – Excising The Fraud Exception, 117 L.Q.R. 300 (2001)

> There are some areas of the law of agency that remain seriously disordered. The case law on imputed knowledge is undoubtedly one of them. It has become almost customary for judges to recite Palles C.B.'s statement in Taylor v. Yorkshire Insurance Co., 'But when a question of notice, or knowledge, arises, we find ourselves overwhelmed in a sea of authorities, not altogether reconcilable with each other. . . (quoting Taylor v. Yorkshire Insurance Co., 2 I.R. 1, 21 (1913)).

69. *See* RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 3, 2002); *see also* RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 4, 2003)

> Pragmatic considerations also justify charging a principal with notice of facts that an agent knows . . . Most agents most of the time fulfill their duties, including the duty to

evidentiary surrogacy rationale for the imputed knowledge rule.

From the perspective of the evidentiary surrogacy rationale, the imputed knowledge rule is necessary to resolve a factual dispute between the parties as to whether the principal actually possessed certain legally relevant knowledge or notice. Typically, the notice in question was to be provided by the third party and the principal's receipt is critical to the resolution of a legal dispute between the principal and the third party, such as whether the third party successfully has triggered an option offered by the principal or whether the principal has the status of a bona fide purchaser for value without knowledge. If both the principal and the third party agree that the notice was not successfully given, or if both agree that the principal actually received it, then there is no dispute between the parties on this point that requires resolution by the courts. However, if the parties are not in agreement, then the courts must decide the factual issue in one way or the other. Making this problem more difficult for courts is the likelihood that most, if not all, of the relevant evidence will come from the testimony of the two interested parties themselves.

This basic situation remains essentially the same when the principal is doing business with the third party through an authorized agent. The principal and the third party usually agree that the third party has provided the notice in question to the agent, but then disagree as to whether the agent successfully transmitted it to the principal. Again, the evidence relevant to resolving this issue comes largely from the testimony of the interested parties: the principal, the agent, and the third party. Given that the positions of the parties are in conflict, and that the relevant evidence comes from thoroughly self-interested sources, the litigation process is rarely of much value to the court in resolving the factual dispute. After all, the agent can be expected to feel significant pressure to confirm the assertion of the principal (who is, typically, the agent's employer or client) that he never actually received the third party's notice from the agent, especially if the lack of receipt is legally advantageous to the principal and the principal agrees to hold the agent harmless for the failure to provide him the notice.

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disclose material facts to the principal or to co-agents designated by the principal. If both agent and principal deny that an agent transmitted knowledge of a particular fact, a third party may confront difficulties in proving otherwise.

What is the court to do in such circumstances? The answer is provided by the imputed knowledge rule.[70] Assuming that, in the normal course, an agent will dutifully pass along to the principal relevant notice or knowledge received from a third party, the imputed knowledge rule operates in the absence of, and as a surrogate for, credible direct evidence and puts into effect a conclusive presumption that the agent did in fact successfully transmit the knowledge or notice to the principal.[71] Like any assumption, the operation of the imputed knowledge rule will not always get it right, but so long as it is true that most agents will perform their duty to the principal adequately and convey to them important knowledge or notice that they receive, then the rule will get it right more often, and probably much more often, than would a rule that assumes the agent's breach of duty and failure to transmit.[72] Again, in the absence of credible conclusive evidence either way, the court is forced to, in effect, embrace one or the other of these factual assumptions in order to resolve the dispute between the parties.

The evidentiary surrogacy rationale not only supports the existence of the basic imputed knowledge rule, it also satisfactorily explains the existence of both the confidential relationship and the adverse agent exceptions to the rule. An easy assumption of agent transmission of knowledge or notice to the principal is not really tenable in circumstances in which the agent has acquired the knowledge from the

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70. RESTATEMENT (SECOND) OF AGENCY § 268 (1958).

71. *See* Apollo Fuel Oil v. United States, 195 F.3d 74, 76-77 (2d Cir. 1999); Triple A Mgmt. Co. v. Frisone, 81 Cal. Rptr. 2d 669, 678-79 (Cal. Ct. App. 1999). *See also* Daniel S. Kleinberger, *Guilty Knowledge*, 22 WM. MITCHELL L. REV. 953, 971 n.100 (1996). The evidentiary surrogacy rationale has also been used to rationalize the operation of the imputed knowledge rule in English law. See Peter Watts, *Imputed Knowledge In Agency Law – Excising The Fraud Exception*, 117 L.Q.R. 300, 307 (2001)

> According to the doctrine of Equity, a purchaser has constructive notice of that which his solicitor, in the transaction of the purchase, knows with respect to the existence of the rights which other persons have in the property. . . . [I]t is a moot question upon what principle this doctrine rests. It has been held by some that it rests on this: that the probability is so strong that the solicitor would tell his client what he knows himself, that it amounts to an irresistible presumption that he did tell him; and so you must presume actual knowledge on the part of the client (quoting Boursot v. Savage, L.R. 2 Eq. 134, 142 (1866)).

72. *See generally* RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 4, 2003).

third party within the context of a formally confidential relationship.[73] Now, unlike the usual case, the agent will most likely have to breach the confidence that he owes to the third party in order to convey such knowledge to the principal, and the agent may well be exposed to liability to the third party as a result. In such circumstances, it is not at all clear that most agents will in fact break the confidentiality owed to the third party and transmit the information to the principal, and the appropriate legal response to this altered probability of agent conveyance is the maintenance of a confidential relationship exception to the imputed knowledge rule.[74]

Similarly, the likelihood of full and accurate agent transmission of knowledge or notice to the principal is greatly diminished in those situations in which the agent possesses interests that are adverse to, and thus in conflict with, those of the principal.[75] As Justice Van Voorhis puts it in his dissenting opinion in the case of *Farr v. Newman*,

> . . . the basis on which the principal is charged with knowledge of the agent is that it is presumed that the latter will normally communicate the information to his principal in the course of the performance of his duties [citation omitted], but such an inference is not indulged where the agent or attorney is already employed by another party having an adverse interest respecting the transaction in question.[76]

Thus the existence of the adverse agent exception to the imputed knowledge rule.

THE RISK ALLOCATION RATIONALE

While the evidentiary surrogacy rationale makes sense of the imputed knowledge rule and its confidential relationship and adverse agent exceptions, it does not support the result in either the case of

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73. *See* RESTATEMENT (THIRD) OF AGENCY § 5.03 cmts. b and e (Tentative Draft No. 4, 2003).

74. RESTATEMENT (SECOND) OF AGENCY § 281 (1958).

75. *See* RESTATEMENT (THIRD) OF AGENCY § 5.04 cmts. b and c (Tentative Draft No. 4, 2003); *see also* RESTATEMENT (THIRD) OF AGENCY § 5.04 cmts. b and c (Tentative Draft No. 3, 2002).

76. Farr v. Newman, 199 N.E.2d 369, 374 (N.Y. 1964) (dissenting opinion of Van Voorhis, J., dissenting).

Munroe v. Harriman[77] or *Farr v. Newman*,[78] nor does it make sense of the general principles which these cases represent. In *Munroe*, the fact that Harriman was undoubtedly an adverse agent to his principal, the bank, did not prevent the court from imputing to the bank knowledge possessed by Harriman. The court ignored the usual operation of the adverse agent exception to the imputed knowledge rule because Harriman was the sole actor in obtaining securities for the bank.[79] However, from an evidentiary surrogacy perspective, it is very hard to explain why Harriman, with interests in direct conflict with those of the bank, should be any more likely to divulge fully and accurately the knowledge that he possessed regarding his acquisition of the securities to the bank because he was, or was not, the sole actor for the bank in the transaction.[80] More generally, it is difficult to see why any agent who is adverse to the principal and motivated not to disclose fully, would have his incentives in this regard significantly altered in those circumstances in which he can be characterized as a sole actor agent. Thus, it is fair to conclude that the evidentiary surrogacy rationale for the imputed knowledge rule does not support the existence of a sole actor exception to the adverse agent exception to the rule.

In the case of *Farr v. Newman*, the court held that the adverse agent exception to the imputed knowledge rule should not apply because the attorney was an agent for notice, possessing a primary responsibility to collect exactly the kind of knowledge and notice that the third party wished to impute to the principal.[81] Again, however, the fundamental insight supporting the adverse agency exception from an evidentiary surrogacy rationale perspective, that an agent with significant interests in conflict with those of the principal can not be assumed to have engaged in full disclosure to the principal, remains valid regardless of whether the agent's basic duties included the collection of the knowledge or notice in question or not. In other words, the ability of the third party to characterize the adverse agent as an agent for notice appears to have little relevance to the question of how likely it is that the adverse agent will have in fact conveyed the relevant information to the principal.

77. 85 F.2d 493 (2d Cir. 1936).
78. 199 N.E.2d 369 (N.Y. 1964).
79. *See Munroe*, 85 F.2d at 496-97.
80. *See generally Munroe*, 85 F.2d 493.
81. *Farr*, 199 N.E.2d at 372-73.

Thus, it is fair to conclude that the evidentiary surrogacy rationale also does not support the existence of an agent for notice exception to the adverse agent exception to the imputed knowledge rule.

While the evidentiary surrogacy rationale does an impressive job of supporting and explaining much of the imputed knowledge rule doctrine, there exists a very different, wholly independent line of analysis that also makes sense of much of the imputed knowledge rule jurisprudence. This second approach to explaining the imputed knowledge rule can be called the risk allocation rationale.[82]

From the perspective of the risk allocation rationale, it does not matter whether the agent in fact transmitted any knowledge or notice that he received to the principal or not. As has been noted already, the court is unlikely to have before it objective, fully credible evidence with which to decide this factual issue. Moreover, even in cases in which it can be shown that the principal did not actually receive the knowledge or the notice from the agent, not all such situations should, in fairness, result in the principal's legal protection from that knowledge or notice. For instance, it is possible that the third party successfully provided the notice to the agent, and the agent took all reasonable means to convey the notice to the principal, but the principal was simply not available to receive it, and did not in fact receive it. In such a case, should the issue of the third party's effective exercise of an option that must be triggered by notice, or the status of the principal as a bona fide purchaser for value without knowledge, be resolved in favor of the principal because it is

82. *See* RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958) ("The rules designed to promote the interests of these enterprises are necessarily accompanied by rules to police them. It is inevitable that in doing their work, either through negligence or excess of zeal, agents will harm third persons or will deal with them in unauthorized ways. *It would be unfair for an enterprise to have the benefit of the work of its agents without making it responsible to some extent for their excesses and failures to act carefully.* The answer of the common law has been the creation of special agency powers or, to phrase it otherwise, the imposition of liability upon the principal because of unauthorized or negligent acts of his servants and other agents. These powers or liabilities are created by the courts primarily for the protection of third persons, either those who are harmed by the agent or those who deal with the agent. In the long run, however, they inure to the benefit of the business world and hence to the advantage of employers as a class, the members of which are plaintiffs as well as defendants in actions brought upon unauthorized transactions conducted by agents." Emphasis added.)

clear that the principal did not actually receive the relevant notice or knowledge?

The risk allocation rationale looks at situations involving agents gathering information and notice on behalf of principals and recognizes that there will inevitably exist some percentage of these situations in which the knowledge or notice will not reach the principal successfully. In some of these situations, the failure to transmit will clearly be the fault of the agent, in others clearly not, and in still others it will be difficult to tell. In some of these situations, the failure will clearly be the fault of the principal, in others clearly not, and in still others it will be difficult to tell. In some situations, both the principal and the agent may be at fault, or neither.

The risk allocation rationale is indifferent to whether the knowledge or notice was successfully transmitted to the principal or not, and if the information clearly was not transmitted, the risk allocation rationale is indifferent to the reason.[83] Instead, the risk allocation rationale looks at these situations and asks: As between the principal and the third party, who should appropriately bear the risk of knowledge or notice that has been received by the agent but not successfully transmitted to the principal?[84] Given that the principal is the one who generally selects and hires the agent, who monitors the agent's activity and compensates him, who has the power to terminate the agency and on whom the agent may depend for future references and referrals, it is, in general, the principal who is in the best position to manage the risk of a possible failed transmission.[85]

Again, if the law were to allocate to the principal the risk of failed

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83. RESTATEMENT (THIRD) OF AGENCY §5.03 cmt. b (Tentative Draft No. 4, 2003) ("An agent also has a duty, unless otherwise agreed, to use reasonable effort to transmit material facts to the principal or to co-agents designated by the principal. A principal's right to control an agent engables the principal to consider whether and how best to monitor agents to ensure compliance with these duties. A principal may not rebut the imputation of an agent's notice of a fact by establishing that the agent kept silent.").

84. *Id.*

85. RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 4, 2003) ("Imputation creates incentives for a principal to choose agents carefully and to use care in delegating functions to them. Additionally, imputation encourages a principal to develop effective procedures for the transmission of material facts, while discouraging practices that isolate the principal from facts known to the agent. This serves the function of assuring the reasonable expectations of third parties who deal with a principal through an agent designated by the principal.").

agent transmission of knowledge or notice, principals in general could respond to this burden by more carefully selecting their agents, more closely monitoring them, more vigorously disciplining them, more vigilantly crafting procedures for the receipt of information from agents and more diligently establishing procedural redundancies for important transmissions.[86] On the other hand, if the law were to allocate to the third party the risk of failed agent transmission to the principal, then the most likely response by third parties would be either to bypass notice to the agent and provide it directly to the principal, or to provide required notice routinely to both the agent and the principal.[87] Both strategies threaten to undermine the powerful efficiency available through the use of agents that agency law is in part intended to create and support. Pretty clearly, as between the principal and the third party, the principal is the least cost avoider of failed transmission of knowledge or notice between the agent and the principal.

Therefore, from this perspective, the basic imputed knowledge rule makes sense as an appropriate allocation to the principal of the risk of failure of transmission of knowledge or notice from the agent to the principal. This allocation, and thus the basic rule, makes sense regardless of whether the transmission from agent to principal was completed successfully or not. If the transmission failed, the basic rule makes sense whether that failure was the fault of the principal, the agent, both or neither.

Can the risk allocation rationale for the imputed knowledge rule accommodate the confidential relationship exception to the rule? Probably not on its own terms. That is to say that the fact that the agent has acquired the knowledge or notice at issue from a third party within the context of a legally confidential relationship, by itself, most likely does not change the presumption that as between the principal and the

86. RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 4, 2003); Duckworth v. Bernstein, 466 A.2d 517, 523 (Md. App., 1983) ("It is the principal who has selected the agent, and if he has chosen unwisely, it is he who should bear the burden, and not a third party who has dealt with the agent to the third party's detriment.").

87. RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 4, 2003) ("Imputation also supports the efficiencies to be achieved in many situations when parties communicate through agents instead of through direct principal-to-principal communication.").

third party, the principal is the preferred manager of the risk of transmission failure.

However, it may be the case that in certain circumstances, allocation of the risk of transmission failure to the preferred party is not the preeminent goal of the law. Occasionally, the goal of optimal risk allocation may conflict with other important social policies. One such policy could be the maintenance and support of legally confidential relationships.

If the imputed knowledge rule did not have a confidential relationship exception, then agents, like doctors and attorneys, who obtain knowledge that is relevant and valuable to their principal within the context of a confidential communication with a third party would be caught in a difficult dilemma.[88] Either they would convey the information to their principal and violate the confidentiality owed to the third party or they would honor the confidentiality and deprive the principal of important knowledge which the principal will nevertheless be legally deemed to possess. Principals anticipating such a situation could be expected to try to avoid having knowledge imputed to them which they did not in fact receive by exerting considerable pressure on these agents to breach their confidentiality and communicate the information they have received from the third party to the principal.[89]

It seems clear that an imputed knowledge rule without a confidential agent exception would work against, and thus to some degree compromise, the social benefits that are sought by the creation and maintenance of legally confidential relationships. Thus, while the risk allocation rationale may not directly support a confidential relationship exception to the imputed knowledge rule, it can be said that the existence of the exception is consistent with the rationale to the extent that it demonstrates a social choice to prefer the goals of confidentiality over optimal risk allocation when the two come into conflict.

It can be argued further that the existence of the confidential relationship exception to the imputed knowledge rule is not deeply destructive of the optimal risk allocation sought by the basic rule for at

88. RESTATEMENT (SECOND) OF AGENCY §§ 281, 281 cmt. a, 281 cmt. b (1958).

89. RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 4, 2003) ("Imputation reduces the risk that a principal may deploy agents as a shield against the legal consequences of facts the principal would prefer not to know.").

least two reasons. First, the number of instances in which agents obtain information of legal significance to their principal from third parties while in a legally confidential relationship with those third parties can be expected to be quite small.[90] Certainly they can be expected to represent a very small percentage of all situations in which an agent obtains knowledge or notice that is legally significant to the principal and to which the imputed knowledge rule might apply.

Second, the confidential relationship exception applies to situations in which the third party can reasonably determine in advance that the exception will be in effect.[91] This can be called the quality of self-identification. The creation and operation of any exception to the imputed knowledge rule will, in effect, reverse the normal allocation of risk created by the rule and encourage the third party rather than the principal to insure that the legally relevant knowledge or notice is actually received by the principal.[92] Given this, it is important that the third party be reasonably able to identify those situations to which an exception is likely to apply and special precautionary measures are necessary. In the absence of reasonably certain self-identification, third parties could be expected to insure against the possibility of the exception applying by engaging in precautionary measures in a wide range of circumstances. To the extent that the primary precautionary measure available to third parties in the imputed knowledge rule context is direct communication to the principal, either bypassing or duplicating communications with the agent, and thus eroding the usual efficiency of agency, a broader than necessary range of precautionary behavior should

90. RESTATEMENT (SECOND) OF AGENCY § 281 cmt. a (1958) ("The rule stated in this section applies most frequently where an attorney at law receives information from a client under such circumstances that he has a duty not to reveal it without the client's permission. . . . The rule also applies to confidences given to physicians in jurisdictions in which physicians are privileged or required not to reveal confidences, and to other situations in which one has a duty to a third person which creates in him a privilege not to reveal or a privilege of his own by virtue of which he can act irrespective of the information.").

91. *See* RESTATEMENT (SECOND) OF AGENCY § 281 cmt. a (1958); Confidential relationships are entered into voluntarily. *See e.g.* MODEL RULES OF PROF'L CONDUCT R. 1.2 (2003) (On formation of the attorney client relationship.); RESTATEMENT (THIRD) OF TRUSTS §§ 10-16 (2003) (Creation of a trust relationship through the trust instrument).

92. *See supra* note 86.

not be encouraged.[93] Thus it is important from a risk allocation perspective that any exception to the basic imputed knowledge rule be reasonably self-identifying to the third party.

Generally, given the relative rarity of such relationships, third parties will know in advance whether they are in a legally confidential relationship with an agent of the principal when they are conveying legally significant knowledge or notice to the agent.[94] They can then, in those circumstances, take special precautions to communicate the knowledge or notice directly to the principal. While such precautions generally work against the usual efficiency of agency, one can take comfort in the case of the confidential relationship exception that such precautions will be encouraged in only a small percentage of cases. Thus, it can be said that the confidential relationship exception to the imputed knowledge rule is at least understandable within, and to that extent consistent with, the risk allocation rationale for the imputed knowledge rule.

This same claim cannot be made with any confidence regarding the adverse agent exception to the imputed knowledge rule. As noted earlier, there are a large number of possible reasons why an agent might fail to successfully transmit relevant information to her principal, ranging from a conscious choice on the part of the agent, to a variety of combinations of carelessness by the agent and the principal, to pure accident.[95] Except in a very limited set of such circumstances, the fundamental logic of the risk allocation rationale supports the application of the basic imputed knowledge rule, and not the adverse agent exception.

In evaluating the status of the adverse agent exception to the imputed knowledge rule within the context of the risk allocation rationale, one should ask: As between the principal and the third party, who is best able to manage the risk of agent transmission failure caused by the agent's possession of interests in the transaction that are adverse to those of the principal? As in the case of transmission failure in the absence of agent adverse interests, the principal may effectively minimize transmission failure in adverse agent situations, even if she may not be able to completely eliminate it, by investing additional

93. *See* RESTATEMENT (SECOND) OF AGENCY § 281 cmt. a (1958).

94. *See supra* note 91.

95. *See supra* notes 82-83 and accompanying text.

resources in more effective agent selection, monitoring, disciplining, termination, and redundant transmission procedures. In other words, the principal would seem to enjoy essentially the same panoply of precautionary options with respect to the existence of an adverse agent, or transmission failure by an adverse agent, as she does in the case of transmission failure for any other reason. Thus, from the principal side of the risk allocation analysis, there exists no compelling reason to shift the risk of transmission failure away from the principal in those situations in which the agent possesses interests that are adverse to those of the principal.

The third party's primary precautionary option in circumstances of a suspected adverse agent is the communication of the relevant information directly to the principal, just as it is in situations in which no adverse agent interests are involved. However, unlike those situations to which the confidential relationship exception will apply, it is not likely that the third party will know in advance, or at all, that the agent with whom she is dealing possesses interests that are adverse to those of the principal. Such circumstances lack the quality of self-identification from the third party's point of view. The inability of third parties to identify reliably in advance circumstances to which the adverse agent exception is likely to apply will cause third parties to avoid communication to the principal through the agent, or to duplicate it, in a far broader range of circumstances than is actually necessary or desirable. Such an overbroad pattern of precautionary investment is an inevitable consequence of the lack of third party self-identification in the operation of the adverse agent exception and it encourages a wasteful expenditure of resources by third parties.

Given the above considerations, one can conclude that the adverse agent exception to the imputed knowledge rule is not preferred by either the principal or the third party side of risk allocation analysis, and thus that the existence of the adverse agent exception to the imputed knowledge rule is not supported by the risk allocation rationale. Stated slightly differently, one can conclude that from a risk allocation perspective, the possibility of an adverse agent failing to transmit successfully to the principal important knowledge or notice is a problem far better managed by the principal than by the third party. As a result, the law in this area should not create or maintain a general exception to the imputed knowledge rule, which in effect allocates the risk of agent

failure to the third party, that applies to situations in which the agent possesses interests in the transaction that are adverse to those of the principal.

Once one clarifies that the risk allocation rationale for the imputed knowledge rule does not support a general adverse agent exception, then the existence of a variety of exceptions to the adverse agent exception becomes understandable. Courts, or majorities on courts, that understand the imputed knowledge rule from a risk allocation perspective, appear to be seeking some plausible rationale in adverse agent cases to justify not applying the established exception. Here it is the sole actor exception to the adverse agent exception. There it is the agent for notice exception. These exceptions to the adverse agent exception are so appealing because they lead to a result in the case, the application of the basic imputed knowledge rule unmodified by the adverse agent exception, that makes fundamental sense from the risk allocation rationale perspective.

One can sense this underlying dynamic in the decision of the court in the *Munroe v. Harriman* case:

> But to explain the [imputed knowledge rule] cases in terms of presumptions is not a rational analysis. The presumption of communication is a pure fiction, contrary to the fact, for it is only when the agent has failed to communicate his knowledge that any occasion arises for imputing it to the principal. The rational explanation of the Distilled Spirits case is that common justice requires that one who puts forward an agent to do his business should not escape the consequences of notice to, or knowledge of, his agent.[96]

Similarly, the tension that exists between the evidentiary surrogacy rationale and the risk allocation rationale regarding the adverse agent exception to the imputed knowledge rule is evident in the byplay between the majority and the dissenting opinions in the case of *Farr v. Newman*. The dissent believes that:

> The reason for [the adverse agent exception to the imputed knowledge rule] . . . is manifestly that the basis on which the principal is charged with knowledge of the agent is that it is presumed that the latter will normally communicate the information

96. Munroe v. Harrison, 85 F.2d 493, 495 (2d Cir. 1936).

> to his principal in the course of the performance of his duties [citation omitted], but such an inference is not indulged where the agent or attorney is already employed by another party having an adverse interest respecting the transaction in question.[97]

The majority, in contrast, believes that:

> The mere fact that the attorney acted for both parties in the real estate transfer, with defendant Hardy's knowledge, cannot insulate defendant from his agent's knowledge to the detriment of the otherwise superior right of a third party. . . . the presumption sometimes relied upon to support imputation, i.e., that an agent will communicate to his principal all relevant matters, has no place in this situation. If, under the substantive rules of equity and agency, actual knowledge by the principal is unnecessary, the presumption of communication becomes irrelevant. . . . It may thus be seen that the question in this case is not an evidentiary one of presumptions or inferences; it is one of substantive law. If the agent was authorized to receive notice, and did receive it within the scope of his authority, that act as such binds the principal as does any act performed within an agent's authority [citations omitted].[98]

LOOKING INTO THE FUTURE

There may be reason to hope for greater coherence and predictability in imputed knowledge rule jurisprudence in the future. Such hope comes in the form of the American Law Institute's current draft of Restatement (Third) of Agency.

In 1923, acting upon the December 1914 recommendation of the American Association of Law Schools, the American Law Institute (ALI) was founded.[99] The new organization brought together the preeminent members of the legal community to meet the need for "a permanent organization for the improvement of the law."[100] In 1933, the ALI published the Restatement of Agency, closely following the 1932

97. Farr v. Newman, 199 N.E.2d 369, 374 (N.Y. 1964).

98. *Farr*, 199 N.E.2d at 371-72.

99. John P. Frank, *The American Law Institute: 1923-1998*, *in* THE AMERICAN LAW INSTITUTE SEVENTY-FIFTH ANNIVERSARY: 1923-1998 3, 8 (1998).

100. *Id.* at 3, 8-9 (citing statement of Elihu Root).

publication of the Restatement of Contracts, making it the second Restatement of the Law to be published by this eminent group of scholars.[101] The first two restatements of agency were stewarded through the process of being drafted, accepted and published by two of the foremost authorities on agency law. The Restatement was brought to fruition by Floyd R. Mechem and the Restatement (Second) was shepherded through by Warren A. Seavey.[102] In 2000, under the direction of Deborah A. DeMott, the new reporter of the Restatement of Agency, the ALI first discussed the first two chapters of the Restatement (Third) of Agency.[103] From there, the Restatement (Third) of Agency has been undergoing an entire redraft up to the present time.[104]

The relevant provisions of Restatement (Third) of Agency are sections 5.03 and 5.04.[105] Section 5.03 reads, "Notice of a fact that an agent knows or has reason to know is imputed to a principal if knowledge of the fact is material to the agent's duties to the principal and to the principal's legal relations with third parties. Notice is not so imputed if the agent acts adversely to the principal as stated in § 5.04 or is subject to a duty not to disclose the fact to the principal."[106] This is a more or less straight-forward articulation of the classic imputed knowledge rule. It begins with the basic doctrine, imputing to the principal information received by the agent within the scope of the agency.[107] It then sets forth the two traditional exceptions: the adverse agent exception and the confidential relationship exception.[108]

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101. RESTATEMENT (THIRD) OF AGENCY ix (Tentative Draft No. 1, 2000).

102. RESTATEMENT (THIRD) OF AGENCY ix (Tentative Draft No. 1, 2000).

103. RESTATEMENT (THIRD) OF AGENCY ix (Tentative Draft No. 1, 2000).

104. RESTATEMENT (THIRD) OF AGENCY xi (Tentative Draft No. 22, 2001).

105. *See* RESTATEMENT (THIRD) OF AGENCY (Tentative Draft No. 4, 2003).

106. RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 3, 2002). This has subsequently been revised to read:

> § 5.03 Imputation of Notice of Fact to Principal
>
> For purposes of determining a principal's legal relations with third parties, notice of a fact that an agent knows of has reason to know is imputed to the principal if knowledge of the fact is material to the agent's duties to the principal, unless the agent
>
> a) acts adversely to the principal as stated in § 5.04, or
>
> b) is subject to a duty to another not to disclose the fact to the principal.

RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 4, 2003).

107. *See* RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 3, 2002); RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 4, 2003).

108. *See* RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 3, 2002);

So far, the Restatement (Third) of Agency is a standard codification of the traditional doctrine and does not seem to offer much promise of improvement. Optimism dims further upon a first reading of section 5.04, which states:

> § 5.04 An Agent Who Acts Adversely to a Principal
>
> (1) Notice is not imputed to a principal of a fact that an agent knows or has reason to know if the agent acts adversely to the principal in the transaction or matter without the principal's knowledge, unless
>
> (a) the agent deals with a third party who does not know or have reason to know that the agent acts adversely to the principal and who reasonably believes the agent to be authorized so to deal; or
>
> (b) the principal knowingly retains a benefit from action taken by the agent that the principal would not otherwise have received.
>
> (2) For purposes of this Chapter, an agent acts adversely to a principal if the agent acts in the transaction or matter without any intention of benefiting the principal by the action taken.[109]

This section sets forth the adverse agent exception to the imputed

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RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 4, 2003).

109. RESTATEMENT (THIRD) OF AGENCY § 5.04 (Tentative Draft No. 3, 2002). This has subsequently been revised to read:

> § 5.04 An Agent Who Acts Adversely to a Principal
>
> For purposes of determining a principal's legal relations with third parties, notice is not imputed to the principal of a fact that an agent knows or has reason to know if the agent acts adversely to the principal in a transaction or matter for the agent's own purposes or those of another person. Nevertheless, notice is imputed
>
> a) when necessary to protect the rights of a third party who dealt with the principal in good faith; or
>
> b) when the principal has ratified or retained benefit from the agent's action.
>
> A third party who deals with a principal through an agent, knowing or having reason to know that the agent acts adversely to the principal, does not deal in good faith for this purpose.

RESTATEMENT (THIRD) OF AGENCY § 5.04 (Tentative Draft No. 4, 2003).

knowledge rule, and identifies two exceptions to the exception, just as the doctrine has been traditionally understood.[110] Structurally, the Restatement Third appears on first glance to faithfully codify the imputed knowledge rule, and the multiple exceptions and myriad exceptions to the adverse agent exception, that are symptomatic of the unresolved policy tension that plagues the doctrine.[111]

A source of optimism emerges, however, upon closer examination. The comments to section 5.03 clearly endorse the risk allocation rationale for the imputed knowledge rule.[112] They state:

> Imputation creates incentives for a principal to choose agents carefully and to use care in delegating functions to them. Additionally, imputation encourages a principal to develop effective routines for the transmission of material facts, while discouraging practices that isolate the principal from facts known to an agent. . . . Imputation thus recognizes the efficiencies to be achieved in many situations when parties communicate through agents instead of through direct principal-to-principal communication.[113]

In contrast, the evidentiary surrogacy rationale receives only a passing mention, and that less in the context of justifying the imputed knowledge rule as an attempt to embrace the most accurate factual assumption available than as part of a much vaguer collection of "[p]ragmatic considerations."[114]

Since the Restatement grounds the imputed knowledge rule squarely in the theoretical justification of the risk allocation rationale, why does it then also include an adverse agent exception to the rule? As discussed herein, the risk allocation rationale simply does not support a general adverse agent exception to the rule. One possible explanation is that the existence of an adverse agent exception is manifestly clear in the current case law and the Restatement, operating in its role as a codification project, could simply not ignore it. Current imputed knowledge rule jurisprudence is profoundly conflicted, and any attempt to describe it accurately cannot help but display some of these same

110. *See* RESTATEMENT (THIRD) OF AGENCY § 5.04 (Tentative Draft No. 3, 2002).

111. *See id.*

112. *See generally* RESTATEMENT (THIRD) OF AGENCY § 5.03 cmts. (Tentative Draft No. 3, 2002).

113. RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 3, 2002).

114. RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 3, 2002).

features.

Assuming the need to recognize formally the existence of an adverse agent exception, one must give great credit to the Restatement's efforts to harmonize the exception with a risk allocation rationale for the basic rule. This work takes place in section 5.04.[115] The work begins at the end of the section, in paragraph (2), where the Restatement defines an adverse agent as one who, ". . . acts in the transaction or matter without any intention of benefiting the principal by the action taken."[116] This is a remarkably narrow definition of an adverse agent for purposes of the rule. According to this definition, the agent in question must not just possess interests in the transaction that are in conflict with those of the principal, which is the traditional approach, but must have so completely abandoned his efforts on behalf of the principal that the agent acts without any intention of benefiting the principal at all.[117]

Such a definition of adverse agent would exclude from the operation of the adverse agent exception a wide range of cases that conventionally have been thought to come clearly within its purview. For example, it is not at all clear that the agent in *Munroe*[118] could be characterized successfully as an adverse agent under this definition. After all, Harriman, the agent in *Munroe*, might well have been argued to be involved in bringing profitable loan business to the bank, or, at the least, to be concerned with securing the loan with the fraudulently obtained securities for the bank's benefit, even though it was also the case that the loan was being made to him. The comments to section 5.04 make it clear that divided loyalty alone is not enough: "An agent is not acting adversely if the agent acts with mixed motives, intending to achieve a benefit for the principal as well as for the agent's own self or for a third party."[119] Perhaps in reaction to the apparent narrowness of

115. *See generally* RESTATEMENT (THIRD) OF AGENCY § 5.04 (Tentative Draft No. 3, 2002) (defining adverse agent acts).

116. RESTATEMENT (THIRD) OF AGENCY § 5.04(b) (Tentative Draft No. 3, 2002).

117. *See* RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c (Tentative Draft No. 3, 2002) ("an agent acts adversely to a principal when the agent acts with *no intention* of benefiting the principal." (emphasis added)).

118. 85 F.2d 493 (2d Cir. 1936).

119. *See* RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c (Tentative Draft No. 3, 2002) (stating the principal is not affected by the knowledge of an agent as to matters involved in a transaction in which an agent of the principal as, or on account of, an

the resulting definition, the commentary does go on to then reassure that, "An agent may act adversely toward a principal through conduct less grievous than looting or embezzlement,"[120] though, the implication seems to be, it will take conduct fairly close to criminal for the agent to achieve technically adverse status.[121]

Similarly, pursuant to the definition in section 5.04, the attorney double agent in *Farr*[122] is most likely not an adverse agent whose possession of relevant information is subject to the exception. The attorney in *Farr* ran into difficulty not because he acted without any intention of benefiting either principal, but because he too aggressively sought a way of consummating the transaction that both principals desired.[123] Indeed, the commentary to section 5.04 makes it clear that the fact that the attorney in that case was representing parties on opposite sides of the transaction does not, by itself, make him technically adverse to either one:

> An agent who acts as a dual agent . . . may not always act adversely as to both or either of the agent's principals for purposes of subsection (1). This is because whether an agent acts adversely under subsection (2) turns solely on the subjective determination of whether the agent acted with no intention of benefiting the principal.[124]

This very narrow definition of adverse agent in paragraph (2) of section 5.04 severely narrows the scope and practical application of the adverse agent exception to the imputed knowledge rule, and is thus much more in harmony with the risk allocation rationale for the rule. If this is not enough, however, section 5.04 contains three additional limitations on the operation of the adverse agent exception.[125] The first, contained in paragraph (1), is the requirement that the principal have no

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adverse party).

120. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c (Tentative Draft No. 3, 2002).

121. *See generally* RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c (Tentative Draft No. 3, 2002) (illustrating adverse actions of agents).

122. *See* 199 N.E.2d 369 (NY, 1964) (holding that the mere fact the attorney acted for both vendor and purchaser of realty, with purchaser's knowledge, could not insulate purchaser).

123. *See generally id.*

124. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c (Tentative Draft No. 3, 2002).

125. *See* RESTATEMENT (THIRD) OF AGENCY § 5.04 (Tentative Draft No. 3, 2002).

knowledge of the agent's adverse actions in order for the adverse agent exception to apply.[126] The second, set forth in paragraph (1)(a), prevents the application of the adverse agent exception against a third party who was unaware that the agent was acting adversely to the principal.[127] The third, contained in paragraph (1)(b), denies the use of the adverse agent exception to a principal, even if all of the other requirements of 5.04 are satisfied, if, "the principal knowingly retains a benefit from action taken by the agent that the principal would not otherwise have received."[128]

Section 5.04 therefore defines an adverse agent exception to the imputed knowledge rule in a manner that requires for its successful application that:

> 1) the agent to have acted in the matter in question without any intention of benefiting the principal;
>
> 2) the principal to have been without any knowledge of the agent's actions in this regard;
>
> 3) the third party to have been aware of the agent's adverse status with respect to the principal; and
>
> 4) the principal not to have retained a benefit from the actions of the agent.[129]

Taken together, these requirements define an extremely narrow version of the adverse agent exception to the imputed knowledge rule that can be said to be as close to consistent with the risk allocation rationale as is possible while still retaining an adverse agent exception. If jurisdictions will in the future follow the lead of Restatement (Third) of Agency in this regard, it will go a very long way toward making the imputed knowledge rule more coherent and more predictable, and thus more valuable.

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126. RESTATEMENT (THIRD) OF AGENCY § 5.04(1) (Tentative Draft No. 3, 2002).
127. RESTATEMENT (THIRD) OF AGENCY § 5.04(1)(a) (Tentative Draft No. 3, 2002).
128. RESTATEMENT (THIRD) OF AGENCY § 5.04(1)(b) (Tentative Draft No. 3, 2002).
129. *See* RESTATEMENT (THIRD) OF AGENCY § 5.04 (Tentative Draft No. 3, 2002).

CONCLUSION

The imputed knowledge rule is currently characterized by complexity and contradiction. The basic rule imputes to a principal knowledge or notice received by an agent within the scope of the agent's authority.[130] The principal is deemed to have received the information in question even in the absence of any evidence that the agent successfully transmitted it to the principal.

There are two well-established exceptions to the imputed knowledge rule, one known as the confidential relationship exception and the other known as the adverse agent exception.[131] The first applies to situations in which the agent has obtained the information in question from a third party in the context of a legally confidential relationship with that third party.[132] The second comes into play when the agent possesses interests in the transaction that are adverse to those of the principal.[133] Both operate, when successfully invoked, to prevent relevant information received by the agent from being automatically imputed to the principal, thus requiring the third party in such cases to directly establish the principal's receipt of the relevant knowledge or notice.

A significant number of cases exist that have created, in effect, a variety of exceptions to the adverse agent exception to the imputed knowledge rule.[134] These cases identify discrete reasons for legally imputing to a principal information received from an adverse agent, despite the situation being one in which the adverse agent exception would normally apply. The existence of these multiple exceptions to an

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130. RESTATEMENT (SECOND) OF AGENCY §§ 268, 272 (1958); RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 3, 2002); RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 4, 2003); Munroe v. Harriman, 85 F.2d 493, 494-95 (2d Cir. 1936); Farr v. Newman, 199 N.E.2d 369, 371 (NY, 1964).

131. RESTATEMENT (SECOND) OF AGENCY §§ 281, 282 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 5.03, 5.04 (Tentative Draft No. 3, 2002); RESTATEMENT (THIRD) OF AGENCY §§ 5.03, 5.04 (Tentative Draft No. 4, 2003).

132. RESTATEMENT (SECOND) OF AGENCY § 281 (1958); RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 3, 2002); RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 4, 2003).

133. RESTATEMENT (SECOND) OF AGENCY § 282 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 5.03, 5.04 (Tentative Draft No. 3, 2002); RESTATEMENT (THIRD) OF AGENCY §§ 5.03, 5.04 (Tentative Draft No. 4, 2003).

134. *See supra* notes 33, 64 and accompanying text.

exception to the basic rule push the doctrine to a level of unusual complexity for a long-standing part of the common law, and thus create inevitable uncertainty in its application.

The above analysis suggests that the current complexity and uncertainty surrounding the imputed knowledge rule is explained by the existence of a fundamental tension residing at the heart of the doctrine. This tension is created by the influence of competing conceptions of the rule's basic purpose. From one perspective, here called the evidentiary surrogacy rationale, the imputed knowledge rule is designed to provide the most empirically plausible answer to the question of whether the principal actually received the information in question from the agent when no objective credible evidence exists to directly resolve the issue.[135] The evidentiary surrogacy rationale supports the existence of the basic imputed knowledge rule. It also supports the existence of both the confidential relationship exception and the adverse agent exception. It does not, however, support the various exceptions to the adverse agent exception that have been carved out by various courts.

The competing understanding of the imputed knowledge rule, here called the risk allocation rationale, views the imputed knowledge rule as a mechanism for allocating between the principal and the third party the risk of a failure of information transmission from the agent to the principal.[136] Like the evidentiary surrogacy rationale, the risk allocation rationale supports the existence of the basic imputed knowledge rule and the confidential relationship exception to the rule. In sharp contrast to the evidentiary surrogacy rationale, however, the risk allocation rationale does not support the existence of the adverse agent exception to the rule, except in a very limited set of circumstances. Therefore, the risk allocation rationale inevitably serves as support for the identification and creation of most any exception to the adverse agent exception.

An evidentiary surrogacy perspective on imputed knowledge in agency would generate an imputed knowledge rule and both a confidential relationship exception and an adverse agent exception. A

135. *See* RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 3, 2002).

136. *See* RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 3, 2002).

risk allocation perspective would generate the basic rule and a confidential relationship exception, but not a general adverse agent exception. The current rule, in which both rationales intermingle and mix, is doctrinally faithful to neither. As a result, the current version of the rule is not fully coherent, unnecessarily complex, and unpredictable in its application. Significant hope for improvement is promised by the upcoming Restatement (Third) of Agency that appears to embrace the risk allocation rationale and the doctrinal structure that logically follows.