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Loan Distinguished from Agency - Liability of Lender as Principal on Contracts Made by Borrower with Third Parties - Commercial Credit Co. V. L. A. Benson Co.

LOAN DISTINGUISHED FROM AGENCY—LIABILITY OF LENDER AS PRINCIPAL ON CONTRACTS MADE BY BORROWER WITH THIRD PARTIES

Commercial Credit Co. v. L. A. Benson Co.[1]

Defendant-appellant, a commercial loan corporation, advanced money to the Poole Engineering Company which was a manufacturing corporation, to be used by the latter in carrying out its contracts for the construction of voting machines. The defendant was to receive interest on the loan and a certain bonus for each machine made. The Poole Company later encountered difficulty in completing the machine contracts and the defendant agreed to furnish more money upon the stipulation that it be allowed to place two representatives in the manufacturing plant to check on the

[1] 170 Md. 270, 184 Atl. 236 (1936).

expenditures made and the application of incoming funds. This was done. Later the Poole Company went into bankruptcy, and plaintiff-appellee, which had supplied materials to the Poole Company during the period in which defendant was advancing money, sued defendant as an undisclosed principal of the machine manufacturing corporation.

The trial court refused to grant defendant company's demurrer prayers to the evidence. The fact of agency was left to the jury which found for the plaintiff. On appeal, *held:* Reversed without new trial. The relation between the parties to the loan was that of debtor and creditor. The chief concern of the loan corporation was to regain the money advanced and compensation for its use. There was an entire lack of evidence tending to show a principal-agent relationship. The manufacturer was not subject to the defendant's control, as the latter's representatives in the plant of the former acted in an advisory capacity only. Such an arrangement was consonant with the attempt of a creditor to protect his investment. Defendant's demurrer prayers to the evidence should have been granted.

The principal problem is that of distinguishing a mere loan from an agency. As the implications arising from such a distinction are various, it should be noted at the outset that the principal case, involving the undisclosed principal situation is but a phase of the larger problem mentioned, and should be treated as such. This is indicated by the statement in the opinion in the principal case that, in order to find an undisclosed principal, it must first be established that there was a principal at all, and that to do that, there must be established an agency relationship between the parties.[2]

Certain general principles of agency might be quickly reviewed at this point in order for comment to be made upon the instant problem. These involve, first, the creation of an agency and, second, the contract liability of a principal to third parties.

[2] The word "parties" may be considered as a general all-inclusive term, although it might become apparent that certain groups would be excluded from the principles enunciated by reason of an inherent incapacity. For example, the principles of agency as applied to corporations might present the question of *ultra vires*. It is not within the scope of this casenote to comment upon such separate questions unless directly involved.

However, as to the power of one corporation to act as agent for another, see Alley v. Bessemer Gas Engine Co., 262 Fed. 94 (D. Tex., 1919); Liberty Coal Mining Co. v. Frankel Coal Co., 206 Ky. 647, 268 S. W. 280 (1924). As to the establishing of a corporation as principal, see In re Kentucky Wagon Mfg. Co., 3 Fed. Supp. 958 (D. Ky. 1932); American National Bank v. National Wall Paper Co., 23 C. C. A. 33, 77 Fed. 85 (1896); Westinghouse Electric and Mfg. Co. v. Allis-Chalmers Co., 100 C. C. A. 408, 176 Fed. 362 (1910).

1. Agency is the relationship resulting from the mutual consent of the parties, one party, the agent, agreeing to act on behalf of the other, the principal, and subject to his control. It is not necessary that the parties intend to subject themselves to the liabilities imposed upon them as the result of their acts, and the legal relation of agency may arise by written or oral agreement, or by the conduct of the parties themselves.[3]

2. It is a general rule that a principal is liable upon the contracts of his agent when made within the scope of the agent's express, implied, or apparent authority. This rule applies to an undisclosed principal, who, at the election of the third party, may be held liable upon simple[4] non-negotiable contracts made by his agent, although the third party dealt with such agent in ignorance of the existence of the principal,[5] unless such third party gave an exclusive credit to the agent.[6] Where a third party wishes to hold an undisclosed principal upon a contract, he must show that there existed an actual agency, whether implied or not. An undisclosed principal cannot be held liable upon the theory of "agency by estoppel", because his non-disclosure precludes any holding out by the principal.[7] However, where one person does hold out another as an agent, such person may incur liability as a principal.[8]

The above mentioned principles seem to have been grafted by the courts upon loan contracts in proper cases, and the question whether a particular transaction is a mere loan, creating only a lender-borrower situation, or is a principal-agent relation, generally depends upon a consideration of the whole arrangement between the parties. The courts look to the terms of the agreement as well as the intent of the persons involved, as otherwise expressed. If the parties regard the money advanced as a mere loan, and the money is used in a business in which the lender takes no interest, there is generally no basis upon which to raise an agency relationship.[9] If, however, the money is advanced without expectation of repayment to be used in a venture

[3] Restatement of Agency, Secs. 1, 14. That the relation of principal and agent may be implied from the words or conduct of the parties see Heise & Bruns v. Goldman, 125 Md. 554, 559, 94 Atl. 159 (1915).

[4] See Md. Code, Art. 75, Sec. 15, as to sealed instruments.

[5] Mechem, Agency, 2nd Ed., Vol. 2, Sec. 1731.

[6] Restatement of Agency, Sec. 186. See also York County Bank v. Stein, 24 Md. 447 (1866).

[7] 95 A. L. R. 1319. Mechem, Agency, 2nd Ed., Vol. 2, Sec. 1763. Also, Abuc Trading Corp. v. Jennings, 151 Md. 392, 135 Atl. 166 (1926).

[8] See Himmel v. Merchants Transfer & Storage Co., 134 Md. 38, 106 Atl. 157 (1919).

[9] 2 C. J. S. 1030 Agency, Sec. 1, g.

wherein the lender is to share in the profits and to exercise some measure of control, the courts have often found an agency, partnership, or joint adventure.[10]

An outstanding text-writer says of the matter:

> "Where there has been no holding out as principal, courts in modern times endeavour to give effect to the real intention of the parties, and not to charge one as a principal or partner who did not intend to become such, unless that is the necessary legal effect of the arrangement."[11]

A glance at certain typical cases which have dealt with the instant problem will serve to bring out applicable general principles. Thus, in the Kansas case of *Burton v. Larkin*,[12] A contracted to furnish B with money to pay B's current expenses. C, having supplied goods to B, now sued A on the theory that A was a principal. There was evidently nothing to show that A had held B out as an agent, and the court said that the agreement between A and B was a mere loan.

In contrast is the Iowa case of *Van Sandt v. Dows*.[13] There A furnished B with money to buy corn to be marked with A's name. A was to sell the grain and to deduct from the proceeds his original advances plus eight per cent. interest and one cent per bushel sold, B to receive the balance. The court held that this was an agency contract, and not a mere loan. The court considered the fact that the title to the grain was in A, and that B had acted on A's behalf and upon A's authority. As a matter of comparison, suppose A bought grain on his own account and at his own risk, and then supplied it to B, who sold it, crediting A with the sale, deducting B's expenses and commissions? In such a case, would A be a mere lender interested only in regaining his investment plus compensation for its use? It would seem not, in the light of the fact that A's return would be predicated, not upon the value of the material "loaned", but upon the price realized at B's sale. In a Texas case,[14] which had

[10] Ibid. The question of a loan contract involving a partnership or joint adventure is not included in this comment; but for an interesting discussion of the possibilities, see Annotation, 48 A. L. R. 1055, 1072. See also, Atlas Realty Co. v. Galt, 153 Md. 586, 139 Atl. 285 (1927).

[11] Mechem, Agency, 2nd Ed., Vol. 1, Sec. 55.

[12] 36 Kan. 246, 13 Pac. 398 (1887). See also, Owl Fumigating Corp. v. California Cyanide Co., 24 Fed. (2d) 718 (D. Del., 1928), to the effect that a mere loan of money by one corporation to another does not make the borrower the agent of the lender.

[13] 63 Iowa 594, 19 N. W. 669 (1884).

[14] Davis and Hamm Commission Co. v. Mt. Vernon Bank, 63 Tex. Civ. A. 347, 133 S. W. 448 (1910).

almost identical facts, the court held that the relation of principal and agent did not exist, but merely that of lender and borrower.

The Maine case of *Chase v. West*[15] presented a somewhat more involved situation. There A contracted with B corporation, agreeing to finance certain lumbering operations for the latter. A was to pay for the land and to supply money for initial work, while B was to go upon the land, to cut the lumber and to sell it. A was to handle the proceeds obtained from the sales and to apply them to accounts accruing against the operations. A was to receive the money advanced plus an additional sum, at which time A was to convey the property to B, who should thereafter assume all debts. C sold materials to B corporation, and sought to hold A liable as undisclosed principal. The court held that the contract did not create the relation of principal and agent, as the manifest purpose was the financing of B's lumbering operations. In its opinion the court, looking at the transaction as a whole, said:

> "Defendant's (A) connection with the matter was temporary, incidental, and only for the purpose of securing the advancement and bonus. . . . A principal does not usually make a formal contract with his agent as to what the principal shall pay. He does not ordinarily require the agent to supply the whole or even a part of the capital needed for carrying on the principal's business. He commonly directs his agent, and does not mutually agree with him as to what contracts shall be made. . . . Defendant had no interest in the profits except as security for the payment of a fixed sum. . . . Defendant had no authority to control the lumbering operations. . . . The contract did not make the corporation an agent to purchase supplies upon the credit of defendant."[16]

There is another group of cases, including the principal case, which present a more subtle situation. Suppose A loans B money to be used in B's business. Later, B's financial position becomes precarious, and A desires to protect his investment. To what lengths may A go to do this without involving himself as a principal upon contracts made by B with third parties? In the principal case, the defendant was no doubt in the first instance a mere lender of money; but did subsequent developments modify its status? The

[15] 121 Me. 165, 116 Atl. 213 (1922).
[16] Ibid, 116 Atl. 214.

court said not, keeping in mind the facts that the defendant owned no stock in the debtor corporation nor had any representation upon its board of directors, that the corporate structure of the debtor was not affected, that the debtor never surrendered its business to the creditor, and that the services of the creditor's representatives were rendered in an advisory, co-operative, and consulting capacity, with no authority to compel compliance with their advice.

Compare the principal case with a lower court Federal decision, *Chicago Lumber Co. v. Bank.*[17] There, the Bank loaned sums of money to A corporation. Later the Bank became dissatisfied with the internal management of the corporation. Several officers and stockholders of the latter sold their interests to one B, who secured for them a release from the Bank of personal obligations owed by them to the Bank. B became sole stockholder of the debtor corporation, and assumed personal liability for the money owed to the Bank, giving the Bank all of the stock of the debtor corporation as security. Then a cashier of the Bank was elected president of the debtor company "to protect the interests of the Bank", said president receiving several shares of the corporate stock subject to the aforementioned pledge. C now contracted with the debtor corporation; and when the latter went bankrupt, C sued the Bank as a principal. C claimed that the Bank held the debtor corporation out as an agent. There was not sufficient evidence to support C's theory of "agency by estoppel", but in dealing with the question of an actual agency, the court stated that where one corporation owned or controlled all the property of another, and operated the business of the latter as a department of its own, that such controlling corporation would be responsible for obligations incurred by the other, but that such liability would not be imposed when a creditor corporation should interest itself in the business of a debtor corporation of doubtful solvency, even if it should go to the extent of *actively taking a part in the management of said debtor company, in order to protect its investment as a creditor.*

A closer analysis of the cases presented furnishes ground for speculation whether the courts, consciously or not, lean in the favor of a creditor who interests himself in his debtor's business to protect a doubtful investment, and fail to see the significance of the creditor's conduct, which in other circumstances would hardly be overlooked. One of the most distinctive, if not decisive, elements of agency is

[17] 234 Fed. 41 (D. Mo., 1916).

the factor of control. It is the *sine qua non* of an agency relationship, and is the foundation of the maxim "*qui facit per alium facit per se*". The word control standing by itself in this connection is somewhat ambiguous. It is subject to at least two interpretations, one being the direction of physical movements, the other being action by the authority of another. It is the latter concept which is the essence of agency and which is closely interrelated with the representative quality of agency. An agent does not merely act "for" his principal, but he acts "on behalf of" him, that is to say, he acts not upon his own responsibility (as does an independent contractor) but upon the authorization of the principal. The question of physical control is only important when it is necessary to distinguish an agent from a servant. The element of authoritative control may be largely of a subjective nature, and its legal determination necessarily depends upon its objectivity as seen through the conduct of the parties. Therefore, it should behoove the courts to scrutinize with great care the acts of said parties, and to give due regard to what might excite a reasonable suspicion. Take, for example, the "advisory activities" of the defendant in the principal case. There is hardly any doubt that mere advice does not establish an agency relationship, but when that advice is so closely connected with other dubious relations it should be judged in connection therewith. The set-up between the creditor and debtor in the instant case was not without certain equivocal features. The debtor corporation is about to go insolvent and close; the creditor steps in with a very understandable desire to prevent the taking of a loss; the debtor has practically proved itself unable to cope with the difficulties, so the creditor determines to offer its advice, and in so doing checks upon all purchases of materials and the application of incoming credits. Should not a court look at least with suspicion upon such an arrangement and be sure that what in the beginning was supposed to be advice did not in reality become a direction by tacit agreement? It is submitted that the courts cannot be too careful in their examination of such an arrangement, for it involves not only the rights of the immediate parties, but the rights of other creditors who have been contracting with the debtor. If the courts are not alert, a creditor might by a tacit understanding under the guise of "advice" direct a debtor into making numerous contracts otherwise not contemplated, and when the debtor goes insolvent escape all responsibility therefor, even though he had stood to profit had events taken another turn.

It must be admitted that the Federal decision mentioned goes to extreme limits in its efforts to help the creditor. This court failed to find anything suspicious in an arrangement whereby the creditor was actively represented on the directorate of the debtor corporation and necessarily had a direct voice in all important decisions involving contracts with third parties. Yet the court used these words: "The Bank's actions were referable to a legitimate and customary practice of keeping an oversight by a creditor over the business of a debtor of doubtful solvency". It is not the intention of the present commentator to state flatly that in all cases involving the intervention of a creditor in the business of his debtor such intervention automatically establishes a principal-agent relation; but it is most strongly contended that such an arrangement should be closely searched in order to seek out the element of authoritative control, so that what may have been at first a mere lender-borrower situation does not later become an agency relationship whereby the creditor authorizes the debtor as agent to collect his own debt. The Federal decision seems to allow the creditor to escape liability unless he should be so injudicious as to constitute the debtor a mere servant. The factors of agency are the same, whether A goes into B's business for a profit, or whether he intervenes in said business to collect a debt; and the rights of third party contractors should be as zealously guarded in the one case as in the other.

The principal case seems to present an unique situation as far as Maryland cases are concerned. Whether the Maryland Court would follow the Federal decision if presented with the same facts is largely conjectural. It must be reiterated in this connection that in the principal case the Court failed to find a scintilla of evidence showing an agency relation, and looked upon the "advisory" activities of the creditor with perfect equanimity. However, it did note the absence of any representation by the creditor upon the directorate of the debtor corporation, and thereby impliedly considered that as some evidence tending to show agency, should it be present.

It is interesting to note that exactly the same facts as were involved in the principal case were presented to the United States District Court for the District of Maryland in *Doehler Die Casting Co. v. Commercial Credit Co.*[18] This latter case also arose out of the Commercial Credit Com-

[18] Both the charge to the jury and the opinion denying the motion for new trial appear in The Daily Record, December 30, 1932.

pany's financing of the Poole Engineering Company. The District Court's charge to the jury and the opinion denying a motion for new trial took an opposite view of the law of the situation from that of the Court of Appeals of Maryland in the instant case. There was an appeal taken therein from the judgment rendered for the plaintiff, but the case was settled before it was argued on appeal.