NEXUSES OF CONTRACTS, THE AUTHORITY OF CORPORATE AGENTS, AND DOCTRINAL INDETERMINACY: FROM FORMALISM TO LAW AND ECONOMICS

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This article examines the law and economics of the authority of corporate agents. It deconstructs the doctrine to show that its ability to produce correct 'legal' conclusions is destroyed by contradictions, circularities and indeterminacies. The article counsels, therefore, the rejection of formalism. Game theory and economic analysis are used to show how legal rules impact on the incentive of companies and contractors to incur costs in order to prevent the occurrence of unauthorised transactions. This analysis is used to derive a framework in which to examine cases of disputed authority. The framework is motivated by the minimisation of transaction costs, and is demonstrated to work well with existing legal principles.

I. INTRODUCTION

On 4 March 1997, the Federal Treasurer, Mr Costello, announced the introduction of the Corporate Law Economic Reform Program (CLERP). The accompanying press release described it as a "wide ranging initiative intended to improve the content and implementation of the law".[1] The CLERP Strategy Document foreshadows an extensive review of areas of corporate law which affect business and market activity, including directors' duties, mandatory disclosure and takeovers.[2]

As an attempt to improve the *Corporations Law*, CLERP might be regarded as but the latest in a succession of similarly motivated inquiries and programmes, arriving before the former crusade of simplification had even finished. It may promise a more informed attempt to locate the elusive balance between

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1 The Hon Peter Costello, "New Focus for Corporate Law", Media Release No 15, 4 March 1997.

2 Corporate Law Economic Reform Program, Strategy Document, March 1997 at 4.

regulation and facilitation, but how much can it deliver, before it, too, is unwound by a future government?[3]

If it accomplishes nothing else, CLERP may be remembered for recognising officially the relevance of economic analysis (and, perhaps, theory in a more general sense)[4] to regulation. While economic analysis has been adopted by several scholars (and even a few practitioners),[5] Australia's corporate law reform bodies have paid it little attention. Law reform bodies have put great confidence in the ability of black letter law, and the judges who apply it, to solve corporate problems. In some ways, however, the neglect of economics may not be a bad thing, because 'corporate law and economics', for all its rhetoric, is still in its infancy. Scholars continue to wrestle with the implications of new theoretical approaches, such as game theory[6] and network externalities.[7] These developments in theory are qualifying the earlier denunciations of regulation as inefficient and illiberal. A little learning is a dangerous thing, most especially in the hands of a regulator.

Scholars and practitioners may therefore find it interesting to examine whether or not, given the catalyst of CLERP, Australian corporate law surrenders any of its conceptual autonomy to the influence of another discipline. The purpose of this article is to show that we stand to gain if we query the utility of legal formalism, while simultaneously exploring the pragmatic usefulness of economic theory and analysis. The subject of the article is the authority of corporate agents, a doctrinal stronghold and a theoretical wilderness. Part II demonstrates (at times with a nod towards deconstructionist techniques) the contradictions, circularities and indeterminacies that destroy the ability of the received doctrine to derive demonstrably correct 'legal' conclusions.

In Part III, the situations in which disputes about agent authority arise are recast as noncooperative games. Game theory is used to examine how legal rules affect the incentives of companies and contractors to incur costs to prevent such

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3 *Cf* WJ Beerworth, "The New Tide of Corporate Legislation: Reform or Red-tape?" (1993) 5(3) *Sydney Papers* 116 at 118-19.

4 For an analysis of the theoretical perspectives now being applied in Australian corporate law, see Symposium, "Corporate Law Research Methods and Theory" (1996) 3 *Canberra Law Review* 1

5 Given its recent proliferation, I will not attempt a complete bibliography. A short list of theoretical works might include R Campbell, "Opportunistic Amendment of the Corporate Governance Contract" (1996) 14 *Companies & Securities Law Journal* 200; RI McEwin, "Public Versus Shareholder Control of Directors" (1992) 10 *Companies & Securities Law Journal* 182, IM Ramsay, "Liability of Directors for Breach of Duty and the Scope of Indemnification and Insurance" (1987) 5 *Companies & Securities Law Journal* 129; IM Ramsay, "Company Law and the Economics of Federalism" (1990) 19 *FL Rev* 169, MJ Whincop and ME Keyes, "Corporation, Contract, Community An Analysis of Governance in the Privatisation of Public Enterprise and the Publicisation of Private Corporate Law" (1997) 25 *FL Rev* 51 See also MJ Whincop, "Of Fault and Default· Contractarianism as a Theory of Anglo-Australian Corporate Law" (1997) 21 *MULR* 187 (notes 11 and 298) for further references to theoretical and empirical works.

6 See, for example, I Ayres, "The Possibility of Inefficient Corporate Contracts" (1991) 60 *University of Cincinatti Law Review* 387; JC Coffee, "Unstable Coalitions: Corporate Governance as a Multi-Player Game" (1990) 78 *Geo LJ* 1495, JN Gordon, "Shareholder Initiative. A Social Choice and Game Theoretic Approach to Corporate Law" (1991) 60 *University of Cincinatti Law Review* 347

7 M Klausner, "Corporations, Corporate Law and Networks of Contracts" (1995) 81 *Virginia Law Review* 757; M Whincop, note 5 *supra*.

transactions. The Part concludes that there are no simple solutions (as regards legal rules) to problems of contested authority, because of the dominance of situational specific factors. Given this conclusion, Part IV develops a framework of principles that may assist efficiency minded judges in resolving cases consistently with the object of minimising the joint costs of unauthorised transactions. The framework transforms the theory of Part III into principles that provide a more secure basis for adjudication than legal conceptualism. These principles also prove to be generally conservative, in the sense that they can operate without the need for much formal revision of company law doctrine. Part V is a conclusion.

II. DECONSTRUCTING ACTUAL AND APPARENT AUTHORITY

A. Method and Introduction

This part studies the formal principles of actual authority and apparent authority, which determine whether or not a company is bound by a transaction. These are supplemented by the 'indoor management rule'. The purpose of this part is primarily critical; it demonstrates the instability of these principles. This article maintains that the pragmatic application of economic analysis can improve the certainty and efficiency of the law. The need to recognise, and to specify, relevant economic and social influences goes beyond this, however. I seek to demonstrate in this Part that any attempt to justify authority concepts in a non-contextual, formalistic manner must end in contradiction or indeterminacy.

This conclusion is difficult to demonstrate using a theory as inherently instrumental as economics.[8] My overview of the doctrine therefore seeks to examine how judges have justified, explained and distinguished the primary doctrinal constructs. The method I use to do this is none the worse for occasionally borrowing from critical legal studies (CLS).[9] On the contrary, the rejection of formalism should appeal to lawyer-economists and CLS theorists alike. I grant that the latter may be less well disposed to the supplementary principles proposed in Part IV.

The next section offers a primer on actual and apparent authority. Section C then demonstrates the falsity of the formalistic premise that these concepts are independent and integral. The doctrine of apparent authority operates to defeat its own justification - its observability. Section D continues the observability theme, by demonstrating the conceptual instability of the indoor management rule. Section E shows that some of the problems in this area derive from the influence of foundational principles of company law formalism - the formal legal model and the separate legal entity concept.

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8 RA Posner, *Overcoming Law*, Harvard University Press (1995) pp 4-5.

9 See, for example, MV Tushnet, "Perspectives on Critical Legal Studies - Introduction" (1984) 52 *George Washington Law Review* 239, M Kelman, *A Guide to Critical Legal Studies*, Harvard University Press (1989) p 12. See generally P Drahos and SJ Parker, "The Indeterminacy Paradox in Law" (1991) *UWALR* 305 at 308-9

B. An Exposition of Principles of Authority

Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd[10] is one of the most commonly cited expositions of the authority of corporate agents. Diplock LJ emphasised that he was purporting to restate the law upon a rational basis, it having "developed pragmatically rather than logically".[11] His Lordship's analysis was directed to distinguishing actual and apparent authority. While the two might co-exist, they were integral concepts.[12] Actual authority involves a relationship between the company (as principal) and its 'agent'. Apparent authority involves some form of relationship between the company and the third party contractor.

The concept of actual authority depends on an antecedent agreement between principal and agent, under which the former confers the latter with authority. The scope of that authority is a matter of contractual construction.[13] Diplock LJ however recognised that in "ordinary business dealings", the contractor will be a stranger to the authority relationship, and without investigation, will know nothing of the authority.[14]

Notwithstanding the unobservability of actual authority, the principal will yet be bound if its agent has apparent authority. According to Diplock LJ, apparent authority requires that the principal represent that the agent has authority to enter into a contract of a kind within the scope of that authority. If the contractor relies on that representation by contracting with the agent, the principal will be estopped from asserting any lack of actual authority.[15] When the principal is a company, the matter is complicated by the capacities of the company's structural organs. To be effective as a basis for apparent authority, the representation concerning the agent must emanate from the person who has actual authority under the company's constitution either to make the representation or to enter the transaction in question.

C. Conceptual Interdependence and Indeterminacy

For all its weight, Lord Justice Diplock's judgment ultimately fails to demonstrate that there is value in these authority concepts, or that there is a meaningful difference between them. First, the relationship between the concepts is circular. Although described as independent of one another,[16] the existence of apparent authority depends on the existence of actual authority in the person, or group of persons, alleged to have made the representation concerning the agent's authority. Therefore, apparent authority of the agent turns on the existence of the actual authority of the representor. Yet Diplock LJ recognised that at the time of entering the contract, the contractor "can hardly

10 [1964] 2 QB 480
11 *Ibid* at 502 Was this a point in its favour?
12 *Ibid.*
13 *Ibid.*
14 *Ibid* at 503
15 *Ibid*
16 *Ibid* at 502.

ever rely on the 'actual' authority of the agent",[17] since actual authority is based on a relationship to which he or she is a stranger. How then can the contractor rely on the actual authority of the representor?[18]

Second, analysis of the representation concerning the agent's authority reveals a potent source of confusion and indeterminacy. Diplock LJ said:

> The commonest form of representation by a principal creating an 'apparent' authority of an agent is by conduct, namely, by permitting an agent to act in the management or conduct of the principal's business. Thus, if in the case of a company the board of directors who have 'actual' authority under the memorandum and articles of association to manage the company's business permit the agent to act in the management or conduct of the company's business, they thereby represent to all persons dealing with such agent that he has authority to enter on behalf of the corporation into contracts of a kind which an agent authorised to do acts of the kind which he is in fact permitted to do usually enters into in the ordinary course of such a business.[19]

This approach stretches the representation concept to the point where no discernible representation was ever made. Such a representation, as Diplock LJ envisages, involves no formal communication by the putative representor to the contractor. Neither is there usually a larger pre-existing relation between the two from which that representation might be inferred. The only sense in which there can be a representation is by reference to the company's failure to restrain the agent from acting in a certain way. Such a representation is impossible to describe or delimit - for instance, when was it made, and to whom? Again, the apparent authority concept turns on the character of the relationship between company and agent, to which the contractor is a stranger.

The concept of a representation by inaction resembles misrepresentation by silence. The law prefers to fix liability by reference to positive action rather than failures to act.[20] A conventional technique which permits the evasion of undesirable consequences flowing from such an approach is to create a duty to act (for example, to speak), anterior to the facts.[21] However, Diplock LJ did not posit, and the doctrine does not recognise, the existence of a duty (for example, a duty to prevent the agent from acting beyond authority), the breach of which equates to making a representation of authority. The law thus contradicts itself, since a representation which suffices to establish apparent authority arises from a failure to restrain the actions of an agent who lacks that authority.

Third, in the preceding quote, Diplock LJ further tangled the authority concepts. His Lordship described the content of the representation by inaction as involving "authority to enter ... into contracts of a kind which an agent authorised to do acts of the kind which he is in fact permitted to do usually

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17 *Ibid* at 503

18 See, for example, *Brick and Pipe Industries Ltd v Occidental Life Nominees* (1991) 9 ACLC 324 at 348-50 (trial), 10 ACLC 253 at 263-4 (appeal) (authority of a director to make representations concerning company office holders); *Re Madi Pty Ltd* (1987) 5 ACLC 847.

19 Note 10 *supra* at 505

20 *Cf* P Drahos and SJ Parker, "Critical Contract Law in Australia" (1990) 3 *JCL* 30 at 39.

21 *Ibid*. *Cf* C Dalton, "An Essay in the Deconstruction of Contract Doctrine" (1985) 94 *Yale LJ* 997 at 1060-1

enters into in the ordinary course of such a business".[22] In other words, the representation concerning the agent's *apparent* authority is construed by reference to the authority *usually* possessed by agents possessing *actual* authority (which the particular agent lacks *ex hypothesi*) to do the sorts of acts which the principal permits the agent to do. Again, actual authority is called on to delineate apparent authority. Also, this analysis suggests that agent authority is not definable except by reference to a context involving a range of usual relationships. If this is acknowledged, the formalistic premises and application of this branch of the law must be rejected.

Fourth, the conceptual indistinguishability of the authority concepts can be proved in reverse by demonstrating that actual authority is defined by reference to apparent authority. Diplock LJ stated that actual authority is ascertainable by:

> ... applying ordinary principles of construction of contracts, including any proper implications from the express words used, the usages of the trade, or the course of business between the parties.[23]

The invocation of "ordinary principles of construction" resonates with classical approaches to contractual interpretation, which identify terms from *ex ante* promises.[24] However, the reference to trade usage and course of business implies that the contract between principal and agent is incompletely specified. Thus, the scope of actual authority, like the scope of apparent authority, cannot be resolved in a legal vacuum. The reference to trade usage suggests that "actual" authority is referable to the authority that similarly situated agents have.[25] The circularity of such a principle is obvious.[26] In addition, the reference to the authority of similarly situated agents must be partially to their apparent authority. This is because, on the judge's account, apparent authority is the only authority that strangers to the relationship actually experience.

The definition of an agent's *actual* authority by reference to a course of dealings is analogous to the 'representation by nonrepresentation' that was a peculiarity of *apparent* authority doctrine. Permitting - or failing to prevent - an agent from acting in a certain way is also relevant to the agent's actual authority. Once again, the two concepts are interdependent and difficult to distinguish, and their categorical value is minimal. For example, in *Hely-Hutchinson v Brayhead Ltd*,[27] Lord Denning MR said that actual authority can be implied by inference from conduct.[28] In that case, the Court of Appeal concluded that a director who was permitted to act as a managing director had actual authority to make contracts of indemnity and guarantee. This conclusion derived from the board's permissive course of dealing. The trial judge concluded that the director had

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22 Note 10 *supra* at 505.

23 *Ibid* at 502. By referring to "parties", Diplock LJ appears to mean the company and its agent

24 See generally IR Macneil, "Contracts: Adjustments of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law" (1978) 72 *Northwestern University Law Review* 854 at 893.

25 It also reinforces the contextual (and non-formalistic) properties of the doctrine

26 Actual authority is defined by reference to actual authority. Note also the principle's indeterminacy: how do we define similarly situated agents? How do we resolve differences in the authority of these agents?

27 [1968] 1 QB 549.

28 *Ibid* at 583.

apparent authority; the Court of Appeal considered that its conclusion was consistent with that finding.[29] While some may be unconcerned by such a conclusion (since neither result contradicts the effect of the other in the instant case) it shows clearly that the concepts are strongly interdependent, since the analytical methods of each are virtual duplicates.[30]

In conclusion, the distinction between the two authority concepts supposedly corresponds to the agent's relation to the principal on one hand, and the agent and principal's relation to the contractor on the other. Apparent authority compensates for hiatuses in actual authority, by reference to what is observable by the contractor. That logic is destroyed as soon as one understands that the basis for a conclusion of apparent authority may often depend on unobservable inaction. Ironically, to be effective, the inaction must be authoritative inaction. One is thus back at the beginning, since apparent authority is only comprehensible in terms of an actual authority concept. However, if contracts are specified incompletely *ex ante*, actual authority comes to turn on the apparent incidents of a course of dealings.

D. The Indoor Management Rule

The indoor management rule, usually traced to *Turquand's* case,[31] can be regarded as a liberalisation of rules relating to dealing with companies.[32] Early dicta suggested that it protected contractors from the difficulties of unobservability. In *Turquand's* case, Jervis CJ said contractors must be familiar with the company's public documents and constitution:

> But they are not bound to do more. And the party here, on reading the deed of settlement, would find, not a prohibition from borrowing, but a permission to do so on certain conditions. Finding that the authority might be made complete by a resolution, he would have a right to infer the fact of a resolution authorising that which on the face of the document appeared to be legitimately done.[33]

One definition, conforming to the liberalisation story, was offered in *Morris v Kanssen*:

> ... persons contracting with a company and dealing in good faith may assume that acts within its constitution and its powers have been properly and duly performed and are not bound to inquire whether acts of internal management have been regular.[34]

That definition leaves unresolved the rule's relationship with the authority concepts. That issue was recently considered by the High Court in *Northside Developments Pty Ltd v Registrar-General*.[35] A majority held that the ambit of

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29 See, for example, *ibid* at 584.

30 An important recent case, *Brick and Pipe* note 18 *supra*, also demonstrates the virtual interchangeability of the concepts, when it considers the authority of a director permitted to act as a managing director.

31 *The Royal British Bank v Turquand* (1856) 119 ER 886.

32 See, for example, HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law*, Butterworths (8th ed, 1997) p 606.

33 Note 31 *supra* at 888.

34 [1946] AC 459 at 474, per Lord Simonds

35 (1990) 170 CLR 146.

the indoor management rule's operation is to be ascertained by reference to the agent's actual or apparent authority.[36]

Recall the argument in Section C that both authority concepts depend on the unobservable. *Prima facie*, this contradicts the underlying purpose of the rule, which holds the unobservable not to operate to the contractor's detriment. In the *Northside Developments* case, however, the court purported to hold the balance between the rule and the authority concepts by reference to whether the contractor was 'put on inquiry'.[37] In that case, the transaction should have made the contractor suspicious. However, this is not a satisfactory answer. The problem with using the 'put on inquiry' exception to the indoor management rule is best appreciated from a CLS perspective. CLS charges legal liberalism with relying on flawed dichotomies. Of these dichotomies, one pole is favoured above the other; however, that pole is only comprehensible and controllable by reference to its antipole. The antipole is sometimes described as a *dangerous supplement*:

> ... the 'dangerous supplement' ... has subversive potential. First, the favoured pole can only be fully defined by reference to the other pole (one can only define, say, private by knowing what public would be) so it contaminates attempts to rely exclusively on one pole. Second, because the dangerous supplement can never be pushed out of sight it can always be invoked to corrupt the normative practices that have been established around the favoured pole.[38]

The indoor management rule is justified because it excuses contractors from the need to inquire into unobservable facts concerning the company's management. However, the rule can only be understood by reference to the 'put on inquiry' exception, which defines the contractor's obligation to ascertain the nature of the unobservable. That exception functions as a dangerous supplement because it can subvert the normative practices and justification of the rule. The indoor management rule therefore does not resolve the indeterminacy problems of unobservable authority, because its limitation on the relevance of the unobservable is defined in a circular way.

That point is illustrated by an example in which a contractor is not put on inquiry, but the agent does not possess actual authority. Justice Brennan stated that a transaction entered into without authority would bind a company if the instrument is regular in form, the transaction appears to be entered into by agents acting within their ordinary authority for the purposes of the company's business, *and* the contractor is not put on inquiry by the circumstances of the case.[39] The statement contradicts itself because the existence of ordinary authority and the purpose of the transaction are not gleaned *except* by inquiry, the most obvious cases excepted. The concept of apparent authority and the inquiry exception have the potential to swallow each other up. As the law demands that the contractor make a greater level of inquiries, it simultaneously

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36 *Ibid.* See at 160-1, per Mason CJ, at 171-2, per Brennan J, at 197-8, per Dawson J; at 207, per Toohey J

37 Note 35 *supra* at 157.

38 P Parker and SJ Drahos, note 20 *supra* at 35.

39 Note 35 *supra* at 184-5. *Cf* HAJ Ford et al, note 32 *supra*, p 589.

decreases the circumstances in which it will hold that a valid representation of authority was made. As these investigatory demands intensify, the actual authority concept becomes the touchstone of liability. However, this result emphasises a concept that even a formalistic analysis recognises to be unobservable. The opposite possibility is also true - the grant of authority itself is an act of 'indoor management'. The more extensive the region of indoor management, the greater the region of apparent authority.

E. The Legitimation of Formalistic Concepts

Despite their indeterminate nature, the two authority concepts have endured because they convey an image of order in corporations, and because they perpetuate principles that are central to company law formalism. The central principles are the separate legal personality concept and the formal legal model. The separate legal personality concept means that legal rules can and ought to be applied to the corporation as if it were a person.[40] The formal legal model, the less celebrated of the two, recognises two possible sites of corporate decision making power: the general meeting and the board of directors.[41]

The formal legal model is a product, and an enabling principle, of the separate legal entity concept. If one reifies the corporation, liberal philosophy suggests a need to find, and to legitimate, ways in which the entity acts.[42] The formal legal model accomplishes this by formally constituting the bodies wielding power, and strictly limiting their number.[43] Alternative conceptions of the corporation do not demand such a model. Economic theory regards the 'corporation' as a nexus of contracts.[44] The means of authority and control arise from the terms, agreed or implied, of these contracts. There is no need to centralise power, or to standardise its use.[45]

Any legal system must decide the minimum requirements for a person seeking to establish a contractual claim to the corporation's assets. In company law formalism, the reified corporation can be treated as a principal, and the means by which it contracts can be assimilated *mutatis mutandis* with legal agency doctrine. The separate legal entity concept directs attention away from the policy considerations which are relevant to how the law should allocate the losses of unperformed transactions. Instead, it asks whether the 'corporation' conferred authority on its agent. Such an inquiry depends on several legal and analytical fictions. The corporation is a fiction, as is 'its' contract with the agent. We have also observed other fictions central to this process, the main one

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40 *Cf* SJ Stoljar, *Groups and Entities. An Inquiry into Corporate Theory*, ANU Press (1973)

41 R Tomasic and S Bottomley, *Corporations Law in Australia*, Federation Press (1995) pp 286-92.

42 See generally S Bottomley, "From Contractualism to Constitutionalism: A Framework for Corporate Governance" (1997) 19 *Syd LR* 277.

43 See generally GE Frug, "The Ideology of Bureaucracy in American Law" (1984) 97 *Harv L Rev* 1277.

44 FH Easterbrook and DR Fischel, *The Economic Structure of Corporate Law*, Harvard University Press (1991), HD Butler and LE Ribstein, *The Corporation and the Constitution*, American Enterprise Institute (1995).

45 This is an inherent neoclassical world view. For its high water mark, see AA Alchian and H Demsetz, "Production, Information Costs and Economic Organization" (1972) 62 *American Economic Review* 777.

being the 'representation' of authority by the company. In the presence of so many fictions, a conclusion of indeterminacy is hardly remarkable.

The formal legal model has a pervasive effect on the form of corporate authority doctrine. As we have seen, authority concepts posit the existence of an authorised person. If one adopts the formal legal model, authority must have its utmost source in the board of directors. Because the board is, in large corporations, too ineffective,[46] and in small corporations, too infrequently constituted,[47] to act itself, it must delegate power. However, doctrine stresses that delegation will only bind the corporation if the power of delegation exists, and either is exercised, or is represented to have been exercised.[48] The doctrine therefore acts to legitimate the formal legal model by requiring that power be exercised only by the company's formal instrumentalities, or the properly authorised delegates of these. We can therefore see how corporate authority doctrine and the formal legal model are mutually reinforcing. Corporate authority doctrine depends on the existence of a locus of authority within the corporate entity; the formal legal model supplies a conceptualisation of the corporation with a determinate locus. The formal legal model depends on describing corporate power allocations in an accurate way; corporate authority doctrine functions in a supportive way by being predicated on its validity.

The doctrinal perpetuation of the formal legal model has further implications concerning how we regard corporations. Concepts of authority encourage a view of order and due process; the formal legal model emphasises accountability and control. These concepts project an image that power is used in the interests of the 'corporation', and that those who use it, or who authorise its use, will be held accountable.[49] This formalist model of corporations finds echoes in early company law. In *Ernest v Nicholls*,[50] Lord Wensleydale said that those who deal with companies are fixed with constructive notice of its constitutional provisions, including those related to the authority of its agents.[51] Thus, limitations on authority protect the rights of shareholders. Creditor protection, however, was also important to early company law.[52] However, creditor and shareholder protection conflict with each other. Thus, concepts of authority were pulled in two opposing directions. Along the way, legal concepts emerged - apparent authority and the indoor management rule - which protected creditors, while others - the various limits on the indoor management rule - protected shareholders. I have shown that none of these formalistic concepts really means anything as a concept. Each was definable only to the extent one held the opposite at bay. Ultimately, we must reject formalism, because it lacks any

46 See, for example, ML Mace, *Directors Myth and Reality*, Harvard Business School Press (rev ed, 1986).

47 Joint Statutory Committee on Corporations and Securities, *Close Corporations Act* 1989 (1992) at [2.12]

48 *Freeman and Lockyer* note 10 *supra* at 505-6.

49 G Frug, note 43 *supra* at 1297-317

50 (1857) 10 ER 1351

51 *Ibid* at 1358.

52 *Trevor v Whitworth* (1887) 12 App Cas 409.

means for deciding when one set of interests should be favoured. Economics is used in the rest of this article as one means of informing this decision.

III. USING GAME THEORY TO ANALYSE STRATEGY CHOICES AND LEGAL RULES IN CORPORATE CONTRACTING

A. Introduction

This Part uses game theory to understand how legal rules effect the incentives of parties to incur costs associated with preventing unauthorised transactions. The process of transacting is modelled as a noncooperative game.[53] Section B introduces game theory and its relevance to the law. Section C looks at the strategy choices of a contractor by assuming that the company is not bound by unauthorised transactions. This assumption is relaxed in Section D in which the effects of legal rules allocating the cost of unauthorised transactions between contractor and company are examined. Legal rules should attempt to minimise the sum of the joint costs of preventing unauthorised transactions, and the expected value of losses from such transactions. Section E considers the possibility of perturbing (that is, manipulating) the *agent's* payoffs where the agent acts without authority. Section F argues that where the game is one of incomplete and imperfect information, no simple legal rule is likely to be demonstrably efficient. Possible responses to this conclusion are considered.

B. Game Theory

Economics' most distinctive assumption is that humans behave and make economic decisions rationally; that is, they compare means with ends. Game theory refines our understanding of rational choice. It examines the concept of strategic behaviour, which occurs when two or more individuals interact and each individual decision turns on what that individual expects the other will do.[54] Game theory analyses situations by specifying the *players*, the *strategies* available to them, and the *payoff* each will receive for all possible strategy combinations. With that information, *solution concepts* can be applied to see what strategy combination the players will adopt. Much of the analysis in this part is sufficiently simple to permit application of the simplest solution concepts - these are the *dominant strategy* (a strategy which is a best choice for one player, no matter what strategy the other chooses) and *iterated dominance* (players choose strategies given the belief that players will choose available dominant strategies).[55]

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53 The game theory used in this paper is elementary. The analysis in this part is influenced by D Baird, R Gertner, R Picker, *Game Theory and the Law*, Harvard University Press (1995). As to noncooperative game theory, see D Kreps, *A Course in Microeconomic Theory*, Princeton University Press (1990), pp 355-6.

54 D Baird et al, note 53 *supra*, p 1.

55 *Ibid*, pp 11-12.

Legal rules are germane to game-theoretic analysis because they show how legal rules affect strategy choice by perturbing payoffs. The very simple models in sections C and D are assumed to be games of complete but imperfect information. That is, the parties know everything about the game (the available strategies and their payoffs), but they cannot observe the other player's strategy choice. After the insights of these games are considered, I note that real life games of agent authority are games of incomplete and imperfect information between the agent, the contractor, and the company. The formal analysis of such games is beyond the scope of this paper, but the analysis can suggest a number of important matters relevant to legal rules.

C. Modelling the Contractor's Strategy

This section examines how a contractor will respond when approached by a person who seeks to enter a contract allegedly on behalf of a company. The model assumes:

1. The contractor has not dealt previously with the agent or the company. The contract, if performed, will yield a profit for the contractor of m, but if it is not performed (as it will not be if the agent lacks authority), it will cost the contractor c. The 'price' of the transaction is therefore $m+c$.
2. The contractor cannot determine in the absence of investigation whether the agent definitely is, or definitely is not, endowed with authority. However, the contractor knows that the probability of the agent not having the professed authority is P_u.
3. The contractor has the opportunity to determine whether or not the agent has the authority that he or she professes, by investigating. The cost of an investigation is denoted i. If the contractor spends i, and the agent lacks authority, the contractor's dominant strategy is to never enter the contract.

The payoff to the contractor of always investigating the *bona fides* of the agent is:

$$Y_i = m(1-P_u) - i \qquad (1)$$

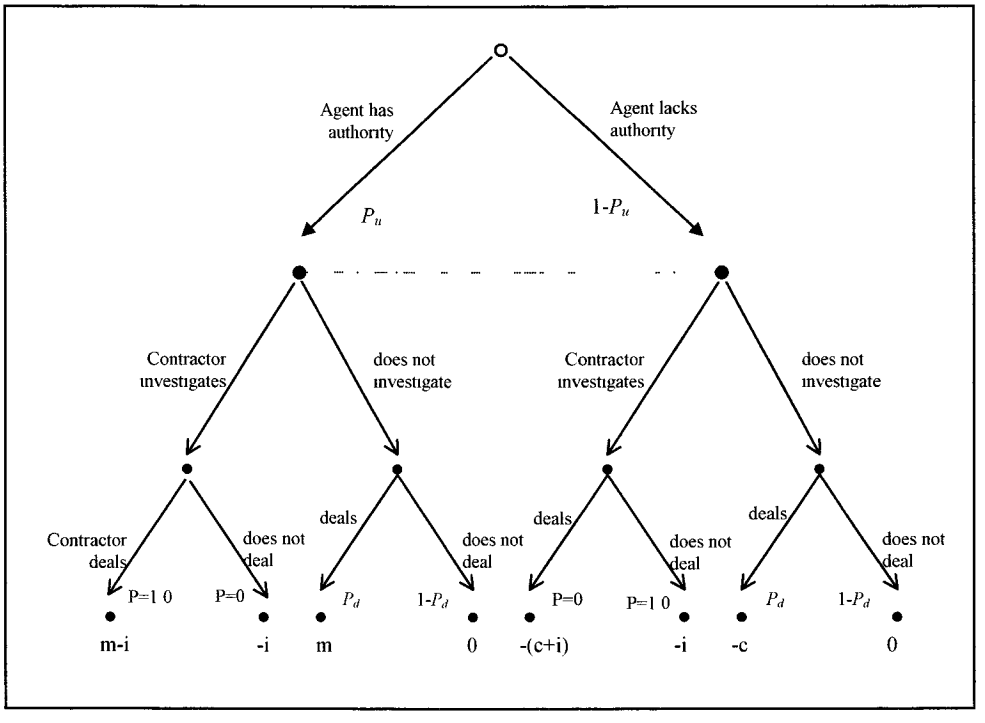
The precise payoff to the contractor of not investigating depends on the actual strategy. The contractor can choose between three types of strategies, two being *pure*, the other being *mixed*. A pure strategy involves an action taken in all cases; a mixed strategy involves two or more actions between which the player randomises. The two pure strategies are always to deal and never to deal with the agent. The cost of pursuing any of these strategies can be represented by a single formula, which involves a new variable, P_d. P_d is the probability that a contractor, randomising between the two pure strategies, will deal with the agent. The payoff from a non-investigation strategy is therefore:[56]

$$Y_r = m.P_d(1-P_u) - c.P_dP_u \qquad (2)$$

56 This formula also captures the two pure strategies of always dealing ($P_d = 1$), or never dealing ($P_d = 0$)

The contractor's strategy space can thus be represented as follows:

Fig 1. Extensive Form Analysis of Contractor Strategy



The dotted line indicates that the contractor is incapable of knowing which node he or she is at. The terminal nodes represent the payoff to the contractor. Of these, two will never be reached: those where there is an investigation, a lack of authority and a dealing; and those where there is an investigation, authority exists and no dealing. Therefore, the strategy relating to dealing only matters where there is no investigation.

Y_i will equal Y_r, and the contractor will be indifferent between investigating and not investigating where the cost of investigating takes the value i'. This value can be derived:

$$\begin{aligned} m(1\text{-}P_u) - i' &= m.P_d(1\text{-}P_u) - c.P_d.P_u \\ i' &= m(1\text{-}P_u) - m.P_d(1\text{-}P_u) + c.P_d.P_u \\ &= m(1\text{-}P_u)(1\text{-}P_d) + c.P_d.P_u \end{aligned} \qquad (3)$$

In other words, the contractor will investigate if the cost to do so is less than the sum of (a) the expected value, given the dealing strategy employed in cases of non-investigation, of the profits foregone from not dealing with authorised agents, plus (b) the expected value, given the dealing strategy, of the losses from contracting with unauthorised agents. Consideration of the payoff functions

shows that Y_r will be maximised only by a pure strategy, and that a mixed strategy is never optimal. However, the nature of that strategy (ie, does P_d equal 0 (never deal) or 1.0 (always deal)?) depends on the value of P_u. Y_r will be maximised by a pure strategy of always dealing (ie, $P_d = 1$) where

$$P_u < \frac{m}{m+c}.$$

Where this inequality does not hold, Y_r will never rise above zero. It will reach zero if the contractor adopts a pure strategy of not dealing (ie, $P_d = 0$).[57]

It can also be shown that where $P_d = 1$, then, for any value of P_u,[58] $i' \equiv c.P_u$. $c.P_u$ is the expected value of losses from dealing with unauthorised agents, and therefore defines the upper limit of the social value of the information.

Two points can be derived from the above analysis. The first applies where

$$P_u < \frac{m}{m+c}.$$

Where the cost of investigation exceeds its social value (ie, $i > c.P_u$), an efficient outcome will result if the contractor does not investigate and enters into all contracts. This is called a *pooling equilibrium*, as the contractor treats all agents identically.[59] The contractor should investigate only if $i < c.P_u$. Second, where

$$P_u > \frac{m}{m+c},$$

the contractor will investigate where $i < m(1\text{-}P_u)$. If i exceeds this value, the contractor would be irrational to investigate, as the agent will lose money on average. The contractor should therefore revert to the pure strategy of not contracting.

Notwithstanding the restrictive assumptions, some extrapolations of general significance can be drawn from these points. In a competitive market, in which there are no monopolistic rents, the fraction

$$\frac{m}{m+c}$$

would be expected to be smaller. In those circumstances, costly investigation can be the source of social costs, as it may lead to exchange not occurring even at moderate values of P_u and i. If, however, P_u is low, the efficient equilibrium may involve an absence of investigations, in which contractors do not attempt to differentiate. These extrapolations provide insight into the effect of legal rules, pursued below.

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57 To say that another way, the nil payoff of a pure strategy of never dealing ($P_d = 0$) strictly dominates any other dealing strategy once P_u achieves the said value

58 In a pure strategy of always dealing, $P_d = 1$. Therefore:
$i' = m(1 - P_u)(1\text{-}P_d) + c.P_d.P_u$
$i' = m(1 - P_u)(1\text{-}1) + c\ P_u$
$i' = c\ P_u$

59 The opposite is a separating equilibrium: D Baird et al, note 53 *supra*, p 83.

D. Modelling the Company's Strategy

So far the analysis has assumed that where a company does not authorise a transaction, it bears none of its costs. Such a world is one where there is no doctrine akin to that of apparent authority: the company need only perform transactions in respect of which the agent is granted express authority. Such a regime may cause a company to underspend on preventing unauthorised transactions. In economic analysis, the corporation is a nexus of contracts. The employees are one group of these contracting parties, as are managers, directors and shareholders. Managers and employees are responsible for *decision management*, that being the initiation and implementation of management decisions.[60] Directors are responsible for *decision control*,[61] that being the ratification and control of management decisions.[62] The purpose of separating management from control is to prevent those who exercise management powers from misusing or abusing those powers.[63] Part of the process is the imposition of an internal control system of checks and balances on the actions of managers and employees. An internal control system prevents unauthorised transactions from occurring, and ensures that resources are dedicated only to properly initiated and ratified transactions.[64]

A legal system might require a company to perform all transactions entered into by its agents and officers. It would do this by entitling those dealing with the agents of a company to make irrebuttable presumptions concerning the authority of these persons. If so, shareholders would expect managers to equate a dollar spent on internal control with a dollar saved from the prevention of unauthorised transactions.

The legal rule considered in the last section has two effects. The first, demonstrated above, is that contractors must decide whether to spend i to ascertain that the agent has authority. Second, the rule would affect the company's decisions regarding its internal control. The benefit of an extra dollar spent on internal control to prevent an unauthorised transaction would be lower under this rule than the one described in the last paragraph, because the company does not bear the costs of unauthorised transactions. While a company may implement control for other reasons, the marginal benefit curve, showing the benefit from preventing unauthorised transactions would be flatter.[65] The effect

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60 EF Fama and MC Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301 at 301-4, 307-8

61 *Ibid* at 308-9.

62 There is no neat, or mutually exclusive, division between managers and directors, since managers engage in aspects of control (for example, by mutual monitoring), and directors engage in some management (particularly through committees).

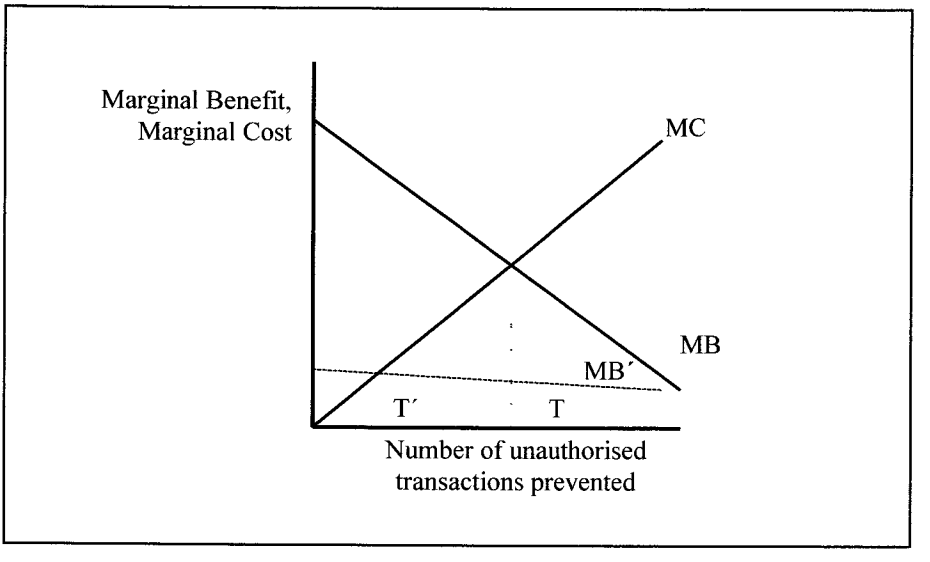
63 Note 60 *supra* at 309

64 CT Horngren, G Foster, SM Datar, *Cost Accounting. A Managerial Emphasis*, Prentice Hall (9th ed, 1997) ch 27.

65 It would not be totally flat A system in which unauthorised transactions did not bind the company would affect worker motivation, since they would be able to transact in a way that benefited from them This would undermine the process of contracting in order to equate the worker's productivity with his or her compensation· see generally RJ Haft, "The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation" (1982) 80 *Michigan Law Review* 1051.

of the change on the number of unauthorised transactions prevented by the control system can be shown graphically as the change between T and T′ in Figure 2 below.

Fig 2. Equilibria for Internal Control System under Varying Corporate Authority Rules



The legal rule has the effect that contractors bear the costs of decreased internal control by the company. That however does not justify one rule over another.[66] The legal rule would be irrelevant (other than to distribution of wealth) if transaction costs were nil.[67] Even if transaction costs exist, one can make out a case for efficiency under either rule provided the incidence of those costs does not vary between the company and the contractor.

These ideas can be modelled. Assume that the company must decide whether or not to invest an amount, s, in a system of control which detects and prevents agents from engaging in unauthorised transactions with probability P_f. Thus, if the company invests s, the probability of the contractor being approached by an agent lacking authority is $P_u(1\text{-}P_f)$. If the system was perfect, that term would equal zero, because $P_f = 1$. The company and the contractor know all of the payoffs, but neither can observe which strategy the other plays. That is, the game is one of complete but imperfect information. The payoffs to the contractor are described by the functions Y_t and Y_r, modified for the changed probabilities of the new system. Using the same legal rule (*ie* the contractor

66 See generally DD Haddock, JR Macey, FS McChesney, "Property Rights in Assets and Resistance to Tender Offers" (1987) 73 *Virginia Law Review* 701 at 723-6

67 RH Coase, "The Problem of Social Cost" (1960) 3 *Journal of Law and Economics* 1

bears the cost of all unauthorised transactions), the game can be depicted in the following bimatrix:[68]

		Company
Contractor	Invest in control system	Don't invest in control system
Investigate	$[m(1-P_u(1-P_f))-i]$, $-s$	$[m(1-P_u)-i]$,0
Don't investigate	$[m.P_d(1-P_u(1-P_f))-c.P_d.P_u(1-P_f)]$, $-s$	$[m.P_d(1-P_u)-c.P_d.P_u]$,0

Payoffs Contractor, Company

Not investing in control is a *strictly dominant* strategy for the company.[69] The company will be worse off if it invests s, no matter what strategy the company plays. Knowing the company's strategy, the contractor must choose a strategy, on the basis that the payoffs will be those in the bimatrix's right hand column.

We can reverse the legal rule so that instead of the contractor bearing the cost of unauthorised transactions, the contractor is legally entitled to assume that the agent has authority. If, however, the contractor investigates, and finds a lack of authority, the contractor will not enter the agreement.[70] The payoffs are thus:[71]

		Company
Contractor	Invest in control system	Don't invest in control system
Investigate	$[m(1-P_u(1-P_f))-i]$, -s	$[m(1-P_u)-i]$,0
Don't investigate	$m.P_d$, $[-s-(P_d.P_u(1-P_f))(c+m)]$	$m.P_d$, $[-P_d.P_u(m+c)]$

Payoffs: Contractor, Company.

The only payoffs that change are those in the lower row of the matrix. However, the strategic positions of each player are reversed. The contractor has a dominant strategy of not investigating. It cannot do as well by investigating. The company must decide whether or not to invest in control. We can determine the value of the investment in control (denoted s') at which the company will be indifferent between investing and not investing:

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68 A bimatrix depicts the combination of players' strategies and the payoffs of these.

69 D Baird et al, note 53 *supra*, p 11 In other words, the game is solved using the dominant strategy solution concept

70 This may be because the presumption of authority is rebuttable if the contractor has actual knowledge to the contrary: *cf Corporations Law*, s 164(4).

71 The payoffs could be rewritten by omitting P_d, since in this case the contractor's pure strategy of always contracting strictly dominates the alternative pure strategy of never contracting, or any mixed strategy

$$-s' - P_d P_u(1-P_f)(c+m) = -P_d P_u(c+m) \quad (4)$$

$$s' = P_d P_u(c+m) - P_d P_u(1-P_f)(c+m)$$

$$= P_d P_u(c+m)(1-(1-P_f))$$

$$= P_d P_u P_f(c+m)$$

The formula logically suggests that as the probability of detecting and preventing an unauthorised transaction rises, the indifference value of s rises; this is also true of the probability of an agent seeking to enter an unauthorised transaction. It is also logical that s' will rise as the value of the transaction $(c+m)$ rises.

If the company invests in control, the value of i' falls. In other words, the cost of the investigation now must be lower in order for it to be worth its cost to the contractor. This is intuitive, since the probability of an unauthorised agent transacting with the contractor falls if the company invests in internal control. The value of i' falls from its value in equation (3), to the following value (call this i''):[72]

$$m(1-P_u(1-P_f)) - i'' = m.P_d(1-P_u(1-P_f)) - c.P_d.P_u(1-P_f) \quad (5)$$

$$i'' = m(1-P_u(1-P_f)) - m.P_d(1-P_u(1-P_f)) + c.P_d.P_u(1-P_f)$$

$$= m(1-P_u(1-P_f))(1-P_d) + c.P_d.P_u(1-P_f)$$

The drop from i' to i'' represents a decrease in the amount that a rational contractor will spend to investigate the transaction. If the amount of this drop is *greater* than s, the company should be induced to make that investment. What is the change between i' to i''? If we subtract equation (5) from equation (3), we get:[73]

$$i' - i'' = m(1-P_u)(1-P_d) + cP_dP_u - [m(1-P_u(1-P_f))(1-P_d) + cP_dP_u(1-P_f)] \quad (6)$$

$$\Delta i' = -mP_uP_f + mP_uP_fP_d + cP_uP_fP_d$$

$$= mP_uP_f(P_d - 1) + cP_uP_fP_d$$

So far, the analysis of i and s has ignored their cost structures. Cost structure refers to how a cost changes in response to a change in some relevant level of activity. The likely cost structure of i and s is implicit in how I have described

72 It can be observed that despite the complexity of the formula, the adoption of a pure strategy of always dealing ($P_d = 1$) reduces the left hand term to zero, and the only the right hand term ($c\,P_d.P_u(1\text{-}P_f)$) remains.

73 If the pure strategy of always dealing is adopted the first term falls out.

the decisions of contractor and company. That is, the contractor must decide whether to spend i on the occasion of *each* proposed contract. It is therefore a variable cost, which increases in direct linear proportion to the number of transactions. In contrast, the company must decide whether to invest s in a system of internal control. Thus, s would be expected to be primarily a fixed, 'up front' cost, which is stable over a range of transactions. The average cost falls as the number of transactions rises.

Although the first legal rule (no apparent authority) will never induce the company to invest in control, even in the efficient case where $s < \Delta i'$,[74] the selection of a legal rule which motivates the company to invest s may be efficient. If the company does not invest in control, exchange may not occur at all.[75] We observed this earlier, when we noted that if i and P_u are of sufficient size, Y_i (equation (1)) may be negative for the contractor, even though there are social gains to trade. If systems of control are introduced in order to achieve aims other than preventing unauthorised transactions (such as for management information, or strategic planning), s becomes a joint cost. The marginal and average cost of deterring transactions would be expected to be lower as a result of the economies achievable by incorporating controls within a larger system of management control.

The significance of corporate authority doctrine is therefore its effect on the incentives of the players to incur costs in order to prevent unauthorised transactions. Different legal rules perturb the payoffs and consequent desirability of different strategies. Ideally, the legal system should aim to minimise the sum of the costs of transaction investigation, control investments and the losses from unauthorised investments. The dominance of formalism in corporate authority doctrine leads lawyers to ignore the possible manipulation of the plasticity of doctrine consistent with that aim.

The importance of legal rules can be demonstrated by an example, based on the models described above. Assume that unless both parties incur costs of prevention the unauthorised transaction will occur. Assume that $P_u = 20\%$; $m = 20$, $c = 80$, $i = 5$, $s = 3$, and that a pure dealing strategy is employed (ie, $P_d = 1$) if the contractor does not investigate. If the contractor invests and discovers an unauthorised agent, no contract is entered into. There are three possible legal rules:

1. The contractor carries all losses (ie, there is no rule binding the company to perform unauthorised transactions).
2. The company carries all losses (ie, the contractor can make an irrebuttable presumption of authority).
3. The party who fails to take precautions carries the loss. If both parties fail, the loss lies where it falls (ie, the contractor can presume authority where it investigates; the company can deny authority where it invests).

The game under each rule is described in a bimatrix, and the game solution is shaded. Under rule 1, the mutual non-precaution strategy obtains because it is a

74 s here should be understood as the average cost, or s divided by the expected number of transactions

75 In other words, $P_d = 0$.

dominant strategy for the company not to invest (0 is better than -3). Therefore, using the iterated dominance solution concept, the contractor will not investigate, because 0 is better than -5.

		Company
Contractor	Invest in control system	Don't invest in control system
Investigate	**11** [-5 + 20×80%], **-3**	**-5** [-5 + 20×80%-20×80%], **0**
Don't investigate	**0** [20×80% - 80×20%], **-3**	**0** [20×80% - 80×20%], **0**

Payoffs. Contractor, Company

Under rule 2, the mutual non-precaution strategy obtains because it is a dominant strategy for the contractor not to investigate (20 is better than 11 or 15). Therefore, the company should not invest either, because -20 is better than -23.

		Company
Contractor	Invest in control system	Don't invest in control system
Investigate	**11** [-5 + 20×80%], **-3**	**15** [-5 + 20×100%], **-20** [100×20%]
Don't investigate	**20** [20×100%], **-23** [-3+100×20%]	**20** [20×100%], **-20** [100×20%]

Payoffs: Contractor, Company.

Under rule 3, the mutual precaution strategy obtains because it is a dominant strategy for the contractor to investigate (11 and 15 are both better than 0). Therefore, the company should invest, because -3 is better than -20.

		Company
Contractor	Invest in control system	Don't invest in control system
Investigate	**11** [-5 + 20×80%], **-3**	**15** [-5 + 20×100%], **-20** [100×20%]
Don't investigate	**0** [20×80% - 80×20%], **-3**	**0** [20×80% - 80×20%], **0**

Payoffs: Contractor, Company.

A number of points are significant. First, only in the third game do the parties adopt the solution that is in their joint interests. That this solution is the efficient one can be observed by adding the joint payoffs, which are highest in the first

cell in all three games.[76] Legal rules can therefore impact on efficiency. Contractarian philosophy holds that, subject to transaction costs, the parties will arrive at an efficient contractual allocation of property rights, irrespective of the default legal rule's form.[77] This principle needs to be treated with caution. The contract by which property rights are allocated between the 'company' and the contractor depends on the existence of the agent's authority. In the absence of authority, the allocation of property rights is nugatory. Whether or not one treats this as a source of transaction costs, corporate authority doctrine forms an integral part of the legal infrastructure for intercorporate dealings, the form of which *does* matter.

Second, although in the third game, the payoffs in the fourth cell (mutual non-precaution) were the same as in the first game (**0,0**), it would not matter if we had used the payoffs for that cell from the second game (**20,-20**): the mutual precaution strategy would still be played.[78] Thus, changing the payoffs to the former solution to the game has no effect on the solution under this legal rule. This conclusion suggests that changes in legal rules may not have the effect that we suspect that they will have.

Third, it is important to qualify the noted 'robustness' of the legal rule used in game 3. In the analysis of game 3, the company had to choose a strategy by deducing the opponent's strategy. The likelihood of the efficient result obtaining, and the justification of the legal rule, depend on the correctness of this deduction. It is possible to transform the game to give both parties a dominant strategy, so avoiding the need for one player to deduce the existence of the other's dominant strategy. To say this another way, one need not rely on the iterated dominance solution concept. This would involve perturbing the payoffs in cell 4 (neither party takes precautions). The contractor's payoff would have to be less than 15 (the contractor earns 15 if it investigates and the company does not invest), and the company's loss would have be more than -3 (since that is the payoff from investing). A legal rule which could accomplish this would allow the contractor to enforce the contract against the company, while limiting recovery to half of the contract price. This would be similar to a rule of contributory negligence, which requires the contractor to internalise part of the loss because of its own negligence. The payoff would then be (**10,-10**). Each party would then have a dominant strategy of investigating and investing. Neither party has to choose a strategy by reference to what the other is expected to do. The administration of such a rule may, however, be costly.

By contrast, many games may not involve a dominant strategy for either player. This could be attributable to legal rules, the value of the variables, the incidence of loss, or any combination of these. The solution concept normally

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76 This is the famous *prisoner's dilemma* game, where a problem of acting collectively gives the parties an incentive to diverge from the efficient solution. D Baird et al, note 53 *supra*, pp 31-5.

77 R Coase, note 67 *supra*.

78 As the matrix shows, the only difference is that the dominant strategy is the company's, not the contractor's.

11, -3	15, -20
0, -3	20, -20

used to solve such a game is the *Nash equilibrium*, which is defined as the combination of strategies whereby no player could do better by choosing a different strategy given the strategy that the other party chooses.[79] Unfortunately, a game may have several Nash equilibria. If one uses the Nash equilibrium concept as a means for setting legal rules, one must make sterner assumptions about party rationality and computational abilities.

Fourth, many games will involve both incomplete and imperfect information, in which the players do not know the history of the game, or the payoffs, to themselves or to the other party. The contractor may not know what the probability of dealing with an unauthorised agent is, nor the cost of investigating. On the other hand, agents may leave 'clues' concerning their authority status that an astute principal can use to modify beliefs concerning the agent's authority. Before addressing the transition to the real world of incomplete information, a further approach to the agency problem can be offered that remodels the game as a tripartite one.

E. Modelling the Agent's Strategy

The analysis has assumed that the loss of an unauthorised transaction falls in full on the contractor or the company, and on no other. Similarly, any benefit from unauthorised transactions cannot be recovered either by the company or by the contractor.[80] This approach implies that the agent avoids the consequences of entering into unauthorised transactions. This gives rise to the pooling equilibrium described above, in which authorised and unauthorised agents do not distinguish themselves. However, it is important not to assume that these perspectives are representative. A richer perspective may reveal new possibilities for legal intervention.

First, the relationship between the agent and contractor is of a very different sort to that between the agent and the company. The problems of the pooling equilibrium arise from the absence of dealings between the agent and the contractor. Had there been a history of dealings, the performance by the company of those contracts would form a strong basis, even according to conventional doctrine, for holding that the company was bound by subsequent transactions. Whereas this relation is discrete, lacking in history or context, the relationship between agent and company is that of repeat players.[81] The parties have dealt with each other in the past and will deal with each other in the future. Economics suggests that longer term contracts generally tend to be self enforcing. The costs that one party imposes on the other by observable opportunism can be taken into account in contractual renegotiation. This is known as '*ex post* settling up'.[82] In other words, agents who commit their

79 D Baird et al, note 53 *supra*, pp 19-21

80 This can be true if, for example, the agent absconds with, or dissipates, the proceeds of the transaction.

81 Note 24 *supra*. See also D Baird et al, note 53 *supra*, pp 165-78.

82 EF Fama, "Agency Problems and the Theory of the Firm" (1980) 88 *Journal of Political Economy* 288. The argument on *ex post* settling up is regarded sceptically by some authors in other areas of corporate law: BS Black, "Is Corporate Law Trivial? A Political and Economic Analysis" (1990) 84 *Northwestern University Law Review* 542 at 579 (rejecting *ex post* settling up for chief executives)

principals to costly unauthorised transactions will bear at least some of the costs themselves, either directly, or through slower promotion or lower remuneration. An agent who internalises these costs is likely to act to minimise them.

The costs of unauthorised transactions are one form of agency costs. One of the insights of agency theory is that the parties will subject their relationship to governance in order to minimise agency costs.[83] This in turn supports the proposition (articulated earlier in this article) that companies will invest in internal control. Manipulating corporate authority doctrine in order to subject companies to the costs of their agents' unauthorised transactions may therefore be efficient. The company has the ability, which the contractor does not, to impose these costs on the agent by virtue of their repeat contracting relationship. The corporation thus functions as a sort of gatekeeper.[84]

Second, other legal principles subject agents to liability for acting without authority. Where the agent acts in self interest, fiduciary principles and duties of honesty apply. The tort of deceit may be committed in some cases. Whereas fiduciary duties can only be invoked by the company, the deceit action would be thought to lie with the contractor. Additionally, courts might construe the agent as making a warranty of authority to the contractor.[85] The agent might thus be in the invidious position of holding any profits on constructive trust for his or her fiduciary (the company), while having a pecuniary liability to the contractor. However, the deterrent aspect of this sort of action only functions in respect of agents who expect to remain solvent. Also, these remedies are costly to assert. The contractor may therefore be better off investigating *ex ante* rather than relying on these causes of action *ex post*.

Criminal or penal law may also constrain the agent. Of particular significance is the *Corporations Law*'s prohibition in s 232(6) of an officer's improper use of position. That provision has always been regarded as embodying the fiduciary principle. Thus, directors who act in breach of fiduciary duty may face a civil penalty. However, in the leading case on s 232(6), *R v Byrnes; R v Hopwood*,[86] the High Court of Australia made an interesting further extension. The Court held that an officer could act improperly if he or she acted without authority and without the knowledge of the board.[87] That case involved officers who bound their company to transactions, despite lacking actual authority. It is an open question whether an agent acts improperly if he or she negotiates a transaction that the company is able to avoid. The equation of impropriety with unauthorised conduct represents a means to force agents to internalise the cost of their actions.

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83 See generally MC Jensen and WH Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305

84 See generally R Kraakman, "Corporate Liability Strategies and the Costs of Legal Controls" (1984) 93 *Yale LJ* 857.

85 See, for example, *Brownett v Newton* (1941) 64 CLR 439. For an example of a case where a warranty of authority could be maintained, see the facts of *Brick and Pipe* note 18 *supra*

86 (1995) 183 CLR 501

87 *Ibid* at 515. See also *R v Cook; ex parte Commonwealth DPP* (1996) 20 ACSR 618

However, a legal rule which subjects the agent to the cost of unauthorised transactions can be difficult to formulate. Subjecting an agent to a liability imposes risk on the agent. In some cases, the agent is the logical bearer of that risk if he or she can avoid that risk at lower cost than anyone else. This is true of the opportunistic, fraudulent agent. In other cases, subjecting the agent to the risk of the transaction may compound a larger problem of agent risk aversion. The risk aversion of senior managers is a motif which pervades recent corporate law scholarship.[88] The benefits arising from lower investigation and control costs may be offset by increased agent risk aversion.

F. Conclusion

This part argues that legal rules should attempt to minimise the joint costs of unauthorised transactions. The company has an advantage in bearing these costs because, first, its investment in control is largely a fixed cost incurred jointly as part of management and governance processes, and, second, it has a greater ability to require the agent to internalise some or all of the costs of unauthorised transactions. However, even a simple rule, which imposes all of the losses on the lowest cost avoider, may not necessarily motivate that party to make these investments.

Determining which party should be motivated to incur prevention costs, and the legal rules which can achieve efficient outcomes, is demonstrably complicated. Parties usually play a game of incomplete and imperfect information. Except in the rare cases where each party has a dominant strategy, the choice of a strategy is greatly complicated by a lack of the information concerning each other's payoffs. If the problem for the players is difficult to overcome, the problem for the legislature must be greater. If we cannot specify clearly efficient rules, the only solution lies in reworking the existing doctrine. Part IV uses the material in this part to construct a pragmatic framework in which a trial court can consider problems involving a lack of authority.

IV. THE ECONOMICS AND REFORM OF AUTHORITY DOCTRINE

A. A Framework for Cases of Contested Authority

Part III concludes that the use of legal rules could have a powerful effect on whether or not companies and contractors take efficient precautions. However, where information is incomplete and imperfect, and where empirical research is lacking concerning the structure and incidence of prevention costs, the efficiency

88 Kraakman, note 83 *supra*, K Arrow, "The Economics of Agency" in J Pratt and R Zeckhauser (eds), *Principals and Agents: The Structure of Business*, Harvard Business School Press (reprint ed, 1991) 37 at 44-5; JC Coffee, "Shareholders Versus Managers. The Strain in the Corporate Web" (1986) 85 *Michigan Law Review* 1 For an application of this theory to the decision in *R v Byrnes*, see MJ Whincop, "An Economic Analysis of the Criminalisation and Content of Directors' Duties" (1996) 24 *Australian Business Law Review* 273.

of simple legal rules seems doubtful. The courts, and the judicial processes of *ex post* balancing of competing merits, are destined to play a central role.[89] Yet, Part II argues that the conceptual foundations of the doctrine are circular, contradictory and indeterminate. This Part offers a framework of principles that gives guidance to a trial court which is required to resolve a corporate authority case. I recognise that it is unrealistic to expect judges to abandon embedded doctrinal concepts, no matter how cogent the critique advanced. However, at the moment, the self-referential quality of the doctrine renders its concepts an empty shell. By supplying a framework, the certainty with which the doctrine operates would be improved. The efficiency of outcomes may also be improved, given the framework's derivation from economic theory.

While these principles should not be regarded as if they were 'legal' rules, judges have referred to the need to advance 'business convenience'.[90] The empty shell of formalism renders business convenience little more than a cipher. The framework, by contrast, applies the analysis in Part III to give business convenience a functional and defensible content. After discussing and justifying each rule, the analysis examines the consistency of each principle with the common law, and its supplementation by statute.

B. Non-Agents and Non-Employees

Principle 1: A contractor takes the risk that he or she is dealing with a person employed by the company

There are some famous contract law cases in which persons passed themselves off as employees of companies.[91] It will be difficult for a company to invest in an internal control system that applies to everyone in the world. The contractor should therefore satisfy herself that she is dealing with an agent of the company. The contractor has a better opportunity to make this limited inquiry than the company has to subject every possible rogue to its control system. This principle accords with the necessity for apparent authority to be based on a representation. It will be difficult to establish any basis - even by inaction - by which the company could be held to make representations with respect to persons they do not employ and of whom they know nothing.[92]

C. Referring Representations of Authority to Investments in Control

Principle 2: The existence of 'apparent authority' should be referable to those transactions which a company's system of internal control does not prevent, or minimally obstructs.

In equilibrium, a company will equate a dollar spent on control with a dollar saved from the prevention of unauthorised transactions. If control is costly,

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89 See generally I Ayres, "Making a Difference: The Contractual Contributions of Easterbrook and Fischel" (1992) 59 *University of Chicago Law Review* 1391

90 *Morris v Kanssen* note 34 *supra*; *Northside Developments* note 35 *supra* at 164, *Bank of New Zealand v Fiberi Pty Ltd* (1993) 14 ACSR 736 at 741-2.

91 See, for example, *Cundy v Lindsay* (1878) 3 App Cas 459; *Roache v Australian Mercantile Land & Finance Co Ltd* [1964] NSWLR 1015.

92 *Cf Story v Advance Bank Australia* (1993) 11 ACLC 629 at 640

some unauthorised transactions will occur. Companies should not be worse off for the investments they make in control; but neither should they be rewarded for investments they do not make, by permitting them to disavow what they have not sought to control.

This principle can be incorporated into the idea that a representation of authority is the basis of apparent authority. In Part II, I criticised the analysis of these representations. The indeterminacy of this principle can be resolved if one looks to the company's investments in internal control of its agents. Where the company invests in control to prevent certain actions, a court should be reluctant to hold the existence of a representation of authority. In contrast, a failure to prevent action provides a stronger basis for holding that the company represented that the action was valid. Thus, companies capture the benefits, but internalise the deficiencies, of control.

D. Unusual Transactions and Investigations

Principle 3: The contractor's ability to enforce without investigation a contract against a company depends on the contract being of a type entered within the ordinary course of business of the contractor. Unusual or untoward transactions, such as those which confer a significant collateral benefit on the agent, or the contractor, or which are demonstrably to the company's disadvantage, are not included in this group.

It is implicit in this principle that some transactions can be distinguished from each other *ex ante*, even without investigation. If so, the strategies the contractor adopts should be consistent with any revision that takes place in its beliefs about the authority of the agent, based on the information revealed by the course of play.[93] If the agent's course of play is inconsistent with the strategies that an authorised agent would choose, the contractor's assessment of P_u should increase. Where P_u increases, the strategy of investigating the agent's authorisation becomes more attractive. In such a case, the contractor is likely to have the lowest costs of avoiding the unauthorised transaction, and should therefore be required to investigate.

In *Northside Developments*, Brennan J stated that:

> In transactions other than those engaged in for the purposes of a company's business or otherwise for the benefit of the company, and in transactions where the officer or agent has purported to exercise an authority over and beyond that authority which an officer or agent in that position would ordinarily be expected to possess, a party seeking to bind the company by estoppel must rely on particular representations of authority made by the company.[94]

Does this conform to Principle 3? The legal rule that Brennan J describes requires a contractor to know, or imputes the contractor with knowledge of, the business of the company or the benefit of the company. This knowledge may not be acquired costlessly by the contractor from the details of the transaction

93 D Baird et al, note 53 *supra*, pp 80-9.

94 Note 35 *supra* at 178.

itself.[95] To require the contractor to obtain this knowledge is likely to be inefficient, especially where P_u is generally low.

However, a legal rule that prevents the contractor from enforcing, without investigating, those contracts in which the agent's actions signal a lack of authority is the essence of Principle 3. The difficulty, however, is determining when the law should regard a contractor as having acquired new information. This should be limited to transactions that are not of the sort usually entered within the contractor's ordinary course of business, those that confer an unusual advantage on the agent, or are demonstrably to the disadvantage of the company. Why should the principle be limited to these obvious cases? Because we are not sure of the efficient limit, it makes more sense to *underestimate*, rather than to overestimate, the types of events giving the contractor new information. Where the law holds an event does not confer the contractor with information, when, in fact, the event implies a high probability that the agent lacks authority, the rational contractor will investigate. Although the costs of investigation are positive, they are likely to be less than the expected costs of litigation in order to enforce the contested contract. Holding that an event gave information to the contractor, when in fact it did not, undermines Principle 2, because it permits companies to avoid transactions that they failed to control. It also requires contractors to make more investigations than may be efficient. Underestimation therefore decreases the expected costs of judicial errors.[96]

How should a court interpret ss 164(4) and (5) of the *Corporations Law*, which in some circumstances, deny contractors the right to make assumptions concerning agent authority specified in s 164(3)? The first circumstance is where the contractor knows the assumption is false. The second is where the person's connection or relationship with the company is such that the person ought to know that the assumed matter is incorrect. The logic of the first is unarguable, since the contractor knows that the agent lacks authority (ie, $i = 0$, $P_u = 1.0$) from s 164(4)(b): the second exception has been the subject of diverging interpretation. The most difficult words to understand are "person's connection or relationship with the company". In *Lyford v Media Portfolio Ltd*,[97] these words were interpreted narrowly. Justice Nicholson said that:

> It is not the case here that Cribb [the contractor's representative], the person having dealings with the [company] and with [the agent], had any legal or non-arm's length relationship with the first defendant. He was not a director, secretary, shareholder or employee of the first defendant ...[98]

That it is appropriate to *include* such relationships within the meaning of the contested phrase is obvious. These persons have a privileged position in obtaining accurate information concerning the authority of the agent with whom they deal. To such persons, i is likely to be low. That it is appropriate to *limit*

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95 However, in a few cases, it may be, as is argued below.

96 See generally K Davis, "Judicial Review of Fiduciary Decisionmaking - Some Theoretical Perspectives" (1985) 80 *Northwestern University Law Review* 1.

97 (1989) 7 ACLC 271

98 *Ibid* at 281.

the meaning of these words to these categories is doubtful. In *Fiberi*,[99] Kirby P rejected this approach, holding that the compass of the words was similar to the 'inquiry' exception to the indoor management rule.[100] In contrast, Justice Priestley, with whom Clarke JA agreed, said that the section referred to a case where the person acting reasonably in the particular circumstances of the case would have discovered the true situation.[101] Unlike Justice Nicholson's approach, this method permits establishment of the relationship by reference to the contract itself. Priestley JA emphasised that, on the facts before him, the information that the contractor ordinarily acquired would have revealed a defect.[102]

The interpretation of s 164(4) must be consistent with the object of minimising the *joint* costs of unauthorised transactions, not the costs only of the contractor. As I have argued, the contractor should investigate where the agent's actions convey information to the contractor to the effect that the agent lacks authority, as occurs in cases that fall outside the contractor's ordinary course of business, or which are unusually advantageous to the agent. Where information of this sort is conveyed, a legal rule should encourage the contractor to incur i, because of the increased probability of P_u. It does not matter that such information comes only from the contractual dealings, provided (a) it is observable by the contractor and verifiable by a court; and (b) its implications are sufficiently straightforward to fix the contractor with knowledge of them.[103] Interpretations of s 164 that preclude fixing contractors with obvious implications should therefore be rejected.

One issue that cuts across the third party's obligations to investigate, and that raises subtle and complex issues, is the proximity of fiduciary duties to authority concepts. The major cases involving authority in the past decade involved transactions (in particular, finance transactions) to which officers sought to bind their companies in breach of their duties to act in the best interests of their companies.[104]

Our leading scholars have asserted that fiduciary duties and authority concepts are doctrinally independent.[105] While a transaction for which authority does not exist is void, a transaction entered into in breach of fiduciary duty is voidable at the company's option. The protective doctrines for third party contractors also differ - an unauthorised transaction may be upheld if the contractor can invoke the indoor management rule; a transaction in breach of fiduciary duty can be

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99 Note 90 *supra*

100 *Ibid* at 742-4.

101 *Ibid* at 750. Chief Justice Gleeson (Cripps and Mahoney JJA agreeing) adopted a similar construction in *Story*, note 92 *supra* at 638-9

102 Note 90 *supra* at 751 This approach accords with the logic of principle (4) discussed below

103 More direct relationships may increase the number of cases where a court treats the implications of the information as straightforward.

104 *Brick and Pipe* note 18 *supra*; *Story* note 92 *supra*, *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 11 ACSR 642; *Fiberi* note 90 *supra*.

105 R Carroll, "Proper Performance of Duties by Company Officers: The Statutory Assumption in s 164(3)(f) of the *Corporations Law*" (1995) 69 *ALJ* 200; HAJ Ford et al, note 32 *supra*, pp 630-1, P Lipton and A Herzberg, *Understanding Company Law*, Law Book Company (6th ed, 1995) pp 134-5

upheld if the contractor is a purchaser for value of the legal title, without notice.[106] However, this powerful projection of legal formalism precisely obscures the fact that there is, if not a single problem, a common set of issues. The formalistic insistence on doctrinal clarity also disguises the inability of formalism to explain why the answers it provides to these common issues should vary, depending on what the plaintiff pleads.

This point is illustrated by the statutory assumption in s 164(3)(f). Section 164(1) permits a person having dealings with a company to assume that "the directors, the secretaries, the employees and the agents of the company properly perform their duties to the company." Should that provision be interpreted to permit a contractor to assume that the directors (et al) perform their fiduciary duties, just as the other assumptions in s 164(3) permit the contractor to assume that the agent possesses authority?

Varying views have been articulated.[107] Perhaps the most interesting - and the most formalistic - is expressed by Robyn Carroll,[108] who asserts that "duties" do not include fiduciary duties. Thus, equitable doctrines of constructive notice apply when the company asserts the transaction to be in breach of fiduciary duty. The authority for this view is meagre. Perhaps the most decisive refutation is offered by Ford, Austin and Ramsay, who note that s 166 permits the assumption to be made when the agent acts in fraud of the company - it would be "odd" if fraudulent conduct against the company's interests attracted s 164, but fiduciary breach did not.[109] Ford et al nonetheless remain of the view - practically little different to Carroll's - that s 164(3)(f) does not change the law of constructive trusts, because the indoor management rule operated separately from the constructive trust.[110] Again, formalism (or perhaps historicism?) triumphs. Ford et al do not explain how assumptions found in the same section can be treated differently. Carroll, by contrast, argues that 'duties' should be construed in a narrow task-oriented way. Such a view should be rejected. First, unlike ss 164(3)(b) and (c), in s 164(3)(f) reference to the "duties" is followed by the phrase "to the company", so clearly the term describes a definite jural relation, not just the incidents of office. The reference to "properly perform" also resonates with fiduciary ideology. Second, Carroll's reliance on the interpretation of "duties" in cases involving s 232(4) and its predecessors is weakened by the fact that these provisions referred to the "duties of ... office", which lends itself well to a task-oriented view.[111] They did not refer to the performance of "duties to the company". Carroll argues that the assumption could be made where a director bound a company to a transaction in violation of

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106 *Belmont Finance Corp Ltd v Williams Furniture Ltd (No 2)* [1980] 1 All ER 393

107 R Carroll, note 105 *supra*; R Carroll, "'Duly Sealed' Documents and Knowledge of Directors' Breach of Fiduciary Duty" (1993) 23 *UWALR* 173; HAJ Ford et al, note 32 *supra*, pp 630-1; R Tomasic and S Bottomley, note 41 *supra*, p 263; J O'Donovan, "Corporate Benefit in Relation to Guarantees and Third Party Mortgages" (1996) 24 *Australian Business Law Review* 126

108 R Carroll, note 105 *supra*

109 HAJ Ford et al, note 32 *supra*, p 630

110 *Ibid*, p 631

111 An unsurprising conclusion for a section imposing a non-fiduciary standard of care: *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109 at 157-8

the board's procedural standing orders.[112] That approach to deducing the meaning of the section is questionable. At common law, those standing orders could not undermine the validity of the transaction if the agent in question had apparent authority. Under the section, it would seem to suffice also if the contractor could establish authority by relying on ss 164(3)(b) or (c). Section 164(3)(f) need not come into the conclusion. Carroll's other arguments rely on extrinsic material. It seems a remarkable thing to read down the literal meaning of "duties owed to the company" by reference to what is, at most, an implication drawn from the general, even exiguous, content of that material.[113]

All of that is to say that the formalist can support any interpretation of the section, without being concerned about normative justifications. How *should* a contractor be affected by a breach of fiduciary duty, and how, if at all, should the effect differ from acting without authority? Authority and fiduciary concepts both arise from the control of agency relations.[114] The standard economic analysis is that incentives of agents (whether employees or directors) are imperfectly aligned with those of their principal. However, the means for controlling these agency costs vary, depending on the observability and controllability of the agent's exercises of discretion. Where discretions are costly to observe, and sufficiently broad to permit a multitude of abuses, the most efficient means of control will often operate *ex post*. Thus, lawyer-economists see the fiduciary duty as a device which operates to fill gaps in contracts of high level agents, whose discretions are costly to monitor.[115] The breach of the fiduciary duty is an occasion to administer an *ex post* punishment.[116] Agents conferred with less open ended discretions are generally better able to be monitored, as their discretion is subject to vertical constraints. It therefore makes sense for such agents to be subject to formal grants of authority.[117] So analysed, fiduciary duties and authority concepts are two sides of the same coin - both control agency problems, one by *ex post* deterrence, the other by *ex ante* monitoring. The prevalence of one over the other depends on the cost of monitoring.

It follows that separating authority concepts from fiduciary duties is perilous. If the two are to be differentiated, this must drive from the economic distinction - differential costs of *ex ante* monitoring - not from their conceptual pedigree. While the agent subjected to fiduciary duties is harder to control by investment

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112 R Carroll, note 105 *supra* at 203-4.

113 *Explanatory Memorandum, Companies and Securities Legislation (Miscellaneous Amendments) Act* 1983 (Cth), at [188], [205], *cf Corporations Law* s 109J(2)

114 One could extend this statement to include a third concept - the limitation on the exercise of corporate powers for non-corporate purposes. *ANZ Executors and Trustees Company Ltd v Qintex Australia Ltd* (1990) 8 ACLC 908, *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246; R Grantham, "Ultra Vires' Gone but not Forgotten" (1993) 10 *ABR* 233 This, however, is beyond the scope of this paper.

115 See, for example, FH Easterbrook and DR Fischel, "Contract and Fiduciary Duty" (1993) 36 *Journal of Law and Economics* 425; M Whincop, note 5 *supra*.

116 R Cooter, BJ Freedman, "The Fiduciary Relationship. Its Economic Character and Legal Consequences" (1991) 66 *NYULR* 1045

117 Even these constraints will be incompletely specified' see text accompanying notes 24-6 *supra*

in internal control, that provides no reason why the losses from transactions in breach of fiduciary duty should be borne by the contractor, rather than the shareholders. On the other hand, the principles of constructive trusteeship are also soundly based. The ability of equity to deter fiduciary breaches in the manner described will be eroded if those who participate in, and profit from, fiduciary breaches are not subject to disgorging their gains.[118] Those who know they participate in a fiduciary breach should be deprived of legal protection, irrespective of whether they are purchasers for value.[119] The difficult intermediate question is how far this principle should extend to persons who do not have this 'subjective' knowledge?[120]

The logic of principle 3 outlined in this section suggests that courts should regard transactions outside the contractor's ordinary course of business, and those where the agent gains an unusual advantage, as altering the beliefs of the contractor regarding the agent's authorisation. Because the contractor's estimate of P_u rises, the law should encourage investigation. A substantially similar principle can be applied to cases of fiduciary breach. Transactions that harm the interests of the company (and so constitute fiduciary breaches) may be more readily identifiable as such, on the face of the formal contractual terms, than transactions exceeding the agent's actual authority. The benefit to the agent, and the harm to the principal, are usually easier to identify than the nature of constraints imposed on the agent by the internal control system. The law should require the contractor to investigate cases of manifest harm to the company, and advantage to the agent. However, the fiduciary principle is characterically broad and inflexible.[121] An example is the case of transactions between group companies.[122] The director of a 'losing' group company can be confronted by a claim of fiduciary breach, even if the transaction can be justified, at the time, by group interests. The application of the principle requiring the contractor to investigate should therefore be confined to those situations where (a) harm to the company or benefit to the agent is probable; and (b) the transaction cannot be justified by any rational business judgment taken on the company's behalf. This reflects the fact that fiduciary breaches can occur, but never become litigious, because the corporation is not harmed by the technical conflict of interest. This approach to fiduciary breaches in the context of corporate groups is broadly similar to the analysis of the majority in *Equiticorp Finance Ltd (in liq) v Bank*

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118 See generally *Barnes v Addy* (1874) 9 Ch App 244, *Consul Developments Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373

119 The fact they purchase for value merely increases their loss, so increasing the deterrence of the law

120 *Cf* C Harpum, "The Stranger as Constructive Trustee" (1986) 102 *LQR* 114

121 See, for example, *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 at 473; *Parker v McKenna* (1874) LR 10 Ch App 96 at 124; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 at 144-5; *Warman International Limited v Dwyer* (1995) 182 CLR 544 at 557-8 *Cf Chan v Zacharia* (1984) 154 CLR 178 at 205.

122 *Walker v Wimborne* (1976) 137 CLR 1; see generally RP Austin, "Problems for Directors within Corporate Groups" in M Gillooly (ed), *The Law Relating to Corporate Groups*, Federation Press (1993) p 142.

of New Zealand.[123] The application of this principle, in practice, should have regard to evidence concerning the costs of investigation and the frequency with which disputes arise concerning the validity of transactions of the sort impugned.

This analysis informs the relation of s 164(4) to s 164(3)(f). The unification of authority and fiduciary concepts should lead us to reject formalistic separations, except in so far as fiduciary breach transactions are less costly for contractors to detect, than unauthorised transactions are. The approach in the *Lyford* decision should be rejected to the extent that it permits contractors, who lack antecedent relations with the company, to avoid investigating *prima facie* abuse of the duties of office. The majority approach in *Fiberi* is preferable, because it accepts that information may be revealed by the course of play.[124]

E. Investigation Costs as a Joint Transaction Cost

Principle 4: The contractor's ability to enforce a contract should be limited where the transaction is one where the contractor would normally collect information concerning the client before making a decision to proceed with the transaction, but did not in fact do so.

The company may have an advantage in investing in control to prevent unauthorised transactions, since the costs of doing so are joint costs of investing in multipurpose management control systems. However, the contractor's costs of investigation may also be joint costs. The contractor may collect information about the company. The marginal cost of investigating authority, *i*, may therefore be relatively low. Lenders and investors collect information about the companies they transact with, regarding their solvency, profitability, director background and the like.[125] Given that these processes involve some degree of investigation, the marginal broadening to inquiry into authority is unlikely to occasion major costs.

Principle 4 may be undermined by the assumptions in s 164 which a contractor is entitled to assert. These include the assumptions that the company's constitution was complied with, that agents were duly appointed and have the authority to exercise such power as is customary to their position, and that officers properly perform their duties. The company cannot argue that the assumption was incorrect, or was not actually made. However, the company can prove that the contractor had actual knowledge inconsistent with those assumptions, or that a person's connection or relationship with the company is such that the contractor ought to know the matter is not correct.[126] We therefore return to material analysed in the last section.

In *Lyford v Media Portfolio Ltd*,[127] the company alleged that the contractor's usual practice was to seek copies of the board resolution authorising the

123 Note 104 *supra* at 726-8. See also *Northside* note 35 *supra* at 182-3, per Brennan J, at 165, per Mason J.

124 In so concluding, I recognise that these principles may be more restrictive than those of constructive trusteeship: *cf* J O'Donovan, note 107 *supra* at 131

125 *Brick and Pipe*, note 18 *supra* at 332-5

126 *Corporations Law*, s 164(4) See also s 164(5)

127 Note 97 *supra*

transaction. The relevance of that contention was rejected as being inconsistent with the Act.[128] Although in that case the agent's evidence was unreliable,[129] the legal principle may be inefficient. First, it discourages the contractor from investigating even where there is evidence that the marginal cost of i is low.[130] Second, the actual departure, in an isolated case, from an established practice, is a move which suggests something about that player's beliefs. Unusual actions (especially where the transaction is unusual[131]) suggest the player has information that P_u may be high.[132] While the actual beliefs of the player are difficult to observe, or verify, a discretion in a trial judge to withhold recovery from a player who does not play his or her usual move, may be a valuable one. It does not need to predicate formally on the existence of information possessed by the contractor, but on the existence of a separating equilibrium.[133]

Justice Priestley's preferable interpretation of s 164(4)(b) in *Fiberi* permits a court to consider information that contractors normally acquire as part of their dealings. Such an approach is consistent with Principle 4.

F. Non-standard Delegations and Allocations of Power

Principle 5: A company should not be able to assert against the contractor a non-standard allocation or delegation of power.

The principle is illustrated by *Crabtree-Vickers Pty Ltd v Australian Direct Mail Advertising and Addressing Co Pty Ltd.*[134] The case is the high water mark of formalism in corporate authority doctrine.[135] The contractor failed because the managing director lacked actual authority to enter a particular transaction, despite the position carrying apparent authority to do so. This effected the authority of another officer 'represented' (by inaction) by the managing director to have his authority. In general, the company will have the lowest costs of knowing the nature and effect of its allocations and delegations of power. Where these are not standard allocations, it is efficient to require the company to take the costs of informing third parties about them, rather than expecting the latter to ascertain them.

This principle resembles the economic justification for the indoor management rule. Thus, to quote Brennan J, the rule

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128 *Ibid* at 280

129 *Ibid* at 281

130 Note the possible recurrence of the *prisoner's dilemma* studied in section III.C - a company that always bears the costs of unauthorised transactions may make inefficient investments in control

131 For a review of the unusual features of the transaction, see *Lyford v Media Portfolio Ltd* note 97 *supra* at 281

132 One might describe this result as a separating equilibrium, as contractors who do not believe that authority is lacking make the investigation because it has a low cost, but contractors who believe there may be a lack of authority do not investigate, and rely on the statutory assumption to enforce the agreement. For an intriguing example, see *Brick and Pipe* note 18 *supra*, in which the lender demanded proof of appointment to office, but subsequently settled in the absence of proof In less than three weeks, the lender sought to enforce the security

133 D Baird et al, note 53 *supra*, pp 125-42.

134 (1975) 133 CLR 72.

135 R Tomasic and S Bottomley, note 41 *supra*, p 253.

> ... covers each of the links between the constitution of the company and the particular act (or omission) done (or omitted) by a purported officer or agent of the company in the transaction. It covers the due making of appointments of the ... officers and of agents; it covers the conferring of authority on officers and agents; and it covers the satisfaction of conditions governing the exercise of authority in the instant case.[136]

It makes sense for the company to bear any risk that contractors are unaware of non-standard governance and power allocations, since it encourages companies to invest in control systems which conform to, and enforce, these power allocations. This analysis is consistent with Principle 2.

Principle 5 is supported by some of the assumptions in s 164(3). These are the assumptions that the company's constitution has been complied with,[137] and that a person who appears from corporate returns to be an officer, or who is held out by the company to be an agent, has been duly appointed and has authority to exercise the powers customarily exercised by such an officer or agent.[138] The constitution is a power allocation document. The company must bear the costs of noncompliance with constitutional procedures which it is in the best position to monitor. The assumptions regarding agents refer to powers customarily exercised in analogous situations. If costs are not incurred to enforce non-standard power allocations, the company cannot assert them against contractors.

G. Lower Level Agents

Principle 6: A contractor should be permitted to enforce contracts negotiated by lower level agents and employees, provided these do not fall outside the ordinary course of business.

This Principle conforms to the argument that employees are likely to bear the costs of unauthorised transactions to which they bind their company. The company should bear the cost of these transactions, since it has the greatest capacity to require the agent to internalise these costs.[139] The company may have an advantage in litigating against even former agents for breach of implied terms in the employment agreement, compared to the contractor's cause of action for breach of warranty of authority or deceit.

The law may end up applying in this way. The main cases of contested authority involve agents who operate at the highest levels of the company (where monitoring costs are highest). The generality and variability of directorship cause doubts about its inherent authority. The responsibilities of lower level agents are inevitably circumscribed. In doctrinal terms, the implied actual authority, or the representation of authority of a circumscribed position is easier to establish,[140] and is therefore less disputatious.

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136 *Northside Developments* note 35 *supra* at 178. See also *Re Madi Pty Ltd* note 18 *supra* at 851

137 *Corporations Law* s 164(3)(a)

138 *Corporations Law* s 164(3)(b), (c)

139 *Cf Crabtree-Vickers* note 134 *supra* at 81

140 See, for example, *Northside Developments* note 35 *supra* at 205.

H. Dominant Management Agents

Principle 7: Where a contract is negotiated by an agent who dominates the company's decision management and control processes, the contractor should be able to assume that the agent's authority is coextensive with the authority of the board of directors.

Difficulties arise where decision management and control are concentrated in the hands of the person responsible for negotiating the contract. As Part II explains, corporate authority doctrine is predicated on the formal legal model. The domination of management and control by one person empirically refutes the formal legal model. The idea that the Board is the locus of power, and confers power on agents, yields to the case in which the company is equated with a single individual for practical purposes. Any attempt to determine that individual's authority by reference to the usual powers of a person with his or her official designation, or by reference to some representation of the Board is an irrelevant inquiry. Although the agent has the opportunity, and frequently, the incentive, to act in breach of fiduciary duties, little is to be gained by placing the contractor on inquiry (except in cases that fall within principle (3), because the director benefits from harm to the corporation). The concept of inquiry assumes a process by which the truth may be discovered before the transaction is entered. However, if the person dominates the corporate organs, any inquiry of these organs can be manipulated. Employees can be suborned, and other directors 'snowed'. In effect, *i* approaches infinity, since the definitive truth cannot be learnt *ex ante*. It follows that the authority of the agent should not be limited *ex post*.[141]

I. Loss Spreading

Principle 8: Civil remedies should permit courts to divide the loss of unauthorised transactions where the taking of precautions by both parties is desirable.

Despite the law's plasticity in holding that a transaction is, or is not, authorised by the company, the law has never allocated loss except in an unsophisticated, binary fashion. It may be in the interests of both parties to incur costs in order to prevent unauthorised transactions. In the example used in Part III Section C, the legal rule lead to a predictable outcome because one of the parties had a dominant strategy. However, that may often not be the case. It was shown there that the outcome could be made more certain by allocating the loss when neither party takes precautions. The principle thus operates in a similar way to apportioning damages for contributory negligence. It may therefore encourage mutual prevention, although the law will always have difficulty in identifying when this is efficient.[142]

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141 *Brick and Pipe* note 18 *supra* 9.

142 An example might be *Northside Developments* note 35 *supra* - the director seemed to be subject to no constraints (witness principle (7)), but the court held the contractor was put on inquiry. Allocating the loss would motivate the contractor to ask for, say, a copy of the authorising board resolution.

This principle cannot be reconciled with received doctrine. It is conceivable that unjust enrichment might permit partial recovery by an otherwise unsuccessful contractor. This, however, would depend on the company deriving a benefit from the transaction.[143] I would argue that the law should be amended, by conferring on the trial judge a discretion to apportion the loss, where both parties have failed to take precautions.

J. Letting the Loss Lie

Principle 9: Where the incidence of unauthorised dealings is very low for the sort of transaction involved in the instant case, the loss should lie where it falls.

Where P_u is low, and the course of play reveals no new information, it will be irrational for the contractor to investigate. The marginal cost to the company of eliminating such transactions may exceed the marginal benefit. In these circumstances, a legal rule which permits a judge to let the loss lie where it falls is likely to be a sensible one. Litigation is a negative sum game, since the winner wins by as much the loser loses, and both will pay some legal costs. Litigation however is part of a larger repeated game, in which the parties decide whether or not to undertake precautions. However, when the pre-litigation moves seem to be efficient - as evidenced by a very low incidence of unauthorised transactions - the legal rule should not encourage the loser to commence litigation. The principle to let the loss lie where it falls is *not* a rule which states that the loss should fall on the contractor. It depends on who first performs contractual obligations.[144]

If one rejects the possibility of doctrine applying in a strictly formalistic manner, it is easy for a court to manipulate its view of the law's application to 'the facts', so as to deny assistance to one of the parties. A court must apply this principle with care. It depends on evidence regarding the incidence of the excess of authority alleged. It is difficult for courts to know what constitutes a 'low' incidence of fraud. Nonetheless, a judge may be able to obtain a perception of whether the industry suffers significantly from problems of fraud and lack of authority. Where these matters arise infrequently, the case for intervention is reduced.

K. Conclusion

These principles provide a practical reduction of the economic modelling and game theoretical material in Part III for the use of a judge confronted with a case of contested authority. They are not intended to operate precisely. However, they operate rather more substantially than judicial lip service to 'business convenience', and they provide an externally derived framework in which legal principles can operate.

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143 The practical advantage of such a remedy is doubtful in any event. Where the company derived some benefit from the transaction, it would arguably be open to a court to say that the company had ratified the transaction.

144 Whereas the loss from a transaction involving the loan of money to a company would fall on the contractor, the loss from a transaction involving the grant of security would fall on the company.

V. CONCLUSION: ECONOMICS, MORALS, AND RHETORIC

In *Northside Developments*, Mason CJ said of the concept of being put on inquiry, that:

> there is much to be said for the view that the adoption of such a principle will compel lending institutions to act prudently and by so doing enhance the integrity of commercial transactions and commercial morality.[145]

Similar rhetoric can be found in Justice Brennan's judgment. His Honour describes principles that require less of the contractor than the common law does, as a "charter for dealings between fraudulent officers of companies and supine financiers".[146]

These claims about the law are empirical, although difficult (probably impossible) to prove, and in the absence of proof, hard to accept. This article has shown that the only claim that can be made for the doctrine is one of indeterminacy. The building block concepts of apparent authority and actual authority are impossible to understand except by reference to each other. The formalistic premises on which these principles operate cannot be accepted.

If legal formalism ceases to provide a basis for legal reasoning and adjudication, does economics do any better? This article has shown that economics does not always provide simple answers. Although it is difficult to know for sure, some advocates of economic analysis and corporate law seem to think it has the capacity to simplify and to reduce the need for formally specified rules.[147] This notion seems to be one of the premises of CLERP. However, the simple games used as examples in this paper show that situational specific factors prevent us from settling on straightforward rules. This article used these insights to build up a framework which assists judges to make use of corporate authority doctrine in order to encourage efficient outcomes. The embodiment of this framework in legislation would be an important contribution. The framework has the advantage of conservatism - it needs very few new rules in order to lead corporate authority doctrine out of the wilderness of indeterminate formalism into a regime that is constructed on reasonably transparent economic policy considerations. A century after the decision in *Salomon's* case, where company law formalism was born, CLERP gives us an opportunity to look anew at company law, economics, and the rhetoric of both. None of them alone will be of much assistance to reform. However, the first two have a great deal to contribute to each other, if the proponents of each can keep rhetoric to manageable levels.

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145 Note 35 *supra* at 165

146 *Ibid* at 189.

147 See, for example, J Mannolini, "Creditors' Interests in the Corporate Contract: A Case for the Reform of our Insolvent Trading Provisions" (1996) 6 *Australian Journal of Corporate Law* 14 See generally R Epstein, *Simple Rules for a Complex World*, Harvard University Press (1995).