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Distilling the Essence of Contract Terms: An Anti-Antiformalist Approach to Contract and Employment Law

Rafael Gely
University of Missouri School of Law, gelyr@missouri.edu

DISTILLING THE ESSENCE OF CONTRACT TERMS: AN ANTI-ANTIFORMALIST APPROACH TO CONTRACT AND EMPLOYMENT LAW

Rafael Gely[*]

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"[W]here law ends, tyranny begins."[1]

I. INTRODUCTION

Despite what some argue is an overregulated employment relationship,[2] for millions of workers in the United States,[3] the above quote represents their daily experience when they leave their homes and commute to their places of work. While at times in our history tyranny in the workplace has taken openly hostile and even violent forms,[4] my reference here to a state of tyranny in the workplace is intended to convey a different idea. My vision of tyranny refers to a value system (which has had legal implications) that places individuals in their roles as employees in a subservient capacity vis-á-vis the employer.

A look at the development of labor and employment law in the U.S. reveals one astonishing principle. There is an underlying assumption that employers own the time and activities of employees, and thus any change in the allocation of rights between employers and employees has to be justified against the "interference" with the rights of employers. For example, whenever legislation has been introduced intended to protect workers' rights, employers have argued that such protections will interfere with the right of employers to control their employees.[5] This argument has been successfully made many times, and it has, I argue, shaped the debate on workers' rights.[6] By arguing that the employees' time and activities are

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1. William Pitt, Earl of Chatham, Debate in the Lords on the Address of Thanks (Jan. 9, 1770), *in* 16 PARL. HIST. ENG. 644, 665 (1996) (paraphrasing JOHN LOCKE, SECOND TREATISE OF CIVIL GOVERNMENT 202 (Russell Kirk ed., 1955) (1690)).

2. *See generally* PHILIP K. HOWARD, THE DEATH OF COMMON SENSE: HOW LAW IS SUFFOCATING AMERICA (1994); *see also* David Weil, *Implementing Employment Regulation: Insights on the Determinants of Regulatory Performance, in* GOVERNMENT REGULATION OF THE EMPLOYMENT RELATIONSHIP 429, 430 (Bruce E. Kaufman ed., 1997) (describing the increase in the number of programs administered by the U.S. Department of Labor, from 18 in 1940, to 180 in the mid-1990s).

3. Currently only ten percent of the labor force is unionized or covered under the protections of a collective bargaining agreement. FOUNDATIONS OF LABOR AND EMPLOYMENT LAW iii (Samuel Estreichier & Stewart J. Schwab eds., 2000).

4. *See generally* THOMAS R. BROOKS, TOIL AND TROUBLE: A HISTORY OF AMERICAN LABOR (1964) (describing the violent confrontations between workers and employers during the early years of the development of the labor movement in the United States).

5. JAMES B. ATLESON, VALUES AND ASSUMPTIONS IN AMERICAN LABOR LAW 7-10 (1983) (arguing that one of the basic assumptions underlying the development of labor law in the United States is the subordinate nature of employee rights vis-á-vis the property rights of the employer).

6. Mayer G. Freed & Daniel D. Polsby, *Just Cause For Termination Rules and Economic*

employers' "property," employers have successfully shifted the default allocation of rights in their favor. The argument, which according to employers has become a truism, can be succinctly stated as follows: since employers "buy" the time of employees, employers presumptively have the right to control all aspects of the employees' life while at work, and at times even outside of work. This argument can be found in both academic writings[7] and in judicial opinions.[8]

The validity of this argument depends on the answer to a critical question, which often has been ignored by courts and scholars alike: What is the nature and content of the exchange entered into by the employers and employees in employment contracts? Traditionally, the argument has been that employees and employers arrive at tradeoffs concerning wages and conditions of employment.[9] For example, employees will accept lower wages in exchange for better working conditions.[10] While it could be possible for employees and employers to explicitly identify all the details of the exchange, most of the time they do not. Indeed, this feature of employment contracts has been identified as one of the key virtues of employment arrangements in the United States.[11] Silence, or absence of

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Efficiency, 38 EMORY L.J. 1097, 1098-99 (1989) ("Although buyers and sellers of labor regularly dicker, at least implicitly, about wages, work assignments, fringe benefits, working conditions and many other variables, the employer usually keeps the unilateral power to terminate the employee's job tenure."); Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 951-52 (1984) ("When the law introduces a just-cause requirement, it flies in the face of ordinary understandings and thus rests upon an assumption that just-cause arrangements are in the broad run of cases either more frequent or desirable than the contract at will, though neither is the case."). *See generally* Stewart J. Schwab, *The Law and Economics Approach to Workplace Regulation*, *in* GOVERNMENT REGULATION OF THE EMPLOYMENT RELATIONSHIP, *supra* note 2, at 91-123 (surveying law and economics literature related to labor and employment law).

7. Pauline T. Kim, *Privacy Rights, Public Policy, and the Employment Relationship*, 57 OHIO ST. L.J. 671, 709-20 (describing and then criticizing the market argument to the regulation of privacy rights in the workplace).

8. *See, e.g.*, Patton v. J.C. Penney Co., 719 P.2d 854, 857 (Or. 1986) ("It may seem harsh that an employer can fire an employee because of dislike of the employee's personal lifestyle, but because the plaintiff cannot show that the actions fit under an exception to the general rule, plaintiff is subject to the traditional doctrine of 'fire at will.'").

9. *See* Schwab, *supra* note 6, at 101-02; Epstein, *supra* note 6, at 963-67.

10. Ronald G. Ehrenberg, *Workers' Compensation, Wages, and the Risk of Injury*, *in* NEW PERSPECTIVES IN WORKERS COMPENSATION 74-81 (John F. Burton, Jr. ed., 1988) (discussing the dynamics of wage differentials arising to compensate workers for unsafe and unhealthy working conditions). *See generally* ROBERT FLANAGAN ET AL., ECONOMICS OF THE EMPLOYMENT RELATIONSHIP 161-67 (1989) (analyzing how factors like work environment and risk of injury influence an employee's job choice).

11. *See* Freed & Polsby, *supra* note 6, at 1098-99. Legal scholars, primarily in the law and economics tradition, have explained this feature of employment contracts by referencing transaction costs economics. *See* Michael J. Phillips, *Disclaimers of Wrongful Discharge Liability: Time for a Crackdown?*, 70 WASH. U. L. Q. 1131, 1165 (1992) (describing the transaction costs associated

details, has become therefore a key, dominating feature of employment contracts and, in turn, of employment law.[12] The practical effect of this argument has been the development of default rules used to solve disputes arising out of the employment relationship.[13]

In this Article, I question whether the parties to employment contracts are as "silent" as we have deemed them to be: By looking in more detail at the exchanges employers and employees explicitly make, as for example the manner and level of compensation, we can derive rules that more accurately reflect what exchanges they intended. In particular, I will argue that while the employer clearly "buys" something when hiring an employee, it is critical to distinguish *what* the employer is buying. Different arrangements can be conceptualized in which employers will purchase different "things" from employees. Thus, a first step in understanding the employment relationship requires us to distinguish among the different exchanges entered into by employers and employees. In particular, by looking at the arrangements the parties have made with respect to how employees get paid, that is, the "basis of pay," we can obtain some information regarding the terms to which the parties have agreed.

In a sense, this Article could be understood as juxtaposing the employment law area and the recent and interesting contract law debate

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with negotiations over job security provisions). Basically, the argument goes, because of high transaction costs, the parties to employment contracts are better off by only defining the outward parameters of the employment relationship and leaving the details unspecified. "There is one last way in which the contract at will has an enormous advantage over its rivals. It is very cheap to administer." Epstein, *supra* note 6, at 970.

12. "Yet labor contracts are commonly said to differ fundamentally from other commercial contracts, because they are on one view 'by design, an incomplete form of contracting': workers give no concrete consideration to employers in exchange for the agreed-upon wage because the concrete limits of performance are left blank." Marc Linder & Larry Zacharias, *Opening Coase's Other Black Box: Why Workers Submit to Vertical Integration Into Firms*, 18 J. CORP. L. 371, 404 (1993) (footnotes omitted).

13. For example, law and economics scholars have proposed a number of default rules, which they argue, derive from the contracting parties' behavior. Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 864-67 (1992) (describing the development of default rules in contract law); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87-95 (1989) (developing a theory of default rules); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 597-616 (1990) (developing criteria for the selection of optimal default rules). These scholars argue that since employers and employees enter "vaguely" defined employment contracts, in which they chose to be "silent" about most of the details of the exchange, courts should adopt default rules that are consistent with the parties' behavior. *See* David Millon, *Default Rules, Wealth Distribution, and Corporate Law Reform: Employment At Will Versus Job Security*, 146 U. PA. L. REV. 975, 990-92 (1998) (describing the development of employment law default rules).

between "formalists," "anti-formalists," and "anti-antiformalists."[14] This debate, which has its origins in the development of Article 2 of the Uniform Commercial Code (UCC)[15] more than six decades ago, has been rekindled in the last few years.[16] The debate has occurred in three stages.[17] In the first stage, formalism, which preceded the development of the UCC, "lawyers aspired to deduce the vast edifice of contractual rules from an essentialist understanding of the nature of promise and consent."[18] The second stage, which is captured in the UCC, rejected the "deductive system"[19] that the formalists had construed, focusing instead on the premise that contract law should be based on the unwritten customs and usages of trade that are practiced by the contracting parties.[20]

The "anti-formalism" approach, as Professor Lisa Bernstein points out, is justified on five basic premises: that contracts are incomplete because rationality is bounded; the high transaction costs associated with negotiating fully contingent contracts; the difficulty in drafting fully contingent contracts; that customs and norms are understood by merchants to be part of their agreement and thus are good indications of their intent; and finally, that customs and norms tend to be efficient.[21] This approach is the intellectual basis of the UCC,[22] as best evidenced by the UCC use of

14. *See* David Charnay, *The New Formalism in Contract*, 66 U. CHI. L. REV. 842, 843 (1999).

15. U.C.C. § 2 (1977).

16. For example, the University of Chicago Law Review Symposium on "Formalism Revisited" included a section on Formalism in Commercial Law. 66 U. CHI. L. REV. 710, 710-859 (1999).

17. Charnay, *supra* note 14, at 842-43.

18. *Id.* at 842. More generally, formalism has been defined as "adherence to a norm's prescription without regard to the background reasons the norm is meant to serve." Larry Alexander, *"With Me. It's All er Nuthin": Formalisn in Law and Morality*, 66 U. CHI. L. REV. 530, 531 (1999).

19. Charnay, *supra* note 14, at 842.

20. Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 710, 710-12 (1999) ("The Uniform Commercial Code, the Convention on Contracts for the International Sale of Goods, and the modern Lex Mercatoria are based on the premise that unwritten customs and usages of trade exist and that in commercial disputes they can, and should, be discovered and applied by courts. . . . More broadly, the idea that courts in deciding cases should look to immanent business norms, consisting of both the practices of contracting parties and unwritten customs, is a fundamental tenet of the legal realist approach to contract interpretation. . . ." (footnotes omitted)).

21. *Id.* at 746-47.

22. *Id.* at 710. *But see* Richard Epstein, *Confusion About Custom: Disentangling Informal Customs from Standard Contractual Provisions*, 66 U. CHI. L. REV. 821, 821-23 (1999) (countering that custom is still plainly influential in commercial dealings).

the concepts of "usage of trade,"[23] "course of dealing,"[24] and "course of performance."[25]

The "anti-formalism" approach has been attacked along various fronts.[26] For example, various commentators have questioned the claim about the efficiency of the customs that the UCC seeks to incorporate.[27] Others have questioned both the competency of courts in identifying and incorporating the business customs into contracts,[28] and more fundamentally whether the parties prefer to have customs enforced by means of legal sanctions.[29] More recently, even the very existence of the customs that the UCC seeks to incorporate has been called into question.[30]

This group of challenges, which Professor Charnay refers to as the "anti-antiformalism" stage of the debate,[31] rejects the incorporationist methodology of anti-formalism, and in particular the gap-filling use of custom.[32] Having rejected the Hayekian view that "efficient custom should evolve through the natural selection of rules and practices,"[33] anti-

23. A "usage of trade" is "any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question." U.C.C. § 1-205(2).

24. "Course of dealing" refers to "a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct." U.C.C. § 1-205(1).

25. "Course of performance" relates to the behavior of the parties in the present contract and requires that a contract "involve[] repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other" and that the other "accept or acquiesce in [the performance] without objection." Christopher R. Drahozal, *Commercial Norms, Commercial Codes, and International Commercial Arbitration*, 33 VAND. J. TRANSNAT'L L. 79, 85 (2000). Such course of performance will be relevant to determine the meaning of the agreement "[w]here the contract for sale involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other." U.C.C. § 2-208(1).

26. Bernstein, *supra* note 20, at 712-13; Charnay, *supra* note 14, at 842-43; Omri Ben-Shahar, *The Tentative Case Against Flexibility in Commercial Law*, 66 U. CHI. L. REV. 781, 782 (1999).

27. Bernstein, *supra* note 20, at 712; Ben-Shahar, *supra* note 26, at 782.

28. Bernstein, *supra* note 20, at 712-13.

29. Charnay, *supra* note 14, at 842-43.

30. Bernstein, *supra* note 20, at 713; Ben-Shahar, *supra* note 26, at 782.

31. Charnay, *supra* note 14, at 842.

32. It appears from a review of the literature that not even anti-antiformalists are willing to completely do away with the use of norms and customs. For example, Professor Bernstein develops a categorization of norms (e.g., relationship-creating norms and relationship-preserving norms), which are important in sustaining transactions in particular types of markets. *See* Bernstein, *supra* note 20, at 760-76.

33. *Id.* at 754.

antiformalists are left with the task of developing "a prescription for a formalist contract jurisprudence."[34]

This task is already underway, and some solid, intriguing work has already surfaced. Professor Bernstein, for example, points out the importance of distinguishing between different kinds of norms and the different uses parties make of those norms.[35] She argues that the norms that courts are likely to apply when a contractual relationship has broken down ("endgame norms") are likely to differ from those that the parties are likely to adopt when creating and maintaining a relationship ("relationship-creating" and "relationship-preserving" norms).[36]

In a different vein, and to some extent arising out of a defense of the gap-filling approach, Professor Epstein suggests a possible way to salvage the use of norms and customs is by distinguishing between "implicit custom" and "standard provisions."[37] Professor Epstein argues that "a customary commercial term" can refer to those terms that the courts would use when commercial agreements are silent (implicit custom), or to those "express provisions that the parties commonly incorporate into commercial arrangements" (standard provisions).[38] Most of the criticism of the incorporationist approach of anti-formalism, argues Professor Epstein, applies forcefully to implicit customs, but should not call into question the validity of standard provisions.[39] Standard provisions, in his view, "should bind, no matter how great our doubts about the validity of implicit customs that are said to fill gaps."[40]

These, as well as other recent developments in this literature,[41] point towards a renewed interest in conducting more in-depth analysis of the subject matter over which the parties are contracting, that being commercial contracts or employment contracts, before making a policy decision to rely on customs and norms as contract gap fillers. Professor Charnay, for example, suggests that anti-antiformalism ought to consider the solving of legal disputes, yet with the understanding that relationship-creating and relationship-preserving norms might not have been intended to govern end-game situations but in "accordance with an 'all things considered' judgment of the competing claims of the two transactors."[42]

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34. *See* Charnay, *supra* note 14, at 843.
35. *See* Bernstein, *supra* note 20, at 760-76.
36. *Id.* at 769-70.
37. Epstein, *supra* note 22, at 823.
38. *Id.*
39. *Id.*
40. *Id.* at 829.
41. *See generally* Drahozal, *supra* note 25; Ben-Shahar, *supra* note 26.
42. *See* Charnay, *supra* note 14, at 852.

It is in this sense that this Article develops an anti-antiformalist approach to employment law. Unlike the commercial law area, in the employment law area there is nothing similar to the beacon of anti-formalism represented in the Uniform Commercial Code. However, the anti-formalist tendencies of employment law can be clearly seen in the use of default rules that permeate some of the most important issues in the area, as for example the employment-at-will debate[43] and the debate over privacy issues in the workplace.[44] By questioning the use of default rules in the employment law area and focusing instead on a more detailed analysis of the subject matter under consideration—the employment contract–this Article attempts to advance our understanding of the regulations involving the employment relationship.[45]

Part II commences by providing an expanded definition of "work."[46] The objective here is to explore possible dimensions of work not previously included in the employment and labor law discourse. This Part concludes with the observation that work and labor markets are heterogeneous institutions, which differ along a number of important dimensions such as the objectives pursued by the parties and the incentive structures utilized in achieving those objectives.[47]

In Part III, I discuss the role that compensation plays in the design and implementation of labor contracts.[48] One aspect that is constant about all work arrangements in labor markets is the use of compensation. Surprisingly, while labor economists have now for over two decades made significant advances in understanding the implications of compensation arrangements,[49] little of this discussion has been incorporated into the discussion of the legal dimensions of employment contracts. Contrary to conventional wisdom, I argue that the parties to employment contracts have not been silent in their allocation of rights and duties.[50] Employers and employees constantly make, I argue, conscious contractual tradeoffs when they enter employment contracts. Reliance then upon default rules, as is normally found in the literature, is unwarranted.

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43. *See generally* Epstein, *supra* note 6.

44. *See generally* Kim, *supra* note 7.

45. *See* Pauline T. Kim, *Bargaining with Imperfect Information: A Study of Worker Perceptions of Legal Protection in an At-Will World*, 83 CORNELL L. REV. 105, 150-53 (1997) (challenging the default rule approach as based on the erroneous assumption that parties are well informed as to the level of protection afforded by the law).

46. *See infra* notes 56-82 and accompanying text.

47. *See discussion infra* Part II.B.

48. *See infra* notes 85-224 and accompanying text.

49. *See, e.g.*, Ronald G. Ehrenberg, *Introduction: Do Compensation Policies Matter?*, 43 INDUS. & LAB. REL. REV. 3-5 (1990) (discussing special issue on developments in the study of compensation practices).

50. *See infra* notes 185-224 and accompanying text.

In Part IV, I apply this framework to two areas in employment law: the employment-at-will debate and employees' privacy rights.[51] This Part develops two arguments. First, as a matter of contract law, courts should consider the information provided by compensation arrangements in employment contracts, as constituting the basis for enforceable legal rights regarding job security and privacy claims.[52] Unilateral changes by the employer, for example, regarding monitoring practices without the employee's approval could result in a breach of contract claim. In the context of job security, dismissals that fail to comport with the risk-sharing understandings that are reflected in the compensation terms should similarly be the basis of a breach of contract claim. Second, and probably a less controversial implication of the argument developed in the Article, courts should in general pay attention to the information that is available in compensation agreements and use this information in informing their decisions, whether based on contract or tort law.[53]

Part V explores the implications of my argument for contract law theory and proposes some alternative ways of incorporating the model into contract law discourse.[54] Part VI concludes the Article.[55]

II. THE WORK CONTEXT

A. *What Is Work?*

Work can be defined as "any human effort adding use value to goods or services."[56] Under this definition, work could occur not only in the traditional context of labor markets but also in other contexts including, volunteer work, household labor, and the arts and crafts.[57] What

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51. *See infra* notes 226-369 and accompanying text.

52. *See infra* notes 226-369 and accompanying text.

53. *See infra* notes 226-369 and accompanying text.

54. *See infra* notes 371-89 and accompanying text.

55. *See infra* notes 390-92 and accompanying text.

56. CHRIS TILLY & CHARLES TILLY, WORK UNDER CAPITALISM 22 (1998). This definition is rather broad and intentionally includes exchanges that occur not only in labor markets but also in other environments such as, for example, the household and local communities. *Id.* While broad, this definition is discriminating enough to leave out some activities such as expressive and consumptive acts. *Id.* at 23. The effort involved in consumptive and expressive activities does not result in added value, which is available to others, and thus such kinds of effort do not amount to work under the definition here proposed. *Id.*

A similar definition was provided by the United States Supreme Court in *Tennessee Coal, Iron & Railroad v. Muscoda Local No. 123*, 321 U.S. 590, 598 (1944). The Court held that under the Fair Labor Standard Act, 29 U.S.C. §§ 201-219 (2000), "work" means "physical or mental exertion (whether burdensome or not) controlled or required by the employer and pursued necessarily and primarily for the benefit of the employer and his business." *Id.*

57. TILLY & TILLY, *supra* note 56, at 30-32.

distinguishes labor markets from these other contexts is that the work that occurs in labor markets is characterized by a high degree of "short-term monetization" and the extent of "time discipline."[58] "Short-term monetization" refers to the extent to which workers exert work effort on the expectation of monetary compensation in the short term.[59] "Time-discipline" refers to the degree to which the individual exerting effort or someone else decides on the disposition of a worker's effort within the working day."[60] Labor markets, generally, involve both a high degree of short-term monetization and also a high degree of time-discipline.[61] That is, work in labor markets is characterized by the creation of incentives under which individuals work to be compensated in some relatively short term and where their time is controlled by the recipient of the work effort (e.g., more commonly the employer).[62]

The distinction between labor markets and the other contexts in which work occurs has been amply recognized in the literature.[63] Somewhat less recognized, however, is the variance that exists across the monetization and time-discipline dimensions even within labor markets. For example, within the context of labor markets, unskilled labor is subject to a larger degree of time-discipline than skilled workers, with professions being subject to even a less amount of time discipline. Entrepreneurs, who might still operate in the labor market context, are similarly subject to less time discipline than unskilled and even skilled workers. Entrepreneurs are also subject to less short-term monetization, given their usually longer investment horizons and their willingness to undertake greater risks in these investments. This analysis indicates that there exists, even within labor markets, non-trivial variation in the tradeoffs that parties make when entering employment relationships.[64]

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58. *Id.* at 31.
59. *Id.* at 30.
60. *Id.*
61. *Id.* at 31 (displaying findings at Figure 2.1).
62.

> With the frequent intervention of state agencies, households, and organizations such as trade associations and labor unions, capitalists and workers today create labor markets where workers deliver a high proportion of all work for monetary compensation at the scale of the transaction, the piece, the hour, the day, or the week, and producers yield control of their time and effort to others, at least for the paid workday's duration.

Id.

63. *See generally* Reva B. Siegel, *Home as Work: The First Woman's Rights Claims Concerning Wives' Household Labor*, 1850-1880, 103 YALE L.J. 1073 (1994) (drawing attention to the amount of work that is actually performed outside the world of wages).

64. TILLY & TILLY, *supra* note 56, at 31.

Another issue, which has not received a complete treatment in the analysis of work, is the discussion regarding the objectives that employers bring to the workplace and the incentives they utilize to achieve those objectives.[65] The employer's basic function is to motivate employees to

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65. While the issue of objectives and incentives has been explored in the literature, most previous work has focused on a single issue, normally dictated by the paradigm being used. Traditionally, theories of work have adhered to one of three major paradigms: Neoclassical, Marxist, and Institutional. *Id.* at 5-12. Each of these theories tends to focus on a particular dimension of work, normally to the exclusion of others. For example, Neoclassical theories have traditionally been uninterested in the concept of work. *Id.* at 5–8. The basic view is best captured by the remarks of Paul Samuelson: "In a perfectly competitive market, it really doesn't matter who hires whom: so have labor hire 'capital.'" Paul Samuelson, *Wages and Interest: A Modern Dissection of Marxian Economic Models*, 47 AM. ECON. REV. 884, 894 (1957). Neoclassical theories emphasize the existence of forces that help prevent deviations from market outcomes. TILLY & TILLY, *supra* note 56, at 5-8. A key implication of this approach is that workers get paid the value of their marginal product, that is, the value of the marginal contribution they provide to the production process. *Id.* at 8.

Marxists theories of work emphasize class-consciousness as opposed to individual preferences. TILLY & TILLY, *supra* note 56, at 10. Three propositions derive from this emphasis in class level consciousness. Samuel S. Bowles, *The Production Process in a Competitive Economy: Walrasian, Neo-Hobbesian, and Marxian Models*, 75 AM. ECON. REV. 16, 17-18 (1985). First, efficiency is not the only goal pursued by the owners of capital; at times, mechanisms that help capital to exercise control over labor will be favored. *Id.* Second, discrimination among equally productive workers is likely to exist, since it is in the interests of the owners of capital to foster division among workers. *Id.* Finally, significant involuntary unemployment is a permanent, necessary feature of a capitalist economy. *Id.* Wages, under Marxist models, are determined not on the basis of marginal productivity, but based instead on a combination of class struggles and history. Tilly & Tilly, *supra* note 56, at 10. Work, accordingly, is defined by the existing social relationships within a firm. These relationships are not entirely explained on the basis of either technological changes or even market relationships.

Institutional theories rely on the use of norms, customs, and institutions to interject a certain amount of contingency into models of labor market. *Id.* at 11. Similar to Marxist theories, institutional theories acknowledge power asymmetries between employers and employees. *Id.* However, institutional theories point out the existence of "countervailing forces" such as labor organizations and interests groups, which facilitate a bargaining process where economic outcomes are not pre-determined. *Id.* Regarding individual preferences, the focus of institutional theories is on group norms. Wage determination, for example, is based not on calculations of marginal productivity, but on notions of relative wage comparisons and fairness. *See generally* ARTHUR ROSS, TRADE UNION WAGE POLICY 53-64 (1948) (introducing the concept of "orbits of coercive comparison"); John Dunlop, *The Task of Contemporary Wage Theory*, *in* THE THEORY OF WAGE DETERMINATION 3 (John Dunlop ed., 1957) (discussing the concept of "wage contours"). While in institutional models individuals are believed to behave rationally, this rationality is "bounded." TILLY & TILLY, *supra* note 56, at 12 (crediting HERBERT SIMON, ADMINISTRATIVE BEHAVIOR: A STUDY OF DECISION-MAKING PROCESSES IN ADMINISTRATIVE ORGANIZATION (1945) for the concept of "bounded rationality"). The implication of the notion of "bounded rationality" is that managers' behavior, for example, is shaped in many instances by customs, beliefs, and even arbitrary experimentation, so as to make their behavior essentially non-rational. *Id.* From the institutional perspective work is explained as a set of smaller relationships shaped by conditions in the product market, technology, custom, and a variety of institutions (e.g., labor organizations

exert work effort,[66] in order to accomplish one or more of three primary objectives: quality, efficiency, and power.[67]

Quality focuses on the question of "how closely the use values produced by various levels of a worker's effort approximate an ideal configuration of product characteristics."[68] Efficiency denotes elimination of waste and is at the core of the neoclassical model. These two objectives are the most commonly used in the literature, and they are central to both neoclassical and institutional accounts of work.

Power is defined in terms of how much quality effort the employer receives from the employee relative to the level of incentives provided.[69] Thus, a powerful employer in this context is one that receives high quality effort on the basis of small incentives.[70]

To achieve these objectives, employers utilize three kinds of incentives: compensation,[71] commitment,[72] and coercion.[73] These incentives are grouped into what are referred to as "work contracts." Work contracts are enforceable agreements that include features like time durations and enforcement mechanisms and that stipulate the parties,

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and collective bargaining). *Id.* at 11.

66.

> How does the immediate recipient (R) of work's product get useful effort from the producer (P)? From R's viewpoint, P must have the propensity and capacity to perform or to learn the task in question, as well as the material means to do so. From P's view point, R must supply information about what task to perform and how to perform it, as well as incentives to do so.

TILLY & TILLY, *supra* note 56, at 72.

67. *Id.* at 84. How do we explain that employers are able to pursue objectives other than efficiency? First, "[c]ompetitive pressure is blunted . . . by the fact that all businesses are in the same boat. All confront bounded rationality and multiple objectives." *Id.* at 111. Second, "large sections of capitalist economies are buffered from competition." *Id.* Third, "potentially more efficient strategies are also often excluded, or at least rendered unattractive, by short time horizons and externalities." *Id.*

> Thus workers, like employers, pursue multiple objectives. They work for pay, to be sure, but they also toil for pride in a job well done, for the enjoyment of learning, for the appreciation of bosses and coworkers, for continuing access to the social world of the workplace, and for the purpose of fulfilling traditions or the expectations of others.

Id. at 116.

68. *Id.* at 84.

69. *Id.* at 85.

70. "[I]f R gets extensive and/or high-quality effort from P for small inputs of incentives, R exercises great power over P." *Id.*

71. Compensation refers to the offer of contingent rewards. *Id.* at 74.

72. Commitment refers to the invocation of loyalty and solidarity. *Id.*

73. Coercion refers to the use of threats to inflict harm. *Id.*

rights, obligations, and sanctions.[74] In this sense, work contracts govern the process by which effort is exerted in work transactions.[75]

Work contracts differ in terms of the mix of incentives that are used to generate effort. An infinite number of combinations of commitment, coercion, and compensation exist.[76] For example, work contracts involving unskilled labor are more likely to rely on a mixture of compensation and coercion of either the "drive" or "payment by results" method. The system of drive provides employers with significant control over their workers' time and effort by relying on extensive monitoring, standardization of tasks, penalties for non-compliance, and threats of unemployment.[77] Payments by results involve compensating employees on the basis of what is actually produced.[78] These arrangements rely on piecework or commissions.[79] For work contracts involving skilled labor, there is normally less reliance on coercion and more on commitment and compensation.[80] Rewards for loyalty are common, as are incentives systems arranged in the form of tournaments and internal labor markets.[81]

One remaining issue is left. What factors affect the selection of one work contract over another? Can we explain why there is a variance in the mix of incentives in work contracts? The structure of the work contract is, to a large extent, determined by the primary objective pursued by the employer.[82] For example, where efficiency is the primary goal, we should expect to observe reliance on compensation, while quality is likely to be pursued via commitment and power via coercion.

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74. *Id.* at 75.

75. *Id.* Work contracts differ from non-work contracts, in that they involve the expenditure of human effort that adds or transfers use value (i.e., the work transaction). *Id.* Non-work contracts include consumption only contracts. *Id.*

76. *Id.* at 74.

77. *Id.* at 170.

78. *Id.*

79. *Id.*

80. *Id.* at 76-77.

81. *Id.* at 117.

82. The objectives pursued by the employer depend in turn on the nature of the specific context. For example, quantity, with just scant attention to quality, predominates very competitive industries, such as fast-food service. In the Health Care industry, quality has traditionally been a primary objective, although changes in the market structure of the industry are calling into question that understanding. The domestic worker relationship has been characterized on the other hand by a focus on the employer's power over the employee with the other objectives taking a secondary role. *See* Peggie R. Smith, *Regulating Paid Household Work: Class, Gender, Race, and Agendas of Reform*, 48 AM. U. L. REV. 851, 890-92 (1999).

B. *What Do Parties Exchange?*

The framework discussed above suggests that the employment relationship involves a complex set of transactions. These transactions are grouped into work contracts which are designed in turn to pursue different objectives and which combine different incentives. There is a connection both between the type of work transaction involved and the objective that is pursued and also between the objective that is being pursued and the type of incentives that is adopted. Thus, for example, an employer that pursues quantity as the primary objective will be more likely to rely on a mix of incentives that emphasizes compensation and to some extent power, without much concern for commitment. On the other hand, an employer that perceives a market need to focus on quality might have to use a combination of incentives that emphasizes commitment and compensation.

The framework also suggests that there is a relationship between the various incentives. Compensation arrangements, for example, have spillover effects on commitment and even on coercion type incentives.

Finally, the framework adopted here makes it clear that even in labor markets, where compensation incentives tend to be dominant, there exists variation in the kind of arrangements that form work contracts. Work contracts vary in terms of the level of short-term monetization and the level of time discipline.[83] These variations are related to the kind of incentives that are offered and to the objectives that are pursued.[84]

Recognition of these relationships is central to the understanding of the exchanges that occur when employers and employees enter employment contracts. Unfortunately, in the rush to simplify the nature of these exchanges, courts have often ignored the "richness" of information coded in these contracts. In the next part, I begin to explore the sources of this new information in more detail.

III. THE ROLE OF COMPENSATION

A. *The Functions of Pay*

Establishing the employment relationship requires an agreement over a significant number of features.[85] Parties must agree on what the work

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83. TILLY & TILLY, *supra* note 56, at 75-78.

84. *Id.*

85. This is one issue over which there is widespread agreement across theoretical frameworks. *See, e.g.*, ROBERT KUTTNER, EVERYTHING FOR SALE 68 (1997); Freed & Polsby, *supra* note 6, at 1098-99; James B. Rebitzer, *Radical Political Economy and the Economics of Labor Markets*, 31 J. ECON. LIT. 1394, 1394 (1993).

transaction is all about: job duties, rights, and expectations.[86] The parties also must agree on the terms and form of compensation.[87] Labor exchanges tend to be open-ended in the sense that specific work activities, as well as specific levels of work intensity, are not identified.[88]

This occurs because, like any other contract, employment contracts serve a wide variety of functions.[89] Two important functions of employment contracts are the valuation or pricing of labor inputs and the description of job duties.[90] Employment contracts, however, serve various other functions. For instance, employment contracts also play the role of screening and sorting mechanisms, by allocating a labor force with different preferences to particular jobs.[91] Employment contracts are used also as the means of allocating employment-related risks.[92] Finally, employment contracts also serve as incentive mechanisms.[93] In this capacity, employment contracts convey information to both parties about preferences and about unobservable contingencies. These three functions are explored in detail below. The initial point is that in determining the structure of compensation, the parties to the agreement are making complex choices about several issues. In the presence of incomplete information, the challenge of designing employment contracts is that "of finding the appropriate reward formula that generates incentives for the supply of the desired inputs at the least cost in terms of inefficient risk sharing."[94] Understanding these choices and the reasons for making them will provide useful information in developing a legal framework to regulate employment contracts disputes.

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86. "Employment contracts, whether explicit or implicit, are economic instruments that serve a wide variety of functions. Far more is involved than the mere pricing of labor inputs, the provision of work incentives or the specification of job descriptions." Haig R. Nalbantian, *Incentive Compensation in Perspective*, *in* INCENTIVES, COOPERATION, AND RISK SHARING 3, 6 (Haig R. Nalbantian ed., 1987).

87. TILLY & TILLY, *supra* note 56, at 75.

88. James B. Rebitzer, *Efficiency Wages and Implicit Contracts: An Institutional Evaluation*, *in* MICROECONOMIC ISSUES IN LABOUR ECONOMICS: NEW APPROACHES 16, 21 (Robert Drago & Richard Perlman eds., 1989).

89. Nalbantian, *supra* note 86, at 6.

90. *Id.*

91. *E.g.*, Martin Brown & Peter Philips, *The Decline of Piece Rates in California Canneries: 1890-1960*, 25 INDUS. REL. 81, 82-83 (1986) (describing the sorting effects of compensation systems in the cannery industry).

92. Joseph E. Stiglitz, *The Design of Labor Contracts: The Economics of Incentives and Risk Sharing*, *in* INCENTIVES, COOPERATION, AND RISK SHARING 47, 50 (Haig R. Nalbantian ed., 1987).

93. Nalbantian, *supra* note 86, at 13-15; Stacey R. Kole, *The Complexity of Compensation Contracts*, 43 J. FIN. ECON. 79, 81-83 (1997) (describing the incentive functions of pay with respect to managerial compensation).

94. Nalbantian, *supra* note 86, at 12.

1. The Sorting Function

Employment contracts serve a sorting function.[95] Sorting refers to a mechanism needed to match individuals' skills and preferences with particular jobs and contractual arrangements.[96] The need for a sorting device arises from the limited knowledge both parties have about the labor market.[97] Employers have incomplete information about the supply of labor, in particular the quantity and quality of labor they will be able to hire at a given price.[98] Employees lack complete information about all the wage offers and the characteristics of all relevant jobs.[99]

In this context of incomplete information, the dilemma faced by both employers and employees is to find the proper match between their preferences and their needs. Employment contracts serve the function of sorting out individual employees to proper jobs.[100] Consider, for example, an employer who faces a fairly heterogeneous labor pool with regard to the productivity of different workers. It is likely that such an employer will possess relatively little information, both prior to and after hiring, about the factors that produce such a variance in the employees' productivity.[101] The employment contract, specifically the compensation structure, provides adequate incentives for individuals to gravitate towards the type of arrangement that maximizes their preferences.[102]

2. The Risk-Sharing Function

In general, employment contracts can be understood as instruments attempting to allocate the various contributions and rewards of the parties to the contract.[103] Allocating these elements requires that the risk associated with the contract be in turn distributed between the parties.[104] In particular, the risks associated with stochastic factors that could affect

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95. Brown & Philips, *supra* note 91, at 82; Harry J. Holzer, *Wages, Employer Costs, and Employee Performance in the Firm*, 43 INDUS. & LAB. REL. REV. 147-S, 148-S (1990).

96. *See* John H. Pencavel, *Work Effort, On-the-Job Screening, and Alternative Methods of Remuneration*, *in* 1 RESEARCH IN LABOR ECONOMICS 225, 232-34 (Ronald G. Ehrenberg ed., 1972).

97. *Id.* at 232.

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.* at 233.

102. The incentive system is but one piece of the sorting process. Because of the likelihood of opportunistic employee behavior, employers need to rely on other mechanisms to discover information about the employee, once the employee is hired. Nalbantian, *supra* note 86, at 15-16.

103. *See* Stiglitz, *supra* note 92, at 50.

104. "Economists believe that, in general, the employment relationship is *not* a zero sum game, that by structuring the employment relationship appropriately, both workers and the firm can benefit." *Id.* at 47.

income have to be allocated between employers and employees.[105] As part of the various complex arrangements that are made when entering employment contracts, the parties also "negotiate" the allocation of these risks.[106]

Risk management theory suggests that it is efficient to allocate risk to the party better able to bear the cost associated with any specific risk.[107] In the employment context, since employers are generally believed to be risk-neutral, and employees are believed to be risk-averse, employers are in a better position to bear the risk associated with stochastic fluctuations in income.[108] Unlike most employers, employees have a fairly limited ability to diversify their human capital portfolio.[109] That is, it is much more difficult to spread one's human capital among different projects or functions than it is for the owners of capital to diversify their wealth among a wide variety of investments.[110] Accordingly, we should expect to see employers assuming the role of "insurers" of "employment-related risks,"[111] by insuring employees against the risks associated with income uncertainty. This is accomplished by properly structuring the compensation arrangements in a way that reflects the desired share of risks.[112] With respect to income fluctuation, for example, the contracts should provide for some form of guaranteed income, as opposed to a pay-by-result agreement.[113] By guaranteeing employees, say, a monthly income, the parties are shifting to the employer the risk associated with month-to-month variations in productivity.[114] Similarly, time-based compensation (salary and wages), as compared to result-based compensation, tends to be associated with longer job duration.[115] For example, it is common for wages and salaries to increase as the

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105. Nalbantian, *supra* note 86, at 14-15; Eugene F. Fama, *Time, Salary, and Incentive Payoffs in Labor Contracts*, 9 J. LAB. ECON. 25, 42 (1991) (modeling the choice between various forms of compensation).

106. Stiglitz, *supra* note 92, at 54-61.

107. *Id.* at 50.

108. *Id.* If employees were not risk averse but were instead risk neutral, designing an efficient contract would become a trivial issue. Nalbantian, *supra* note 86, at 12.

109. Human capital refers to the investments individuals have made in education. GARY S. BECKER, HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS, WITH SPECIAL REFERENCE TO EDUCATION 15-17 (3d ed. 1993).

110. Nalbatian, *supra* note 86, at 10.

111. *Id.*

112. *Id.*

113. Stiglitz, *supra* note 92, at 50.

114. Nalbantian, *supra* note 86, at 10. Notice that under such an agreement, although the risk is shifted to the employer, employees, at least in part, are likely paying for the shift in the burden of risk by accepting a lower wage rate. *Id.* at 11.

115. TILLY & TILLY, *supra* note 56, at 226.

employee's seniority increases. This aspect of employment contracts has been associated with the existence of Internal Labor Markets.[116]

3. The Incentive/Monitoring Function

The manner in which compensation is structured also serves incentive and monitoring functions. If it were possible for employers to observe at zero cost the quantity and quality of the labor inputs provided by employees, employees would be paid their value or marginal product.[117] Under such conditions, there would be no monitoring costs and the only "incentive" aspect with which the employer would have to be concerned would be that of paying employees enough to motivate them to enter the labor force.[118] In the presence of informational asymmetries and positive monitoring costs, employers are not able to observe perfectly labor input effort.[119] Therefore, the need arises to create proxies or estimators of the actual labor input effort.[120] These estimators take the form of the various types of compensation arrangements entered as part of the employment contract. As developed below, these could take the form of paying individuals by the time worked or by the result or outcome of their effort.[121]

The need for the use of estimators thus arises as the result of imperfect observation of the labor input effort.[122] Imperfect observation creates various problems. First, the fact that effort is not directly observable means that it is impossible for the employer to attribute variations in productivity either to worker-induced reasons, that is, shirking, or to stochastic, non-worker controlled factors.[123] Second, assuming, as described earlier,[124] that workers are risk-averse, imperfect observation is likely to result in inefficient risk sharing.[125]

Against this background, employment contracts serve an important purpose: designing a reward formula that motivates the employee to supply the desired work effort and motivates the employer to share an

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116. *See infra* notes 324-51 and accompanying text.

117. Robert Drago & John S. Heywood, *The Choice of Payment Schemes: Australian Establishment Data*, 34 INDUS. REL. 507, 509 (1995) (estimating the determinants of incentive schemes).

118. Nalbantian, *supra* note 86, at 10.

119. *Id.*

120. *Id.*

121. *See infra* notes 148-85 and accompanying text.

122. Nalbantian, *supra* note 86, at 10.

123. Nalbantian, *supra* note 86, at 11-12.

124. *See supra* notes 103-16 and accompanying text.

125. Nalbatian, *supra* note 86, at 11.

"efficient" level of risk.[126] Thus, for example, a contract under which the employee is paid exclusively by the result of his or her effort will include strong incentives for the supply of adequate job efforts.[127] Such a contract, however, is likely to lead to inefficient risk-sharing.[128] Exclusive time-based compensation leads to opposite results–more efficient risk-sharing but weaker incentives.[129]

Closely related to the incentive function of compensation arrangements are the monitoring features of employment contracts.[130] In the same way as different compensation agreements have different incentives effects, the employment contract also contains information about the level of monitoring of the employee's effort that is incorporated into the employment relationship. Monitoring, in the employment contract context, is intended to increase the level of information concerning employees' work effort. Monitoring of work effort thus can be understood as either a complement or a substitute to the incentive function.[131] As a substitute, monitoring might serve the function of increasing the probability that shirking will be detected.[132] By increasing the probability of detection, monitoring increases the costs of shirking, potentially affecting decisions by employees concerning their job efforts.[133] As a complement, monitoring serves to implement the incentive system. The development of an incentive system requires information about work-effort inputs.[134] The choice among the various forms of compensation is thus related to the assessment employers make regarding their ability to monitor effort or to monitor the quality of the final product or service. The more costly it is for the employer to meter the output of the employee, the less likely the employer is to use compensation arrangements that require output monitoring. Instead, the employer will rely on compensation agreements that are time based, accompanied by supervision of work effort.[135] When output is measurable at little cost, a results-based compensation agreement is more likely to be used. In the latter case, the employer will monitor the quality of the output as opposed to the effort.

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126. *Id.* at 12.

127. *Id.; see also* Charles Brown, *Firms' Choice of Method of Pay*, 43 INDUS. & LAB. REL. REV. 165-S, 171-S (1990) (testing the theory that firms choose their methods of pay by balancing the gains from more precise links between performance and pay against monitoring costs).

128. Nalbantian, *supra* note 86, at 16.

129. *Id.* at 15-16.

130. *Id.*

131. *Id.*

132. *Id.* at 14.

133. *Id.* at 13.

134. *Id.* at 14.

135. Pencavel, *supra* note 96, at 232.

In addition to the relationship between form of compensation and monitoring, there is also research indicating that different expectations concerning the type of monitoring that will take place at work vary within salary type contracts. Research on wage structure demonstrates that there is a relationship between wages and supervision.[136] Among the various factors that influence determination of wages are the type of supervision and the nature of the work that a firm is likely to provide.[137] Early research in labor economics suggested that supervision was an undesirable work condition and thus that increased supervision might be associated with higher wages since firms would have to pay a wage differential to compensate employees for the less desirable working conditions.[138]

More recent research, however, points out that higher wages are most likely to relate to low levels of supervision. Two alternative rationales have been advanced. First it has been argued that higher wages increase the costs to the employee of being fired and thus increase the likelihood of self-supervision, while at the same time reducing the need for external monitoring. Under those conditions, we should observe firms that engage in little supervision paying higher wages.[139] In the alternative, it also has been argued that what makes the high wage/low supervision incentive structure possible is not the threat of dismissal implicit in the efficiency wage model but the development of trust among employers and employees.[140] Low levels of supervision, according to this model, promote

136. Erica L. Groshen & Alan B. Krueger, *The Structure of Supervision and Pay in Hospitals*, 43 INDUS. & LAB. REL. REV. 134-S, 134-S (1990).

137. *Id.* at 136-S. For example, monitoring the work effort of a sales clerk in a store is less expensive than monitoring the costs of a salesperson that works outside the employer premises. Robert Drago & Richard Perlman, *Supervision and High Wages as Competing Incentives: A Basis for Labour Segmentation Theory*, *in* MICROECONOMIC ISSUES IN LABOUR ECONOMICS: NEW APPROACHES 41, 43-44 (Robert Drago & Richard Perlman eds., 1989).

138. Groshen & Krueger, *supra* note 136, at 138-S. Employees might dislike being supervised either because they find the intrusion objectionable or because the added supervision forces them to exert more effort than what they would consider ideal. *Id.*

139. In an analysis of supervisory and wage practices at hospitals, Professors Groshen and Krueger found that nurses do not command additional compensation to endure more intensive supervision. *Id.* at 143-S. Instead, their research found that hospitals that practice more intense supervision tend to pay lower wages. The results were statistically insignificant for the other two categories of hospital workers analyzed by Groshen and Krueger. For results consistent with the efficiency wage theory, see, e.g., Alan Krueger, *Ownership, Agency, and Wages: An Examination of Franchising in the Fast Food Industry*, 106 Q. J. ECON. 75, 75-101 (1991); Douglas Kruse, *Supervision, Working Conditions, and the Employer Size-Wage Effect*, 31 INDUS. REL. 229, 238-40 (1992). *But see, e.g.*, Jonathan Leonard, *Carrots and Sticks: Pay, Supervision, and Turnover*, 5 J. LAB. ECON. S136, S136 (1987) (finding that increased supervision has insignificant effects on wages in six different occupations).

140. Drago & Perlman, *supra* note 137, at 43-45.

trust so that employees choose effort levels that are equitable and consistent with the trust employers have shown.[141]

One interesting implication of the trust explanation is the effect that different technologies have on the incentive structure. The model also suggests that different kinds of supervision are likely to have different effects in the development of trust and in a sense involve a specific kind of exchange. Supervisory efforts that rely on non-human interaction, for example, output monitoring or machine monitoring, are less likely to provoke the level of distrust which in-person supervision generates.[142]

Regardless of which view one accepts, it is clear that there exists a relationship between the form of compensation and supervision. If supervision provides no information about effort, the firm is likely to pursue a compensation strategy based on results or a compensation strategy based on time with a high wage component. Underlying this strategy are a number of understandings. First, the parties have reached an understanding as to what level of supervision is expected during the course of employment. A trade-off clearly exists between compensation and level of supervision. Employees have accepted their compensation on the understanding that a given level of supervision will follow. Second, the form of compensation also requires an understanding regarding the parties' expectations with respect to the duration of the employment relationship. The risk-sharing and sorting functions of employment contracts suggest that employees and employers will structure the terms of employment with a given set of expectations as to how long the employment will last.

To the extent that these understandings are part of the work contract, any changes that affect the contours of these agreements should be recognized as changes in the employment contract, and treated as such by the parties, and, in the event of a dispute, by the courts. For example, an attempt by an employer to alter the amount of supervision, without a corresponding change in compensation, might involve a violation of the parties' understandings regarding the trade-off between wages and supervision. These changes can occur in a number of ways. For instance, technological advances, particularly deriving from advances in computer technology, are reducing in an increasingly rapid fashion the cost of monitoring workers in some industries.[143] For example, it is possible for employers to monitor the employees' use of computers, such as, key-strokes and internet use, without the employees' knowledge.[144] Similarly,

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141. *Id.*

142. *Id.* at 53.

143. Michael J. McCarthy, *Virtual Morality: A New Workplace Quandary*, WALL ST. J., Oct. 21, 1999, at B1 (describing various ways in which employers can utilize computers to monitor employees at work).

144. Gene Bylinsky, *How Companies Spy on Employees*, FORTUNE, Nov. 14, 1991, at 131,

the use of video cameras and other surveillance devices continues to be on the rise.[145]

B. *The Basis of Pay*

There are three types of pay arrangements in employment contracts: employers can pay employees by the hour, on a salary basis, or based on results.[146] Hourly work is directly linked to time at work during a pay period.[147] A large majority of employees in the United States are employed under arrangements in which they are paid for the time they work.[148] Hourly pay incentives are likely to occur under three scenarios. First, to the extent that the pace of the job is controlled by the employer or dictated by the work situation rather than controlled by the worker, employers are more likely to rely on hourly pay, since it facilitates a fixed relationship between time at work and the output produced.[149] Second, hourly pay is more attractive to employers to the extent that the individual employee's output is observable by the employer at the time it is produced.[150] Finally, hourly pay is more likely to be used when the job involves tasks whose duration is certain and easy to predict, since this predictability makes it possible for the employer to plan staffing and production requirements.[151]

Salary compensation refers to situations in which the contract specifies a weekly or monthly salary.[152] While salary contracts normally include an agreement about general tasks and normal hours on the job per salary period, the salary is not adjusted from period to period if actual hours or output are more or less than normal.[153]

Government employees are an example of the use of salary payoffs.[154] Compensation is generally independent of output and depends primarily on time worked, although pay does not vary strictly from month to month

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132; *see also* S. Elizabeth Wilborn, *Revisiting the Public/Private Distinction: Employee Monitoring in the Workplace*, 32 GA. L. REV. 825, 825-27 (1998) (describing various other examples of workplace monitoring).

145. More traditional forms of monitoring have not been abandoned, as, for example, the use of supervisors to observe workers while at work. Tony Horwitz, *Mr. Edens Profits From Watching his Workers' Every Move*, WALL ST. J., Dec. 1, 1994, at A9.

146. Fama, *supra* note 105, at 25.

147. *Id.*

148. FLANAGAN, *supra* note 10, at 251.

149. Sheldon E. Haber & Robert S. Goldfarb, *Does Salaried Status Affect Human Capital Accumulation?*, 48 INDUS. & LAB. REL. REV. 322, 326 (1995).

150. *Id.*

151. *Id.*

152. Fama, *supra* note 105, at 25.

153. *Id.*

154. *See id.*

depending on actual time worked.[155] Job descriptions are normally well defined. Screening by means of entrance exams and monitoring of performance during probationary periods are fairly common parts of the workplace.[156]

Under result-based compensation (RBC), pay is made proportional to outcome.[157] RBC utilizes individual or group performance indicators as proxies for labor inputs.[158] Among the different types of RBC systems, piece-rates systems are the most widely known.[159] Under piece-rate systems, rewards are contingent on the number of units of output produced subject to some minimum qualitative standard.[160] The main advantage of the piece system is that it tracks variations in individual effort very well.[161] The 1890 Census of Population reports that eighteen percent of the labor force was employed under a piece-rate type of arrangements.[162] The use of piece rates continued to grow over the next couple of decades, experiencing a high during the 1920s, corresponding to the period of the height of scientific management.[163] While there was a reduction in the use of piece-rate based compensation for a number of years, variants of the piece-rate system have resurged in the last couple of decades. Recently, there has been experimentation with RBCs at the group level and across other industries, including what observers deem to be firms with sophisticated human resources practices.[164] Profit sharing and productivity gain sharing are examples of RBCs based on group performance.[165] Profit-sharing programs base employee's compensation on changes in the firm's profits.[166] Productivity gain sharing programs normally base bonus

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155. "A salaried employee is compensated not for the amount of time spent on the job, but rather for the general value of services performed." Abshire v. County of Kern, 908 F. 2d 483, 486 (9th Cir. 1990), *cert. denied*, 498 U.S. 1068 (1991), *rev'd by regulation*, 29 C.F.R. § 541.118(a) (2000); *see also* Edward P. Lazear, *Salaries and Piece Rates*, 59 J. BUS. 405, 406-07 (1986) (identifying the factors that influence the employer's decision to pay on the basis of time or on the basis of output).

156. Lazear, *supra* note 155, at 407.

157. *Id.* at 406.

158. Nalbantian, *supra* note 86, at 16.

159. Brown & Philips, *supra* note 91, at 81.

160. Nalbantian, *supra* note 86, at 16.

161. *Id.*

162. *Id.* at 31 (discussing the reliability of such an estimate and arguing that such an estimate was probably low).

163. *Id.* at 32. Scientific management is associated with the writings of Frederick Taylor and exposes the basic premise that "the best management is a true science." FREDERICK W. TAYLOR, THE PRINCIPLES OF SCIENTIFIC MANAGEMENT 7 (1911).

164. George P. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593, 605-06 (1988) (describing the increasing use of profit-sharing plans).

165. *Id.*

166. *Id.*

payments on changes in economic or physical labor productivity measures with respect to a previously determined base.[167] Piece-rate type compensation has found a new venue with the increasing use of part-time and contingent workers.[168] Unlike more traditional piece-rate use, which tended to involve low-pay workers, this new venue involves employees from a variety of social and economic backgrounds. The recent use of part-time or "gypsy faculty,"[169] has been well documented.[170] While some have lamented the increase of part-time faculty,[171] others have alluded to the benefits embedded in those arrangements for both employers and employees.[172] Similar developments are being experienced in the information technology industry, where the term "netslaves" has been recently coined.[173] Stock options are a commonly used form of compensation.[174] Commentators have already noticed the similarities to the more traditional piece-rate arrangement.[175]

The use of RBCs appears to be related to a number of factors such as the size of the firm, the lack of expectation of a long-term employment relationship, and the level of product market competition.[176] Reliance on piece-rate systems is more likely to exist where employees are less likely to be permanently attached to an industry or to a particular employer.[177] Similarly, piece-rates are more likely to be used where it is difficult to assess in advance the productivity of employees.[178] In that sense, piece rates allow employers to save on labor-screening costs.[179] The nature of the

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167. *Id.*

168. CHRIS TILLY, HALF A JOB 13-17 (1996) (describing the increasing use of contingent workers and part-time employees).

169. Tara Fitzpatrick, *The Troubles of Academe: Examining the Problems Faced by America's Colleges*, CHI. TRIB., Aug. 31, 1997, at C14 (describing the increasing use of part-time faculty).

170. Courtney Leatherman, *Part-Timers Continue to Replace Full-timers on College Faculties*, CHRON. HIGHER EDUC., Jan. 18, 2000, at A18 (reporting that between 1970 and 1997 the proportion of professors that taught part-time increased from 22% to 42.5 %).

171. Courtney Leatherman, *Heavy Reliance on Low-paid Lecturers Said to Produce 'Faceless Departments,'* CHRON. OF HIGHER EDUC., Mar. 28, 1997, at A12.

172. Robin Wilson, *For Some Adjunct Faculty Members, the Tenure Track Holds Little Appeal*, CHRON. HIGHER EDUC., July 24, 1998, at A8.

173. *Missing the 9-to-5 Routine: Burnout Factor: Some Defectors Already Regret Taking on the Stress and Grueling Hours of Web Jobs*, NEWSWEEK, Dec. 13, 1999, at 67.

174. *Id.*

175. "The reality, though, is that the new-media and high-technology workplace today often more closely resembles a piecework-industry sweatshop than a pristine NASA laboratory." Karl Taro Greenfeld, *Living the Late Shift; Call Them the E-coal Mines: Internet Start-ups Are Long on Hours, Short on Millionaires*, TIME, June 28, 1999, at 46.

176. Drago & Heywood, *supra* note 117, at 521-29.

177. Brown & Philips, *supra* note 91, at 82 (noting that the seasonal nature of the cannery industry made it impossible for employers to offer anything other than seasonal employment).

178. *Id.*

179. *Id.*

work to be performed is also related to the use of piece-rates and other RBC systems, as, for example, where there is little integration in the production process. To the extent that the functions of the employees are not related, piece-rates are a good substitute for direct supervision.[180]

There are some drawbacks associated with piece-rate systems. Primarily, there is a concern with perverse incentives on quality.[181] Similarly, piece-rates are designed to result in little attachment to a particular employer.[182] Turnover costs could become excessively high, requiring the employer to reconsider reliance on piece-rate systems.[183]

Notice that the high-wage strategy described earlier is not dependent on the form the compensation package takes. That is, the high wage strategy is possible under a RBC system, as well as under a compensation system that pays on the basis of time. While traditionally we have not associated piece-rate systems with the high wage strategy, under the model developed here that is entirely possible.[184]

C. *Relationship Between Pay Functions and Pay Basis*

The employment relationship, thus, involves a complex series of exchanges between the contracting parties. Choices regarding sorting, risk sharing, levels of incentives, and levels of monitoring, are all part of what the parties exchange.[185] These exchanges are normally not explicitly made, at least not in the contract law sense.[186] However, as the discussion above illustrates, these exchanges are essential to the efficient operation of labor markets. While the parties are "silent" about most of these exchanges, they are always specific as to the form of compensation the contract involves.[187] The previous two parts suggest that there is a connection between the form of compensation and the various exchanges or trade-offs parties to employment contracts make. This part elaborates on such relationships.

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180. For example, in production processes where very little equipment is used and a very small proportion of the raw material flows through the hands of any one worker, piece rates are used as a substitute for supervision. *Id.* at 82-83.

181. *Id.*

182. *Id.*

183. *Id.*

184. Eugene L. Hartwig, *Flexible Staffing: Exploding the Myths*, 2000 A.B.A. SEC. OF LAB. & EMP. L. ANNUAL MEETING PROGRAM MATERIALS 2, 4-7 (describing the range in earnings in the contingent sector).

185. *See supra* notes 89-94 and accompanying text.

186. *See* Freed & Polsby, *supra* note 6, at 1098-99.

187. "Prices are by far the most neglected form of knowledge we have. The reason for this is that the knowledge embedded in prices is not explicit; we are never conscious of it as knowledge. It is encoded knowledge, and we are conscious only of the code." Barnett, *supra* note 13, at 846.

1. Form of Pay and Sorting

The employment contract, in particular the compensation structure, provides adequate incentives for individuals to gravitate towards the type of arrangement that maximizes their preferences.[188] RBC, with its corresponding focus on rewarding diligence and hard-work, will likely attract the more entrepreneurial individuals.[189] This group also will be less likely to have any form of permanent attachment to a particular employer.[190] On the other hand, time-based compensation agreements focus on longer terms rewards, such as promotion and career advancement.[191] Accordingly, these type of agreements are more likely to attract employees with preferences for a longer term relationship who agree to be rewarded on the basis of habitual work effort over longer periods of time and who agree to the implications of such a reward structure.[192]

2. Form of Pay and Risk Sharing

The choice of form of compensation has obvious implications for risk sharing. Under a salary based system, the employer shares a bigger portion of the risk associated with fluctuations in income, by basically insuring the employer against any such fluctuation.[193] Accordingly, we should expect such an exchange to involve an expectation of longer time horizons and a corresponding expectation of job security.[194] RBCs, on the other hand, place the risk of income fluctuations on the employee.[195] This in turn should involve a lower expectation of job security, with a corresponding lower sense of investment by both parties.[196]

The argument that the use of RBC is less likely to be associated with a long-term employment relationship is based on the risk-sharing function of compensation. RBCs place the income fluctuation risk on the employee, while in time-based compensation agreements, employers serve as risk

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188. *See supra* notes 95-102 and accompanying text.

189. Pencavel, *supra* note 96, at 232.

190. Brown & Philips, *supra* note 91, at 82. The case study of the California cannery industry is illustrative. *Id.* Employees in the industry were likely to move from one cannery to another, not only from season to season but also within a season, even within a given day, depending on the availability and quality of fruit the employer provided. *Id.*

191. Pencavel, *supra* note 96, at 233.

192. Here I have in mind the implications in particular with respect to privacy and employment tenure. *See* discussion *infra* Part IV.A.-B.

193. *See supra* notes 103-16 and accompanying text.

194. *See infra* notes 339-51 and accompanying text (discussing the implications of internal labor markets for job security issues).

195. *See infra* notes 339-51 and accompanying text.

196. Brown & Philips, *supra* note 91, at 82.

insurers.[197] Even if sometimes employees working under RBCs were successful in avoiding wide variations in income, we should expect that on average they will be more likely than employees paid on the basis of time to experience income fluctuations. These fluctuations are likely to be followed by changes in employment, as the employees seek to improve their economic situation.[198]

3. Form of Pay and Supervision

Under what conditions would an employer choose hourly wages over salaries or RBCs over wages or salaries? The choice between wages and salary depends on three key factors: the extent to which output is observable and attributable to the particular employee, whether the pace of production is controlled by the employer or by the employee, and "the degree to which the job involves tasks whose duration is certain and easy to predict."[199] Wages are likely to be paid in those cases where the output is observable, the employer controls the pace of production, and it is easy to predict the duration of producing a unit of output.[200]

For example, as compared to a production worker in a manufacturing plant, the amount of time that it would take to produce a unit of output is significantly harder to predict in the case of a scientific researcher working in the development of a new product.[201] In the case of a production worker, it is also likely that the output is both observable and attributable to an individual employee and that the pace of production is controlled by the employer via the control over the speed of the production line.[202] Thus, we should expect contracts involving production workers to rely on hourly wages and those involving research scientists to rely on the use of salaries.[203]

What factors affect, in turn, the choice between time-based compensation and RBC? One key aspect of this decision relates to the type of work involved. RBCs are more likely to take place in situations where it would be too costly to supervise the employee directly or where supervision of the employee's effort is "noisy" and thus provides little information about the relationship between effort and productivity.[204] In these cases, employers are shifting the risk associated with fluctuation in

197. *See infra* notes 339-51 and accompanying text.

198. *See generally* Sharon R. Cohany, *Workers in Alternative Employment Arrangements*, 119 MONTHLY LAB. REV. 31 (1996) (describing the relatively short tenure of contingent employees).

199. Haber & Goldfarb, *supra* note 149, at 326.

200. *Id.*

201. *Id.* at 325.

202. *Id.*

203. *Id.* at 325-26.

204. Pencavel, *supra* note 96, at 231-34.

income to employees.[205] Employees are accepting this shift with the expectation that they will be able to perform their job in a more autonomous manner.[206] Obviously there is a need for supervision under both regimes.[207] However, the type of supervision that is envisioned is very different under each approach, since the type of shirking that could potentially occur is different under each. In time-based arrangements, shirking could occur in the form of reducing the pace of work.[208] Accordingly, supervisory effort is directed at monitoring the pace at which individuals work.[209] When payment is based on results, shirking takes the form of a tendency for the quality of product to fall.[210] Supervision thus focuses on examining the output to determine the care and assiduousness exhibited by the workers.[211]

A clear, and perhaps extreme, example of this is the case of a restaurant waitress. In a fascinating study of a group of waitresses in a New Jersey restaurant, Greta Foff Paules describes the relationship between form of pay and supervision.[212] Paules notes that despite what appears to be a number of demeaning and unpleasant features of the job, the waitresses enjoyed a substantial amount of autonomy in their job, due to the very weak form of supervision to which they were subject.[213] This large degree of autonomy, argues Paules, can be attributed in large measure to the tipping system.[214] The tipping system transfers control of the employee's income to the public, divesting "management of a traditional source and symbol of managerial authority."[215]

In short, the analysis in this part suggests that when entering employment contracts, employers make specific calculations concerning issues like supervision and job security. Employers will rely on compensation agreements that minimize their labor costs. This calculus is affected by factors such as the cost of monitoring effort as compared to monitoring output.[216]

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205. *Id.* at 232-33.

206. *Id.*

207. *See id.*

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.*

212. *See* GRETA FOFF PAULES, DISHING IT OUT: POWER AND RESISTANCE AMONG WAITRESSES IN A NEW JERSEY RESTAURANT 169-78 (1991).

213. "I'm so relaxed at [the restaurant] because . . . when I come in there, it's what I want to do, regardless of what you say, you know. Like, 'Don't tell me nothing. I know what I got to do.'" *Id.* at 77 (quoting a waitress).

214. *Id.* at 54.

215. *Id.*

216. In making this determination employers will consider various other factors. For example,

D. *Summary*

There appears to exist specific kinds of exchanges in employment contracts that are related in a non-trivial way to the type of compensation arrangement that the parties incorporate in those contracts. Identifying these exchanges allows us to better understand the rights and obligations of parties to employment contracts.

The analysis in this Part suggests at least two specific exchanges. First, there is a very specific relationship between the form of compensation and the level, intensity, and kind of supervision. Second, the analysis of this Part also identifies a relationship between form of compensation and allocation of risk regarding job security and fluctuations in the stream of income. Employers are likely to shift from time-based compensation to result-based systems in response to the difficulties associated with monitoring the work effort of employees. Thus, in entering a RBC type of agreement employers are giving up their ability to monitor employees' work effort, not altruistically, but because it is efficient to seek to motivate employees not by direct supervision but by the use of incentive pay systems. Employees in turn agree to the increased autonomy associated with RBCs, but have to pay a price, to wit, the increased risk associated with income fluctuations under this type of arrangement.

Notice that the idea that there is some specific relationship between the form of payment and other aspects of the employment contract has been recognized in a number of statutes. Probably the most notable example is the Fair Labor Standard Act (FLSA).[217] The FLSA establishes for a broad range of workers a federally mandated minimum wage[218] and premium wage rates for overtime work.[219] While the FLSA is intended to be comprehensive and thus covers a wide sector of the labor force,[220] it specifically exempts from its coverage all employees who work in a "bona fide executive, administrative, or professional capacity."[221] This exclusion from the minimum wage and overtime requirements of the FLSA is in part based on the premise that employees employed in those capacities provide

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in comparing the costs of monitoring output versus effort, the familiarity of employers with their employees might lead employers to one form of monitoring over the other. Drago & Heywood, *supra* note 117, at 509. Other factors such as plant size and product market competition might also be relevant. *Id.*

217. 29 U.S.C. §§ 201-19 (2000).

218. *Id.* § 206(a)(1).

219. *Id.* § 207(a)(1).

220. Peter D. DeChiara, *Rethinking the Managerial-Professional Exemption of the Fair Labor Standards Act*, 43 AM. U. L. REV. 139, 144-49 (1993) (describing the origins of the FLSA).

221. 29 U.S.C. § 213(a)(1).

their employer services that cannot be directly tied to hours worked.[222] In enacting the FLSA, Congress recognized that many of the tasks performed by workers in these groups could not be confined to certain fixed hours.[223] As the United States Court of Appeals for the Ninth Circuit recently noted, "[a] salaried employee is compensated not for the amount of time spent on the job, but rather for the general value of services performed."[224]

The distinction drawn in the FLSA, I argue, is consistent with the argument made in this Article. There is a close correspondence between the manner in which employees get paid and a number of other features of their employment agreements. While the FLSA recognizes this relationship, this interaction has been lost in other areas of employment law.

IV. IMPLICATIONS OF THE THEORY

In this Part, I discuss the legal implications of the theoretical framework developed in the prior part. If my argument is correct, and the details of the employment contract convey useful information in determining the exchanges that the parties have made in establishing the employment relationship, this information ought to be particularly helpful in resolving disputes in areas where the courts have, for the most part, interfered to resolve disputes by "filling the gaps" left by the contracting parties.[225] Two areas in the employment law context in particular have been exposed to this judicial technique: the employment-at-will debate and issues involving employee privacy rights.

A. *Privacy Issues*

Challenges to adverse employment actions on the basis of some notion of privacy rights have involved a diverse set of factual backgrounds and numerous legal theories.[226] Employees have alleged violations of their privacy rights based on employers' attempts to monitor their phone calls and e-mails or to videotape their workstations.[227] Employees have also challenged no-spouse, dating, and cohabitating policies, as well as

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222. DeChiara, *supra* note 220, at 182.

223. *Id.*

224. Abshire v. County of Kern, 908 F.2d 483, 486 (9th Cir. 1990), *cert. denied*, 498 U.S. 1068 (1991).

225. *See infra* notes 375-89 and accompanying text.

226. *See generally* Kevin J. Conlon, *Privacy in the Workplace*, 72 CHI.-KENT L. REV. 285 (1996) (surveying challenges to employers based on privacy rights).

227. *See, e.g.*, Vega-Rodriguez v. P.R. Tel. Co., 110 F.3d 174 (1st Cir. 1997) (litigating video surveillance of employees); Briggs v. American Air Filter Co., 630 F.2d 414 (5th Cir. 1980) (litigating eavesdropping on employee's telephone calls); Smyth v. Pillsbury Co., 914 F. Supp. 97 (E.D. Pa. 1996) (litigating an employer's right to read an employee's e-mail).

attempts by employers to regulate other activities engaged in by employees after the workday has ended.[228]

As suggested by these examples, cases involving employees' privacy rights can be categorized as involving on-the-job or off-the-job activities. In this Part, I briefly discuss both the basic legal theories that have been used in each type of case and the implications that the model developed earlier has on these cases.

1. Background

a. Off-the-Job Activities

Off-the-job-activities cases involve adverse employment decisions based on an employee's activities outside of working hours, as for example, dating employees of competitors, dating or cohabitating with subordinates, and volunteering or participating in groups that the employer might find objectionable.[229] Employees challenging these adverse employment actions have raised a number of arguments including statutory, constitutional, and common law.[230] In general, employers have been fairly successful in defending against these challenges.[231]

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228. Terry Morehead Dworkin, *It's My Life–Leave Me Alone: Off-the-Job Employee Associational Privacy Rights*, 35 AM. BUS. L.J. 47, 60-72 (1997).

229. *See, e.g.*, Rulon-Miller v. IBM Corp., 208 Cal. Rptr. 524 (Cal. App. 1984) (concerning an employee fired for dating an employee of a competitor); Federated Rural Electric Ins. Co. v. Kessler, 388 N.W.2d 553 (Wis. 1986) (concerning an employee fired for dating a subordinate); Bellamy v. Mason's Stores, Inc., 508 F.2d 504 (4th Cir. 1974) (concerning an employee fired for being a member of the Ku Klux Klan).

230. In this part, I concentrate on constitutional and common law arguments. A majority of states provide employees with some version of off-duty privacy protection laws. *See* Dworkin, *supra* note 250, at 49-56. By in large, these statutes are directed to the protection of smokers who smoke outside the workplace. However, at least four jurisdictions have enacted language broad enough to cover other off-duty activities. *E.g.*, COLO. REV. STAT. § 24-34-402.5 (1999) (making it illegal to discriminate against an employee for engaging in lawful off-premises activities during non-working hours unless termination relates to a bona fide occupational requirement or is necessary to avoid a conflict of interest or appearance of conflict of interest); CONN. GEN. STAT. § 31-51q (2001) (prohibiting disciplining of employees on account of the exercise of rights guaranteed by the First Amendment to the U.S. Constitution or by Article 1, sections 3, 4, or 14 of the Connecticut Constitution, as long as the activity does not substantially or materially interfere with bona fide job performance or with working relationships); N.Y. LAB. § 201-d(2)(c) (2000) (prohibiting discrimination against employees based on off-hours, off-premises "recreational activities" unless necessary to protect trade secrets, or unless employee activity would interfere with a unique professional services contract); N.D. CENT. CODE § 14-02.4-01 (2000) (making it unlawful to fail or refuse to hire, discharge, or discriminate against anyone because of participation in lawful activity off employer's premises during non-working hours unless the adverse employment action relates to a bona fide occupational qualification).

231. *See, e.g.*, Patton v. J.C. Penney Co., 719 P.2d 854 (Or. 1986) (dismissing a wrongful

The nature of the cases challenging employers' attempts to regulate off-duty activities varies depending on whether the employees work in the public or private sector. When challenging these employers' adverse employment actions dealing with off-duty activities, government employees have argued that their employer violated their constitutional right to privacy,[232] freedom of association,[233] right to marry,[234] or due process rights.[235]

Generally, when reviewing challenges on the basis of the public employees' right of privacy, courts have refused to implicate constitutional privacy interests in employee cohabitation and dating cases. For example in *Shawgo v. Spradlin*,[236] two police officers were suspended for off-duty dating and cohabitation. The disciplinary action was taken on the basis of a broad regulation which prohibited conduct that, "if brought to the attention of the public, could result in justified unfavorable criticism" of either the officer or the department.[237] In finding that a police department's suspension and demotion of two cohabiting employees did not violate the employees' right to privacy, the Fifth Circuit noted that when a state acts as an employer, it may be justified in imposing regulations on its employees that would be unconstitutional if imposed on the public at large.[238] The court went on to apply a rational basis test, and unsurprisingly found that there existed "a rational connection between the exigencies of

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discharge claim, reasoning that "[i]t may seem harsh that an employer can fire an employee because of dislike of the employee's personal lifestyle, but because the plaintiff cannot show that the actions fit under an exception to the general rule, plaintiff is subject to the traditional doctrine of 'fire at will'").

232. *See, e.g.*, Briggs v. N. Muskegon Police Dep't, 563 F. Supp. 585, 587 (W.D. Mich. 1983) ("When the state acts as an employer, it may not without substantial justification condition employment on the relinquishment of constitutional rights, but it has greater latitude in restricting the activities of its employees than of its citizens in general." (citations omitted)).

233. *See, e.g.*, Wilson v. Taylor, 733 F.2d 1539, 1544 (11th Cir. 1984) (finding that plaintiff policeman's constitutional right to association was violated when he was discharged for dating a known felon's daughter); *cf.* Montgomey v. Carr, 101 F.3d 1117, 1124-32 (6th Cir. 1996) (recognizing that a no-spouse rule imposed some costs and burdens on marriage, the court nevertheless refused to apply a heightened standard of scrutiny to a school district's rule preventing a married couple from working together as teachers).

234. *See, e.g.*, Kukla v. Village of Antioch, 647 F. Supp. 799, 811 (N.D. Ill. 1986) (finding that although the right to marry is constitutionally protected, "the constitutional balance still . . . favor[s] . . . regulation").

235. *See, e.g.*, Shawgo v. Spradlin, 701 F.2d 470, 474-83 (5th Cir. 1983) (rejecting a challenge to an anti-cohabitation regulation based on selective enforcement). For a review of public employees' privacy rights at the workplace, see Jennifer L. Dean, *Employer Regulation of Employee Personal Relationships*, 76 B.U. L. REV. 1051, 1058 (1996).

236. 701 F.2d 470, 472 (5th Cir. 1983).

237. *Id.*

238. *Id.* at 483 (citing Kelly v. Johnson, 425 U.S. 238, 244 (1976)).

Department discipline and forbidding members of a quasi-military unit, especially those different in rank, to share an apartment or to cohabit."[239]

Challenges based on a constitutional right to marry[240] or on selective enforcement in violation of due process rights[241] have encountered similar resistance. Courts have broadly construed the state's interest in regulating the off-duty activities of public employees.[242]

Private sector employees have brought claims for intentional infliction of emotional distress, have invoked the public policy exception to the employment-at-will doctrine, and on a very limited basis have raised breach of contract claims. Like their counterparts in the public sector, private sector employees have also experienced the courts' reluctance to second-guess employers' decisions to terminate employees based on the employees' off-duty activities. In general, the courts have limited the extent of these doctrines in cases involving off-duty conduct, even though the same doctrines have been successfully raised in other areas of employment litigation.

For example, private sector employee plaintiffs raising claims of intentional infliction of emotional distress have found the burden of proof difficult to satisfy.[243] In intentional infliction of emotional distress cases, courts normally require that the defendant's conduct consist of "some extraordinary transgression of the bounds of socially tolerable conduct" or that the actions of the employer must exceed "any reasonable limit of

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239. *Id. Cf.* Briggs v. N. Muskegon Police Dep't, 563 F. Supp. 585, 590 (W.D. Mich. 1983), *aff'd*, 746 F.2d 1475 (6th Cir. 1984) (finding that a police officer's dismissal for cohabiting with a woman separated from her husband implicated First Amendment association and Fourteenth Amendment privacy interests and stating that the "fundamental" nature of the interests involved warranted "more than a minimal rationality" standard of review).

240. Public sector employee plaintiffs challenging employer regulation of employee personal relationships have argued that the regulations violate the fundamental right to marry. *See, e.g.*, Wright v. MetroHealth Med. Ctr, 58 F.3d 1130, 1134 (6th Cir. 1995), *cert. denied*, 116 S. Ct. 1041 (1996).

241. Public employees who have been disciplined under a regulation that has not been consistently enforced or strictly followed have argued that the discipline violated their due process rights because they lacked notice of the prohibition or because they were unaware that the employer's regulation prohibited their conduct. *See, e.g.*, Waters v. Gaston County, 57 F.3d 422, 424 (4th Cir. 1995) (finding that rule prohibiting employees who marry each other from working in same department is not a violation of the due process clause).

242. *See, e.g.*, Kukla v. Village of Antioch, 647 F. Supp. 799, 812 (N.D. Ill. 1986) (noting that heightened protection for the right to marry is counterbalanced by the government's heightened interest in maintaining a well-functioning police department and providing police protection to the community). *See also* Keeney v. Heath, 57 F.3d 579, 580 (7th Cir. 1995) (requiring the state to show only a plausible reason to justify a regulation prohibiting prison guards from "becoming involved socially with inmates in or out of the [jail]" (alteration in original)).

243. *See* Wilborn, *supra* note 144, at 844-46.

social toleration."[244] This has proven to be a very hard standard for employees to meet.[245] When employees are discharged for off-duty activities, courts have reasoned that the act of terminating the employee is not beyond the bounds of socially acceptable behavior, regardless of the reasoning behind the termination.[246]

For example, in *Patton v. J.C. Penney Co.*,[247] the Oregon Supreme Court rejected a dismissed employee's claim of intentional infliction of emotional distress. In *Patton*, the employer dismissed the plaintiff for dating a coworker, despite the absence of any written or unwritten policy on the issue and despite the fact that the social relationship did not interfere with the plaintiff's performance at work.[248] The Oregon Supreme Court found that although the supervisor's conduct may have been "bad conduct or offensive conduct,"[249] it was "not an 'extraordinary transgression of the bounds of socially tolerable' behavior."[250]

The few plaintiffs that have been successful in this type of claim have focused not on the employer's decision but on the manner in which the decision was implemented. *Rulon-Miller v. IBM Corp.*[251] is one of the few successful intentional infliction of emotional distress (IIED) cases. In *Rulon-Miller*, the employer terminated the plaintiff because of her romantic involvement with the manager of a rival firm.[252] In finding that there existed sufficient evidence to support a jury's verdict that the dismissal constituted intentional infliction of emotional distress, the court particularly objected to the manner in which the dismissal had been handled. The court noted that the employer had acted deceptively and oppressively when he unilaterally terminated the plaintiff without giving her a chance to consider her options.[253] In particular, the court noted that the plaintiff's supervisor had told her that she would have the chance to choose between her job and her relationship, only to renege the following day, telling the plaintiff that he was "making the decision for [her]."[254] According to the court,

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244. Patton v. J.C. Penney Co., 719 P.2d 854, 857 (1986) (quoting Hall v. May Dept. Stores, 637 P.2d 126, 137 (Or. 1981)).

245. *See* Regina Austin, *Employer Abuse, Worker Resistance, and the Tort of Intentional Infliction of Emotional Distress*, 41 STAN. L. REV. 1, 6-7, 21-24 (1988).

246. *E.g.*, *Patton*, 719 P.2d at 857.

247. *Id.*

248. During the time the plaintiff was engaged in the relationship, he had earned several performance awards given by the employer. *Id.* at 856.

249. *Id.* at 857.

250. *Id.* at 858.

251. 208 Cal Rptr. 524 (Cal. Ct. App. 1984).

252. *Id.* at 527.

253. *Id.* at 534-35.

254. *Id.* at 534.

> [The supervisor's] unilateral action in purporting to remove any free choice on her part contrary to his earlier assurances also would support a conclusion that his conduct was intended to emphasize that she was powerless to do anything to assert her rights as an IBM employee. And such powerlessness is one of the most debilitating kinds of human oppression.[255]

Thus, in limiting the availability of this tort, courts appear to be willing to interfere with the employer's decision only when the terminations are handled in an excessive manner. Courts, however, do not appear to be interested in questioning, as a matter of tort law, the rationale for the decision to terminate the employee, and they assume that the employer can indirectly control the activities of employees even outside of work. Courts have not inquired whether the parties to the employment contract have addressed any of these issues.

Private employees have been even less successful in challenging adverse employment actions based on off-duty activities under a theory of wrongful discharge in violation of public policy. Some employees have argued that their dismissals for off-duty activities (e.g., dating or cohabitating) violate a public policy favoring the right to privacy.[256] Normally courts have rejected this kind of argument because it fails to define a true "public policy" and not merely a "private" interest.[257] Even in cases involving dismissals based on the identity of the employee's spouse, in which allegedly a public policy in favor of marriage could be identified (i.e., a "true" public policy), courts have denied plaintiffs' claims.[258]

In a few instances, private employees have used contract theory to challenge adverse employment decisions taken on the basis of the employees' off-duty activities. In *Rulon-Miller*,[259] the court, in discussing the wrongful discharge claim of the plaintiff, framed the issue as:

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255. *Id.* at 534-35.

256. *See, e.g.*, Staats v. Ohio Nat'l Life Ins. Co., 620 F. Supp. 118, 120 (W.D. Tenn. 1985) (finding that, while freedom of association is an important social right which should not ordinarily affect employment decisions, "the right to 'associate with' a non-spouse at an employer's convention without fear of termination" did not involve a threat to "some recognized facet of public policy" required under the state wrongful discharge exception to the employment-at-will doctrine).

257. Dworkin, *supra* note 230, at 76-78 (noting that many courts require a clearly expressed statement of public policy in upholding a wrongful discharge claim).

258. McCluskey v. Clark Oil & Ref. Corp., 498 N.E.2d 559 (Ill. App. Ct. 1986) (finding that terminating an employee for marrying a co-worker did not constitute a wrongful discharge in violation of public policy despite the recognition under state law of the existence of a fundamental right to marry).

259. *Rulon-Miller*, 208 Cal. Rptr. 524 (Cal App. 1984).

> When [the supervisor] questioned her relationship with [her partner], respondent invoked her right to privacy in her personal life relying on existing IBM policies. A threshold inquiry is thus presented whether respondent could reasonably rely on those policies for job protection. Any conflicting action by the company would be wrongful in that it would constitute a violation of her contract rights.[260]

The court then discussed a memo from the chairman of the company that provided employees certain guarantees concerning their expectation of privacy in off-the-job activities.[261] The court concluded that the company policy provided the employee both the right of privacy and the right to hold a job even though "off-the-job behavior" did not meet with the approval of the employee's manager.[262]

The breach of contract theory used in *Rulon-Miller* has been seldom used in cases involving off-the-job activities, despite the plaintiff's success in the case and despite the fact that the theory has been successfully used to challenge other adverse employment actions.[263] In part, this is due to the fact that *Rulon-Miller* presented an unusually attractive set of facts for the plaintiff (i.e., the chairman's memo) and in part due to the fact that damages under this theory are limited to contract damages.[264]

The set of cases discussed above illustrates that courts have been extremely reluctant to second-guess employers' decisions to dismiss employees based on their off-the-job activities. Courts have given employers broad discretion to control, albeit indirectly, what their employees do outside of work. It also appears that the approach taken by courts in this area is somewhat based on the premise that employers' ownership of employees' time is not limited to the time they are at work, but spills over into non-working hours.

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260. *Id.* at 529.

261. The memo provided in part:

> We have concern with an employee's off-the-job behavior only when it reduces his ability to perform regular job assignments, interferes with the job performance of other employees, or if his outside behavior affects the reputation of the company in a major way. When on-the-job performance is acceptable, I can think of few situations in which outside activities could result in disciplinary action or dismissal.

Id. at 530.

262. *Id.*

263. Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment at Will*, 92 MICH. L. REV. 8, 11, 32-33 (1993).

264. Foley v. Interactive Data Corp., 765 P.2d 373, 401 (Cal. 1988).

b. On-the-Job Activities

Cases in this area have involved challenges to employment practices like drug testing,[265] personal property searches,[266] honesty and psychological testing,[267] mandatory polygraphs,[268] and monitoring of phone calls, mail, and most recently, electronic mail.[269] While the model developed here is generally applicable to these diverse situations, I focus the discussion on the monitoring cases.

Monitoring cases involve situations such as the interception of phone calls[270] or electronic communications,[271] the installation of video cameras in working areas,[272] and other kinds of monitoring of workstations.[273] As in the case of off-the-job activities, somewhat different standards have been developed for public and private employees. Public employees have primarily relied on the Fourth Amendment protection against unreasonable searches and seizures, while private employees have relied on invasion of privacy actions, wrongful discharge claims, statutory protections under federal and state laws, and in a very few instances breach of contract claims.

A review of cases in this area indicates that there is wide support for the proposition that employees retain some legitimate expectations of privacy even while at work.[274] This expectation, however, has been narrowly defined for private sector employees. Challenges to monitoring activities under invasion of privacy theories have been successful mainly in the most extreme cases, such as those involving the videotaping of restrooms and changing rooms.[275] Videotaping in other areas, however, as well as other forms of monitoring (e.g., computer based monitoring and telephone call accounting) have generally survived invasion of privacy claims.[276]

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265. *See, e.g.*, Luedtke v. Nabors Alaska Drilling, 768 P.2d 1123, 1134-35 (Alaska 1989).

266. *See, e.g.*, K-Mart Corp. v. Trotti, 677 S.W.2d 632, 635 (Tex. Ct. App. 1984).

267. *See, e.g.*, Soroka v. Dayton Hudson Corp., 1 Cal. Rptr. 2d 77, 79 (Cal. Ct. App. 1991).

268. *See, e.g.*, Kamrath v. Suburban Nat'l Bank, 363 N.W.2d 108, 109 (Minn. Ct. App. 1985).

269. *See, e.g.*, Smyth v. Pillsbury Co., 914 F. Supp. 97, 98-99 (E.D. Pa. 1996).

270. *See* Wilborn, *supra* note 144, at 826-28.

271. *Id.*

272. *Id.*

273. *Id.*

274. Kim, *supra* note 7, at 703.

275. Doe v. B.P.S. Guard Servs., Inc., 945 F.2d 1422, 1427 (8th Cir. 1991); Phillips v. Smalley Maint. Servs., Inc., 435 So. 2d 705, 711-12 (Ala. 1983); Harkey v. Abate, 346 N.W.2d 74, 76 (Mich. Ct. App. 1983); *see also* Julie A. Flanagan, *Restricting Electronic Monitoring in the Private Workplace*, 43 DUKE L.J. 1256, 1267 (1994).

276. *See* cases cited *supra* note 275.

Employees have been equally unsuccessful when raising state and federal statutory claims. For example, Title II of the Omnibus Crime Control and Safe Streets Act of 1968, as amended by the Electronic Communications Act of 1986,[277] prohibits the monitoring of wire communications[278] and oral communications[279] unless one of the communicating parties has given consent. Title III, however, provides a broad exception for employers. Private employers are not required to provide any type of notice of monitoring to employees and are only limited by the provision requiring that the monitoring be "in the ordinary course of its business."[280] Courts have construed this requirement very broadly,[281] in practice, giving employers complete freedom to monitor employees.[282] Employees have not fared any better under state protections, as those statutes generally mirror the protections under Title III and have similarly been interpreted by courts to allow broad monitoring of employees.[283]

The greatest protection is probably that enjoyed by public employees under the Fourth Amendment. The Fourth Amendment protects individual privacy from government intrusion.[284] Public employees are thus protected from unreasonable searches whenever the employee has a reasonable expectation of privacy.[285] The Supreme Court has held that such an expectation generally extends to some areas of the workplace. In

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277. Pub. L. No. 90-351, § 82 Stat. 212 (1968) (codified as amended at 18 U.S.C. §§ 2510-2520 (1988)).

278. "Wire communication" is defined as any communication

> made in whole or in part through the use of facilities for the transmission of communications by the aid of wire, cable, or other like connection between the point of origin and the point of reception (including the use of such connection in a switching station) furnished or operated by any person engaged in providing or operating such facilities for the transmission of interstate or foreign communications or communications affecting interstate or foreign commerce.

18 U.S.C. § 2510(1).

279. "Oral communication" refers to "any oral communication uttered by a person exhibiting an expectation that such communication is not subject to interception under circumstances justifying such expectation." *Id.* § 2510(2).

280. *Id.* § 2510(5)(a).

281. Briggs v. American Air Filter Co., 630 F.2d 414, 420 (5th Cir. 1980); Watkins v. L.M. Berry & Co., 704 F.2d 577, 583 (11th Cir. 1983).

282. *See* Flanagan, *supra* note 275, at 1269.

283. *See* Wilborn, *supra* note 144, at 842-43.

284. U.S. CONST. amend. IV (providing that "[t]he right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated").

285. Similar protections are afforded under most state constitutions. Flanagan, *supra* note 275, at 1265.

O'Connor v. Ortega,[286] a case dealing with a state hospital official's search of the office, desk, and file cabinet of a physician who was under investigation concerning allegations of mismanagement,[287] all nine Justices agreed that the physician had a reasonable expectation of privacy in his desk and file cabinets.[288] Five Justices went farther and concluded that the doctor also had a reasonable expectation of privacy in his office, when he had occupied the office for seventeen years, had kept numerous personal materials there, had exclusive use of his desk and file cabinets, and had never been discouraged from storing personal items at work.[289] The plurality warned, however, that "[p]ublic employees' expectations of privacy in their offices, desks, and file cabinets, like similar expectations of employees in the private sector, may be reduced by virtue of actual office practices and procedures, or by legitimate regulation."[290] The Court accordingly adopted a test requiring not only a determination of whether the employee had a reasonable expectation of privacy, but also whether the search was reasonable under the circumstances.[291] This latter prong requires a balancing of the governmental interest in the efficient and proper operation of the workplace with the employee's privacy interests.[292]

2. Contract-Based Claims

The argument developed in this Article, I argue, provides the groundwork for both a contract-based claim and a torts-based claim, challenging invasion of privacy and employment terminations. In this Part, I discuss the contract-based claim, while the next section identifies the implications of the theory in the torts area.

Cases like *Rulon-Miller*,[293] in which the courts have looked at the employment contract to define the on/off-the-job boundary, provide an example of the kind of claim that this Article proposes. However, even in cases like *Rulon-Miller*, the analysis falls short of the implications of the model developed here. If the argument developed earlier is correct, employees in a situation similar to the plaintiff in *Rulon-Miller* could point to their compensation arrangement to show that a certain understanding regarding privacy rights had been reached by the parties. This could be done, even in the absence of the kind of language included in the chairman memo to IBM's employees.

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286. 480 U.S. 709 (1987).
287. *Id.* at 712-13.
288. *Id.* at 719.
289. *Id.* at 718.
290. *Id.* at 717.
291. *Id.*
292. *Id.* at 721.
293. *See supra* notes 251-55 and accompanying text.

More generally, the focus that the model developed here places on compensation arrangements suggests that employers do not have a valid claim on the employees' time outside of work. This is particularly true for employees that are paid based on results (RBCs), as well as for employees that are paid by the hour. These employees have made no commitment to the employer, nor has the employer sought such a commitment, other than to the extent of the hour paid or the specific performance sought.

For example, in *Brunner v. Al Attar*,[294] the plaintiff, an employee in an automobile repair shop, was terminated when she notified the employer that she was volunteering to work with an AIDS organization during her free time.[295] The employee told the employer that her volunteering work would not affect her availability for work, that there were no dangers of anyone at work contracting the AIDS virus, and that the customers did not have to know about her volunteer job.[296] The court of appeals affirmed the summary judgment order in favor of the employer, since the plaintiff's claim did not fall under the narrow exception recognized by Texas law to the employment at-will doctrine.[297] Absent from the court's opinion is any discussion regarding any claim the employer might have to control, albeit indirectly, the employee's off-duties activities. Assuming that the plaintiff in *Brunner* was paid by either the results or by the hour, limiting therefore the employer's control of the employee to working time, it is hard to imagine what claim the employer could have on the plaintiff's volunteering activities.

Employees that are paid on the basis of salary (not directly tied to a specific number of hours) might have the weakest argument against their employers in these types of cases. Salary compensation involves a mix of time- and result-based compensation. Employees under salary type compensation are not only paid according to some average number of hours that they might be expected to be at work, but are also compensated on the basis on some expectation that certain results will follow. By defining the required performance broadly enough, employers can claim that achieving satisfactory performance requires the employee to follow certain behavioral guidelines outside of work.

Take, for example, the case of a top executive in a not-for-profit charitable organization whose job duties include fund-raising as well as managing the affairs of the organization. The charitable organization could argue that by paying the individual a salary, the parties have mutually

294. 786 S.W.2d 784 (Tex. Ct. App. 1990).

295. *Id.* at 784-85.

296. *Id.*

297. "That narrow exception covers only the discharge of an employee for the sole reason that the employee refused to perform an illegal act." *Id.* at 785 (citing Sabine Pilot Serv. Inc. v. Hauck, 687 S.W.2d 733, 735 (Tex. 1985)).

agreed that the employee will not engage in any activities that jeopardize her ability to perform her job duties. In that sense, employers can make a stronger argument that the understanding with the employee as to the amount of control the employer has over the activities of the employee extends even after working hours. Such an argument might give the employer a greater measure of control over the employee's off-the-job activities.[298]

A similar contract-based claim can be made in cases involving monitoring of employees' behavior at work. First, the model advanced here suggests that the right to monitor the behavior of employees while at work should be treated as any other term of employment. As such, there is not an a priori reason to expect that monitoring rights are the same across the wide variety of diverse workplaces. While we should expect that all employment contracts would involve some kind of monitoring (either of the performance or the output),[299] not every contract will involve the same understanding regarding the level and amount of monitoring. Accordingly, in deciding disputes over privacy rights, courts should search for information in the employment relationship that illuminates the parties' understanding. The form of compensation to which the parties have agreed provides such information.

The analysis of compensation agreements suggests that result based compensation (RBC) is used when the costs of monitoring efforts are high, and the costs of monitoring output are low. Employees that agree to this form of compensation are accepting the risk of income variability in exchange for higher wages. Employers understand that the costs of monitoring efforts are high and thus see it as a cost saving measure not to be involved in the monitoring of effort: that is, employers are agreeing not to monitor the way employees accomplish their job. Employees in these contracts thus have bargained for greater autonomy in their workplaces. Therefore, unless otherwise specified in their contracts, RBC employees have a strong claim that any attempts by the employer to monitor their conduct on the job are outside the parameters of their employment contract.

Compensation agreements that rely on time (hourly wages and salaries) are used when it is less costly to monitor effort than to monitor output. Under these arrangements, monitoring of work effort is expected. The employer agrees to pay by the time and thus assumes the risk of variations in productivity. The employee is in effect paying for the costs of

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298. *See, e.g.*, Korb v. Raytheon Corp., 574 N.E.2d 370, 372 (Mass. 1991) (rejecting a claim of a defense contractor spokesperson who was fired for criticizing increased defense spending at a news conference, reasoning that the spokesperson statements were directly contrary to the company's financial interests).

299. *See supra* notes 200-13 and accompanying text.

monitoring by agreeing to a lower wage rate. Employees that agree to time-based forms of compensation are in a sense agreeing to a larger degree of employer monitoring of work activities.

It is important to emphasize, however, that even in the case where the employee has agreed to a larger extent of monitoring activity, the employer does not have an "unlimited" right to monitor employees. There must be some correspondence between the amount of monitoring and the wage differential employees have accepted.

In a sense, the basic core idea of the approach advanced here is similar to that of the approach adopted by the Court in the *O'Connor* decision.[300] Workplaces operate under very different dynamics. We should expect employers and employees to make different, jointly maximizing adjustments to their work environments in light of the circumstances they face. The role of the courts, when disputes arise, is to determine what those adjustments were and to give them validity. The information encoded in compensation agreements provides a source of information to accomplish this task.

3. Tort-Based Claims

In addition to the contract-based claims, the framework advanced in this Article might have implications for other kinds of claims. For example, cases like *Shawgo v. Spradlin*[301] appear to be based on the rationale that when regulating the off-the-job activities of employees, employers are exclusively doing so on the basis of business interests, since after all that is what employers seek to maximize. The argument that employers maximize goals other than efficiency (e.g., power) should provide some validity to the argument that employers are overreaching when terminating employees for off-duty activities.[302]

Second, the cases reviewed above also indicate that courts have not paid any attention to the form of compensation as a source of information regarding the nature of the employment contract. In the cases raising the IIED claim, for example, courts have assumed, without any further inquiry, that the act of firing employees for their off-the-job activities is not "outrageous" enough to meet the tort's standard. Courts have reached this conclusion even in the absence of any contract language suggesting off-the-job activities are the basis for employment decisions. This conclusion appears to be premised on the belief that the employer has the right to control off-the-job activities. The framework developed in this Article provides the basis for an alternative argument. An employer's

300. *See supra* notes 286-92 and accompanying text.

301. 701 F.2d 470 (5th Cir. 1983).

302. Bowles, *supra* note 65, at 17.

attempt to justify a dismissal on activities occurring after working hours could be interpreted as an attempt to control the employee during a time period that the parties have not included in their initial agreement. In the context of IIED claims, courts could use this information to help define the contours of actionable conduct. By looking at the compensation arrangement, the argument could be made that there was an understanding that the off-the-job activities of the employee were outside the reach of the employer, and thus any attempts by the employer to control such a sphere in the employee's life by means of adverse employment actions are, by themselves, outside the sphere of reasonableness.

B. *Job Security: The Employment-at-Will Debate*

1. Background

Employment-at-will represents the basic common law rule governing the employment relationship in the United States.[303] Under the at-will rule, the employment relationship is presumed to be at will, unless there is an agreement to the contrary.[304] The major implication of this presumption is that either party can terminate the employment relationship at any time for basically any reason.[305]

Over the last several decades the at-will presumption has been eroded both by statute and by common law.[306] A myriad of statutes, at federal, state, and local levels, prohibit terminating employees for certain reasons. At the federal level, Title VII prohibits employment terminations based on sex, race, ethnicity, or religion.[307] The National Labor Relations Act prohibits employment decisions based on the decision of an employee to engage or not to engage in collective bargaining.[308] Similar protections exist at the state and local levels.[309]

Courts have also created a number of exceptions to the at-will doctrine: the public policy exception, the implied contract doctrine, and the

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303. *See generally* MARK A. ROTHSTEIN & LANCE LIEBMAN, EMPLOYMENT LAW 24-30 (1998). On the origins of the doctrine see generally Sanford M. Jacoby, *The Duration of Indefinite Employment Contracts in the United States and England: An Historical Analysis*, 5 COMP. LAB. L. J. 85 (1982); Jay M. Feinman, *The Development of the Employment At Will Rule*, 20 AM. J. OF LEGAL HIST. 118 (1976); and Andrew P. Morriss, *Exploding Myths: An Empirical and Economic Reassessment of the Rise of Employment At Will*, 59 MO. L. REV. 679, 680-773 (1994).

304. Payne v. W. & Atl. R.R., 81 Tenn. 507, 519-20 (Tenn. 1884).

305. *Id.*

306. ROTHSTEIN, *supra* note 303, at 30-31.

307. 42 U.S.C. §§ 2000e to 2000e-17 (1994).

308. 29 U.S.C. § 158 (1994).

309. For a summary of the various state and local level protections, see RESEARCH INSTITUTE OF AMERICA, INC., EMPLOYMENT COORDINATOR (1999).

covenant of good faith and fair dealing doctrine.[310] The public policy exception involves situations in which the termination of the employee contravenes some explicit, well-established public policy.[311] Under this doctrine, employers are prohibited from firing employees for actions supportive of public policy, as for example firing an employee for refusing to violate the law or for claiming benefits to which the individual employee is legally entitled.[312]

The covenant of good faith and fair dealing doctrine is based on the contract law principle that neither party to a contract should be allowed to engage in behavior that denies the other party the benefit of the bargain.[313] Courts have limited the application of this doctrine in employment cases to situations in which employers engage in "bad faith" actions intended to deny employees benefits and payments already earned.[314]

Lastly, and more traditionally rooted in contract law, is the implied contract doctrine.[315] Under this doctrine, representations made by the employer regarding job security, disciplinary and dismissal procedures, and other employee privileges are treated by courts as enforceable provisions, even in the absence of an express employment contract.[316] Employees raising this exception have relied on employee manuals, performance evaluations, and oral statements made by supervisory personnel, as the contractual basis for the implied promise of some form of job security.[317]

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310. *See* David J. Walsh & Joshua L. Schwarz, *State Common Law Wrongful Discharge Doctrines: Up-date, Refinement, and Rationales*, 33 AM. BUS. L. J. 645, 646 (1996).

311. *See, e.g.*, Foley v. Interactive Data Corp., 765 P.2d 373, 374-418 (Cal. 1988).

312. Cases involving the public policy exception tend to involve an adverse employment action in response to one of the following employees' activities: (1) refusing to perform unlawful acts, (2) whistleblowing, (3) attempting to exercise their legal rights, and (4) performing a public duty. ROTHSTEIN, *supra* note 303, at 921.

313. *See, e.g.*, Fortune v. Nat'l Cash Register, 364 N.E.2d 1251, 1257 (Mass. 1977) ("[I]n every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.").

314. Walsh & Schwarz, *supra* note 310, at 670-71.

315. *See generally* ROTHSTEIN & LEIBMAN, *supra* note 303, at 932-47. The implied contract exception includes both cases based on written and oral communications (*e.g.* Chiodo v. Gen. Waterworks Corp., 413 P.2d 891 (Utah 1966); Wooley v. Hoffman-La Roche, Inc., 491 A.2d 1257, *modified*, 499 A.2d 515 (N.J. 1985)) as well as cases based on conduct (*e.g.* Grouse v. Group Health Plan Inc., 306 N.W.2d 114 (Minn. 1981)).

316. *See, e.g.*, Small v. Springs Indus., 357 S.E.2d 452, 454-55 (S.C. 1987) ("It is patently unjust to allow an employer to couch a handbook, bulletin, or other similar material in mandatory terms and then allow him to ignore these very policies as 'a gratuitous, nonbinding statement of general policy' whenever it works to his disadvantage.").

317. Walsh & Schwarz, *supra* note 310, at 665-69.

2. Implications

As in the area of privacy rights, courts have completely ignored the information this Article suggests is available in the compensation component of employment contracts. The public policy exception, as the invasion of privacy doctrine in the privacy area, is a tort-based doctrine and thus focuses on "third-party" effect of employers' actions. Accordingly, no attention is paid in this context to the particular information that might be encoded in the employment contract. The covenant of good faith and fair dealing exception, while based in contract law principles, does not particularly focus on the parties' specific intent but on some general understanding of fair play. As such, courts applying this doctrine have not looked for information in the employment contract that indicates whether the parties have reached specific understandings regarding job security rights.

The implied contract exception is probably the exception closest to suggesting the kind of questions raised by the approach advanced in this Article. By looking at issues such as whether a specific disciplinary procedure was outlined in the employee manual[318] or whether specific promises were made to the employee regarding the relationship between job performance and job security,[319] courts are inquiring into understandings that the parties might have reached when commencing the employment relationship. However, not even under this approach, have the courts searched for the information I argue is available by looking at the compensation arrangements.

As discussed above,[320] there exists a relationship between the form of compensation and understandings concerning the duration of employment. Pay agreements serve sorting and risk-sharing functions, among others. The sorting function involves the matching of jobs with the "right" kind of employees, while the risk-sharing function involves the allocation of risks between employers and employees.[321] By properly structuring the compensation package, employers should be able to attract employees that are willing to share the risks associated with conditions exogenous to the workplace in a manner employers find efficient.[322]

On a sliding scale comparing time-based compensation and result-based compensation, it could be argued that time-based arrangements are based on an expectation of long-term employment. Employers use time-

318. Wooley v. Hoffman-La Roche, Inc., 491 A.2d 1257, 1258 *modified*, 499 A.2d 515 (N.J. 1985).

319. Ohanian v. Avis Rent-A-Car Sys., Inc., 779 F.2d 101, 104 (1985).

320. *See supra* notes 188-98 and accompanying text.

321. *See supra* notes 188-98 and accompanying text.

322. *See supra* notes 188-98 and accompanying text.

based systems when they are trying to attract specific individuals. For example, salary compensation shifts the risk associated with income fluctuation to the employer and is more conducive towards the internal labor market. Both of these features are likely to be of interest to employees that seek some measure of job stability.

Consider for example, the internal labor markets (ILMs) model. The employment relationship can take a variety of forms.[323] Employers and employees can enter discrete contracts of fairly short duration and with no expectation of continuing employment.[324] These types of arrangements have been described as encompassing what economists call external labor markets (ELMs).[325] ELMs are characterized by large numbers of workers and large numbers of employers.[326] In general, ELMs are considered relatively competitive due to the mobility of workers and the competition among firms for these new workers.[327]

ELMs operate on two basic assumptions. First, the tasks performed by employees are of a general kind, in the sense that there is very little about the task that is specific to the particular organization.[328] "General skills" are learned by employees at their expense and thus require no training from the particular firm.[329] "General skills" are equally valuable to any other firm in the search for the same type of knowledge.[330] Second, within the ELM context there is no expectation of a long-term employment relationship.[331] Both parties to employment contracts within the ELM can terminate the contractual relationship without incurring any substantial loss.[332]

Not all employment transactions, however, are of this form. Some jobs require the learning of skills that are somewhat specific to the particular

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323. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 57-81 (1975).

324. *Id.*

325. Michael L. Wachter, *Labor Law Reform: One Step Forward and Two Steps Back*, 34 INDUS. REL. 382, 385-86 (1995); *see also* Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure, and Relocation*, 136 U. PA. L. REV. 1349, 1353 (1988).

326. Wachter & Cohen, *supra* note 325, at 1357.

327. *Id.* This "ideal" view of the external labor market is realized only under a very detailed, specific set of assumptions (e.g., perfect information, workers' mobility, profit maximization). Where these conditions are not met, market distortions can arise. DOUGLAS L. LESLIE, CASES AND MATERIALS ON LABOR LAW: PROCESS AND POLICY 25-28 (1992).

328. Wachter & Cohen, *supra* note 325, at 1358-64 (distinguishing between firm-specific skills that are not easily transferable to other firms and general skills that are easily transferable across firms within the same industry); *see also* BECKER, *supra* note 109, at 29-31.

329. BECKER, *supra* note 109, at 29-31.

330. *Id.*

331. Wachter & Cohen, *supra* note 325, at 385.

332. *Id.*

contracting firm.[333] These "specific skills" are valuable only to the particular firm, and thus there are no incentives to acquire them within the ELM context.[334] Employees will be reluctant to invest in skills that are only valuable to a particular employer in the absence of some expectation of a long-term employment relationship.[335] Employers will be equally reluctant to train employees in these more specific skills, since there is no guarantee that employees will stay with the firm or will perform in a way that allows the employer to recover the costs associated with the training of employees.[336] Thus, the need arises to devise a mechanism that will create the right kind of incentives for the acquisition of firm-specific skills.[337]

ILMs provide such a mechanism and thus constitute an alternative to exclusive reliance on the use of ELMs.[338] ILMs arise because of the ELMs' inability to deal with employment transactions when there is a need for skills that are specific to a firm.[339] Implementation of an ILM requires the employers and employees to agree to an understanding of a long-term employment relationship.

By internalizing parts of the employment relationship, firms potentially can encourage workers to make long-term investments with them, which in turn produce technological and cost efficiencies for the firm.[340] The "internalizing" involves undertaking certain types of investments in human capital.[341] Employees invest early in their career while learning the skills required by performing a job at a wage rate lower than what they could potentially get elsewhere (e.g., the employee's opportunity wage).[342]

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333. Douglas L. Leslie, *Labor Bargaining Units*, 70 VA. L. REV. 353, 366-67 (describing the relationship between internal labor markets and specific jobs skills). "The key premise of the relational contract model of labor markets is that many job skills are learned on the job and are specific to the firm. *Employees work in teams, and tasks are complex.*" *Id.* (emphasis added). Oliver Williamson et at., *Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange*, 6 BELL J. ECON. 250, 251 (1975).

334. Wachter & Cohen, *supra* note 325, at 1358.

335. *Id.*

336. *Id.*

337. Ramona L. Paetzold & Rafael Gely, *Through the Looking Glass: Can Title VII Help Women and Minorities Shatter the Glass Ceiling?*, 31 HOUS. L. REV. 1517, 1521-24 (1995) (discussing the development of internal labor markets and their application to employment discrimination problems).

338. Wachter & Cohen, *supra* note 325, at 1358 (asserting that ILMs arise because of the costs of job-specific or firm-specific skills); *see also* Wachter, *supra* note 325, at 385-86.

339. Wachter & Cohen, *supra* note 325, at 1358-64.

340. *Id.* at 1360-61.

341. Wachter, *supra* note 325, at 385.

342. Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment At Will*, 92 MICH. L. REV. 8, 12-19 (1993). Professor Schwab provides an excellent analysis of the internal labor markets concept from two different perspectives: the "specific human capital" story

Employees recover their return on their investments at a later point in their careers, when their actual or inside wages are higher than their opportunity or outside wages.[343] Employers, on the other hand, invest at earlier stages in the employee's career, by paying a wage that is higher than that employee's marginal productivity.[344] Employers recover their investment during the employees' mid-career years.[345] At that stage the employee's marginal productivity is believed to exceed the wage paid by the employer.[346]

Central to the ILMs' functioning is the expectation that employees will be attached to the firm for a long period of time or that they will be adequately compensated for their investments in the case of a breach.[347] The employer arguably would not want to lose an employee with specialized training because this would require the training of another employee and result in a corresponding loss in productivity during the training period.[348] The employees, on the other hand, will possess skills that are not readily transferable and will therefore be reluctant to leave employment voluntarily until after they have recovered all of their investment.[349] Thus, to the extent that the parties to the ILM arrangement continue their relationship, their agreement will be fully realized.[350]

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and the "efficiency wage" story. *Id.* Under the "specific human capital" story, investments in firm-specific skills occur under an incentive system in which both parties share the cost and benefits associated with the learning of firm-specific skills throughout the employee's work life. *Id.* at 13. Schwab points out that a critical aspect of the "specific human capital" story is the self-enforcing nature of the employment relationship. *Id.* Since the "specific human capital" story assumes that at later stages in the employment relationship, the employee's productivity is higher than the employee's inside wage; at the same time the employee's inside wage is higher than the employee's opportunity wage; and consequently there is no incentive by either party to terminate the employment relationship. *Id.* at 13-14. Employees have no incentive to leave the firm, since they are being paid more than what they could make in the outside market, and employers have no incentive to fire the employees, since their productivity exceeds their wages. *Id.* Under the "efficiency wage" story, while employees' productivity later in their careers is higher than their outside or opportunity wage, their inside wage, at that stage, is even higher. *Id.* at 15. Consequently, there exists an incentive on the part of the employer to terminate late-career employees, since their wages exceed their productivity. *Id.* at 16. My description of the development of internal labor markets is consistent with Professor Schwab's "efficiency wage" story.

343. *Id.* at 18; *see also* Wachter & Cohen, *supra* note 325, at 1363.

344. Wachter & Cohen, *supra* note 325, at 1361.

345. *Id.*

346. *Id.*

347. Paetzold & Gely, *supra* note 336, at 1522.

348. Wachter & Cohen, *supra* note 325, at 1361.

349. *Id.* at 1363.

350. *See* Paetzold & Gely, *supra* note 336, at 1523; Wachter, *supra* note 325, at 385; *see also* George M. Cohen & Michael L. Wachter, *Replacing Striking Workers: The Law And Economics Approach*, *in* PROCEEDINGS OF NEW YORK UNIVERSITY 43RD ANNUAL NATIONAL CONFERENCE ON LABOR 109 (Bruno Stein ed., 1990) (applying the internal labor model to the issue of strikers'

As this account suggests, employees working in ILMs that are paid on the basis of time are entering employment relationships that include a certain degree of job security. While this expectation is not explicitly spelled out, the compensation structure that is embodied in the contract of employment appears to have a very close, one-to-one relationship with this expectation.

Consider as an example the situation of the employee in *Bay v. Times Mirror Magazines*.[351] While *Bay* involved a challenge under the Age Discrimination in Employment Act,[352] the case is illustrative of the possible application of the framework advanced in this Article. The plaintiff in *Bay* was terminated after complaining about a number of organization changes that affected his immediate position.[353] At the time of dismissal the plaintiff was earning a base salary of $150,000 and was eligible for an annual bonus of approximately $45,000.[354] The Court of Appeals upheld the summary judgment order of the plaintiff's ADEA claim, on the grounds that the employee had not established that the dismissal occurred because of his age.[355]

The result in the *Bay* case could arguably have been different under the approach suggested here. The plaintiff had been employed for over fifteen years and was paid on the basis of salary. An expectation of some degree of job security arguably existed in this case. The employee could have claimed that his compensation agreement involved an expectation of job security similar to that existing under a just-cause employment contract.

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replacements under the NLRA). While solving the problem regarding the acquisition of specific skills that is caused by the discrete nature of transactions in the ELM, ILMs raise problems of their own due to the highly specific nature of the investments that workers and employers may be making in each other. Specific skills are, in a sense, sunk investments. Once these investments have been made, a bilateral-monopoly type of bargaining is created, which is ripe for strategic or opportunistic behavior. "Opportunistic" behavior appears when one party or the other attempts to breach the ILMs arrangement by trying to "expropriate" the returns that the other party expects out of its investments. The incentives for the employer to comply with the implicit contract are significantly reduced once the employer has recouped its investment. Thus, if the employer terminates the employment relationship after the employees have learned the firm-specific skill and the employer has recovered its investment but before the employees are able to recover their investments, the employees' investments will be lost. Similarly, employers' investment could be lost if, during the mid-career years, employees make it more difficult for employers to recover their investments by engaging in behavior such as shirking, withholding information, or otherwise increasing monitoring costs.

351. 936 F.2d 112 (2d Cir. 1991).

352. 29 U.S.C.A. §§ 621-634 (2000).

353. *Bay*, 936 F.2d at 115-16.

354. *Id.* at 114.

355. *Id.* at 117.

The court then should have required the employer to demonstrate that the termination was supported by just cause.[356]

What about employees that are paid on the basis of performance? What does the model advanced in this paper suggest regarding their expectations of job security? The compensation model leads to two major implications. The same logic that led to the conclusion that employees paid on the basis of time operate under an expectation of a longer-term employment relationship would require us to conclude that employees paid under a result-based system enjoy a diminished expectation of job security. RBC is premised on the rationale that employees are willing to accept a greater share of the risk concerning income fluctuations and employment instability. In a sense, these employees appear to have agreed to operate under something akin to an employment-at-will regime.

However, the model suggests that even this group of employees has some legitimate expectation of employment security. This expectation is, however, for a much shorter duration, and it is delimited by the manner in which performance is being measured. That is, employees paid by the result are being measured in terms of their performance. The contract revolves around the employee's responsibility to produce a specific output. The employee's wage is negotiated with this performance measure in mind. The employee's wage is the result of the assessment of the risk associated with stochastic factors that could affect the ability of the employee to achieve the desired result, which in turn includes an expectation that the employee will be allowed enough time to complete the task at hand. A corresponding expectation of job security should accompany the employment relationship. That is, the parties should be presumed to have agreed to an employment contract at least of the duration by which the performance would be measured.[357]

Rowe v. Montgomery Ward & Co.[358] presents an interesting factual pattern. In *Rowe*, the plaintiff, a salesperson paid entirely on commissions,[359] was terminated for leaving the store one day without

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356. *See* Schwab, *supra* note 343, at 44, for an analysis of this case from the life-cycle/internal labor markets perspective.

357. A similar idea indeed preceded the adoption of the employment-at-will rule.

> If the hiring be general without any particular time limited, the law construes it to be a hiring for a year; upon a principle of natural equity, that the servant shall serve, and the master maintain him, throughout all the revolutions of the respective seasons; as well when there is work to be done, as when there is not: but the contract may be made for any larger or smaller term.

1 WILLIAM BLACKSTONE, COMMENTARIES (1765) *425.

358. 473 N.W.2d 268 (Mich. 1991).

359. *Id.* at 270.

explanation.[360] The employer made the following statement regarding hiring:

> When we hired commission salespeople, that's sort of a different type of employee than a time card person. Their main objective, the number one thing was that they must attain their draw of a hundred and twenty-six dollars a week, and generally, as long as they generated sales and were honest, why, they had a job at Wards, and that's the way we used to hire our people.[361]

Several years after being hired, the plaintiff received a handbook from the employer, which contained disciplinary guidelines and a "New Employee Sign-Off Sheet" that included a statement making clear that the employment relationship was at-will.[362] The plaintiff refused to sign the sheet but acknowledged receiving and reading the handbook.[363] The plaintiff's employment continued for another two years until the events leading to her dismissal took place.[364]

While the trial court found in favor of the plaintiff, both the court of appeals and the Michigan Supreme Court found against the employee.[365] The Michigan Supreme Court phrased the issue in terms of whether an employer's oral statements and written policy created an employment contract terminable only for cause.[366] The court found no support for the plaintiff's contention that there existed an implied-in-fact promise limiting the employer's ability to terminate her employment.[367] The court did not consider the implications of the compensation arrangements, on which both parties were in agreement.

The framework developed in this Article suggests a different approach that could have led to a different outcome. First, as a commissioned employee (e.g., an RBC type of arrangement), the plaintiff arguably had a lesser expectation of job security. However, the expectation was not null. As suggested above, even under RBC agreements there is an expectation of job security that matches the period necessary to accomplish the result envisioned in the employment relationship. In fact, the dissent in *Rowe*

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360. *Id.* at 270-71.

361. *Id.* at 270.

362. "I also understand and agree that my employment is for no definite period and may, regardless of the time and manner of payment of my wages and salary, be terminated at any time, with or without cause, and without any previous notice." *Id.*

363. *Id.*

364. *Id.*

365. *Id.* at 271.

366. *Id.* at 272.

367. *Id.* at 271.

raises a similar argument.[368] Justice Levin forcefully argued that since the promise made to the plaintiff stated a durational term, and since it did not require any performance other than that she sell, the plaintiff could only be discharged for nonperformance.[369] Since she was not discharged for poor performance, her discharge, according to Justice Levin was inappropriate.[370]

V. THE MEANING OF SILENCE: A DETOUR INTO CONTRACT LAW

The approach that I have advanced in this Article has implications outside the employment law area. My basic argument is that while the parties only explicitly negotiate over a few terms, those terms contain information that can be useful in solving a myriad of disputes that arise during the course of the employment relationship. To obtain that information, we have to "distill" the explicit contract terms.

A question that still needs to be answered is how to reconcile this argument with traditional contract law doctrine. The problem we face is that there does not appear to be any adequate conceptual legal framework to deal with the set of dynamics identified earlier. We come back to the question raised by Professor Charnay, "Does anti-antiformalism . . . lead us back to formalism?"[371] In this Part, I suggest a possible set of analytical tools that could be used to make the model developed earlier operational.

The question we face is how to incorporate the understandings that I argue the parties have made regarding job security and privacy issues into the employment contract, given that the contract is "silent" about these issues. An initial inquiry is how to characterize the "absence" of the job security or privacy rights terms. Are those terms omitted from the contract?[372]

The development of default rules has been justified on the premise that the employment contract was silent on a particular question and, thus, the court needed to step in to imply the missing terms.[373] That is, the basic

368. *Id.* at 291.

369. *Id.*

370. *Id.* at 292.

371. Charnay, *supra* note 14, at 843.

372. Omissions in contracts are believed to occur in two situations. First, there are cases where the parties foresaw the situation, but made a conscious decision not to address it in the contract. E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS 331-39 (3d ed. 1999). This could occur for a number of reasons, such as informality, the low likelihood that the situation will arise, reluctance to raise the matter, or lack of care in negotiating the contract. *Id.* In the alternative, omissions could occur when the dispute was simply unforeseen. *Id.*; *see also* Binder v. Aetna Life Ins. Co., 89 Cal. Rptr. 2d 540, 553 (Cal. Ct. App. 1999) ("The supplying of an omitted term is not technically interpretation, but the two are closely related. . . .").

373. *See supra* notes 9-13 and accompanying text.

premise has been that the parties have omitted a term or a number of terms from the contract. This practice, commonly used in contractual disputes, has been referred to as the "implication" stage of the process used by courts to supply a term in cases of omissions.[374] Implication requires the court to supply a term to resolve the dispute created by the omission.[375] Courts do this by implying the existence of a term into a contract.[376] Such terms are called "implied-in-law" terms.[377] Implied-in-law terms are found by the court to be part of a contract, even though there is no express contract term to support it[378] nor can the term be inferred from the conduct of the parties.[379]

The implication stage, however, must be preceded by a conclusion that there indeed exists a gap in the contract, that is, that the dispute involves an omitted term. This initial stage, "interpretation," involves a decision by the court that the language in the contract does not cover the particular dispute.[380] In deciding the "interpretation" question, courts use essentially the same analysis that is used to decide cases involving vague and ambiguous language.[381] For example, courts look at "common habits and practices in the use of language"[382] and the characteristics of the agreement itself, as for example completeness.[383] Another factor that has proven to be decisive in various cases is the issue of foreseeability.[384] "If the court is convinced that the parties could not have foreseen [the situation], and therefore could not have intended their agreement to cover [the situation],

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374. "When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court." RESTATEMENT (SECOND) OF CONTRACTS § 204 (1981); *see also* FARNSWORTH, *supra* note 372, at 331-39; Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 273-76 (1985) (discussing the process of supplying implied terms).

375. RESTATEMENT (SECOND) OF CONTRACTS § 204 cmt. c (1981) ("Interpretation may be necessary to determine that the parties have not agreed with respect to a particular term, but the supplying of an omitted term is not within the definition of interpretation. . . .").

376. *Id.* § 204 cmt. d.

377. Implied-in-fact terms are terms that are implied from the conduct of the parties. JOHN E. MURRAY, MURRAY ON CONTRACTS 34-35 (3d ed. 1990).

378. Express terms are terms that are articulated or stated in words, rather than inferred from the language or the circumstances. *Id.*

379. *Id.*

380. *See* Farm Bureau Mut. Ins. Co. v. Sandbulte, 302 N.W.2d 104, 107-08 (Iowa 1981) ("'Interpretation,' the process of determining the meaning of words used, is also a matter for the court to decide as a matter of law, unless it depends upon extrinsic evidence. . . .")

381. FARNSWORTH, *supra* note 372, at 255-62.

382. *Id.*

383. *Id.*

384. *Id.*

the court may refuse to apply the contract language, despite its apparent applicability, and may find that the case before it is an omitted one."[385]

While there is some variance regarding which of these factors is controlling and at what point the court will consider an omission case to exist, it is clear that courts will first go over this step. That is, a court will not supply a term, unless "it has determined that the language of the agreement does not cover the case at hand."[386]

While the courts are not explicit about it, it appears that in the employment law area, the courts have deemed the parties to be silent regarding job security and privacy rights, answering, the interpretation question by concluding that there is an omitted term problem. Having reached that conclusion, courts have then proceeded, under the "implication" stage of the analysis, to supply the missing terms.

It is my contention that the problem created by the "absence" of the job security and privacy rights terms in employment contracts should be addressed in the "interpretation" stage of the analysis, thus limiting the role of courts in supplying contract terms. By properly construing the terms of the employment contract (i.e., the compensation terms), courts should conclude that the parties have reached specific understandings regarding job security and privacy rights issues. The courts will only have to enforce those terms, obviating the need for any "implication."

The focus of the inquiry then becomes what analytical tools courts can use in interpreting the contract so as to "distill" the terms that I argue are embedded in the compensation provisions of employment contracts. It is crucial to note that the need for "interpretation" derives not from "vague and ambiguous" language,[387] but from the imbedded nature of the job security and privacy rights terms of the employment contract.[388]

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385. *Id.*

386. *Id.*

387. *Id.*

388. My argument is that the employment contracts (at least with regard to job security and privacy issues) do not fit the omission cases. First, the "omission" of these terms does not appear to fit any of the reasons normally advanced to justify the absence of a term. For example, it is hard to argue that neither the employer nor the employee thought about the length of the employment relationship or about the ability of the employer to monitor the behavior of the employee at the time the employment relationship was formed. Thus, we do not appear to be dealing with the type of cases involving unforseeability. It might be plausible to argue that the parties might have made a conscious decision not to deal with these issues. For example, employees might not raise the termination terms in negotiations because they mistakenly believe that the law restricts the employer's ability to terminate them to a greater extent than it does. *See generally* Kim, *supra* note 45. Second, there might be signaling concerns; employees may be worried that by raising termination issues they will signal that they are shirkers. *See* Keith N. Hylton, *A Theory of Minimum Contract Terms, With Implications for Labor Law*, 74 TEXAS L. REV. 1741, 1744-45 (1996) (describing efficiency failures in employment contracts).

Accordingly, I suggest that a new concept has to be developed to capture the essence of the kind of terms I describe here.

One way of thinking about these terms is as "proxy" and "underlying" terms. The "proxy" term is the term that appears in the contract and that addresses two aspects of the contract: the direct aspect for which it expressly stands, and the underlying aspect for which it serves as a proxy. The "underlying" terms thus are terms that should be incorporated into the contract via the "proxy" term. In the context of employment contracts, the "proxy" terms are the terms dealing with compensation. The "underlying" terms are the terms dealing with privacy and job security.[389]

These "proxy" and "underlying" terms should be used by the courts in deciding that there are no omitted terms and then substantively uphold their meaning. That is, the courts should read the "underlying" terms into the contract, barring specific language to the contrary in the contract.

In this framework, the key argument is that of establishing the one-to-one relationship between the proxy and the underlying terms. The burden is on the party seeking to incorporate the term to show that the "proxy" term, which was expressly included in the contract, can be related with certainty to the "underlying" term in a particular way. This relationship can be established by looking at developments in our understanding of employment relationships.

VI. CONCLUSION

At a recent conference attended by labor and employment law attorneys,[390] various participants addressed employee privacy rights and raised questions about what access employers could have to the employees' homes when homes become part of the workplace. The suggestion was made that employers should have the same ability to monitor employees at home, as in the workplace. A plaintiff's lawyer in the room asked whether anyone was troubled by such an idea. The

389. Similar constructs have been suggested in the venue of treaty interpretation. *E.g.*, Michael P. Van Alstine, *Dynamic Treaty Interpretation*, 146 U. PA. L. REV. 687, 749-53 (1998). In his groundbreaking article, Professor Michael Van Alstine proposes two interrelated approaches to aid in the interpretation of international treaties and conventions: "deductive general principles" and "inductive general principles." *Id.* Deductive general principles involve distilling "the values involved in the resolution of one normative problem and applying those values to a separate, but analogous, situation. *Id.* at 749. Inductive general principles are derived, on the other hand, by probing the values imbedded in specific provisions and from them deriving general principles. *Id.* at 751. While somewhat different, these two constructs are based on the rationale that a deeper and more prying analysis into the terms of a document (i.e., a contract or treaty) might reveal information essential in the resolution of disputes.

390. Institute of Law and the Workplace Members Conference—1998, Chicago-Kent College of Law.

response by a management lawyer, which most people in the room appeared to accept without much trouble, was that since management is "buying" the employees' time, it is management's prerogative to monitor the employees' performance.[391]

More recently, the following question was posted in an internet discussion group. The message was:

> A manager is sent by his company, at company expense, to a national high tech trade show and conference. Various exhibitors have donated door prizes to be awarded to attendees based on free tickets they have received upon registration. The manager wins the lottery drawing, a valuable prize worth about $12,000. The certificate he receives is in his name so that initial title resides in him. When he returns to his office the corporate CEO informs him that the prize actually is company property and insists that he assigns it or its value to his employer. Question: Does the employer have a valid claim?[392]

The posting generated a good amount of interesting discussion among the list participants. Most of the respondents' initial reaction was that the employer had a valid claim, and thus the employee had to return the prize. Their rationale was primarily that the employee was the agent of the employer, and thus anything he did during the course of employment was on behalf of the employer. A couple of responses suggested that the employee should claim that the raffle was structured in such a way that it was not related to the employee's official duties, and thus that the employee could keep the prize. These responses appear to also assume that since the employee was being paid by the employer to attend the conference, the employer owned all the time of the employee and everything that happened in the course of the employee's employment.

This Article challenges the assumption underlying the responses to these two situations: the assumption that employers and employees are silent with regard to issues such as job security and privacy rights, and thus that default rules such as employment at will should be imposed on the parties. While the employers in the two scenarios just described could

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391. Similar concerns have already been raised in the national labor and employment law community. *E.g.*, Victoria Roberts *Analysis and Perspective—Attorneys Say Employees' Use of E-mail Creating Possible Legal Pitfalls for Employers*, Daily Lab. Rep., July 6, 2000, at C1 ("The components of an employer's e-mail policy are 'pretty clear cut within the four walls of the office, but once you're out hither and yon,' things get more complicated.").

392. Posting of Jordan Leibman, jleibman@IUPUI.EDU, to ALSBTALK@LISTSERV.MUOHIO.EDI (Mar. 15, 2000) (contributing to the discussion group of the American Legal Studies in Business Association) (copy on file with the author).

claim a right to monitor the employee who works at home to the same extent of the employee that comes to the employer's premises and could also claim the prize won by the employee while attending the conference, there are not a priori reasons why such claims should be deemed valid. The court should inquire into the nature of the various components of the work contract on which the parties were explicit, such as the compensation terms, and then inquire into what insights such terms bring into the dispute at hand. Employees should be allowed to raise the argument that the nature of their contract reflects the intent to limit the control the employer has over the employee in both of the above scenarios. More broadly, this Article suggests a new vision of employment contracts, a vision which parallels the recent debate on commercial law between "anti-formalism" and "anti-antiformalism." This Article illustrates that commercial law and contract law have experienced parallel developments regarding the development and use of default rules, gap fillers, and other interpretation strategies. This Article suggests some preliminary ideas in the development of a neo-formalist jurisprudence.