Why Are There Explicit Contracts of Employment?

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Abstract: In this paper we explain the prevalence of explicit contracts of employment, particularly those that embody high- rather than low-powered incentives and clauses that supersede the common law defaults. Our analysis is based on an understanding of two fundamental problems that arise when agency relationships are established between a worker and firm. The first is that agency relationships often require the creation of specific property rights in order for firm owners to realize productive efficiencies of scale or scope from agency. The second is that the economic characteristics of the agency relationship, which generally entail the transfer of specific "process rights" to agents, are often quite different from the nature of agency characterized in and supported by the common law. The implication is that implicit employment contracts supported by the common law are incapable of effectively governing employment relationship characterized by these two problems. Thus, explicit contractual provisions are required in the employment relationship.

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Why Are There Explicit Contracts of Employment?

The purpose of this paper is to explain the prevalence of explicit contracts of employment, particularly those that embody high- rather than low-powered incentives and clauses that supersede the common law defaults. Unlike the "employee or independent contractor" issue, which is a question of organizational boundaries (see James, 2000), this paper examines the problem of "explicit or implicit contracts" *within* the employment relationship. We argue that the explicitness of contracts of employment is generated by both economic *and* legal aspects and is much subtler than the analysis of the make or buy problem. Explicit contracts of employment become important when workers are integrated into the firm as agents and when they are given significant discretion over firm assets. As we explain below, two fundamental problems arise when agency relationships are established between a worker and firm that require an explicit rather than implicit contractual solution. The first is when agency relationships require the creation of specific property rights in order for firm owners to realize productive efficiencies of scale or scope from agency. In this context the common law defaults forming the basis for the existence of the implicit, "at-will" employment contract are fundamentally ill equipped to govern agency relationships because they cannot create the internal property rights necessary to align the interests of both the principal and agent. Consequently, firm owners are forced to rely on imperfect and costly explicit contracts to align the interests of employees with those of firm owners by creating specific property rights and by formally detailing the rights and duties transferred between principal and agent. The second is that the economic characterization of agency differs from the way agency is characterized in and supported by the common law. According to the law, an agency relationship is characterized by the authorization of the agent to conduct business transactions with third parties in the name of the principal.

Economic agency, on the other hand, typically involves the transfer of specific "process rights" from the principal to the agent, such as the discretion to choose the means by which a task is done or the right to control the use of a company asset. Process rights are distinguished from residual "product rights," which principals generally retain when agency relationships are created. Thus, a "gap" exists between the economic and legal treatment and support of principal-agent relationships requiring a formal contractual solution and the creation of specific rights in employment as a bridge between economic agency and the common law.

While our paper is not the first to examine the differences between explicit and implicit contracts of employment (see Bull, 1987; MacLeod and Malcomson, 1989; and Schmidt and Schnitzer, 1995), ours moves the topic from the narrowly microfoundational concern of whether implicit contracts are self-enforcing to the institutional context within which implicit employment contracts actually exist – namely, the common law and the employment relationship. Moreover, while the nature and boundaries of the firm and employment relationships have been well canvassed in the transaction cost and property rights literatures, the evolution of explicit contracts in the face of implicit "at will" employment supported by the common law have not been adequately addressed. Observability of production and performance, adverse incentives, and monitoring issues germane to these analyses are largely framed by the neoclassical conceptions of the firm and market, with institutional structures, including the legal framework in which employee-employer contracting decisions are made, in the background. As a result, the explicit internal contract required to create internal (or inside the firm) and external (or outside the firm) property rights within large-scale hierarchical organizations, Marshallian industrial districts, business networks and the like have largely been ignored. For example, explicit management or employment incentive contracts create and truncate both external and internal rights between employer and employee. But why do such contracts exist if common law defaults would otherwise be capable of governing the employment of employees, including top corporate managers? And why do these contracts have relatively high-powered stock and other performance incentives when, as Williamson argues, high-

powered incentives are not conducive to internal organization (1985, chapter 6; 1988; 1991)? This paper fills gaps in the transaction cost literature by showing that explicit contracts are necessary to exploit productive efficiencies inherent in certain organizational forms that cannot be captured or sustained through implicit contracts supported by the common law within the existing institutional structure. Additionally, by aligning interests and allowing firm owners to capture dynamic internal productive efficiencies, particularly by the retention of new employees, explicit employment contracting suggests organizational advantages superior to other institutional responses, such as employee-owned companies.

The paper is organized as follows. The first section describes the limitations of transaction cost economics and the property rights view of the firm in justifying the prevalence of explicit contracts in employment when implicit contracts supported by the common law confer important control rights to the employer. In section two we draw distinctions between traditional and modern employment, economic and legal agency, and product and process rights, and we explain how these distinctions can justify the use of explicit employment contracts in resolving the common law problem. In section three we link the use of explicit contracts to agency relationships and the allocation of product and process rights within organizations. Finally, in section four we offer some concluding comments, including a response to the obvious question of why, if explicit contracts arise in firms, owners will employ workers at all.

1. Organization of the Firm

1.1. Transaction Costs and the Employment Decision

Under the transaction cost view, firms *are* the institutional response to the existence of transaction costs in the market. Firms are hierarchical, vertically organized institutions creating nesting principal-agent relationships so as to organize production in a manner that economizes on search and information costs, bargaining and decision costs, and policing and enforcement costs that are associated with "market" transactions. According to the transaction cost framework, the specific contractual relationship linking workers to the firm is discriminatively linked to the governing structure (Williamson,

1979), in the sense that a particular governing structure is linked to a particular type of contract. To be specific, when a firm uses independent contractors, the contracts established are relatively explicit, with the actions of workers bilaterally determined *ex ante*, and the performance and other risks shared between the worker and firm owner. Additionally, compensation is "high-powered" in the sense that it is tied to contractual performance by the worker. When disputes arise over contractual performance, parties can turn to the courts for adjudication. In short, markets govern explicit contracts embodying the *ex ante* determination of performance coupled with high-powered incentives.

When a firm internalizes workers as employees, according to transaction costs economics, the workers are placed within a hierarchal structure subject to a manager who, to varying degrees, controls, monitors, and evaluates their activities. Performance risks are largely assumed by the firm owner, who determines the actions of the worker *ex post* in exchange for a wage payment that is, at least compared with markets, relatively flat or low-powered. With the exception of issues of workers rights and termination violating public laws or policies, courts will generally refuse to adjudicate disputes "internal" to the firm (Williamson, 1991). And, as we explain below, contracts in this case do not have to be explicit, because common law defaults are effective at governing contractual relationships of this type. In short, employment governs relatively implicit contracts between the firm and workers, in which workers are managerially controlled *ex post* and paid relatively fixed wages. Employment, as described here, is important from the transaction cost perspective because the total costs associated with production when workers are employed – which costs include transaction, management, and production costs – is often lower than the total costs associated with production when workers are linked to the firm as independent contractors (see Demsetz, 1988). Typical reasons why employment may be preferred to independent contracting include search and contracting costs (Coase, 1937), uncertainty (Simon, 1951), team production externalities (Alchian and Demsetz, 1972), and monitoring and bonding problems (Jensen and Meckling, 1976; Holmstrom and Milgrom, 1991).

The problem with the transaction cost framework when applied to the employment of labor, as opposed to the ownership and control of physical assets, is that the boundary or governing question – whether workers are brought into the firm organization as employees or retained through the market as independent contractors – is not the same as the contracting question – whether workers are managerially controlled and paid fixed wages or granted discretion and paid incentive wages. For instance, transaction cost savings in employment contracts that allow management to determine and direct the activities of workers can also exist in market contracts "by the adoption of broad and vague commitments in contracts for services" (Collins, 1993, p. 765). Moreover, employment is not automatically linked to managerial control and the payment of fixed wages, since transaction cost explanations for employment can also be used to explain the specific form the contract takes that links the worker to the firm, but these are separate effects (James, 2000). Transaction costs affect the degree to which workers are subject to direction or are granted discretion by firm owners and, as a result, impact the manner and extent to which owner authority is delegated (James, 1998). Furthermore, many employed workers are not governed by implicit contracts but rather sign explicit contracts with features that mirror the high-powered incentives and clauses adopted in market contracting. To be sure, there are really three distinct, though related, questions transaction cost economics must answer with respect to the issue of how workers are connected to the firm. The first is the governance question (employment or independent contracting). The second is the contracting question (fixed or incentive wages). The third is the explicitness question (implicit or explicit contracts). Though many employed workers are governed consistent with the transaction cost explanation, in the sense that their employment is equated with fixed-wage contracts and managerial control and with non-explicit contracts relying on common-law defaults, some employees are not. Why some employed workers are granted significant discretion over their activities, have high-powered incentives, and sign detailed contracts of employment is an important issue that transaction cost economics has not adequately explored.

1.2. Property Rights, Reserved Rights, and the Common Law Defaults

The property rights view of the firm states that the firm differs from the market in the ownership of physical assets (Hart and Moore, 1990; Moore, 1992). The advantage of ownership within a firm organization comes from the ability of management to control economic assets and activities of workers without the need for costly and repeated bargaining between workers and asset owners (Alchian and Demsetz, 1972). When contracts involve the use of physical assets, as in plant machinery, market contracting may give way to integration, or a transfer of ownership of physical assets when market contracting is expected to result in potential hazards that cannot be resolved by the language of the contract or by courts at relatively low cost (Klein, Crawford, and Alchian, 1978) or when the surpluses generated by assets are sensitive to the actions taken by workers (Hart and Moore, 1990). By acquiring ownership of physical assets, owners acquire property rights over those assets, meaning they are entitled to use, alter, transfer, and destroy the assets as they choose, as well as to exclude others from using, altering, transferring, and destroying the assets, with the obvious restrictions that such actions do not endanger human life or result in the wanton destruction of the surrounding environment. Without ownership, however, the ability to use, alter, transfer, destroy, or exclude is governed by contractual relations. The integration of human capital differs from the integration of physical assets because laborers cannot be "owned" in the same sense that physical assets are owned. An "acquired" worker cannot be destroyed, sold, or physically altered, for instance. The actions of workers may be controlled only through contractual means. The relationship between an owner of human capital (laborer) and a firm owner is always governed by *contract* rather than by *ownership rights*.[1] Parties entering into a contractual agreement are free to bargain over the specific contractual provisions without the threat of unfettered dominance by one party. Workers supply their services to firms because they believe it is in their interest to do so, not because they are coerced into the agreement. And, of course, they are capable

of walking away from the contract, while "owned" property is not. Employment is important from a property rights perspective because the common law vests certain nonreplicable cost or production advantages to the firm *qua* employer. The advantage of employment over market contracting is rooted in the legal precedents and doctrines that have developed in case law defining the relationship between an employer and employee. These precedents exist independent of the existence of a formal, written employment contract or an implied-in-fact contract inferred from company bulletins, handbooks, or published personnel policies. They are in essence defaults that govern employment when not expressly superseded by formal bilateral agreements. For instance, the rule that employment is "at will" is "implied in the absence of explicit agreement on the question of duration or grounds for termination" (Epstein, 1984, p. 951).[2]

Employment relations as supported by the common law defaults provide two basic advantages over external, market contracting. The first is that firm owners and workers can economize on the costs of negotiating and drafting agreements by accepting the legal defaults as the basis for the contract linking the worker to the firm (Masten, 1988). Firm owners and workers can utilize the common law defaults in framing the employment relationships because they are uniform and general. Accordingly, employers and employees need only to agree on a wage payment and the time period during which workers will supply their labor to the employer. However, the actions of workers must still be coordinated. In the absence of bilateral agreements between the firm owner and worker that stipulate what services the worker will provide and how those services will be integrated into the production process, how is such coordination accomplished? The second advantage of employment as supported by the common law is that the default conditions defining the employment relationship also define the right of firm owners or their representatives in management to control and coordinate the actions of employed workers in the absence

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[1] See *U.S. v. Wholesale Oil Co*., C.C.A. Kan., 154 F.2d 745; *Ledoux v. Joncas*, 204 N.W. 635, 163 Minn. 498; *Schmuesen v. Copolin*, 192 N.E. 123, 99 Ind.App. 209. These cases recognize the "contractual" nature of the employment relationship. See also Alchian and Demsetz (1972) and Cheung (1983) for similar conclusions.
[2] The "at will" rule "default" has been codified under California law (Cal. Labor Code § 2922).

of explicit contractual agreements. These rights are "reserved" to management and are "supreme in all matters except those it has expressly conceded . . . and in all areas except those where authority is restricted by law. Put another way, management does not look to the [employment contract] to ascertain its rights; it looks to the agreement to find out which and how many of its rights and powers it has conceded outright or agreed to share with [the workers]" (Prasow and Peters, 1983, pp. 33-34). Absent contract, public policy or legal restrictions, employers are free to assign projects to workers and to modify what tasks employees engage in, just as asset owners are free to use their capital in ways they desire. For this reason, the integration of physical assets through ownership and the integration of labor through the employment relationship are often considered one and the same. Masten (1988) concurs by stating that "there is no substantive difference between the power of a manager to direct an employee and an owner's ability to restrain the use or removal of an asset. Just as control over individuals is influenced by the rules and penalties prescribed in the law, so is control over physical capital" (p. 208).

Although the common law provides the basis for integrating workers into a firm without required detailed explicit contracts of employment, the property rights view of the firm does not explain why some workers actually sign detailed, explicit contracts of employment.

1.3 Limitations of the Common Law "At Will" Employment Relationship

A firm owner's right over physical assets is critically distinct from its common law right to direct and control the actions of workers. The common law defaults and the reserved rights of control they confer to management vest no affirmative property rights *to* the employment and post-employment relationship for either the firm owner or worker. While firm owners may have "property rights" over company assets and have the "reserved right" to assign tasks to workers, the common law does not create for the firm owner property rights to the labor services of employed workers, since workers are free to

leave employment "at-will."[3] That is, according to common law doctrine, the right of management to direct the actions of workers exists only so long as workers choose to remain employed in the firm. When an employed worker terminates employment "at-will," the reserved rights of the firm owner to direct and control the actions of workers ends. Similarly, workers do not have property rights to employment in the firm, since workers may be terminated at any time for any reason, or for no reason at all, absent specific contract or public law exceptions. Employees cannot sell their employment or the positions they hold in the firm, since employees possess no property rights to their jobs. Moreover, outside of the employment relationship, neither workers nor firm owners have property rights over the other party once employment has been terminated. For instance, firm owners may not restrict where and under what conditions former employees work, since the common law does not grant to owners property rights over such activities. In short, the common law does not create or support specific property rights to employment that have not been *explicitly* negotiated by the employer and employee.

The inability of the common law defaults to grant specific and tailored property rights to or in the employment relationship provides the economic and institutional foundation necessitating explicit contracts of employment. Likewise, even when the common law defaults are inapplicable, public policy exceptions to "at will" employment, such as anti-discrimination laws, only create general property rights that explicit contracts of employment can tailor. Many commentators have suggested that firms and markets defy precise economic definition because they often share similar characteristics relating to contracting (Cheung, 1983). But the similarity is not that firms are a "nexus of contracts." Explicit contracting may be required to establish internal property rights between employees or between employer and employee so as to exploit existing internal production efficiencies and to develop others by

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[3] The "at will" doctrine states that employees may be fired for "good cause or for no cause, or even for bad cause" (*Payne v. Western & Atlantic Railroad*, 81 Tenn. 507 [1884] at 518-519) and is acknowledged in the United States by the U.S. Supreme Court in *Adair v. U.S.* (208 U.S. 161 [1908]). Subsequent case law and public policy requirements, however, have modified the "at will" doctrine by placing some restrictions on employers from unilaterally firing workers. For instance, employers generally may not terminate employees on the basis of race, sex, age, nationality, or religious beliefs (Title VII of the 1964 Civil Rights Act, 42 U.S.C. Sec. 2000e-2).

expanding core business competencies, not unlike the contracting required to allocate external property rights and to exploit productive efficiencies attendant to complex market exchanges.

2. Employment and Agency Relations

Employment offers firm owners important advantages over independent contracting because of the hierarchal structure of firm organization and the resulting "reserved rights" of management to direct the activities of employees and because explicit contracts do not have to be established with each individual "employee." These advantages are based on the fact that the common law defaults are general enough to be applicable in a variety of employment settings and are consistent with the "traditional" concept of employment in both economics and the common law (Bishop, 1991). An employee, according to traditional economic and common law principles, is one who has little discretion but is subject to considerable direction by superiors. In the transaction cost literature, traditional employees are employed for the purpose of being "told what to do" by company managers.[4] Traditional employees are governed by the common law defaults rather than explicit, formal contractual agreements because it is for "traditional" employment that the common law defaults are best suited. Oral agreements, or written contracts if they exist, between the firm owner and worker are usually simple documents that specify the wage the employer will pay the worker and the hours or time period within which the worker will work. All other terms are implicit in the law.[5] The obligations of the worker are to work during the specified hours, to follow the instructions of the employer, and to work adequately. While the employer is obligated to pay a wage and to give reasonable notice of termination, employment is not considered to be long-term or permanent but rather indefinite, thus making employment "at will."

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[4] Examples include Holmstrom and Milgrom, who describe employment in part as having "significant restrictions on worker freedom" (1994, p. 973), and Milgrom and Roberts, who liken employment to "the traditional assembly line .. [in which] individuals on the line have little or no discretion about what they do and how they do it" (1992, p. 114).

[5] *Walker v. John Hancock Mutual Life Insurance Co.*, 79 A. 354, 80 N.J.L 342.

Modern employment relations consist not just of direction but also of direction *and* discretion. Many employed workers are granted a wide degree of authority to make decisions and act almost independent of formal review and supervision by firm owners. Indeed, under many circumstances employers voluntarily give up their rights to manage the activities of employees by making them "agents." For instance, stockholders, acting through the board of directors, grant authority to top management to make the day-to-day decisions regarding production and distribution within and outside of the firm, and firm owners empower sales representatives to enter into contracts on behalf of the firm. In both cases the workers – top management and sales representative – are agents of their principal, the employer. The granting of discretion and authority to senior management, sales representatives, and others is not the same contractual relationship as workers employed in the traditional sense explained above. In fact, we should expect the contractual relationship to change substantially if stockholders considered top management "servants," paid them wages, and subjected them to traditional forms of hierarchical control and managerial oversight.

Both the law and economic theory offer important insights into the employment relationship when workers are made agents and are given authority over the actions they may take on behalf of the firm. Nevertheless, the legal and economic treatments of agency differ in significant respects and thus have important implications for contracting in employment relations.

2.1. Economic Agency

According to economic theory, an "agent" is a person who is granted authority to act for a principal or who is delegated some rights over a resources owned by a principal (see Ross, 1973; Grossman and Hart, 1983). The nature of the agency granted to workers from the economic perspective involves in part "discretionary rights," such as discretion over how workers are to do their work. For example, workers may be granted discretion in choosing the order in which the steps of a production process occur or how tasks are to be allocated among members of a group. "Modern" employment is

consistent with this characterization in the sense that a modern employee may be given discretion to take actions on behalf of the employer (Stiglitz, 1989; Bishop, 1991). Thus, Rosen (1984) states that employment is not only authoritarian but also may contain "elements of delegation in which the employee is given latitude within broad limits to behave in the interests of the firm" (p. 986). Aghion and Tirole (1997) distinguish between "the right to decide" and "the effective control over decisions" and show how the different types of discretionary authority may be allocated among decision makers within an organization. Furthermore, James (1998) finds evidence that the amount of discretion, or agency, employees have varies according to transaction cost factors, suggesting that employment is not strictly "managerial control" in the traditional sense.

Workers linked to firms through the modern employment relationship differ from workers linked to the firm according to traditional employment in more than the amount of discretion workers have over decisions they may make. To exploit, develop, and expand a firm's productive efficiencies often requires the transfer of ownership attributes to the employee, typically involving the employee's authority to control and allocate physical and human capital. As such, when a firm owner and worker enter into an agency relationship, they negotiate not only over the discretionary authority and its limitations granted to the employee, but also (implicitly) the transfer of property rights over economic assets owned by the firm or created by the delegation of authority and direction. Firm owners generally seek to retain residual rights to income and the residual right to terminate an employee's right to control and direct the firm's assets, but actual control rests with the employee. While not unlike that envisioned by Grossman and Hart (1986) and Hart and Moore (1990), the residual right of control retained by the firm owner is the right to terminate specific rights previously vested to its agent-employee. For example, when a storeowner hires a worker to manage her store, she may transfer to the worker discretionary authority over when to offer discounts on store merchandise, as well as the property right to operate the cash register and the discretion to hire other employees to operate the cash register. In fact, she may even transfer all property rights over the cash register to the store manager, including the right to sell the

machine. In this sense, the store manager has "internal property rights" over the cash register, since he not only may use the machine but also exclude others from using it. In return for the transfer of discretionary and internal property rights, however, the agent is required to account for and turnover to the principal the "residuals" or sale proceeds from the sale or production process.

Because the agent is granted certain discretionary and internal property rights, with the principal contractually retaining "residual rights" to the agent's products and actions, the modern agency relationship results in certain "*process* rights" contractually vested in the agent – discretion, rights to use company assets, etc. – while vesting certain "*product* rights" to the principal – residuals generated by the agent. This differs from traditional employment in which the "reserved rights" of firm owners *de facto* vests both product and process rights with owners; under traditional employment, the firm owner not only directly controls and monitors the actions of the employee but also retains the surplus produced by that worker. It also differs from independent or outside contracting in that workers linked to firms through "outside" contracts often results in *both* product and process rights adjusted between owner and independent contractor as they negotiate over the allocation of risk and the gains from trade. Nevertheless, to effectively exploit these internal economies arising from separable process and product rights, express or explicit contracts are required. Explicit contracts, with, among other things, high powered incentives, are best suited to exploit the uniqueness of each firm's processes, products, organizational hierarchy, and market environment because they are able to incorporate unique sets of employment property rights. The general and uniform standards and defaults of the common law are simply ill equipped to exploit modern firm and employment competencies.

2.2. Legal Agency

According to common law principles, an "agent" is a person who is authorized, subject to certain implied fiduciary duties, to conduct business with third parties on behalf of the person or entity that has hired him. Thus, from a legal perspective, workers who are made agents have *legal power to bind the*

employer in contractual relationships with a third party. "An agent is not only employed by the principal but represents him as well, and is the business representative of the principal, acting not only for him but in his place and stead whereas a servant simply acts for his principal and usually according to his direction and without discretion" (2A Corpus Juris Secundum §16, p. 578). For example, an employee who is legally an agent of her employer may enter into a contract with a customer, set contractual terms and prices, and otherwise obligate her employer to perform the contract that she, the agent, has negotiated with the customer.

Agency relationships may be inferred from circumstances or implied by law. The agency relationship may also be expressed through formal, written contractual arrangements. The critical element of any agency relationship from the legal perspective, however, is a delegation of actual (or apparent) authority for the worker to represent the principal in dealings with other parties. That is, the principal delegates its authority to do business with third parties to the agent and, as to these third parties, the agent is the principal and through the agent's conduct, binds the principal.[6] By delegating its authority, the principal (ex ante) divests both its control and supervision over the agent as well as the principal's relationship to the third parties.

2.3. Agency Relations and the Common Law Problem

There is considerable overlap in the treatment of agency in both economic theory and the law, which suggests that many principal-agent agreements in employment can be governed by common law defaults. For example, the discretion granted to a worker from an economic perspective may be to enter into a contractual agreement with a third party, consistent with the common law characterization of agency. As an illustration, consider a sales clerk in a retail establishment who is authorized to sell a product for the listed price to any customer in the store willing to pay the price. To the store owner, the

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[6] See *2A Corpus Juris Secundum §16* and *Restatement (Second) of Agency §§1-et.seq* for a complete description of how the law distinguishes between "master-servant" and "principal-agent" relationships.

clerk is an agent in the legal sense, since the offer to pay for a product by a customer, when accepted by the sales clerk, legally requires the store owner to transfer ownership of the good to the customer and in many cases further obligates the store owner to warrant the product for product defects. But if the sales clerk is not authorized to renegotiate the price and terms of sale with the customer, then the degree of discretion granted from an economic perspective is minimal. In general, when a firm owner hires a worker as a traditional employee – that is, one who is not granted significant discretion or allocated internal property rights – then the firm owner may economize on contracting costs by relying on an implicit contract, the common law defaults, and the reserved rights of direct managerial supervision, even when the worker is an agent in the legal sense. These common law defaults provide general and self-enforcing contractual safeguards and require only low-powered incentives to coordinate the activities of the traditional employee, which is why it is not necessary for firm owners to formalize the employment relationship with explicit contracts.

However, suppose the sales clerk is authorized to negotiate the selling price and other contractual terms with a customer or to purchase equipment or inventory for the store. How sufficient are the common law defaults governing the traditional employment relation when the agent's discretionary decision-making authority is expanded to include not only dealings with (third party) customers but also decisions regarding the terms and circumstances under which a sale occurs and what company-owned assets are acquired and how they are used? Precisely when agency arrangements involve complex negotiations over the transfer of discretionary and physical property rights, a "gap" emerges between the economic problems of agency and the relatively more narrowly-focused legal treatment of agency based on third-party liability, which may require an explicit and costly contractual bridge that supersedes the common law defaults governing employment and simple agency relationships. Moreover, the very act of establishing an agency relationship in the economic sense requires an agreement over the terms and conditions that are specific to the transaction negotiated between the worker and firm owner. Because the common law defaults governing employment are general and uniform, they are inconsistent with the

specific requirements of many agency relationships. Furthermore, while the myriad of transaction cost factors may impact the scope of the agency relationship or the contractual specificity arrangements required to address the corresponding agency "problem," it is the agency relationship itself, the delegation of authority, and the transfer of property rights that require contractual solutions to align the worker's interests with to the firm's interests. As a result, articulating and defining appropriately explicit agency incentive structures in the face of monitoring and other contractual costs are some of the central problems of the economic theory of agency, involving such issues as delegation (Jensen and Meckling, 1992; Minkler, 1993; Aghion and Tirole, 1997), job design (Holmstrom and Milgrom, 1991; Hirao, 1993; Valsecchi, 1996), and the control of agents (White, 1992; Fumas, 1993).

Nevertheless, these problems more generally require solutions based on *explicitly* negotiated specific contractual safeguards in addition to the focus on incentive structures. Williamson (1985) states that the integration of workers in the firm "is regularly attended by an impairment of incentives." (p. 161). But the "impairment of incentives" is further attenuated by the "disintegration" of property rights *in the firm*, if agents act *on behalf* of the firm. Implicit contractual relationships and common law defaults are appropriate for workers with minimal discretion and few rights to control firm assets absent direct supervision. The common law defaults do not, however, provide the required specificity needed to resolve and govern the incentive problems arising in modern employment relationships characterized by discretionary agency attributes and broadly granted property rights over specific company assets.

3. The Explicit Employment Contract Requirement

In traditional employment relationships, the common law defaults and the mutual right to terminate the employment contract "at will" provide sufficient governance structure and incentives for parties to enter into employment contracts characterized by direct control and supervision. But the mutual right to exit (ex post) does not provide an adequate governance framework for employment relationships characterized by employee discretion and agency attributes establishing potential (third party) liability

when the agent possesses broad discretionary decision-making authority to act in the name of the principal and use organizational assets. Increases in discretionary authority given by employers to agent-employees must be accompanied by adjustments to the contractual agreement that replace the low-powered incentives of traditional employment. Until the common law evolves to accommodate these relatively more complex "modern" agency relations, explicit contractual provisions and high-powered incentives that create economic loyalty between the employer-principal and employee-agent are therefore required. However, such an evolution is not likely to occur because modern employment-agency relationships require the creation of specific property rights to employment and post-employment as contractual safeguards to the agency problem, particularly when agency requires the transfer of "process rights" to the employees. But the creation and maintenance of specific employment rights are not consistent with the general and uniform framework of the common law.

Traditional neoclassical economic theory largely equated the "firm" with the underlying production function. The firm was merely a costless transformer of inputs into outputs. Nevertheless, the firm is not a production relationship; rather, the firm is an institutional structure through which production occurs, and resources are typically directed by employees and not capital owners with rights to the residual product. That is, process rights are often vested in employees, and not employers. The creation of specific employment rights, such as specification of duties, "just cause" termination restrictions or penalties, seniority enhancements, severance pay, stock option rights, buy-out terms and other "high powered" incentives, and post-employment rights, such as covenants not to compete and confidentiality provisions, are required to exploit the organizational and productive specialization that occurs as firms seek to retain their residual product rights and align employee interests as they delegate process rights to their employees. For example, employees must be afforded property rights in employment when workers have discretion to propose and implement labor-saving processes that may cost them their jobs or be provided favorable post-employment severance packages to maintain employment in the face firm downsizing. Post-employment rights, such as covenant not to compete

provisions, reduce the likelihood that the employer's delegation of process rights and investment in an employee's core competencies will be dissipated by restricting the employee's post employment opportunities.

The common law has not, and cannot, integrate these common elements of employment contracts to govern all employment relationships. Common law defaults – incorporating the "at will" terms – are uniform and accurately reflect the employment terms that owners and workers would have entered into absent the delegation of meaningful process and agency rights. Thus, relative to ex post administrative costs, the acceptance ex ante and utilization of these defaults results in relatively lower overall contracting costs for the firm owner. In all other situations in which economic agency prevails, employment rights would be expressly negotiated since meaningful employment and post-employment terms must be specific to the firm, product, process, and market. That would still be the case even had the common law implied or afforded general employment rights. For example, the erosion of "at-will" employment through public policy exceptions has resulted in firms adopting explicit contract terms that limit or tailor enforcement of these implied rights. The reason is that, under modern employment relationships, explicitly-negotiated employment (presumably) results in lower ex ante contracting costs relative to the ex post administrative costs of any alternative "just cause" rights that could be embodied in the common law.

The common law is incapable of generating specific contractual safeguard rights in the employment relationship, yet the creation of such rights is necessary to govern agency relationships characterized by the transfer of discretionary and internal property rights to agents, and residual product rights to principal. And, at the firm level, if there were no productivity gains from agency relationships that arose through the delegation of ownership attributes, there would be no reason to incur the contracting cost associated with explicit employment contracts.

4. Conclusions

Why are there explicit contracts of employment, when employment can be governed by common law defaults or market contracts can be devised to govern the services of workers? Explicit, formal contracts of employment are designed to supersede specific aspects of the common law governing the employment of labor in two fundamental ways. First, they separate process and product rights, with many process rights being transferred to employees *qua* agents. These process rights consist of rights to act, or discretionary rights, and internal property rights over company assets. Generally, firm owners formally retain product rights, or rights to the surpluses created by the productive capabilities, efficiencies, and core competencies of human and physical capital organized as a "firm." Explicit contracts are necessary to formally separate and allocate these different rights because of a gap that exists between economic and common law characteristics of employment when firm owners choose to "integrate" workers and when they make them agents. While both the law and economics considers an agent to be someone who is authorized to act for and in the interests of the principal, the nature of the characterized actions are fundamentally different in economics and the law. According to economic theory, an agent has discretion over how work is to be accomplished and may also have substantial control rights over company assets, while under common law an agent has authority to bind the principal contractually with a third party.

Second, explicit contracts create and allocate certain employment and post-employment property rights. We argue that the common law is inherently incapable of creating such rights *to* employment, which are often necessary contractual safeguards to help align the interests of principal and agent when organizational process rights of discretion and internal property rights are transferred to employees so as to exploit internal scale and scope efficiencies. Employment rights may consist of termination for "just cause" or limitations on post-employment opportunities, which are often standard elements of formal contracts of employment. Accordingly, common law defaults and the low-powered incentives characteristic of traditional employment relations are often insufficient in governing employment and aligning the interests of agent and principal beyond a minimum standard, thus creating a role for explicit contractual provisions in the employment relationship.

The evolution and development of explicit employment contracts within the common law context, however, raises an important question. If explicit contracts of employment are required to handle agency relations, why employ workers? Why not rely on high-powered incentives of independent, outside contracting? To adequately answer these questions requires a more comprehensive examination of the nature of the internal efficiencies of employment and firm organization, which has not been fully explored in the literature of the theory of the firm. Nevertheless, one possible answer is that employment is dictated by forces other than those arising from economics or the legal system. For instance, the Internal Revenue Service (IRS) in the United States requires that workers be classified as either employed or independently contracted according to a 20-factor test the IRS promotes. These factors may or may not coincide with economic reasons for employing workers. Thus, if the IRS constraint were removed, the designation of "employment" may be meaningless and all contracts would be "market-based," except those narrowly described as traditional employment because of the common law defaults governing relationships of that type. Of course, a problem might arise for the firm owner if a worker, linked to the firm by a formal contract granting significant discretionary and internal property rights, were not "labeled" an employee, and that worker in turn hired others in the traditional sense who were governed by the common law defaults. Would it make sense for the top manager to not be labeled an employee of the firm if the workers he hired and supervised were labeled employees of the firm (by nature of their being subject to the common law defaults)? Another possible answer is that integration within the firm solves problems that market incentive mechanisms alone cannot, in part because the political setting of hierarchal organization can result in the creation of socially defined strategies that resolve the short-term incentive problems of market organization (Miller, 1992).

The issues affecting the employment status of workers and the contractual relationships linking them to firms are complex and varied. While transaction cost arguments may help explain the employment status of workers – whether they are integrated into the firm or remain outside the firm as independent contractors – further research is required to understand the degree to which firms utilize

explicit contracts of employment and how these contracts are related to the institutional environment of the common law and the organizational problems of control, discretion, and the allocation of internal property rights. We hope this paper is the beginning of a more unified theory of the firm linking all of these important concepts.

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