A Legal Basis for Workers as Agents: Employment Contracts, Common Law, and the Theory of the Firm

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Abstract: The purpose of this paper is to show that the common law governing the employment of labor makes the distinction not only between employee and independent contractor but also between managerial control and agency. The idea is that common law precedents govern workers who are employed and managerially controlled without the requirement that formal, written contracts be established, and that these defaults support the authority of management to direct their activities within the firm. However, many firm owners voluntarily restrict their ability to control workers by making them agents. Workers who are agents differ from workers who are managerially controlled in that in the former caseworkers are treated differently in the eyes of the common law and they often sign detailed, formal employment contracts. The typical features of formal employment contracts are examined. The principal conclusion is that formal employment contracts facilitate the granting of discretion to workers by superseding many of the legal defaults that define the relationship between the worker and firm owner.

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1. Introduction

According to transaction cost economics, managerial control and market contracting are two distinct forms of governing the employment of labor (Coase, 1937; Simon, 1951; Alchian and Demsetz, 1972). A key feature of managerial control is that workers are directed by a manager, who "tells" workers what to do in exchange for a wage payment. This is in contrast to a market contract, in which the manager and worker bilaterally agree over the actions the worker will perform and what the payment will be. In both cases, workers are linked to a firm by means of a contract (Cheung, 1983). The contract specifies what the worker will do and how the worker will be compensated. In the case of market contracting, the actions of workers are generally determined before the contract is formally ratified. In the case of managerial control, the actions of the worker are dictated by the firm owner after the contract is established. Workers accept this arrangement as long as the wage payment is acceptable and the actions specified by the firm owner are within agreed-upon parameters.

Because both market contracting and managerial control are contractual in nature, Masten (1988) argues that the advantage of managerial control over market contracting rests in part in the legal precedents that grant authority to employers to direct the activities of employees through the employment relationship without the necessity of establishing a formal contract with each worker. That is, when a firm owner employs a worker, the worker agrees to be subject to the control of the owner without having to sign a formal contract specifically granting that right to employers. Instead, the contractual relationship is implied by the agreement of the worker to work for the firm owner, with details defined by the common law defaults governing the employment relationship. For this reason, economists generally consider employment and managerial control to be equivalent. When a firm owner contracts with an independent contractor through the market, however, formal contracts are required and the contract, rather than common law defaults, govern the relationship between the worker and firm owner. Thus,

managerial control through employment differs contractually from market contracting in the explicitness of the contract and in the source of the terms and conditions governing the contractual relationship. For managerial control the employment contract is implicit and is defined by common law defaults, whereas for market contracting the contract is explicit and is defined by the formal contractual agreement.

The purpose of this paper is to demonstrate that while there are legal precedents supporting the right of management to control employees, as illustrated by Masten (1988), many firm owners voluntarily restrict this right by making workers agents – that is, by authorizing them to act on behalf of the firm owner. Indeed, the common law governing the relationship between firms and workers distinguishes not only between employees and independent contractors but also between agents and workers who are not granted agency rights. Accordingly, the distinction between workers who are agents and those who are non-agent has important implications for the theory of the firm.

Workers granted discretion, or made agents, by firm owners are distinguished from other workers not only by the way in which common law treats such workers, but also by the nature of the contract adopted by the worker and employer. Firm owners forego the advantages of accepting the common law defaults that support employment and the control of workers by establishing formal contractual relationships with workers. As this paper shows, the role of formalized contracts of employment is to modify the relationship between an employer and employee so as to *facilitate* the granting of discretion to workers. Employees who sign formal contracts of employment are typically granted significantly more discretion regarding the actions they take than employees who do not sign contracts of employment.

An examination of the role of the formalized contract of employment vis-à-vis the common law is important for several reasons. First, typically only senior-level personnel or employees with unique or exceptional skills are required by the firm to sign contracts. Most other employees do not sign employment contracts. If they do, the contracts are usually simple documents stating a starting wage, starting date, and hours of employment. Second, most formalized contracts of employment are remarkably similar. The most common features of formal employment contracts are provisions specifying the compensation package, conditions under which the employee may be terminated, restrictions on

obtaining employment with competitors, and proprietary information clauses.[1] The similarity in types and even wording of contractual provisions suggests that their purpose may be independent of the idiosyncratic requirements of the employer.

Third, formalized contracts of employment generally supersede the default provisions that have developed in the common law governing the employment relationship. These defaults grant employers a significant degree of latitude to direct the activities of their employees, which is ostensibly the source of the advantage of managerial control over the use of market-mediated contractual arrangements (Masten, 1988). Yet, many firms voluntarily place restrictions on these rights. For instance, while the common law recognizes that employment is "at will" and may be terminated by either party for any reason,[2] most formal contracts provide that employment may be terminated by the firm owner (or representative) for "just cause" only.

Finally, when employment is characterized by agency relations, then we will expect contracts to reflect the desire of principals to ensure that their agents' interests are as closely aligned with their own interests as possible. While the nature of compensation will play an important role in how incentive mechanisms are structured, performance-pay mechanisms are often ineffective in fostering loyalty and in ensuring that agents have the proper incentives. For instance, the incentives of employees may be disrupted by competing offers. Consequently, many agency relations will be governed by contracts with both monetary and non-monetary features. An examination of the compensation and non-pay properties of employment contracts will help us understand the nature of agency relations, why they exist, and how they differ from employment relations not affected by these features.

The role of the formal contract in defining the nature of the relationship between a worker and a firm has not been examined extensively. Only a few scholars have considered the features and purposes

[1] For a discussion of advantages and disadvantages of some employment contract provisions, see Nye (1988, Ch.6).
[2] 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).

of the formal employment agreement. Rosen (1993) states that non-monetary features of employment contracts are designed "to internalize technological dependencies among workers" (p. 79). Stiglitz (1987) argues that employment contracts are utilized to shift a disproportionate share of the risk born by the firm to employees. The argument presented here departs somewhat from these views and is based on the "relational" role of contracts (Goldberg, 1982). Among other things, employment contracts define in broad terms and objectives the responsibilities and obligations of the worker and the employer and thus facilitate the granting of discretion to workers. However, employment contracts also have the (potential) effect of changing the nature of the contractual relationship between the worker and firm from managerial coordination to worker-granted discretion by formally specifying the types of actions workers may or may not do. Moreover, contracts formally transfer to employees many of the rights reserved for firm owners and management. By transferring certain rights to employees, firm owners may provide increased motivation for workers to act in the interest of the firm if they have a stake in the organization through their acquired rights.[3]

This paper builds on the work of Masten (1988) and Williamson (1991), who show how the law supports distinct, alternative forms of organizing economic activities. Masten (1988) argues that the common law recognizes the rights of employers to control the actions of employees, and that such law is distinguished from contract law governing market exchanges. Similarly, Williamson (1991) shows how different forms of contract law map onto market, hybrid, and hierarchical forms of organization. This paper extends these studies by describing circumstances in which firm owners voluntarily relinquish the right to control workers, as defined by law, in order to grant discretion to workers – that is, in order to make workers agents. The granting of discretion to workers, and the associated contracts linking the workers to the firm, are shown to represent an alternative to the traditional market coordination versus managerial control problem as described by transaction cost economics.

This paper also builds on recent research on delegation (Jensen and Meckling, 1992; Minkler, 1993; Aghion and Tirole, 1997), job design (Holmstrom and Milgrom, 1991; Hirao, 1993; Valsecchi,

[3] For a discussion of rights acquired by employees from employers, see Edwards (1993).

1996), and the control of agents (White, 1992; Fumas, 1993) by showing how contractual relationships change when workers are granted discretion over the actions that they may take for the firm owner. The change occurs in the adoption of formal contracts that supersede the common law defaults governing the employment relationship. Understanding how formal employment contracts supersede defaults defined in the common law will provide insight into the extent to which firm owners transfer decision-making authority to workers.

This paper will first examine the nature of the common law concerning the employment relationship. The examination will show that the law recognizes the right of firm owners to control the activities of workers within the firm, as expected under managerial coordination, and that these rights are embodied in legal defaults that exist without the establishment of a formal contract of employment. The analysis is based in part on Masten (1988). The paper will then show how the law distinguishes between workers who are managerially controlled from workers who are granted substantial discretion. Specifically, the paper shows that the law recognizes a distinction between workers who are "servants" and those who are "agents" in addition to the distinction made between workers who are employed and those who are not employed. The idea is that an employee may or may not be an agent, and an independent contractor may or may not be an agent, depending on the authority the worker has to act on behalf of the firm owner. As will be shown, the distinction between employee and independent contractor, and between agent and servant, is important in a legal as well as organizational perspective. Employees characterized as "servants," in the common law sense, embody the notion of managerial control as defined in the transaction cost literature, while employees defined as "agents" are generally granted substantially more discretion to act for the firm owner than servants. Moreover, employees who are servants are governed by common law defaults in the absence of formal, written contracts, while employees who are agents are governed by contracts the supersede the common law precedents. The paper will then describe the features of the typical formal employment contract. These features will be compared to the common law provisions governing the firm-worker relationship to show how employment contracts support contractual relations based on agency and the granting of decision-making authority to workers.

2. Reserved Rights and Managerial Control

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 activities of workers without the need for costly and repeated bargaining between worker and owner (Alchian and Demsetz, 1972). When contracts involve the use of physical assets, as in plant machinery, market contracting over those assets may give way to integration, or a transfer of ownership of physical assets, when market contracting is expected to incur hazards that cannot be resolved by the language of the contract or by courts at relatively low cost (Klein, Crawford, and Alchian, 1978). By acquiring ownership of physical assets, owners acquire property rights over those assets. The possession of property rights over assets means that owners have the right to use, alter, transfer, or destroy the assets as they choose.[4] Without ownership, however, the ability to use, alter, transfer, or destroy assets 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*.[5] Parties entering into a contractual agreement are free to bargain over the specific contractual provisions without the threat of unfettered dominance by one party. Laborers supply their services to firms because it is in their interest to do so, not because they are coerced into the agreement. Workers are free to walk away from the contractual agreement, whereas "owned" property is not free (or able) to walk away.

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[4] With the obvious restrictions that such use does not endanger human life or result in the wanton destruction of the surrounding environment.

[5] 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) for a similar conclusion.

If employment is contractual, where is the advantage of employment over market contracting? If contractual provisions govern employed workers, where is the savings employment offers as an efficient substitute for bilateral agreements governed by market mechanisms? These questions are more profound when one considers what would happen if employers required their workers to conform to the exact provisions of their employment contracts. Production and exchange as we know it would likely grind to a halt.

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 are embodied in the legal notion of an "employer-employee relationship" and exist independent of the existence of a formal, written employment contract. They are in essence defaults that govern employment when not expressly superseded by formal bilateral agreements.[6] Masten (1988), who has shown that the common law recognizes that contractual relations internal to the firm differ from those that are external to it, makes this point as follows:

> Employer-employee relations could be replicated, for instance, through detailed stipulation of the duties and sanctions defined in the law of master and servant in a contract, in which case the contract rather than the case law would become the reference point in the event of a dispute. But accomplishing this would, for all intents and purposes, require reviewing and repeating the entire case law in each contract, obviously forfeiting a substantial economy. Reliance on common law doctrines, in contrast, permits transactors to choose that combination of legal "defaults" or "presets" that most closely approximates the ideal arrangement simply by identifying the class of transactions that the parties intended, to which they may again make incremental adjustments by mutual consent (p. 207).

Thus, an important advantage of employment relations over market contracting comes from the fact that the firm owner and worker can forgo the costly procedures of writing detailed agreements and instead accept the legal defaults as the basis for the contract linking the worker to the firm. In such instances, employers and employees only need 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

[6] 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). The "at will" rule "default" has been codified under California law (Cal. Labor Code § 2922).

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?

An additional advantage of the employment relationship comes from the fact 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 of explicit contractual agreements. These rights are "reserved" to management and are binding unless specifically relinquished by firm owners to workers through contracts.[7]

The "reserved rights" of management over workers is thus similar, but not identical, to the "residual rights of control" that ownership gives asset owners (Grossman and Hart, 1986). Absent contract, case law, or public policy 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.[8] The "reserved rights" doctrine forms the basis for the transaction cost argument that employment has unique advantages over contingent contracting for labor services. The extent to which reserved rights are upheld by courts and legislative processes will determine, at least in part, the benefits of managerial control over market coordination. If managerial coordination is to be an effective and efficient substitute for market contracting, managers must be able to control not only where and how the services of workers are utilized within the firm, but also what and when workers are employed. To show how the common law supports these advantages of employment, the following sections describe briefly how the law affects a firm owner's ability to control the actions of worker and the use of labor inputs.[9]

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[7] On this point Prasow and Peters (1983) assert the following: "Stated in an unqualified simplistic form, the reserved-rights theory holds that management's authority is 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 worker(s)]" (pp. 33-34).

[8] It is for this reason that 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) states 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).

[9] For a more extensive treatment, see Masten (1988).

2.1. Control Over Actions of Workers

The common law recognizes the right of employers to control employed workers, and the law governing this right is distinguished from contract law governing market exchanges (Master, 1988; Williamson, 1991). According to law, the right to control workers is one of the primary considerations in determining whether a worker is an employee or an independent contractor.[10] It is the right to control and not necessarily the exercise of control that is crucial, however (see Aghion and Tirole, 1997). Thus, employers may voluntarily transfer discretion regarding the exercise of control to representatives in management or to other employees without endangering the employment relationship. In addition, the assumption, and thus exercise, of control will typically establish the existence of employment, even when the relationship is formally that of independent contractor (30 Corpus Juris Secundum §15).

The right and nature of the control of firm owners over their employees is considered authoritative and substantial rather than merely suggestive (30 Corpus Juris Secundum §9).[11] Courts recognize what is known as the "business judgment rule," which holds that "absent bad faith or some other corrupt motive, directors are normally not liable to the corporation for mistakes of judgment" (Gilson, 1986, p. 741). While the "business judgment rule" applies directly to the relation between directors and shareholders, the rule also applies to the firm's management of workers in that courts will generally refuse to hear disputes between various divisions of a firm over technical issues, such as price, quantity, or quality decisions (Williamson, 1991). The implication is that workers are denied access to courts when they are employees, even though they may have access if they are independent contractors. Moreover, employers may control workers even if workers are hired and paid by a third party unless specifically restricted from doing so by contract.[12] Thus, there is legal support for the growing prevalence of temporary help supply and employee leasing services. These workers, while formally

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[10] Marvel v. U.S., 719 F.2d 1507; *Green Val. Co-op Dairy Co. v. Industrial Commission*, 27 N.W.2d 454, 250 Wis. 502. See also Mota (1993); 30 Corpus Juris Secundum §§9, 15; Restatement of Agency [2nd] §2. Furthermore, the "20 factor test" listed by the Internal Revenue Service used to distinguish employees from independent contractors for tax purposes is based on the issue of control of workers.

[11] *Young Demos*, 28 S.E.2d 891, 70 Ga.App. 577; *Baugh v. Rogers*, 148 P.2d 633, 24 Cal.2d 200, 152 A.L.R. 1043.

[12] *C.F. Lytle Co. v. Hansen & Rowland*, C.C.A. Wash, 151 F.2d 573. *Jones v. Goodson*, C.C.A. Okl, 121 F.2d 176.

employees of the supplying organization, are subject to the authority of the firm using the workers' services even though they are not employees of the firm.

While employees are subject to the control of employers and are thus "told what to do," the common law also states that employees are under no obligation to submit to a significant change in position or duties. Employers may only reassign work or reorganize the activities of workers if such changes are "reasonable." That is, employees are required to accept work "reasonably incidental" to their position, but they are not obligated to accept assignments of a materially different nature (30 Corpus Juris Secundum §109).[13] For instance, a supervisor is generally not obligated to accept an assignment which is "inferior" or to perform "ordinary" duties.[14] Thus, it appears that there are some restrictions on the ability of firm owners to allocate labor resources internally, especially when formal contracts prohibit firm owners from terminating employment unilaterally. Changes may only be marginal, unless employers are willing to renegotiate the agreement with employees.

2.2. Control Over the Hiring and Discharge of Workers

The right of employers to hire and terminate workers is also well grounded in common law tradition. "As a general rule, an employer has the power to discharge an employee even though the discharge constitutes a breach of contract" (30 Corpus Juris Secundum §35).[15] That is, employees may be fired at any time for no reason or for virtually any reason. The right to terminate employment "at will" generally applies when employment is for an unspecified term.[16] In order for managerial control to be a viable alternative to market contracting, employers must be able to retain the ability to utilize and terminate their use of labor inputs so as to allow the greatest freedom to maximize profits. Restrictions on the right to terminate employment unilaterally place constraints on profit maximization. Employment "at will" gives employers the flexibility to permit "the ceaseless marginal adjustments that are necessary in

[13] Supported in *Walter v. Vance County*, 369 S.E.2d 631, 90 N.C.App. 636.
[14] For example, in *Cooper v. Stronge & W. Co*. (126 N.W. 541, 111 Minn. 177) the court held that an employer violated an employment contract by reducing the status of an employed manager to sales clerk. See also *Karas v. H.R. Laboratories*, 67 N.Y.S. 2d 15, 271 A.D. 530, affirmed 74 N.E. 2d 192.
[15] Supported in *Taylor v. Tulsa Tribune Co*., C.C.A. Okl, 136 F.2d 981.
[16] See, for instance, *Marin v. Jacuzzi*, 224 Cal.App.2d 549, 553, 36 Cal.Reptr. 880.

any ongoing production activity conducted . . . in conditions of technological and business change" (Epstein, 1984, p. 982).

While employment at will is an accepted doctrine under common law, there are notable exceptions to and restrictions on the ability of employers to terminate employment unilaterally, such as reasons that are against public policy. In *Tameny v. Atlantic Richfield Co*. (27 Cal.3d 167,610 P.2d 1330), the court noted "the employer is not so absolute a sovereign of the job that there are not limits to his prerogative" (p. 178). The most important limits are legislative restrictions on termination when such action is motivated by preferences regarding race, sex, age, nationality, or religious beliefs (see Title VII of the 1964 Civil Rights Act, 42 U.S.C. §2000e-2). The National Labor Relations Act of 1935 places additional restrictions on the ability of employers to apply the "at will" doctrine in terminating employees.[17] For instance, employers may not terminate employees for organizing or participating in union activities, insisting on union representation, refusing to cross a picket line, walking off the job site due to hazardous or unhealthy conditions, or stopping work as a sign of disagreement with management.[18]

3. Employment and Agency Relations

While employment offers firm owners important advantages over contingent contracting, many employed workers are not subject to the "reserved rights" of management. Under many circumstances employers voluntarily give up their rights to manage directly the specific activities of workers to the workers themselves. For instance, stockholders, acting through the board of directors, may grant authority to top management to make the day-to-day decisions regarding production and distribution within the firm. When firm owners cede portions of their "reserved rights" to employees, the contractual nature of the relationship between firm owner and worker changes significantly. The working relationship between employer and employee looks less like "master and servant" and more like

[17] 29 U.S.C. §§151-169.

[18] See Hill and Sinicropi (1986, ch. 4) for a discussion of these and other restrictions on the employer's reliance on the "at will" doctrine.

"principal and agent." For instance, we would expect the contractual relationship to change substantially if stockholders considered top management "servants," paid them wages, and subjected them to traditional forms of hierarchal control and managerial oversight. This distinction has been recognized by some scholars. For instance, Rosen (1984) states that employment is not only authoritarian but also contains "elements of delegation in which the employee is given latitude within broad limits to behave in the interests of the firm" (p. 986).[19]

In order to understand the distinction between "master-servant" and "principal-agent," consider Bishop's (1991) discussion of the difference between the "traditional employment relationship" and the "modern employment relationship." Traditional employees are governed by the common law defaults and do not utilize extensive formal contractual agreements. Oral agreements, or written contracts if they exist, between the firm owner and worker usually specify only 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.[20] 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. Traditional employment relationships are typically found in capital or resource intensive industries. These employment relations most closely resemble that of a "servant" and seem to describe characteristics of managerial coordination as expressed in the literature on the nature of the firm.

The modern employment relationship, on the other hand, arises from social and technological developments that require greater skill and initiative on the part of the worker, according to Bishop (1991). Contractual agreements are designed to foster commitment, loyalty, and the long-term well-being of the worker, and they depart significantly from the default provisions found within the common law. The contractual arrangements linking the worker to the firm are designed to ensure that the worker's interests are in line with those of the employer. Workers generally have more freedom to act independent

[19] See also Ouchi (1980) and Milgrom and Roberts (1992, pp. 26-27).
[20] *Walker v. John Hancock Mutual Life Insurance Co*., 79 A. 354, 80 N.J.L 342.

of direct supervision by superiors than traditional employees. Workers linked to firms through the modern employment relationship most closely resemble the notion of an "agent" to the firm owner.

That a distinction exists between workers who are servants and those who are agents is recognized in the common law.[21] On the one hand, courts have defined a servant as a workers "who perform[s] tasks for compensation under the direction, control, or supervision of another."[22] On the other hand, courts have defined an agent as a person "employed by another to act for him."[23] The legal usage of the word *employ* suggests that workers not only are required to follow the directions of their employers but also may be authorized to represent the employer as an agent. The 1899 edition of the *American and English Encyclopedia of Law*, for instance, defines *employ* as "to engage in one's service; to *use as an agent* or substitute in transacting business; to commission and *entrust with the management* of one's affairs" (emphasis added).[24] Similarly, in *Brugier v. Moussier* (5 La 93) the court stated that "the word employed may mean either busy, or occupied at work, or it may mean commissioned or *entrusted with the management* of an affair" (p. 93; emphasis added).

Usually, the distinction between a worker who is a servant and one who is an agent rests in the amount of discretion or agency granted to the worker and the right of the worker to enter into contractual relations with third parties which are binding on the principal. Courts have recognized both of these elements. For instance, in *Hass v. Kaster* (66 N.W.2d 878, 880, 246 Iowa 48) the court noted that "one who is employed to represent another in contractual negotiations is an 'agent,' while one who is employed to perform personal services for another is an 'employee' or 'servant' and mere fact of employment does not necessarily bespeak agency and scope of agency." In *C.M. & W. Drilling Co. V. Schieck* (284 P.2d 390, 397) the court stated that an "'agent' in the restricted and proper sense is representative of his principal in business or contractual relations with third persons, and an 'employee' is one engaged not in creating contractual obligations but in rendering service chiefly in regard to things but sometimes with

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[21] See 2A Corpus Juris Secundum §16 for a complete description of how the law distinguishes between "master-servant" and "principal-agent" relationships.
[22] Quoted in *People v. Kirstein*, 148 N.W.2d 539, 543, 6 Mich.App. 107.
[23] Quoted in *Webb v. Commercial Credit Corp*., 163 N.E.2d 727, 24 Ill.App.2d 75.
[24] This definition was used in *Drucker v. State Board of Medical Examiners*, 300 P.2d 197, 203, 143 C.A.2d 702. See also *Miller on Behalf of State Ins. Fund v. Garford Laboratories*, 16 N.Y.S.2d 279, 281.

reference to persons when contractual obligation is not to result." The court in *Columbia University Club v. Higgins* (23 F.Supp. 572, 574) summarized these two characteristics of agency by stating that the "two essential elements of 'agency' are that the agent is a representative and acts not for himself but for another and that his acts within the scope of his authority are binding on his principal."

More important, workers who are agents are seen as possessing substantially more discretion regarding the actions that they may take than workers who are not agents, although in practice it is recognized that the distinction may be difficult to define.[25] In *Gulf Refining Co. v. Shirley* (Civ.App., 99 S.W.2d 613, 615), the court observed that:

> [t]he distinction between principal and agent and master and servant is one of degree only, the essential distinction being that the agent is employed to represent his principal in business dealings and to establish contractual relations between him and third persons, while the servant is not, and is not allowed the use of his discretion as to the means to accomplish the end for which he is employed.

Nevertheless, the courts have distinguished between employees who are and are not agents in a number of instances. [26] In all cases in which workers have been held to be agents, their responsibilities and obligations, and the obligations of their employer, have changed relative to those existing when the employment relationship was found not to be characterized by agency. For instance, courts have held that knowledge possessed by an agent is knowledge possessed by the employer.[27]

The servitude and agency distinction is especially important in cases regarding the liability of employers for acts done by employees.[28] Employers are held liable for negligent acts by employees if the worker is viewed as an agent. Employers are generally not liable for acts done by employees viewed as

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[25] The court in *Lynch v. Walker* (31 So.2d 268,270, 159 Fla. 188), for instance, observed that "some confusion has arisen as to the distinction between the relationship of master and servant and principal and agent." Some courts have held that there is no essential difference between a servant and an agent (*Murray v. Hills Can Co*., 198 N.E.2d 466, 199 Ohio App. 211), while others have held that an employee and agent are not synonymous (*First Jackson Securities Corp. v. B.F. Goodrich Co*., 176 So.2d 272, 253 Miss. 519).

[26] Workers have been held agents in the following cases: *Sidney Smith, Inc. v. Steinberg*, App., 280 S.W.2d 696; *Roberts v. U.S. Fidelity & Guaranty Co*., 157 S.E. 537, 42 Ga.App. 668; *Thomas v. Smith-Wagoner Co*., 234 P. 814, 114 Or. 69; *Morrow v. Tunkhannock Ice Co*., 60 A. 1004, 211 Pa. 445; *Moss v. Ole South Real Estate, Inc*. 933 F..2d 1300. Workers have not been held agents, or the relationship was held to not characterize agency, in these cases: *Baer v. Lorimar*, 28 P.2d 909; *Dimos v. Stowe*, 71 S.E.2d 186, 193 Va. 831.

[27] *Smith v. Samuel T. Gately Marble & Granite Works*, 157 So. 802, 803. The court in this case ruled that an agent's knowledge of injury to a worker was sufficient notice to the employer.

[28] In fact, tort cases are generally the most common reasons courts distinguish between servants and agents.

servants unless such acts were expressly or impliedly authorized or sanctioned by the employer. The court in *East Coast Freight Lines v. Mayor and City Council of Baltimore* (58 A.2d 290) addressed this point by observing that a "conventional agent is employed to represent a principal . . . whereas the servant is employed to render service to rather than for the master. . . . The fact that the servant is in the general employment of the master does not create an inference that a certain act done by him was in the scope of his employment" (pp. 303-304).[29] Typically in suits against an employer resulting from actions taken by a worker, the employer will try to convince the court that the worker was not an agent but acted independent of the employer's intentions, while those seeking damages will attempt to show that the worker in fact acted for the employer, thus making the employer liable.

There are a number of characteristics that distinguish workers who are subject to the traditional controls of employers from workers who are agents. These common law distinctions have been enumerated as follows:

1. There are distinctions between the rights, duties, and obligations arising from the relation of principal and agent and master and servant.

2. 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.

3. Usually an agent is paid differently, has more freedom of action, and requires less supervision than a servant and usually has more authority, works alone and has some discretion, not being subject to constant supervision and control.

4. A servant is a person employed by a master to perform services in his affairs whose physical conduct in the performance of service is subject to the right of control by the master, whereas an agent is one who is employed under agreement to accomplish results on behalf of his principal, whom he represents, but who, in attaining the end for which he is employed, is not subject to principal's right of control over the manner in which the acts that constitute execution of the agency shall be performed (2A Corpus Juris Secundum §16, pp. 578-579).

[29] From a legal perspective, the "concept of 'scope of employment' was developed to protect employers from absolute liability" for torts committed by employees (Weber, 1992, p. 1514f). A worker is functioning within his scope of employment if the activities (1) are of the kind he was employed to perform, (2) occur while formally "on the job," (3) are of such purpose as to serve the employer, and (4) are incidental to the conduct authorized by the employer. A worker is not functioning within his scope of employment if his actions are outside those explicitly authorized by his employer or are not reasonably part of the worker's job requirements (see Restatement of Agency [2nd] §§ 228, 229).

The characteristics of agency as expressed in the common law suggest that there are important differences in the contractual relations of workers linked to firms beyond the mere classification of employee and independent contractor. Specifically, workers may also be either servants or agents. It should be noted that the categories of agent and servant are somewhat stylized and are not mutually exclusive. Still, courts and employers often recognize and rely on such distinctions. The responsibilities, duties, and obligations of the worker and firm depend on the particular form that the contractual relationship takes and the degree of discretion granted to the workers. The presence or absence of the exercise of control over workers is an important element in determining not only whether a worker is an employee or independent contractor, but also whether a worker is held to be an agent or a servant. For example, in *Sidney Smith, Inc. v. Steinberg*, the court noted that for the category of servant to hold, the "essential elements are that the master shall have control and direction not only of the employment to which the contract relates, but of all its details, and shall have the right to employ at will and for proper cause discharge those who serve him. *If these elements are wanting, the relation does not exist*" (emphasis added; 280 S.W.2d 696 at 697).

4. Formal Contracts of Employment

The formal contract of employment plays an important role in structuring the relationship between worker and firm. Courts look first to the language of the formal agreement to determine the nature of the contractual relationship,[30] although courts examine all the facts relevant to the circumstances.[31] For instance, even though a contract may indicate that a worker is an independent contractor, the actual working relationship may suggest that the worker is in reality an employee. Nevertheless, courts generally rely on the wording of the contract not only to determine the status of the worker, but – especially in the case of agency relationships – to determine the extent of authority granted to workers. In *East Coast Freight Lines v. Mayor and City Council of Baltimore* (58 A.2d 290), for example, the court stated that while employment characterized by either agency or servitude is

[30] *Stuckey v. University of South Carolina*, 325 S.E.2d 709, 284 S.C. 295.
[31] See *McReynolds v. Oklahoma Turnpike Authority*, 291 P.2d 341.

contractual, "in measuring the extent of an agent's authority emphasis is more often placed upon the terms of the contract than in the case of a servant where the emphasis is ordinarily placed upon the nature of the employment" (p. 303). The reason is based in part on the fact that employees who are servants are less likely to sign formal, written contracts of employment. When an agency relation exists and there is a formal contract in place between the contracting parties, it is assumed that the contract entails provisions specifying the scope of the worker's responsibilities and obligations above that expected under the default requirements of the common law. In *Smith v. Steinberg*, the court noted statements in the contract that indicated that the defendant was to "manage the business" and to do everything to advance the company, and which granted the defendant authority to hire and fire workers, as evidence suggesting that the worker was an agent and not a servant.

What follows below is a discussion of some of the more common features of formal employment contracts and how they affect the contractual relationship. While not all contracts are the same, many employment contracts contain similar clauses and features. Because of the similarity of many employment contracts, the clauses and features may reflect general principles, such as the granting of agency to workers, rather than idiosyncrasies of the contractual relationship. These features often supersede common law defaults and thus are used to affect the incentives faced by workers. The contractual provisions examined here may be grouped into two categories: those which create positive incentives for agents to act in the employer's interest and those which protect the employer from actions taken by the agent which may damage the employer. Positive incentives are created by appropriate compensation schemes and by restrictions on the ability of the employer to terminate the agent's services. Protective features work to ensure that the worker directs his efforts in the employer's interest. They also keep the agent from working for competitors and from using firm-specific knowledge against the employer.

The use of formal contracts is an important indication of the existence of an agency relationship that differs significantly from the form of managerial control characterized in the literature on the nature of the firm. It should be noted, however, that no single feature of a contract is conclusive in demonstrating whether an agency relationship does or does not exist or whether workers do or do not

have discretion granted to them. Courts generally construe the employment contract as a whole.[32] Nevertheless, as noted below, contractual features do affect the contractual relationship existing between firm and worker in specific ways.

4.1. Nature of Compensation

Most formal agreements stipulate the nature of the compensation paid to the worker. The means by which workers are compensated is an important feature of employment contracts. Courts typically consider the mode of payment when attempting to determine whether a worker is an independent contractor or agent.[33] The existence of some form of incentive compensation formally outlined in a contract has been used as evidence showing that workers were granted discretion to act for their employer or to represent the employer's interests.[34] The presence or absence of incentive pay features in contracts is important because employees are generally not entitled to incentive compensation, such as commissions or bonuses, unless the contract expressly provides otherwise (30 Corpus Juris Secundum §§140, 143). Similarly, employees generally cannot recover compensation for extra work performed within the scope of the worker's employment in the absence of express agreement or custom (30 Corpus Juris Secundum §147). The presumption is that such effort is voluntary or that salary or wage compensation is intended to compensate the worker for the extra effort. Interestingly, courts have held that a promise to pay a bonus in a terminable-at-will employment contract is an unenforceable obligation.[35] It is recognized that incentive compensation, such as a promise to pay a bonus, is intended to encourage more efficient and diligent service by the employee,[36] and that such contractual obligations are generally not intended when employment is "at will." Incentive-pay contracts are especially important when workers are agents and are expected to act in the interest of the employer. Because performance-

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[32] *Arkansas Amusement Corp. v. Kemper*, 57 F.2d 461.

[33] *Dorsett v. Pevely Dairy Co*., 124 S.W.2d 624, 629, 630. While the court considered the mode of payment, it also indicated that other considerations must also be examined when determining the extent of a worker's agency.

[34] The existence of incentive compensation of the form of a profit-sharing agreement was used as evidence of agency relations rather than servitude in *Roberts v. U.S. Fidelity & Guaranty Co*. (supra) and *Sidney Smith, Inc. v. Steinberg*, (supra), for instance.

[35] *ED Lacey Mills, Inc. v. Keith*, 359 S.E.2d 148, 183 Ga.App. 357.

[36] *Buchele v. Pinehurst Surgical Clinic*, 341 S.E.2d 772, 80 N.C.App. 256, affirmed 349 So.2d 579, 318 N.C. 503.

based contracts reward higher effort (Levinthal, 1988), they are more likely to attract workers with exceptional skills and talent (Zenger, 1994; Clinch, 1991; Brown, 1990). Workers with few desired skills or low ability – or workers most likely to be contracted as servants rather than as agents – generally prefer fixed wages and pay linked to non-performance criteria, such as seniority (see Zenger, 1994). Indeed, it is widely accepted by scholars studying agency issues that incentive contracts are an effective way of aligning the interests of the principal and agent (see Lazear, 1989) and that incentive pay and efficiency wages are substitutes for control (Osterman, 1994).

4.2. Termination for "Just Cause"

A common feature of employment contracts is a provision indicating the terms under which the employee may be terminated. Generally, the requirement for termination is based on "just cause," although some contracts explicitly state that the employment relationship is terminable "at will." The purpose of "just cause" provisions is to restrict the employer from terminating the contractual relationship for any but "good" reasons. Often, the reasons for termination are explicitly stated in the contract and may include illegal acts or conduct damaging to the company, willful breach of responsibilities, expiration of agreement, workforce reduction, death, and so on.

Courts generally uphold just cause provisions, even if they are only implied by a personnel manual. For instance, in *Toussaint v. Blue Cross & Blue Shield* (292 N.W.2d 880, 408 Mich. 579), the court held that:

1. A provision of an employment contract providing that an employee shall not be discharged except for cause is legally enforceable although the contract is not for a definite term – the term is "indefinite," and

2. Such a provision may become part of the contract either by express agreement, oral or written, or as a result of an employee's legitimate expectations grounded in an employer's policy statements (p. 885).

Since courts accept such provisions, and because they restrict the ability of employers to reallocate labor resources "at will" as allowed under common law, their existence suggests efficiency reasons. The idea is that by providing employment security in the form of contractual safeguards against

indiscriminate firing, workers may be more inclined to make firm-specific investments and to act in the employer's interest than in the absence of such provisions. This is particularly true when the compensation of agents has efficiency-wage characteristics (James and Johnson, 2000). "At will" agreements, however, are more important the greater the divergence between when a worker performs an action and when the benefits are realized by the worker.[37]

4.3. Exclusive Service Agreements

Contracts typically contain language specifying that the worker is to devote his or her entire productive time, ability, and attention to the company. While alone these features do not indicate decisively that a worker has substantial discretion granted to act in the employer's interests, they do signal that the worker's actions are expected to affect the company in a significant way. Employers use exclusive service clauses to ensure that the worker directs his or her efforts in the employer's, rather than individual's or other employer's, interests. Thus, they are particularly important when the worker's actions are difficult to monitor or control by supervisors, such as when workers are contracted to act for the employer as an agent rather than servant.

Often, employment contracts place restrictions on the types of activities the worker may engage in "outside" of work. While such restrictions on outside activities are commonly associated with employment, control, and the payment of wages (Holmstrom and Milgrom, 1994), they are also expected to be important in the presence of incentive pay and the granting of discretion to workers because they provide a legal means of binding the worker to the firm. Courts generally uphold such restrictions as long as they are "reasonable" (30 Corpus Juris Secundum §112). Courts have recognized "reasonable" restrictions to include any activity which is detrimental to the employer's interests or which may harm the firm, such as working for a competitor.

4.4. Non-Competition Agreements

[37] Scott Masten suggested this point.

Many employment contracts will contain provisions barring a worker from working for a rival company not only during the worker's employment, but also for a period of time following his termination from the company.[38] Non-competition agreements typically define the duration of the restriction (e.g., one year), the geographic area it covers, and the manner of behavior restricted (Sprague, 1988). Non-competition agreements are used to protect the interest of the firm and to bind employees to their employer, especially when workers receive firm-specific training or have access to business secrets and other confidential or proprietary information (Schulman, 1992).

Courts have traditionally been reluctant to uphold non-competition agreements, in part because they represent a restriction on free trade. Courts also recognize the importance of protecting the employer, however. Thus, non-competition clauses may not be used in all circumstances. Courts generally uphold non-competition agreements if they are reasonably necessary to protect the employer, they do not unnecessarily restrict the employee, and they are not against the public interest.[39] Specifically, non-competition agreements may only be used when the employee's services are sufficiently "unique," "peculiar," or "extraordinary,"[40] or in the case of high-status or high-profile positions when "reasonable," such as management (Wonnell, 1993; Schulman, 1992). Under most employment conditions, especially those employers seek to maintain as "at will," non-competition features of contracts are not binding. However, when workers are granted significant discretion to act for the employer, non-competition agreements in effect signal the worker that self-interest must be checked against the employer's interest.

4.5. Proprietary Information Clauses

Related to non-competition features of contracts are provisions placing restrictions on the ability of the worker to use certain knowledge or information obtained from the employer when the worker

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[38] Non-competition agreements have their roots in the 1852 English case *Lumley v. Wagner* (42 Eng.Rep. 687). The case involved a suit by an opera company to enjoin an opera singer from singing for a rival company while under contract for the plaintiff.

[39] See, for instance, *Raimonde v. Van Vlerah*, 325 N.E.2d 544, 42 Ohio St.2d 21, 24; *Raymondo v. Hammond Clinic Association*, 405 N.E.2d 65.

[40] See, for instance, *Clark Paper & Manufacturing Co. v. Stenacher*, 236 N.Y. 312, 319-322, 140 N.E. 708, 711-712.

leaves the organization. Restrictions on the use of proprietary information or trade secrets are often used when the worker has access to company secrets, documents, lists, files, or other information specific to the organization. Access to confidential information is often given to workers, such as sales or service representatives, who are granted authority to enter into contractual agreements with third parties that are binding on the principal.

Implicit in the common law is the provision that employees may not disclose the trade secrets of the employer, even after employment is terminated (30 Corpus Juris Secundum §123). However, the law also recognizes the distinction between exclusive reliance on the common law and the explicit restrictive covenants often found in employment contracts. In general, protective covenants may extend beyond matters traditionally characterized narrowly as trade secrets in the common law.[41] Thus, employers may use proprietary information agreements in an effort to ensure that agents do not engage in activities that may harm the company, since agents are more likely to have access to compromising information than servants. Courts often uphold such provisions in employment contracts. Moreover, courts have used as evidence in supporting the claim that a worker is an agent the fact that the worker has access to proprietary or confidential information.[42]

5. Conclusions

This paper has shown that the common law distinguishes not only between employees and independent contractors, as developed in the transaction cost literature by Coase (1937), Alchian and Demsetz (1972), Simon (1951), Williamson (1975), Masten (1986) and others, but also between workers who are subject to traditional forms of managerial control, "servants" as the terms of the common law, and workers who have discretion granted to them, or "agents." In particular, the distinction among employees, independent contractors, servants, and agents in the common law suggests an important

[41] *Cincinnati Tool Steel Co. v. Breed*, 2 Dist., 482 N.E.2d 170, 90 Ill.Dec. 463, 136 Ill.App.3d 267. The common law defines trade secrets and proprietary information as patent information, process technologies, business codes and records not available to the public, price lists, and customer lists (see 30 Corpus Juris Secundum §§125, 126).
[42] In *Smith v. Steinberg* (supra), the court noted that the defendant was an "agent" in part because he had access to mailing lists and other proprietary information that could be used without consultation with or the direct consent of his employer.

difference among market or bilateral coordination, managerial control, and worker-granted discretion as contractual forms linking workers to firm organizations.

The idea that workers may be either employees or independent contractors, and either agents or non-agents, helps explain a number of market and organizational innovations that have evolved in recent years. For instance, self-managed teams, networks, temporary workers, quality circles, employee empowerment, the flattening of hierarchies, and employee leasing services, to name only a few, are being increasingly adopted by economic organizations as alternatives to the more traditional practices of coordinating production and exchange through either centralized control within hierarchies or decentralized, market-based contracts with independent vendors. This paper has provided an explanation for these phenomena by distinguishing not only between employment and independent contracting, but also between that nature of the contractual relationship linking workers to firms. Simply put, the governance structure or boundary question – whether workers are "employed" or not – does not explain the form of the contract linking the worker to the firm organization (James, 2000). For instance, some employed workers may be given substantial discretion to act for the firm owner, such as when organizational hierarchies are flattened. On the other hand, many non-employed workers are subject to traditional forms of managerial control and oversight, such as temporary workers or "leased" employees. The implication is that employment is not equivalent to managerial control in the sense used by many economists, since transaction cost considerations that affect the employment status of a worker also affect the nature of agency granted to workers (James, 1998).

The identification of alternative contractual forms, and their relationship with specific contractual features, is important not only from a legal perspective but also from an economic one. When agency is granted, employers may expect that agents will make decisions and engage in activities that will be difficult to monitor and control using traditional forms of managerial oversight. While positive incentives, in the form of incentive pay, may help align the interests of principal and agent, alone they are ineffective in completely protecting the employer from opportunistic behavior by an employee. Thus, non-monetary features, such as "just cause" or non-compete clauses, are also important in constructing contractual relationships. Their presence, while not conclusive evidence of agency and worker-granted discretion, is strongly indicative. This is because the traditional default provisions of the common law are

generally adequate in framing the relationship between a firm and its workers when the relationship is characterized by managerial control as defined in the literature on the nature of the firm. The fact that employers voluntarily override the common law defaults in constructing the contractual relationship, however, suggests that employers have something to gain by using these features of formal employment contracts. As shown in this paper, these contractual elements are especially important when workers have significant authority granted to them to act in the employer's interests, thus suggesting that agency relations and the granting of discretion to workers may be considered substitutes for traditional forms of managerial coordination and market contracting. Consequently, as firms increase the authority of their workers – such as through worker empowerment, teams, quality circles, or the flattening of managerial hierarchies – we may expect firms to introduce formal contracts, or elements of formal contracts described above, in addition to incentive and pay-for-performance compensation.

That agency is an alternative to control also has important implications on the nature of ownership. Grossman and Hart (1986), Hart (1988), and Hart and Moore (1990) examine how residual rights of control help explain ownership. Residual rights of control over an asset are defined as the right to control an asset in ways not explicitly formalized in a contractual agreement. When parties enter into a contractual relationship, not all contingencies will be expressed within the terms of the agreement. When eventualities do arise that are not expressly controlled by the contract, parties with residual control rights will likely behave opportunistically so as to increase their own well-being by manipulating the returns generated by the asset. If these contingencies are important enough, they may dull the incentives of the contracting parties to remain within the terms of the formalized agreement. Grossman and Hart argue that ownership, and thus rights of control, will be expected to be transferred into the hands of the party most able to control the asset's returns. Therefore, we may expect that under certain circumstances, control over the actions of workers may be transferred to workers for efficiency reasons. By granting discretion to workers, workers in effect acquire the residual rights of control over firm assets they utilize (see Rayton, 1994). One implication of this paper is that firm owners may choose to sacrifice ownership for improved performance or low-cost means of transacting for labor services. This is odd, since efficiency is generally associated with well-defined, rather than vague or dispersed, property rights (see Coase, 1960).

Further work is needed in understanding the relationship between the law and economic organization. Of particular importance is the study of the feedback effects between alternative forms of organization and the law. While the law supports the development of alternative contractual forms, such as independent contracting, managerial control, and the granting of discretion, changes in organizations may affect the law. For instance, as organizations experiment with a number of innovative programs in an effort to become more competitive – such as re-engineering, the flattening of hierarchies, the use of self-managed teams, and so forth – we may expect legal precedents to change as contractual disputes that inevitably arise when change occurs are resolved by legal and legislative advances.

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