Employee Privacy and the “Theory of the Firm”

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Bruce Kobayashi and Larry Ribstein apply the “theory of the firm” to worker privacy with specific application to the employer’s ability to monitor employee performance and behavior. They take the theory to drive toward a much reduced role for law in favor of regulation by contract. This essay unpacks their theory. It faults the theory for its failure to come to grips with the possibility of monopoly in the labor market, its failure to appreciate the “public goods” nature of privacy policies and the related assumption that the employer’s ability to adopt and apply privacy-invasive policies is invariably a product of a consensual arms-length bargain.

I. Introduction

Bruce Kobayashi and Larry Ribstein examine the relationship of employer monitoring to employee privacy through the lens of the “theory of the firm.” At the outset they acknowledge both the managerial and employee interests at stake and advert to a role for law in accommodating them; but, they take the “theory of the firm” to drive toward a law-preclusive role for contract and, in the absence of contract, for default rules generally deferential to managerial judgment. My analysis tracks that detour and concludes by advising a return to the main road.

II. The Theory Applied

Kobayashi and Ribstein begin with a capsule theoretical summary to the effect that economic activity is carried out by a firm when the costs of market transactions are relatively high: when there are greater advantages to employers and workers by entering into an employment relationship than in engaging in spot market transactions for the purchase and sale of labor (which could be termed a “sales contract”). These ideas have been summarized by David Marsden:

Employers gain flexibility and the knowledge that labour will be available to them when they know more precisely what their work requirements will be. Workers gain by the continuity of activity, an important benefit when their principal source of income is the sale of their labour. Finally, both sides benefit, as Coase stressed, by substituting a single transaction for what otherwise might have been many.

JOURNAL OF LABOR RESEARCH
Volume XXVI, Number 4 Fall 2005
A problem inherent in so open-ended a relationship is opportunism. Managers and workers have goals that at once overlap and diverge, and there are informational asymmetries as well. Management knows more about the state of the product or service market and of its production goals and needs; workers know more about the actual work tasks. Management may seek to assign work or intensify it in a way that maximizes its utility but that diminishes employee satisfaction below what workers had expected. Workers may seek to shirk dissatisfactory work or hoard useful information. In consequence of either prospect or both, management may impose more or less stringent systems of monitoring work and workers. The dissatisfied employer is also free to discharge the shirking (or information-hoarding) employee; and the employee, disgruntled by employer opportunism or excessive monitoring is free to quit. But discharge or quitting introduces the respective cost of replacement and job search that set the economic parameters within which these sorts of behavior by employers and employees can take place. Thus, the question is whether or not there is a role for law in placing a limit on forms of monitoring that infringe employee privacy when imposed within these economic margins.

At the outset, Kobayashi and Ribstein acknowledge the legitimacy of both the employer's interest, in monitoring employees, and the employee's interest, in protecting his or her "private space." The "first-best" resolution of these conflicting interests, against excessive intrusion by employers (for employees "may divine utility from protecting their personal space") and against shirking or information hoarding by employees is contract: "Employers arguably would not seek excessively to invade employees' privacy, because they will have to pay employees to succumb to this surveillance." Absent contract, the law needs be concerned with fashioning default rules. But, the default rule arguably should favor surveillance because the employee has a better idea of the negative information that the employer might discover. The default rule, of course, would not be expected to prefer unlimited surveillance because this would impose high costs on employees without enough benefit for employers to justify sufficient wage adjustments to cover these costs. This supports the general requirement of surveillance being reasonably related to the employer's business purpose.

Even so, a rule of law to just that effect—that is, that employer action invasive of employee privacy must bear a sufficient business justification when weighed against the privacy interest invaded—would, they opine, be "too broad to provide adequate guidance in specific situations." So, contract remains the first-best solution, buttressed by default rules that generally defer to management's claimed need for surveillance but are otherwise left undefined.

From this, Kobayashi and Ribstein are critical of the decisional law "against the enforcement of [just such] contracts," citing Cramer v. Consolidated Freightways, Inc. as the prime (indeed singular) example. The fair implication of this decision, they argue, is that employers cannot rely on contracts with employees "at least as viewed from the intrastate perspective" because some state laws are an obstacle