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EMPLOYER REPUTATION AT WORK

Samuel Estreicher*

Employer reputational costs -- that is, the loss in value of the firm's reputational assets if the firm reneges on its promises to workers, both express and implied, -- has played an important role in the economic literature of employment contracts, but this factor has itself generated little sustained analysis. Reputation is often offered as a late-appearing *deus ex machina* explaining why opportunistic behavior by employers even in internal labor markets is likely to be relatively unimportant. A standard treatment is offered by Wachter and Wright:

Reputational consideration are also frequently cited as critical in restraining strategic behavior. Obviously firms are more likely than workers to acquire reputations in the external labor market. To the extent that firms engage in strategic behavior at the cost of workers, their reputation in the external labor market will suffer. These firms will have to pay higher wages to attract new workers or it will find it more costly to continue the contract provision that requires the workers to post a bond in the form of deferred compensation.¹

This explanation for the enforceability of implicit labor contracts in internal labor markets seems unsatisfactory. It assumes a well-functioning market in information about past and projected firm behavior, for a loss in reputation can only occur if job applicants from the external labor market are able readily to distinguish between "opportunistic" behavior (where, say, a termination of employment reflects an employer's renegeing on implied promises of deferred compensation or late-career immunity from close monitoring of performance) and legitimate behavior (where a discharge reflects an appropriate response to shirking on the job or unforeseen business conditions).

Even more fatal, the reputational-loss explanation assumes that employers in the first period (when they make the implied promise of deferred compensation or late-career job

* Dwight D. Opperman Professor of Law & Faculty Director, Center for Labor and Employment Law, New York University School of Law. An early version of this paper was prepared for the NYU Center's Research Conference on Behavioral Law and Economics in the Workplace, April 10, 2001. I focus here on the role of employer reputation in the operation of labor markets. Reputational costs to employees, while indeed important, are beyond the scope of this paper.

¹ Michael L. Wachter & Randall D. Wright, *The Economics of Internal Labor Markets*, 29 *Indus. Rels.* 240 (1990). Reputational costs play a pervasive role in Wachter's account of the operation of internal labor markets and the role of labor law. See, e.g., *The Enforceability of Norms and the Employment Relationship*, 144 *U.Pa. L. Rev.* 1913, (1996) (with Edward B. Rock); *Labor Law Successorship: A Corporate Law Approach*, 92 *Mich. L. Rev.* 203 (1993) (with Edward B. Rock); *Replacing Striking Workers: The Law and Economics Approach*, in *Proc. N.Y.U. 43d Ann. Cont. on Labor* ch. 6, p. 118 {Bruno Stein ed., 1990} (with George M. Cohen); *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure, and Relocation*, 136 *U.Pa. L.Rev.* 1349 (with George M. Cohen).

security) are in the same product market position in the later period (when they are expected to perform these implied promises). If the employer in the later period has disappeared, operates in a different product market, or has a need for workers with a different skill mix than in the first period, it will become even more difficult for job applicants in the external labor market to evaluate whether the firm's past behavior is relevant their probable job experience with that firm.

The reputational explanation also makes certain assumptions about how workers process information. As Lorne Carmichael (a leading student of reputation in labor markets) puts it:

Firms' reputations ... enter into the model in the way workers form their expectations about the expected utility each firm offers. Workers are assumed to possess very good information about the way each firm has treated its workers in the past. They also are aware of the distribution of states of the world, and observe the states when they are revealed. They believe (correctly) that each firm's technology is stable, so that their best predictor of what the firm will do in a given state is simply what the firm did the last time the state occurred.³

I. What is Employer Reputation?

Initially, we need a definition of what the term "reputation" means in this context. Reputation here refers to characteristics of the firm that are not readily verifiable by job applicants. In colloquial usage, the term is also often used as a shorthand for verifiable characteristics, as when the reputation of law schools is based on the median LSAT scores of its admitted students or the placement record of its graduates; or when the reputation of law firms is based on per partner profitability or the prevalence of judicial clerkships among its incoming class. In these circumstances, however, applicants can readily obtain the background statistic. Although a process of inference is involved in drawing lessons from the available verifiable information about the desired characteristics, the process is itself not very difficult, and the ultimate criterion appears to be one of selectivity, which is captured by the background statistic.

The reputational factor that arguably explains the enforceability of implied employment contracts, however, involves characteristics of the firm that are not readily verifiable. The job applicant knows the wage and working conditions and, to the extent gleanable from public information, the present profitability of the firm. What the applicant does not know and cannot easily find out is information concerning (1) the future economic health of the firm; (2) the economic health of, and future plans for, the particular division or facility the applicant is interested in;⁴ (3) whether the firm will make (what the applicant

³ H. Lorne Carmichael, Reputations in the Labor Market, 74 Amer. Econ. Rev. 713, 716 (Sept. 1984). See also Carmichael's Self-Enforcing Contracts, Shirking, and Life Cycle Incentives, 3 J. Econ. Persp. 65 (Fall 1989).

⁴ Public information like 10-K reports required by the U.S. Securities and Exchange Commission help illuminate the firm's general profitability but do not ordinarily disclose profit figures or future plans for particular divisions or facilities.

will regard as) “fair” compensation, promotion and discipline decisions; and (4) whether the firm will live up to implied promises of deferred compensation and late-career job security. All of these are aspects of future performance by the firm. Predictions are required, predicated largely on the firm’s reputation in the labor market.

Of course, if the job applicant has unlimited resources to expend in the search process, and is given unrestricted access to (and could obtain reliable information from) current employees, the applicant could learn a good deal more about the firm's actual record and draw improved inferences accordingly. In the real world, however, this would not be a rational investment of resources for any particular applicant to make. Moreover, there is reason to doubt whether he could obtain reliable information from past or current employees. Discharged shirkers would be unlikely to be forthcoming about the real basis for their loss of employment, and current employees may be less than candid about their situation (downplaying negative facts if they fear employer retaliation or suffer from cognitive dissonance or themselves desire that the applicant join them, or overstating negative facts if they are unreasonably disgruntled or wish to discourage ambitious applicants from joining their ranks). Moreover, unlike financial markets, sophisticated, well- informed job applicants who have a special ability to evaluate the firm's record, are not, likely to influence firm behavior because they will exit from the applicant pool.⁵

Instead, the typical applicant must do the best he can with the information he can easily verify and the aspects of firm reputation he can glean from readily available sources.

II. Why Does the Employer Care At All About Its Reputation?

Given the amorphousness of reputation as a firm asset, and the difficulty applicants have in evaluating firm reputation, we should ask why employers care at all whether they have reputations as "good" employers.

There are employment settings where employers plainly do not care. Where employers hire from the low-skill segment of the external labor market, expect high turnover, and can easily monitor job performance, they can obtain the workforce they need by simply paying the going wage in that labor market. Each day in a sense leads to the formation of a new "at will" employment contract; there is no need for a contingent contract to deal with future contingencies.

At the high-skill end of the external labor market, a similar process may be at work. Where workers have highly portable skills and their performance can be easily monitored, they may be hired effectively on a project-only basis. Both employer and employee have no particular interest in contracting for continued employment; hence, they have relatively little need for a contingent contract to deal with future contingencies.

⁵ See Carmichael, Reputation in Labor Markets, at 715 & n.2.

The reputation issue arises in "internal labor market" firms,⁶ where employers have an interest in encouraging some measure of job commitment by employees, and employees have an interest in some measure of continued employment with the firm. Here, judgments about future conditions at the firm are relevant to the job applicant, and the firm has an interest in maintaining its reputation as a promise-keeper.

In theory, the parties to a prospective internal labor market employment relationship would write a fully specified agreement, setting out the conditions for future compensation, promotion prospects and the like. However, contracts are 'likely to be implicit here because (1) the firm's future economic position or other factors influencing future compensation, promotion and the like are not knowable ex ante; (2) employee performance (by hypothesis) is not readily monitorable; and (3) a fully specified contract would be difficult to write even where predictions as to (1) and (2) could be solidly based.

It has been suggested that the internal labor market is fast becoming a relic in today's economy. Some point to an increasing incidence of workers changing employers.⁷ Others point to changes in technology, making acquisition of firm-specific skills (skills that increase with the particular employer but not to the same extent in the external labor market) increasingly unnecessary; others to legal innovations such as the vesting of defined pension benefits or the shift to portable defined contribution plans and the abolition of mandatory retirement⁸ as undermining the efficiency of internal labor market arrangements.

Although significant changes have occurred in U.S. labor markets – some firms are less concerned about job commitment, and some workers are less concerned about job security than they have been in the past -- internal labor market firms are likely to continue to be important for some time. For many job applicants, a reasonable prospect of continued employment with the same employer is desirable because it helps facilitate location and family planning decisions; and a pay system that rewards treasure is valued because "deferred rewards provide security for senior years and correspond to psychological desires for increased rewards over time."⁹ To the extent firms believe that applicants with such preferences are likely to possess unobservable characteristics associated with subsequent valuable performance (again, under conditions in which performance is not readily monitorable), they will want to attract (and keep) such workers. This phenomenon should continue even in the absence of any premium paid for firm-specific skills.¹⁰

⁶ This concept was first developed in Peter B. Doeringer & Michael J. Piore, *Internal Labor Markets and Manpower Analysis* (1971).

⁷ Mean tenure (years with the same employer) and long-term employment (say, fraction of workers aged 35-64 with their employer for at least 10 years) is declining in the U.S. private sector. See Henry S. Farber, *Job Loss and the Decline in Job Security in the United States* (CEPS Working Paper No. 171, June 2008).

⁸ See Samuel Issacharoff & Erica Worth Harris, *Is Age Discrimination Really Age Discrimination?: The ADEA's Unnatural Solution*, 72 N.Y.U. L. Rev. 783 (1997).

⁹ *Id.* at ____.

¹⁰ The acquisition of firm-specific skills, while significant in Doeringer & Piore, *supra* note.6, at 15-16, and in Oliver E. Williamson, Michael L. Wachter & Jeffrey E. Harris, *Understanding the Employment*

Reputation thus acts in a manner analogous to the "efficiency" wage model advanced by Akerlof and others.¹¹ It is a factor that helps attract and retain desired workers under conditions where monitoring of ongoing worker performance is difficult.

III. Enforceability Problems

This brings us to the question of whether implicit employer promises in internal labor market arrangements are capable of being self-enforced through the reputation mechanism. To highlight the issue, consider Lazear's oft-cited account of why employers are not likely to renege on such promises when they benefit from a pay system that pays workers less than their marginal productivity when junior and more than their marginal productivity when they are senior:

Firms may also deviate from the contract. The most obvious form of deviation manifests itself as unanticipated termination of the worker's labor contract before time T [the "socially efficient point of contract termination"¹²]. For example, in a world where no information passes from old workers to new workers, it is optimal for the firm to terminate all workers at time t [where the wage begins to exceed the worker's marginal productivity. It is unlikely, however, that contract violations are costless. To the extent that new workers use the firm's history as an indicator of future honesty, a cost is associated with any violation?¹³

[Insert Figure 1 somewhere around here.]

A. Reliable Information About Past Firm Behavior

How significant is this cost likely to be? In most employment settings, reliable information about the firm's record of promise-keeping is not readily obtainable. Current employees are likely to be the best source of such information but, under real world

Relation: The Analysis of Idiosyncratic Exchange, 6 Bell J. Econ, 250 (Spring 1975) is not an important part of other influential accounts of internal labor markets. See Akerlof, *supra* note 11, or Edward P. Lazear, Why Is There Mandatory Retirement?, 87 J. Pol. Econ. 1261 (No. 6, 1979); and his Agency, Earnings, Profiles, Productivity, and Hours Restriction, 71 Am. Econ. Rev. 606, 607 (No. 4, 1981) ("Even in the absence of any on-the-job training or investment in human capital, it pays to enter into long-term wage-employment relationships which pay workers wage rates less than [the value of their marginal productivity (VMP)] when they are junior, and more than their VMP when they are senior employees ."). See also James M. Malcomson, Work Incentives, Hierarchy, and Internal Labor Markets, 92 J. Pol. Econ. 486, 490 (No. 3, 1984).

¹¹ See George A. Akerlof, *An Economic Theorist's Book of Tales* (1984); *Efficiency Wage Theories of the Labor Market* (George A. Akerlof & Janet Yellen eds. 1986).

¹² This is defined by Lazear as the point "the value of a worker's time used outside the firm exceeds the value of his time used inside the firm," i.e., the point at which the present value of the internal wage path is equal to the present value of the worker's opportunity costs in the external labor market. Because the worker would prefer working beyond this time, since the wage continues to exceed both his external wage as well as his marginal productivity to the employer, Lazear would permit mandatory retirement at this point. See Lazear, *Agency, Earnings Profiles*, *supra* note 10, at 607 & n.2. Age-based mandatory retirement is, of course, no longer lawful in the U.S.

¹³ *Id.* at 607-608.

conditions, they are not likely to transmit this information to job applicants, Moreover, they are unlikely to transmit informational signals by exiting employment, because it is difficult to evaluate why employees are leaving and, given the lock-in effect of the internal labor market contract, it is difficult to evaluate why they stay.

In some settings, there are mediating institutions that help lower some of these information costs. Unions are ideally suited to play this role, to the extent they function as keepers of the institutional memory of the firm and adopt policies, such as seniority as the basis for allocating the risk of layoff, that help deter employer opportunistic behavior at the expense of late-career employees. Hyde also has written about the role of employee caucuses and other institutions that facilitate information-sharing between employees and applicants.¹⁴ In most situations, however, these institutions have not formed, and are not likely to.

B. Change in the Firm's Product Market Position

To the extent firms go out of business or exit from a particular product market at a later stage, staff reductions are less likely to be perceived by remaining or new employees as a reneging on past promises, and the firm is also less likely to care about reputational loss to extent its hiring needs have materially changed. The seniority principle, championed by labor unions but also used by many non-union employers, requires the employer generally to favor the more senior worker in retention decisions, and hence helps reduce the incidence of employer opportunism.¹⁵

IV. Difficulties in Processing Information About a Firm's Record

In addition to these difficulties, the behavioral law and economics (BLE) literature suggests that applicants will not be able to do a particularly good job processing information about the firm's record of promise-keeping. These cognitive limitations are likely to obtain even if we assume information is readily available.

One problem is the assessment of low-probability events, for any opportunism is likely to occur in the case of late-career employees. The BLE work thus far is contradictory on how workers process information about low-probability events. Kim and others argue

¹⁴ Alan Hyde, Employee Organizations in High-Velocity Labor Markets, in Employee Representation in the Emerging Workplace: Alternatives/Supplements to Collective Bargaining, Proc. N.Y.U. 50th Ann. Conf. on Labor ch. 12 (Samuel Estreicher ed. 1998).

¹⁵ However, unlike the situation where the firm continues in a steady state, unions are not likely to continue to have a presence when the firm goes out of business or exit a particular product market, to the extent the new employing entity hires an entirely new workforce. This is because purchasers of the assets of a business have no obligation to assume the collective bargaining obligations of the seller, and indeed have a right to hire an entirely new workforce, as long as they do not discriminate against the seller's employees because of their union status. See *NLRB v. Burns Security Services*, 405 U.S. 272 (1972); *Howard Johnson Co. v. Hotel Employees*, 417 U.S. 249 (1974). The existing doctrine is defended in Wachter & Rock, Labor. Law Successorship, supra note 1.

that workers are unduly optimistic¹⁶; Viscusi, on the other hand, finds they are unduly pessimistic.¹⁷

A second problem is the assessment of complex multivariate phenomenon. Here, the future contingencies that are likely to unravel implied promises cannot be specified ex ante, and applicants will have difficulty reading the signals from salient events, such as layoff announcements: Are layoffs legitimate responses to unforeseeable economic conditions or do they reflect an opportunistic renegeing on past implied promises?¹⁸ Applicants will also have difficulty determining whether the skill mix and other attributes they bring to the job are sufficiently similar to the characteristics of those laid off, such they face a comparable risk of (unjustified) layoff.¹⁹

Where Does This Leave Us?

Does the law have a role to play in helping promote enforcement of implied employment contracts? On one level, it might be said that to the extent contracts are implied, the parties know there are risks associated with their arrangement. They are betting on the future, and presumably are comfortable ex ante with (or at least have factored into their bargaining position) the lack of specification. From the employer's perspective, if it suffers a diminution in reputational assets, it has only itself to blame, and presumably will incur increased hiring costs.

The concern arises from the employees' perspective: both those caught in the midstream who suffer an opportunistic late-career change in their implied compensation/job security package, and new hires who misread the employer's reputation as a promise-keeper.

One approach might be to improve the market for information, by subsidizing the development of information-sharing networks where unions are not present to do the job. The Internet should facilitate the gathering and categorization of information.²⁰ The law might impose a tax on employers, similar to the experience rating of employers under unemployment insurance, to finance the operation of such networks. Absent the commitment of extensive resources to such an undertaking, that the information will be sufficient reliable to guide decisions; moreover, the mere provision of information does not address the information-processing limitations of applicants.

¹⁶ See Pauline T. Kim, Norms, Learning, and Law: Exploring the Influences on Workers' Legal Knowledge, 1999 U.Ill. L. Rev. 447.

¹⁷ See W. Kip Viscusi, Rational Risk Policy (1998).

¹⁸ Unfair-dismissal or discrimination lawsuits are no easier to evaluate. Most claims cannot attract lawyers. Of those that do, the overwhelming number of cases settle, without reliable information being imparted about the employer's behavior. Even cases resulting in litigated judgments are "noisy". Are they attributable to the misbehavior of isolated agents of the employer? Or are they attributable to the relative ease with lawsuits can be pursued? And so on.

¹⁹ This problem is further complicated by the practice of at least large employers to offer enhanced severance benefits in exchange for release of all claims.

²⁰ See generally David H. Autor, Wiring the Labor Market (NBER Working Paper W7959, Oct. 2000).

Sunstein suggests that perhaps changes in default rules can be designed to force employers to give better signals as to firm culture and their record of promise-keeping.²¹ However, a reversible "just cause" default rule, even if enhanced in the ways Estlund recommends,²² is not likely to do very much to improve the quality or the processing of information. The experience of jurisdictions like California and Michigan that have gone the furthest in this direction is that employers readily contract out of a "just cause" default rule, presumably without any marked, effect on the quality of their applicants.²³

Applicants seeking employment with an internal labor market firm are not necessarily looking for explicit "just cause" employment contracts. When confronted with employers who, responding to Sunstein's change in the background rule from "at will" to a "cause" regime, expressly disclaim any binding commitment not to discharge without cause, these job-seekers may, as Morriss suggests,²⁴ properly discount the incidence of wrongful dismissal and decline to negotiate varying terms. Rather, what they are seeking is some assurance that the firm is one with which they reasonably can make a career. Such assurance cannot be reduced to contract because, as earlier explained, future contingencies likely to affect the firm's ability to provide a secure working environment in the later stages of their employment cannot be spelled out. The most that can be expected is a good basis for predicting the firm's future performance based on its past record, and this requires some mechanism for storing, accessing, and evaluating the firm's institutional history.

One approach suggested by Weiler is to have the law require every firm over a certain size to establish an inside-the-firm employee organization that would serve as a repository of institutional memory and enforcement agent for job security promises.²⁵ In his proposal, this organization could convert itself into a traditional labor union.²⁶

Weiler's proposal merits more attention than it has received in the nearly two decades since it was first aired. One problem is that of institutional fit, because in the U.S. labor unions function as firm-based organizations, whereas in Continental Europe (where this idea has gained some traction) they do not, thus permitting creation of a dual track for employee representation (collective bargaining for distributive bargaining at the supra-enterprise level, and works councils for integrative bargaining at the level of the firm). Will these organizations operate here as mere beachheads for traditional union representation? If so, the proposal has to be seen as one effectively mandating union representation for all workforces, and needs to be justified accordingly. Informational problems should not serve as the tail wagging a much larger dog.

²¹ See Cass R. Sunstein, *Switching the Default Rule*, 77 N.Y.U. L. Rev. 106 (2002).

²² See Cynthia L. Estlund, *How Wrong Are Employees About Their Rights, and Why Does It Matter?*, 77 N.Y.U.L.Rev. 6 (2002).

²³ See generally Max Schanzbach, *Exceptions to Employment at Will: Raising Firing Costs or Enforcing Life-Cycle Contracts*, 5 Amer. L. & Econ. Rev. 470 (No. 2, 2003).

²⁴ See Andrew P. Morriss, *Bad Data, Bad Economics, and Bad Policy: time to Fire Wrongful Discharge Law*, 74 Tex. L.Rev. 1901, 1917(1996).

²⁵ Paul C. Weiler, *Governing the Workplace* 282-95 (1990).

²⁶ See *id.* at 294-95.

There are other questions that would need to be addressed. Some go to efficacy: Under what conditions are elected employee representatives likely to do a better job, than current arrangements, in gathering, processing and disseminating relevant information? Can such an organ function effectively without the institutional support of a labor union? Others go to costs: what are the costs of such a proposal in the U.S. rights-based legal culture? Is it likely that the activities of the employee organization could be limited to the information clearinghouse function? Will these organs ultimately impose the same costs on firms as unions, but without the same ability to function as effective bargaining agents?