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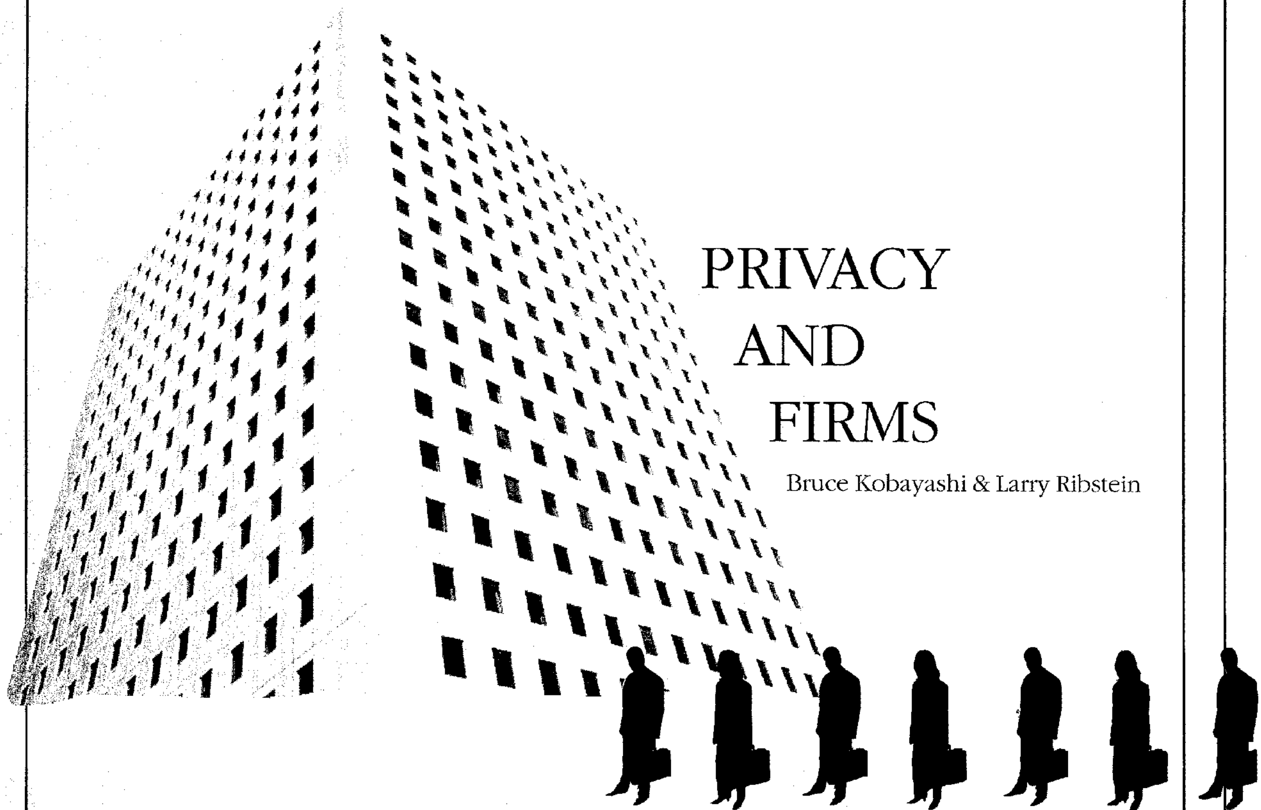
Bruce Kobayashi

Larry Ribstein



PRIVACY AND FIRMS

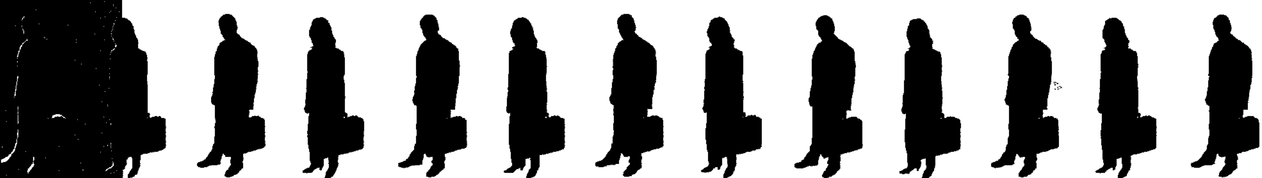
Bruce Kobayashi & Larry Ribstein

Questions concerning the extent to which privacy should be governed and what the rules should be.

Employees and employers have competing interests in disclosing

Privacy is a loose collection of principles, particularly including a property right in information and an interest in a protected personal sphere.[1] In general, there are questions concerning the extent to which privacy should be governed by default or by mandatory rules, and what these default or mandatory rules should be.

Privacy raises particularly difficult and important questions in the employment context. Employees and employers have competing interests in disclosing and preventing disclosure of information. For example, firms may want to share information with their employees about customers, trade practices and technology that helps the employees do their jobs. This raises the concern that employees will reap private advantage by selling or otherwise transferring this information to third parties during or following their employment. This concern could reduce firms' willingness to share such information with employees, and can suppress incentives to develop information or inventions.[2] At the same time, excessive protection of the employers' information could reduce employees' mobility and the flow of valuable information in society.



Employers, in turn, need information about employees in order to evaluate them for hiring and to monitor them while they are employed. Employees have an incentive to disclose because employers' information costs affect the cost of employment and ultimately jobs and compensation. But employees also may have an interest in keeping some information private to protect their personal space or to hide shirking or other bad acts that are detrimental to the firm.

Appropriately balancing employers', employees' and society's interests in workplace privacy contributes to social wealth by encouraging efficient employment relationships. This requires sensitivity to the unique characteristics of the economic activity that gives rise to the specific organizational form chosen by a given firm. It follows that balancing may best be achieved by enforcing firms' contracts. Contracts covering employment issues in general, and privacy in employment in particular, are among the nexus of contracts that are the central characteristic of a firm.[3] Since efficient restrictions add value to the firm by protecting its proprietary information and ability to monitor employees, employers and employees usually are better off if contracts are enforced than if they are not. To be sure, employees may prefer *ex post* not to be bound by restrictions on disclosure and not to be monitored by the employer. But employees are better off *ex ante* to the extent that they share in the value of efficient arrangements through higher compensation.

That is not to say that enforcing contracts is always efficient. There may be some role in this area as in other areas of intra-firm contracting for legal regulation. For example, restrictions on the dissemination of employer information or on employee mobility may benefit both employees and employers but reduce social wealth because of their negative effects on development of intellectual property and competition. Employers' intrusions into employee privacy may be privately wealth maximizing within the firm, but have social costs in terms of the loss of individuality. Thus, it may be tempting to regulate these contracts.

But in order to fully evaluate such regulation, it is important to measure costs as well as benefits. The full costs of regulating employer/employee contracts appear only from an understanding of the role these contracts play in the overall operation of the firm, and an appreciation of the second-best alternatives parties would resort to if regulation precludes first-best contracts. For example, restricting protection of employer information can inhibit firms from disseminating confidential business information to employees[4] and, in turn, force revision of relationships with employees. Protecting the privacy of employees' information can inhibit monitoring of employees and force employers to resort to non-agency-type relationships.

This paper is both normative and positive. It shows why contracts regarding these issues *should* be enforced. It also shows that the contracts are enforced despite seemingly mandatory state rules preventing enforcement. The key to understanding the positive analysis is to see the enforcement issue in the *interstate* context, where both employers and employees are free to choose the states in which they live, contract, and sue.

Part I presents an overview of the theory of the firm and its implications for privacy. Part II discusses the issues regarding privacy of the employers' information, including enforcement of contracts between employers and employees from intra- and interstate perspectives. Part III discusses privacy issues concerning employees, again including enforcement of contracts.

I. THE THEORY OF THE FIRM AND PRIVACY

Economic activity is carried out within a firm when the costs of using market transactions are relatively high.[5] Within a firm, a nexus of longer-term contracts that direct activity and restrain the behavior of the transactors replaces spot transactions directed by market prices.[6] The form of these contracts is shaped by the nature of the transactions and information costs the parties face. One circumstance in which the cost of using market transactions is high is team production. Team production occurs when individual resources are combined so that the value of the combined output exceeds the sum of the outputs of the individual resources, and it is costly to determine an individual's marginal contribution to team output.[7] Increasing the cost of monitoring an individual's effort level increases moral hazard costs, ceteris paribus. Moreover, if the team resources become specialized to the team, individual members can opportunistically "hold up" the team by threatening to withdraw team resources under their control unless they receive a larger share of the team's marginal product.[8]

The use and production of confidential business information is an example of the team production problem. Team production is present because the value of information produced by many individuals exceeds the sum of the values of each individual's separate information. Moreover, the value of the combined information is often maximized when it is then widely disseminated among members of the team, as opposed to being closely held by management. Thus, to maximize the value of team production, individuals must be induced to disclose their valuable private information to the firm, and the firm in turn must be able freely to disseminate the information among team members.

The inherent attributes of information can, however, make both types of disclosures costly. First, it is difficult to monitor individuals' use of the team's information because information is intangible, thereby facilitating hidden behavior,[9] and plastic in the sense that it can be used in many different ways.[10] This deters sharing of valuable information and reduces the value of team production.[11] Individuals may fail to disclose valuable information to the team, inadequately safeguard valuable information, or use disclosed information for their own benefit at the team's expense,[12] by direct or indirect disclosure to competitors.[13]

Second, it is difficult to design mechanisms for encouraging disclosure by individual team members. Prior to disclosure, the discloser may be unable to convince others of its value. Indeed, even after disclosure it may be difficult to value the marginal contribution of an individual's information.[14] If the owner of the information has been unable to strike a bargain prior to disclosure, it may lose the value of the information on disclosing it because, absent legal protection, the potential buyer or others may disseminate it.[15] These problems may lead to "adverse selection" in the sense that team members are induced to disclose only low quality information.[16] A team member also may be able to use his private information to hurt the team, or threaten to do so unless he is given a larger share of the benefits the team creates.

The firm must devise ways to solve these problems of moral hazard and opportunism associated with the disclosure and use of information by individuals in the firm. This includes restricting individuals' access to valuable information, and developing incentives to create information. The firm can promulgate rules apportioning the value of the firm's information among team members, contract with employees to restrict their behavior during and after their employment, and monitor employees'

"...firms' incentives to share information with their employees may be affected by the risk that employees will disclose this information with others"

creation and use of information. These rules and contracts may involve intrusions into the employee's "privacy" and restrictions on the employee's "freedom." But such "intrusions" are no more onerous than terms contained in licensing agreements that serve to restrict the "freedom" of the licensee.[17] Both types of restrictions facilitate the voluntary production and dissemination of information.

How a firm addresses these problems depends on several factors. First, firms differ in the extent to which their activities use resources and information that are costly to monitor and expose the firm to opportunistic behavior. Second, employees vary in their costs of reduced privacy and ability to move to other jobs. These differences can be expected to produce many different approaches to protecting information.

Firms' contracts also depend on legal rules precluding enforcement of some types of contractual restrictions. For example, rules that protect employees' privacy can increase firms' monitoring costs by precluding them from using some types of intrusive surveillance techniques. Firms then will have to use less preferred methods of reducing the costs of employee moral hazard. Firms may not only switch to less intrusive and effective monitoring methods, but also make more fundamental changes in the way they conduct their business. For example, firms' increased exposure to tort and criminal liability resulting from diminished ability to effectively monitor employees may induce firms to replace employees with independent contractors, thereby effectively altering the scope of the firm.[18] Also, reducing firms' abilities to protect their information also may reduce dissemination of information with the firm and potential marginal benefits of team production.

The desirability of legal rules prohibiting enforcement of agreements that restrict employee privacy and mobility must consider several issues in addition to the substantive nature of such rules, including whether such rules should be mandatory or default rules, what legal regime will apply to a contract between a firm and its employees, and how such rules should be made. For example, if a wide variety of approaches would be optimal, default rules may be superior to mandatory rules, and different types of firms may need different default rules. Under these circumstances, a decentralized, bottom-up approach to legal restrictions may be preferred to a top-down, centralized uniform approach.[19] Finally, while different firms may prefer a wide variety of approaches, a given firm may prefer that a particular rule apply uniformly to all members of a firm. Otherwise, forum shopping by mobile employees of multi-state or multi-jurisdictional firms can result in the non-uniform and non-optimal application of rules regulating the employer/employee relationship.[20] This suggests that parties should be able to enter into enforceable contracts by choosing which law governs the employee/employer relationship.[21]

II. PROTECTING EMPLOYERS' INFORMATION

This Part builds on the general discussion in Part I by discussing more specifically the employment contracts that protect dissemination of employer information and the costs and benefits of enforcing these contracts. It shows that, while enforcing these contracts usually is efficient, there may be some justification for state laws restricting enforceability. However, the politics of such laws suggests that state regulation may be excessive. In particular, states may internalize the benefits of using these laws to protect local interests while imposing costs out of state. This Part also shows that this problem ultimately can be disciplined by the parties' ability to locate and litigate in jurisdictions that enforce efficient contracts. Subpart A discusses the countervailing considerations that drive contracts in this area. Subpart B discusses state provisions and enforcement of contracts regarding these issues, including the default rule protecting trade secrets and customized contracts regarding ex-employees' competition and disclosure. It shows that, viewing the issues solely from an intrastate perspective, states have perverse incentives not to enforce efficient contracts. Finally, subpart C discusses the interstate dynamic that disciplines state law inefficiency.

A. THE BASIC PROBLEM

As discussed in Part I, firms' incentives to share information with their employees may be affected by the risk that employees will disclose this information with others. Employees may do so by either straight sale or by effective sale in the form of employment. During employment, the firm can monitor employees' misuse of information, subject to restrictions on such monitoring resulting from privacy considerations discussed in the next Part. The employer's biggest problem, therefore, may be the employee's use of the information to compete with her former employer after leaving employment.

From the standpoint of the employer's and employee's joint welfare, the optimal contractual restrictions depend on the risk to the employer associated with the employer's disclosure of proprietary information; the value to the employer of disseminating the information to the employee compared to alternative relationships in which information is not shared with the agent, and the costs to the employee of being restricted from sharing information that the employee may have helped create and that is inherent in the employee's expertise. For example, the employer may have developed customer lists or technical information that the employee must have in order to be able to sell or develop the product. However, if dissemination of the information to the employee is likely to lead to the further disclosure of the information to competitors, sharing this information will result in a significant reduction in the value of the employer's valuable informational property right. The employer's only alternative to restricting disclosure may be a less productive relationship with the employee. However, the employee may have also contributed to the development of the employer's products and its clientele. Also, a highly specialized employee may be unable to separate her own expertise from that of the employer. Variations on these facts would produce different levels of optimal restrictions on information in particular relationships.

The policy analysis is complicated by social costs of contracts regarding dissemination of employer information. Dissemination of information may be valuable to the amount of innovation.[22] Conversely, inability to protect proprietary information may reduce incentives to produce it in the first place.[23] Thus, default rules and contract enforcement matter.

B. ENFORCEMENT OF CONTRACTS: INTRASTATE PERSPECTIVE

This subpart discusses the basic law of enforcing contracts that protect employers' information. It assumes that the relevant law is that provided by a single state. Subpart C widens the perspective to the multi-state scenario.

1. The default rule: Trade secrets law

Trade secrets law most directly protects the employer's business information. However, this law has important gaps, and may be costly and uncertain to apply.[24] Thus, employers must supplement default legal protection of trade secrets by actively monitoring employees' theft of information and with other contractual protection, including non-competes, as discussed in the next subsection.

2. Express contractual protection: Non-compete covenants

Although employees may become involved in industrial espionage and outright theft, while they are with the firm it would seem that the threat of dismissal would deter most direct misuse of corporate information.[25] However, after the employee leaves, firing the employee obviously is no longer a viable sanction for misuse of information and the employee has much stronger incentives to abuse corporate information. The employee might sell the information outright, but more often is likely to try to use the information as leverage in getting another job or as the basis for a competing business. As noted above, relying on trade secret law alone may not be an effective means to prevent such abuse of employer information. Thus, the most important protection in this setting is through the use of covenants not to compete.[26] These contracts impede employees from effectively selling the information by pursuing lines of work after employment where the information is most valuable. The agreements also serve several other functions, including ensuring the retention of unique talent, and protecting the firm's investment in training employees.[27]

Covenants not to compete are not always enforced under state law. The main question regarding enforcement concerns the scope of the restriction. Most states enforce "reasonable" restrictions,[28] although they may differ on standards of reasonableness. Some states have strong statutory policies against enforcement set forth in statutes. In particular, the California statute provides, "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void."[29]

The states appear to have several reasons for not enforcing these agreements. First, where the agreement restricts the employee more than appears necessary to protect the employer's property rights, the agreement may be anti-competitive — that is, it may prevent employees with valuable expertise from working for competitors. Also, employers may try to piggyback competition restrictions onto protection of information by disclosing more trade secrets to employees than the job requires in order to justify broad restrictions.[30] Second, some courts appear to be concerned with inequality of bargaining power between employer and employee, perhaps attributable to employees' lack of market power or sophistication. Third, Ronald Gilson has argued that enforcing non-competes reduces positive externalities of information sharing between firms that can permit the growth of high-tech corridors.[31]

These arguments may or may not justify non-enforcement.[32] In general, even if non-compete agreements have costs, it is important to consider whether the benefits of enforcement discussed above outweigh the costs. Even if the court imposes a seemingly mild "reasonableness" restriction, it may be hard for employers to design a restriction that is both broad enough to protect their information and narrow enough to satisfy the courts. Thus, holding agreements unenforceable may impede protection of employers' information. This seems particularly clear where alleged costs are internalized between the employer and employee.

With respect to the argument that the agreements are anticompetitive, it is not clear why employers in general should be deemed to have enough market power in the employment market to render their employment agreements suspect. Just as employers compete for valuable employees at the time of employment, so they must compete as to the terms of employment, including terms that restrict employees' mobility. Thus, employers would internalize the costs of these agreements through the wages they must pay employees to agree to the covenants. Indeed, it would seem that employers would have to pay employees more than the agreements are worth as restrictions on competition since employees, whose human capital is not diversifiable, could be expected to be averse to the risks of immobility.

Perhaps the competition argument reduces to an argument that the employers have unfair bargaining leverage over employees. But again, it is not clear why this would be the case throughout the employment market. Moreover, covenants not to compete are most prevalent with respect to the most highly trained workers and professionals, who are presumably most able to protect themselves contractually. Although legal restrictions on non-competes may make workers better off than they would be without the restrictions, it is not clear whether this is efficient or in any sense fair. Non-enforcement of the covenants may transfer wealth from employers and low human capital workers to high human capital workers.[33] Even if employers do have bargaining leverage, restrictions on non-competes may accomplish little, since employers can use their leverage to reduce the employees' compensation to adjust for the inability to impose a non-compete, or substitute other devices that may be inferior from the employers' standpoint but hurt employees as much or more than non-competes. For example, employers have the option of simply disclosing less information to employees.

With respect to Gilson's argument that non-competition agreements may impose social costs by impeding the flow of information, it is not clear when this benefit of restrictions is outweighed by the social costs of reducing incentives to produce information or making employment relationships less efficient. All of this is not to say that restrictions on non-competition agreements are never efficient. The benefits of certain types of restrictions certainly outweigh the costs for some types of economic activities. But the opposite will be true for other types of economic activities. Even if legislation or common law rules that restrict enforcement of non-competition agreements enforce efficient norms or practices for the former subset of activities,[34] applying such laws to the latter set of activities will be socially costly. Thus, there is room for experimentation with and competition among various regimes. This raises the question, discussed in the next subpart, whether jurisdictional choice leads to efficient rules.

C. THE INTERSTATE PERSPECTIVE

Gilson suggests that states should be able to decide what policy they will follow regarding enforcement of non-competes because employers can leave states that inadequately enforce contracts and protect property rights.[35] But a state's regulation may apply to employers who have offices in multiple states, that seek to recruit in the regulating state, or whose employees are being recruited by an employer in the regulating state. The national or international scope of many modern firms makes it costly for them to structure their businesses so that they avoid operation in states with undesirable rules. This may enable states — particularly a large, economically powerful state like California — to impose the costs of its competition policy on firms elsewhere while local firms get the benefits. Conversely, California's firms are subject to the costs of other states' inadequate regulation while they must play by local rules in doing business locally. This problem of "spillover" of regulatory costs suggests that state competition may lead to inefficient results.

Firms' practical inability to avoid undesirable state regulation is partly attributable to default choice-of-law rules regarding enforcement of contracts that make it difficult for employers to predict whether their agreements will be enforceable in these interstate situations. Restatement (Second) of Conflicts indicates the range of considerations courts may take into account:

> (1) The rights and duties of the parties with respect to an issue in contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties under the principles stated in § 6.
>
> (2) In the absence of an effective choice of law by the parties (see § 187), the contacts to be taken into account in applying the principles of § 6 to determine the law applicable to an issue include:
>
> (a) the place of contracting,
>
> (b) the place of negotiation of the contract,
>
> (c) the place of performance,
>
> (d) the location of the subject matter of the contract, and
>
> (e) the domicil, residence, nationality, place of incorporation and place of business of the parties. These contacts are to be evaluated according to their relative importance with respect to the particular issue.
>
> (3) If the place of negotiating the contract and the place of performance are in the same state, the local law of this state will usually be applied, except as otherwise provided in §§ 189-199 and 203.[36] The general factors that guide choice of law under this section are:
>
> (a) the needs of the interstate and international systems,
>
> (b) the relevant policies of the forum,
>
> (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue,
>
> (d) the protection of justified expectations,
>
> (e) the basic policies underlying the particular field of law,
>
> (f) certainty, predictability and uniformity of result, and
>
> (g) ease in the determination and application of the law to be applied.[37]

Thus, for example, a court might apply the law of the raiding employer's state rather than that of the employee's or employer's state, even if the employee originally resided there, because of the raiding state's strong policy favoring sharing information. The regulating state might be able to have it both ways, since in the reverse situation its own interest in protecting local

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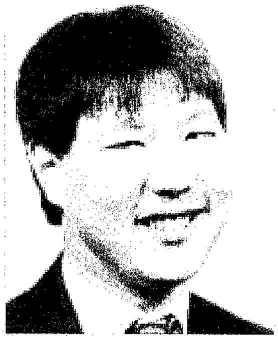

Bruce Kobayashi is Professor of Law, George Mason University School of Law.
Professor Kobayashi received his Ph.D in economics from the University of California, Los Angeles. He is the author of numerous articles on the law and economics of intellectual property, antitrust, regulation, litigation, and procedure. He and Professor Ribstein have published numerous articles on jurisdictional competition and regulation, including recent articles on state regulation of consumer marketing information and state regulation of electronic commerce.

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employers' information may override the interests of a state that has no policy favoring sharing information.[38]

A potential solution to all these problems is allowing the parties to nail down the applicable state law by including a choice-of-law clause in their employment contracts. This can potentially ensure enforcement of the clause against application of state law that protects employees or raiding employers. The Restatement provides that the law designated in the contract is not enforced as to a regulatory issue if:

(a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or

(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.[39]

Since the chosen state is often the employer's headquarters or at least a branch office, the main issues concern, not the relationship with the chosen state,[40] but whether another state has a fundamental policy against enforcement and that state's interests outweigh the chosen state. The cases reach varied results, but a review of 67 restrictive covenant cases involving choice-of-law clauses shows that clauses were enforced in 39 cases, not enforced in 25 cases, and interpreted as inapplicable in three cases. To be sure, further analysis is necessary to determine the marginal effect of the clause - that is, whether the court would have reached the same result under either law. But the courts' tendency to enforce contractual choice suggests that the clauses may have some effect in inducing courts to enforce restrictive covenants.

This brief review of the law suggests that the parties gain something from these choice-of-law clauses, even if they are frequently not enforced. Where the law of a contractually selected state is fairly similar to that of another state whose law would apply in the absence of contractual choice, but where the law of the two states might go either way with close facts, the court likely will apply the selected law. Thus, a firm may be able to gain predictability by contracting for the application of the law of a state that has experience with these clauses or has enforced the particular clause or clauses in relevant industries.[41] Also, even if the two potentially applicable laws differ significantly, a court may choose to apply the less regulatory statute where the fact situation is arguably not covered by the more regulatory statute.[42]

However, these clauses do not give employers perfect protection. The problem is that states enforce their own "fundamental" policies, while at the same time refusing to apply the laws of states that have weak contacts with the contract. This often means protecting local employers against employers based out of state. Consider, for example, *Application Group, Inc. v. Hunter Group, Inc.*,[43] in which a California state court protected a local employer raiding an employee of a Maryland firm despite a Maryland choice of law clause. Applying the Restatement[44], the court held that California's anti-non-compete policy applies to employment involving performance of "services for California-based customers" even if the employee had no prior contact with California and does not reside in California. The court reasoned:

In this day and age—with the advent of computer technology and the concomitant ability of many types of employees in many industries to work from their homes, or to 'telecommute' to work from anywhere a telephone link reaches—an employee need not reside in the same city, county, or state in which the employer can be said to physically reside. California employers in such sectors of the economy have a strong and legitimate interest in having broad freedom to choose from a much larger, indeed a 'national,' applicant pool in order to maximize the quality of the product or services they provide,

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in the judicial process because Ms. Lewinsky struck a deal with Mr. Starr and voluntarily turned over the records.

The Tattered Cover, in its case, urged the court to apply the compelling need standard. We argued that the government did not demonstrate a compelling need for the information to make their case, nor did authorities exhaust their other alternatives in gathering information. Only when there is compelling need and there are no other alternatives should First Amendment guarantees be set aside.

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as well as the reach of their 'market.'[45]

In short, the court insisted on the ability of California employers to compete for employees nationwide irrespective of the costs incurred by non-California employers from abrogation of their non-competition agreements.

There are strong arguments for enforcing contracts choosing the law applicable to non-competition agreements. First, such agreements are likely to reflect the contracting parties' mutual interests. Second, enforcement allows firms to escape inefficient restrictions on contracting, particularly where states otherwise would be able to reach far outside their borders, as in *Hunter*. Third, enforcing agreements notifies parties what law will be applied to their contract, and therefore how to draft the contract, price its provisions and behave in accordance with the applicable law. Fourth, these contracts allow firms to impose the same rules with regard to all employees, even if they live in states with different rules on enforcement of non-competes. This may be significant where the firm must design company-wide rules and contracts relating to information dissemination, incentives, and basic structure of its employment relationships.[46] For example, a firm may want to make its compensation contracts contingent on compliance with the non-compete in order to discipline potential abuse of corporate information.

The problem with enforcing contractual choice is that it can allow an end-run around efficient state regulation. If state regulation of non-competes reduces externalities such as the efficiency of free-flowing information, it follows that these externalities will impede efficient contractual choice just as they do efficient non-competes.[47]

One way to accommodate arguments for and against enforcement is to enforce contractual choice of law except where a state whose law would apply in the absence of a choice of law clause specifically legislates against enforcement of the non-compete. This restriction has two components. First, it limits the reach of state restrictions on contractual choice. This focuses attention on the terms of the default choice-of-law rule. In contrast to the current multi-factor test, this rule should be designed to be as precise and predictable as possible. Predictability would maximize the parties' ability to exit from oppressive laws by avoiding regulating states, and would let the parties shape their conduct and contract with reference to the applicable law.[48] These considerations would, for example, usually preclude application of the law of a raiding employer's state where the firm is raiding employees of an out-of-state firm, as in *Hunter*.[49]

Second, the applicable state should be able to restrict contractual choice only by explicit legislative policy. This again reflects the need to facilitate contracting with reference to the applicable law. It also helps ensure popular support for any restrictions on contractual choice by making the restriction salient and thereby inviting active competition among interest groups.[50] This is not feasible where courts decide choice of law disputes *ex post* in specific cases.[51] This approach contrasts with the current emphasis on "fundamental policy" and a state's "interests," which make it uncertain which states' regulation will be applied to trump contractually selected law. The vagueness of these tests sometimes allows states to have it both ways, applying their laws to enforce contracts of local firms against out-of-state firms, as well as to trump contracts of out-of-state firms in favor of local firms.

Efficient enforcement of contractual choice of law consistent with the recommended rule may follow from the combined influence of several related contractual devices and legal rules. First, since results like that in *Hunter* are likely to be reached only by state courts in states with self-serving policies regarding non-competition agreements, the parties may be able to minimize these results through choice-of-forum or arbitration clauses that choose more contract-friendly adjudicators or jurisdictions. For example, in the *Hunter* situation, the parties might agree to have the case tried in Maryland. Although the employee may seek to avoid the effect of this clause by suing in California, a California state court may have some incentive to avoid having to decide the tricky choice-of-law issue by enforcing the choice-of-forum clause.[52] The Federal Arbitration Act may ensure enforcement of the arbitration clause if the transaction involves interstate commerce.[53]

Second, to the extent that courts do not enforce *ex ante* choice of forum clauses, the parties have significant leeway to ensure enforcement of their chosen law by choosing to litigate in a hospitable forum. For example, the employer can sue in the contractually selected state or in federal court to enforce the choice-of-law clause or to get a declaratory judgment that the contract is enforceable. Although federal courts apply local state law in diversity cases,[54] they may tend more than state courts to enforce contractual choice of law in marginal cases because they lack state judges' incentives to back the prerogatives of the local legislature.[55] In fact, a survey of approximately 20 years of decisions under the Restatement provisions quoted above showed that federal courts were approximately twice as likely to enforce contractual choice as state courts.[56] As one might expect, most cases involving enforcement of contractual choice of law have been decided in federal court.[57]

To be sure, the employee can play the same game and sue in a non-enforcing court to invalidate the agreement. Indeed, both games played out in *Hunter*, with the wronged employer suing and getting a judgment in Maryland, and the competing new employer suing in California.[58] The former employer was able to stay the California action pending completion of the Maryland action.[59] The California court noted that it was not determining the full faith and credit effect of any judgment Hunter might obtain in Maryland.[60] Although the employer will not always succeed in this game, the prospect of competing judgments may be enough to persuade courts to enforce choice of forum clauses and eliminate any uncertainty about the forum.[61]

Third, even if the parties cannot control the forum, they may be able to structure their contracts to avoid application of regulating states' laws, or avoid contacts with those states that might justify application of those states' laws. In *Hunter*, for example, the raided employer could avoid subjecting its own activities to California law by not stationing employees with non-competes in California, instead working there through independent contractors.

Although none of these approaches helped Hunter avoid application of California law to the California firm that raided its employees, *Hunter* should be seen as an extreme case where Hunter was specifically concerned about being raided by the California firm. The application of California law there meant that the parties were at least treated symmetrically — that is, Hunter could not hide behind Maryland law while raiding the California firm under California law. Thus, the decision effectively preserves the viability of California law, which otherwise would have been threatened by one-sided application of the California regulation. Moreover, the quote from the opinion above makes clear that the court was specifically concerned about "virtual" or knowledge-based firms with no fixed location.[62] The court held that under its rule "it is plainly not sufficient simply to be employed by a California-based employer such as AGI, or to be treated as a California employee for tax and other legal purposes, if the employee is to perform services exclusively 'beyond the borders of California.'"[63]

In sum, this discussion raises two general points. First, the existence of an externality or spillover problem with state regulation is based on the same factors that give rise to jurisdictional choice. Second, jurisdictional choice supports enforcement of contracts from an interstate perspective even if these contracts do not seem to be enforceable from an intrastate perspective.

III. PROTECTING EMPLOYEES' PRIVACY

This Part discusses the issues regarding privacy of employees' information. As discussed in Part I, above, the employers' need for this information is a function of the inherent characteristics of the firm — namely, the team production problem, which triggers a need for monitoring. As discussed in subpart A, this need for information may collide with employees' desire for and expectation of privacy. As discussed in subpart B, these problems theoretically may be resolved by contracts between employers and employees, although these contracts may not always be enforced. Subpart C shows that, as with privacy of employers' information, contracting is a viable solution from an interstate perspective.

A. GENERAL POLICY CONSIDERATIONS

Employees have an interest in protecting against employers' intrusions on their private space. Conversely, employers have a legitimate interest in monitoring employees, including preventing abuse of employers' confidential information and detecting crimes and other wrongs committed by employees. Enforcing contracts regarding these matters increases social wealth by encouraging efficient employment arrangements.

Arguments concerning the employee's privacy draw on the economic theories of privacy and information costs. Protecting employees' privacy increases employers' information costs, thereby making the employment market less efficient and increasing agency costs.[64] This may both reduce social wealth and redistribute wealth from "good" to "bad" employees. Among other effects, the inability to monitor may decrease employers' ability to protect against employee abuse of trade secrets, thereby increasing the firm's need to rely on non-competition agreements.

On the other hand, protecting employees' privacy to some extent may be efficient. Employees may derive utility from protecting their personal space.[65] This protection may enable them to better realize their private preferences, such as sexual orientation, or to avoid misinterpretation of isolated bits of information, such as out of context statements.[66] If legal protection is inadequate, employees may have to invest in self-protection, which would force greater expenditures on reputation than would be the case under an efficient legal rule.[67] Even if

Larry Ribstein

I am currently Foundation Professor of Law, George Mason University School of Law. Effective in May I will be the Richard W. and Marie L. Corman Professor of Law, University of Illinois College of Law. I am the author or co-author of six books and more than 80 articles on corporations, securities law, partnerships, conflict of laws, professional responsibility, bankruptcy, constitutional law and other topics. My interest in privacy law stems from my work on contractual choice of law. See especially my written articles with Professor Bruce Kobayashi: A Recipe for Cookies: State Regulation of Consumer Marketing Information, Federalism Project Roundtable Paper Series, No. 1, May 2001, available at http://www.federalismproject.org/conlaw/ecommerce/cookies.pdf, and State Regulation of Electronic Commerce, George Mason Law & Economics Working Paper 01-31, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=294466, forthcoming Emory Law Journal.

the particular basis for employee utility cannot be identified, the test arguably should be subjective rather than objective.[68]

B. ENFORCING CONTRACTS: INTRASTATE PERSPECTIVE

As with non-competition agreements and protecting against abuse of trade secrets, enforcing contracts can lead to the optimal rules for particular situations. Employers arguably would not seek excessively to invade employees' privacy because they will have to pay employees to succumb to this surveillance. Employers seemingly would have little interest in generating irrelevant or inaccurate information about employees. The courts have, in fact, enforced employer surveillance where it has a business purpose.[69]

An initial contracting issue regarding employer surveillance concerns the appropriate default rule.[70] In the consumer information context, a default rule favoring privacy may be appropriate because the merchant arguably has a better idea than the consumer of the value of the information.[71] However, in the employment context 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.[72]

But it is not feasible to design a default rule that adequately covers all situations because such a rule would have to be too narrow or too broad. A default rule based on a legitimate business purpose might cover all employers and employees but is too broad to provide adequate guidance in specific situations. Thus, the parties will need to rely on specific contracts.

Nevertheless, there is significant recent authority against enforcement of contracts. *Cramer v. Consolidated Freightways, Inc.*[73] held that a collective bargaining agreement that arguably allowed video surveillance behind two-way bathroom mirrors could not supersede what the court deemed to be the mandatory provisions of state privacy law. The judge who wrote the en banc decision expressed a concern in his panel dissent about Orwellian intrusions.[74] This makes little sense assuming that the employees consented to the intrusion in the collective bargaining agreement, as a dissenter to the en banc decision argued.[75] Moreover, the Orwellian argument suggests the implementation of a federal policy, which is inappropriate in the context of purportedly interpreting a state restriction on intrusions. In any event, this case indicates that, as with non-competition agreements, employers apparently cannot rely on contracts with employees, at least viewed from the intrastate perspective.

C. ENFORCING CONTRACTS: INTERSTATE PERSPECTIVE

The interstate perspective on employee privacy contracts differs from that in the non-competition setting because employee privacy agreements are more likely to be anchored in a single state. The non-compete context involves the competing interests of states where raiding and raided firms are located. With respect to employee privacy, on the other hand, the primary interests are focused in a single state, where the employee whose interests are at stake is located. Thus, there are less likely to be regulatory spillovers in this context. In other words, the employers' ability to select jurisdictions in which they locate may be enough to internalize regulatory costs and benefits in regulating jurisdictions. At the same time, employers' ability to choose the applicable jurisdiction is likely to be more limited. Under the Restatement, courts are unlikely to enforce the contractual choice of a jurisdiction other than where the invaded employee works to trump the "fundamental" regulatory policy of the state of employment.

Despite these considerations, employee privacy has a real interstate dimension. Multi-state employers are likely to want to choose a single policy for monitoring employees. The problem is even more serious for "virtual" companies like those in *Hunter*, where employees live and work in several states and the employers' privacy policies relate to, for example, networked computers.

Although default choice of law rules raise fewer problems in this context than in the non-compete context, choice-of-law clauses may be useful to enable employers to avoid oppressive states without having to avoid hiring in those states. Again, these clauses should be enforceable unless the "default" state specifically legislates against them. However, the *Consolidated Freightways* case indicates that contractual choice may not always be enforceable. The court refused to enforce the employer's effective choice of federal labor law against a supposed state mandatory privacy rule.

As with non-competes, employers may be able to enforce jurisdictional choice by choosing the forum in which they litigate. To be sure, courts with strong pro-privacy policies may be unwilling to enforce contractual choice of forum. But an employer may be able to choose *ex post* to litigate the enforceability of the contract in a state in which it does substantial business.

IV. CONCLUDING REMARKS

Traditional economic theories of the firm intersect with modern concerns about privacy. The firm is about ensuring the free flow of information, while privacy policies attempt to intersect these flows. These competing concerns generally should be resolved by contracts. In some cases state regulation is appropriate. Jurisdictional choice in our federal system serves to discipline excessive state regulation.