HR Law Hotline

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CONTRACT THEORY: LESSONS FOR EMPLOYMENT LAWYERS

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The 2016 Nobel Prize for Economic Sciences was awarded to Dr. Oliver Hart and Dr. Begnt Holmstrom for their remarkable work in the field of Contract Theory. In this article, we provide an overview of Contract Theory principles and how employment lawyers can best utilize these principles to structure employment contracts in areas of employee remuneration and incentivisation.

INTRODUCTION

Contract Theory is the study of contract design and contract optimization - using economic, mathematical, and sociological tools to design and interpret contracts. The cornerstone of Contract Theory is the principle of party autonomy, implying that parties are free to design their contracts in a manner that best reflects their commercial intent. This principle becomes pertinent in the event of a dispute, where courts employ the rules of interpretation to discover the intent of the parties. Therefore, parties must allocate sufficient resources towards designing a contract that accurately communicates the performance standards and obligations of the parties. For instance, parties could opt to internalise costs of determining performance standards by including specific and defined terms in their contracts. These defined terms instruct courts to enforce the obligations that parties have specifically agreed to at the time of formation of the contract, and thereby reduce the courts' need to determine the performance standard.

Contract Theory is particularly useful in its analysis of the 'agency problem', which arises when an agent (the employee), who is supposed to independently act on behalf of the principal (for the principal's benefit), fails to do so because the parties' objectives are not aligned. For instance, a manager might take actions that further his/her career-building goals but not the organisation's. These instances of misaligned objectives are broadly categorised as the 'moral hazards' of agency.

COMMON PRACTICE

The regulation of employee conduct through comprehensive and universal HR policies, in addition to individual employment contracts, is common practice. Often, the employment contract itself is cursory, with the HR policy containing the vast majority of the terms and conditions of employment. It is therefore imperative to eliminate from the employment arrangement subjective elements which might give rise to conflicting views between the employer and the employee with respect to the rights, duties and obligations of either party. Additionally, the employer must hedge against the ability of an employee to plead ignorance of certain HR policies.

Using the principles of Contract Theory, employment contracts and incentive schemes should ideally contain provisions that: (i) accurately communicate to the employee the performance standards and obligations relating to the incentive; (ii) provide a specific list of 'do's' and 'don'ts' that the employee must adhere to, failing which the employer is insulated from harm/loss arising out of the conduct of the employee; and (iii) provide a specific set of remedies addressing employee grievances. However, in some cases the employment contract and HR policies do not completely cover these aspects and, therefore, the employer's intent is not fully communicated to its employees, resulting in friction at the workplace. Conversely, employees cannot appreciate/evaluate the incentive policies being offered by the employer and could be unaware of their criteria for performance evaluation, which could lead to under performance.

The principles of Contract Theory might be useful in drafting more robust employment contracts, and aid employment lawyers in advising their clients (employers) in a manner that adds value to the workplace by boosting employee performance, compensation, growth and retention, with minimal conflict of interests.

PRINCIPLES OF CONTRACT THEORY

Dr. Holmstrom has developed the following principles that could be applied to employment contracts, and employee remuneration and incentivisation, to ensure an optimal balance of employer and employee interests:

The Informativeness Principle: This principle requires that the employer internalise costs of determining the exact performance outcome expected of the employee. In other words, the Informativeness Principle seeks to set out specific and verifiable performance parameters to which an employee should adhere in order to maximise performance and incentives. This formulation requires that the evaluation of the employees' performance be insulated from any non-verifiable or uncertain factor. Accordingly, the practice of linking key management bonuses to the company's stock price would fail because it is based on the assumption that a company's performance is directly proportional to the performance of its employees. However, stock price does not necessarily reflect the performance

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of its employees because stock price may be affected by extraneous factors. An incentive model based on 'chance' is counter-productive. Contract Theory proposes that incentives be linked to quantifiable factors, determined by the employer.

Using a robust incentive scheme enables the employer to direct its employees' actions by picking the most efficient incentive scheme that is aligned with the desired object of ensuring employee performance. On the other hand, having a specific incentive template allows employees to adjust their performance according to the incentive desired and to calibrate their exertions to suit their desire for compensation/incentive. Both the employers and employees are informed of the criteria for evaluation and output, thereby eliminating lack of information as a basis for negative employee morale.

Moral Hazard in Teams: Where employee incentives are based primarily on team performance, the 'free-rider' problem exists: certain employees may shirk work because they believe that other team members would pick up their slack. This situation might also create conflict within the team. To reduce this moral hazard, Contract Theory seeks to allocate incentives to both individual and team performance - team performance would not be considered when an individual's performance is poor. In effect, this is an extension of the Informativeness Principle, wherein the costs of information dissemination with respect to performance parameters and incentives is shared by the employer and the individual team leaders. There is greater focus on joint and several efforts of individual team members.

Multitasking: In several instances, employee incentives might be linked to a predominant performance parameter. This, in turn, allows employees to manipulate their performance to focus solely on this parameter without balancing his work-time towards other requirements that might be part of his responsibilities. To avoid this shirking of responsibilities, it is recommended that employers distribute appropriate weightages to the different performance parameters/responsibilities of the employee in a manner that allows the firm/employer to utilize the employee's abilities in a holistic fashion.

Career Concerns: Employers might also wish to calibrate the incentives in light of the employees' concern for career development, progress and growth by balancing monetary incentives against non-monetary facilities/incentives such as status, recognition, and leadership roles. The employment contract should address employee concerns in relation to promotion, additional responsibilities, facilities, and status as they relate to performance.

DRAFTING EMPLOYMENT CONTRACTS AND INCENTIVE SCHEMES BY APPLYING THE PRINCIPLES OF CONTRACT THEORY

To draft employment contracts and incentive schemes that optimally balance employer- employee interests, lawyers must be mindful of certain principles of Contract Theory. We have attempted to categorise and apply the above-mentioned principles of Contract Theory to contracts of the following nature:

Key Management Contracts: In most instances, these employees would not be incentivized by the possibility of career progress as they are already at senior positions within the organisation. Hence, employment lawyers might advise employers to provide these employees with sufficient monetary incentives. Further, while structuring an incentive and remuneration scheme in the contract, employment lawyers could help their client apply the Informativeness Principle and the principle of Multitasking, whereby the employee's incentive is based on identified performance parameters that are attributable solely to the employee's performance. For instance, the incentive and remuneration scheme in the key management contracts may be structured as follows:

- Bonuses must be split into a yearly bonus indexed to the individual employee's performance and a long term bonus that is indexed to the company's performance. However, external factors must be taken into consideration when indexing the company's performance; and
- Performance parameters be distributed based on the company's long term objectives.

Managerial/Mid-Level Employee Contracts: Unlike key managerial personnel, mid-level managers would still be motivated by the aspect of career progress. Additionally, it is important to factor in the 'moral hazard in teams' theory as these employees would be in charge of teams and, in most cases, the performance of their teams would determine their incentives. Therefore, while drafting managerial contracts, employment lawyers could help their clients ensure that that apart from monetary incentives, good performance is also rewarded with career progress. Further, the performance parameters should be fluid to the extent that the performance of managerial/mid-level employees can be distinguished from the overall performance of their teams. For example:

- Provide stock options with a moderate timeframe for vesting and with a predetermined exercise price to assure the employee of adequate remuneration in the future; and
- Link a portion of the employee bonus or increment to the performance of the individuals in the employee's team, rather than the overall performance of the team to ensure that managerial employees try to enhance each team member's performance, resulting in good performance for the team.

Junior Level Employee Contracts: While structuring contracts for junior level employees, employment lawyers can ensure that employers rely primarily on the career progression theory for employee incentivisation. Such contracts could be have monetary incentives are deferred to a later stage of employment, but current performance attributed to this incentivisation. Further, the contract could contain performance criteria that are linked to the individual employee's performance, thereby reducing the moral hazard inherent in teams. Therefore, the contract and remuneration could be structured as follows:

- They should contain a schedule informing employees of the performance parameters required for promotions. The employer, however, must ensure that these parameters are achievable and benefit the company.
- The company should provide these employees with significant yearly increments, rather than bonuses, as this would increase the employee's need for career progression – an increase in remuneration each year would support the employees' belief that monetary drawbacks during the start of the employee's career would be set-off against their future earnings.

CONCLUSION

Contract Theory could help employment lawyers 'design' employment contracts, not just draft them, thereby acting as true business enablers for their clients.

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