Losing the Freedom to Manage

It’s Not Amusing or Appreciated, But Court Actions Have Gradually Diminished Many of the Prerogatives of Managing Your Own Business

Quietly, so quietly that most executives aren’t yet aware of what’s happening, courts and state legislatures are rewriting the rules by which managers run U.S. corporations. Some of the changes severely curtail the freedom of managers to decide fundamental business matters. Recent court decisions restrict management’s ability to fire employees, even inept ones. Another ruling suggests that a company must have good cause not to hire someone, and may be liable for damages if it rejects a job applicant on the basis of faulty information. In a few instances courts have prohibited companies from moving money-losing operations to lower-cost plants.

Corporations also are under pressure from the American Law Institute, an association of lawyers, judges, and law professors. A primary function of the ALI is to clarify broad areas of law by restating legal principles, and its conclusions often influence court decisions. The group is in the process of restating the area of law known infelicitously as corporate governance. The ALI’s proposals would do so in ways that could broaden the personal liability of directors and open corporations to considerable second-guessing about investments and other decisions by shareholders and the courts.

The success of this new assault on management prerogatives comes at a surprising time. Serious efforts in Congress to expand corporate “accountability” waned in the late Seventies and have practically vanished under President Reagan. But corporate reformers didn’t surrender. They simply shifted the locus of their attacks from Washington to the states and from legislatures to the courts. They have won remarkable victories that impinge much more on day-to-day management than the myriad regulations heaped on corporations over the last six decades.

Management’s freedom to fire workers traditionally has been extremely broad. Labor contracts routinely specified causes for dismissal of union workers. But companies could fire non-union workers “at will” so long as they didn’t violate antidiscrimination laws. No more. Over the past couple of years, courts have hacked away at management’s right to deal at will with the 80% of the private work force that isn’t covered by union contracts. U.S. managers now face some of the same constraints their European counterparts do.

The decisions limiting the freedom to fire are founded on the reasonablenessounding but vague notion, not previously established in U.S. law, that companies must deal “fairly” with employees. Until recently few courts would consider suits based on fairness. Now 25 states have allowed damages for “unjust” dismissals. Says Victor Schachter, a San Francisco labor lawyer, “You have what amounts to judicial review of routine employment decisions. It’s making companies paranoid.”

A Nevada court ruled last summer that company employment manuals can amount to contracts with workers. Karen Ahmad, 33, a legal secretary with Southwest Gas Corp. of Nevada, was fired for poor performance. She sued, claiming the company had not given her sufficient warning that she wasn’t doing her job well enough before sacking her. The court found that Southwest Gas had to give her the advance warning and a chance to improve her performance, as outlined in its personnel manual. Since it hadn’t done so, Ahmad got damages of $14,567. The amount was based on the time she was out of work and the pay cut she took in her new job.

The Nevada case came soon after a similar decision in Michigan against Bissell Inc., the carpet-sweeper company. Bissell fired John Chamberlain, a manufacturing manager, after 23 years with the company. Chamberlain charged that the company had not told him that he’d be fired if his work...
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didn’t improve. A U.S. District Court agreed that Bissell should have given Chamberlain more warning during his annual evaluations. The judge formally awarded Chamberlain $360,000, but decided that Chamberlain too had been blameworthy for doing a poor job, and cut the actual award to $47,000.

The Montana courts have expanded the principle of unjust dismissal to include resignations. Four years ago Marlene Gates resigned from her job as a $7,200-a-year cashier at Life of Montana Insurance Co. Nevertheless, Gates sued the company, charging it had tricked her into leaving. The company had given her the choice of quitting or being fired, and said it would give her a letter of recommendation if she resigned. Gates persuaded a jury that Life of Montana had acted in bad faith and never intended to give her the letter. Last summer the Montana Supreme Court upheld a jury award of $1,891 in compensatory damages and $50,000 in punitive damages.

Unjust terminations can cost a company more than money. “What company wants to have its actions portrayed as wrecking someone’s life?” asks Alan Westin, a professor of law and government at Columbia University who has studied corporate efforts to avoid such suits. IBM is still stinging from a suit last year by a woman it had fired for dating an executive employed by a competitor, Exxon’s Qyx division. Virginia Rulon-Miller claimed the firing was unfair and invaded her privacy. The case against the big, bad corporation was an easy one to make, boasts lawyer Clifford Palefsky, who represented Rulon-Miller. “We went into court with a jury of 12
working-class people and made the case that this was someone who devoted her life to IBM,” says Palefsky. “IBM walked in with 17 lawyers in pinstriped suits. We asked, ‘Can the corporation invade your rights? Can it presume to tell you who your friends can be?’” The jury awarded Rulon-Miller $300,000. IBM is appealing the decision.

Labor lawyers trace acceptance of the idea that workers should be able to collect punitive damages for unfair dismissals to a 1980 California decision against Atlantic Richfield. A California judge found that Arco had unjustly fired salesman Gordon Tameny because he would not take part in a price-fixing scheme, and ruled that Tameny was entitled to a jury trial and punitive damages. Aggrieved employees have been finding judges and juries with sympathetic ears ever since. Frederick Brown, a San Francisco labor lawyer, estimates that employers have lost about 80% of the 40 to 50 cases that have gone to trial in California. The awards have averaged around $500,000.

Companies also can be liable for damages if they aren’t careful enough in how they evaluate job applicants. Robert Olson, a pilot, applied for a job with Western Airlines. The company sent Olson to a doctor who diagnosed him as pre-diabetic. Olson didn’t get the job. Later examinations by two other doctors concluded that Olson was not prediabetic. An appellate court in California has ruled that Olson is entitled to damages from Western if he can prove that the doctor was negligent, and that his diagnosis was the reason Olson wasn’t offered a job.

Court cases and regulatory actions also affect the ways companies can reward and discipline employees. A Delaware suit has added a new twist to the matter of sexual harassment. Margaret Toscano claimed she was entitled to a promotion at a veterans hospital that went instead to a female co-worker who was having an affair with their boss. Last summer Delaware Judge Walter K. Stapleton ruled that Toscano was a victim of sexual discrimination, and that the Veterans Administration was liable for damages because she hadn’t been offered the opportunity to curry favor with the manager by sleeping with him.

Toscano settled out of court for $7,500 and a promotion.

A ruling by the National Labor Relations Board complicates the disciplining of non-union workers. The NLRB usually concerns itself with disputes involving unions. But in 1982 it decided that an unjust imbalance existed between union and non-union workers. The NLRB concluded that non-union employees “must look to each other for whatever mutual aid or protection they can muster in the face of unjust or arbitrary employer ac-
tion.” Translation: a non-union employee being interrogated about possible wrongdoing or poor performance can now insist that a co-worker be present, a right that previously applied only to union members.

The NLRB, the courts, and state legislatures all have been whacking away at management’s right to move or close plants. Maine and Wisconsin have enacted laws that require a company to give 60 days’ notice before closing a factory. At least 16 other states are considering similar legislation. A bill before Congress would make it much tougher to shut factories. A corporation planning to lay off more than 100 workers at a single plant would have to give notice a year in advance. The bill would also require companies to make up 85% of the tax revenues that local governments would lose because of reduced payroll and income taxes in the year after the closing. Though the bill has 71 sponsors, its immediate chances of passing are slim. But advocates of a new industrial policy have embraced it, raising the odds that some plant-closing restrictions may ultimately become law.

Legislation may be largely superfluous if another decision by the NLRB remains in force. The board has ruled that companies can’t move operations out of plants that are covered by union contracts. Illinois Coil Spring, an automotive parts supplier, tried to consolidate its money-losing assembly operation in Milwaukee with one in McHenry, Illinois, where labor rates were lower. The NLRB ruled in October 1982 that the company could not move the operation to another location until its union contract expired in April 1983. The company dropped its plan to close the plant after the ruling. Before the Milwaukee Spring decision (the case is known by the name of the division, not the company), corporations were free to relocate so long as the intent wasn’t just to get rid of a union. “Milwaukee Spring set labor law on its head,” says Jerold Jacobson, a New York labor lawyer.

The effect of Milwaukee Spring spread quickly. In October 1982 Echlin Inc. tried to close a plant in Owosso, Michigan, that makes valves for truck brakes. The company still had 21 months to go on its union contract. Thanks to Milwaukee Spring, the union was able to get a federal injunction to keep the 120 workers on the assembly line.

The NLRB made the Milwaukee Spring decision when it still was dominated by holdovers from the Carter Administration. In a highly unusual move, the board—now with a majority of Reagan appointees—has said it will reconsider the decision and rule again within a month or so. Labor lawyers are betting that the board will reverse the decision. The NLRB says its decision will affect only a handful of companies. Lawyers for the United Auto Workers union say it will affect at least 30 planned relocations. If the NLRB should reaffirm the decision, the ruling could affect many more
The American Law Institute’s restatement of the law on corporate governance could open many more management decisions to public inspection. The report won’t have the force of law, but it could exert powerful influence. Judges and lawyers often look to ALI restatements for guidance in interpreting case law.

An ALI panel took up corporate governance in 1978, when the threat of federal legislation limiting management discretion seemed more immediate. The ALI initially got encouragement from Irving Shapiro, then the chairman of Du Pont and a former chairman of the Business Roundtable, the lobbying group. Shapiro and other members of the Roundtable hoped the ALI would come up with modest alternatives to the demands of reformers.

The regulatory winds shifted, but the ALI did not. In April 1982 the ALI came out with a draft report that Philip O’Connell, a senior vice president of Champion International, calls “a new blueprint for the Naderites.” The report got little press attention, but it set off a conflagration among lawyers, economists, and top managers. It even created a new vogue for corporate governance; seminars and conferences on the topic have proliferated.

The Business Roundtable cried foul, and has been trying, so far with limited success, to win major revisions in the report. Shapiro, who advised the ALI panel after he retired from Du Pont, is one of the few business defenders of the report. He characterizes the debate as one “between people who want to leave the law murky and those who want to state it as it is.”

Critics of the report worry most about a section that could weaken the ability of managers and directors to defend themselves against suits by disgruntled shareholders. For a century or so they have relied on the so-called business-judgment rule. That defense requires shareholders to prove that a decision was made carelessly or in bad faith. Judges routinely grant motions to dismiss suits in their early stages because the plaintiffs cannot marshal proof that managers put their personal interests above those of shareholders.

The ALI report would introduce an important new element in the equation. It recommends that judges go through complete trials and hear all the evidence before ruling on a business-judgment defense. Critics say the change would significantly water down the defense because hearing all the evidence would encourage judges to second-guess the wisdom of decisions, and not just the propriety. Says a director of one large company: “We envision a slew of suits that question every Edsel.”

O’Connell of Champion says, “Boards almost never have all the facts when they make decisions. Either it’s impossible to get all the facts or there isn’t enough time—so you can’t always have decisions that are 100% right. This rule discourages risk-taking and the entrepreneurial spirit.” The authors of the ALI report contend it merely clarifies what already is common practice. Chicago lawyer Stanley Kaplan, head of the ALI panel, says the document “doesn’t tell anyone how to run their business, nor does it attempt to reform the law.”

At the heart of both the court decisions and the ALI debate is the
hoary issue of how best to keep managers in line. The ALI report and the rulings on firing and hiring reflect the familiar idea that shareholders and employees are so powerless that they need regulations and easy access to the courts to prevent managers from exploiting them.

The opposite view is that the marketplace provides plenty of incentives for managers to behave. A company with a history of mistreating employees will find it harder to recruit new ones; it will have to pay more for the ones it gets or settle for lower-quality workers. Similarly, observes Frank Easterbrook, a University of Chicago law professor, “Corporate managers have to induce investors to part with their cash. They don’t do that by promising to rob them blind.”

How can business respond to efforts to limit the freedom to manage? Some corporations are beefing up their staffs of statehouse lobbyists. Three-quarters of 253 large corporations recently surveyed by the Conference Board say they’re lobbying more in state capitals. For the most part, however, corporations are simply adapting to the new rules. Many hope to forestall employee lawsuits by rewriting employment manuals and setting up in-house grievance systems. Alan Westin at Columbia says more than 200 companies have taken such steps over the past two years.

The problems that spawned the assault on managerial discretion are real. An employee can be seriously harmed by being fired, and some workers are discharged frivolously. A community can be stunned by the loss of a large plant. And shareholders are damaged by dishonest managers. However, there is no way to open the courts only to those who have legitimate claims. And no one has demonstrated that abuses are so commonplace that the economy should pay the cost of adjudicating every affected employee’s complaint.

In some ways, state laws threaten managements less than court rulings. Plant-closing laws and the like are bound to deter investment and ultimately shrink state tax revenues. When that happens, states are likely to repeal them. Court decisions become embedded in common law and are harder to reverse. That’s where corporations and their counsels face the greater challenge.