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Andrew P. Morriss

Texas A&M University School of Law, [amorris@law.tamu.edu](mailto:amorris@law.tamu.edu)

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# Bad Data, Bad Economics, and Bad Policy: Time to Fire Wrongful Discharge Law

Andrew P. Morriss\*

*If I can fire someone for making shitty ice cream, then I can fire them for being a shitty person.*

*Jerry Greenfield, Ben and Jerry's Homemade, Inc.<sup>1</sup>*

## I. Introduction

Ever since Professor Lawrence Blades's groundbreaking critique of the employment-at-will rule in 1967,<sup>2</sup> courts and legal commentators have decried the at-will rule as having an "unsound foundation"<sup>3</sup> and as "a harsh outgrowth of the notion of reciprocal rights."<sup>4</sup> This unremitting stream of hostile commentary has had an important impact—court after court has accepted the challenge to severely limit this longstanding rule.<sup>5</sup> Based on the assumption that the absence of the state from the decision-

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\* Associate Professor of Law and Associate Professor of Economics, Case Western Reserve University. A.B. 1981, Princeton University; J.D. 1984, M.Pub.Aff. 1984, The University of Texas at Austin; Ph.D. (Economics) 1994, Massachusetts Institute of Technology. Comments from participants at seminars at the Institute for Humane Studies and Case Western Reserve Law School improved early drafts. Additional comments from Carol Akers, Kenneth Dau-Schmidt, Jonathan Entin, Robert Gibbons, Michael Piore, James Rebitzer, Robert Strassfeld, and Symposium participants caught many errors. Alice Hunt cheerfully produced multiple versions. All additional errors are my own.

1. Robert E. Sullivan, Jr., *Just Desserts*, ROLLING STONE, July 9, 1992, at 79.

2. Lawrence E. Blades, *Employment At Will v. Individual Freedom: On Limiting the Abusive Exercise of Employer Power*, 67 COLUM. L. REV. 1404, 1405-06 (1967).

3. *Wagenseller v. Scottsdale Memorial Hosp.*, 710 P.2d 1025, 1030 (Ariz. 1985). For an institutional view of the origins of the rule, see Andrew P. Morriss, *Exploding Myths: An Empirical and Economic Reassessment of the Rise of Employment At-Will*, 59 MO. L. REV. 679 (1994).

4. *Palmateer v. International Harvester Co.*, 421 N.E.2d 876, 878 (Ill. 1981).

5. Even a quick survey of the employment law of the 1980s reveals that "[c]ourts across the country are conducting a frontal assault on this time-honored doctrine [employment-at-will] and in many states, judicially and legislatively created exceptions are eroding it." Nina G. Stillman, *Workplace Claims: Wrongful Discharge, Public Policy Actions, and Other Common Law Torts*, in 2 19TH ANNUAL INSTITUTE ON EMPLOYMENT LAW 57 (1990). Only Florida, Louisiana, and Rhode Island have clearly failed to adopt even one exception to the at-will rule. See 9A Lab. Rel. Rep. (BNA) (Indiv. Empl. Rts. Man.) 505:51-52 (1994). Depending on how one interprets its caselaw, Georgia may also have failed to adopt an exception. See Andrew P. Morriss, *Developing a Framework for Empirical Research on the Common Law: General Principles and Case Studies of the Decline of Employment-At-Will*, 45 CASE W. RES. L. REV. 999, 1058 (1995).

making process implies that the parties' decisions are unconstrained, the critics and courts have painted a picture of Dickensian scope. Arbitrary firings of deserving individuals abound; only the state can deliver these helpless victims from the clutches of their capitalist masters. This picture is, of course, nonsense.

The employment-at-will rule is not a nineteenth-century method of oppressing employees.<sup>6</sup> It is an allocation of decisionmaking authority between the public and private sectors which serves the needs of both employers and employees. The rule enables employers and employees to contract, to their mutual benefit, for a higher level of performance than the alternative "reforms" proposed by various commentators and adopted by courts. Indeed, nineteenth-century trade unions in Britain actively bargained for an equivalent contractual rule, the "minute contract," which lasted a minute and automatically renewed itself, to avoid a system of *criminal* penalties for employees who breached employment contracts by quitting.<sup>7</sup> To an inmate of a British jail serving six months hard labor for daring to leave his employer before the expiration of his contract, the employment-at-will rule would have been a significant improvement.

Perhaps most importantly, the default nature of the at-will rule allows the heterogeneous class of employees to choose among a diverse set of job

6. Avoiding the legal literature's excessive concentration on possibly deserving individuals' cases does not deny that employers sometimes fire employees for irrational or even immoral reasons. See Clyde W. Summers, *Individual Protection Against Unjust Dismissal: Time for a Statute*, 62 VA. L. REV. 481, 481-82 (1976) [hereinafter Summers, *Individual Protection*]; Clyde W. Summers, *Protecting All Employees Against Unjust Dismissal*, HARV. BUS. REV., Jan.-Feb. 1980, at 132. No legal system has yet been devised, however, which can always costlessly prevent such action. This focus on individual cases at the expense of the general is epitomized by Theodore St. Antoine's statement, commenting on Richard Epstein's arguments in favor of the at-will rule, that "[e]ven if Epstein is right in everything he has to say about employees collectively, it is this piercing hurt to individuals which justifies the call for reform of the at-will doctrine." Theodore J. St. Antoine, *A Seed Germinates: Unjust Discharge Reform Heads Toward Full Flower*, 67 NEB. L. REV. 56, 67 (1988). Of course, if Epstein is correct about the value of the at-will rule for employees in general, a change would produce an enormous welfare loss for the majority of employees. Justifying such an imposition would require an extraordinarily "piercing" loss for discharged individuals, who by any count number far fewer than those who are not discharged, to meet any basic notion of fairness.

7. See Sanford M. Jacoby, *The Duration of Indefinite Employment Contracts in the United States and England: An Historical Analysis*, 5 COMP. LAB. L. 85, 98-99 (1982). The dominant feature of employment law in Britain between 1823 and 1875 was the extensive involvement of the state in enforcing employment contracts. The state gave employment contracts special treatment under several statutes. The most important of these statutes was 4 Geo. 4, 34, passed in 1823 (and extended to additional employees by 10 Geo. 4, 23). Morriss, *supra* note 3, at 760-61. Three important features of this statute were unique to Britain: (1) criminal enforcement of employment contracts was available against employees but not employers; (2) enforcement was through summary procedures conducted by local magistrates without juries; and (3) appeals were both formally limited and generally recognized as futile. See generally Andrew P. Morriss, *American Exceptionalism Revisited: State Oppression and Nineteenth Century British Employment Law* (1994) (unpublished manuscript, on file with the *Texas Law Review*). More than 100,000 employees were convicted of violating the Master and Servant Acts between 1860 and 1875, the only years for which there are data. JUDICIAL STATISTICS, ENGLAND AND WALES (1860-75).

characteristics when making employment decisions. Mandating that all employees receive the same level of legal job security will lead to transfers of utility between groups of employees. Such within-class transfers remove the issue from the category of simple redistribution from the haves to the have-nots.

The at-will rule also suits the institutional competence of courts. A critical difference between at-will and just-cause rules is where the final decision on firing is located. Under the at-will rule an insider (the firm) has complete discretion; under a just-cause rule an outsider (a court) has the final say. The at-will rule is also simple: an employer can fire an employee at any time for any reason and an employee may quit at any time for any reason.<sup>8</sup> Just-cause rules are complex: an employer can fire an employee without liability only if he can convince an unknown set of decisionmakers that the discharge was justified based on an unknown information set. The question of reform is thus one of weighing the costs of different institutional structures with the benefits they produce. This is a question courts are ill suited to answer.

Reliance on the courts and governmental agencies as mechanisms to implement a politically defined structure characterized much of the post-Depression period not just in employer-employee relations,<sup>9</sup> but in other areas as well. The structural details have changed over time, reflecting the gradual increase in the role of the state in the national economy and other aspects of life, but the general thrust has remained the same: "outside" decisionmakers, usually courts and administrative agencies, enforce a wide variety of command regulations.<sup>10</sup>

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8. Simplicity has enormous value itself. See, e.g., RICHARD A. EPSTEIN, *SIMPLE RULES FOR A COMPLEX WORLD* 30 (1995) (observing that "simplicity . . . reduces the costs necessary to achieve any agreed-upon end"); Robert E. Hall & Edward P. Lazear, *The Excess Sensitivity of Layoffs and Quits to Demand*, 2 J. LAB. ECON. 233, 235 (1984) (asserting that simple arrangements dealing with wage rates "are in widespread use because they perform better in many respects than more complicated contracts").

9. While many aspects of the employer-employee relationship were left to collective bargaining, that bargaining process took place within a structure defined by the state. See National Labor Relations Act, ch. 372, 49 Stat. 449 (1935) (codified as amended at 29 U.S.C. §§ 151-166 (1994)). The state set the rules for certification elections, defined the economic weapons available to the parties (by prohibiting secondary boycotts and common-situs picketing and allowing permanent replacement of striking workers), and set the goals (by defining mandatory subjects of bargaining and requiring recognition of unions). See *id.* To the extent that employees are blocked from forming or joining unions by state action, it hardly seems appropriate to turn to another branch of the state to create a new right instead of removing the legal barriers to collective action. If some employees have chosen not to join unions for other reasons, mandating just-cause rules is not likely to increase those employees' welfare, let alone social welfare.

10. One prominent exception to this trend is the deference that the courts have shown to grievance-arbitration agreements. A dominant theme of the *Steelworkers* trilogy, for example, is the inferiority of a court's ability to decide industrial disputes, including those over discharges, compared to the ability of an arbitrator to resolve such conflicts. *United Steelworkers of Am. v. American Mfg. Co.*, 363

This broad consensus that state meddling in previously private bargains was both beneficial and appropriate mirrored the post-Depression Keynesian consensus in economic thought.<sup>11</sup> Both the Keynesian consensus on the ability of government to intervene in the economy and the political consensus on the capability of government decisionmakers (happily) have now disappeared. An extensive public choice literature on governmental failures has joined the market failure literature. The disappearance of this consensus ought to inspire us to rethink all interventions into private bargains: If the emperor has no clothes, his judges' robes may be equally threadbare.

One of the many effects of the combination of technological change, globalization of labor, capital, and product markets, and changes in labor force composition in recent years is the disruption of traditional employment patterns based on Fordist production techniques. Of all the branches of government, the judiciary is the least capable of responding to these massive economic and social changes in a productive manner. It has the least capacity for collecting and analyzing data, the least ability to control its own agenda, and the least democratic accountability.

There are a number of possible solutions to the problem of economic insecurity faced by many employees worldwide. They range from traditional unions to forms of employee-employer cooperation which do not fit within the confines of the National Labor Relations Act. None of these solutions is likely to be adequate, not to mention ideal, for all employers and all employees. The massive scale of the societal changes at the root of our current economic instability argue against the one-size-fits-all responses offered by the legal system. Employers and employees must be freed from outside interference to develop solutions appropriate to the many forms of industrial organization which coexist in the economy. Of course, freedom has its price. Not every employee will be "protected" and some employers will undoubtedly do bad things. Protecting all employees without imposing significant costs on other employees and society in general, however, is simply not an option.

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U.S. 564, 568 (1960); *United Steelworkers of Am. v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 584-85 (1960); *United Steelworkers of Am. v. Enterprise Wheel & Car Corp.*, 363 U.S. 593, 598 (1960).

11. There was, of course, disagreement over the particular goals—reducing inflation or raising employment—or the methods—monetary or fiscal policy—but a consensus existed that government could improve the market outcomes with the appropriate policy instruments. See Mark Kelman, *Could Lawyers Stop Recessions? Speculations on Law and Macroeconomics*, 45 STAN. L. REV. 1215, 1235-37 (1993) (observing that although Keynesians disagreed about the appropriate instrument, they all agreed that the government needed to intervene actively in the economy).

## II. Overestimating the Problem

The critics of the at-will rule argue that the wrongful discharge of at-will employees is a major problem for the U.S. economy.<sup>12</sup> Unjustified discharges and general abuse of at-will employees abound, they argue, so something must be done. To support the claim of widespread abuse, critics rely on articles by Professor Cornelius Peck<sup>13</sup> and Professors Jack Stieber and Michael Murray,<sup>14</sup> and horror stories drawn from judicial opinions. When courts have bothered to consider the scope of the "problem" of unjust discharge, Peck's and Stieber and Murray's estimates have found their way into court decisions.<sup>15</sup> Like other aspects of the critics' case against the at-will rule, these estimates are based on untenable assumptions. Data on unemployment show that other causes of job loss overwhelm job losses from "wrongful discharges." Data from quality-of-employment surveys suggest that reliance on court opinions produces overestimates of the incidence of employer abuses of employees. Consideration of these data suggests that the focus of concern for employees should be new job creation and improved economic conditions to preserve existing jobs—a prescription that is unlikely to include new state mandates for employers.

### A. *Estimates of At-Will Discharges*

Professor Cornelius Peck was the first to tackle the question of how many at-will employees are actually discharged. Peck calculated that "the number of discharge and discipline cases in the nonunionized sector that would have been subjected to [arbitration] in a collective bargaining

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12. See, e.g., Blades, *supra* note 2, at 1404 ("It is a widely accepted proposition that large corporations now pose a threat to individual freedom comparable to that which would be posed if governmental power were unchecked." (footnotes omitted)); Committee on Labor and Employment Law, *At-Will Employment and The Problem of Unjust Dismissal*, 36 REC. ASS'N B. CITY N.Y. 170, 170 (1981) ("At present, approximately seventy percent of all employees in the private sector in this country . . . have virtually no protection against unjust dismissal."); Charles B. Craver, *Rearranging Deck Chairs on the Titanic: The Inadequacy of Modest Proposals to Reform Labor Law*, 93 MICH. L. REV. 1616, 1617 (1995) ("It is time to acknowledge that U.S. workers have minimal employment dignity and almost no job security."); Summers, *Individual Protection*, *supra* note 6, at 483 ("[L]ess than a third of our employed work force presently enjoys [just cause] protection; more than two-thirds still have no recourse except to the courts, where 'the law has taken for granted' that an employee can be terminated 'for any or no reason.'" (footnote omitted)) (quoting *Geary v. United States Steel Corp.*, 319 A.2d 174, 176 (Pa. 1974)).

13. Cornelius J. Peck, *Unjust Discharges From Employment: A Necessary Change in the Law*, 40 OHIO ST. L.J. 1 (1979).

14. Jack Stieber & Michael Murray, *Protection Against Unjust Discharge: The Need For A Federal Statute*, 16 U. MICH. J.L. REF. 319 (1983).

15. E.g., *Adler v. American Standard Corp.*, 432 A.2d 464, 470 (Md. 1981) (citing Note, *Protecting At Will Employees Against Wrongful Discharge: The Duty to Terminate in Good Faith*, 93 HARV. L. REV. 1816, 1816 n.2 (1980) (citing Peck, *supra* note 13, at 8-10)).

relationship could be as high as 300,000 a year.<sup>16</sup> Peck's calculation, which uses 1976 data,<sup>17</sup> is presented in Figure 1.<sup>18</sup>

total nonagricultural work force	80,000,000
less employees covered by collective bargaining agreements	- 21,000,000
	<hr/> <hr/>
	59,000,000
less 90% of federal civilian employees	- 2,591,100
less 50% of state and local employees	- 6,084,500
	<hr/> <hr/>
at-will employees	50,324,400
nonunion sector discharge and discipline cases that would have been subject to arbitration in union sector	300,000
number that would have been overturned	150,000

Figure 1: Peck's Calculation of At-Will Employees

16. Peck, *supra* note 13, at 10. A student note uses a similar methodology. See Note, *supra* note 15, at 1816 n.2.

17. Peck, *supra* note 13, at 8 n.39 (citing BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 387 (98th ed. 1977) (Table 625: Labor Force and Employment: 1947 to 1977)).

18. To calculate discharge rates, Peck used arbitration data from the Federal Mediation and Conciliation Service (FMCS) and American Arbitration Association (AAA). Estimating that arbitrators from the FMCS and AAA combined decided approximately 3,500 discharge and discipline cases annually, Peck then doubled that estimate to account for arbitrations unaffiliated with either the FMCS or AAA. This produced an estimate of the total number of cases heard by all arbitrators of "around 7,000 cases of discharge or discipline of employees that labor union officers believe to be unjustifiable and hence worthy of arbitration." *Id.* at 9. Since management is reversed in slightly more than half such cases, and assuming that management makes discharge decisions more carefully when they know arbitration is a possibility, Peck then concluded that "at least 12,000 to 15,000 employees are discharged or disciplined each year under circumstances that would have led to arbitration if they had been working under a collective bargaining agreement and represented by a union. At least half of the discharges would have been found to be unjustifiable." *Id.* at 9-10. Factoring in estimates of the number of cases settled, without specifying the basis for the estimates, Peck concluded that "the number of discharge and discipline cases in the nonunionized sector that would have been subjected to that process [arbitration] in a collective bargaining relationship could be as high as 300,000 a year." *Id.* at 10. This produces an implicit rate of unjust discharge of approximately 0.6% (based on 300,000 unjust discharges resulting from an at-will workforce of approximately 50 million).

A few years later, Professors Jack Stieber and Michael Murray made a similar calculation with 1981 data and concluded that "some 140,000 discharged nonunionized workers with more than six months service would have been reinstated to their jobs with full, partial, or no back pay."<sup>19</sup> Their calculation is presented in Figure 2.<sup>20</sup>

nonagricultural employees on private payrolls	75,000,000
less employees represented by unions	-16,000,000
less at-will employees with < 6 mos. tenure	-12,000,000
	<hr/>
total at-will employees with tenure $\geq$ 6 mos.	47,000,000
$\times$ 3% discharge rate	$\times$ 3%
	<hr/>
	1,410,000
$\times$ 20% grievance filing rate	$\times$ 20%
	<hr/>
	282,000
$\times$ 50% employee success rate	$\times$ 50%
	<hr/>
total employees with tenure > 6 mos. who would have been discharged, filed a claim, and won	141,000

Figure 2: Stieber and Murray's Calculation of At-Will Employees

19. Stieber & Murray, *supra* note 14, at 324.

20. Like Peck, Stieber and Murray began with a residual workforce calculation, although they removed an estimated number of probationary employees and all government employees. *Id.* at 323. Based on unpublished Bureau of Labor Statistics data on discharge rates between 1959 and 1971 and a Michigan survey of employers, they assumed a 4% discharge rate for this residual workforce. *Id.* at 324. Because employees in the first six months of employment are generally subject to a probationary period under both collective bargaining agreements and most modifications of the at-will rule, they arbitrarily reduced the rate to 3%. *Id.* These calculations produced the estimate of 1.4 million nonprobationary employees discharged in 1981. *Id.* Finally, Stieber and Murray assumed, based on union-sector arbitration experience, that 80% of employees with potential claims will not bring a case and that only half of those who do will win. This provided the conclusion that 140,000 at-will employees are discharged who would have had claims under a just-cause standard and who would have both brought a claim and won if offered an arbitration-like remedy. *Id.*

The two calculations use similar, quite inventive methodologies. In each, estimates of employees with non-at-will contracts are subtracted from an overall estimate of the workforce. This residual is then adjusted by various assumed factors to calculate the number discharged who would be successful if given a remedy for wrongful discharge. Both calculations can be brought up to date with more recent data. Table 1 shows that Peck's and Stieber and Murray's methods produce sharply higher estimates of the number of at-will employees, and hence discharges, with more recent data.<sup>21</sup>

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21. Not all the information in Table 1 is presented in Peck and Stieber & Murray. The following calculations and data sources were used: (1) Nonagricultural workforce: Peck, *supra* note 13, at 8 (estimating that there were 80 million nonagricultural workers in the United States in 1976); Stieber & Murray, *supra* note 14, at 322 (estimating that there were 75 million nonagricultural workers on private payrolls in 1981); BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 395 (114th ed. 1994) (Table 614: Employment Status of the Population: 1950 to 1993) [hereinafter 1994 STATISTICAL ABSTRACT] (calculating that the 1993 agricultural workforce consisted of 116,232,000 workers). (2) Covered by union contract: Peck, *supra* note 13, at 8 (stating that only 21 million persons were members of unions in 1976); Stieber & Murray, *supra* note 14, at 322 (stating that there were fewer than 16 million workers represented by labor organizations in 1981); 1994 STATISTICAL ABSTRACT, *supra*, at 439 (Table 683: Union Members, by Selected Characteristics: 1983 and 1993) (estimating that 12.3% of nonagricultural workers were represented by unions in 1993). (3) Excluded government employees: Peck, *supra* note 13, at 8-9 (explaining that more than half of state employees and over 90% of federal employees enjoy procedural safeguards); Stieber & Murray, *supra* note 14, at 322 (excluding all government employees from calculations because they are protected from unjust discharge by collective bargaining or civil service procedures); BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 424 (103d ed. 1982-83) (Table 661: Nonagricultural Industries—Number of Employees, 1970 to 1981, and Number and Earnings of Production Workers, 1975 to 1981) (calculating that there were 16,024,000 government employees in 1981); 1994 STATISTICAL ABSTRACT, *supra*, at 424 (Table 656: Nonfarm Industries—Employees and Earnings: 1980 to 1993) (calculating that there were 18,842,000 government employees in 1993). (4) At-will employees, calculated by subtracting (2) and (3) from (1): Stieber & Murray, *supra* note 14, at 323 (assuming that 20% of all nonunionized workers in the private sector would be excluded from protection for unjust discharge due to falling within the six-month probationary period). (5) Estimated discharges of at-will employees: Peck, *supra* note 13, at 10 (suggesting that "if negotiation of discharge and discipline grievances produces settlements at a rate comparable to that experienced in other dispute settlement negotiations, the number of discharge and discipline cases in the nonunionized sector that would have been subjected to that process in a collective bargaining relationship could be as high as 300,000 a year"); Stieber & Murray, *supra* note 14, at 324 (calculating that the discharge rate for employees who have completed their six-month probationary period would be about 3.0%, and multiplying that percentage by the number of nonprobationary, at-will employees for both 1981 and 1993 to produce discharge estimates of 1,770,000 and 1,994,000 respectively). (6) Estimated unjust discharges of at-will employees: Peck, *supra* note 13, at 10 (suggesting that at least half of the discharges that would have led to arbitration had the workers been under a collective bargaining agreement would have been found unjustified).

Table 1: Comparison and Update of At-Will Estimates

	Peck (in thousands)		Stieber & Murray (in thousands)	
	1976 data	1993 data	1981 data	1993 data
Nonagricultural workforce	80,000	116,232	91,024	116,232
Covered by union contract	21,000	14,296	16,000	14,296
Excluded government employees	8,676	10,586	16,024	18,842
At-will employees with < 6 mos. tenure excluded	—	—	12,000	16,619
At-will employees who would receive protection	50,324	91,350	47,000	66,475
Percent of non-agricultural workforce with at-will contracts	63%	79%	65%	72%
Estimated discharges of at-will employees	300	548	1,400	1,994
Estimated unjust discharges of at-will employees	150	274	700	997

Sources: Stieber & Murray, *supra* note 15, and Peck, *supra* note 14 (for textual explanation of this table, see note 21).

Despite these inventive methods employed in estimating something on which no reliable direct data exists, both sets of calculations are problematic. The calculations can provide at most an upper bound on the number of discharges because both calculate the number of at-will employees as a residual by subtracting other groups from the total labor force.<sup>22</sup> Because fixed-term contracts do exist, even if in unknown quantity, this result provides an upper bound rather than an estimate of the

22. This is unavoidable because there are no data on the terms of employment agreements.

number of at-will employees. So long as the result is treated as an upper bound, this problem is not fatal.

The most serious problem is the use of union arbitration discharge rates for calculations concerning the nonunion sector.<sup>23</sup> Both Peck and Stieber and Murray assume a fifty-percent win rate for at-will employees based upon union-sector arbitration experience.<sup>24</sup> This assumption is not supportable. Under most collective bargaining agreements, the union, not the employee, has the right to take a discharge to arbitration.<sup>25</sup> The union win rate is likely to be influenced by the union's screening of the claims it brings to arbitration. Similarly, union and nonunion employers might

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23. Peck uses union arbitration data and an unsupported assumption concerning settlement rates to conclude that there are 12,000 to 15,000 employees "discharged or disciplined each year under circumstances that would have led to arbitration if they had been working under a collective bargaining agreement and represented by a union." Peck, *supra* note 13, at 10. He then derives the figure of 300,000 discharge and discipline cases by assuming that "negotiation of discharge and discipline grievances produces settlements at a rate comparable to that experienced in other dispute settlement negotiations . . . ." *Id.* This implies that 95% of disputes settle. Although Peck does not describe his calculation of discharge rates, it appears his figures come from doubling the number of reported arbitration cases concerning discharge and discipline and assuming a proportionate number of discharges for employees in the nonunion sector, an implied discharge rate of 0.6%, far lower than the 3% to 4% rate that Stieber and Murray's research indicates. See *supra* note 20. Stieber and Murray base their discharge rates on a separate empirical study, but also adopt employee win rates from the union sector experience with arbitration.

In addition, Peck combines discharge and discipline grievance cases. Peck, *supra* note 13, at 8-10. Discipline and discharge are quite different things, and Peck provides no numbers on how the cases break down. The decision whether to take a grievance over discipline to arbitration differs from the decision to take a discharge to arbitration in at least one important respect: discharge imposes a sufficiently high cost on the discharged employee so that the benefit to the employee (although not necessarily to the union) of arbitration is almost certain to outweigh the costs, yet the cost to the employee of discipline varies widely with the specific sanction. Peck also assumes that the same proportion of cases submitted to AAA, FMCS, and unaffiliated arbitration panels are settled and involve discharge and discipline. *Id.* at 9. Given the many differences between arbitrations conducted by these different types of arbitrators, the FCMS's and AAA's rules governing arbitrators' conduct differ in some respects. The lists of arbitrators used by the two services are not identical. The AAA charges a docketing fee, while the FMCS does not, reducing the cost of filing an FMCS arbitration. The FMCS has a higher prehearing settlement rate, which is at least partially attributable to this difference. Interview with Elvis Stephens, Arbitrator, University of North Texas, in Denton, Tex. (Nov. 6, 1991). Even greater differences exist with respect to unaffiliated arbitrators. The parties will choose between the sources of arbitrators based on the characteristics of the underlying agreement, introducing selection bias. The rates of particular types of disputes will not, therefore, necessarily be the same.

24. Peck, *supra* note 13, at 9; Stieber & Murray, *supra* note 14, at 324.

25. It is axiomatic that the union exercises that right in pursuit of the maximum benefit to the union, rather than to the individual. This casts no aspersion on the motive of the union. A favorable view of a union's motives might mean that the union is seeking to maximize the benefit to all its members by conserving scarce resources in frivolous cases, while a less favorable view of union motives might see the decision as one used by the union leadership to keep loyal members in their jobs and letting disloyal ones lose theirs. Unions bring discharge grievances not because the union officers believe the discharge is "unjustifiable" but because it serves the unions' purposes to do so. Further, unions' decisions are complicated by the duty of fair representation imposed upon them by federal law. Finally, arbitration costs in the union sector are borne by the union, not the discharged employee, as they would be in the nonunion sector.

make the decision to discharge differently.<sup>26</sup> Employees might also behave differently in the union sector.<sup>27</sup> Whatever the motives of either side, it is clear that there is no reason to expect the employee win rate for discharge claims to be the same for nonunion employees as for union employees.

Another reason to be suspicious of the applicability of the union-sector win rate to the nonunion-sector rate is the difference in the types of jobs in each sector. Unionization rates vary by industry, ranging from 30.5% in transportation and public utilities to 1.9% in finance, insurance, and real estate.<sup>28</sup> To the extent that dispute, win, and unionization rates vary by industry, estimates based on union-sector job distributions will be incorrect. Since we know that "large, systematic wage differences exist among industries even for workers who have similar observed characteristics and work in the same well-defined job classification in the same locality,"<sup>29</sup> there is every reason to expect dispute and win rates to differ across industries.<sup>30</sup> Finally, in other work, Stieber identified significant differences

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26. Peck asserts that unionized employers discharge more carefully since they are aware of the arbitrator looking over their shoulder. Peck, *supra* note 13, at 9-10. It might be, however, that unionized employers view arbitration strategically. For example, they might see it as expanding the range of employee penalties. An employer might discharge a valuable but recalcitrant employee with the expectation of an eventual reinstatement, to give him a scare. Alternatively, the employer might see the arbitrator's decision as a means to overturn a supervisor's firing decision without requiring the employer to contradict the supervisor, preserving what could be an important aspect of the employer-supervisor relationship. The parties might also seek to arbitrate claims an outsider would consider meritless. As Justice Douglas noted in the *Steelworkers'* trilogy, "The processing of even frivolous claims may have therapeutic values of which those who are not a part of the plant environment may be quite unaware." *United Steelworkers of Am. v. American Mfg. Co.*, 363 U.S. 564, 568 (1960) (footnote omitted); see also Archibald Cox, *Current Problems in the Law of Grievance Arbitration*, 30 ROCKY MTN. L. REV. 247, 261 (1958) (presenting the benefits of arbitration clauses that cover all collective bargaining disputes without regard to merit); Denise R. Chachere & Peter Feuille, *Grievance Procedures and Due Process in Nonunion Workplaces*, in INDUSTRIAL RELATIONS RESEARCH ASSOCIATION SERIES: PROCEEDINGS OF THE FORTY-FIFTH ANNUAL MEETING 446, 447 (John F. Burton, Jr. ed., 1993) [hereinafter PROCEEDINGS] (explaining that grievance procedures in union firms "serve as remedial voice mechanisms").

27. Knowing that they have the union to back them up and that an arbitrator will review their case, they may be emboldened to push a dispute to the point where it reaches a discharge, rather than accept a lesser disciplinary measure. For example, if a company changes a work rule in the union sector, this may lead to a dispute over whether bargaining is required, and some employees who hew to the union position may be disciplined while that dispute is being resolved. Such disputes obviously cannot arise without a collective bargaining agreement.

The union context also provides additional reasons for disputes: employees may be engaged in disputes over working conditions with employers which lead both employees and employers to fight issues which would not be present in the nonunion sector.

28. 1994 STATISTICAL ABSTRACT 439 (Table 683: Union Members, by Selected Characteristics: 1983 and 1993). An even higher percentage of the government sector is unionized (37.7%). *Id.*

29. Lawrence F. Katz & Lawrence H. Summers, *Industry Rents: Evidence and Implications*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 209, 216 (Martin N. Baily & Clifford Winston eds., 1989).

30. To the extent that the wage differences reflect labor rents rather than differences in labor quality, they create important differences in incentives for both employers and employees. For

in arbitration outcomes based on the arbitrator used and the reason for the discharge.<sup>31</sup> Unless the reasons for discharge are similarly distributed in the union and nonunion sector<sup>32</sup> and the pool of arbitrators used is similar, the union sector is an unreliable guide.

Four factors suggest that, aside from the methodological problems in their calculations, Peck's and Stieber and Murray's estimates grossly overestimate the scope of the problem of "unjust discharges." First, even at-will firms operate within the general framework of federal, state, and local antidiscrimination laws.<sup>33</sup> Employers have responded to civil rights laws by, among other things, adopting personnel policies and practices that reduce the risk of arbitrary behavior by bureaucratizing employment decisions.<sup>34</sup> These procedures are likely to protect employees against arbitrary discharges in general for the simple reason that maintaining two sets of personnel practices to prevent prohibited discrimination while allowing other arbitrary actions would be expensive, breed resentment, and produce no discernible benefits.

Second, union-sector employees frequently win arbitrations based on factors which are not applicable to nonunion firms.<sup>35</sup> For example, employees in union-sector firms often argue in arbitration cases that they have been treated differently than other employees.<sup>36</sup> There is no reason to think, however, that comparable treatment will be an equally important part of just-cause litigation.<sup>37</sup>

example, if employers are paying wages above market rates, they have an incentive to discharge less productive employees. The presence of significant labor rents would also motivate discharged employees to pursue remedies more aggressively than those employees would in the absence of such rents. These differences are likely to affect the character of discharge disputes.

31. Richard N. Block & Jack Stieber, *The Impact of Attorneys and Arbitrators on Arbitration Awards*, 40 INDUS. & LAB. REL. REV. 543, 548-52 (1987).

32. Because of the lack of union influence on work roles in the nonunion sector, these reasons are unlikely to be similar.

33. These laws are increasingly used in discharge cases. See John J. Donohue III & Peter Siegelman, *The Changing Nature of Employment Discrimination Litigation*, 43 STAN. L. REV. 983, 1015-17 (1991) (describing a shift in the nature of employment discrimination litigation from predominantly hiring charges to termination charges).

34. Thomas A. Kochan & Peter Cappelli, *The Transformation of the Industrial Relations and Personnel Function*, in INTERNAL LABOR MARKETS 133, 146-48 (Paul Osterman ed., 1984).

35. There is also some evidence that even within union-sector firms, employees who are members of the union file grievances at a greater rate than nonmembers do. Karen E. Boroff, *The Probability of Filing A Grievance—Does Union Membership Make a Difference?*, in PROCEEDINGS, *supra* note 26, at 251, 256-57. This suggests that the filing rates may be lower in nonunion work situations.

36. FRANK ELKOURI & EDNA A. ELKOURI, *HOW ARBITRATION WORKS* 684-87 (4th ed. 1985) ("[A]ll employees who engage in the same type of misconduct must be treated essentially the same unless a reasonable basis exists for variations in the assessment of punishment.")

37. The small businesses and white-collar employees who will now be covered present smaller groups of comparable employees, among whom disparate treatment claims will be harder to frame because the sample size is smaller even if unfair treatment is more noticeable.

Third, consider Richard Epstein's argument that "unjust discharges" are reduced over time because employees and employers each become more valuable to the other as time passes. Not only are replacement costs high, but both have built up relationship-specific capital which ending the relationship would eliminate.<sup>38</sup> Although one may disagree with Epstein about how strong this effect will be, and most critics of the at-will rule disagree quite vehemently with him, the effect must exist to some degree. At-will employers' behavior at the margin, wherever that is, is clearly constrained by the ability of at-will employees to quit.<sup>39</sup>

Fourth, attempting to estimate the significance of the at-will rule by focusing on terminations rather than on individuals is likely to produce overestimates. The typical job in the United States is extremely brief, but most employees hold stable jobs lasting years.<sup>40</sup> A rule that works well for the vast majority of employees could thus appear to cause many problems if the focus is on terminations.

Perhaps the most important reason why these estimates are unreliable is the fundamental difference between the union sector and the nonunion sector in the content of jobs. To the extent that union-sector job disputes are about disagreements about verifiable information,<sup>41</sup> the experience with those disputes will not provide any information about how courts (or any other dispute resolution mechanism) will resolve disputes that are based on disagreements over observable but not verifiable information.<sup>42</sup>

The extent of the problem of unjustified discharges is simply unknowable given the data available.<sup>43</sup> If these estimates are the best that can be done, can these calculations provide at least a rough guide for policymakers? No. The fundamental flaw in the methodologies, the use of union arbitration data to estimate the effect on nonunion firms, obscures any potential benefit from even a rough calculation. The union and nonunion sectors are so different that it is simply impossible to apply information accurately based on one to the other.

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38. Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 974-75 (1984).

39. Union-sector firms are subject to the same pressure, of course, but given the substantial wage premium associated with union-sector jobs, employees will be less willing to quit. The premium is estimated to be as high as 14%. See H. GREGGS LEWIS, *UNION RELATIVE WAGE EFFECTS: A SURVEY* 174-87 (1986).

40. Robert E. Hall, *The Importance of Lifetime Jobs in the U.S. Economy*, 72 AM. ECON. REV. 716, 720-22 (1982).

41. Union sector disputes are more likely to turn on disagreements about verifiable information because of the work rules necessary for protection of the union.

42. I thank Professor J. Hoult Verkerke for suggesting this point to me in discussions during this Symposium.

43. Professor Verkerke suggested at the Symposium that "it generally takes an estimate to beat an estimate." I would agree that it takes a *theory* to beat a *theory* but not that it takes an estimate to beat an estimate. Seriously flawed estimates require only the identification of the flaws, not substitute national surveys, to call their validity into question.

Moreover, attempting to calculate the number of “wrongful discharges” from scratch ignores the data we have on unemployment. By examining the data we can gain some perspective on the estimates of at-will discharges. Table 2 shows data on causes of unemployment for the years for which Peck’s and Stieber and Murray’s calculations are reported in Table 1. Even if we were to accept the studies’ estimates as roughly correct,<sup>44</sup> their size relative to the job losses caused by layoffs and the number of new entrants and re-entrants unable to obtain work suggest that public policy would be better focused on removing obstacles to economic growth.<sup>45</sup>

Table 2: Unemployment by Reason

Year	Reason for unemployment (in thousands)					
	Job losers			Job leavers	Re-entrants	New entrants
	Total	Layoff	Other			
1976	3,679	1,050	2,628	903	1,928	895
1981	4,267	1,430	2,837	923	2,102	981
1993	4,769	1,104	3,664	946	2,145	874

Source: ECONOMIC REPORT OF THE PRESIDENT 326 (1996) (Table B-40: Unemployment by Duration and Reason 1950-95) (figures rounded).

### B. *How Many Bad Things Happen to Good Employees?*

Courts created wrongful discharge law on a foundation of anecdotes drawn from the peculiar sample of cases that reach state courts. In general, anecdotes are a poor basis for public policy. Anecdotes gathered by surveying people in lawsuits are even worse. The grim picture of the workplace those anecdotes paint is contradicted by the evidence that does exist about the extent of the problems employees face in the workplace.

In two surveys done before the rise of the common law wrongful discharge remedies—a time when employees were presumably at their most vulnerable—investigators asked employees about an extensive list of

44. Both ignore an additional consequence of their analysis: if  $N$  at-will employees are “unjustifiably discharged,” then, presumably, some number close to  $N$  of others are hired to fill their places. If changing the rule succeeds in reducing “irrational discharges,” it will also increase the number of unemployed people who are unable to find work. That may be good or bad socially, but if I am unemployed, it is clearly bad from my perspective.

45. Some authors view economic pressures as simply another reason for state intervention. See, e.g., Craver, *supra* note 12, at 1630.

employer abuses. The questions included whether the supervisor or personnel department went into personal matters; required the respondent to take personality tests; collected ratings on the respondent from others; ran a credit check on prospective employees or the respondent; collected medical information on the respondent; collected other personal information on the respondent; divulged personal information either inside or outside the company; required particular activities during the respondent's own time; pressured the respondent into thinking, voting, or acting in a particular way; or invaded the respondent's privacy in some other way.<sup>46</sup> What is so striking about the results is that almost no employees reported any of the individually named violations. The main complaint, and the only one that more than two percent of all workers in the survey noted, was the collection of "other personal information" about employees by supervisors. Thus, when asked directly about the types of abuses which are alleged to lead routinely to abusive discharges, employees not protected by formal, state-manuated legal job security did not indicate this was a serious problem.

### III. A Foundation of Sand

Read as a whole, the courts' and critics' assertions imply a model of the labor market with five key features:

1. employees are routinely fired for irrational reasons;
2. employers do not consider the impact of firing an employee;
3. proving just-cause is neither costly nor difficult;
4. the at-will rule produces large negative externalities; and
5. employees underestimate their risk of job loss.

This paints a grim picture of the United States workplace. Irrational or simply mean employers abound, firing employees at random or for the most morally reprehensible reasons. Not only do these employers wreak financial and emotional havoc upon their former employees, but their unrestrained abuse of employees is financially detrimental both to their own firms and to the efficient functioning of the economy as a whole. How could such a dreadful situation come about?

The short answer is that it has not. The focus on individuals with colorable claims of irrational discharges has led the critics and courts astray. The question is how often these circumstances exist, something on which the courts have no data. This focus on sad individual tales also

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46. See SURVEY RESEARCH CENTER, SURVEY OF WORKING CONDITIONS 335 (1970); ROBERT P. QUINN ET AL., 1972-73 QUALITY OF EMPLOYMENT SURVEY (1975). I calculated the results reported by removing those not employed by others from the data and then calculating percentages. I attempted a number of divisions of the data (by sex, race, occupation, and so on) and did not find any significant differences in the results among any subgroup of employees.

leads the critics to ignore the institutional structure of the employment relationship. Because the analysis occurs in the context of a single deserving individual and his callous employer, courts generally fail to consider the problems of asset specificity, bounded rationality, and opportunism that the at-will *relationship*,<sup>47</sup> rather than the at-will *legal rule*, is successful at accommodating under some circumstances.

Even the most skeptical critic of the discipline of the market would have to concede that the profit motive would force at least some employers to adopt rational management techniques that would preclude such behavior. Indeed, the rise of the modern corporation with its bureaucracies provides an additional motive: even if they care nothing for the stockholders' profits, personnel managers would seek to restrain arbitrary firings by line managers to protect their own powers and positions. Of course, there are bad personnel managers, just as there are bad accountants, bad engineers, and bad lawyers. Some may even be petty or immoral people who regularly treat others—not just employees—harshly and insensitively. It is not clear, however, that such people will respond to the discipline of the legal system any better than they respond to the discipline of the marketplace. Simply commanding all arbitrary or unfair actions of any type to cease will not stop them, and until there is some evidence that such a command is likely to be obeyed by the people whose behavior we want to change, the wisdom of creating a legal command is in doubt.<sup>48</sup>

#### A. *Employees Are Routinely Fired for Irrational Reasons*

Generalizing from cases brought by ex-employees claiming wrongful discharge, rather than on the experiences of the far larger group of employees who do not lose their jobs, legal commentators have concluded that employers routinely discharge employees for arbitrary, irrational, illegal, or immoral reasons. How can employers persist in such behavior despite market pressure to adopt more rational discharge policies?<sup>49</sup> The

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47. An at-will relationship could be created by a contract or by the at-will rule.

48. Some people think it is appropriate for the law to play a moral role, forbidding behavior even when the state is incapable of enforcing its prohibition. *See, e.g., Bowers v. Hardwick*, 478 U.S. 186, 196 (1986) ("The law . . . is constantly based on notions of morality . . ."). I think *Bowers* provides a convincing argument why such a role is inappropriate. Even if there is a role for exhortation here, exhortations typically do not involve creation of private rights of action, which exist for enforcement and compensation purposes.

49. If, as critics suggest, employees value job security highly, employers who provide protection against arbitrary and irrational discharges are likely to be able to pay their employees less and so give an advantage over those who do not provide job security. Moreover, all available evidence suggests that managers who provide a favorable work unit climate are rewarded with "higher returns on assets and sales and faster growth in revenue" than those who do not. Karen L. Newman & Stanley D. Nollen, *The Effect of Work Unit Climate on Performance*, in *PROCEEDINGS*, *supra* note 26, at 42, 50.

critics claim that employers and employees fail to negotiate efficient levels of job security, falling back on the default at-will contract, because bargaining over job security is sufficiently costly that employers and employees are unable to vary the terms of individual employees' contracts.<sup>50</sup> The choice the firm faces, however, is not limited to a choice of individual negotiation or the default at-will rule. Firms could easily choose a different rule for all or some of their employees by offering renewable term contracts<sup>51</sup> or by simply announcing a different rule for a class of employees, just as many firms do now with respect to probationary employees<sup>52</sup> or for management and union employees.<sup>53</sup> Firms routinely rely on schedules that list pay and fringe benefits by employee status or job title, which could include, at minimal cost, job security provisions.<sup>54</sup> Thus the firm could obtain a result that approximates the benefits of individually negotiated contracts with an internal rule providing more job security than the at-will rule.<sup>55</sup> Since firms do not routinely

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[I]ndividualized bargaining is impractical because negotiating with a large number of employees in a firm and maintaining adequate records of job security terms involve high administrative costs. Employers and employees generally fail to bargain over job security and instead rely on a 'standard' at will term because they are unwilling to incur the costs of individually negotiating a limitation on the employer's power to discharge. Thus, the parties are deterred from making a more complete contract, and the duration of employment is left indefinite.

Note, *supra* note 15, at 1830-31.

51. *See, e.g., Tollefson v. Roman Catholic Bishop*, 268 Cal. Rptr. 550, 556 (Cal. Ct. App. 1990) (upholding the express terms of a renewable term contract against an employee seeking to imply an obligation of continued renewal absent good cause).

52. Firms frequently do this in the employee handbooks which form the basis for the implied-contract exception to the at-will rule. *See, e.g., Garza v. United Child Care, Inc.*, 536 P.2d 1086, 1087 (N.M. Ct. App. 1975) (rejecting the claim that status as a "permanent" employee was more than an indication of nonprobationary status).

53. A frequent source of cases challenging the at-will rule is the promotion of an employee out of a unionized job into a management job and that employee's subsequent dismissal. *See, e.g., Page v. Carolina Coach Co.*, 667 F.2d 1156, 1157-58 (4th Cir. 1982); *Johnson v. Carpenter Technology Corp.*, 723 F. Supp. 180, 182-83 (D. Conn. 1989); *Pinnix v. Babcock and Wilcox, Inc.*, 689 F. Supp. 634, 636 (N.D. Miss. 1988); *Wilson v. Vulcan Rivet and Bolt Corp.*, 439 So. 2d 65, 66-67 (Ala. 1983); *Gesina v. General Elec. Co.*, 780 P.2d 1376, 1378 (Ariz. Ct. App. 1989); *Clay v. Louisville & Nashville R.R.*, 71 S.W.2d 617, 619 (Ky. 1934); *Chavez v. Manville Prods. Corp.*, 777 P.2d 371, 373-74 (N.M. 1989).

54. Firms currently offer employees benefit menus of many types. Large employers may offer a large choice of health insurance plans, for example, and many employers offer menus allowing employees to allocate benefit dollars among multiple categories. Similar provisions could be made for job security.

55. A bit more formally, suppose the firm and employee produce a joint surplus of  $p$  under the at-will rule, and could produce a joint surplus of  $p' > p$  under an alternative rule that provided the employee with greater job security. The firm receives a proportion  $a$  of the surplus. The firm's cost of negotiating the alternative rule is  $t$ . The critics' argument is that  $ap' - t < ap$ , or, rearranging terms, that  $t > (p' - p)a$ . Since the critics argue that both  $a$  and the difference  $(p' - p)$  are large, in order for the inequality to be true  $t$  must also be large. Yet, as discussed above, the cost to the firm of implementing an alternative rule approximating individual negotiation is not large.

take these low-cost steps, there must be something more than "transaction costs" preventing them from doing so.

Indeed there is: the reported cases provide an extensive supply of stories of an employee's dismissal for reasons that any disinterested observer would find stupid, if not immoral.<sup>56</sup> Many critics and judges therefore assume that employers value the ability to discharge at will because they can force their employees to commit bad acts.<sup>57</sup>

However, if employers have sufficient bargaining power to force employees to join the Elks, save the rain forest, or commit perjury, they will drive their employees to the minimum utility level in the bargain, regardless of the degree of job security provided by law, by readjusting the other terms of the contract if a just-cause rule is legally mandated. Society may end up with fewer Elks, less rain forest, and less perjury, but it is not clear that employees will end up better off as a group. Nor is it at all clear that there will be less perjury: employers who want employees who are willing to commit perjury may simply screen prospective employees more carefully or adopt incentive structures that share the benefits of perjury as well as the risks.

To rescue the critics' argument, suppose further that under an alternative rule that provides more job security, the firm loses some bargaining power so that the firm gets  $a'p'$ , with  $a' < a$ . The transaction costs argument is now that  $a'p' - t < ap$  or  $t/a > (1-Q)p' - p$ , where  $Q = [(a - a')/a] > 0$ . If  $t$  is not large, and (using the critics' assumptions)  $a$  is large, the transactions costs criticism requires that the loss to the firm from the change in bargaining power  $(a - a')$  be relatively large in magnitude. If, however, the firm's bargaining power is assumed to be large under the at-will rule, to prevent the firm from imposing the change in the default rule the change in the rule must prevent the employee from credibly committing to a contract that offers her a wage of  $(1 - a)p + e$ , where  $e$  (employee's effort) is small and the level of job security is that provided by the new rule. Again, this is difficult to reconcile with the claim of a de minimis effect on employers. This is also inconsistent with the critics' claim that the change will not significantly restrict the employer's ability to discharge employees when necessary and that firms do not benefit from the at-will rule.

56. For example, employees have alleged they were discharged for refusing to commit perjury, *Petermann v. International Bhd. of Teamsters*, 344 P.2d 25, 26 (Cal. Dist. Ct. App. 1959); or for serving on a jury, *Nees v. Hocks*, 536 P.2d 512, 513 (Or. 1975).

57. In some of these cases the employee is obliged by the threat of discharge to engage in legal activities outside of work in which they would not otherwise choose to engage. In others the employer's "bad act" is alleged to impose a social cost (other than the reduction in social efficiency from the employee being forced away from the optimum) as well as a private cost on the employee.

One example of employer bad acts is attempts to influence employees' political choices. *See, e.g., Novosel v. Nationwide Ins. Co.*, 721 F.2d 894 (3d Cir. 1983) (employee allegedly fired for not participating in his employer's lobbying campaign); *Chavez*, 777 P.2d at 372 (employee allegedly fired after complaining that his employer sent a mailgram urging a vote on asbestos reform legislation in the employee's name despite his explicit refusal to participate in a lobbying campaign); *Chin v. AT&T*, 410 N.Y.S.2d 737, 738 (Sup. Ct. 1978), *aff'd*, 416 N.Y.S.2d 160 (App. Div. 1979), *appeal denied*, 396 N.E.2d 207 (N.Y. 1979) (employee allegedly discharged because he held "certain political beliefs and associations"). Whether such attempts are "bad acts" or not depends on the point of view from which they are evaluated. Ben and Jerry's, for example, requires employees to participate in the company's "social mission." Workers who do not participate lose points, which can prevent wage increases. Ultimately, employees who do not participate can be fired. *Sullivan, supra* note 1, at 79.

Another potential motive is to steal from employees by violating the implicit contracts employers have formed with their employees regarding the totality of employment.<sup>58</sup> The critics argue such contracts must be legally enforceable to prevent employer opportunism. There are reasons to be skeptical of this argument. First, an employer that systematically violates its implicit contracts risks discovery of its opportunistic behavior by current and prospective employees, with the result that current employees will leave and future employees will refuse to accept the implicit contracts.<sup>59</sup>

Second, Richard Epstein's question "Who cares if he is fired by an employer who cheats him regularly?"<sup>60</sup> has a great deal of force here. Peter Linzer's answer of "the person who now has no job cares greatly"<sup>61</sup> is incomplete. The opportunistically fired employee is worse off only under some circumstances.<sup>62</sup> Moreover, the whole point of the critique of the at-will rule is that it results in people losing good, hard-to-replace jobs, not bad jobs. Losing a job in which the employee is regularly cheated may cause a period of unemployment. It is not as likely to result in the employee suffering a significant future income loss as does moving from a good to a bad job.

Since the essence of being an employer is having the power to direct the actions of your employees, the critics' complaints often amount to little

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58. They are implicit contracts rather than explicit contracts because the explicit contract takes the form of "if you are employed at time X, you will receive \$Y" while the implicit contract is to employ the employee until time Z. If there were an explicit agreement as to duration, the at-will rule would not apply.

59. OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 261 (1985). In such schemes, employers opportunistically discharge employees until the expected cost to the employees of opportunistic discharge is at most equal to the expected cost to employees of job security provisions. See Note, *Employer Opportunism and the Need for a Just Cause Standard*, 103 HARV. L. REV. 510, 523-25 (1989). Under those conditions, employees are indifferent between at-will and just-cause contracts, so imposing a just-cause standard does not raise employees' utility. (This is true unless it is accomplished in a manner that makes it a transfer of income from employers to the employees, which is a different justification from the issue of opportunism.) Further, the question of the distributional effects within the class of employees arises again. Those employees whose implicit contracts are not violated may be—and indeed will be if employers react to the imposition of a just-cause rule—worse off when the rules are changed because the terms of their contracts will be altered.

60. Richard A. Epstein, *Agency Costs, Employment Contracts, and Labor Unions*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 127, 138 (John W. Pratt & Richard J. Zeckhauser eds., 1985).

61. Peter Linzer, *The Decline of Assent: At-Will Employment as a Case Study of the Breakdown of Private Law Theory*, 20 GA. L. REV. 323, 413 (1986).

62. The discharged employee is, of course, worse off than if he had had the same job and not been discharged, but that was not his choice when he took the job. The employee chose this job over other jobs, with their respective wage-job, security-benefit combinations. Whether he would still take this job knowing he would be opportunistically fired later will depend on when he is fired, his discount rate, and his other options. Personal discount rates differ dramatically. George Lowenstein & Richard H. Thaler, *Anomalies: Intertemporal Choice*, 3 J. ECON. PERSP. 181, 184 (Fall 1989). These differences prevent a comprehensive answer about all employees' welfare from being determinable.

more than disagreements over whether they think an employer's acts are appropriate. It does not require modifying the at-will rule to deal with the few truly stupid employers who suborn perjury or incite employees to avoid jury duty; it merely requires enforcing existing laws against criminal behavior or adopting narrow laws prohibiting discharges based on jury service. Similarly, if the problem is not the regular fleecing of employees by massive numbers of unscrupulous employers but occasional arbitrary and irrational actions by a few, then no basis for a large-scale reordering of the workplace arises.

### B. *Employers Do Not Consider the Impact of Firing on Employees*

While the courts and critics generally assume that employees suffer considerable losses when they lose their jobs,<sup>63</sup> employers, on the other hand, are generally assumed to face insignificant costs in replacing employees.<sup>64</sup> Combined with this disparity in costs is the "problem" of unequal bargaining power between employers and employees. This was the central theme of Blades's early, and still influential, critique of the at-will rule.<sup>65</sup> The issue of relative bargaining power could simply reflect

63. See *K Mart Corp. v. Ponsock*, 732 P.2d 1364, 1372 (Nev. 1987) (noting the dependence and economic vulnerability of an employee in relation to his employer); *Darlington v. General Elec.*, 504 A.2d 306, 309 (Pa. Super. Ct. 1986) (contending that the philosophy underlying employment-at-will "failed to consider the lack of bargaining power in an individual employee, *i.e.*, that there can be no freedom of contract between parties of grossly unequal bargaining power"); *Little v. Bryce*, 733 S.W.2d 937, 940-41 (Tex. App.—Honston [1st Dist.] 1987, no writ) (Levy, J., concurring) ("Losing a job today, in this age of increasing technology, specialization of employee skills, and an unstable, if not contracting, economy, is very risky for the worker whose livelihood depends entirely upon his labor."). These include search costs, lost wages and benefits, lower future earnings, and a wide range of noneconomic costs such as lessened self-esteem, increased illness, and stress. See, *e.g.*, Nora J. Pasman, *The Public Interest Exception to the Employment-At-Will Doctrine: From Crime Victims to Whistleblowers, Will the Real Public Policy Please Stand Up?*, 70 U. DET. MERCY L. REV. 559, 572 (1993) (noting that when an employee is fired, she is "faced with all the personal consequences, outrageous offense and despair associated with such an economic tragedy"); Cheryl S. Massengale, *At-Will Employment: Going, Going . . .*, 24 U. RICH. L. REV. 187, 201 (1990) (noting the existence of "[b]oth psychological and economic effects on individuals who lose their jobs").

64. This alleged disparity in costs also prompts many critics to conclude that because employers do not consider the total cost of discharge, they discharge too many employees. Even if it were true that employers did not suffer significant losses when an employee is incorrectly discharged and that discharged employees always suffer large losses, it would not follow that employers would not consider the effect of discharge on employees; the size of that effect would determine the effectiveness of discharge as a penalty for violating the employers' work rules.

65. Blades, *supra* note 2, at 1411-12 ("Only the unusually valuable employee has sufficient bargaining power to obtain a guarantee that he will be discharged . . . only for 'just cause'"). Blades is still cited as an authoritative critique. See, *e.g.*, *In re Hotstuf Foods, Inc.*, 95 B.R. 355, 357 (Bankr. E.D. Pa. 1989); *Hoffman-La Roche, Inc. v. Campbell*, 512 So. 2d 725, 744 (Ala. 1987) (Maddox, J., dissenting); *Holmes v. Union Oil Co.*, 760 P.2d 1189, 1192 (Idaho Ct. App. 1988). Unequal bargaining power was also the main concern voiced by Commons and Andrews in their earlier analysis of at-will employment. JOHN R. COMMONS & JOHN B. ANDREWS, *PRINCIPLES OF LABOR LEGISLATION* 373-74 (4th rev. ed. 1936). Even the Mississippi Supreme Court, which has not been

a desire to redistribute income from employers to employees, but many critics argue that this inequity results in contracts whose result is lowered social welfare, not just an unappealing distribution of income.<sup>66</sup> Assuming these effects are true, this argument rests on unsupported assumptions about the value of legal job security.<sup>67</sup> This criticism rests on the implicit assumption that employees want additional job security. Of course, holding everything else constant, most rational people would prefer jobs with more security rather than less. However, in the real world all else is rarely constant and employees must make tradeoffs between different job characteristics. It may be, therefore, that some employees prefer jobs with more of some other characteristic (money, for example) and less job security to jobs with less of the other characteristic and more job security.

There is a simple means of determining preferences: ask people about their preferences for different job characteristics. The General Social Survey (GSS), a large national opinion poll conducted annually by the

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receptive to arguments to overturn the at-will rule, noted its regret in upholding a contract that had an explicit at-will provision: "Conceding as an illusion that the parties are in a posture of economic parity one with the other, particularly in ability to absorb the consequences of termination, we consider it our obligation to enforce the contract as written . . . ." *Shaw v. Burchfield*, 481 So. 2d 247, 249 (Miss. 1985).

66. See, e.g., Craver, *supra* note 12, at 1626 (claiming employment security produces increased social welfare through increased commitment to employers, reduced turnover, and increased training of employees); Committee on Labor and Employment Law, *supra* note 12, at 170. There are economic arguments about the "efficiency" of different income distributions, and the consequences of income redistribution are also usefully analyzed with economic tools. See, e.g., James S. Coleman, *Equality*, in 2 THE NEW PALGRAVE: A NEW DICTIONARY OF ECONOMICS 169, 171 (John Eatwell et al. eds., 1987); Erik O. Wright, *Inequality*, in THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS, *supra*, at 815, 817-18. These are not, however, the arguments made by the critics.

67. The question remains whether such a change in legal rules will actually produce the redistribution the critics desire, and if it does, what the distributional effects will be within the class of employees. No reason indicates that all employees should equally value legal job security. Since employers with significant bargaining power will undoubtedly alter other terms of the employment relationship to compensate for the loss of the ability to fire at will, different employees will experience different levels of transfers from employers, and some employees, particularly those who place little value on legal job security, may experience a net loss. These intraclass effects of a change in the rules have been ignored. The claim that employees value job security highly is generally based on the example of employees who have made high job-specific human capital investments and who thus suffer the greatest cost from job loss. These employees are, by definition, highly skilled and highly compensated. At the other extreme, low-wage, low-skill employees' primary loss is from a period of unemployment between low-wage jobs. They have less to gain in absolute terms from the imposition of job security and the most to lose from reduced employment opportunities caused by the increase in the cost to firms of hiring additional employees.

Since low-wage, low-skill employees are also the most vulnerable to employer strategic reactions to the imposition of just cause (through worsened working conditions or lower wages), they also stand to lose the most from the employer's strategic response. Imposing a just-cause rule, therefore, may most likely lead to a net loss for the most vulnerable group. If their wages are low enough that the minimum wage is a binding constraint, they may be protected from some wage-related strategic behavior by employers.

National Opinion Research Center at the University of Chicago, has asked about individuals' preferences for job characteristics, including job security, since 1973.<sup>68</sup> One question regularly included in the GSS asks individuals to rank five job characteristics:

1. no chance of being fired;
2. high income;
3. chances for advancement;
4. job is meaningful and provides a feeling of accomplishment; and
5. short hours.<sup>69</sup>

The responses for all years are presented in Table 3.<sup>70</sup> As Table 3 shows, job security comes in a distant fourth, ahead of only short working hours in the number of people ranking it either first or second.

Table 3: Job Characteristic Rankings

Job Characteristic	Number Choosing Rank of Characteristic (percent in parentheses)				
	First	Second	Third	Fourth	Fifth
No Danger of Being Fired	1178 (7.1)	2190 (13.2)	3405 (12.3)	5367 (19.3)	4487 (27.0)
Short Working Hours	610 (3.7)	1364 (8.2)	1869 (11.2)	4004 (24.1)	8780 (52.8)
Work Important and Feeling of Accomplishment	8204 (49.2)	3116 (18.7)	2318 (13.9)	1896 (11.4)	1093 (6.6)
Chances for Advancement	3124 (18.8)	5861 (35.2)	3906 (23.5)	2386 (14.4)	1350 (8.1)
High Income	3511 (21.1)	4096 (24.6)	5129 (30.8)	2974 (17.9)	917 (5.5)

N = 16,627 (all who answered question in years asked).

68. James A. Davis & Tom W. Smith, *General Social Survey, 1972-1991* (machine-readable data file). The question was asked in 1973, 1974, 1976, 1977, 1980, 1982, 1984, 1985, and 1987-91.

69. *Id.* Individuals were shown a card with the five characteristics listed on it in a random order. They were asked: "Would you please look at this card and tell me which one thing on the list you would most prefer in a job?" Then they were asked: "Which comes next?" "Which is third most important?" and "Which is fourth most important?" JAMES A. DAVIS & TOM W. SMITH, *GENERAL SOCIAL SURVEYS, 1972-1991: CUMULATIVE CODEBOOK 230-32* (1991). This is obviously a less-than-perfect question, but it does provide some evidence. Perhaps a better question would provide different evidence—but the burden rests on the proponents of change to provide such evidence.

70. Table 3 includes the data for all responses to this question in all years asked (16,627 respondents). See JAMES A. DAVIS & TOM W. SMITH, *THE NORC GENERAL SOCIAL SURVEY: A USER'S GUIDE 74* (1992).

A factor analysis of these data reduces the five dimensions to three.<sup>71</sup> The results of the factor analysis are given in Table 4. All three factors have natural interpretations as tradeoffs between different job characteristics. Factor 1 can be interpreted as a meaningfulness-promotion tradeoff, Factor 2 as an hours-income tradeoff, and Factor 3 as a tradeoff between job security and all other job characteristics. These results demonstrate empirically what is intuitively obvious—different employees have different preferences about job security. Legal rules which apply one-size-fits-all standards of job security will inevitably disadvantage some employees. Default rules, like the at-will rule,<sup>72</sup> allow individuals freedom to find employment situations which more closely approximate their preferences. The existence of impediments to bargaining over job security is an argument for removing the impediments, not intruding the state into private relationships to advantage some employees and disadvantage other employees.

Table 4: Rotated Factor Matrix of Job Characteristic Data

Job Characteristic	Factor 1	Factor 2	Factor 3
No Danger of Being Fired	-0.02161	0.02586	0.99608
Short Working Hours	0.11563	0.89041	-0.20784
Work Important and Feeling of Accomplishment	0.82047	0.04237	-0.20364
Chances for Advancement	-0.86888	-0.07812	-0.17276
High Income	-0.00769	-0.78817	-0.41130

The responses to the GSS questions also reveal important differences among various groups. These responses are summarized in Table 5,<sup>73</sup> which shows the percentage of each group ranking the various characteristics first or second. Union members rank job security more highly than

71. A varimax rotation was used. Factor analysis is based on the assumption that the variation in a set of  $N$  variables is due to the variation in a set of  $K < N$  underlying unobserved factors. See HARRY H. HARMAN, *MODERN FACTOR ANALYSIS* 4 (3d ed. 1976). For a brief, less technical explanation of factor analysis, see JAE-ON KIM & CHARLES W. MUELLER, *INTRODUCTION TO FACTOR ANALYSIS* 7 (1978) and JAE-ON KIM & CHARLES W. MUELLER, *FACTOR ANALYSIS: STATISTICAL METHODS AND PRACTICAL ISSUES* (1978).

72. Just-cause rules are generally not implemented as default rules because people would contract around them.

73. Table details: Respondents whose spouse belonged to a union but who did not themselves belong to a union (674 respondents) were excluded (the results were not significantly different if they were included as union members). Total respondents: 1,633 union members, 8,205 nonmembers; 7,420 men, 9,207 women; 13,973 white, 2,654 nonwhite.

do nonmembers and rank chances for advancement less highly than do nonmembers—responses consistent with the benefits and costs of union-sector jobs.<sup>74</sup> Nonwhites rank job security more highly than do whites, and men rank it more highly than do women. These results are significant in several ways. First, nonwhites are far more likely than whites to face discharge due to racial or ethnic prejudice, and so Title VII, which has largely become a vehicle for wrongful discharge suits in recent years,<sup>75</sup> is available as an avenue of redress. Second, to the extent that common-law remedies carry costs with them, the net benefit of a common-law remedy is likely to vary over groups and will be greater for men as a group than for women as a group.<sup>76</sup>

Table 5: Group Differences in Job Characteristic Rankings

	Job Security	Chances for Advancement	Meaningful Work	High Pay	Shorter Hours
Union Member	26.0**	48.7**	61.4**	51.0**	13.0
Not Union Member	18.6**	55.1**	69.8**	45.0**	11.3
Male	22.6**	52.6**	64.6**	47.7**	12.5**
Female	18.5**	55.2**	70.8**	44.2**	11.4**
White	18.4**	54.9**	72.2**	42.8**	11.8*
Nonwhite	30.0**	49.6**	46.5**	61.5**	12.4*

\* difference significant at 5% level; \*\* difference significant at 1% level

Critics of the at-will rule also argue that it is unfair that employees who belong to a union or have a public-sector job receive more legal job

74. Unions generally reduce "dispersion of earnings within and across establishments" and reduce the "effect of standard wage-determining factors on earnings." Richard B. Freeman, *Unionism and the Dispersion of Wages*, 34 INDUS. & LAB. REL. REV. 3, 23 (1980). Union jobs have many characteristics that differ from other jobs. Perhaps most importantly, union members "pay" for the legal job security benefits they receive in many ways: they pay union dues, accept a greater role for seniority in advancement and layoffs, limit the potential for merit-based advancement, and so forth. See Katharine G. Abraham & James L. Medoff, *Length of Service and Layoffs in Union and Nonunion Work Groups*, 38 INDUS. & LAB. REL. REV. 87, 89 (1984) (citing survey results finding that 78% of union hourly groups were covered by written policies that specify seniority as the most important factor to be considered in permanent layoff decisions compared to 16% of nonunion hourly groups). Selecting out one characteristic of these jobs is a shaky foundation for an argument from fairness. Moreover, this argument denies that employees make choices about their jobs.

75. Donohue & Siegelman, *supra* note 33, at 984.

76. This is even more true to the extent that Title VII largely serves to protect women rather than men in sex-based discrimination cases.

security than employees who do not.<sup>77</sup> This argument is based on the false assumption that all employees' preferences for job security are alike, the failure to recognize that union-sector and public-sector employees have traded significant job characteristics for their job security, and a paternalistic vision of the State's giving employees what they need, regardless of their preferences.

Employees do care about job security, but they care about other aspects of jobs as well. To the extent that employees are able to find jobs that match their preferences, the provision of jobs with varying degrees of job security is evidence not that employers do not consider the impact of firing on employees, but rather that the labor market is able to succeed in satisfying employee preferences despite its imperfections.

### C. *Proving Just Cause Is Neither Costly nor Difficult*

If an employee is unproductive for whatever reason, the critics claim, the employer should be able to prove it easily, to a jury or other fact finder. The primary costs of proof are assumed to be the legal fees for the employer in defending wrongful discharge suits. By advocating an arbitration-like mechanism instead of court suits, the critics argue that costs can be reduced to a minimal level.

Just cause does not simply mean that more evidence is necessary to support a claim that an employee is performing poorly.<sup>78</sup> It means that poor performance must be proven to an outsider, so verifiable evidence will be needed. More broadly, the difference is that under an at-will regime the firm can act on observable but not verifiable evidence, while under a just-cause rule the firm requires verifiable evidence.<sup>79</sup> Consider

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77. Professor Peck, for example, contends that

[t]he sharp contrast between the protection available to public employees and that available to private employees should cause us to ask whether there is justification for that difference. The justification for permitting termination of employment without cause grows even more difficult when consideration is given the fact that twenty-five percent of the private nonagricultural work force is now represented by labor unions.

Cornelius J. Peck, *Some Kind of Hearing for Persons Discharged from Private Employment*, 16 SAN DIEGO L. REV. 313, 315 (1979). See also Craver, *supra* note 12, at 1643 (advocating statutory just-cause rules as well as significant increases in federal wage and fringe benefit floors). The proportion of the private nonagricultural workforce represented by unions has continued to decline: in 1994 it was 12.0%. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 445 (115th ed. 1995) (Table 698: Union Members, by Selected Characteristics: 1983 and 1994).

78. Economic analysis of the employment-at-will rule has focused on the effects on employees of reducing the chance of being fired. In the formal models of the at-will and just-cause rules, effort has been held fixed. David I. Levine, *Just-Cause Employment Policies When Unemployment Is a Worker Discipline Device*, 79 AM. ECON. REV. 902, 902 (1989). The more informal economic discussions in the legal literature have made similar assumptions.

79. See BRUCE HARRISON & J. MICHAEL MCGUIRE, *EMPLOYEE DISCIPLINE AND DISCHARGE POLICIES* 33.02 (1991) ("Too frequently, employers face substantial hurdles in defending themselves

a typical set of factual contentions from a wrongful discharge suit: the discharged employee alleges that he was fired for some reason that violates public policy, while the employer claims the employee was fired for poor performance. The final decision at this company rests with the vice president for human relations, who has an "open door" policy allowing employees to bring their complaints to her. The employee and the supervisor both tell the vice president their stories. Under the at-will rule the vice president makes her decision based on her knowledge of the firm and the participants. At the very least, she will know the supervisor better than an outside decisionmaker would and can use this information to evaluate the supervisor's claims about the employee's job performance.

Under a just-cause rule, however, the vice president must consider how her decision will look to the outside decisionmaker. A statement by her that the supervisor has always been truthful in the past and that she puts great weight on his judgment will not be persuasive evidence to an outsider, since the vice president has every incentive to make that statement even if it is not true. So even a supervisor with a record of finding performance problems is likely to be sent back for documentation if he comes in with an unverifiable claim of poor performance.

Using a very simple model analogizing just cause to a tax on effort levels,<sup>80</sup> mandating just-cause protection appears problematic in a heterogeneous labor market.<sup>81</sup> The insight offered by the model is straightforward: Requiring employers to prove with verifiable evidence that their discharge decisions meet a standard of cause will result in employers substituting tasks which produce verifiable outputs for those which produce merely observable outputs. To the extent that observable but not verifiable outputs exist, they are likely to be the product of creative, high-skill jobs. Reducing those types of outputs leads to a reduction in welfare for both employees and employers.

If we assume a simple labor market in which jobs differ only in their responsiveness to the employee's investment in effort, the at-will rule is more efficient for the more responsive jobs.<sup>82</sup> Highly skilled, highly

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against challenges to disciplinary and discharge decisions involving these subjective evaluations because they give rise to issues that can only be resolved by two fact finders believing or not believing the contradictory statements of union witnesses."); DOUGLAS H. THOMPSON, DISCHARGE FOR CAUSE: ARBITRAL ENFORCEMENT UNDER THE COLLECTIVE BARGAINING AGREEMENT at ix (1989) (arguing that "the question of whether an involuntary ending of an employment relationship is truly for 'cause' properly follows objective standards that are derived from sound legal principles").

80. See *infra* Appendix.

81. The version here is constrained by the limitations of the symposium format. For a more detailed version of this model, see Andrew P. Morriss, *The Law and Economics of Employment-At-Will* (1994) (unpublished Ph.D. dissertation, Massachusetts Institute of Technology, on file with author).

82. In terms of the model in the Appendix, for sufficiently large values of the parameter  $\beta$ , the cubed term dominates the others.

compensated employees—those most likely to be able to bring a common-law wrongful discharge action—are more likely to be in such jobs than are assembly-line workers. The common law's provision of a remedy-in-fact to the former and not to the latter maximizes the inefficiencies associated with displacement of the at-will rule.<sup>83</sup>

Such a simple model does not "prove" the inadequacy of the just-cause rule. It does identify how incorrectly assuming that proving just-cause is neither costly nor difficult can significantly reduce the welfare of employers and employees. The question then is whether proving just cause is costly. A definitive answer awaits a suitable empirical investigation into employers' costs and behavior. The evidence we have, however, suggests that employers think it is costly and difficult.<sup>84</sup>

#### *D. The At-Will Rule Produces Large Negative Externalities*

Critics make this argument in three ways: employers do not fully consider the cost of discharges to (i) themselves, (ii) employees, and (iii) society in general.

The first is not a credible claim.<sup>85</sup> Firms which ignore significant internal costs are not firms for long.<sup>86</sup> Those that do survive are at a serious competitive disadvantage. Personnel managers are just as capable of reading the literature on which these claims are based as are lawyers, and they have a much greater incentive to do so. Moreover, there are significant reasons why employers provide job security voluntarily.

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83. Where just-cause remedies are instituted, reducing the costs of proof will reduce the inefficiencies associated with the rule. Reducing the costs of proof brings the variables' values closer to the values under the at-will rule and so reduces the inefficiencies introduced by the just-cause rule. To reduce the costs of proof requires more than simply decreasing attorneys' fees. Allowing employers to defend discharge decisions based on good faith rather than requiring discharges to be objectively justified, for example, would reduce the costs of proof significantly. Similarly, shifting decisions on wrongful termination claims to decisionmakers less likely to be swayed by sympathy—replacing lay juries with arbitrators, for example—would also reduce the cost of proof since the amount of evidence needed to convince such a decisionmaker would be less.

84. See, e.g., JAMES N. DERTOUZOS & LYNN A. KAROLY, RAND INST. FOR CIVIL JUSTICE, LABOR MARKET RESPONSES TO EMPLOYER LIABILITY 49-52 (1992) (offering evidence of significant declines in employment following adoption of common-law exceptions to the at-will rule).

85. Employers also incur costs when an employee is discharged. If the employee is replaced, they incur recruiting costs, training costs, and lost production before the employee is replaced and during the training period for the replacement. They also lose the benefit of any specific human capital the discharged employee had accumulated. In addition, the employer suffers a loss in productivity from the remaining employees, who are demoralized by the arbitrary firing of their colleague. *Id.* at 36-40.

86. Unless, of course, they are able to secure government subsidies. Chrysler Corporation, for example, was rewarded for its spectacular failure to remain competitive in the auto industry with a \$3.5 billion debt-restructuring package which included a federal loan guarantee of \$1.5 billion. Chrysler Loan Guarantee Act of 1979, Pub. L. No. 96-185, 93 Stat. 1324; REGINALD STUART, BAILOUT: THE STORY BEHIND AMERICA'S BILLION DOLLAR GAMBLE ON THE 'NEW' CHRYSLER CORPORATION 199 (1980).

Economists Katherine Abraham and James Medoff, who can hardly be considered apologists for employers, found in their early 1980s survey that "in over 80 percent of private sector nonagricultural, nonconstruction employment, senior workers enjoy substantial protection against losing their jobs."<sup>87</sup> They went on to suggest reasons why employers voluntarily provide job security: avoiding unionization, maintaining morale to preserve short-term efficiency, and attracting new hires.<sup>88</sup>

With respect to the second, although employers do not directly incur the costs of firing suffered by employees, they must still consider the size of the loss. The degree of the penalty (firing) is an important part of the structure of the discipline scheme the employer chooses. The costlier the penalty is to the employee, the less the employer must spend on detection to impose a given discipline scheme, for example.<sup>89</sup> Moreover, *employees* must consider these costs in determining their behavior under a given discipline scheme, which is also something the employer must consider. Again, employers' self-interest will dictate that they will consider these costs.<sup>90</sup>

The critics' third argument is based on the claim that unfair discharges alienate the discharged employees, which in turn causes a wide range of social problems.<sup>91</sup> A forced change to a just-cause regime reduces the number of "bad" firing decisions and therefore alienation. If simply identifying a source of "alienation" were all that was required to justify state intervention, we should expect restrictions on the ability to publish

87. Abraham & Medoff, *supra* note 74, at 96.

88. *Id.*

89. See George J. Stigler, *The Optimum Enforcement of Laws*, 78 J. POL. ECON. 526, 527 (1970).

90. Consideration does not, however, mean the firm will not act; instead, it means simply that the act will be taken in light of the costs. Interestingly, none of the critics' reform proposals suggest that the outside decisionmaker will be empowered to consider these costs in deciding whether discharged employees will win their cases. Presumably, fewer people will be discharged, but those who do will still suffer these costs plus the additional cost of being labeled a lemon for having lost their discharge case. Given that mistakes are inevitable, those who are mistakenly fired under a just-cause regime will bear a greater burden than those mistakenly fired under an at-will regime. Again the remedy imposes greater losses on a few in return for alleged benefits to a larger group. Without some substantive evidence, such utilitarian calculations are suspect and smack of Benthamism. Moreover, such claims, even if supported by actual evidence, would be morally suspect because of their imposition of costs on (presumptively) deserving members of the group whom the "reforms" are designed to help. Given the critics' assumptions about risk aversion among employees generally, this cost is a particularly heavy burden.

91. Brian F. Berger, Note, *Defining Public Policy Torts in At-Will Dismissals*, 34 STAN. L. REV. 153, 168 (1981). Berger writes,

The public's interest in the employment relationship arises out of employment's interdependence with a stable economy and worker productivity. The ethos of work is important to workers in the United States. Job insecurity may lead to deteriorating moral and psychological standards in the workforce. Moreover, actual job displacement may result in political, financial, and social alienation of workers, all of which contribute to underproductivity and other social and economic problems.

*Id.* (citations omitted).

books and a host of other activities which offend and potentially "alienate" others as well. Part of the point of a society based on individual rights is that we need not consider (even if morally we should) such costs.

Further, eliminating the at-will rule may well produce externalities of its own. Professor Gail Heriot argues persuasively that mandating job security will lead employers to seek to impose restrictions on employees far beyond those alleged to occur under the at-will rule.<sup>92</sup>

### *E. Employees Significantly Underestimate Their Risk of Job Loss*

Employees allegedly make "bad" bargains in the sense that if they had known the true probabilities of discharge under the at-will and just-cause rules, they would have chosen a just-cause contract.<sup>93</sup> The root of the problem is either the employee's misperception or the employer's misrepresentations to the employee to encourage employees to accept lower wages or to be more productive.<sup>94</sup> The latter is covered by the common law of fraud and does not require changes in employment law to prevent.

How bad is employees' information about job security likely to be? One obvious characteristic of the at-will rule is that the legal responsibilities of the employer are clear—it has none. How then are employees systematically fooled? The critics of the at-will rule are silent on the mechanism for this, aside from general references to psychological studies that individuals underestimate the likelihood of experiencing bad events.<sup>95</sup> Some employees may at first mistakenly believe a crafty, opportunistic employer who later takes advantage of them, but it is a large and unwarranted step to conclude from this that employees in general systematically fail to understand their personal risk of job loss.<sup>96</sup>

92. Gail L. Heriot, *The New Feudalism: The Unintended Destination of Contemporary Trends in Employment Law*, 28 GA. L. REV. 167, 172-73 (1993).

93. This argument is that

[e]mployees may for a variety of reasons misperceive their best interests at the outset of the employment relationship. For example, employees may tend to discount substantially the risk of wrongful discharge, and as a result systematically undervalue job security. This reflects a common psychological response; since most people prefer not to think about the possibility of disaster, employees understandably tend to disregard the possibility of job loss.

Note, *supra* note 15, at 1831 (footnotes omitted).

94. This is a common assumption about employee handbook provisions adopted by employers and used by courts to impose just-cause requirements. For an example, see the leading case of *Toussaint v. Blue Cross & Blue Shield*, 292 N.W.2d 880, 895 (Mich. 1980). See also *Price v. Federal Express Corp.*, 660 F. Supp. 1388, 1392-93 (D. Colo. 1987) ("Employers must realize that if they are going to reap the profits and rewards of employee loyalty and enhanced workmanship which are coaxed by implied promises made to the workforce, then such employers must be held to their word.").

95. See *supra* note 93.

96. Furthermore, employees' expectation that they will not be discharged or that they will be treated fairly is not the same thing as a belief that they have an enforceable legal claim if they are discharged without "just cause."

One thing we do know about employees is that they know much more about their particular employer, its practices, and their circumstances than lawyers and economists do. What appears to an outsider as underestimation of the risk of discharge may be actually the result of the different information available to insiders.<sup>97</sup> Employees' perceptions of the likelihood of discharge will be based on: (i) their observations about the fate of other employees of their employer; (ii) their observations of the fate of people they know who work for other employers; (iii) general knowledge from the media and other sources; (iv) their knowledge of their performance and their employer's assessment of their performance; and (v) their knowledge of the practices of their employer, as gleaned from personnel handbooks, conversations with managers, and the like.

The employer can directly affect only the last of these sources. Indirectly, the employer could lie to employees about why other employees were fired, raising doubt among the employees that a discharged employee's story of arbitrary discharge is true, or structure the workplace to hinder employees' exchange of information.<sup>98</sup> The employer is not likely, however, to be wholly successful in preventing the employees from

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97. The ex post utility of job security provisions also depends not only on the true ex ante probability of dismissal but also on the realization of the risk of job loss. Consider the example of insurance: My demand for insurance stems from my preference for avoiding risk. If I face a risk that I am unaware of and do not buy insurance to cover the risk, I am worse off ex post only if the risk is realized or if I realize, too late to purchase insurance but with time to worry, that the risk exists. If I never learn of the risk and it is never realized, by remaining ignorant of the risk I save the insurance premium and am able to spend it on other items. (Since I did not know that the risk existed, I did not experience any disutility from the worry about the unrealized risk.)

If employees' ex ante estimates of job-loss risk are systematically biased downward, the effect on their utility will be different ex post for different subgroups. Those who do not lose their jobs are better off ex post than if they had been correctly informed of the true risk ex ante, since they received higher wages for the entire period of employment and did not lose their jobs. Those who do lose their jobs are *potentially* worse off ex post than if they had been correctly informed ex ante. Among this group the net gain or loss will depend on how long they held their initial job, the difference in wages between it and the subsequent job, their discount rate, and the length of any period of unemployment.

What is important to note is that some employees—those who are not discharged under the at-will rule—are made worse off by learning the true probability of discharge since they must now buy insurance. Only some employees who are actually discharged are made better off ex post. This group's gains are thus financed, at least in part, by their fellow employees rather than by their employers. Even if we assume the desirability of a transfer of wealth from employers to employees, it is not clear that the increased job security would accomplish that aim without penalizing some employees as well. Finally, since public corporations' stock is largely held by institutional stockholders such as mutual funds and pension plans, even transfers from corporations to employees are often at the expense of individuals who are not clearly better off than the beneficiaries of the transfers.

98. See, e.g., *Zinda v. Louisiana Pac. Corp.*, 440 N.W.2d 548, 553 (Wis. 1989). In *Zinda*, the company used a newsletter to inform other employees of the basis for recent discharges. *Id.* at 550. A dismissed employee sued the employer for defamation and invasion of privacy as well as wrongful discharge. *Id.* at 556. The Wisconsin Supreme Court found the employer's interest in communicating with its employees to maintain morale to be a "common interest" entitled to privilege under Wisconsin law. *Id.* at 553.

making assessments of these factors. This is particularly true where the employer frequently discharges employees, since a false and misleading explanation that is credible the first time becomes less so when repeated for the  $n$ th time.

Moreover, for a misperception-deception theory to be viable, the number of misled employees actually discharged must be sufficiently small that other employees do not learn the truth either by observation or from the experiences of others (relatives, friends, neighbors, or coworkers). Correcting the misperception-deception problem may therefore result in a transfer of wealth from many employees to a relatively small group, a result that is not necessarily acceptable even to the proponents of the just-cause rule.

Much of the uncertainty in employees' careers today is the result of changes in the economy which are beyond the ability of the law, common or statutory, to prevent. Not only have firms been under significant economic stress in recent years, but economic changes have meant changes in career patterns and firms' internal labor markets as well.<sup>99</sup>

In one particularly significant development, structural change in the U.S. economy has transformed the traditional, seniority-based career ladder. Rosabeth Moss Kanter identified, for example, a significant shift away from the traditional managerial career patterns in high-technology firms.<sup>100</sup> The consequences of these changes are significant both for the

99. Profound economic changes have occurred in the U.S. economy since the 1950s. Many of these changes have had the result of introducing market forces into previously sheltered sectors of the economy and, in particular, into areas inhabited primarily by relatively well-paid professional or technical employees. Professor Richard Peterson, a commentator more than sympathetic to the plight of these employees, summarized the changes as follows:

The element of cost discipline has become a growing reality to a greater segment of the labor force. Once largely restricted to the factory floor, cost discipline governs even professional employees. For example, public accounting and law firms use ever tightening control devices such as billable hour competition to assure that everyone is carrying his or her share of the load and also to assure comfortable partner bonuses. Top management is continually reminded by the financial community that they need to improve quarterly and yearly profits to maintain or improve stock price and assure better executive bonuses. Telephone operators and service representatives are regularly monitored to count the seconds that an operator takes to complete a call. . . .

Uncertainty about one's job and income is far more evident in the labor force now than it was 30 years ago. Historically most job layoffs affected the factory work force, unless the plant, office, or company was closed. However, with the recessions of the mid-1970s, early 1980s, and the most recent recession, managers and professionals/technical began to share the brunt of unemployment. . . . These traditionally privileged groups, in terms of pay, benefits, and job security, increasingly find themselves vulnerable to economic events and top management mandates.

Richard B. Peterson, *The Elements of Industrial Relations: A Retrospective View*, in PROCEEDINGS, *supra* note 26, at 176, 181-82.

100. Rosabeth M. Kanter, *Variations in Managerial Career Structures in High-Technology Firms: The Impact of Organizational Characteristics on Internal Labor Market Patterns*, in INTERNAL LABOR MARKETS 109 (Paul Osterman ed., 1984). Kanter notes that, instead of careers marked by

individual's career and for managerial level employees as a group. Not only is there greater mobility due to increased managerial job opportunities and a greater reliance on outside personnel for filling such vacancies, but frequent reorganizations and rapid technological change lead to "less overall stability in job and organizational structures."<sup>101</sup>

These changes in the economy are the true cause of misperceptions about job security. It is not that employees underestimate their legal rights but that the economy is in transition and economic job security is dwindling. Whatever one may think about those changes, wrongful discharge law is largely irrelevant to altering their impact.

### F. Summary

The critics' arguments do raise two important points, but on closer examination those points undermine the case for abolishing the at-will rule. First, many of the critics' arguments discussed above suggest that employers do highly value the ability to fire at will.<sup>102</sup> Given that employers fail to exploit what the critics claim are substantial productivity gains from providing job security, at-will contracts probably have some efficiency characteristics of their own. The preference for at-will contracts is at least partially explained by the "effort tax" effects of introducing outside decisionmakers into the employment relationship.

Second, the distributional effects of a change from the employment-at-will rule to a just-cause rule within the class of employees is an important issue that has not been addressed by the critics. If the change results in a net loss for low-wage, low-skill employees but a net gain for high-wage, high-skill employees, then the critics' fairness claims are substantially weakened on their own terms. Unfortunately, the distributional impact is primarily an empirical question, which would be difficult to assess without

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functionally based careers, with movement up a long ladder in a single function, . . . career movement that is largely linear and vertical, with moves implying promotions to a higher hierarchical level, . . . a long process of development from entry-level management jobs to making key business decisions, with a large number of moves in-between, [and] achievement of a general manager post (or top management position as part of a chief executive's staff) relatively late in the career, [newer high-technology firms often had managerial careers marked by] career movement that is often nonlinear or lateral, . . . a career arena that encompasses many units of the organization rather than just one, . . . a rapid process of development from entry-level management jobs to positions making key business decisions, in relatively few moves, [and] attainment of a general manager-type position (or position on a chief executive's staff) relatively early in the career.

*Id.* at 109-10.

101. *Id.* at 111-12.

102. Off-the-record interviews with employers and employers' counsel suggest the same. It is possible that some of this value is the employers' desire for power over employees for its own sake. It is unlikely that such cravings are widespread enough to explain the presumed high frequency of at-will contracts.

data on employment contracts. Such data do not exist. Nevertheless, one must consider the possible within-class distributional impacts as well as the between-class changes when arguing that at-will contracts are unfair.

#### IV. Conclusion

Based on overestimates of wrongful discharges, peculiar views of labor markets, and overconfidence in the efficacy of state-imposed solutions, courts and commentators have produced a complex and often incoherent patchwork of reforms: public policy exceptions, unilateral contract theories, newly discovered implied covenants, and tort theories. These reforms have barely satisfied the appetites of some commentators for state interference, of course, but courts and legislatures have been reluctant to tamper too much with private employment relations.

The cure is in many respects worse than the disease. The legal remedies provide effective relief only to the extent potential plaintiffs have access to lawyers. Lawyers are available only to those who can pay, either up front or through contingency fees combined with the potential for substantial recovery. Since few discharged employees can afford to pay attorneys by the hour or are discharged under circumstances which are sufficiently egregious to generate damages large enough to compensate both the ex-employee and her attorney, the remedy reduces to something of a lottery. Moreover, because it is a game played with loaded dice, the ex-employees most likely to win are those with high salaries to begin with since their damages are greater. Yet these are precisely the employees who are most likely to have performance standards that are difficult to quantify and hence suffer from discharge decisions that are difficult to defend to outside decisionmakers.

Perhaps the most baffling aspect of the debate over the legal regulation of employment in general is the apparent willingness of so many advocates of employees' interests to trust the state. At the Symposium at which these papers were discussed there was some discussion of when the "golden age" of labor and employment law (during which the state championed the interests of employees) existed. There never was a "golden age" of labor and employment law in this sense because there has never been a time when the state sided with employees.<sup>103</sup> The state does not side with the powerless and the weak but with the powerful. Allocating disputes to state dispute resolution mechanisms to be decided according to state-mandated rules would inevitably lead to worse conditions for employees.

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103. I am sure I differ with many of the other Symposium participants on the issue of whether the state ought to intervene on behalf of employees as a group even if it were so inclined. Neutrality of the entity which holds a legal monopoly on the use of force strikes me as the only fair allocation of that monopoly, since once that monopoly has been deployed on behalf of any interest, that interest is no longer weak and powerless by definition but capable of doing great harm to others.

When considering allocating disputes to the courts, we should begin with the simple proposition that using the courts is costly. Courts are costly not merely because judges, court reporters, and especially lawyers all expect to be paid, but also because proving something to an outside decisionmaker requires verifiable, not merely observable, information. The cost of verifiable information is not simply that employers must pay for lawyers; it is that employers will alter their employment relationships to make performance a matter which can be evaluated on the basis of verifiable information. Those changes will reduce the level of performance the employers ask of their employees, and *both* employers and employees will be worse off.

Would-be reformers must also consider the imperfection of human institutions. Any just-cause regime, whether a haphazard affair like the current common-law regimes or a more comprehensive statutory one like Montana's,<sup>104</sup> neglects to consider that employers cannot be forced to be good employers simply by ordering them to be good employers.<sup>105</sup> This expresses itself in two ways. First, attempting to command behavior by employers (or employees) will often be unsuccessful, for the employer (or employee) whose behavior is affected will simply shift his attention to a different margin of activity. As there is no guarantee that the parties (or any particular party) will be left better off at the end of the process of adjustment, proponents of radical change ought to be under some obligation to produce evidence to support their claims. Courts are particularly ill-suited as forums for collecting and evaluating such evidence. Consider the difference between the factual record supporting Title VII and that supporting the judicial erosion of employment-at-will.

Second, to the extent the attempt to command has an impact, such attempts at command and control regulation of the labor market will lead to distortions of both the labor market and of the legal system. Markets require winners and losers to operate. As Adam Smith noted, it is not due to the benevolence of the butcher that we expect our beef, but to his self-interest in selling us meat.<sup>106</sup> More precisely, it is because if the butcher does not offer us meat of acceptable quality at the market price, then we will not buy from him, and he will lose his investment in his inventory, shop, and tools and be reduced to a pauper. When a butcher does offer meat of substandard quality or service of an unreliable nature, in a market

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104. See MONT. CODE ANN. §§ 39-2-901 to -915 (1995).

105. Similarly, employees cannot be forced by the state (or anyone else) to be "good" employees, as the experience of the former East Bloc countries showed. The old Soviet proverb that "they pretend that they pay us and we pretend that we work for them" illustrates the foolishness of attempting to command behavior by either employers or employees. Dimitri K. Simes, *Fist That Held Hammer and Sickle Is Now an Open Palm*, NEWSDAY, June 30, 1991, at 36.

106. ADAM SMITH, 1 AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 21-22 (London, 8th ed. 1796) (1776).

economy he does indeed lose his investment—if he did not, the incentive to make us an attractive bargain would be greatly reduced. The savings and loan industry in the 1980s is a classic example of the consequences of freeing market participants of the consequences of their choices.

Similarly, functioning labor markets require that people who make bad choices suffer the consequences of those choices. Employers must bear the risk that bad employment practices will make them unpopular with employees,<sup>107</sup> while employees must bear the risk that they have chosen their employer poorly. Failing to allocate these risks properly will guarantee that labor markets fail.<sup>108</sup>

An even more pernicious influence of wrongful discharge remedies is their corrosive effect on the union sector. One of the original impetuses for the adoption of wrongful discharge remedies was the perceived “unfairness” of nonunion employees’ lack of protection from discharge when compared to union-sector employees’ protection through their union contracts. Not only do the legal remedies reduce the incentive to join unions, their growing extension to union members is reducing employers’ willingness to accept unions. If union contracts are allowed to be subverted in this fashion not only will employees’ incentives to join unions be reduced (something to which most critics of the at-will rule would be opposed), but firms’ incentives to accept union contracts as the price of

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107. Consider the case of an employer in an at-will state and an employer in a state with some form of mandated just-cause protection. In the at-will state, the employer must compete for employees in the marketplace. One way to do so is to offer attractive terms of employment, and to the extent employees prefer employment security, the employer will do so. If all employers are mandated to offer identical employment-security arrangements, however, employers will no longer be able to differentiate themselves. Some employers clearly do attempt to differentiate themselves to prospective employees on this ground. Employees will be left to choose between jobs with less information—thrown back precisely on the mechanisms like reputation and social networks so scorned by critics of the at-will rule.

Not only will employees still rely on these same institutions for information about jobs, but they will do so in an environment in which there is less incentive to develop such networks and less information for the networks to disseminate. Without the relatively clearcut issue of job security, employers will be distinguished more by more subtle and difficult to differentiate aspects such as the quality of the health plan offered (comparing an HMO with a PPO, let alone with a traditional insurance plan, is difficult) or the subjective reports of treatment by superiors.

108. Indueing such failures as an excuse for additional government intervention is a classic strategy for increasing state control. See ROBERT HIGGS, *CRISIS AND LEVIATHAN: CRITICAL EPISODES IN THE GROWTH OF AMERICAN GOVERNMENT* (1987). In addition, to the extent that existing labor market imperfections have resulted in successful rent-seeking behavior, creation of job security for those holding jobs with high rents—precisely the effect of the common-law remedies—increases the incentive for such behavior by preserving the successful rent-seekers and rents. See Katz & Summers, *supra* note 29, at 257-60, 269 (discussing interindustry wage differentials resulting from rent-seeking behavior).

Restrictions on discharge can also hinder the search process through which employers and employees learn about each other and determine if a good match exists. Analyzing data from the 1960s and 1970s, a period of virtually complete at-will employment in the nonunion sector, economist Robert Hall found evidence that most job changes occur before the fifth year of employment. Hall, *supra* note 40, at 720. Restricting at-will discharges to six months as some courts have done and some critics have advocated would significantly hamper this process.

labor peace would be reduced. After all, why expose yourself to arbitration over discipline and discharge if it will not buy you freedom from common-law tort liability for wrongful discharge claims?

Finally, the remedies distort the legal system. Because the common-law remedies grew out of the actions of the worst employers, the remedies and sanctions have developed in response to the behavior of an unrepresentative sample of employers.<sup>109</sup> These remedies are often overly generous, prompting otherwise marginal claims to be brought.<sup>110</sup>

During the past quarter century courts have revolutionized the law governing employment. This revolution was the product of a flawed analysis of the incidence of "bad" discharges, a persistent underestimation of the strength of market forces, and an equally persistent faith in the benevolence and efficacy of government. This revolution has not been built on a serious analysis of data or even a serious attempt to collect data. It was built on a foundation of anecdotes. It is time to admit this was a mistake and abandon wrongful discharge law.

There is a price for mandating legal job security, and it is a price which ought to concern even those who do not share my concern for freedom of contract. Jerry Greenfield ought to be able to fire an employee for "making shitty ice cream" and he ought to be able to fire an employee for "being a shitty person." If he does, he ought to be answerable to his conscience and his shareholders, not to a court. He ought to be able to do these things not because he is a smart person or because he has politically correct values but because he is an employer and that is how markets separate good employers from bad employers.

As Professor Heriot notes, "We can attempt to purchase greater job security for our employee citizens, but we must not pretend for a moment that we are unaware of the price that is being paid or of the currency in which it is being paid."<sup>111</sup> The burden rests upon the advocates of change to demonstrate positive evidence to justify remaking the U.S. economy in the image of the post office. So far they have proved only that courts are indeed bad places to make social policy.

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109. Even if the courts have correctly designed the remedies for these employers, other employers will be deterred from appropriate action because the sanctions will be too severe. See Louis Kaplow, *Optimal Sanctions, Uninformed Individuals and Acquisitions, Information about the Law* (Discussion Paper No. 62, Program in Law and Economics, Harvard Law School) (July 1989) (discussing the problem of severe sanctions deterring legal as well as illegal conduct).

110. A clear example of this is the development of the implied covenant of good faith and fair dealing in Montana. Andrew P. Morriss, *"This State Will Soon Have Plenty of Laws"—Lessons from One Hundred Years of Codification in Montana*, 56 MONT. L. REV. 359, 430-42 (1995).

111. Heriot, *supra* note 92, at 222.

## APPENDIX

In this Appendix, I set out a simple model which illustrates the observable/verifiable distinction discussed in subpart III(C).

Assume effort ( $e$ ) is a continuous variable which lies in  $[0, \infty]$  and is not directly observable. Output ( $y$ ) is effort plus noise ( $e$ ), so that  $y = e + \epsilon$ , where  $\epsilon$  is distributed uniformly between  $-x$  and  $x$  and  $E(\epsilon) = 0$ . Further assume that employers can observe only whether the employee's performance passes or fails an output test, *i.e.*, whether  $y > \bar{y}$  or  $y < \bar{y}$ , where  $\bar{y}$  is the test standard.<sup>112</sup> This binary observation is not unrealistic: it suggests employees are monitored by whether they meet a standard of performance.<sup>113</sup> If employees meet the standard (pass) they keep their jobs; if they fall below it (fail) they are fired.<sup>114</sup> While employers can observe the pass-fail result costlessly, it is costly to prove the result to an outsider if they are required by legal rules to do so. Moreover, the cost of proof depends on the standard by which employees are measured. The cost of proof is represented by the function  $c(\bar{y})$ , which for convenience I assume has the form  $c(\bar{y}) = c\bar{y}$ .<sup>115</sup> Employers pay the

112. This observation will be determined by the employer's choice of monitoring technology. For my purposes I need not consider whether observation is costly and so will assume firms incur no cost in observing an employee's effort.

113. Difficulties in measuring output where employees work in teams or where the work is difficult to quantify (an attorney, for example) also suggest this is a reasonable assumption.

114. An employer might care about performance in excess of the standard for other reasons, in deciding about promotions, for example, but in determining whether to fire the employee the real question is whether the employee has met the minimum standard or not, not the precise level of the employee's effort or investment. Since the employer is unable to directly observe  $y$ , it cannot offer a contract  $w(y)$ , which pays a wage directly linked to observed output (a piece rate).

115. A simple example clarifies the role and properties of  $c(y)$ . Assume for the purposes of the example that the support of  $e$  and distribution of  $e$  are such that  $y$  lies in  $[0, 1]$ . If an employer's standard is simply that  $y > 0$ , then the employer is partitioning the observed output spectrum into  $[0]$  and  $[0, 1]$ . Obviously, proving which set the employee's  $y$  fell into in this case would not be costly. (Success in a case like this is not always guaranteed. In *Willis v. Lowery*, 57 So. 418 (Miss. 1912), an employee was discharged as a cotton buyer after three months when he failed to purchase any cotton during that time. The employer claimed that the employee had spent the three months drunk; the employee claimed that the employer's price was too low. The employee won at the trial level, but the employer succeeded in getting a new trial.)

Next consider two alternative standards of higher level performance:  $\{[0, 0.1], [0.1, 1]\}$ , represented by  $c(0.1)$ , and  $\{[0, 0.9], [0.9, 1]\}$ , represented by  $c(0.9)$ . In my model it is costlier to prove to an outsider whether an employee satisfied the second than it is to prove whether he has satisfied the first. That is,  $c(0.9) > c(0.1)$ .

If  $y$  simply represented attendance at work, for example, this would not be realistic; it is no costlier to count ten absences than it is to count two. Output represents something more subtle here. Consider the manager of a factory with a complex production process. What  $y$  measures is the investment by the factory manager in her performance: Does she devote time each evening to studying the production process? Does she cultivate a good relationship with employees and suppliers? It is hard to measure this type of performance, yet it may be critical to getting the plant to operate at maximum efficiency. It is increasingly difficult to measure high levels of output. For example, it is relatively easy to prove if the manager takes off every afternoon to play golf, but harder to prove she

cost of proof<sup>116</sup> when they see the employee's output.<sup>117</sup>

Assume further that employees are risk neutral, receive utility from wages ( $w$ ), and experience disutility of effort according to a function  $g(e)$ , where  $g'(e)$  and  $g''(e)$  are both positive. The probability of an exogenous job change (due to spouse relocation, for example) is  $b$ . The discount rate is  $r$ . Both are constant. Even a hard-working employee may be discharged for "slacking" if the employee gets a bad  $\epsilon$ . Since output is effort plus noise, the probability of discharge for "slacking" is  $F(\bar{y} - e)$ .

Letting  $V_U$  be the lifetime utility of a currently unemployed person and wages be  $w$ , the optimal level of effort ( $e^*$ ) that the employee will

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could have had better suggestions for improving the plant if she had spent more time studying up at home.

The golf example is not unrealistic. In one Alabama case, a salesman who had been employed by the defendant for 18 years was fired for "being at the golf course in violation of a previous directive." *Kitsos v. Mobile Gas Serv. Corp.*, 431 So. 2d 1150, 1151 (Ala. 1983); *see also* *Bauer v. American Freight Sys., Inc.*, 422 N.W.2d 435, 437 (S.D. 1988) (noting that the employee admitted to having spent an "inordinate" amount of time at a pool hall during working hours and was observed there in a company car approximately 30 times during an eight-week period); *Haag v. Revell*, 184 P.2d 442, 443 (Wash. 1947) (observing that "[t]here is quite persuasive evidence that [the employee] spent a great deal of time in a nearby coffee house which should have been spent in pruning the orchards").

116. For convenience, I assume that the less thorough documentation of employees who will not be fired is costless. Alternatively, one might view  $c(y)$  as the incremental cost over that which an employer would incur under an at-will regime. There may also be some *ex ante* cost to monitoring—an initial investment in monitoring technology or the like. These costs are not the focus of my model, however, and are assumed away.

117. For example, when an employer observes  $y < \bar{y}$ , it might send the employee's file to its attorney, who reviews it for potential liability if the employee is fired and recommends further steps. Expenditures on proof need not affect what the employer *knows* about performance, only what it can *prove*. This assumption simply means that employers document cases in which they plan to fire the employee more thoroughly than cases in which they do not. Although they observe the performance of those they will not fire (which is how they decide whom to fire), they do not document as thoroughly the performance of employees who perform adequately since such an expenditure would serve no purpose. Many employers conduct regular performance appraisals. These appraisals are often used for many purposes, however, such as building morale or signaling that the employer is watching. Thus, it is not uncommon for employers to find that even an employee whom it plans to fire has had a long string of satisfactory performance appraisals, nor is it uncommon to have to take special steps to document performance more accurately after deciding to fire an employee. *See* STUART H. BOMPEY ET AL., *WRONGFUL TERMINATION CLAIMS: A PREVENTIVE APPROACH* 348-49 (2d ed. 1991) (warning of pitfalls in employer evaluations). Even a record of poor evaluations may be challenged by an employee as insufficient cause for dismissal. *See* *Shebar v. Sanyo Business Sys. Corp.*, 544 A.2d 377, 379 (N.J. 1988) (employee claimed his poor performance evaluations were the result of a Japanese business practice of setting performance goals at unattainable levels to motivate employees to excel).

choose,<sup>118</sup> given the values of  $w$  and  $\bar{y}$  chosen by the employer, is defined by the first-order condition:

$$g'(e) = \frac{[w - g(e) - rV_u] [F(\bar{y} - e)]}{r + b + F(\bar{y} - e)}$$

according to the value of a parameter,  $\beta$ , which is high when  $e$  has a large impact and small where  $e$  is less important.<sup>119</sup> Although there is a wide range of possible legal rules<sup>120</sup> governing the standard for discharge, for the model's purposes we can reduce these to two: the at-will rule<sup>121</sup> and the just-cause rule.<sup>122</sup>

The first-order condition<sup>123</sup> for the employee's problem provides the

118. An asset equation for an employed person who supplies effort  $e$  can be written as

$$rV_E - w - g(e) + [b + F(\bar{y} - e)] (V_u - V_E)$$

where  $V_E$  is the lifetime utility of a currently employed person. Employees thus solve

$$\max_e \frac{w - g(e) + [b + F(\bar{y} - e)] V_u}{r + b + F(\bar{y} - e)}$$

119. The model's use of a single  $\beta$  is an oversimplification in this regard. Clearly employers actually face a variety of production techniques which use different proportions of different " $\beta$ -types" of employees. Introducing these complications here would only muddy the results without capturing any additional effects of interest.

120. To list just a few, consider the opinions of Judge Reinhardt and Judge Kozinski in *Sanders v. Parker Drilling Co.*, 911 F.2d 191 (9th Cir. 1990), *cert. denied*, 500 U.S. 917 (1991). Reinhardt advocates requiring a company to prove an event took place to rely on it as the justification for discharging an employee. *Id.* at 196-97 (Reinhardt, J., concurring). Kozinski argues that all that is required is a good-faith belief that the event occurred. *Id.* at 205, 209 n.7 (Kozinski, J., dissenting). Consider also the Montana Wrongful Discharge from Employment Act, MONT. CODE ANN. § 39-2-904(2) (1995) (requiring the employer to show "good cause" for firing an employee after completion of the "employer's probationary period of employment"); THE MODEL EMPLOYMENT TERMINATION ACT, 7A U.L.A. 71, 73 (Supp. 1995) (granting covered employees "an expanded substantive right to 'good cause' protections against discharge"); and the union-sector just-cause rule present in most collective bargaining agreements. See Peck, *supra* note 13, at 8 (stating that 80% of collective bargaining agreements contain cause or just-cause provisions).

121. Under the at-will rule, the revenue function is

$$R(L) = L\beta e - \frac{1}{2}L^2 - wL.$$

Expanding labor use requires additional supervision, and this is reflected by the second term in the firms' revenue function.

122. Under the just-cause rule, the revenue function is

$$R(L) = L\beta e - \frac{1}{2}L^2 - wL - Lc\bar{y}.$$

123. Note that the first-order condition for this problem is not sufficient to characterize the employee's choice of an optimal  $e$ ; where  $\bar{y} - e^*(w, \bar{y}) = \pm x$ , the employee's optimal  $e$  is zero. (Increasing  $\bar{y}$  above  $e+x$  will not raise effort since the employee will be fired anyway as  $F(\bar{y}-e)=F(x)=1$ . If  $\bar{y}$  is lowered below  $e-x$ , the employee will have no incentive to work hard because he will not be fired as  $F(\bar{y}-e)=F(-x)=0$ .)

solution<sup>124</sup>

$$e = 2xr + 2xb + \bar{y} + x - \sqrt{(2xr + 2xb + \bar{y} + x)^2 - 2(w - rV_U)}$$

The value of  $\bar{y}$  is such that the employee chooses the maximum effort where

$$\bar{y} - e^*(w, \bar{y}) = x.$$

Writing in terms of parameters and  $w$ , denoted as  $\bar{y}^*(w)$ :<sup>125</sup>

$$\bar{y}^*(w) = \sqrt{(2xr + 2xb + 2x)^2 + 2(w - rV_U)} - 2xr - 2xb - x.$$

The firm's problem is thus to choose employment ( $L$ ) and wages ( $w$ ) to maximize profits.<sup>126</sup> Solving for the values of  $e$ ,  $\bar{y}$ ,  $w$ , and  $L$  under each

To make the problem solvable, I assume  $g(e) = \frac{1}{2}e^2$ . The employee's choice of effort level can now be written as

$$\max_e \frac{w - \frac{1}{2} e^2 + [b + \frac{\bar{y} - e + x}{2x}] V_U}{r + b + \frac{\bar{y} - e + x}{2x}}.$$

124. The first-order condition gives a quadratic expression for  $e$ ; the negative root is the appropriate solution. By examination, we see that the positive root is outside the range where  $F(\bar{y} - e) = [\bar{y}e + x]/2x$  since

$$2xr + 2xb + \bar{y} + x + \sqrt{(2xr + 2xb + \bar{y} + x)^2 - 2(w - rV_U)} > \bar{y} + x.$$

Turning to the negative root, if  $\bar{y} - x > e$ , then it too would be outside the proper range for  $F(\bar{y} - e)$ . Checking the values from Table 1 for this condition shows that both the at-will and just-cause solutions satisfy this requirement.

125.  $\bar{y}$  must also be at least  $[(2xr+2xb)^2 + 2(w-rV_U)]^{1/2} - 2xr - 2xb - x$  to motivate the employee.

126. Under the at-will rule the firm's problem will be

$$\max_{w,L} L\beta e - \frac{1}{2}L^2 - Lw.$$

Defining  $K$  as  $[2xr + 2xb + \bar{y}]$  and substituting, the first order conditions under the at-will rule are

$$L: \beta [(k + x)^2 + 2(w - rV_U)]^{\frac{1}{2}} - \beta(k + x) - L - w = 0$$

and

$$w: \beta [(k + x)^2 + 2(w - rV_U)]^{-\frac{1}{2}} - 1 = 0.$$

Under a just-cause rule the firm's problem will be

$$\max_{w,L} L\beta e - \frac{1}{2}L^2 - Lw - c\bar{y}L.$$

The first-order conditions will then be

$$L: (\beta - c) [(2xr + 2xb + 2x)^2 + 2(w - rV_U)]^{\frac{1}{2}} - \beta(2xr + 2xb + 2x) - w - L + ck = 0$$

rule gives the values in Table 6. Effort and the firing rule are lower under the just-cause rule, while the sign of the difference in employment levels depends upon parameter values due to the presence of the efficiency wage effect identified by David I. Levine.<sup>127</sup> Denoting the values of  $e$ ,  $\bar{y}$ ,  $w$ , and  $L$  under the at-will and just-cause rules respectively with subscript  $as$  and  $js$  and comparing social welfare under the two rules, the at-will rule will be more efficient when

$$L_a (\beta e_a - \frac{1}{2} e_a^2) > L_j (\beta e_j - \frac{1}{2} e_j^2 - c\bar{y}_j) .$$

Substituting and canceling terms, this yields an unwieldy inequality<sup>128</sup> which shows that for values of  $\beta$  sufficiently large,<sup>129</sup> the inefficiencies associated with the just-cause rule increase with  $\beta$ .<sup>130</sup>

Table 6: Model Results

	At-Will	Just-Cause
$e$	$\beta - 2rx - 2bx - 2x$	$\beta - 2rx - 2bx - 2x - c$
$\bar{y}$	$\beta - 2rx - 2bx - 2x$	$\beta - 2rx - 2bx - x - c$
$w$	$\frac{1}{2}\beta^2 - \frac{1}{2}(2rx+2bx+2x)^2 + rV_U$	$\frac{1}{2}(\beta-c)^2 - \frac{1}{2}(2rx+2bx+2x)^2 + rV_U$
$L$	$\frac{1}{2}\beta^2 + \frac{1}{2}(2rx+2bx+2x)^2 - rV_U - \beta(2rx+2bx+2x)$	$\frac{1}{2}(\beta-c)^2 + \frac{1}{2}(2rx+2bx+2x)^2 - rV_U - \beta(2rx+2bx+2x) + c(2rx+2bx+x)$

and

$$w: \frac{\beta - c}{[(2xr + 2xb + 2x)^2 + 2(w - rV_u)]^{\frac{1}{2}}} - 1 - 0.$$

127. See Levine, *supra* note 78, at 902-05.

128. Reducing to parameter terms, this inequality is:

$$\begin{aligned} & \frac{\beta^3}{2} (2rx + 2bx + x + c) \\ & - \beta^2 (\frac{c^2}{2} - 4x^2 (3r + 3b + 2 + 4rb + 2b^2 + 2r^2) - 3xc(r + b + \frac{1}{2})) \\ & + \beta (\frac{1}{2} (2xr + 2xb + 2x) - 3x^3 (r + b + \frac{1}{2}) - rV_u (2rx + 2bx + 2x) - xc (c - 2xr - 2xb - \frac{3}{2}x) \\ & + c (2xr + 2xb + x) (x^2 + \frac{c}{2} + 2cx + \frac{1}{2} (2xr + 2xb + 3x + c) (2xr + 2xb + x)) > 0. \end{aligned}$$

129. That is,  $\beta$ s large enough to allow the cubed term to dominate the expression.

130. The at-will rule is not more efficient in all cases because of the Levine efficiency wage effects. Levine, *supra* note 78, at 902.

