The Employment Contract

Ian Ayres and Stewart Schwab

Editor's Note: This article consists of Professors Ian Ayres and Stewart Schwab's presentation given at the Economic Analysis of State Employment Law Issues Symposium. Following the presentation, audience members and the presenters participated in a discussion concerning employment contracts. The Journal *staff and Professors Ayres and Schwab compiled and edited some of these questions and responses.*

I. Employee Benefits in a Well-Functioning Market

Professor Schwab

The topic for this afternoon is the employment contract. As Henry suggested, I'd like to start with a standard law-and-economics analysis and ask: what benefits or protections to workers will a well-functioning market provide? I'll save for a little while a precise definition of "well-functioning," but the basic point is that in a well functioning employment market, employers will provide all benefits and protections that employees are willing to pay for. (I'll now assume that benefits and protections are mostly the same thing, and thus state more simply that well-functioning markets will provide all benefits that employees are willing to pay for.) It's sometimes phrased "willing *and able* to pay for," which is an accurate qualification. If a worker does not have the money to offer two dollars for some benefit, then that benefit is a luxury the worker prefers not to have. In a well-functioning market, employers will not provide benefits and protections that employees are unwilling to pay for.

We could debate in the abstract what this means, but I'd instead like to start off with an example. The example will be central, which is the at-will contract versus the just-cause contract, versus some possible variations or midpoints between the two. So, let's take just-cause as an example of a benefit that could potentially be provided to workers.

To stylize the situation, let's say that just-cause compared to at-will costs employers 50 to provide. If you are unwilling to accept the notion that just-cause is more expensive to employers, the skepticism against the just-cause contract vanishes. So we start at 50 (let's not worry about the units). Now, two employers exist. First is Schwab Corporation, the rough and ready type of corporation. We go with an at-will contract at my place and pay wages equal to W. The other employer is Ayres Corporation, the caring corporation. It offers a just-cause contract, but a wage of W minus 50. This wage is lower by exactly the cost of providing the just-cause benefit.

Let's pause just a moment and interrogate the CEO of this corporation. Why did you lower the wage by 50 if you're so caring and nice? Why not just lower it by ten?

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Professor Ayres

I'm not that caring. With a competitive market, I can't make a profit if I offer my workers benefits that cost me 50 and pay wages that are only ten less than my competitor's wages.

Professor Schwab

You can't sell something that costs you 50 for ten and stay in business too long. Okay, it's got to be at least 50. Well, why not reduce their wage by 100? Have you thought about that?

Professor Ayres

I have thought about it.

Professor Schwab

With the subtitle of his corporation's slogan being "the caring, but also caring to our shareholders" corporation.

Professor Ayres

I would be terribly worried that my competitors would take workers from me.

Professor Schwab

The concern is that with competition among employers, Ayres Corporation will shoot itself in the foot if it tries to price this benefit too much to its shareholders' advantage. Other employers, such as the Butler Corporation, knowing the lay of the land, will say, "Well, if Ayres is going to deduct 100 from wages when providing this benefit to its workers, I'll only deduct 80 and attract all the good workers." Other competitors will come in and say, "We can make money by deducting just 70, . . . just 60, . . . and so on." So the argument is, in a competitive market these benefits, like anything else, will be sold at cost. "Cost," of course, is an economic term of art. It includes a normal return on profit. Ayres Corporation will make money when it sells this benefit at 50, but it will make just a normal or ordinary profit.

So now we have two corporations: Schwab Corporation offering a wage of W and at-will contracts, and Ayres Corporation offering a wage of W-50 and just-cause protection. The question that arises is, where are the workers going to go? Are they going to choose the Schwab firm? "Workers, watch out," is the slogan at Schwab. Or will workers chooses Ayres "the caring" Corporation, which is willing to back up its promise to terminate workers fairly by allowing judges to entertain breach-of-contract suits. If a worker has a problem with the way he or she was dismissed by Ayres, go run to the judge. Well, where would the workers go?

The answer can't be determined until I give you one more piece of data. How much do workers value this benefit? We can determine this by seeing which workers choose Schwab and which choose Ayres. Ayres Corporation gets those workers who value just-cause at more than fifty. Schwab Corporation gets the rest. This is a stylized example, but it illustrates the economic argument. We're in a competitive labor market. Ayres and Schwab have two different business strategies; Ayres will attract certain workers, or maybe all the workers, and Schwab will attract other workers, possibly all of them.

II. Legal Intervention in Labor Markets

Professor Schwab

Walter Olson keeps emphasizing that most (maybe all) employers offer at-will. What are we to conclude from this, based on the stylized example? We can conclude one of two things. First, we can conclude that workers are unwilling to buy just-cause at its cost. This does not mean that workers don't at all value the benefit. Of course they want it. We all want lots of things but are either unwilling or unable to pay for most of them. We conclude that workers would rather have an additional 50 in wages, apparently, than the just-cause benefits. In other words, they prefer the higher wages from Schwab Corporation to the job protection of Ayres Corporation. Workers don't value it as much as it costs. And that's why the benefit is not provided. The other conclusion is that something is wrong with the market. And, I think from the economist's perspective, that exhausts the possibilities.

Following this analysis, if the law is to intervene in the market for just-cause benefits, it can be justified only on one of two grounds. The first justification is paternalistic: it's true the workers didn't value just-cause protection, but they didn't know what they were doing. Workers don't what is in their best interests. If that's true, the fact that they aren't choosing firms that would offer this benefit is of no consequence. We know better. Of course, who "we" is becomes the troublesome point in paternalism arguments. It is not impossible to make paternalistic arguments, and I think that a lot of employment regulation is based at least in part on a paternal rationale. Indeed, paternalistic arguments have seen a resurgence in recent years. Cass Sunstein has explored the idea of anti-anti-paternalism arguments, pointing to psychological blocks that workers might have that counter the concern that regulation against what workers want is paternalistic.[1]

The other justification for regulation is that the labor market has failed, so we should correct the market failure. That's why we are intervening in these markets and mandating that benefits be provided. I will list just a few possible market failures. First, because workers have no bargaining power in an unregulated market, we should therefore intervene and mandate benefits. This is the rationale typically used to justify employment regulation. Undoubtedly you have encountered this argument in your own caseloads. Imperfect, especially asymmetric, information can cause market failure. If workers don't know what Ayres Corporation and Schwab Corporation are offering, one cannot confidently assume that the market will offer all benefits that workers are willing to pay for.

Professor Ayres

If I can jump in, not only is worker ignorance about conditions a problem, but employer ignorance about the qualities of the employees can lead to certain types of market failure. Perhaps all employees currently say they want employment at-will as a way of signaling to employers that they are good employees. But this is because the workers cannot prove they are good workers in other ways. Willingness to accept at-will contracts is a way of signaling when employers are ignorant about the employees good qualities. There are a lot of signaling models that sometimes lead to disastrous effects. If everybody tries to show that they are better than other people, we can have inefficiently large amounts of signaling. For example, in debt contracts, if you want to really show that you are going to pay back a debt then you promise to give a pound of flesh along with it. Even though libertarians might allow such contracts, forbidding them can stop wasteful arms races among workers.

Professor Schwab

A somewhat different but related market failure is asymmetrical performance. When locked into a long-term career relationship, a worker may have done all the hard work and the employer hasn't paid up fully. This can lead to problems. Another market failure comes from externalities touched on by the panel today: third-party effects not captured in the employment contract. I want to come back to this, and particularly, its relationship to the tort of wrongful discharge in violation of public policy.

Another source of market failure that I am not planning to talk much about concerns collective goods. Unregulated markets are not good at getting the right quantity of a good that's going to apply the same way for everyone in the workplace. This is particularly so when locked-in, inframarginal workers differ from younger, marginal workers. Employers in competitive markets tend to cater to younger people who are just deciding whether to accept this job or another. If these workers on the margin (or fence) value benefits differently than older, locked-in workers, the employer may not offer the optimal amount of the benefit. Assessing those arguments can lead to a technical discussion (they are alluded to in some of the note materials that I gave you). I think we've got enough to discuss without going into those types of market failure in detail.

I want to highlight this, and Henry would have killed me if I hadn't put this one in. Just because a market failure has been identified, all that suggests is that intervention might help. But it is also quite possible that the cure could be worse than the disease. Calling for intervention simply because a market failure has been identified is known as the "nirvana fallacy." A policymaker spots a failure in a real world market, and then assumes that government intervention—be it through the common law or administrative agencies or anything else-will correct it. Walter Olsen quite correctly emphasizes that there are a lot of unintended consequences from some of these well intended interventions. Pointing to a market failure does not yet justify intervention.

I think we lawyers are well familiar with burden of persuasion and burden of proof arguments. The nirvana fallacy argument attempts to tweak the burden of persuasion. Going back to the opening part of the lecture, the economic approach asserts that, prima facie, markets will provide all benefits that workers are willing to pay for. Suppose it is shown that a certain benefit is not provided. Just-cause is a good example. The economic approach concludes that workers would prefer higher wages to the benefit. Policymakers who insist on just-cause protection are being paternalistic. Given the bad light of paternalism these days, the burden shifts to those advocating intervention. How do they meet that burden? First, by pointing to some market failure. But the "nirvana fallacy" argument requires interventionists to overcome a second burden: They must also show that the cure is not worse than the disease.

III. Unequal Bargaining Power as a Rationale for Intervention

Professor Schwab

Let's discuss the unequal bargaining power issue. For non-economists, this is the basic argument for legal intervention in employment markets. Economists are dubious of this argument. They don't believe that the concept is meaningless; in fact, I think we can give bargaining power a meaning. Bargaining power explains which side will get the lion's share of gains from trade, including the gains from providing a particular benefit that workers are willing to pay for. However, unequal bargaining power does not explain why a particular benefit will not be provided at all. In other words, the following argument shows a lack of understanding of labor markets: "Here is a benefit that workers want, are willing to pay for, but it's not being provided. Why not? Because of unequal bargaining power. Companies are big and employees are little." Unequal bargaining power is not a problem that will cause markets not to provide all benefits that workers are willing to pay for, nor is unequal bargaining power a type of market failure.

Professor Ayres

I want to add the broader analogy to anti-trust law. In anti-trust, the same fallacy holds that monopolists would tend to produce shoddy merchandise when in fact, it would actually be more profitable for them to provide the efficient level of quality. One of the first big insights of law and economics is that profit-maximizing monopolists want to produce their product efficiently, but they don't want to price it efficiently. If they produce a product that the market wants the most, they'll be able to extract the biggest amount of profit. The failure to recognize this is a flaw in dozens of law review articles that complain about monopoly power.

Professor Schwab

I want to hammer this point home because of its importance. The argument against the usefulness of unequal bargaining power as a concept is controversial because unequal bargaining power itself is vaguely stated. Often it is a reflexive rationale for protecting the little guy. What are some of the possible meanings of "unequal bargaining power?" By the way, the best writing on this point is by Duncan Kennedy.[2] Some of you may know the Harvard Law School professor and a leader of the Critical Legal Studies Movement. He is hardly a disciple or card-carrying member of law and economics, but he is a sophisticated analyst of the law. Let me summarize some of his writings on this point.

One possible meaning of unequal bargain power is, "Hey, I didn't have a chance to negotiate on this." The worker cannot negotiate whether there is going to be at-will or just-cause in his or her contract. In the extreme form, it does become an adhesion take-it-or-leave-it contract. Not all such contracts, however, are adhesion contracts. The economist's favorite example to show the lack of connection between take-it-or-leave-it contracts and oppression is with Rice Krispies. Does Kellogg's have bargaining power over consumers? Have you ever tried to negotiate with Kellogg's on the fraction of corn it puts in the corn flakes, or the quality of its additives? You wouldn't get too far. The point is that you don't have to negotiate with Kellogg's, you can go somewhere else, to another grocery store or another brand of cereal. The fact that the sale is take-it-or-leave-it neither shows bargaining power nor shows that consumers are not getting what they want or are willing to pay for. There is an infinite variety of breakfast cereal, and just because we aren't negotiating individually over each transaction does not imply that we aren't getting the exact breakfast cereal we are willing and able to pay for.

But take-it-or-leave-it is not the only possible meaning of unequal bargaining power. Work is a necessity, which may distinguish cornflakes. Food, of course, is a necessity. Work is also a necessity, but somehow workers cannot get benefits that they are willing to pay for. And then, the related complaint that I have already mentioned, is the relative size point. The employer is large, the worker is small. These conceptions of unequal bargaining power do not hold up either.

Well then, let's continue with the stylized example of earlier just to pin down the argument against unequal bargaining power. Let's suppose Ayres Corporation has run me out of business. Now, Ayres is a monopoly employer. The technical term on the labor side is that he is a monopsonist, because he is the only buyer of labor in this town. A situation of many sellers and one buyer is called monopsony, but the basic principles are identical to monopoly.

As the only game in town, Ayres is only paying his workers 200. Again, I'm trying to be a little vague on the units here. Whatever 200 units is, it's low. As a monopsonist will do, it pays lower wages than would be provided in a competitive market. Look at Ayres with all that bargaining power over there. It's unbelievable how strong he is. But the question is, will he offer just-cause to workers? Would you? That's the question.

Professor Ayres

Naively, I'll say no.

Professor Schwab

Let's review his decision. Just-cause costs monopsonist Ayres 50. That's what we said earlier, and it still holds true. The additional people needed in the human resources department and all the other difficulties with a just-cause environment compared to an at-will environment will cost Ayres 50. Suppose, however, that the workers in this town value it at 60. What this means is that they would prefer just-cause and wages reduced by 60 to their current wage and an at-will environment.

Recognizing the issue, will Ayres rethink? Remember, you are a greedy, money grubbing, profit maximizing, huge bargaining power monopsonist.

Professor Ayres

Ok, I think I'd now cut my wage to 140 and offer just-cause.

Professor Schwab

Ah, what a clever monopsonist Ayres is! He will drop the wage by the full cost of providing just-cause. In my handout, I suggested dropping the wage by 59 to 141 so that workers would benefit from the change in policy. But let's not quibble over the last dollar. Ayres will drop the wage by 59 or 60. The point being, if he sees a profit opportunity from those exploited workers, he can exploit them all the more by offering this benefit. This is just playing out the point that Ian made earlier, that a monopolist will try to provide the product that consumers want the most, i.e., are willing and able to pay the most for. And if workers are willing to pay for just-cause, the monopsonist can make more profits by providing it.

Suppose this monopsonist is lazy and doesn't want to maximize profits. It was said, for example, that Henry Ford paternalistically wanted to help his workers rather than squeeze maximum profits out of his car company. First, this might not help the workers if they prefer money to job protection. But if a lazy monopsonist won't maximize profits by providing benefits workers desire, the market for corporate control may change his mind. In other words, a corporate raider, seeing the profit potential from providing just-cause benefits, may take over Ayres Corporation if Ayres for some reason is too lazy to provide the benefit. More simply stated, the only way a monopsonist will not provide the benefits workers are willing to pay for is if the monopsonist does not maximize profits. Thus, ironically, what started as an unequal bargaining power argument became an argument against the profit-maximizing assumption.

Audience member question [hereinafter "Question"]

Is a safe work place assumed here?

Professor Schwab

I would say that safety could be a benefit just like job security. For our purposes, I'm willing to cross out the term just-cause and insert safe work place. One complication is that there are degrees of safety, rather than safe or unsafe. Ignoring this complication, I'd be willing to say that if workers prefer working with a slicing machine that has a hand guard on it that costs employers an extra 50 a year, a monopsonist employer will provide the hand guard so long as workers are willing to accept a wage deduction greater than 50. The monopsonist won't voluntarily offer the safety measure otherwise.

Professor Ayres

Just to reemphasize, the real point of this exercise is to say that unequal bargaining power by itself is not a good explanation for why employers will evilly deny just-cause protection. It could be true, and we will be getting to this, that unequal bargaining power plus some other stuff—particularly employee ignorance—could lead toward inefficient contracting. Maybe your question about safety suggests that employees really won't know what level of safety they have contracted for. If so, that is an information problem rather than an unequal bargaining power problem. For now, we are arguing that if workers know the effects of just-cause, or safety, unequal bargaining power isn't going to be a pathology that leads to the wrong kind of quality.

This is an important point. It's not unequal bargaining power. That's the argument that economists think is just not a coherent or logical explanation for why the preferences of workers won't be honored. It's not an example of market failure. Other examples of market failure may explain or justify intervention in the name of safety. We have a session tomorrow afternoon on both workers' compensation and OSHA, which are premised on the idea that something has gone wrong in the unregulated safety market. But unequal bargaining power is not the explanation for what went wrong.

Question

It's been a long time since I applied for a job, and hopefully it'll be a lot longer. But, as a practical matter, is this something that workers bargain for, just-cause versus at-will? Are they aware? At least in my recollection, I don't ever recall asking an employer "Are you going to have at-will or just-cause?"

Professor Schwab

Two separate issues are implied by your question. One is that you never recalled bargaining over just-cause. The other is that you don't recall even knowing whether the job was at-will or just-cause. You are talking about face to face negotiations, but we are not assuming face to face negotiations in this standard model. Rather, the idea is that workers shop around for more or less friendly employers. For example, until recently, IBM carefully nurtured a reputation for caring for its workers, including a policy of no layoffs. I think that's a good example. Did anyone negotiate individually with IBM for this clause? No. Did some people think it important that they go with IBM rather than another company? Yes. The choice of which job to take depends on a number of factors, but the model suggests that at the margin, this is important. It's one of the factors you think about.

Now, there is a related point suggested in your question. When you were young and had a lifetime ahead of you, did you worry about job security? Less than you might value it now that you are thirty-nine? That raises the very significant problem of infra-marginal workers valuing job security differently than marginal workers. That can lead to market failure, but that is not an unequal bargaining point.

Question

What is the reality of when the competitor is driven out of town: is the monopsonist still going to offer just-cause at a wage reduction of 50? It seems that the monopsonist is not going to raise his price, but that he's going to drop just-cause and still get the employees.

Professor Schwab

The question is, why did Ayres have a price of 200 at the beginning? It should have been 150. He was stupid in the beginning if as you suggest, he could get enough workers at 150 with an at-will relationship. He wasn't getting the maximum profits out of his workforce.

Question

He offered one-half of the competition's offer (i.e., 50, which was half of your offer), but he used just-cause. You're gone. He's going to stay at that price level and drop just-cause. That's the reality.

Professor Schwab

Why do you think that's reality? In other words, why do you think that it is profit-maximizing behavior to drop just-cause when workers are valuing it at 60?

Question

I don't think he needs it. Work is a necessity.

Professor Schwab

Why did Ayres pay more than 150 in the first place?

Question

He could hire people at fifty percent of what you paid. In my view, he's going to stay at fifty percent because he has employees and now he can get them without just-cause once you leave town.

Professor Ayres

Your example makes sense, but this is a slightly different point. Let's just say that I'm a monopolist and there's nobody else that's going to compete with me for wages, and let's further assume we start in a world where I have to give just-cause. I'm going to think about what's the best wage I can pay before the workers say they won't work for me. Let's even pick out a completely different number. Let's say there's no other place in town where if they can get just-cause they'll work for me for $100. Now, Olsen wins the day and I have the chance of waiving just-cause. What will happen if I waive just-cause? Well, I think I'm going to have to pay them more money. They were willing to work for me at $100 when they had just-cause protection. If I waive it, they value that just-cause protection at $160. Now I'm going to have to raise their wage to provide for the difference between working for me at $100 with just-cause protection. Why will they work for me for $100 without just-cause protection?

Question

What if they have to?

Professor Ayres

Well, if they have to work for the employer at 100 without just-cause protection, then the employer paying 100 with just-cause protection was too much. The employer could have gotten away with paying the workers only 90 or 80 with just-cause protection. The point is that in the initial just-cause regime, a savvy employer will keep wages lower until the employees are indifferent between working and quitting. If the employer then reduces benefits by switching to at-will and doesn't increase the wage, then employees will quit.

Question

Well, there's going to be a level where people won't work, or they will drive 100 miles to another company.

Professor Ayres

That's precisely the point. I'm going to drive it, but the thing is, I'm basically not just a monopolist in regard to hiring them. I'm also the monopolist that can sell them this extra price, just-cause. And, if I sell them that too, I can make ten bucks off of it. That's a product that costs me 50 and I can sell for 60 to them. Why not be a monopolist in regard to these two things instead of one?

IV. Evaluating Employment at Will

Professor Schwab

Richard Epstein has made a detailed argument in defense of contracting at-will.[3] His key insight is that dangers arise from being in a long-term relationship. I think the analogy to marriage is useful, though not perfect. A danger of opportunism by the other side exists when you are locked into a relationship. Epstein is good at pointing out is this: who can be opportunistic? Opportunism can come from either side of this employer/employee relationship. The employer can be opportunistic by paying low wages (at least lower wages than the parties thought was appropriate when the relationship began) or the employer can be opportunistic by firing workers. A certain inconsistency arises with this point. Why would an employer want to fire workers whom it is ripping off by paying low wages? The employer won't want to fire under-paid workers because it is making plenty on them.

The more controversial point by Epstein is that the worker, as well as the employer, can be opportunistic. The worker knows that the employer is undertaking a lot of job-search costs, training costs, etc. It's not easy to replace that employee. The employee can underperform to certain degree without risk of being fired. Economists use the controversial term "shirking" for this behavior. As long as the cost to the employer from the worker's shirking are less than the costs of replacement, the employer will not fire the worker.

Epstein's basic argument is that at-will reduces the problems of opportunism on both sides. A party who feels exploited threatens to end the relationship, and this threat becomes credible when the other side is in fact being opportunistic. If you are being taken advantage of, you can say to the other side, "You are treating me so badly that it's now becoming worthwhile for me to walk away. Ease up. Start performing your side of the bargain a little better or I will end this relationship." That's a more credible threat when you can easily end a relationship, and at-will relationships are easy to end.

Epstein's other point is that good workers are in little danger of being fired. Employers generally are not in the business of firing workers that employers are making money on. Now, clearly some mistakes (meaning the firing of productive workers) can happen. But then the question arises: is this whole legal apparatus an efficient way of correcting those mistakes when it is in the employer's interest to keep those mistakes to a minimum? Employers generally like to keep workers that they are creating profits for the company.

This is Epstein's argument for at-will contracts. What are the exceptions to the at-will contract? Epstein recognizes some exceptions. As Epstein notes, "Contract at-will works only where performance on both sides takes place in lock-step progression."[4] What does he mean? He gives a couple of examples. The problems arise when the parties contemplate asymmetrical performance. One side performs its side of the bargain before the other side performs. You then have problems, and at-will is not a good tool for correcting such problems. A worker who threatens to quit when he has done all the work and not yet been paid is not posing a very credible threat. "Go ahead and quit, make my day," is the employer's likely response. When the work is done and the employer refuses to pay wages, at-will cannot correct that problem. Compensation for job related personal injuries is another category where Epstein says there is asymmetrical performance, and at-will is not good at handling this.

Problems with asymmetric performance also arise over the career life-cycle of an employee. In many career employments, a worker implicitly agrees to work hard early in the career in return for getting generous promotions and benefits later. That is an example of asymmetrical performance because the employer could receive its part of the bargain (the hard work) before it must pay the generous promotions and benefits. The employer has an incentive to end the relationship before it must make these payments.

Professor Ayres

I think about law firms where you toil away as an associate for years before getting the big rewards.

Professor Schwab

Yes. When I give this talk to law students who are about to jump in at the low end of an eight-year pecking order with an implicit promise of a fair chance at partnership, they tune into this model. Large law firms often work under this model. In fact, it's designed to get associates to work hard in return for the possible rewards. The main reason that Epstein would give as to why this does not create a big problem is that the employers worry about their reputation. How many times can you fire these workers after they've done their hard work, but before you've given them the rewards, and still expect new workers to come in?

There are other problems with at-will contracts that Epstein mentions. The most important being that the contracting parties ignore the third-party effects of their bargain.

Question

Before you move on, if you favor employment at-will, then don't you have to disfavor covenants not to compete? Or, if you've got employees with covenants not to compete, should they be treated as subject to a more just-cause kind of standard? In other words, if the employer is free to fire the other while the employee is not free to seek employment elsewhere.

Professor Schwab

Those are the most interesting cases that I've included in my employment law case book. When the employee is fired and then the employer wants to enforce the covenant not to compete, it gives the court some pause; however, there are examples of this taking place. Something does seem wrong about it. Now, wrong on what level? If the contract very explicitly calls for this, maybe you enforce it. I'd be very reluctant to assume that there are all implicit understandings, and I'd be even more reluctant to enforce it. Of course, do not compete clauses can be implicit trade secrets as sort of the variation.

Question

I'm not talking about entirely legalistic points of view, but strictly from an economic point of view. Would it seem that there should be some special consideration for the covenant contracts?

Professor Ayres

It suggests that there is an intermediate legal outcome where parties might want to contract to the likes of, "Employer, you can discharge for good, bad, or no reason, but we'll only enforce covenant not to complete if the discharge was for good reason." If you have no good reason to discharge, then the covenant won't be enforced. There's a question of actually interpreting whatever contract they chose, but as an economic matter, I can imagine some employer/employee relationships where they wouldn't want just-cause because that would subject the employer to too much employee opportunism. But they would want an intermediate condition which would say, "Employer, you can discharge for any reason, but we'll only let you enforce the covenant if the employee quits or if you discharge them for good reason."

When judges confront these issues after the fact, there are usually important interpretative questions of what the parties actually agreed. The economic analysis we are doing is aimed at assessing what the parties might have implicitly contracted for. And I think your questions lead to the possibility of the intermediate standard.

Professor Schwab

Let me go through the life-cycle argument because I want to know whether this rings true with you. The point being, repeating Epstein, that two opportunism problems exist in career employment. One is on the employer side: employers can be opportunistic once their employees are locked in, which just-cause best protects. When workers have worked hard for a number of years in return for the implicit promise that they will be rewarded later, just-cause protects that promise better than at-will. On the other hand, at-will best protects employers from employee shirking. So, what to do? Well, the answer comes from recognizing that these dangers vary over the life-cycle or career pattern of a career worker. Employer opportunism is greatest at the beginning and especially at the end of a career, when the worker has invested a lot and relatively speaking, the employer has reaped the rewards. The moving cases that give some courts trouble are examples of beginning career opportunism, and end of career is the other one.

During mid-career when employees are productive, employee opportunism is the greater threat. If forced to define "mid-career," I mean that point in the relationship when a worker's current productivity exceeds her current wages, so that the employer is definitely making money on this worker. With a goal of minimizing the overall opportunism on both sides, courts will strictly enforce at-will contracts during the mid-career, but they scrutinize firings relatively more at the beginning and particularly at the end of the career. Now, again, it is important to emphasize that this is only a default rule. In other words, the clear intent of the parties to have an at-will relationship throughout will trump this life-cycle analysis, just as if an agreement to the effect of "we have a just-cause contract from beginning to end of the career" would trump the life-cycle presumption. The life-cycle default would apply when the parties' intentions are less clear. In that situation, the life-cycle guidance for the court is this: if an employee is mid-career, be less suspicious of the firing. Employers aren't in the general business of firing productive workers. Recognize, of course, that mistakes can happen, but there is more to be said for at-will at this stage as compared to later.

In summary, my positive analysis (trying to be careful to Henry's admonition to separate positive from normative analysis), is that courts tend to enforce this life cycle model by scrutinizing the late-career firings more than mid-career, absent contractual language giving courts a clue what to do. My normative claim is that this is good and efficient.

Allow me to move on to the important subject of default versus mandatory rules.

Professor Ayres

Before you do so, did you say that the need to hire new workers is an additional constraint on employer opportunism? This would suggest that in declining industries we should have more severe scrutiny, or that there is more severe scrutiny.

Professor Schwab

The positive claim is that courts will be stricter here. I am, however, unaware of any cases in which courts give declining industry as a reason for scrutinizing the termination. The normative claim is that there should be stricter scrutiny in declining industries. Reputation is less of a check when a particular employer is unlikely to be hiring new workers. The employer does not care what the job recruits think about it because it is in a declining industry, as opposed to a hiring industry. I think that is a good point.

Question

In applying the life-cycle model, do you mean that judges apply this standard on their own? I would say that we (i.e., judges) do it because there is specific legislation aimed at those people that are doing their job later on in life because they are older. It's just something we do because of statute.

Professor Schwab

Well, certainly the age discrimination statutes reinforce this model. Age discrimination statutes on their face just instruct us to worry about whether the worker is 55. It is essentially irrelevant whether they have been at the firm for 30 years or two years. It's quite critical for my argument that there be long job tenure rather than old age. But, I'm mainly talking about common-law courts. And the argument that judges are activists in the common law is not one that I have much sympathy for. I don't know exactly what it means to be an activist in the common law. The common law evolves. Individual judges emphasize in a particular case what the best facts are to support the desired judgment. Later judges (probably appellate judges), helped or spurred by law professors, then create rules that synthesize these various judgments. My argument is that courts will be more sympathetic on particular matters when you are late in the life-cycle. And, they should be.

Professor Henry Butler

Stewart, I have a question relating to the explanations for the above — that is, market salaries that some workers may be earning later in their career. You can distinguish part of it, I think, between the type of investment that has been made early on in the career. For example, let's say someone stays with the same company for a long period of time and they're at the last stage of the game where it appears that there has been an opportunistic termination. One thing you could say is that early in their career, they excepted a below market wage while they were getting general market training that could be used with some other employer. That was an investment in them and they have stayed with this employer; out of seniority, they have ended up getting an above-market wage for their productivity under that rationale.

Another situation would be where they stayed with this employer and did a very firm-specific apprenticeship, yet did not receive a higher wage. That is, most of the models predict that if you are making an investment, but it's not something you can capture somewhere else in the market, the employer will go ahead and pay you a market wage at that time. Suppose that for some reason this employee, out of faith in the employer, goes ahead and makes this firm-specific investment, and that's the reason they are getting this above-market wage later on. That was the implicit contract. You make the investment in us and then we're going to pay you off later on. Do those situations seems different to you?

Professor Schwab

Those situations do seem different. In the appendix I handed out, there are two different graphs. The first one is actually a firm-specific model where at all points the worker is being paid less than his productivity. Actually, that's not at all times, but all times late in the life cycle, in the payback period rather than the training period. In this case, there's no incentive to get rid of the workers. The second graph depicts what economists call the efficiency-wage model. In that model, late in the life cycle the worker is being paid more than he or she is currently producing. To make such relationships work, the parties must rely either on the employer's desire for a fair reputation, or turn to the court. So, the way this can be done is to say, "I'm going to hire you long term; work real hard and you'll be rewarded for it." You work hard, work hard, work hard. I then fire you. Recognizing this danger at the outset, the worker might say, "I'm skeptical of that. I'm not going to enter this contract even though it is good for both of us." The employer can counter: "To back up my reputation, I'll agree that a court can scrutinize me later on. I'm so confident in my willingness to be fair that I'll agree to let the courts scrutinize my actions."

This leads directly to my next point. We don't have any of this in writing; we don't really have any of this orally. It's just an implicit understanding. What are courts to do in that situation? Courts recognize that this life-cycle approach is just a default term, and that they would defer to any clear statement of the parties.

Question

What do you mean by a "default" term?

Professor Schwab

What I is mean is this: if the parties do not clearly indicate what legal rule they want to govern their relationship, we assume that they wanted a life-cycle default. This is my unique little theory. Others might assume they wanted just-cause, or they wanted at-will. But whatever the default term is, the parties can write a contract that alters the judicial presumption. That's what I mean by default term.

Professor Ayres

Let me add to the discussion of default rules. Another term would be a "back-stop" rule. The modern term "default" comes from computers. When you turn on your computer the word processing system has a default left-hand margin of one inch. But if you don't like the default margin you can change it. So, in contract theory, people think about whether the default term in employment contracts should be at-will. If at-will is the default, contractors are free to contract around this default by providing expressly for just-cause protection, but an at-will default rule means that in the absence of a contrary term, at-will treatment will apply.

For example, what is the default price if somebody leaves a price out of a contract? Common law says it's the reasonable price. What's the default quantity if somebody leaves out the quantity in a contract? This happens very rarely, but the default quantity is not reasonable, default quantity is zero. If you leave quantity out of your contract, the contract is not enforceable. So those are the gap-fillers. We refer to them as defaults.

Professor Schwab

And, of course, much of the day-to-day activities of judges is how to fill in gaps in contracts. The judges fill in the gaps with default terms.

Professor Ayres

There are basically three deep arguments about contracts here. One is whether a particular issue should be contractible or non-contractible. For example, should parties be able to have an arbitration clause that allows them to contract away their court rights in Title VII cases, or should we say it's not contractible? It's not merely a default rule if employees have an absolute right to try their Title VII claims in court. If employees can't contract away their right to Title VII actions, then non-arbitration is more than a default rule—it is a mandatory rule. You can't contract it away. Statutes do not solely create mandatory rules. The common law sometimes creates mandatory rules; as we are about to see, tort laws are mostly mandatory. Common law judges make mandatory rules when they rule that there's a duty of good faith performance in all contracts. If a party enters a contract saying, "Seller waives duty of good faith performance," nobody's going to enforce that clause. As a result, sometimes you worry about whether a rule should be mandatory and non-contractible, or merely default.

The second deep issue of contracts is if it's going to be a default, what is the best default term? Is it better to have an "at-will" or "just-cause" default? The third issue is this: what does it take to contract around the default rule? For example, is a statement in the employment handbook sufficient? What kind of words are enough to displace employment at-will?

So the three issues in contract are: (1) is this particular rule contractible at all? (2) what's the appropriate default? and (3) how can the parties contract around it? Libertarians mainly argue about the first issue. No mandatory rules. Everything should be contractable. But libertarianism doesn't tell us whether the default should be just-cause (where people can opt out of it to employment at-will), or whether the default should be employment at-will (where people can contract into just-cause). It also doesn't tell us much about what should be sufficient to contract around either an opt-out or opt-in default. That's what we are about to give you some economic thoughts about.

Question

To clarify, you are suggesting that the default rules apply only if the parties have not addressed the issue? So, the question is, do we default at-will or just-cause if the parties have not addressed the ground upon which the relationship may sever? But now you are saying that another issue is how many words are necessary to contract around a default. If the parties have words, doesn't that eliminate the default? If they have addressed it in some fashion, how do we get to the default?

Professor Schwab

The key problem is your qualification of "in some fashion."

Professor Ayres

Common law or statutory law sometimes makes certain defaults very sticky. Sometimes parties can only get around a default by using magic words. Under the UCC, if you want to disclaim certain implied warranties, you can address it with all kinds of fancy words but if you don't use the magic words of "merchantability," you don't effectively disclaim the implicit (or default) warranty. Also, in corporate law, sometimes the statutes say this will be the default unless you clearly indicate otherwise. In employment law, some jurisdictions are very clear when they say, "I don't care how many representations were made in all these employment handbooks," "addressing it in those places will have no effect," or "the parties must use certain words to have that effect."

Professor Schwab

Let me discuss the approaches to choosing the appropriate default rule. "Mimicking the market" is probably the most common approach. Choose as the default rule what most parties would adopt if they focused on the issue. The basic argument is that this approach saves transaction costs. Most parties are not going to have to negotiate or decide because you have provided them with the default, which is what they probably want. Unfortunately, that's not the only possible standard for creating a default rule.

Another standard is that courts should choose as the default the more difficult rule for the parties to write down themselves. Why is this? This is efficient when transaction costs differ between the rules. For example, perhaps it's relatively easy if you don't like default A, to write down term B. But if term B is a default, it may be hard to go to term A. Under this approach, courts don't necessarily care what most people do. Even if most people want another rule, they can easily opt out whereas people would otherwise have a hard time getting to this rule.

Professor Ayres

Let me apply that right away to Schwab's model. I think it's easy for people to contract for employment at-will. You can do that in about ten seconds with very clear language. It is much harder to contract for the kind of implicit protections that the Schwab life-cycle rule. How can you write that down? You don't want to use the words, "When you're in mid-career you won't get as much protection as when you are old or young." There are many more nuances involved.

By the way, I might emphasize that Schwab has looked at tons of cases. The argument isn't that nobody has ever written a life-cycle default into the contract; rather, case-law suggests that it's much more likely that plaintiffs are going to win when they've been there many years (or just a few), and that they are less likely to win in the intermediate years. Schwab's descriptive claim is that we have this kind of vague, fuzzy default, and maybe that's a good thing because of this second reason: it's hard to write it down, but easy to write down the opposite if particular parties don't want that type of relationship.

Professor Schwab

The third approach to default rules, which I don't think we'll spend too much time on, is actually the one made famous by Ian. This is what is called "information forcing" default rules or penalty defaults. The idea is this: in some situations we are quite sure that many or most people don't want this rule, but this rule gives the parties incentives to reveal that another rule would be more appropriate and the revelation of this information is useful. Applied here—and it is questionable whether it should be applied here—if workers don't know what the state of the law is out there, but employers have a pretty good guess, let's have just-cause as a penalty default. If employers don't want it, they have to tell the workers what the rule is. That will get the information out there.

Professor Ayres

It shows we've spent a lot more time on Schwab's theory here. The penalty-default approach will be relevant too when we finally get to our survey about people's knowledge of the law. If some people don't know what the law is, the idea here is you might want to penalize the side that knows what the law is. Not penalize them ultimately, this is still freedom of contract. But just say, "Look, unless you tell your employees that they can be fired for good, bad, or no reason, then we're going to hold you to just-cause firing."

To go back to your earlier question, if you take this penalty default theory seriously, you really want to make sure that the words that were used to contract around a penalty default were ones that were clear enough that the employee sees it. You might want to have procedures which the common law sometimes requires like a franchise agreement. For example, perhaps employees must initial the at-will clause. Or perhaps the contract must explain the at-will relationship sufficiently so that it actually informs employees, so that they say, "Yikes! This is an employer that really is going to have power over me."

Professor Schwab

Let me move on to the mandatory employment rules. These are defined to be parts of the contract that the employees cannot waive the protections of or the parties cannot write around. There are lots of examples. Wage and hours laws are typically mandatory rules. Workers' compensation is typically this way; employment discrimination is typically this way. We've been discussing the very intricate rule of arbitration of employment discrimination complaints—should it be this way? In the common-law, what is the general line between default and mandatory rules? It's typically between contract or contract-like issues and tort rules. In contract, at the end of the day courts usually try to enforce what the parties want, and the parties can enforce anything they want. In tort, at the end of the day courts say, "We don't care what you intended here because this is the rule."

Professor Ayres

But even within contract law there is a respectable theory of mandatory rules. You can't waive the duty of good faith; you can't waive unconscionability; you can't contract for an unreasonably long covenant not to compete. In many jurisdictions there are things you just can't contract away. It's not just activist judges, but good common-law practice asks whether particular terms are waiveable.

Professor Schwab

It is definitely a simplification to say that all contract issues are default issues only. But just to remind us again, what's the rationale as to the mandatory rules? The law is very confident that at least one of the parties is not acting in their own interests. This harkens back to the paternalism argument. Or we have market failure. Let me apply this to the tort of wrongful discharge against public policy, which is something that you judges confront frequently. This is a mandatory rule because employees cannot waive this protection in advance. If they later want to bring this wrongful discharge claim, they can.

Professor Ayres

At least in some jurisdictions.

Professor Schwab

The tort is not recognized in every jurisdiction, that's right. Indeed, my home state of New York does not have general wrongful discharge tort. But when it is recognized, as far as I know, it invariably has this form of being mandatory.

The best rationale for this tort is that a market failure exists. It's the classic market failure of external or third-party effects. The contracting parties, the employer and employee, are not considering all the costs in their transaction when they agree to an at-will contract. For example, a classic situation arises in cases like *Nees v. Hocks*.[5] An employee was fired for refusing jury duty. The employer and employee did not consider the effects of the judicial system when they agreed to an at-will contract. Because of these third-party effects, we will not enforce the at-will contract. The *Nees v. Hocks* case was creating new law in 1975, and they had a little trouble naming the tort. They rejected the label prima facie tort, however. Today, this is a classic example of the tort of wrongful discharge in violation of public policy.

Another classic case of third-party effects involves whistle blowing. Whistle blowing is a tricky category as you undoubtedly know. But the third-party effects are sometimes clear. Suppose an employee is fired after informing authorities that the company was dumping toxic waste into the river. The third-party damages from chilling such whistleblowing are clear.

Some cases are difficult to justify on third-party effects grounds. The biggest example involves employee privacy claims, which I think a lot of courts wrestle with. It's very hard except in really outrageous cases to have successful employee privacy claims. There's good reason why these cases are so hard: the third-party effects are hard to see. And so, my argument is that courts mostly enforce privacy claims only on contract grounds. There's a well-known case of *Rulon-Miller v. IBM*,[6] cited by Walter Olsen, where an employee recovered damages when she was fired for dating an employee of a competitor. I view that as largely contract-based. IBM got in trouble in that case by promising to be fair and then reneging on their promise.

Question

What is an employee privacy claim?

Professor Schwab

An at-work example occurs when employees complain that supervisors invaded their privacy by searching their lockers, such as the *K-Mart v. Trotti* case from Texas.[7] Other examples involve eavesdropping on phone calls. Many computer e-mail cases lead to invasion-of-privacy claims. Legislatures have stepped in here in an important way. Common-law courts, however, are constrained in aggressively policing of employee privacy claims, precisely because the third-party effects are hard to see. Why should courts intervene in a contractual relationship where the parties clearly agreed to an at-will relationship and no third parties are being harmed when the employer searches for drugs? Employees occasionally succeed on common-law privacy claims, but they really involve extreme facts.

Notes

1. *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).
2. *See* Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563 (1982). *See also* STEWART J. SCHWAB, THE LAW AND ECONOMICS APPROACH TO WORKPLACE REGULATION, IN GOVERNMENT REGULATION OF THE EMPLOYMENT RELATIONSHIP 91, 111-13 (Bruce E. Kaufman ed., 1997).

3. *See* Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947 (1984).
4. *Id.* at 979.
4. 536 P.2d 512 (Or. 1975).
5. 208 Cal. Rptr. 524 (Cal. Ct. App. 1984)
6. *See* K-Mart Corp. Store No. 7441 v. Trotti, 677 S.W.2d 632 (Tex. App. 1984).