In Defense of the Contract at Will

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The persistent tension between private ordering and government regulation exists in virtually every area known to the law, and in none has that tension been more pronounced than in the law of employer and employee relations.

One manifestation of that position was the prominent place that the common law, especially as it developed in the nineteenth century, gave to the contract at will. The basic position was well set out in an oft-quoted passage from Payne v. Western & Atlantic Railroad:

[M]en must be left, without interference to buy and sell where they please, and to discharge or retain employees at will for good cause or for no cause, or even for bad cause without thereby being guilty of an unlawful act per se. It is a right which an employee may exercise in the same way, to the same extent, for the same cause or want of cause as the employer.*


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In the remainder of this paper, I examine the arguments that can be made for and against the contract at will. I hope to show that it is adopted not because it allows the employer to exploit the employee, but rather because over a very broad range of circumstances it works to the mutual benefit of both parties, where the benefits are measured, as ever, at the time of the contract's formation and not at the time of dispute.

I. The Fairness of the Contract at Will

The first way to argue for the contract at will is to insist upon the importance of freedom of contract as an end in itself. Freedom of contract is an aspect of individual liberty, every bit as much as freedom of speech, or freedom in the selection of marriage partners or in the adoption of religious beliefs or affiliations. Just as it is regarded as prima facie unjust to abridge these liberties, so too is it presumptively unjust to abridge the economic liberties of individuals. The desire to make one's own choices about employment may be as strong as it is with respect to marriage or participation in religious activities, and it is doubtless more pervasive than the desire to participate in political activity. Indeed for most people, their own health and comfort, and that of their families, depend critically upon their ability to earn a living by entering the employment market. If government regulation is inappropriate for personal, religious, or political activities, then what makes it intrinsically desirable for employment relations?

It is one thing to set aside the occasional transaction that reflects only the momentary aberrations of particular parties who are overwhelmed by major personal and social dislocations. It is quite another to announce that a rule to which vast numbers of individuals adhere is so fundamentally corrupt that it does not deserve the minimum respect of the law. With employment contracts we are not dealing with the widow who has sold her inheritance for a song to a man with a thin mustache. Instead we are dealing with the routine stuff of ordinary life; people who are competent enough to marry, vote, and pray are not unable to protect themselves in their day-to-day business transactions.

Courts and legislatures have intervened so often in private contractual relations that it may seem almost quixotic to insist that they bear a heavy burden of justification every time they wish to substitute their own judgment for that of the immediate parties to the transactions. Yet it is hardly likely that remote public bodies have better information about individual preferences than the parties who hold them. This basic principle of autonomy, moreover, is not limited to some areas of individual conduct and wholly inapplicable to others. It covers all these activities as a piece and admits no ad hoc exceptions, but only principled limitations.

This general proposition applies to the particular contract term in question. Any attack on the contract at will in the name of individual freedom is fundamentally misguided. As the Tennessee Supreme Court rightly stressed in Payne, the contract at will is sought by both persons. Any limitation upon the freedom to enter into such contracts limits the power of workers as well as employers and must therefore be justified before it can be accepted. In this context the appeal is often to an image of employer coercion. To be sure, freedom of contract is not an absolute in the employment context, any more than it is elsewhere. Thus the principle must be understood against a backdrop that prohibits the use of private contracts to trench upon third-party rights, including uses that interfere with some clear mandate of public policy, as

2 See supra note 5 and accompanying text.
in cases of contracts to commit murder or perjury.\textsuperscript{14}

In addition, the principle of freedom of contract also rules out the use of force or fraud in obtaining advantages during contractual negotiations; and it limits taking advantage of the young, the feeble-minded, and the insane.\textsuperscript{15} But the recent wrongful discharge cases do not purport to deal with the delicate situations where contracts have been formed by improper means or where individual defects of capacity or will are involved. Fraud is not a frequent occurrence in employment contracts, especially where workers and employers engage in repeat transactions. Nor is there any reason to believe that such contracts are marred by misapprehensions, since employers and employees know the footing on which they have contracted: the phrase "at will" is two words long and has the convenient virtue of meaning just what it says, no more and no less.\textsuperscript{16}

An employee who knows that he can quit at will understands what it means to be fired at will, even though he may not like it after the fact. So long as it is accepted that the employer is the full owner of his capital and the employee is the full owner of his labor, the two are free to exchange on whatever terms and conditions they see fit, within the limited constraints just noted. If the arrangement turns out to be disastrous to one side, that is his problem; and once cautioned, he probably will not make the same mistake a second time. More to the point, employers and employees are unlikely to make the same mistake once. It is hardly plausible that contracts at will could be so pervasive in all businesses and at all levels if they did not serve the interests of employees as well as employers. The argument from fairness then is very simple, but not for that reason unpersuasive.

II. THE UTILITY OF THE CONTRACT AT WILL

The strong fairness argument in favor of freedom of contract makes short work of the various for-cause and good-faith restrictions upon private contracts. Yet the argument is incomplete in several respects. In particular, it does not explain why the presumption in the case of silence should be in favor of the contract at will. Nor does it give a descriptive account of why the contract at will is so commonly found in all trades and professions. Nor does the argument meet on their own terms the concerns voiced most frequently by the critics of the contract at will. Thus, the commonplace belief today (at least outside the actual world of business) is that the contract at will is so unfair and one-sided that it cannot be the outcome of a rational set of bargaining processes any more than, to take the extreme case, a contract for total slavery. While we may not, the criticism continues, be able to observe them, defects in capacity at contract formation nonetheless must be present: the ban upon the contract at will is an effective way to reach abuses that are pervasive but difficult to detect, so that modest government interference only strengthens the operation of market forces.\textsuperscript{17}

In order to rebut this charge, it is necessary to do more than insist that individuals as a general matter know how to govern their own lives. It is also necessary to display the structural strengths of the contract at will that explain why rational people would enter into such a contract, if not all the time, then at least most of it. The implicit assumption in this argument is that contracts are typically for the mutual benefit of both parties. Yet it is hard to see what other assumption makes any sense in analyzing institutional arrangements (arguably in contradistinction to idiosyncratic, nonrepetitive transactions). To be sure, there are occasional cases of regret after the fact, especially after an infrequent, but costly, contingency comes to pass. There will be cases in which parties are naive, befuddled, or worse. Yet in framing either a rule of policy or a rule of construction, the focus cannot be on that biased set of cases in which the contract aborts and litigation ensues. Instead, attention must be directed to standard repetitive transactions, where the centralizing tendency powerfully promotes expected mutual gain. It is simply incredible to postulate that either employers or employees, motivated as they are by self-interest,

\textsuperscript{14} See supra note 11.

\textsuperscript{15} For my elaboration of this general point, see Epstein, Unconscionability: A Critical Reappraisal, 18 J.L. & Econ. 293 (1975).

\textsuperscript{16} In the absence of force or fraud, any disclosure law would be regarded as only a nuisance by employers and employees alike, whatever the case for such laws in other contexts. See, e.g., Krohn, Misake, Disclosure, Information, and the Law of Contracts, 7 J. LEGAL STUD. 1, 11-18 (1978).

\textsuperscript{17} Krohn, Paternalism and the Law of Contracts, 92 Yale L.J. 763, 777 (1983).
would enter routinely into a transaction that leaves them worse off than they were before, or even worse off than their next best alternative.

From this perspective, then, the task is to explain how and why the at-will contracting arrangement (in sharp contrast to slavery) typically works to the mutual advantage of the parties.

The modern view tends to lay heavy emphasis on the need to control employer abuse. Yet, as the passage from Payne indicates, the rights under the contract at will are fully bilateral, so that the employee can use the contract as a means to control the firm, just as the firm uses it to control the worker.

The issue for the parties, properly framed, is not how to minimize employer abuse, but rather how to maximize the gain from the relationship, which in part depends upon minimizing the sum of employer and employee abuse. Viewed in this way the private-contracting problem is far more complex. How does each party create incentives for the proper behavior of the other? How does each side insure against certain risks? How do both sides minimize the administrative costs of their contracting practices?

1. Monitoring Behavior. The shift in the internal structure of the firm from a partnership to an employment relation eliminates neither bilateral opportunism nor the conflicts of interest between employer and employee. Begin for the moment with the fears of the firm, for it is the firm's right to maintain at-will power that is now being called into question. In all too many cases, the firm must contend with the recurrent problem of employee theft and with the related problems of unauthorized use of firm equipment and employee kickback arrangements. As the analysis of partnerships shows, however, the proper concerns of the firm are not limited to obvious forms of criminal misconduct. The employee on a fixed wage can, at the margin, capture only a portion of the gain from his labor, and therefore has a tendency to reduce output. The employee who receives a commission equal to half the

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19 For example, in Perks v. Firestone Tire & Rubber Co., 611 F.2d 1363, 1364 (3d Cir. 1979), the plaintiff, a discharged employee, had allowed the representative of a supplier to procure prostitutes for him.

20 By way of comparison, his position is like that of a lienholder who is quite happy so long as the value of the security remains above the level of the lien, even if the venture itself does not prosper. This is one reason why there is an enormous reluctance to allow the mortgagee to enter into possession before default, especially when the equity in the property is large. The risks, of course, change radically upon default, at which point a mortgagee will generally want to keep up the property because its value is less than that of his lien. Note too that the conflict of interest is of great importance to an equity investor in a limited partnership who, having relied upon the valuation of property prepared for the mortgage lender, discovers that the lender's assessor was less sensitive than he is to the positive po-
firm’s profit attributable to his labor may work hard, but probably not quite as hard as he would if he received the entire profit from the completed sale, an arrangement that would solve the agency-cost problem only by undoing the firm.

The problem of management then is to identify the forms of social control that are best able to minimize these agency costs.

Internal auditors may help control some forms of abuse, and simple observation by coworkers may well monitor employee activities. (There are some very subtle tradeoffs to be considered when the firm decides whether to use partitions or separate offices for its employees.) Promotions, bonuses, and wages are also critical in shaping the level of employee performance. But the carrot cannot be used to the exclusion of the stick. In order to maintain internal discipline, the firm may have to resort to sanctions against individual employees. It is far easier to use those powers that can be unilaterally exercised: to fire, to demote, to withhold wages, or to reprimand. These devices can visit very powerful losses upon individual employees without the need to resort to legal action, and they permit the firm to monitor employee performance continually in order to identify both strong and weak workers and to compensate them accordingly. The principles here are constant, whether we speak of senior officials or lowly subordinates, and it is for just this reason that the contract at will is found at all levels in private markets.

In addition, within the employment context firing does not require a disruption of firm operations, much less an expensive division of its assets. It is instead a clean break with consequences that are immediately clear to both sides. The lower cost of both firing and quitting, therefore, helps account for the very widespread popularity of employment-at-will contracts. There is no need to resort to any theory of economic domination or inequality of bargaining power to explain at-will contracting, which appears with the same tenacity in relations

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88 See, e.g., Malcolmson, Work Incentives, Hierarchy, and Internal Labor Markets, 92 J. Pol. Econ. 486 (1984), for one effort to model the effectiveness of using internal promotions to improve workers’ performance when monitoring is costly and hence imperfect. Malcolmson’s model does not address the question of whether the workers are under term contracts or contracts at will, but the structure of his argument is consistent with the at-will model of legal relations.
between economic equals and subordinates and is found in many complex commercial arrangements, including franchise agreements, except where limited by statutes.\footnote{As an example of a restriction upon the power of termination, automobile dealers may recover damages resulting from a manufacturer's failure to act in good faith in not renewing the dealer's franchise. 15 U.S.C. §§ 1221-1225 (1982). These provisions were conceived of as a supplement to the antitrust laws. Act of Aug. 8, 1956, Pub. L. No. 1026, 70 Stat. 1125 (codified at 15 U.S.C. §§ 1221-1225 (1982)) (statement of purpose).}

Thus far, the analysis generally has focused on the position of the employer. Yet for the contract at will to be adopted ex ante, it must work for the benefit of workers as well. And indeed it does, for the contract at will also contains powerful limitations on employers' abuses of power. To see the importance of the contract at will to the employee, it is useful to distinguish between two cases. In the first, the employer pays a fixed sum of money to the worker and is then free to demand of the employee whatever services he wants for some fixed period of time. In the second case, there is no fixed period of employment. The employer is free to demand whatever he wants of the employee, who in turn is free to withdraw for good reason, bad reason, or no reason at all.

The first arrangement invites abuse by the employer, who can now make enormous demands upon the worker without having to take into account either the worker's disutility during the period of service or the value of the worker's labor at contract termination. A fixed-period contract that leaves the worker's obligations unspecified thereby creates a sharp tension between the parties, since the employer receives all the marginal benefits and the employee bears all the marginal costs.\footnote{This makes it difficult to accept the argument that "[c]omplex at will is the ultimate guarantor of the capitalist's authority over the worker." Feinsman, supra note 4, at 132-33. Yet, as Feinsman notes, historically the employers who brought actions were generally those who earned high salaries. Id. at 115, 131-33. This is simply enough explained by noting that those would have been the only cases in which the amount in controversy exceeded the plaintiff's expected costs of suit. But the fact that employers could also quit at will makes it difficult to see in the at-will device the exploitation of the working class, especially since real wages were continually rising throughout the eighteenth and nineteenth centuries. See D. Diamond & J. Guilloz, United States Economic History 277, 468 (1973); Herman E. Krooss, American Economic Development 395-98 (2d ed. 1966); S. Ratner, J. Solow & B. Silla, The Evolution of the American Economy 247, 308-09 (1979). Nor does a theory focusing on the employer's authority account for the right of the employee to quit at will.}

Matters are very different where the employer makes increased demands under a contract at will. Now the worker can quit whenever the net value of the employment contract turns negative. As with the employer's power to fire or demote, the threat to quit (or at a lower level to come late or leave early) is one that can be exercised without resort to litigation. Furthermore, that threat turns out to be most effective when the employer's opportunistic behavior is the greatest because the situation is one in which the worker has least to lose. To be sure, the worker will not necessarily make a threat whenever the employer insists that the worker accept a less favorable set of contractual terms, for sometimes the changes may be accepted as an uneventful adjustment in the total compensation level attributable to a change in the market price of labor. This point counts, however, only as an additional strength of the contract at will, which allows for small adjustments in both directions in ongoing contractual arrangements with a minimum of bother and confusion.

2. Reputational Losses. Another reason why employees are often willing to enter into at-will employment contracts stems from the asymmetry of reputational losses. Any party who cheats may well obtain a bad reputation that will induce others to avoid dealing with him. The size of these losses tends to differ systematically between employers and employees—to the advantage of the employer. Thus in the usual situation there are many workers and a single employer. The disparity in number is apt to be greatest in
large industrial concerns, where the at-will contract is commonly, if mistakenly, thought to be most unsatisfactory because of the supposed inequality of bargaining power. The employer who decides to act for bad reason or no reason at all may not face any legal liability under the classical common law rule. But he faces very powerful adverse economic consequences. If coworkers perceive the dismissal as arbitrary, they will take fresh stock of their own prospects, for they can no longer be certain that their faithful performance will ensure their security and advancement. The uncertain prospects created by arbitrary employer behavior is functionally indistinguishable from a reduction in wages unilaterally imposed by the employer. At the margin some workers will look elsewhere, and typically the best workers will have the greatest opportunities. By the same token the large employer has more to gain if he dismises undesirable employees, for this ordinarily acts as an implicit increase in wages to the other employees, who are no longer burdened with uncooperative or obtuse coworkers.

The existence of both positive and negative reputational effects is thus brought back to bear on the employer. The law may tolerate arbitrary behavior, but private pressures effectively limit its scope. Inferior employers will be at a perpetual competitive disadvantage with enlightened ones and will continue to lose in market share and hence in relative social importance. The lack of legal protection to the employees is therefore in part explained by the increased informal protections that they obtain by working in large concerns.

3. Risk Diversification and Imperfect Information. The

contract at will also helps workers deal with the problem of risk diversification.

Ordinarily, employees cannot work more than one, or perhaps two, jobs at the same time. Thereafter the level of performance falls dramatically, so that diversification brings in its wake a low return on labor. The contract at will is designed in part to offset the concentration of individual investment in a single job by allowing diversification among employers over time. The employee is not locked into an unfortunate contract if he finds better opportunities elsewhere or if he detects some weakness in the internal structure of the firm. A similar analysis applies on the employer's side where he is a sole proprietor, though ordinary diversification is possible when ownership of the firm is widely held in publicly traded shares.

The contract at will is also a sensible private adaptation to the problem of imperfect information over time. In sharp contrast to the purchase of standard goods, an inspection of the job before acceptance is far less likely to guarantee its quality thereafter. The future is not clearly known. More important, employees, like employers, know what they do not know. They are not faced with a bolt from the blue, with an "unknown unknown." Rather they face a known unknown for which they can plan. The at-will contract is an essential part of that planning because it allows both sides to take a wait-and-see attitude to their relationship so that new and more accurate choices can be made on the strength of improved information. ("You can start Tuesday and we'll see how the job works out" is a highly intelligent response to uncertainty.) To be sure, employment relationships are more personal and hence often stormier than those that exist in financial markets, but that is no warrant for replacing the contract at will with a for-cause contract provision. The proper question is: will the shift in methods of control work a change for the benefit of both parties, or will it only make a difficult situation worse?

We should greet with skepticism any claim that takes the following form: The at will doctrine should be altered not because of "unequal bargaining power," but rather because it is inefficient. Courts must intervene, according to this view, in order to bring about the substantive outcome that the parties would have reached had transaction and information costs not precluded informed negotiation. When high costs of bargaining prevent negotiation between individual employees and employers, and inadequately access to information prevents parties from properly valuing the benefits of job security, judicial intervention is justified to ensure a more efficient result.

Note, Wrongful Discharge, supra note 4, at 1830. The author is right to dismiss inequality of bargaining power as a makeweight argument. But the discussion of imperfect information is nothing short of mystifying, for it simply assumes that universal arrangements are univer-
4. Administrative Costs. There is one last way in which the contract at will has an enormous advantage over its rivals. It is very cheap to administer. Any effort to use a for-cause rule will in principle allow all, or at least a substantial fraction of, dismissals to generate litigation. Because motive will be a critical element in these cases, the chances of either side obtaining summary judgment will be negligible. Similarly, the broad modern rules of discovery will allow exploration into every aspect of the employment relation. Indeed, a little imagination will allow the plaintiff’s lawyer to delve into the general employment policies of the firm, the treatment of similar cases, and a review of the individual file. The employer for his part will be able to examine every aspect of the employee’s performance and personal life in order to bolster the case for dismissal.

CONCLUSION

The recent trend toward expanding the legal remedies for wrongful discharge has been greeted with wide approval in judicial, academic, and popular circles. In this paper, I have argued that the modern trend rests in large measure upon a misunderstanding of the contractual processes and the ends served by the contract at will. No system of regulation can hope to match the benefits that the contract at will affords in employment relations. The flexibility afforded by the contract at will permits the ceaseless marginal adjustments that are necessary in any ongoing productive activity conducted, as all activities are, in conditions of technological and business change. The strength of the contract at will should not be judged by the occasional cases in which it is said to produce unfortunate results, but rather by the vast run of cases where it provides a sensible private response to the many and varied problems in labor contracting. All too often the case for a wrongful discharge doctrine rests upon the identification of possible employer abuses, as if they were all that mattered. But the proper goal is to find the set of comprehensive arrangements that will minimize the frequency and severity of abuses by employers and employees alike. Any effort to drive employer abuses to zero can only increase the difficulties inherent in the employment relation. Here, a full analysis of the relevant costs and benefits shows why the constant minor imperfections of the market, far from being a reason to oust private agreements, offer the most powerful reason for respecting them. The doctrine of wrongful discharge is the problem and not the solution. This is one of the many situations in which courts and legislatures should leave well enough alone.