A Pound of Prevention? The Indirect Cost of New Wrongful-Termination Laws

Business leaders often claim that new legal doctrines have created a flood of lawsuits that is making American firms less productive. As the grounds to sue multiply, so do the costs to firms—not just for legal fees and awards, but for procedures established to avoid lawsuits. Those expenses, they say, ultimately mean higher prices, lower profits, and fewer jobs. Advocates of the new legal doctrines disagree, contending that the public benefits of the laws far outweigh the costs. Although the debate goes on, there is little scientific evidence; lawmakers have to weigh the arguments using only anecdotal information. To provide more reliable guidance, the ICJ recently measured the cost of one new liability: wrongful termination.

A Moving Target

Until the 1980s, it was hard for employees to claim they had been fired without grounds. Firms were held liable only under dramatic circumstances, such as the firing of an employee for refusing to break the law. The basic rule was simple: Employers could fire nonunion workers for any cause, including no cause at all. Now, however, state courts have sharply expanded the grounds on which a fired worker can sue. In 1980, only 13 states recognized one of these new doctrines; by 1989, 45 did. Some of the new interpretations are quite broad. Under one, a jury ruled that an executive who was told he would “never get hurt with this company” was therefore guaranteed employment for life.

Such doctrines enable fired workers to sue much more frequently than has traditionally been the case. Although no state prohibits firing workers for poor performance or laying them off to reduce the work force, managers complain that the threat of lawsuits makes it difficult to dismiss workers even for the best reasons.

But has responding to these actual and potential suits really increased the cost of doing business? The price tag for a lawsuit can be high; in California, jury awards and legal fees average nearly $750,000. Even so, earlier ICJ research (The Legal and Economic Consequences of Wrongful Termination, R-3602-ICJ) showed that, averaging all firms and suits together, jury awards, pretrial settlements, and legal fees amount to just $100 per termination. These, however, are not the only costs; although few firms are actually sued, all must guard against such suits. To do so, they may keep poor performers on the payroll, offer larger severance payments, screen new hires more carefully, set up time-consuming review procedures for all employees, or force managers to ask senior executives before firing anyone.

To see how much this costs, ICJ researchers James Dertouzos and Lynn Karoly looked at how the new laws changed overall employment. Using data on state-level employment patterns between 1980 and 1987, they found that the cost of wrongful-termination laws is high and that the larger the possible legal award, the more businesses do to avoid litigation. The findings address several key questions:

- What is the total cost? In the states where broad doctrines make it easiest for fired employees to sue, long-term employment is 2 to 5 percent less than it would be under traditional law. The percentage is higher for...
big business; service industries; retail trade; and the finance, insurance, and real estate sector.

Quantifying these benefits would help lawmakers balance them against the costs just measured.

**Does Prevention Cost More Than Litigation?**

This study suggests that the total price tag for the new laws is much larger than the direct costs of lawsuits. The drop in employment corresponds to what could be expected if wages grew by 10 percent. Yet legal costs are estimated to be only one-tenth of 1 percent of the total wage bill. It appears that firms are spending much more to avoid litigation than on the litigation itself. This is neither the expected result nor what some advocates of expanded liability intend.

Why this seeming paradox? We don’t yet know. One reason may be that the direct costs of litigation are larger than the direct *legal* cost. Direct costs also include, for instance, both the time that managers spend defending against lawsuits and the resulting stress and damage to their careers. A second possibility is that businesses, spurred by reports of million-dollar lawsuits, may exaggerate the risk and “buy” unnecessary protection by establishing new procedures or keeping workers they might ordinarily fire. A final explanation is that, since even one lawsuit can be extremely expensive, firms may knowingly pay a great deal to avoid even a small chance of facing one—more, on average, than such judgments would cost. To untangle these possible causes, the ICJ is planning case studies that focus on the decisions individual managers and companies make as they deal with the threat of suits. The results should guide lawmakers as they define workers’ rights and guide executives as they manage American business.

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The research summarized in this brief was carried out within RAND's Institute for Civil Justice. Research results are described in detail in R-3989-ICJ, *Labor-Market Responses to Employer Liability*, by James N. Dettouzos and Lynn A. Karoly, 94 pp., $7.50.

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