

## Employment Law: Courts and Contracts

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### EMPLOYMENT LAW

### COURTS AND CONTRACTS

THERE ARE CLEARLY DEEP DIVISIONS OF OPINION in New Zealand on the relationship between the courts and the Employment Contracts Act 1991 (ECA). These address both substantive and jurisdictional issues. Thus the central dispute concerns the way courts should interpret the various provisions of the Act. The second concerns the question of whether a specialised court should have primary responsibility over administering and interpreting the Act. Clearly the two questions are related for the choice of tribunal is likely to have some systematic effects on the manner of interpretation. But as a foreigner, I plan to avoid these specific controversies by taking a somewhat Olympian perspective. I do not propose to comment on whether the key judicial decisions have been consistent with the new statute, or whether they still reflect the thinking of earlier labour legislation. That issue is best left to local expertise. Instead I will concentrate on two larger questions. What should be our general attitude to specialised courts? And how should we view an employment contract - particularly a contract designed to be terminable at the end of a fixed period? Both questions have broader interest, and the second question in particular is extremely important both for New Zealand and the rest of the industrialised world.

### **Specialist or General Courts?**

The question of specialist courts summons forth two basic attitudes. On the one hand, it is argued that only individuals with long experience in a particular substantive area can gain the appropriate degree of expertise - and even of empathy - over its subject matter. The contrary argument is that judges who only work in a single area of the law risk seeing their 'expertise' turning over time into an intellectual bias, which leads them to develop their self-image as champions of one particular side to a longstanding legal and political dispute.

My own view is that the claimed benefits of expertise are minor and that the problems of bias are much more serious. It is a bit difficult to be wholly categorical about this judgment because much will depend on the nature of the subject matter. Specialised courts of bankruptcy or taxation tend on balance to work relatively well because the technical knowledge needed to administer these complex systems of law is great, while the opportunity for forming political allegiances is somewhat limited. To be sure, one can find some judges who might develop a creditor orientation and others a debtor orientation, but since creditors and debtors come from all walks of life it is not clear that this form of identification, if it develops, maps itself on to any lasting political division within the larger society. So one hears relatively little uneasiness about these kinds of tribunals in the United States.

But labour law presents a different set of issues. Most of the points of contention arise in the formation and interpretation of employment contracts or collective bargaining agreements. Here the level of expertise demanded in these disputes is relatively small, for most of the issues are those which are encountered in any contractual dispute: what were the terms of the engagement, the sequence of performance, the opportunities for mitigation of loss and the like. I quite agree with the view that a labour contract is not the same as a contract for the sale of baked beans. But the parties to a labour contract already know that. When I work, the title for my person does not transfer to my employer in the way that the title for a can of baked beans transfers from a seller to a buyer. The difference between the cases lies in the terms of the respective contracts, express and implied. The role of the judge is to understand what the express terms mean, and what the background conditions and default rules should be. While legal cases will undoubtedly differ by subject matter, in all instances the goal is a set of rules that will maximise the business efficiency of the transactions.

Indeed, a judge who has experience in interpreting contracts other than just labour contracts is likely to understand labour relationships better than a specialist labour court judge. He or she will be better placed to see the interconnections between one type of contract, or one type of tort problem, and other types of legal problem. Judges who have a good overview of the full relationships existing in commerce, family relations and other areas of the law will most likely understand the issues better than judges who are exposed only to a narrow set of cases. For that reason, I would turn the expertise argument around: we will get more real expertise from general judges than from judges consigned to work within a relatively constrained menu of cases.

By the same token, with management/labour relationships, especially in the context of unions, the risk of bias either way is far greater. It is an open secret that the uneasiness with the National Labor Relations Board in the United States is such that it is reflected in part of the composition of the board itself, namely in the requirement that some of the Board members be drawn from the ranks of each political party so as to prevent a truly stacked tribunal. In making this argument I am not referring here mainly to overt, conscious bias. Some of that can surely emerge with time, but I think that the trappings of office help to control those difficulties. Rather, the focus of my concern is with the inclinations that get

reinforced after working constantly in the same field and being long exposed to the same influences.

Thus, particularly for employment disputes, I favour abolishing specialised courts and moving to general and comprehensive jurisdictions. If one is seeking a principle on which to partition cases into separate jurisdictions, that principle should be the monetary amounts at stake rather than the subject under dispute. And if we must have specialist jurisdictions within a general High Court, I would prefer to see this done through the rotation of judges. Judges would stay in one area for a period of time, and then move out before they had become so fixed in their attitudes that they no longer had the freshness of approach that one wants to see on the bench.

The problem of institutional bias is a serious one, and it starts with the selection of the judges. There is an important difference between appointing a judge to a general court and appointing a judge to a specialist court. If I am seeking to pick a judge who will do my bidding, my problem is much greater when appointing a general court judge. I can never know the precise issues that will come in front of that judge. I may find someone whom I regard as sound on issues of, say, toxic torts, but who is rather suspect on labour relationships. Thus I am forced to take the good with the bad, because I am effectively buying a basket of goods, some of which I like and some of which I don't. Because of this, we will get judges who, in general, are more centrist in their orientation, and more open to argument, than if I - as, say, a National or a Labour minister - have the opportunity to buy a specific can of beans in the form of a judge dealing with only one issue. In that case the judge's views on that issue will dominate, and the spread of issues which gives us our buffering capacity will be lost. This is an in-built problem; it has nothing to do with one's own views on labour market questions. There is thus a clear contrast between having the ability to choose one attribute and one only, and being required to weigh up the positive and negative attributes of a judge with respect to a whole host of issues. Put another way, the 'veil of ignorance' constraint operates more powerfully in the appointment of judges to general courts. In the long run, no matter who is in power, this will usually constitute a positive check on judicial bias.

In sum, the 'expertise' argument for a specialist jurisdiction is not only thin but probably runs in the opposite direction to its premise, while the bias argument is very real. As I noted, my degree of conviction varies with subject matter area. Yet by the same token, I suspect that others may find dangers in specialised courts that I think relatively inoffensive, such as specialised tax courts. It may well be that even here the case for picking and choosing expertise is sufficiently weak that we should avoid such devices. Where there is a need for expertise and specialisation, it might be provided through arbitration at the time of the dispute. The parties to the contract could select their arbitrators, who may well have relevant technical expertise. This approach could work generally. More specifically, I would handle the expertise question by introducing to labour disputes the practice already common in New Zealand with commercial arbitration - the ability to go to somebody outside the judicial system for a decision.

This option might not be used often, since the sums involved in labour disputes may not make it generally worthwhile. It may only happen where there is an issue of principle involving a group of workers rather than a single worker. There is little logic in attempting to ensure that all small disputes receive the same level of attention as the large ones. The size of the controversy clearly should have some influence on the amount of attention and the level of expertise devoted to it. But once again, there is little downside if I am wrong. The point is

that so long as the basic institutional choices are sound, we should allow the parties to decide whether or not to opt out of the court system. If in some industries or firms the parties think that it is possible to assemble a permanent panel of arbitrators at low cost, then we should bless that arrangement. Yet if the courts in other regions have lower backlogs or abler judges, the same parties might opt to remain within the legal system. The task of system-design is to predict the outcomes that people will opt for voluntarily. It is to give them the information and incentives that allow them to make an intelligent choice. And that can best be done if courts of general jurisdiction hear employment disputes.

## **The Nature of an Employment Contract**

I can now turn to the more substantive question: how should we conceive of an employment contract? It is easy to draw the wrong inferences about how the relationships in an employment contract actually work. An employment contract needs to be understood on two levels. On one level there is the set of legal arrangements that are written on paper, and perhaps even understood and enforced in accordance with their letter, at least as a matter of law. Separate from that are the full range of additional terms and conditions which are part of the culture of the particular firm in which the employee is embedded, and which the parties may wish the courts to ignore in the disputes that come before them.

In any employment relationship there will be a transfer of information from employer to employee. Various kinds of fiduciary and trust relationships are inevitably created. It is therefore wrong to think of an employment relationship as consisting simply of a specific set of duties owed by the employee to the employer, plus a monetary obligation owed by the employer. The real question is how we should understand the interaction between these two different sets of relationships. My argument is that some of the 'soft' obligations that are vital for the day-to-day functioning of a contract should not be enforced by any court of law. Judges will go badly astray if, after the fact, they try to define the soft conventions and decide who was right and who was wrong with respect to them. Such an approach can only lead to numerous mistakes. On balance, judges are better off understanding what an employment relationship really means - namely, that all the informal, in-house rules will bind the parties in some customary sense but should not be legally enforceable.

Recent experience in the United States is extremely instructive. Workplaces often supply company handbooks to newly hired workers telling them about their rights, duties and expectations. Unfortunately, the tendency in the courts has been to enforce the informal rules found in these books, even if by so doing they have overridden explicit contractual provisions for term employment or for a contract at will. The response of workplaces to these court decisions has been rapid. Virtually all the handbooks now contain conspicuous disclaimers to the effect that the representations or promises in them are informal practices and are not enforceable in a court of law.

That development is surely significant. It does not mean that informal representations are unimportant - clearly they are not. An employer will suffer a big loss of reputation if such representations are unreasonably violated. But the law of the workplace is not necessarily the law of courts, and one needs to keep the two clearly separate. Loss of reputation is a powerful sanction for an employer failing to keep adequate faith with respect to the informal terms that are denied legal enforcement. If one worker is fired, the significance of the event is not lost on other workers. Their greater insecurity will translate into higher labour and operating costs for the employer, unless the decision can be justified to the workforce. But just because an

employer can successfully justify the action to other workers who know the workplace culture and the personalities, it does not follow that when the case comes to court the right outcome will be sustained.

This is not a criticism of judges or lawyers. It is simply a recognition of the fact that the type of local knowledge possessed in one place may not translate well to another forum. This explains why people try to bifurcate the issues, so that the soft conventions can be handled in an informal manner removed from the legal setting.

To all this, it might be said that what I am proposing is simply a cloak for the exploitation that can sometimes happen in employment relationships. But a broader look at termination and business arrangements suggests a very different story. First, within the area of employment contracts, it is important to remember that contract governs the employment of the most senior members of the firm. Exploitation does not explain why employees who are wooed for such large sums accept such harsh written contractual conditions. Rather it is the same efficiency dynamic that is at work at other less senior levels of the employment relationship.

The same message is fortified when one looks at other business relationships that have little or nothing to do with employment. One firm might have an agreement to supply certain services to another; or the two firms could be in a franchise arrangement. Yet these agreements often show the same patterns that I have just described in employment relationships. The ability to sever the relationship may be at will, and often on very short notice. And the terms of the social agreement may not be carried over into the legal agreement. Rather, an 'integration clause' will frequently provide that "the express written terms of this agreement, and none other, constitute the sole source of rights and duties between the parties." Efficiency, not exploitation, explains the use of these terms. It is simply too risky to reconstruct a delicate web of understanding in the course of litigation between business entities, and between employer and employee.

If this analysis is correct, then we can acknowledge that the employment relationship goes deep without any necessity for the relationship to go deep in a legal sense. Indeed the opposite may be true, in employment as elsewhere. An employment relationship is one of trust and confidence. Often an employee has access to trade secrets or other sensitive information owned by an employer. If an employee has that type of information and loses the employer's confidence, the appropriate action by the employer may be immediate dismissal without complications. If not, the information could remain too long in the hands of a person who is likely to turn it against the employer. Once information gets out - often in undesirable circumstances - the consequences will be difficult to trace back to its source. Information is like water that seeps through the ground. It goes in a thousand different directions, and one never knows where it will come out and do harm. In whose interest is it for the finger of suspicion to point in every direction at once?

Accordingly, it is a common practice - often brutally understood and accepted by all parties - that when workers are fired they are barred from their offices immediately and given severance pay. Rarely are they given notice and then allowed to remain on the job, so that the employer gets work for cash. This draconian procedure is followed not because it is pleasant for anyone, but because of the problem of team production. If workers remain after they have been given notice, the strong possibility that they could sabotage a computer programme or steal proprietary information is enough to justify their immediate dismissal, not in the sense

of a criminal sanction but as a prudent business policy. No one can tell which employees might engage in that conduct, and one does not want a cloud of suspicion to hang over each of several workers dismissed at one time. So severing the connection avoids the need to trace the leak should something unfortunate happen. Such a policy of quick dismissal is not, of course, intrinsically desirable. As with so much of life, it is merely the lesser of two evils.

## **The Economics of Unjustifiable Dismissal**

If we accept the legitimacy of immediate dismissal, how should we then approach the issue of compensation for the worker after a dismissal takes place? Here one needs to look to the legal arrangements and the implied arrangements so as to see whether they are designed to afford some legal remedy or simply an informal remedy inside the firm. If the agreement says that the contract is over because it is an at-will arrangement, or because its natural period has expired, that should typically end the matter for the courts. Obligations of good faith for such matters as severance pay are not legal obligations. They are social obligations, and are frequently honoured. But they are not invariably honoured, and should not be confused with legal obligations.

If one deviates from this policy, one soon finds that efforts to protect employees after the fact are counter-productive both to employees and to the wider production relationship. Consider a scenario in which an employer says to a worker: "I will hire you for one year at a wage of \$20,000." Then, at the end of the term when the worker is dismissed, the parties are told that the substitution of the word 'unjustifiable' for 'wrongful' meant that, even though the dismissal was in accordance with the notice provisions in the contract, there could be an award for damages in addition to the agreed compensation. Let us assume that this award constitutes 25 percent of the wage.

After the worker is fired, it is tempting to assume that we are merely engaged in a distributional wrangle over whether or not he or she will receive \$5,000 in compensation for a dismissal made in accordance with the terms of the contract. If one believes that employees are entitled to some type of legal severance protection, one will naturally conclude that some level of compensation is appropriate under these circumstances, given the assumed need to redress the balance between employer and employee.

This, however, is far from the end of the story. Once a precedent has been set - and with a case like *Brighouse* now on the books, precedents are indeed being set in New Zealand - the next employment contract will be negotiated in the shadow of the previous legal decision. The fundamental dynamics of the labour market will be altered, and for the worse. Suppose, in the simplest case, everyone is now certain that if an employee is dismissed at the end of a one year term contract, this 25 percent 'bonus' will be awarded by the courts. The employer in our scenario will still be unwilling to pay more than \$20,000 in total remuneration; the firm needs to control its costs to stay in business. In a competitive labour market, the worker will also be prepared to accept that \$20,000 in total remuneration, as before. Ignoring adjustments for interest, the new wage for the next year should be \$16,000, with a 25 percent judicial bonus payable at the end of the year.

Given these responses, the best that can be said is that the worker will be back where she started. More likely, her economic position will deteriorate in consequence of the judge-made rule. Her preference is to receive even payments to match her expenditures, yet now she is forced to accept an end-loaded payment schedule that may force her into interim borrowing.

In addition, she faces the risk of losing some portion of her year-end bonus if she is dismissed for cause during the year.

This is only the easiest scenario to analyse. But the real-world complications do little to improve the position of the worker, or justify judicial intervention. The outcomes of legal proceedings are notoriously uncertain. In some cases, the judicial bonus will not be awarded. Hard-pressed employers and employees will have to estimate the likelihood and size of the bonus to determine initial wages, and on these matters their estimates are likely to differ. Given the uncertainty, it will be both costly and difficult for them to put together a series of wage and bonus payments that replicates in expected value terms the \$20,000 standard wage contract that both parties would choose in the absence of judicial meddling in the contracting process. Add in the cost of litigation and the employee gets less than \$20,000 while the employer pays more - a senseless tax that reduces both real wages and total employment.

There is a further complication. Suppose we now need to estimate the likelihood that a contract will be renewed. One of the occupational dangers of working in any court is that a judge may suffer from what I term the '*ex post* syndrome'. Courts only look at those transactions that are subject to litigation, and such transactions are only subject to litigation because to some extent they fail. Thus the only term contracts that courts actually see are those that are not renewed. In many cases, of course, term contracts *are* renewed. Sometimes they run for one year, and then for another and so on, in the way ordinary labour contracts will sometimes run for years without anybody rupturing them, despite the fact that both parties understand they have the full legal rights to terminate at any time.

Adding to our scenario the possibility of renewal, consider what would happen if we fully backloaded the dismissal bonus, as before. The employee would receive \$16,000 during the year but at the end of the period she would receive nothing if there were no severance. That constitutes an implicit wage reduction, unless still other adjustments to the compensation schedule are made to respond to that inequity. The wage package now has to take into account the possibility of both dismissal and renewal. Of course all these adjustments do not happen instantaneously, but in a competitive labour market they surely will over time. No matter how the pieces are reassembled the structure will always be inferior to the simple periodic wage contract that has been forced from the field.

*Ex ante*, the mutual benefits of the parties to an employment contract will not be captured by treating workers as a commodity. We do not say: "I have a choice of taking you, Jones, or a sack of beans. You come with me and I will treat you just as well as a sack of beans." That it is hardly a great recruitment strategy. Instead we say: "You are a person we would value. We want you to come on board. This is an organisation with a lot of promise." We make representations about how we would like to see the relationship continue. And the law needs to recognise that, whenever estimations are given about probabilities of success, of renewal, or of advancement, they should not be converted into legally protected rights. Once we start to do this, a very different type of recruitment will take place. We will get a guarded conversation that goes something like this: "I would like to tell you the good news, but I cannot because the law will be read in a way that will hit me badly if the hoped-for outcome doesn't eventuate. So I will offer you a contract for one year. Don't ask me about your future, because that will create legal complications."

Yet in an *ex ante* world people surely want information. When they get that information, they understand perfectly well that they have not been given a warranty. If we follow the line of

thinking of some judges, we run the danger of converting every honest estimation of probabilities into something approaching a warranty. Yet in all sorts of businesses we can see a clear separation of the concept of an estimated probability from the concept of a legal obligation. If a sharebroker touts a stock which subsequently falls in value, we do not expect the buyer of that stock to have his loss refunded out of the brokerage account, despite the fact that the sharebroker thought what was being supplied was good information on its performance. We can't have a world where the buyer keeps the winnings and the broker compensates for the losses. Similar arguments apply to employment contracts. And we know from the experience of contracting-out that all the soft representations that are the basis of such transactions are generally meant to give information and not to create legal relations. Courts should honestly respect those kinds of relationships. They should not be influenced by the *ex post* situation, where they are confronted with circumstances that seriously muddy the water. That only makes contracting more difficult.

The lesson should be clear. The effort to provide a worker a bonus upon non-renewal invariably imposes a tax on employers and employees alike. The effort to improve the lot of individual workers decreases the welfare of both workers and employers as a class. The legal regime that enforces contracts as written will outperform one that reserves to courts the right to rejigger them after the fact. A sound legal regime is one that contains clear and simple rules that respect the rights of parties to enter into any contracts they see fit. That regime should not tip the scales against either contracts at will or fixed-term contracts. Instead, it should recognise them both for what they are - indispensable mechanisms for promoting mutual gain through voluntary exchange. Above all, judges should resist the temptation to play Robin Hood after the fact. The approach taken in the *Brighouse* case, even if it were in perfect congruence with the statute, remains mischievous from an economic point of view.

### **The Perverse Distributional Effects of Judicial Meddling**

Judicial meddling with employment contracts often takes the form of implying terms in the teeth of an agreement with the opposite intention. This practice can have more than adverse efficiency effects. It can also lead to some odd, if not perverse, distributional consequences. This is because, in dealing with employment contracts, we are not just dealing with union contracts and union relationships. The United States again furnishes an instructive parallel. The most lucrative disputes over unjust dismissal typically arise under American anti-discrimination law - the equivalent to New Zealand's so-called Human Rights Act 1993. We have various designated heads of protection - sex, race, age, disability, and, increasingly, sexual orientation. The people who gain under these statutes turn out frequently not to be women or the members of minority groups, where there is a high level of public sympathy and support. Rather, the big winners are the elderly, who sue under the age discrimination provisions, or who do not need to sue because they are effectively insulated from being fired. The same tendency, I suspect, is present in your own employment law. An employee can be anybody from a chief executive to a day labourer. Workers in high positions will often be better placed to argue that their contracts contain implied terms that are not found in the employment contracts of ordinary union workers.

Indeed in the *Brighouse* and *Kerry Smith* cases, the plaintiff employees were situated high up in the employment hierarchy. If one has concerns about income redistribution, it is beyond my comprehension why one would want to give the favoured few an additional earning mechanism, after the fact, that will work in some cases but not in others. I can at least understand efficiency justifications, even though - as I have argued - I do not believe they



stand up. The efficient solution is the clean legal contract, and I hope I have sufficiently explained how complicated contracting becomes when we depart from that model.

Distributional arguments have an enormous appeal in public debate. The problem is that any statutory initiative is almost invariably subject to the law of unanticipated consequences. There are all sorts of follow-on effects, as self-interested actors try to take advantage of the new legal environment. The resulting distributional outcomes rarely coincide with the intentions that led to the passage of the original Act. Thus rent control laws in the United States typically benefit upper class people who live at trendy addresses like Central Park West. They were hardly the individuals whose cases were featured in the anecdotal discussions of the need for these laws.

Similarly, the anti-discrimination laws often work for the greatest benefit of the privileged few: it is far harder for an employer to defend against an age discrimination case brought by a high-priced employee than it is to defend against a suit brought by a low-level minority employee. The age statutes make it quite impermissible to look at background, or general levels of productivity. We are told, however unwisely, that we have to ignore all general evidence of the decline in productivity with age, and concentrate on the facts of the individual case. Yet these will often reveal strong performance and favourable evaluations of past work, and not track the incipient signs of decline that have led to the decision. But for younger workers a case involving discrimination based on race may turn on specific proof of incompetence that can be marshalled in the personnel records. No one claims that this pattern of outcomes matches the original intention behind the anti-discrimination laws. The subversion of legislative intentions takes place not only through judges misreading contracts or misunderstanding social dynamics, but also because the people who bring lawsuits and can present their case are often the last people that the statutes are trying to help. We will see far more equitable results from a seemingly prosaic legal rule that is wary of reading implied terms into a contract.

## **Let Contracts be Contracts**

I will finish with an example from a completely different area of the law - one that reinforces my earlier point about the way in which those working in specialised courts can miss out on important lessons from wider contracting theory. The arbitration of maritime disputes is one area of the law where, for a time, real competition existed. Until around 10-15 years ago, the English courts applied the following formula for maritime disputes: "If you give us a written document, we will not recognise good faith defences or imply terms that accord with our sense of justice. All we will recognise is what is written down in the contract, plus the necessary implications collected from the background norms of the sort that begin 'unless otherwise applied this term is added into a contract.'"

German courts also handled maritime disputes, and they were good faith courts up and down the line. They adopted sophisticated rules of bona fides in contracting; they were prepared to imply all sorts of commercially reasonable terms; they had certain non-waivable provisions that were fundamental to the contract. The contract became the foundation on which an elaborate judicial edifice was erected in accordance with the directives of the most learned of professors. The inevitable happened: 95 percent of the business went to the English courts, and eventually the German courts changed. The English approach won out because most people understand that they don't need a court to address any latent concerns about equitable treatment. They go to court because there has been a breakdown in a contract, and at that

point they want a strict enforcement of their legal rights. So with vigorous competition between jurisdictions, parties gravitated *ex ante* to the jurisdiction where the theory of enforcement was relatively uncomplicated.

That experience should be a powerful lesson in a legal world where we generally do not have competition. If it is good enough for marine arbitration - where people do not like to be treated like commodities either - it is good enough for employment relationships.

As I stated at the outset, I have tried, by and large, to steer clear of issues that have arisen in New Zealand. I can, however, affirm very strongly that the general principle of limiting the scope of legal contractual disputes travels very well from the United States to New Zealand to London and back. This is not a principle that depends on local culture: those issues can be handled informally on the equity side. It is a principle concerning the definition of the enforcement of legal rights. A lean, slimmed-down, comprehensive theory about employment contracts does this job far better than any other approach.