

**AVOIDING LITIGATION: THE BENEFITS OF
EMPLOYMENT CONTRACTS AND ARBITRATION**

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ABSTRACT

This research reviews the current environment in employment disputes. In an ever-increasing litigious era where it is not uncommon to see six-figure settlements, the entrepreneur needs to examine the possible legal options in the event of a lawsuit involving current or former employees. While many employment-oriented lawsuits are settled through litigation, this is a time-consuming and costly process. Indeed, due to its adversarial nature, dispute resolution through litigation can take years to settle. In contrast, one business strategy that is growing in popularity includes the use of employment contracts specifying arbitration in dispute resolution. Because arbitration is "almost entirely separate from the legal system" (Siegel, Sect. 586), it offers many advantages to both employers and employees.

INTRODUCTION

With the exception of one's family, there are few relationships more important than the employer-employee relationship. Each day literally thousands of employment relationships are terminated, often resulting in expensive and/or disruptive disputes. Between 1971 and 1991 employment lawsuits filed in Federal Court have increased 430 percent compared to a 17 percent increase in personal injury suits (Lusky, 1997, p. 8). In fact, employment lawsuits resulting in multimillion-dollar verdicts are now commonplace and well publicized.

[A] wrongful employment practices claim is just one piece of the litigation pie that is growing by leaps and bounds, can easily cost a company six figures to defend. (Israel, 1998, p. 41).

Despite the highly visible and litigious nature of this environment, many employers and employees somehow feel they are better off without a contract. To some degree, it is a normal human tendency to avoid obligations and commitments. Usually, when there is an employment contract, it is only because one party refuses to act without a contract. Perhaps the party requesting the employment contract is seeking to obtain a commitment by making a commitment. It also seems logical that, in most situations, the party with the greatest bargaining power has the least to gain from a contract. Professional sports provide an excellent example of the pros and cons of an employment contract. After having a great year, professional athletes often want to get out of their contracts and become free agents.

However, if they are injured and unable to contribute, they are relieved that they have a contract to protect them.

It might seem logical that an employer would be better off not having contracts with non-critical employees who can be easily replaced. However, this may not be a prudent business practice. The focus for both employer and employee should be *what* the contract contains, rather than whether or not they should enter a contract. Written employment contracts are not a fail-safe measure that prevents all employment disputes. However, they are effective tools for avoiding disputes by establishing a process that limits the damages following a dispute.

The purpose of this article is to make the case that, in almost all situations, both employers and employees benefit from a written contract detailing the terms of employment. The article has three sections. The first section deals with the problems that can occur without employment contracts. The second section compares the processes of litigation and arbitration. The final section reviews the potential benefits of employment contracts.

PROBLEMS WITHOUT CONTRACTS

Misconceptions about Contracts

The belief that avoiding a written contract will result in the avoiding of responsibility is dangerous for both the employer and the employee. One misconception is that the absence of a written employment contract exempts employers from responsibilities to their employees. A second misconception is that, if the employer and employee do not enter into a written employment contract, there is no basis for an employee's claim of breach of contract. In both cases, the law provides that, regardless of whether a written employment agreement exists, both employers and employees have legally enforceable responsibilities to each other.

An employer might believe that it would be sensible to have written contracts only with employees who would be difficult to replace. Implicit in this line of reasoning is that, if it became necessary to terminate an employee who did not have a written contract, the terminated employee would not have a claim against the employer. However, this logic is seriously flawed. A terminated employee may successfully sue his/her employer even without a written contract. The problem may be further complicated by "*statements in supervisors' manuals, company regulations, or employee handbook guidelines that prescribe discipline and discharge procedures*" (Clark, *et al.*, 1998, Sect. 114, 129). An employee who is discharged in violation of these types of written documents or guidelines could have a breach of contract claim against the employer.

Further, public policy "*prohibits an employer from firing a worker for a reason that violates basic social rights, duties, or responsibilities*" (Beatty and Samuelson, 1996, p. 695). For example, an employee who is fired because he/she refused to violate the law at the request of her employer will likely be successful in a lawsuit against his/her employer. In the event of termination, the notion that not having a written contract will insulate the employer from employee lawsuits is dangerous and misleading. In certain situations, some courts also hold that "*an employer's discharge of an employee breaches an implied covenant of good faith and fair dealing*" (Business Law, 1998, p. 8.001).

Unfortunately, part of the problem and misunderstanding stems from a misconception of the term "contract". A properly drafted contract does not add to the employer or employee's obligations. Rather, it defines each party's responsibilities and exempts the parties from the obligations they do not wish to undertake. Reducing their employment agreement to writing has advantages for both the employer and employee. Having a written agreement in place

provides the attorneys of both parties with concrete evidence to review prior to committing themselves to litigation, which can be a lengthy and expensive process. In fact, employment contracts may actually help an employer avoid litigation stemming from a termination.

Implied Contracts

Another important consideration is that it is important to avoid implied contracts. One of the critical ingredients for the success of any business is the ability of the employer to assemble an effective workforce. The threat of a lawsuit by a terminated employee inhibits this process. Lusky (1997, p. 13) maintains that personnel decisions that result in firing an employee potentially represent the greatest risk of litigation to employers.

In the past, employers were protected from lawsuits brought by terminated employees by the employment-at-will doctrine. However, Tobias (1997, Sect. 101) notes that the protection offered by the employment-at-will doctrine eroded in the late 1970's. In an era of growing social consciousness, labor practices that gave employers complete freedom to terminate employees at will were no longer considered reasonable. Currently, most states adhere to "what is commonly called the 'implied-in-fact contract exception' to the at-will rule" (Tobias, 1997, Sect. 4.01).

A potentially dangerous aspect of an implied contract is both employers and employees may actually have obligations they never intended to assume. Although these responsibilities were never agreed to, they may result from a variety of sources. Examples include employee handbooks or what a supervisor/manager told an employee. These responsibilities may also arise from what a judge feels is appropriate given the nature of the relationship.

The unpredictability of implied contracts creates a serious problem for both the employer and the employee. In these cases, either party could be legally punished for what they believed was acceptable behavior. A written employment contract should reduce the misunderstanding between employers and employees that give rise to lawsuits based on implied contracts. When employment contracts are written, both the employers and employees have the opportunity to discuss these contracts with their lawyers. These contracts should clearly explain the responsibilities of each party. Finally, the employee and employer's signatures acknowledge their acceptance of the responsibilities stipulated in the contract.

Small business owners often wrongfully assume that, without a written contract with their employees, no legally enforceable contract obligation exists and that there will be no legal problems associated with terminating an employee. Under the implied contract theory:

[T]he courts will find that an employee handbook or other written documents setting out terms and conditions of employment including discharge and disciplinary procedures, creates an implied contract between employer and employee that the employee will not be fired except in accordance with those procedures. For example, if the handbook talks about progressive disciplinary procedures and lists certain conduct that will serve as grounds for discipline or discharge, a termination that does not follow the procedures set forth in the handbook, or that is for a reason other than those listed, may be considered a breach of the implied contract and, hence, wrongful. (Business Law, 1998, p. 8.002)

LITIGATION VERSUS ARBITRATION

Litigation against Officers

Employees who believe they have been mistreated by their employers are bringing legal actions against their employer corporation and its directors and officers individually. There are good reasons for the employee's attorney to individually name officers and directors in an employment lawsuit even though this may cause considerable discomfort to these persons. For instance, if an officer or director is not sued individually and it turns out that, although the suit is successful, the corporation has no assets, the judgment will be financially meaningless. Another reason for suing an officer or director is that employers are not always liable for the actions of their employees, and the jury may decide that, even though a tort (i.e., civil wrong or negligence) has been committed, the corporation is not responsible.

During the course of the 1980's, the corporate director's job, once regarded as a comfortable symbol of business achievement without too much responsibility, became, in the slightly hyperbolic words of Business Week: "a job nobody wants." (Olson and Hatch, 1998, Sect. 1.01)

An important consideration is the oversight function that knowledgeable directors provide investors. One of the greatest benefits that a company can provide to their officers and directors is to limit their exposure to lawsuits.

Corporate officers are no less concerned than directors because they are subject to much the same duties of loyalty and care as directors, and they cannot avoid liability by declining the honor of service: their livelihoods are at stake. (Olson and Hatch, 1998, Sect. 1.01).

Today, (former) employees are suing their (former) employers at an ever-increasing rate. Indeed, one survey shows that employees were involved in 25 percent of the claims against corporate officers and directors. While the charges in these claims have a wide range, Chew (1998, p. 155) maintains that "*allegations based on wrongful discharge laws are the single most common type of claim.*"

An employment contract can be used to avoid litigation in two ways. First, a contract that outlines the responsibilities of both employer and employee should prevent claims that arise based upon a misunderstanding between the parties. Second, the contract can specify that disputes arising from the employment must be settled by arbitration. Although it is still possible to sue the corporation, its officers, and directors personally, an arbitration clause in the employment contract should dramatically reduce the likelihood of this happening.

Officers and directors of smaller corporations are more likely to be sued individually because in a small corporation there is a much greater likelihood of the officer or director being involved in an employment dispute. Also, the officer or director may be named in the action for allowing a sexually hostile environment to exist within the company (Bennett, 1996). Thus, the officer or director may be liable not only for his/her own conduct but also for the conduct of employees under his/her control.

Avoiding Litigation by Requiring Arbitration

A mandatory arbitration clause in a contract can result in more predictable resolutions of employment disputes. One of the advantages of requiring parties to arbitrate employment disputes is that it avoids the unpredictability of litigation. The predictability of settlements in

disputes resolved through arbitration comes from the common practice of publishing the results of arbitration decisions. Many believe that publishing arbitration settlements serves to create employment guidelines (Elkouri and Elkouri, 1997, p. 601). These guidelines serve as a frame of reference for employee-employer relationship. They also provide both employers and employees a basis for "*resolving their grievances prior to arbitration*" (Elkouri and Elkouri, p. 600). Additionally, the publication process makes the arbitrator more accountable and creates a body of information that can be used for guidance in future decisions.

The employment agreement can also stipulate the process used to select the arbitrator. One of the many options in this process is the mutual agreement of both the employer and employee. Public information on arbitrators is now available from a variety of sources. This information may include education, affiliations, published awards, and experience (Elkouri and Elkouri, 1997, pp. 204-205). In most cases, arbitrators have experience deciding common employment issues. Given similar issues, an arbitrator's "award spectrum" should be much narrower than it would be for juries. In fact, publishing past awards from arbitrators can be helpful to both employees and employers. Prior awards on similar fact patterns may provide both parties with a critical heads-up, which could result in more realistic expectations concerning the eventual outcome. Arbitrators are also immune from community attitudes and prejudices that can potentially influence juries (Littler *et al.*, 1996, p. 2.003).

Speedy Resolution of Disputes

It is usually to the advantage of both parties to avoid litigation and settle an employment dispute in a timely fashion. This is because:

[L]itigation is nothing if not adversarial . . . it can take years to bring an employment dispute to trial. By that time, what may have started out as a misunderstanding or mistake that could have been remedied by reinstatement and a few thousand dollars in lost wages has turned into a battle of epic proportions. (Bales, 1997, p. 159-160)

In arbitration, the involved parties can decide who will hear the matter, how long the arbitrator will have to decide the case, and whether to make the arbitration decision binding. These factors combine to make the process more efficient by avoiding time consuming appeals and other variables. Often, the arbitrator is selected because he/she is considered an expert on the disputed issue. In this case, the arbitrator can use this knowledge to resolve the dispute. Contrasting arbitration with litigation, a judge with extensive personal knowledge of a case would be disqualified from hearing the case (Siegel, 1997, Sect. 586). Additionally, the long, costly, and risky business of jury selection is avoided in arbitration.

Since "[a]rbitration is a form of dispute resolution almost wholly independent of the court system" (Siegel, Sect. 586), employment contracts requiring arbitration provide a more efficient process than litigation. An employment contract allows the parties to tailor the process to avoid the aspects of the litigation process that are inefficient in advance of a dispute. To some degree, the safeguards of litigation are traded off for the speed and economy of arbitration. However, the delays inherent in the litigation process can consume vast amounts of emotional energy. The litigation process also detracts attention of both employer and employee away from everyday critical business concerns.

Disputes that are settled on a timely basis through arbitration also have the advantage of quickly disabusing both parties of any unrealistic notions they may have regarding the dispute. The employee involved in the dispute (and watchful co-workers) may discover that the actions of the employer, although seemingly unfair, are not going to result in a settlement.

On the other hand, the employer may discover that current methods are indeed actionable. Employers may also come to realize that, to avoid future damages, they must immediately change how they do business.

Avoiding Lawsuit Blackmail

A jury sometimes returns a verdict that is in excess of the damages demanded in the complaint. While the plaintiff could amend their complaint, the court would have to agree to allow this modification (36 NY Jur 2d, 1997, Sect. 191). To avoid the possibility of "under bidding" their case, attorneys often demand damages far in excess of what they expect to receive or would take to settle the case. Therefore, the tactic of initially demanding a higher amount is a fail-safe procedure that reduces uncertainty. In light of dramatic jury awards recently made in this area, it may be a wise strategy for the plaintiff to sue for a large amount because this tactic has few, if any, disadvantages.

Being sued for an excessive amount can be the source of numerous problems for the defendant employer. This is because more and more businesses have their financial statements audited each year. As a normal procedure, the firm performing the audit requests a listing and analysis of pending or potential litigation from the business's attorney. Pending litigation containing a large demand for damages can negatively impact the employer's ability to borrow or attract new investors. For example, an employee is suing his/her employer for \$2,000,000. The employer's attorney must reflect this pending litigation in the official report.

Still, what drives employers and their attorneys to settle cases that have little or no merit? To answer this, we will continue our prior example. Additionally, assume that the employee offers to settle the \$2,000,000 claim for \$100,000. In this case, it may be very tempting for management to pay even if the case against the employer is very weak and not worth this amount. The reason it is tempting is that, if management refuses to pay and the matter is tried, a jury could award an amount in excess of \$100,000. Consider the reaction of the Board of Directors if the original settlement offer is turned down by the president and a jury awards \$800,000 to the employee. In this situation, the judgment of both management and the attorney who refused to settle would be severely questioned. As a result, being sued for a substantial sum creates a climate of uneasiness. This is particularly true for the directors of the defendant employer who may not be familiar with the litigation process.

An employment contract can reduce the impact of lawsuit blackmail. With an employment contract requiring binding arbitration, the amount of the award is a more predictable than would be the case with a jury (Littler *et al.*, 1998). This is because some of the arbitrator's past decisions under similar circumstances may be available for review by the parties (Littler *et al.*, 1988). Because they can gauge the potential size of the award, management may be less tempted to settle a case without merit.

BENEFITS OF EMPLOYMENT CONTRACTS

Protecting Proprietary Information

Having an employee leave and go to work for a competitor is not something most employers want. One of the concerns employers have when an employee goes to work for a competitor is that, in addition to losing a skilled employee, the employer may also be losing proprietary information. Even a relatively low-level employee who quits and joins a competitor can present serious problems if that employee had access to proprietary information.

The general rule is that an employee is free to quit his or her job and either join a competitor or start a business unless:

- 1. there is a valid contract through which the employee has agreed not to do so, or*
- 2. the employee takes the employer's trade secrets and uses them to compete with it.*

(Business Laws, 1998, Sect. 2.002)

Thus, unless employer has a contract with the employee that prohibits the employee from working for a competitor, the employee is free to do so. Even former employees who did not have access to trade secrets may pose a competitive threat. Former employees are not legally prevented from soliciting their former customers unless they "*acted wrongfully by either pilfering or memorizing customer lists*" (52 NY Jur 2d, 1997, Sect. 194). However, proving that a former employee memorized a customer list is problematic at best. Again, an employment contract gives the employer an opportunity to address the issues regarding what the employee can and cannot do after an employee is terminated. Employees can, and often do, challenge covenants not to compete on the grounds that they are unreasonable. However, it is difficult to imagine that there is any advantage in the employer not having a contract.

Public versus Private Process

An arbitration clause of the employment contract can provide that any dispute be treated in a confidential manner. The confidentiality aspect of the arbitration process can potentially benefit both employer and employee in employment disputes. Privacy is an important aspect because it is something that most individuals value. Indeed, a condition of many charitable donations is that the individual making the donation remains totally anonymous.

While the courtroom is a valued and important institution, it does allow universal access to its proceeding. However, parties involved in employment disputes often prefer a non-public forum for the settlement of the dispute. In fact, it is not uncommon that both employer and employee may have behaved improperly. So that, the proceedings could damage both parties if they are not confidential. Additionally, in a public forum, attorneys for both sides may be tempted to introduce evidence that is more embarrassing than relevant. Witnesses and the parties themselves may also feel more comfortable about testifying in a confidential atmosphere. If the employer or the employee desire, they can structure their employment contract to provide for confidential arbitration. The American Arbitration Association's National Rules for the Resolution of Employment Disputes (1997, p. 19) states that:

The arbitrator shall maintain the confidentiality of the arbitration and shall have the authority to make appropriate rulings to safeguard this confidentiality, unless the parties agree otherwise or the law provides to the contrary.

However, parties who desire confidentiality should explicitly require confidentiality as a supplement to the American Arbitration Association's general rules. The explicit requirement for confidentiality reduces the possibility of parties other than those involved in the arbitration process from gaining access to any information (Sellier and Shafter, 1997).

DISADVANTAGES OF EMPLOYMENT CONTRACTS

Enforceability of Arbitration Agreements

Like all other agreements, arbitration agreements are of little value unless they are enforceable. In general, employees and employers who enter into arbitration agreements are

bound by these agreements. The Supreme Court's Gilmer decision in 1991 is the most dramatic case regarding the issue of enforcing arbitration agreements.

[In this decision] the court gave its imprimatur to compulsory employment arbitration agreements by dismissing and ordering to arbitration an age discrimination lawsuit brought by an employee who had agreed to arbitrate all his prospective employment disputes. (Bales, 1997, p. 11)

The ability of employees to pursue other remedies despite the fact they have signed an arbitration agreement has been strongly supported by the Equal Employment Opportunities Commission. However, in situations that do not involve union employees or issues involving discrimination, an arbitration agreement that has been fairly entered into by both parties will be enforced in most situations.

The biggest disadvantage associated with employment contracts is the same as the biggest advantage (e.g., that they are enforceable in most cases). Litigation regarding employment contracts usually involves one party who wants to enforce the contract and the other party wants to be released from the contract. When parties enter into employment contracts, they are presumably satisfied with the terms and conditions of the contract. However, a change in circumstances may render the contract burdensome for one of the parties.

Example: Covenant Not to Compete

For an employer to successfully defend the enforceability of a covenant not to compete the covenant must protect a legitimate business interest and the restrictions must be reasonable in terms of time, area, and type of activity (Business Laws, 1998). For example, a public accounting firm in a small city would likely have a legitimate interest in prevent employees who leave the firm from competing with it. However, if the restrictions attempt to prevent the employee from practicing his/her profession within the entire state for a period of ten years, it is unlikely that such restrictions would be upheld because they are unreasonable. The court could reform the contract making the restrictions reasonable if it felt that would be appropriate under the circumstances.

For example, a freshly minted accounting graduate has no intention of staying with his/her employer beyond the two-year term of employment required for certification (e.g., the experience requirement for becoming a CPA). The covenant states that an employee who leaves his/her employment voluntarily may not work as a CPA in the community for a period of three years. Because the accountant does not intend to remain in the area beyond qualifying for certification, he/she signs an agreement thinking this portion of the covenant not to compete is not relevant because. Before the two years is completed, the new accountant marries a person who works and lives in the community and wants to stay in the community. The new CPA decides to stay in the community but there is no future with his/her current employer. In sum, employment contracts combined with an unexpected change in circumstances often result in one of the parties breaching the agreement. Breached agreements usually trigger litigation in which there is often no real winner. A study conducted by the risk management consulting firm of Tillingast-Towers-Perrin found that:¹

If it were viewed as a mechanism for compensating victims for their economic losses, the tort system is extremely inefficient, returning less than 25 cents on the dollar for that purpose. Viewed in this narrow sense, the system is only 25 percent efficient. Even conceding that the tort system also provides compensation for victims' pain and suffering, the study indicates that the tort system "is still less than 50 percent efficient. (Israel, 1998, p. 41)

CONCLUSION

Beatty and Samuelson (1996) maintain that both individuals and businesses use contracts to make the future more predictable. Written employment contracts create control and predictability for both employers and employees. These contracts can be advantageous to both parties because they help to avoid lawsuits. Arbitration is usually resolved far more quickly than lawsuits, which sometimes go on for years. The speedy resolution in arbitration avoids the problem of including pending litigation on the audited financial statements year after year.

Employment litigation is the flip side of the win-win theory of arbitration. Once the litigation begins, attorneys for each party do everything in their power to secure the most favorable result for their client. Of course, each side is interested in winning. Unfortunately, litigation consumes huge amounts of financial as well as human resources. In many cases, the "winner" in the litigation process is often the party that lost the least. Avoiding lawsuits without merit benefits both employers and employees. This is especially true for the small businessperson who could have the entire workforce tied up in the litigation hearing as witnesses.

Employer-employee lawsuits are likely to occur when one of the parties feels the other party has acted in a way that violates their contract. If the employment contract is in writing and clearly delineates the rights and responsibilities of the parties, the process of determining if a contract violation has occurred is simplified. Even without a written contract, a legal contract may still exist; however, when this occurs, it will be a composite of the verbal agreements of the parties. As previously noted, this situation also requires looking at what is stated in the employees' manual, past practices, and other indicators.

If the parties do not have a written contract, the attorney representing the party (normally the employee) initiating lawsuit is forced to rely to a great extent on the client's understanding of the oral or implied employment agreement. The attorney for the party being sued (normally the employer) is similarly limited. As a result, both parties may honestly overestimate the strength of their case. In such circumstances, they are "giving birth" to a lawsuit that neither side can effectively win. Written employment contracts can avoid these problems and help to avoid the time-consuming process of litigation.

Large corporations, whose employees belong to unions, normally have human resource departments and commonly use both employment contracts and arbitration to reduce disputes. On the other hand, smaller employers often view employment contracts and arbitration agreements as unnecessary and intrusive devices that impinge on their freedom to run their business as they see fit. The small businessperson may be correct; employment contracts and arbitration agreements do restrict how they handle employment disputes. However, the alternative of protracted litigation may be far worse. The irony is that the small businessperson, who does not have employment liability insurance, cannot afford even one excessive verdict or perhaps even one pyrrhic victory.²

Other non-legal issues can also be affected by arbitration agreements. Productivity can be higher because both employers and employees have taken time to consider their relationship. Each party understands their individual responsibilities and what they can expect in return. During an extended litigation process, rumors about the outcome can harm what was a relatively congenial working environment. Because of the relatively short settlement period offered by arbitration, morale should not suffer as it sometimes does in the case of protracted litigation. Finally, because the decision of the arbitrator is final, the additional trauma caused by the appeal process is also avoided. The effects of these factors can be especially harmful in the small business environment where most employees are familiar with one another.

ENDNOTES

1. According to this firm, employment lawsuits resulted in damages of about \$160 billion in 1994, which is about 66 percent of what the United States spent on National Defense in 1994.
2. For more information on arbitration, contact the American Arbitration Association at: American Arbitration Association; 140 West 51 Street; New York, NY 10020-1203; Phone: (212) 484-4011; Fax: (212) 541-4841; E-mail: usadrpub@arb.com; Web: <http://www.adr.org>.

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