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## The Human Side of Commercial Law

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# The Human Side of Commercial Law

Daniel Keating\*

Commercial law can be a complex and technical subject. Every course that I teach has a code with lots of different rules that interact in various ways—some of them quite complicated. But that’s not the focus of my discussion. Instead, I want to address here the softer side of commercial law. You are, after all, witnessing the work of an English and Psychology major from a small liberal arts college in Monmouth, Illinois. The parts of commercial law that I want to focus on today harken me back to my days as an undergraduate, when I studied the fascinating subject of human behavior both as a formal science and through great literature.

In fact, as I prepared this discussion, I thought about the advice of one of my Psychology professors at Monmouth College, who used to urge his students before they gave a class presentation on a technical subject: “Explain it in a way so that your grandparents from Oquawka can understand it.” I didn’t realize until after I had graduated that there really is a small town in Illinois called Oquawka, but the utility of my professor’s advice had already been imprinted on my brain. He wanted us to present our topic in a way that was accessible even for the uninitiated, and to present our thoughts with short simple prose rather than with technical jargon. I suspect this advice is just as valuable for law students as it is for a chair installation speaker on a Thursday afternoon.

I chose today’s topic because it is the human side of commercial law which first sparked my interest in the subject and which has sustained my research throughout my career. As I look back over the issues on which I have written, I see recurring illustrations of the

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same human characteristic. An optimist would describe that common thread as the human capacity for hope in a better future. A cynic would call it the human tendency toward self-delusion and procrastination. The truth lies probably somewhere in the middle.

Let me give you three concrete examples of what I mean and describe in each case how the human side of commercial law played itself out in each context. These three examples illustrate that it is not enough to understand the legal rules without an appreciation for human motivations and characteristics that can end up dominating the law that is on the books. First, there is the problem of retiree medical benefits in bankruptcy. Second, I will discuss the issue of underfunded corporate pension plans. And third, I will discuss some recent empirical work that I have done involving the “battle of the forms” in the sale of goods.

The first article that I published as a law faculty member was about retiree medical benefits in bankruptcy.<sup>1</sup> I chose this topic because it was the subject of one of the last memos I wrote as a bankruptcy attorney for the First National Bank of Chicago. As a lawyer for First Chicago, I was focusing on some very technical issues that the bank cared about as a lender to companies that occasionally filed for bankruptcy. In the late 1980s, Congress had amended the Bankruptcy Code to include a new section that would give retiree medical benefits a special priority in Chapter 11 bankruptcies.<sup>2</sup> What First Chicago wanted to know was whether this priority would undermine its own position as a creditor.

As a practitioner, I had a responsibility to my client, the bank, to answer the very focused issue that was set out for me. As an academic, though, I had the luxury of considering the bigger picture, and in particular the human dimensions of this issue. What I discovered was a trail littered with evidence of the human tendencies toward procrastination and self-delusion. The problem of retiree medical benefits in the late twentieth century, I quickly realized, was a classic example of a broader phenomenon known as deferred maintenance.

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1. Dan Keating, *Good Intentions, Bad Economics: Retiree Insurance Benefits in Bankruptcy*, 43 VAND. L. REV. 161 (1990).

2. *See* 11 U.S.C. 1114 (1994).

The way most retiree medical benefit programs work is that a company will promise its current workers that if they stay with the company a certain number of years, then the workers will receive free or significantly subsidized health benefits when they retire from that company. It is a way to induce workers to remain with the same company even if a slightly higher base salary can be found elsewhere.

The problem with retiree medical benefits is that there is no requirement that they be funded in advance by the company that promises them. That is, there is nothing that forces a company to set aside money now to account for the fact that current workers are today accruing the right to collect significant benefits in the future. Retiree medical benefits have historically been handled on a cash basis—the company pays the benefits for current retirees as they come due, but does not save additional money now for future benefits that will necessarily accrue over time. If the number of retirees and workers remains constant and medical costs don't change, paying these benefits on a cash basis would not produce a deferred maintenance problem. However, when the number of retirees grows relative to the number of workers *and* medical costs outpace inflation, then you have the makings of a real mess.

The problem is particularly acute in manufacturing industries where the ratio of younger workers to older workers keeps shrinking. It is not difficult to see, then, how the problem of retiree medical benefits stems from the very human tendency to procrastinate if we are given the chance. At a rational level, the managers of these companies must know that these deferred obligations will eventually come due, but, on the other hand, why worry about the future when there are today's bills to pay?

Indeed, some academics have argued that one of the key justifications for having a consumer bankruptcy law is that it recognizes and accounts for the natural human proclivity to believe that somehow things will be better in the future than they are today.<sup>3</sup> Thus, as we run our consumer credit facilities to the limit and respond to additional invitations for credit cards from increasingly eager credit-card purveyors, we conveniently look past the possibility

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3. See, e.g., Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1985).

that something bad may happen to us in the future. And sadly, the unaccounted for future misfortune often requires a greater financial margin than we have left ourselves with.

In exploring the origins of deferred maintenance, there are actually two different human tendencies at work. The first is the belief that somehow in the future things will be better than they are now and that everything will eventually work itself out. “Why fund retiree benefits now when our future cash flow will likely be adequate?” There is also, however, a second mental trick at work, one perhaps more disturbing than the first: “Well, if eventually things don’t work out, it won’t be *my* problem—by that time, I’ll probably be with a different company. Why make hard choices now for someone else’s benefit in the future?” I have to confess that one of my personal pet peeves is when people are able to externalize the costs of their own bad decisions. But that, unfortunately, is one of the by-products of the deferred maintenance phenomenon.

Nor are academics or government leaders immune from the trap of self-delusion that leads to deferred maintenance problems. Some of our most esteemed academic institutions on both coasts of the country suddenly found themselves faced with deferred building maintenance in the hundreds of millions of dollars for which they had set aside no adequate reserves.<sup>4</sup> The hard lessons that these universities learned in a very public way helped to spur other academic institutions to a more realistic policy about setting aside funds for the inevitable deterioration of physical facilities. On the government side, the current social security conundrum is a classic example of politicians refusing for too long to account in an honest way for the increasing pool of retirees coupled with a relatively smaller work force who are paying into the social security system.

When I was studying the retiree health benefits problem, what was perhaps most fascinating to me was not the human foibles at the corporate level that created the mess in the first place. Rather, it was the superficial Congressional solution that itself only postponed the day of reckoning. In July of 1986, the LTV Steel Company filed for Chapter 11 bankruptcy and informed its 68,000 retirees that the

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4. See, e.g., Martin Van der Werf, *Yale’s Ambitious Renovation Program Tops Any Undertaken by University*, CHRON. OF HIGHER ED., Oct. 20, 2000.

company would cease to pay the medical benefits that they had all been promised for their lifetime of service to the company.<sup>5</sup> Led by Senator Howard Metzenbaum, whose state included many LTV retirees, Congress amended the Bankruptcy Code to give retiree medical benefits a special priority status in Chapter 11 reorganization cases.<sup>6</sup> This amendment increased the chances that the retirees would be the fortunate creditors who would be paid from the limited assets remaining in the company.

As it turned out, this band-aid approach was good enough to handle the problem in this particular bankruptcy case, but the solution left for another day similar risks faced by retirees from other companies. Because the new legislation applied only to Chapter 11 reorganization cases, it would end up affecting only a fairly small percentage of the total cases where companies become insolvent. Although retirees now receive a special priority for their medical benefit claims in Chapter 11 cases, they do not receive a preferred position in Chapter 7 bankruptcy liquidations or in nonbankruptcy dissolutions.

Furthermore, the new legislation ignores the zero-sum nature of bankruptcy. If retirees are suddenly receiving a higher priority, then that means other unsecured creditors are going to be in a relatively worse position. And while no one will likely shed any tears when banks such as First Chicago receive a lower payout on their loan recoveries, other more sympathy-evoking creditors such as tort victims must now also face the prospect of a diminution in their recovery from a Chapter 11 debtor.

The Congressional solution, then, was itself a great example of the human tendencies of self-delusion and procrastination—only this time practiced by our federal government. The hard choice would have been to tackle the real problem behind crises like we saw in LTV: namely, to address the failure to pre-fund the corporate promise to provide medical insurance to retirees. That choice, however, would have created short-term political costs from angry business owners

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5. *Oversight Hearing Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 99th Cong., 2d Sess. 149 (1986).

6. Retiree Benefits Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (codified as amended at 11 U.S.C. 1114 (1994)).

who suddenly would have lost the ability to defer maintenance on their retiree medical benefits. So Congress did the human thing and chose the course that was cheap and painless in the short run, but costly in the long run.

It didn't take long for bankruptcy judges to experience first-hand how deficient this superficial solution really was. In a case that was heard just two years after the enactment of the retiree medical benefits legislation, a Chapter 11 company had literally no assets that were left to distribute beyond those on which there were already existing security interests.<sup>7</sup> The judge in that case received a written statement from one of the sponsoring senators of the retiree benefits legislation. That senator urged the judge to force the continued payment of retiree benefits in this case, notwithstanding the lack of any unencumbered assets in the bankruptcy estate. The obviously exasperated judge ignored the senator's plea and noted in his opinion that "short of printing money, there is no way to see that all claims are paid in full."<sup>8</sup>

A second example of the human side of commercial law played itself out in the area of underfunded pension plans. You can think of the underfunded pension problem as a closely related cousin to the retiree medical benefits mess. The difference between the two is that with underfunded pension plans, Congress actually bit the bullet and decided to require pre-funding as a condition to a company gaining favorable tax treatment for its pension plan.<sup>9</sup> In addition, Congress created a federal insurance agency that would serve as a safety net to take over payments to retirees where companies failed to make their promised pension payments.<sup>10</sup> All in all, it sounded like this was a legislative scheme that faced the pension underfunding problem head-on and did not fall prey to the human tendency to put off hard decisions.

Unfortunately, the fine print here left too many loopholes in which the humans in charge of the funding decisions could still practice

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7. *In re GF Corp.*, 115 B.R. 579 (Bankr. N.D. Ohio 1990), *vacated in part*, 120 B.R. 421 (Bankr. N.D. Ohio 1990).

8. *Id.* at 585.

9. Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65, 68-71.

10. *Id.*

deferred maintenance. In particular, there were actuarial assumptions that could be easily and legally manipulated;<sup>11</sup> there was a transition issue in which companies could defer pre-funding for employees who had already accumulated past-service credit by the time that a company's program began;<sup>12</sup> and there was the phenomenon of "agency capture," in which the folks from the government who were in charge of monitoring a company's pre-funding were just too friendly with the company managers who were supposed to implement those requirements.<sup>13</sup>

What began to happen in practice, then, was that companies experiencing financial problems would offer their employees significant increases in their future pension payments in lieu of a larger increase in wages. Wages, of course, have to be paid with present cash. Increased pensions could be paid later, and even the pre-funding requirements gave financially struggling companies ample room for payment over time. Once again, LTV Steel was the poster child for all that could go wrong with this regulatory scheme, a scheme that still left plenty of room for the human proclivity to procrastinate. By the time LTV filed for bankruptcy, its pension programs were underfunded by two *billion* dollars.<sup>14</sup>

My third and final example of the human side of commercial law comes from recent work that I have done in the sale of goods area. There is a provision in Article 2 of the Uniform Commercial Code that deals with a situation known as the "battle of the forms."<sup>15</sup> Here is how a battle of the forms case arises: Buyer sends a purchase order to Seller in which Buyer offers to purchase a stated quantity of a certain kind of goods from Seller. Buyer's purchase order form includes terms that are customized to the particular order, such as the type of goods, the quantity of goods, and the time and place of delivery. Buyer's form also includes some standard pre-printed language that is not specific to this deal, such as Seller's warranties (which Buyer specifies in a very expansive way) and Buyer's

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11. Daniel Keating, *Chapter 11's New Ten-Ton Monster: The PBGC and Bankruptcy*, 77 MINN. L. REV. 803, 809-13.

12. *Id.*

13. Keating, *supra* note 9, at 78.

14. *Id.* at 66.

15. U.C.C. § 2-207.

remedies if Seller breaches (which are also quite generous to Buyer).

When Seller receives Buyer's purchase order, Seller responds with an acknowledgment form of its own. The deal-specific terms are the same as Buyer's form, such as type of goods, quantity and delivery terms, but the pre-printed terms are quite different: Seller's warranties are all disclaimed, and Buyer's remedies are minuscule. After Seller sends its form to Buyer and Buyer does not object to the form, Seller ships the goods and Buyer sends its payment. Everyone is happy for the moment. Buyer gets the goods it wants, and Seller makes another sale. But occasionally something goes wrong with the goods and suddenly Buyer is forced to look to the warranties and remedies under the contract. The question is: Whose warranties and remedies apply—those on Buyer's form or Seller's form?

The battle of the forms scenario is fascinating from a psychological perspective. In a sense, it is a situation that turns standard contract law on its head. The battle of the forms is essentially a deal in which the two parties recklessly, if not knowingly, consummate a sale of goods without having settled on all of the terms. And while one could argue that every contract is incomplete at some level, what distinguishes the battle of the forms case is that these contracts are most often incomplete at very fundamental levels. Left unsettled are issues like warranties, remedies, and other matters that no one could pretend were beyond the contemplation of the parties at the time of formation.

A second distinction between the battle-of-the-forms situation and the typical incomplete contract is that with the battle of the forms, each side has specifically proposed something for the open term so we know exactly what both parties *wanted* for that term. So why don't the parties sit down and settle these issues in advance? Once again, I attribute it to the tendency we all have to put off unpleasant things if we can. Note that the issues being left unsettled are all non-immediate terms, things that the parties figure they can worry about later, or worse yet, that someone *else* can worry about later. But if and when later comes and something goes wrong with the deal, the parties or their successors are left to wind their way through a complicated statutory morass that sets up default terms for the parties that may or may not be optimal for their particular deal.

In a series of interviews with business people and in-house

lawyers, I learned some interesting things about the way sales transactions are actually conducted in practice.<sup>16</sup> I also learned that even modern technology cannot overcome certain human traits such as the desire to postpone difficult negotiations whenever possible. In many sales of goods transactions today, buyers and sellers no longer exchange paper forms but instead place orders via e-mail through a system called Electronic Data Interchange (EDI). In order to conduct business using EDI, the two sides have to first sit down and draft a single Trading-Partner Agreement that is supposed to include all of the terms and conditions for future sales between the two parties.<sup>17</sup>

One might imagine that when two parties are going to engage in a series of transactions over time, they would have the appropriate incentives to spend the time to negotiate even non-immediate terms of the sales contract such as warranties and remedies. What was fascinating for me to learn, however, is that in many of these EDI arrangements, the two parties simply will put in the agreement that “Seller’s standard warranties and remedies will apply and Buyer’s standard warranties and remedies will apply.”<sup>18</sup> They include this term even though both sides know full well that the two side’s warranties and remedies are very different from one another. Yet the desire to avoid making hard choices in the short term, combined with the ability to postpone the day of reckoning on these non-immediate terms, can lead both parties to take this easy out. Somehow, they choose to avoid negotiating to conclusion on such key terms even in the face of such an obvious opportunity as the drafting of the Trading-Partner Agreement.

I suppose I could stop right here and conclude with the thought that I have loved studying commercial law not only for the challenge of the complex statutes that it presents but also for the human element behind these technical laws. Yet, now that I have identified a common thread that runs through so many of the major commercial law problems I have studied, I feel as though I ought to offer at least some brief observations on what lessons we can learn from the

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16. Daniel Keating, *Exploring the Battle of the Forms in Action*, 98 MICH. L. REV. 2678 (2000).

17. DANIEL KEATING, SALES: A SYSTEMS APPROACH 57-58 (1998).

18. *Id.*

pattern I have discerned. Let me suggest three quick thoughts on the implications of that pattern for commercial law reformers.

First, if you set up a system in which human actors can postpone pain, they probably will. Therefore, you need to create statutory structures that include immediate consequences for the failure to account for future contingencies. If there are not immediate consequences, the problem will only be postponed and aggravated.

Second, for the bankruptcy law reformers, always remember that bankruptcy, like much of a life, is a zero-sum game. Therefore, if you create new bankruptcy priorities with no pre-funding requirement, you are necessarily reducing the relative priority of some other, perhaps worthier, claimant to the assets of the bankruptcy estate. The Bankruptcy Code, which began as an attempt to distribute limited assets in an even-handed way, has increasingly become tilted toward whatever special-interest lobby can produce the biggest campaign contributions.

And finally, commercial law reformers should not assume that technological advances in how business is conducted will solve problems that have their roots in the human condition. Technology creates various efficiencies in commerce, but it cannot by itself overcome certain human tendencies possessed by all, such as avoiding hard choices whenever we can and favoring the path of least resistance in the short term whenever that path is made available to us.





