INDUSTRY
COMMISSION

PRODUCT LIABILITY

REPORT NO. 4
18 JULY 1990

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INDUSTRY COMMISSION

18 July 1990

Honourable P J Keating, M.P.
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

In accordance with Section 7 of the Industry Commission Act 1989, we have pleasure in submitting to you the report on Product Liability.

Yours sincerely

M L Parker	D L McBride	R J Whitelaw
Presiding Commissioner	Commissioner	Associate Commissioner

COMMISSIONER

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TERMS OF REFERENCE

The following are the terms of reference received by the Commission[1] on 18 October 1989.

Industries Assistance Commission Act 1973

I, PAUL JOHN KEATING, in pursuance of Section 23 of the Industries Assistance Commission Act 1973 hereby:

1 refer to the Commission for inquiry and report the matters of:

(a) the economic effects of proposals advanced in the Australian Law Reform Commission report on product liability; and

(b) the effects of those proposals on product innovation and insurance changes.

2 specify that the Commission is to report to these matters within nine months of the date of receipt of this reference.

3 specify that the Commission is free to hold public hearings in advance of releasing a draft report and to take evidence and make recommendations on any matters relevant to its inquiry under this reference.

P J KEATING

18 October 1989

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[1] On 9 March 1990, the Industries Assistance Commission (IAC) was incorporated within the Industry Commission. Section 54 of the *Industry Commission Act 1989* provides that where "…an inquiry or a report under the IAC Act had been begun but had not been completed before commencement, it may completed by the Commission as if it had been begun under this Act."

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ABBREVIATIONS

ACA	Australian Consumers Association
ACM	Australian Chamber of Manufactures
ALRC	Australian Law Reform Commission
APMA	Australian Pharmaceutical Manufacturers Association
BCA	Business Council of Australia
cif	cost, insurance and freight
CPI	consumer price index
fob	free on board
gdp	gross domestic product
IAC	Industries Assistance Commission
ICA	Insurance Council of Australia
MTIA	Metal Trades Industry Association
NISPP	National Injury Surveillance and Prevention Project
TPA	Trades Practices Act
TPC	Trades Practices Commission

OVERVIEW

The Industry Commission has been asked to report to the Commonwealth Government on

- the economic effects of proposals to change product liability laws, as advanced in a recent report by the Australian Law Reform Commission (ALRC), and
- the effects of those proposals on product innovation and insurance charges.

Product liability laws specify the circumstances in which people who suffer product-related loss are entitled to receive compensation from the producers of those products.

Their influence extends beyond people who suffer loss and producers who supply the goods concerned. Payment of compensation by producers will inevitably be reflected in higher product prices and will therefore affect all consumers. Product liability laws also influence the incentives for producers and consumers to avoid product-related loss -- for example, by building safer products or taking care when using goods.

This inquiry is largely about these incentives and their economic consequences. It is important to establish the right incentives because product-related loss is costly not only to the victim but also to the community. The cost of preventing product-related loss -- for example, by producing safer products -- can also be high. A proper balance is needed between all the benefits and costs of imposing liability on producers.

Under current laws, Australian consumers who suffer product-related loss may be entitled to compensation from producers if they can establish one or more of the following:

- a breach of a contract;
- negligence on the part of a producer; and
- a breach of a statutory product standard.

The laws are complex and overlapping, and there are gaps in the provision of compensation.

The ALRC has proposed an innovative approach to product liability which aims to marry the law and economic theory. It has put forward new concepts and a new scheme under which producers of goods would be liable to pay compensation to any person suffering loss caused by something 'those goods did'. To establish liability under these proposals, claimants would simply have to show that they suffered loss or injury as a result of 'the way goods acted'. There would be no requirement (as there is under current laws) for claimants to establish that the goods were 'defective' or that the producer was negligent or breached some statutory duty. A range of defences would be available to producers and there would be provisions to account for the unreasonable use of goods by consumers.

No practical regime can hope to attain a perfect assignment of liability, particularly given the grey areas that inevitably arise in establishing causes of loss. Thus, in examining current laws and the ALRC's proposals, an assessment of imperfect alternatives is involved.

There are problems with current laws. They fail to impose liability on producers on occasions when their goods cause loss, and impose liability on producers on other occasions when the consumer is at fault. For example, people who are injured by faulty products they do not own have difficulty in seeking redress, while owners of products sometimes receive full compensation for loss suffered even though their actions contributed to that loss.

The ALRC's proposals would overcome some of the deficiencies in the current laws. For example, they would provide equal treatment to owners and non-owners of goods. Also, they would make it easier for people injured by faulty products to secure compensation from the producers of those products. The proposals would therefore provide some economic gains, although the evidence suggests that these would be small.

The proposals would also have adverse economic effects. For example, they would provide inferior mechanisms for transferring liability from producers to consumers in the variety of circumstances where this is to the advantage of both. The use of

new life saving drugs which may have severe side effects is one such instance. Without effective mechanisms to transfer liability, such products may not be marketed.

The ALRC's proposals would impose other costs on the community. There would be adverse safety consequences if consumers were to respond to higher prices for new goods by substituting into less safe second-hand goods. Australia's export competitiveness would be adversely affected, albeit in a minor way. And there would be adverse effects on the economy if higher prices under the proposals flowed on to wages.

Adjustment costs would also be incurred as producers and consumers adapted to the procedures and precedents established under the new regime. The adjustment period could be many years.

Inquiry participants focussed on the costs of the ALRC's proposals in terms of their impact on insurance charges, product availability and product innovation. The Commission accepts that the proposals would increase product liability insurance charges and hence product prices, but not to the extent forecast by many in the business community. The proposals would not have a major impact on product innovation and product availability although, for some products such as pharmaceuticals, the impact could be significant.

The ALRC's proposals would avoid some inequities in current laws, but would create others.

Given the longer term efficiency costs, the adjustment costs that a new legal regime would entail, and the evidence that the benefits would be small, the Commission judges that the ALRC's proposals would reduce economic efficiency.

An outcome superior to both current laws and the ALRC's proposals could be achieved by relatively minor amendments to current laws. This approach would avoid many of the costs of the ALRC's proposals.

For these reasons, the Commission considers that the ALRC's proposals should not be implemented.

Details of the Commission's findings, together with a number of attributes which it considers a revised product liability regime should incorporate, are provided in Chapter 8.

1 THE INQUIRY

Product liability laws specify the circumstances in which people who suffer product-related loss or injury are entitled to receive financial payment from the producers of those products.

Over the past century, there has been a world-wide trend in product liability law away from 'buyer beware' towards 'producer beware'. Initially, a consumer could only sue a producer for a defective product if the product did not meet the specific requirements of a contract between them. Over time, producers' legal responsibilities to consumers have been increased in various ways: through specific product standards; through laws that specify basic conditions applying to all consumer purchases; and through development of the principle that producers owe a 'duty of care' to society generally.

While these trends have also been evident in Australia, the development of laws governing product-related loss has been complicated by Australia's federal system of government. Australian laws are complex, overlap and are deficient in certain important respects: for example, the unequal treatment of owners and non-owners of goods.

In a report into Consumer Product Safety in 1987, the National Consumer Affairs Advisory Council argued that there was a compelling need for a comprehensive product liability law that imposed 'strict' liability on producers, and recommended that the Commonwealth Government undertake a thorough study of any practical difficulties which might arise from its introduction.

The Australian Law Reform Commission (ALRC) was subsequently asked to review and report on whether the laws relating to compensation and damage caused by defective or unsafe goods were adequate and appropriate to modern conditions.

In its report, the ALRC (1989) concluded that problems with the existing laws could not be addressed within the existing legal framework, and proposed '... a new scheme of liability for compensation for losses caused by what goods do.' To

establish liability under the scheme, claimants would simply have to show that they suffered loss or injury as a result of 'the way the goods acted'. There would be no requirement (as there is under the current laws) for claimants to establish that the goods were defective or that the producer was negligent or breached some statutory duty. A limited range of defences would be available to producers and there would be provisions to account for the improper use of goods by consumers.

The aim of the proposed law was to assign liability to the party in the best position to take appropriate action to avoid product-related loss. The ALRC considered that its proposals would result in fairer and more economically efficient product liability law.

The ALRC's proposals prompted considerable debate. Consumer groups supported the broad thrust of the scheme, but the business community and some sections of the legal profession claimed that the proposals would impose undue burdens on producers, create considerable uncertainty, and therefore have substantial and unfavourable economic consequences.

In October 1989, the Industries Assistance Commission (now the Industry Commission) was asked to report to the Commonwealth Government within nine months on the economic effects of the ALRC's proposals and their effects on product innovation and insurance charges.

In preparing this report, the Commission drew on information from a variety of sources. It released an issues paper early in the inquiry and received evidence from interested parties in submissions and at an initial round of public hearings. The Commission released its Draft Report in April 1990 and received comments on it in further submissions and at a second round of public hearings. All up, some 120 submissions were made to the inquiry (see Appendix A). The Commission also held informal discussions with interested parties, and used information contained in the ALRC's report and in the various discussion and research papers released by the ALRC during its inquiry. These include papers prepared by an economic consultant that analysed the economic impacts of the ALRC's proposals (Braddock, 1989a, 1989b). The Commission also arranged two consultancies: one to examine product-caused accidents in Australia and the other to examine the effects of New Zealand's no-fault accident compensation scheme (Porter 1990, Somers 1990).

1.1 The Commission's approach

Laws governing product liability influence the way in which markets operate and so affect the range, quality and price of goods. Changes to these laws would therefore have not only legal impacts but also social and other economic effects.

In reporting on the effects of the ALRC's proposals, the Commission, in accordance with its policy guide-lines, takes an economy-wide view. That is, rather than focussing on the benefits and costs for particular sections of the community, it looks at the likely net outcome for the community as a whole.

This is no easy matter: it raises complex conceptual and practical issues. Although the more important economic effects can be identified, it is not possible to compare benefits and costs in any precise way. For example, there are trade-offs between the efficiency with which the community's resources are used and the fairness of the distribution of the nation's wealth. Perhaps most importantly, the effects of implementing the ALRC's proposals are extremely difficult to quantify before the courts have interpreted key aspects of the proposals.

In assessing the proposals, the Commission looks first at their effects on 'economic efficiency'. This refers to the productiveness with which the community uses its resources: it is about getting the highest value -- or 'net social benefit' -- from those resources. Product liability laws can affect efficiency by, for example, changing incentives for producers to build safe goods and by affecting legal and business costs.

In assessing the likely effects on economic efficiency, the Commission has considered both theoretical and practical arguments. Chapter 2 looks at the basis for product liability law and establishes objectives which an efficient product liability regime should aim to achieve. Chapter 3 compares both the current regime and the ALRC's proposals against those objectives. The aim is to determine which comes closest: if the ALRC's does then it would provide better incentives for the attainment of economic efficiency. Chapter 4 then considers the likely magnitude of any efficiency changes which would flow from the operation of the proposals. It looks at the size of deficiencies in the current laws which the ALRC's proposals are intended to address and also examines the impact of different liability regimes overseas.

The early chapters focus on the economic efficiency effects of the ALRC's scheme as if it had been 'bedded down' and was operating smoothly: they do not look at the adjustment costs involved in adopting the new regime. These adjustment costs derive from uncertainty as to how a new legal scheme would work in practice: particularly how new legal definitions would be interpreted by the courts. This aspect is discussed in Chapter 5.

Specific effects of the proposals, including the possible short-term and long-term effects on innovation and insurance charges, and the implications for government policy of some of these effects, are also examined (Chapter 6).

The second broad heading under which the Commission has assessed the ALRC's proposals is 'economic equity'. Equity, in this sense, refers to the fairness of the distribution of society's resources among its people. Product liability laws can affect equity by, among other things, providing for compensation for people who suffer product-related loss. The equity effects of the ALRC's scheme are discussed in Chapter 7.

In making its overall assessment of the case for implementing the ALRC's proposals, the Commission has drawn on its analyses of the economic efficiency and equity effects of the proposals and has also looked at alternative schemes which might address the problems in the existing law. This assessment is presented in Chapter 8.

2 THE BASIS FOR PRODUCT LIABILITY

The influence of product liability laws extends beyond the consumers who suffer loss and the producers who supply the goods concerned. The payment of compensation by producers will be reflected in higher product prices and hence will affect all consumers. Product liability laws will also influence the incentives facing all producers and consumers to avoid product-related loss. An appropriate set of incentives is important in promoting economic efficiency.

Although much of the discussion in this and the ALRC's inquiry focussed on product-related injuries, product-related loss has other dimensions. Damage to property and other economic losses sustained because products do not perform satisfactorily are also relevant.

Whatever its source, product-related loss is costly to both the victim and the community.

But the prevention of product-related loss is also costly. For example, direct costs are incurred when safety features are built into products. Indirect costs are incurred when, for example, additional safety features reduce the usefulness of a product or if accident prevention requires that products be withdrawn from the market.

Given these costs, it is not sensible to attempt to prevent all product-related loss: all motor vehicle accidents could be avoided if motor vehicles were banned but the safety benefits would, from an economic perspective, be far outweighed by the costs to the community of forgoing motor travel.

As the ALRC pointed out in its report, the goal is to establish an environment that leads producers to build safety or quality into their goods, and consumers to exercise care when using goods, up to the point at which the additional benefits from so doing are equal to the additional costs incurred. Because it will not be worth making products totally safe or exercising unlimited care, it is also important that consumers, when deciding whether to purchase goods, have regard to any damage they may incur and thus the total costs involved. The appropriate

incentives will be provided when these damage costs are included in the cost to the consumer: for example, in the price of the product or, as the Industry Commission notes, in the cost of an insurance policy separately purchased by the consumer. The term 'optimal loss prevention' is sometimes used to describe these economic efficiency concepts (see Appendix B).

Some of these objectives can usefully be pursued through product standards and product safety regulation, particularly in areas such as product design, but covering all products by regulations would be impossible. Moreover, regulation tends to be inflexible and to lag behind technological developments. This can be costly to the community.

Accordingly, in most countries including Australia, market competition, underpinned by a set of product liability rules, is generally seen in most circumstances as the best way of encouraging economically efficient levels of loss prevention.

Under a market-based approach, the form that product liability laws take is likely to influence the behaviour of both producers and consumers. If a high degree of responsibility has to be proven before a producer is liable to pay compensation, *the law* will provide only limited incentives for producers to have regard to the risk of their goods causing loss but will provide strong incentives for consumers to take care in using goods. Conversely, if only a low degree of responsibility has to be proven before the producer is liable to pay compensation, *the law* will provide only limited incentives for consumers to take care when using goods but will provide strong incentives for producers to have regard to the risk of their goods causing loss.

In terms of economic efficiency, the fundamental issue for this inquiry is whether the current regime (perhaps modified) or that proposed by the ALRC would promote better outcomes in respect of the production, purchase and use of goods.

2.1 The theory of product liability

The theory of product liability drawn upon by the ALRC to support its proposals highlights the crucial role of information costs: that is, the costs for producers and consumers of assembling and interpreting information about products and product safety. As discussed in Appendix B, if information were costless and producers and consumers could therefore have access to complete information about the likelihood

and possible costs of product-related losses, then economically efficient levels of loss prevention should result, irrespective of which party was assigned liability for product-related loss. In the real world, though, collecting and interpreting information is costly. Consequently, assessments by producers and consumers are usually based on imperfect information. For example, producers may be well informed about risks associated with the characteristics of a product and how those risks might be avoided, but poorly informed about risks associated with the way the product may be used by consumers.

The theory emphasises that liability should, in the first instance, be assigned in such a way as to encourage the party in the position to most cheaply assemble information about the risk of loss to do so. Which party this will be depends on the initial information that producers and consumers have and the costs of gathering additional relevant information. The expectation is that, if liability is assigned in this fashion, more information will be brought to bear. This will improve decisions influencing product safety and the purchase and use of goods (see Appendix B).

From this perspective, the relative economic efficiency of different product liability regimes will therefore depend on assumptions made about the information available to producers and consumers. To the extent that producers can more cheaply assemble information about the characteristics of their products that may cause loss (for example, product design and construction), the implication of the theory is that they should be made liable for losses caused by the characteristics of goods. Similarly, if consumers have better/cheaper access to information about the risks of accidents and loss arising from the improper use of products, the implication is that consumers (or persons advising consumers) should be liable for losses caused by product misuse.

These basic ground rules drawn from a consideration of the relative costs of assembling information must, however, be modified to take account of a number of market realities.

First, producers and consumers sometimes have equal access to information about the risk of product-caused loss. For example, in the case of products for which the risks are effectively unknowable, both producers and consumers have access to zero information. In such circumstances, assigning liability for product-caused loss to

producers would not improve safety decisions. The legal costs of transferring liability through the courts would be incurred for no efficiency gain.

Similarly, it is sometimes less costly for a consumer to bear the risk associated with the characteristics of a product even though the producer can more cheaply assemble information about that risk. In these circumstances, it will be efficient for the producer to make the information about the product available to the consumer -- such that they then have equal information about the risk -- and for consumers choosing to use the product to bear the risk involved. A case where this would be particularly relevant is where a drug causes an allergic reaction in people with a particular medical condition: it would be efficient for the producer to forewarn consumers of the risk and for consumers to be made responsible for avoiding the product if they have the particular condition, rather than requiring the producer to compensate any injured consumers after the event.

Second, consumers place different values on the various attributes of products, including the level of risk. Thus, even with adequate information about the risks of product-related loss, the willingness of consumers to accept risk will vary: that is, some consumers will choose to buy goods that other consumers consider excessively risky. To the extent that assigning more liability to producers requires them to build safer goods or to take out additional insurance, those consumers who want to accept high levels of risk may be forced to buy goods of a higher price and quality than they would prefer. Hence, the efficiency gains of assigning liability to producers to improve product safety decisions need to be balanced against the associated efficiency losses from over-riding consumers' risk preferences. The adverse efficiency effects of over-riding risk preferences are likely to dominate when consumers are willing to take relatively big risks. For example, AIDS patients may be willing to use the drug AZT -- despite its potentially severe side-effects -- because they perceive the alternative to be certain death. However, if the producer was liable for any loss or injury sustained from the use of AZT, the producer would need to increase its price substantially to cover the liability, or withdraw the drug from the market.

Any product liability regime that did not make provision for these situations could reduce economic efficiency even if it encouraged the parties in the best position to assemble information about product-related loss to do so. As discussed in Chapter 3, both the current laws and the ALRC's proposed laws attempt to provide mechanisms for the transfer of liability from producers to consumers.

Third, the costs of enforcing legal rights are also important. Thus, there can be a trade-off between providing the right incentives for the production, purchase and use of goods, and minimising the costs of enforcing the associated legal rights.

It should also be noted that, while the theory of product liability provides an indication of how liability should be assigned to enhance economic efficiency, it does not indicate the extent of the benefits involved. In practice, this will largely depend on the size of existing problems: if, for example, the problems under current laws are small then the potential benefits of changing the law will also be small. This would weaken the case for making substantial changes to the law because legal change itself involves adjustment costs.

Finally, the basic theory and the conclusions that follow from it make no explicit reference to such matters as innovation and product availability: this is because changes to these, consequent upon a change in product liability laws, do not by themselves provide any indication of whether or not economic efficiency has been improved. Rather, the theory implicitly assumes that the general incentives affecting these other aspects of the economy are efficient: for example, that governments support innovation to the extent warranted by any 'external benefits'. These matters are discussed in Chapter 6.

3 THE CURRENT REGIME AND THE ALRC'S PROPOSALS

In this chapter, current product liability laws and those proposed by the ALRC are examined in terms of the economic efficiency objectives established in the previous chapter. In broad terms, both the ALRC's proposals and the current regime seek to achieve these objectives through the general basis of imposing liability and through the defences available to producers. Clearly, no practical regime can hope to attain the theoretical ideal. Thus, evaluating the proposals and current laws involves an assessment of imperfect alternatives.

3.1 Current product liability laws

Under current laws, consumers suffering product-related loss may be entitled to compensation from producers if they can establish one or more of the following:

- a breach of an express or implied term of a contract;
- a breach of a duty of care -- that is, negligence on the part of the producer; and
- a breach of a statutory product standard.

The laws are complex and overlapping. They involve State, Territory and Commonwealth legislation.

What the claimant must prove to receive compensation varies according to the avenue used. Under breach of contract, for example, a claimant must establish

- the existence of a contractual relationship,
- a breach of an express or implied term of the contract by the defendant,
- that the claimant suffered loss or damage, and
- that the breach was a cause of the loss or damage in question.

To Whom It May Concern: succeed in an action in negligence, the claimant must establish that

- the defendant owed a duty of care to a class of people of which the claimant was a member,
- the defendant breached that duty -- that is, was negligent, and
- the breach caused the person to suffer loss.

The defences available to producers are set out in Appendix C. If successfully invoked, they would absolve the producer (either partially or totally) from responsibility for the claimant's loss. Of particular relevance are the defences of contributory negligence (where claimants have contributed to their losses by misuse of the product) and voluntary assumption of the risk by the claimant. Both are specifically available in negligence actions. However, breach of contract actions make no general provision for contributory negligence, although the claimant's conduct is still a consideration in some cases. A rough equivalent to a `voluntary assumption of the risk' defence can be found in provisions absolving producers from responsibility if the defect was specifically pointed out to the buyer, or if the buyer examined the goods and the defect or fault in the goods ought to have been revealed by that examination.

Incentives for producers and consumers

The economic theory of product liability drawn on by the ALRC suggests that it is efficient to assign liability to the party best able to assess the risks of product-related loss and the costs of avoiding them. As noted in Chapter 2, under realistic assumptions about producers' and consumers' access to information, the economic theory of product liability broadly suggests that, if the cause of the loss was a fault in the product, liability should fall on the producer. However, if the way the goods were used caused the loss, liability should lie with the user. Viewed in this light, if a product liability regime is to provide appropriate incentives to producers and consumers, it must ultimately be conditioned by the concept of fault (in a general as distinct from the strict legal sense).

The current product liability regime can be broadly categorised as fault-based even though, in some cases, fault on the producer's part is inferred from a characteristic of the product rather than assessed directly. In contract actions, for example, fault on the producer's part is inferred if goods are found to be defective.

Although the current law is based on fault, it is deficient in at least three respects.

First, not all losses caused by defective products are compensated. In particular, some losses which would have been avoided or, at least, diminished if the product had been designed differently are regarded as having been caused by product misuse (see Chapter 4). Further, non-owners of goods (such as bystanders and children) cannot take action for breach of contract. They must rely on negligence actions or, where applicable, actions for breach of statutory duty. However, establishing a right to compensation because of negligence can be difficult if, say, events leading to the incident are difficult to explain or, as is often the case, there is more than one defendant. A legal action on the part of a claimant who can do no more than show that the loss or injury was caused by the negligence of somebody in the supply chain will probably fail (see Appendix C).

These features of current laws mean that liability for some losses that should lie with producers falls on consumers or bystanders. These aspects of current laws therefore provide insufficient incentives for producers to build safety features into their products or to set prices that take account of losses caused by the consumption of those products.

Second, actions for breach of contract in product liability cases make no general provision to reject or discount plaintiffs' claims where improper use of products has contributed to the loss suffered. As discussed in Appendix C, in some breach of contract actions, improper use of a product by the consumer is a consideration. In other cases, consumers will be compensated for all loss suffered even though their actions contributed to that loss. This aspect of contract law means that producers will bear liability for some loss that should be borne by consumers, thereby providing incentives for producers to build excessive safety features into their products or to set prices that over-account for losses caused by the consumption of those products.

It might be argued that these two countervailing deficiencies in the current law will roughly cancel out to provide approximately the right incentives for producers. But

for individual products, this is unlikely to be so. For products intended for children, the inefficiencies created by the lack of protection to third parties are likely to be more significant than the inefficiencies associated with the failure to properly account for misuse of products. For personal items such as electric shavers, which are unlikely to cause loss to anyone other than the owner, the opposite is likely to be the case.

The third deficiency in current laws relates to the onus of proof. As in the case of the assignment of liability, from an economic perspective, the onus of proof should generally reside with the party in the best position to gather information relevant to the question at issue. This suggests that the onus should lie with producers to prove that products were not faulty and with consumers to prove that negligent conduct did not contribute to the loss suffered. This is not the case under current laws. In broad terms, consumers are made responsible for establishing that a product was at fault and producers are made responsible for establishing any negligence on the part of the consumer.[1]

In those cases where the precise cause of the injury or loss is difficult to discern, the onus of proof under the current law will reduce the probability of a successful claim against a producer of a faulty product or of a successful defence of a claim where negligent use was involved. Hence, at the margin, the onus may allow producers to avoid liability when the product was at fault and may allow consumers to receive compensation even when the loss resulted partly or wholly from their negligence. Whether it is practical to have a regime which requires both producers and consumers to prove that they did not do something is, however, a separate question.

[1] The operation of interlocutory and discovery processes, and the fact that evidentiary onuses can often shift from part to part during a hearing, means that, in many instances, the assignment of evidentiary burdens is not so important. Nevertheless, both producers and consumers will still have to prove matters that the other party would be in a better position to establish (see Appendix C).

Legal costs

Inquiry participants generally agreed that the costs of enforcing legal rights under current laws are high. Lack of a single product liability law, lack of uniformity in State and Federal laws, and uncertainty surrounding the application of current laws were among the factors cited by the ALRC as contributing to high legal costs.

High enforcement costs are obviously of concern, but what is most relevant for this inquiry is whether the costs would be higher or lower under the ALRC's (or other) proposals. This matter is considered later.

3.2 The ALRC's proposals

The ALRC concluded in its report that existing laws are an unsatisfactory platform for reform. Although the third party problem could be resolved by relatively minor changes, it contended that resolution of the current regime's complexity, evidenciary difficulties and associated high legal costs require more fundamental change.

Under the ALRC's proposals, producers of goods would be liable to pay compensation to any person suffering loss caused by something 'those goods did'. Producers are referred to as 'manufacturers and suppliers' in the proposals and are defined as 'persons involved in the manufacture and supply of goods'.

To establish liability, claimants would simply have to show that they suffered loss or injury as a result of 'the way the goods acted'. There would be no requirement to prove that the manufacturer breached a duty of care or that the goods did not comply with some standard. Nor would the claimant need to establish any form of relationship with the defendant.

The ALRC proposed that producers should have available to them three defences that, if successfully raised, would absolve them from liability: an 'acceptance of risk' defence, a 'development risks' defence and a 'mandatory standards' defence.

The 'acceptance of risk' defence acknowledges that some consumers freely choose to bear some risks. Under the proposed regime, the consumer would have no right to compensation if 'what the claimant knew about the goods before the loss or

damage occurred would have enabled a reasonable person to assess the risk that the goods would act in the way they did' (ALRC 1989, para. 4.15). To avoid liability, a producer would have to show that the consumer knew enough to 'assess the risk'.[2] The 'notice before action' provision (described below) would be particularly important in establishing whether this was the case and thus whether this defence was applicable.

A 'development risks' defence would be available when a producer 'could not have discovered, using any scientific or other techniques then known or in any other way, that the goods could act in the way they did' (ALRC 1989, para. 4.21).

A 'mandatory standards' defence would be available 'if the goods acted in the way they did only because they complied ... with a mandatory standard' and loss or injury resulted. The existence of any other contributory cause would defeat the defence. If compliance with a mandatory standard was the sole cause of the loss or injury, the intention is that the government responsible for the standard, or the standard-making organisation, should bear liability for the loss (ALRC 1989, para. 4.25).

If none of the defences were applicable, a producer's liability to the claimant could still be reduced if it were established that the loss or injury was partially or wholly *caused by something other than the way the goods acted*, such as causes independent of human control and acts of persons who were not involved in the production of the goods.

Alternatively, the producer could show that, *even if the way the goods acted was the cause of the loss or injury,* the risk that the goods would act in that way was increased because of an act of the claimant or a third party (including on professional advice). Compensation would then be reduced by an appropriate amount, taking into account the 'unreasonableness' of the act or advice (ALRC 1989, para. 4.09).

[2] To fall within this defence, a producer would have to prove two elements of the claimant's state of mind at the time of the loss or injury, each element applying a different legal standard of 'knowledge'. The first element covers the claimant's knowledge on the part of the claimant – what the claimant *should* have known from the circumstances is irrelevant. The second element deals with the claimant's assessment of the risk once all the relevant facts are known: the test applied here is what a 'reasonable person' would assess at the time of the loss or injury if he or she were placed in the same position as the claimant.

A ‘notice before action’ provision would require the claimant, as part of the pre-hearing process, to disclose on oath such matters as the use to which the goods were put, any maintenance or repairs undertaken in connection with the goods, or facts relevant to the ‘voluntary assumption of the risk’ defence such as warnings provided with the goods. The provision would also require the claimant to answer the defendant’s questions on oath on any of these issues. In its submission to the Draft Report Hearings, the ALRC proposed strengthening this provision by extending (from four to six weeks) the period available to the defendant to require the claimant to provide sworn written answers to questions relevant to the claim.

The ALRC proposed that the amount of compensation payable should be calculated in three stages. First, the total amount of loss would be ascertained. Second, that part of the loss attributable to causes other than the way in which the goods acted would be subtracted. Finally, if it was shown that the risk that the goods would cause the loss was increased by misuse of the product, a further amount would be subtracted to reflect the contribution of that factor. If appropriate, the whole of the original amount could be deducted in the process.

Although the proposals specify the liability of producers as a group, they also allocate liability amongst the members of that group. In an effort to simplify legal procedures and minimise legal costs, the ALRC proposed that the manufacturer of the goods be the representative defendant, except if the manufacturer does not have a place of business in Australia, in which case the importer of the goods would perform this role. The representative defendant could subsequently try to recover compensation from other firms in the supply chain that contributed to the loss or injury. Multiple contributors in the supply chain would share equal liability unless, in the court’s view, this would be inequitable, in which case liability would be apportioned according to the relative value of each producer’s inputs to the goods. Provided they were (in the court’s view) dealing on equal terms, those involved in production of goods would be able to make contractual arrangements with one another to apportion liability: that is, to ‘contract out’ of the product liability provisions as between one another (ALRC 1989, Chapter 5).

Incentives for producers and consumers

Although the ALRC has proposed a totally new regime that avoids reference to ‘fault’, the regime is, in the Commission’s view, still conditioned by the concept of fault or blameworthiness. In contrast to current product liability actions, fault would initially be inferred from the cause of the loss or injury, rather than assessed by reference to some product benchmark or standard of producer or consumer behaviour. Effectively, as discussed below, there would be a presumption of producer liability.

At the Draft Report Hearings, the ALRC strongly objected to categorisation of its proposals as fault-based. In its view, drawing an inference of fault solely from the cause of any loss strips ‘fault’ of any meaning.

However, the ALRC’s economic consultant, Dr Braddock, conceded that, from an economic viewpoint, the proposals still involve fault, albeit ‘a different form of fault to that demonstrated in our current case law’. Dr Braddock suggested that the ALRC’s objection stemmed from its concern that if ‘the reforms were introduced with unconventional uses of existing terms, they would inevitably tend to be interpreted and applied by the legal profession as in the old but conventional usage, thus defeating the reform process’.

Despite the ALRC’s criticisms, the Commission considers that its description of the proposals as fault-based is useful when considering their likely impact on economic efficiency. This categorisation distinguishes the proposals from ‘no-fault’ regimes, such as New Zealand’s accident compensation scheme or Australia’s statutory workers’ compensation schemes, and thus from the specific efficiency impacts inherent in those sort of arrangements. Further, the Commission believes its categorisation assists in identifying the similarities and the differences between the proposals and the current laws and hence the likely economic impact of adopting the proposals.

In considering whether the ALRC’s proposals improve the incentives to producers and consumers, it is important to bear in mind the discussion in Chapter 2: an efficient product liability regime would have three main features.

- First, producers should generally be liable for losses caused by characteristics of products.
- Second, consumers should be liable for losses caused by the misuse of products.
- Third, consumers should also be liable in certain circumstances -- set out later -- even though they suffered loss from risks associated with the characteristics of products.

The proposals undoubtedly compare well with current laws when assessed against the first feature. The proposals would remedy many of the deficiencies of the existing regime by extending an effective right of action to people who do not own the goods that cause loss, by removing the requirement to prove a product standard or standard of producer behaviour, and by reducing the onus of proof on claimants. As noted above, the proposals effectively create a presumption of producer liability. In most cases, a claimant would be required to show little more than that loss was suffered while using the product. The onus would then be on the producer to prove an alternative cause of the loss, successfully raise one of the defences, or show that the loss was the result of `unreasonable' use of the goods.

Regarding the second feature of an efficient regime, in theory the proposals would take full account of misuse of products in determining liability for loss. Hence, they could represent an improvement over current laws -- as discussed earlier, actions under current contract law do not generally consider product misuse.

In practice, however, it is by no means clear that the proposed regime would better assign liability for product misuse than current laws.

One reason for this is that the proposals retain a standard of consumer behaviour -- where use of the product increases the risk that the goods would cause loss, the proposals would take into account the `reasonableness' of that use in determining whether compensation should be reduced. The ALRC argues that this is necessary because any use of a product increases the risk that it will cause harm, so that only unreasonable use should be an issue. But just as standards of producer behaviour under current laws mean that some producers will be able to avoid liability for faulty products, so too would a standard of reasonableness mean that some consumers would be compensated for the consequences of product misuse.

A further reason is that the proposals impose the onus on the producer to prove that a breach of this standard of consumer behaviour caused the loss. This would mean that, in some cases, particularly where there is little evidence available of the circumstances of the loss, producers would be liable due to an inability to prove that 'unreasonable' use of the product actually caused the loss.

A number of inquiry participants argued that imposing the burden on producers to prove 'unreasonable' use in order to avoid liability would also result in a significant increase in fraudulent claims. Greater incentives for producers to settle claims would contribute to this problem.

The ALRC referred to its 'notice before action' provision as a means of reducing the imbalance in the imposition of legal onuses in its proposals and in helping defendants 'weed out' dubious claims. Clearly, such a provision would help alleviate the problems discussed above. However, the Commission considers that the provision would not substantially offset the impact of the proposals' presumption in favour of producer liability and hence the possibility that, compared to current laws, producers would be held more responsible for loss caused by the misuse of products.

The third general feature of an efficient product liability regime is that there should be mechanisms for absolving producers of liability where it is efficient for consumers to bear the risk of product-caused loss. As discussed in Chapter 2, mechanisms for shifting liability from producers to consumers are required when

- consumers know the risks and choose to accept them,
- consumers have a strong desire to accept unknown or ill-defined risks, and
- the risks are so remote that, despite careful investigation, discovery would be unlikely before their realisation.

If the ALRC's proposals were not as effective as the existing regime in absolving producers in these cases then adoption of the proposals would lead to a loss of efficiency. Under the current regime, the defect/negligence concept provides an additional measure of protection to producers and thereby compensates for deficiencies in the defences available to producers (even though that same standard

means that sometimes, producers evade liability for faulty products). But under the ALRC's proposals, the measuring stick of defect would be removed so the operation of the ALRC's defences would be more critical in determining the capacity to shift liability from producers to consumers when, on efficiency grounds, such transfer was warranted.

Voluntary assumption of the risk

The 'voluntary assumption of the risk' defence in the ALRC's proposals is applicable to 'known' risks. It would require producers to prove what claimants *actually* knew, rather than showing, as is currently the case for the equivalent defence in contract actions[3], that the claimant should reasonably have understood the facts.

Many participants argued that this defence would be difficult to establish and would encourage consumers to ignore warnings.

The ALRC submitted that other areas of the law already deal effectively in terms of actual knowledge. The ALRC also pointed out that ignoring warnings would fall within the proposals' 'unreasonable use' provisions.

However, the Commission reaffirms the view expressed in the Draft Report, and subsequently supported by the Trade Practices Commission (TPC), that the requirement to prove what the claimant actually knew would impose too great a burden on producers and reduce the effectiveness of this defence. The fact that the only relevant part of existing product liability law that contains such a test has fallen into disuse supports this conclusion (see Footnote 3).

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[3] The position in actions in negligence is confused by the fact that the defences of contributory negligence and voluntary assumption of the risk often overlap in their application to such circumstances. Strictly speaking, the test for the requisite degree of knowledge for the latter defence is what the claimant actually knew – the same as that for the ALRC's proposals. But as pointed out by the ALRC and Mr Masel, this defence is rarely argued. Commonly, contributory negligence is used in cases where a voluntary assumption of the risk defence might, prmia facie, be more appropriate. In the contributory negligence defence, the test for the requisite degree of knowledge is what the claimant should have known in all the circumstances – the same as in current contract actions.

Unknown or ill-defined risks

The proposed voluntary assumption of the risks defence deals only with 'known' risks.

There is no provision allowing a producer to avoid liability in the case of unknown or ill-defined risks. The ALRC's proposals assume that, in all cases involving unknown or ill-defined risks, it is efficient to impose liability on producers, thereby encouraging them to discover such risks.[4]

But when risks are unknown or ill-defined, the benefits of allowing the consumer freedom of choice will often outweigh the benefits derived from imposing liability on producers (see Chapter 2). A consumer may want to accept an unknown or ill-defined risk far more than a producer may want to bear it -- for example, the use of a life saving drug with potentially severe side effects. Not allowing voluntary assumption of such a risk may mean that the product is priced prohibitively or not available at all.

Under current laws, allowing consumers to accept such risks is facilitated, in some cases, by standards of 'defect/negligence'. For example, as discussed in Appendix C, negligence criteria allow a court to apply a rough cost/benefit analysis of such risks and would probably allow the imposition of liability on the consumer in these circumstances.

Again, in this area, the ALRC's proposals appear inferior to current laws.

Development risks

The 'development risks' defence is directed at allaying concern that the lack of special provision for goods embodying new technology would impede innovation.

Many inquiry participants argued that the wording of the defence -- 'it could not have been discovered using any scientific or other technique then known or in any

[4] The greater likelihood of discovering an 'unknown or ill-defined' risk through investigations by the producer distinguishes these risks from the 'unknowable' risks addressed by the development risks defence.

other way, that the goods could act in the way they did' -- would make it virtually impossible to raise and, thus, if the ALRC's proposals were adopted, innovation would be stifled.

However, the degree of uncertainty about risks is likely to be greater for new products than for established products, so that increased uncertainty does not automatically negate the proposition that producers will be in a better position than consumers to assemble information about those risks.

Nevertheless, if risks are so remote that investigations would be unlikely to reveal them, it could not be said that producers are in a better position than consumers to appreciate those risks. There would thus be no reason to expect efficiency improvements from assigning liability to producers. When account is taken of the legal costs of awarding compensation, liability should remain with consumers in these circumstances.

The Commission considers that the ALRC's defence would be very difficult to raise and therefore sets too high a standard.

Again, by considering whether a product was defective or negligently made, the current regime appears to provide a more effective means of catering for development risks.

Mandatory standards

An efficient product liability regime would not make producers or consumers liable for losses caused by third parties. In this area, the ALRC's approach is broadly similar to existing laws. One exception is the treatment of loss caused by mandatory standards.

The ALRC's 'mandatory standards' defence is designed to absolve producers from responsibility for loss caused by compliance with a mandatory product standard, but the provision states that the producer is absolved if compliance is the only cause. If compliance with a mandatory standard and an act of the claimant were found to be joint causes of the way the goods acted, the defence would not be available because compliance was not the only cause.

According to the ALRC, that part of the loss attributable to the mandatory standard would fall on the consumer -- not the producer -- through the provisions which would reduce the producer's liability for that part of the loss due to other factors.

Thus, the consumer would bear some loss that, from the point of view of providing appropriate incentives, should be imposed on the government promulgating the standard.

As discussed in Appendix C, under current laws, liability for loss resulting from compliance with a mandatory standard generally falls on consumers.

Thus, if the ALRC's proposals were successful in making governments or government bodies accept liability in the small number of cases where loss stemmed solely from mandatory standards, there would be a minor improvement in the incentives facing regulators, and thereby producers and consumers.

Product deterioration

For most products, the risk of loss increases as they deteriorate. The level and type of use influence the rate of deterioration, as does the design and construction of the product. The consumer will generally be better placed than the producer to appreciate the risks associated with product deterioration caused by the way the product has been used. Accordingly, from an efficiency perspective, liability for loss attributable to such deterioration should remain with the consumer rather than be transferred to the producer.

Current liability laws embrace these concerns. 'Defect/negligence' tests tend to concentrate on the condition of the product at the time of sale rather than on their performance over time. Certainly a product which failed after the expiry of its design life would not be considered to be defective or negligently made. Further, the Trade Practices Act 1974 currently includes a ten year statute of repose applying to actions for breach of contract and to specific statutory actions under that Act. A statute of repose refers to the amount of time (after the purchase of the goods) for which a producer can be held liable for loss caused by its goods. Of course, this is an arbitrary means of absolving producers for loss caused by deterioration of a product caused by the way the product has been used.

The ALRC's proposals do not include specific provisions covering product deterioration. Rather, product age and condition would be considerations in determining whether the goods caused the loss, and possibly in determining whether a producer had effectively informed the claimant of any risks associated with product deterioration (see AppendixÿC). But the Commission doubts the efficacy

of this general area of the proposals and, in any event, age and condition would be only two of many factors taken into account in determining producer liability. Thus, under the proposals, liability for some loss stemming from product deterioration caused by the way the product had been used might undesirably be transferred from consumers to producers.

Legal costs

The ALRC argued that implementation of its proposals would lead to a significant reduction in legal costs in product liability cases. It claimed that these savings would come from a number of sources: among them the creation of a single product liability law, the replacement of four separate causes of action (none of which is specifically designed to deal with product liability cases) by a single regime dedicated to that purpose, the provision of greater incentives to settle claims out of court, and the reduction in uncertainties associated with legal interpretations.

As noted in AppendixÿC, some inquiry participants supported these claims. The Australian Consumers Association (ACA) said that any legal change will involve some uncertainty until authoritatively interpreted by the courts, but argued that, in the longer term, the ALRC's proposals would be an improvement on the current laws under which established legal principles give the courts wide discretion on notions such as negligence.

Business, insurance and a number of legal participants disputed the claim of reduced legal costs. They argued that concepts such as `unreasonable conduct', `what the claimant knew', and could not have been discovered `in any other way' would be a source of continuing uncertainty, with little or no savings in costs.

Such claims and counterclaims are virtually impossible to resolve in advance of implementation of the proposals. The Commission accepts that if a single product liability regime were implemented Australia-wide (whether the ALRC's or another regime) to replace the existing range of remedies, there would be cost savings. The

Commission has found no way to verify the ALRC's claim that its approach to product liability law would reduce legal costs.

Other considerations

In addition to the costs associated with increasing the circumstances in which producers would be held liable for loss which is most efficiently borne by consumers, the ALRC's proposals would impose a number of other costs.

Unequal effects of the proposals

Changes in product liability laws would not have an equal effect on all goods (or actions) that might cause loss. The price of new goods would increase under the ALRC's proposals, mainly because producers would be required to build more safety into those goods or take out more liability insurance to offset their increased legal exposure (see Chapterÿ6). However, producers would be unable to influence the price of existing second-hand goods directly (even though they would be liable for losses caused by them). The price of second-hand goods is inevitably linked to the price of new goods. But with no direct insurance impost on second-hand goods, it seems likely that their price under the proposals would increase by less than that of new goods. Further, losses caused by the failure to use a piece of safety equipment or the use of an object such as a tree rather than a ladder to scale a building would continue to be borne by the consumer under the ALRC's regime. Hence the `price' of not using goods would fall relative to the price of new goods.

Thus, if the ALRC's proposals were implemented, there would be incentives for consumers to substitute into less safe second-hand goods and perhaps forgo certain products altogether rather than pay higher prices for new goods.

To the extent that consumers substituted second-hand goods for new goods, some of the hypothesized safety benefits may not materialise. As discussed in AppendixÿD, substitution into second-hand goods in areas such as the light aircraft market, and an increasing tendency to forgo certain types of safety equipment, have accompanied more stringent liability laws in the United States. Thus, at least for these products,

more stringent liability laws have tended to reduce rather than increase safety.

International competitiveness

The theory of product liability does not address the possibility that a change in a country's product liability laws can influence its international competitiveness.

In Chapterÿ6, the Commission examines the likely impact of the ALRC's proposals on Australia's international competitiveness and concludes that Australia's exports could be adversely affected, albeit in a minor way.

Wage flow-on effects

The ALRC's proposals would lead to higher product prices by shifting more liability onto producers, although the extent of the price increases is generally likely to be small (see Chapter 6).

To the extent that the higher prices were reflected in an increase in the Consumer Price Index (CPI), at least a partial flow-on to wages could be expected. But consumers would already have been compensated for higher product prices through the provision of better compensation and, perhaps, through improved product quality. Thus, any flow-on effects to wages would mean that many consumers would be over-compensated.

This potential problem arises partly from the way in which the CPI is measured. If the CPI were to make allowance for all changes in product characteristics, then the ALRC's proposals should not show up as an increase in the `real' price level. Practical considerations suggest, however, that such precise adjustment to the CPI would be technically extremely difficult.

If no adjustments were made to the CPI, then the costs to the economy from the resulting over-compensation to consumers could be significant in relation to any gains which might be expected to flow from the adoption of the ALRC's proposals. In Appendix E, the Commission uses a revised and extended version of the model used by the ALRC's economic consultant to place some orders of magnitude on these effects. The Commission undertook two simulations: one assumed product

liability insurance charges would rise by 50 per cent and the other assumed an increase of 150 per cent. Assuming that 90 per cent of the resulting increases in product prices would flow on to wages, the model predicts that over-compensation for consumers would reduce Australia's output by 0.1 per cent and 0.3 per cent respectively. This translates to falls in gross domestic product of $336ÿmillion and $1009 million respectively.

3.3 Summary

In terms of the economic efficiency principles established in the previous chapter, there are problems with the general basis of liability under the current regime. In particular, producers are not held liable for some losses where the product was at fault and product misuse is not always fully taken into account.

Adoption of the ALRC's proposals would result in an unambiguous improvement over current laws in imposing liability on producers for loss caused by faulty products.

The proposals would also resolve a current deficiency by taking into account product misuse in all product liability actions.

Despite this, the proposals would not better allocate liability for product misuse to consumers in all cases. In the Commission's view, the general presumption of producer liability under the proposals might increase the cases where producers are wrongly held liable for loss caused by product misuse.

The proposals would also be less effective than current laws in assigning liability in those circumstances in which producers should be absolved of liability, even though characteristics of the product caused the loss: in particular, in cases where a consumer voluntarily assumes a known risk or is keen to assume an unknown risk, where loss is caused by a `development risk', and in the treatment of loss caused by use-related product deterioration.

However, if the ALRC's proposals were successful in making governments accept liability in the small number of cases where loss stemmed solely from compliance

with mandatory standards, there would be a minor improvement in the incentives facing regulators, and thereby producers and consumers.

The proposals are designed to reduce legal costs. The Commission accepts that creating a single, Australia-wide product liability law would result in cost savings but cannot verify the more general claim.

The proposals would have a number of other deleterious effects on economic efficiency: for example, a minor reduction in Australia's international competitiveness.

The theory of product liability provides no guidance as to the magnitude of the various costs and benefits. Accordingly, the next chapter examines information which can place some orders of magnitude on these effects.

4 THE MAGNITUDE OF THE EFFICIENCY EFFECTS

Regardless of the product liability regime in force, the self interest of producers and consumers will contribute greatly to securing efficient safety outcomes.

A natural concern to avoid injury is a strong incentive for consumers to take care when buying and using goods. Consumers need not have complete information to make appropriate safety choices. For example, most consumers can make a reasonable assessment of the possibility of injury from a pane of glass without knowing the physical properties of the glass. In situations where consumers have insufficient information to make proper safety assessments, they often have access to specialist providers of information, such as pharmacists. A guide to the likely quality and safety of goods is provided through firms' reputations and through brand names. Information is also available from consumers associations.

The survival of producers in the marketplace depends largely on their supplying products that meet consumer preferences, including desired levels of safety. Producers become aware of such safety preferences through complaints received, their own market research and, most importantly, by consumers buying or not buying their products. A firm's investment in a brand name and its reputation can only serve to reinforce its incentive to provide safe products. Damage to a firm's reputation from adverse publicity about its products can be much more damaging than any compensation it has to pay. In the case of products such as food, for which firms need to secure frequent repeat purchases, these incentives will be particularly strong.

This is not to suggest that the self-interest of consumers and producers will satisfactorily overcome all problems associated with product-related loss: for example, irrespective of market competition (or, indeed, product liability laws), there will always be 'fly by night' operators which sell sub-standard goods. Nor is it to suggest that, for individuals who incur product-related loss, the consequences will not be significant.

Rather, it is to suggest that, in aggregate, the problems may not be of major proportions. This in turn implies that the efficiency effects (whether positive or negative) from changing product liability laws are generally likely to be small.

In this chapter, the Commission examines evidence that might confirm or reject this general presumption. As discussed in the previous chapter, making producers more responsible for loss caused by faulty products would be the main benefit of the ALRC's proposals. Hence, the Commission looks at the incidence of product-caused loss in Australia, the extent to which consumers suffering such loss are denied compensation under current law, and the extent to which the ALRC's proposals might address this problem. The costs of the proposals derive from the increase in cases where producers are wrongly made liable for losses more properly borne by consumers, and also include effects such as increased use of less safe second hand goods. It is obviously difficult to directly estimate these costs in advance of the proposals' implementation. Accordingly, the Commission examines the evidence of the impact of more stringent liability regimes overseas to see whether it provides an indication of the possible magnitude of the costs.

4.1 Product-caused injuries in Australia

Although the inadequate liability on producers under current laws for faulty products will influence the level of both product-caused personal injuries and product-caused property damage, the former category is the more important. Statistics on the relative number of claims made for these two types of loss are regarded as commercially sensitive. However, on the basis of discussions with participants, the Commission estimates that only one third (by value) of total claims made are for property damage, and about two thirds of these are made by businesses. Given that the ALRC's proposals may have a relatively small impact on the commercial proportion of property damage claims -- because businesses will be able to contract out of liability for property damage resulting from commercial dealings -- the main impact of the proposals should be on product-caused injuries.

Evidence available to this inquiry has centred on this type of loss, although much of the information about the level of injuries in Australia and the availability of compensation for such injuries is anecdotal.

In 1985-86, the TPC conducted a national consumer opinion survey which, among other things, examined the extent of product-related loss or injury. Two of the findings of the TPC's survey were as follows:

- Although 7 per cent of more than 8000 respondents could recall a product-related injury or illness occurring to someone in the household, only five respondents reported a serious problem.
- There were only 46 reported cases of product or services-related injury or illness arising from around 90 000 consumer purchases (TPC 1989a).

The TPC argued that the way in which the survey was conducted may have led to some underestimation of the problems facing consumers, but nonetheless concluded that `... serious product/services related injuries/ illnesses are relatively rare occurrences' (TPC 1989a, p. 6).

In *An Arm and A Leg* (ACA 1989), the Australian Consumers Association (ACA) published data covering accidents recorded in the *National Injury Surveillance and Prevention Project* (NISPP) data bases which are clearly identified as being the result of physical product failure.

Although as many as 80 per cent of all recorded accidents involve a product in some way, the data indicate that only 11 300, or about 1 per cent, of the total estimated number of accidents each year are clearly due to physical product failure (see Table 4.1). The ACA argues that, when allowance is made for hospital admissions for which NISPP reports are not filled out and for private treatment of injuries, the figure of 11 300 could be doubled.

Most of these accidents would be potentially compensable under current law. In up to 50 per cent of recorded product-caused accidents involving adults and 10 per cent involving children, the ACA suggests that the owner of the product may have been the victim: such accidents are covered under current contract law. A further 21 per cent of accidents involving adults occurred in the workplace and could thus have been compensable under workers compensation schemes. This means that the number of product-caused accidents for which a remedy would not exist, under

either current laws of contract or workers compensation arrangements, could be as low as 4300, or less than 0.5 per cent of product-related accidents (see Table 4.1). And some of these accidents could have been found compensable either under statutory no-fault motor vehicle schemes or, if negligence on the part of the producer was involved, under negligence actions.

Table 4.1: **NISPP data on product caused accidents**

Type of accident	*Number*[a]
Total accidents	1 150 000
Product-related accidents	940 000
Accidents identified as due to physical product failure	11 300
Product-caused accidents potentially covered by workers compensation arrangements	1 995
Product-caused accidents potentially involving the owner of the goods	5 025
Product-caused accidents conferring no prima facie right to compensation under current laws of contract or workers compensation arrangements	4 280

a Based on recorded NISPP cases for the period March 1987 to February 1988. When allowance is made for hospital admissions for which NISPP reports are not filled out, and for private treatment of injuries, the figures reported in the table could, in the ACA's estimation, be doubled.

Source: ACA (1989).

These findings, however, should be interpreted with caution. The data do not include design-related accidents. In the ACA's assessment, inadequate design causes many more problems than physical product failure: 'case studies of just six products identify design failures which could be contributing factors in up to 18 000 child injuries per year'. Nor do the data indicate the severity of the injuries suffered. Even if there is a considerable number of product-caused accidents for which no remedy currently exists, if most of these involve only minor injury, any adverse effect on incentives and hence economic efficiency will be small. Also, the data do not indicate the extent to which the ALRC's proposals would deal with uncompensated product-caused accidents.

To investigate these matters, the Industry Commission engaged Dr Somers from the South Australian Health Commission to undertake further analysis of the NISPP data.

The consultant's report (Somers 1990) was based upon a case-specific review of 301 non-fatal injury cases documented by the NISPP in 1988 and 326 product-related fatalities extracted from South Australian coronial data. A panel of three safety experts representing the fields of engineering, epidemiology and consumer protection assessed the NISPP cases with a view to judging whether product malfunction, inadequate design or inadequate instructions for use had contributed to the accident. For those cases in which the product was judged to have contributed in some way to the accident, a public health lawyer assessed the likelihood of the victim being eligible for compensation under current laws and under the ALRC's proposals. For the fatal cases for which less information was available, a similar but less case-specific procedure was used. The resultant estimates under current laws and the ALRC's proposals were scaled up to obtain national estimates. Separate documentation was provided on the severity of accidents covered by the NISPP sample.

In the consultant's view, products contribute in some way to as many as 134 500 accidents each year. A large part of the difference between this figure and the figure derived from the ACA's data (11 300 cases per year) presumably reflects the consultant's assessment of accidents in which inadequate product design played some part.

The consultant considered that few of these 134 500 accidents would be covered by either present laws or the ALRC's proposals. In the consultant's view, the courts would deem a large proportion of these accidents to have been caused by improper use of the product by consumers, natural forces, etc, rather than by defective products or 'the way goods acted'.

Accordingly, the consultant estimated that, netting out workplace and motor vehicle accidents[1], the annual number of compensable product liability claims for accident-related loss would be a little over 3500 under current laws and around 6000 under the ALRC's proposals. Moreover, taking account of the relatively minor injuries suffered in many accidents, the consultant estimated that the number of these accidents which would warrant legal actions would be only 500 under current laws and 1000 under the ALRC's proposals.

[1] Workplace accidents are specifically excluded from the ALRC's proposals, while for motor vehicle accidents, compensation is covered by existing State and Territory statutory schemes.

In the Draft Report, the Commission concluded that, given the millions of products purchased each year, this estimate of the potential increase in claims suggests that the adoption of the ALRC's proposals would not have a major impact on the incentives for producers and consumers to avoid product-related injuries.

In a submission following the release of the Draft, the consultant disagreed with this conclusion. The consultant observed that, while there are millions of products purchased each year, there are not millions of different products or producers. More importantly, according to the consultant, even the remote threat of legal action is well-known to influence safety behaviour, as evidenced by the perceived effect of speeding laws on driver behaviour.

However, in the Commission's view, there would be a strong link between safety incentives and the actual increase in successful claims. This is because, in responding to the ALRC's proposals, producers would generally only undertake safety improvements that were more commercially attractive than taking out additional insurance, and insurance premiums would be directly linked to the number of claims paid. Hence, the Commission reaffirms its earlier conclusion.

Further, in the Commission's view, the consultant's findings highlight the difficulties of attempting to deal with faulty product design through product liability laws: often, the courts will attribute resulting accidents to product misuse. For example, in the case of a child scalded after tugging on a rigid kettle cord, the courts would likely find that the child -- rather than the product -- caused the accident, even though the accident might have been avoided at relatively little cost if the kettle had been equipped with a coil-type cord. In this respect, the ACA (1989, p. 11) argued:

> Although a manufacturing fault is sometimes obvious a design inadequacy may be difficult to identify in an individual case and may only emerge after a large number of cases have been studied or the problem has been uncovered by in-depth epidemiological study.

It may be that product standards are a better mechanism to overcome design faults than product liability laws.

In summary, the available evidence suggests that the ALRC's proposals would provide only small efficiency benefits from making producers more accountable for losses caused by faulty products.

4.2 Overseas evidence

The effects of changes in liability regimes abroad are sometimes cited as an indication of likely outcome of changes to the law in Australia and, in particular, of the costs associated with the adoption of more stringent liability laws as proposed by the ALRC.

New Zealand

As part of this inquiry, the Commission engaged a consultant to examine the impact of the replacement in New Zealand of a negligence-based product liability regime with no-fault accident insurance (Porter 1990). Although the consultant's report provides anecdotal evidence indicating that the reduction in incentives for both producers and consumers to take care has increased the number of accidents, the statistical information shows that total claims for compensation decreased over the period examined by the consultant. By contrast, claims for compensation in the high risk sectors increased sharply over the same period, but the consultant was unable to prove that this increase reflected an underlying increase in accident rates. Indeed, the consultant points out that further analysis would be required to establish such a link.

The United States

Much information was received from inquiry participants on problems that they perceive have accompanied the introduction of more stringent liability laws in the United States (see Appendix D). There have been significant increases in product liability insurance premiums for a wide range of products, some products have been withdrawn from the market, and it is also generally accepted that innovation has been reduced. There have been adverse safety effects as consumers have elected to purchase products that are inherently less safe (such as old aircraft) to avoid the price increases for new goods that have resulted from much higher liability awards.

The problems in the United States have not been confined to strict liability laws. Similar effects have also been experienced in other areas such as professional malpractice, where liability is based on negligence. In any case, over two thirds of product liability awards in the United States are still based on negligence (US General Accounting Office 1989). Conversely, the introduction of strict liability laws, similar to those of the United States, for some or all product liability actions in other countries (including Australia) has not been accompanied by the sorts of problems experienced in the United States (see Appendix D).

Many of the problems in the United States can be traced to peculiar features in that country's legal system which have almost certainly resulted in producers facing liabilities that exceed the economic costs of damage that their products have caused. Such factors include jury-determined damage awards, punitive damages, generous provision for loss of future earning capacity and 'non-economic loss', and the fact that, if an action is unsuccessful, consumers incur few costs because of the contingency fee system for lawyers and because each party bears its own legal costs (see Appendix D).

To the extent that features of the United States legal system underlie the problems in that country, it cannot be automatically inferred that the introduction of more stringent liability laws in Australia, with its different legal system, would have an identical impact. The ALRC argued that, whatever changes were to be made to Australian law, the situation in the United States would not be replicated in Australia.

While the United States experience casts little light on the extent of the efficiency costs that would be associated with the adverse aspects of the ALRC's proposals, it does reinforce the view that the gains from the beneficial aspects are unlikely to be large. Although there has been a vast increase in compensation paid in the United States, there is little evidence that there has been any resultant improvement in product use or safety. Babcock (1988) states that United States liability laws have not had a significant effect on the safety of American products and, according to Priest (1988), several studies have shown that product liability laws appear to have had no significant effect on injury rates in the United States.

5 ADJUSTMENT COSTS

While the discussion has thus far concerned the longer term efficiency changes likely to be associated with the ALRC's proposals, there would also be costs during the phasing-in period as consumers and producers adjusted to the new legal regime.

Because the proposals represent a major overhaul of current product liability laws, their precise effects would not be clear until new procedures and precedents were established and new concepts were defined by the courts. Representatives of the legal profession argued that terms such as 'how the goods acted' and 'unreasonable conduct' raise complex issues in law and would give rise to considerable uncertainty (see Appendix C). The ACA pointed out that any change to the law necessarily involves some uncertainty.

The ALRC argued that the adjustment period might not be long: even for legislation of 'considerable economic consequence' involving new language and concepts, three to five years would be all that was required for it to be clearly understood.

Other inquiry participants, however, were of the view that it might be many years before the precise implications of the ALRC's proposals were resolved. The Insurance Council of Australia (ICA) stated that it usually takes six to eight years before most of the claims from a given year flow in. Under a new regime, it would probably take several additional years of appeals to higher courts before an authoritive judgment was achieved. The ICA considered, therefore, that it would need five to ten years to gain a confident understanding of the effects of the ALRC's proposals on insurance premiums. MrÿMasel, of PhillipsÿFox Solicitors, estimated `... the major adjustment period at approximately ten years'. Priest (1980), writing more than a quarter of a century after a major change in product liability laws in the United States, attests to the uncertainty that can follow such a change: `product liability law is widely regarded as the most egregious source of modern legal uncertainty'.

A number of participants argued that there could be significant effects during the adjustment period. The Association of Risk Managers of Australia considered that,

during this period, producers could respond to the proposals by increasing their prices to cater for possible future claims, over-react on the issue of product safeguards, and reduce innovation or withdraw products from sale. If this were to happen, the adjustment costs to society following the introduction of the new laws could be considerable.

However, the evidence from previous similar legal changes suggests that adjustment costs -- as indicated by changes in insurance premiums -- are not likely to be large. As noted in Chapter 6, amendments to the Trade Practices Act in 1978 -- which the ALRC considers a major change -- did not result in any notable change to insurance premiums. Nor did the major changes to the law in the European Community two years ago, or the Canadian Province of New Brunswick twelve years ago. In each of these instances, there were many anticipatory fears in business circles about increases in insurance premiums. Even in the United States, there was no appreciable change to insurance premiums until about ten years after the major change to the product liability regime.

The Commission considers that the ALRC's proposals would give rise to adjustment costs during a phasing-in period of up to ten years. These costs could be reflected in more volatile and higher insurance premiums and/or product prices, excessive increases in product safety, reductions in innovation or the withdrawal of goods from the market during the adjustment period: which of these would be most likely in practice is discussed in the next chapter. Whatever form they might take, though, the weight of evidence suggests that adjustment costs would not be substantial.

6 SPECIFIC EFFECTS OF THE PROPOSALS

In this chapter, the Commission examines the specific effects of adopting the ALRC's proposals on safety, insurance charges, production costs, product prices, product innovation and availability, and the international competitiveness of Australian industry. It draws on earlier findings, information received from inquiry participants, and evidence of the effects of different liability regimes overseas.

In focussing on these specific effects of adopting the proposals, the chapter does not look at the effects of any wage flow-on that might result. As discussed in Chapter 3, if, in addition to the benefits of higher quality and/or more insurance built into goods, workers were to receive wage increases because of higher product prices resulting from the ALRC's proposals, there would be adverse consequences for the economy as a whole. These possible effects are analysed in Appendix E.

6.1 Effects on product characteristics

Implementation of the ALRC's proposals would increase the amount that producers would expect to pay through the legal system per incident involving loss related to their goods. This reflects the Commission's judgment that, in terms of compensation payments, the impact of the extension in producer liability and the greater onus of proof on producers would more than outweigh the impact of any increase in the weight given to product misuse by consumers (see Section C.5).

Producers could respond in four main ways. First, they could improve the safety of their goods. This should reduce the number of product-related accidents and associated compensation claims. Second, they could 'self-insure' by making internal provisions to pay for additional claims. Third, they could increase their product liability insurance cover. Each of these three responses would tend to increase costs and prices. Fourth, they could withdraw their goods from sale.

Producers would generally choose the most cost-effective response.

Effects on the safety of goods

As discussed in Chapter 4, there are strong market incentives for producers to make safe goods. For example, consumers who prefer safe goods are normally willing to pay more and buy more of them. Equally, when consumers come to view products as unsafe, prices and sales can decline. The lengths to which some firms go to inform consumers of the safety features of their products and to protect their reputation is a measure of the market value of product safety.

The ALRC argued that its proposals -- which aim to provide incentives for optimal product safety -- would further increase the level of safety built into goods.

Product safety could in theory be improved in various ways. Producers might devote more resources to designing and testing goods, retain 'tried and tested' technology, use safer materials, incorporate more safety features in goods, or provide consumers with more information about how goods might act in certain circumstances.

While recognising that most goods on the market are reasonably safe, the ACA argued that, for those goods that are unsafe, there are often cheap or costless improvements that can be made to overcome faults. On the basis of extensive product testing undertaken for Choice, it stated:

> ... safe products do not have to be more expensive than unsafe ones. A safe cot costs the same as a dangerous cot. Appendix Five of 'An Arm and a Leg' lists all the safety faults found over the last eleven years. Many of these faults arose from simple design faults or inadequate safety instructions. These are easy problems to fix.

To the extent that low cost safety improvements can be made to goods, an extension in producer liability could in theory further encourage their introduction.

However, in the Commission's view, the overall impact of implementing the ALRC's proposals on the safety of goods would be small in practice, for two main reasons.

First, irrespective of the product liability regime, market competition should provide strong incentives for producers to include the most cost-effective safety features in their products. Many additional safety improvements would substantially increase costs. For example, O'Brien Glass Holdings stated in evidence that shatterproof

safety glass is nearly seven times as expensive as the glass currently used in housing construction. The Institution of Engineers Australia claimed that clear span bridges -- which are less vulnerable to damage by ships -- could cost up to ten times the cost of pylon bridges. Referring to a survey of 17 of its members, the Metal Trades Industry Association of Australia (MTIA) said that most respondents saw very little potential to make products significantly safer and that few such improvements would be cost-effective. Such evidence supports the claim by many producers that they would generally increase their product liability insurance cover rather than build greater safety into their goods.

Second, the evidence presented in Chapter 4 of the practical significance of the change in producer liability under the ALRC's proposals indicates that the consequent changes in production incentives would not be major. This is particularly because product liability laws per se are unlikely to exert a significant influence on product design: faults in design appear to contribute in some way to a large proportion of product-caused accidents but are not easy for the consumer to prove in court.

Effects on insurance

Although many inquiry participants argued that some producers -- particularly smaller ones -- would choose to bear the increased risk themselves (that is, to self-insure), the consensus was that most would seek additional product liability insurance to cover their legal exposure. This should lead to a rise in total product liability insurance costs. Besides increasing premiums, insurers might impose more onerous terms and conditions. It is also possible that insurance would no longer be available for some 'hazardous' products.

The ALRC did not attempt to estimate the changes in insurance premiums. Rather, it noted that any increase in premiums would simply indicate that more of the costs of product-related accidents were being picked up in compensation payments.

Business groups claimed in evidence that adoption of the ALRC's proposals would lead to significant increases in the cost of product liability insurance and that insurance might not be available for some products. The Australian Small Business

Association stated:

> The ASBA has the belief that many small businesses would not be able to obtain affordable product liability insurance. In some instances there will be no insurance company willing to offer product liability insurance because of the uncertainty that would exist under legislation designed to encourage litigation.

A number of participants pointed to the United States 'insurance crisis' -- associated with the move towards more stringent product liability and increased litigation in that country -- as indicative of what could happen in Australia. The Australian Chemical Specialities Manufacturers Association indicated that chemical industry rates rose by 200 to 300 per cent on average between 1986 and 1987. The Association of Consulting Engineers Australia submitted figures showing that United States professional indemnity premiums have risen by around 100 per cent since 1983 and that, as insurance costs have increased, the number of firms taking out liability insurance has declined. The Business Council of Australia (BCA) referred to the findings of a survey of 500 business organisations in the United States:

> Virtually all companies surveyed reported increases in their insurance costs, whether or not they had ever had to defend a product liability case. Many also reported problems in obtaining insurance. Of the companies surveyed, 15 per cent chose to go bare without liability insurance at all since they could not afford the cost of insurance and remain in business.

However, some inquiry participants played down comparisons between United States developments and the Australian proposals. For example, the ALRC argued that the two legal systems operate in vastly different ways and that American society is far more litigious than its Australian counterpart (see Appendix D). The Chemical Confederation of Australia acknowledged these differences, although it considered that some valuable lessons can be learned by studying the United States history.

In commenting on the ALRC's proposals, the TPC (1989b)[1] argued that the United States experience is an inappropriate benchmark for comparison and that the effects of the 1978 amendments to Part V (Division 2A) of the Trade Practices Act in Australia provide a better indication of the likely effects of adopting the ALRC's

[1] While this paper commented on the ALRC's original proposals, the TPC indicated in correspondence to the Commission that its comments remain pertinent for the ALRC's revised proposals, as presented in ALRC (1998).

scheme. It noted that the business community had been initially apprehensive about the changes but had subsequently come to accept the amendments. At the public hearings on the Draft Report, the ACA and the ALRC stated that the amendments have generated little or no change in insurance premiums.

The adoption of stricter product liability laws in Europe -- deriving from the 1985 European Community Directive (see Appendix D) -- does not appear to have dramatically affected insurance charges there, although the scheme has not been in operation long enough for definitive conclusions to be drawn. The ALRC stated that European business and insurance groups have recently moderated the predictions they made during the debate that surrounded the drafting of the directive.

Local insurance groups presented differing views on the likely response of insurers to adoption of the ALRC's proposals. The ICA argued in its initial submission that, although the rate of legislative change has a strong influence on product liability insurance, insurers might initially adopt a 'wait and see' attitude to the proposals, rather than increasing insurance charges as soon as they were implemented. It considered that, as there are approximately 150 insurers serving the Australian market, they could not raise their premiums unduly for fear of being undercut by their competitors. However, in its submission to the Draft Report Hearings, the ICA argued that premiums could increase more immediately. Similarly, in its response to the Draft Report, the Association of Risk and Insurance Managers of Australia stated that insurers would be likely to increase premiums during the adjustment period to build up cash reserves to protect against the possibility of higher future claims.

Local insurance groups' estimates of the magnitude of the increase in premiums also varied. NRMA Insurance simply pointed out that broadening liability should lead to an increase in premiums. Suncorp Insurance and Finance suggested that premiums could rise by 100 to 200 per cent. In venturing a long term forecast, the ICA estimated that the total Australian product liability insurance bill could rise to $724 million per annum -- about 240 per cent more than at present. However, it emphasised that the validity of any estimate depended greatly upon the assumptions made and, at the first round of public hearings, conceded that insurance premiums might not increase substantially under the ALRC's scheme.

Dr Somers' estimate of the increase in product liability actions for personal injury under the ALRC's proposals also provides a basis for forecasting increases in insurance premiums. If the estimated doubling in actions was experienced across all types of product-caused loss (that is, property damage as well as personal injury), insurance premiums might rise by around 100 per cent. However, product liability actions for property damage are unlikely to rise by the same degree because, as discussed in Chapter 4, around two thirds of these actions involve businesses which can contract out of the ALRC's scheme. This suggests that the overall increase in insurance premiums would be less than 100 per cent.

The variance in forecasts reflects the uncertainty that must necessarily accompany the ALRC's proposals in advance of their implementation and during the period in which new legal procedures and interpretations would be tested in the courts. The ICA submitted that it could require more than five years' experience under the proposed regime to gain a confident understanding of its effects on insurance premiums.

The Commission expects that the costs of product liability insurance would rise under the ALRC's proposals. While the magnitude of the increase is uncertain, it is unlikely to be as large as suggested by some inquiry participants. As discussed below, insurance premiums would continue to represent a small proportion of production costs for most goods. For some 'hazardous' goods, though, the impact of higher insurance premiums could be significant.

Effects on production costs and product prices

The extension in producer liability under the ALRC's proposals would induce firms to increase their insurance cover and, in some cases, build greater safety into their goods. This would increase producers' costs and product prices -- an outcome recognised by the ALRC.

Indications derived from insurance loadings suggest that cost increases would not be large on average. The MTIA's survey found that public and product liability premiums currently account for between 0.15 and 3.83 per cent of its respondents' manufacturing costs, with small firms incurring the largest proportional costs. In

Appendix E, liability insurance is estimated to account for an average of 0.7 per cent of current production costs. On this basis, a doubling of insurance premiums would increase production costs in Australia by less than 1 per cent in aggregate.

For some hazardous goods, though, cost increases could be much greater. For example, in the United States, insurance apparently accounts for about one third of the cost of ladders and light aircraft, and around 95 per cent of the cost of some vaccines (Huber 1988, p. 3). The Commission understands, however, that these charges include other forms of liability insurance.

Firms should be able to increase prices to cover most of these higher costs, for three reasons. First, the cost changes would generally be small. Second, they would apply to all goods, including imports: hence, the prices of particular products should change little relative to competing goods. Third, consumers should be willing to pay more for goods because of the additional safety features or 'insurance' they would contain. From a consumers' perspective, the availability of product-related accident compensation paid by producers -- but reflected in prices -- would be equivalent to buying an 'insurance policy' along with the goods.

Some participants suggested that prices would rise by more than the increase in direct insurance costs if firms were to over-insure. This could occur either at the individual firm level or if, taken together, all the firms involved in producing a particular product over-insured: for example, if component suppliers and the final manufacturer all took out full liability insurance cover for a single finished product.

However, because over-insurance, were it to occur, would initially yield above normal profits in the insurance industry, competition among insurers should prompt a compensating drop in premiums.

The Commission therefore considers that product price rises would closely reflect the increases in the direct costs of insuring goods. Most goods would incur small price increases, although the price of some hazardous goods could increase significantly.

Effects on product innovation and availability

The extension in producer liability under the ALRC's proposals would affect product innovation and availability. There would be disincentives for producers to innovate because any new technology necessarily involves more unknowns and risks than equivalent 'tried and tested' techniques, although innovation in the area of product safety might be encouraged. The production and marketing of some goods would cease if the costs of additional insurance or product safety could not be recouped in the marketplace.

Participants' views

Many business groups claimed that the impact would be severe. A number of engineering firms warned that they would curtail their operations if the ALRC's proposals were enacted. The Nutritional Foods Association of Australia suggested:

> ... if the ALRC's approach -- which is designed to protect everybody from just about everything -- had existed at the beginning of the 19th century we would still be travelling by horse, and relying on town criers.
>
> Manufacturers, inventors and entrepreneurs would simply not bother to invest the time and money in product development because of the fear of prosecution if the slightest thing went wrong. The real danger now, already evidenced by experience in the United States where the approach is largely identical to that promoted by the ALRC, is that innovation will die.
>
> New goods either won't be produced or they will become too costly ...

Business participants also drew attention to the effects of United States liability laws on pharmaceuticals and the light aircraft industry. The Australian Pharmaceutical Manufacturers Association pointed out that United States vaccine production has decreased by more than 50 per cent over the last 20 years. Composite Industries noted that, because of the extremely high costs of procuring product liability insurance for light aircraft, the Cessna, Beechcraft and Piper companies have ceased producing some models.

The Commission's view

The Commission accepts that adopting the ALRC's proposals would reduce product innovation and availability but considers that, for most products, they would be unlikely to have the major effects in Australia claimed by many inquiry participants.

One reason for this is that many participants based their claims on the perceived impact of strict liability laws in the United States, but this is likely to be substantially greater than the impact of adopting the ALRC's proposals in Australia. Apart from the differences between the legal systems in that country and Australia discussed in Appendix D, other factors may also have contributed to the disappearance of goods from the United States market. In the case of pharmaceuticals, for example, the reduction in drug development could largely reflect the introduction of more stringent and time-consuming drug testing requirements (IAC 1986, pp. 50-51). In any case, definitive evidence presented to the Commission about goods that have been withdrawn from the United States market is sparse and concerns only a few hazardous products.

A second reason is that, as discussed in Chapter 4, changes in production incentives caused by adopting the ALRC's proposals probably would not be substantial, so the reduction in product innovation and availability should likewise be small.

For some products, though, the ALRC's proposals could have a significant impact. As discussed in Chapter 3, for goods such as pharmaceuticals, notwithstanding the prolonged testing and approval processes, an important part of product development involves trials on consumers who are willing to risk using relatively untested products. Given the major difficulties that producers would likely face in invoking the 'acceptance of risk' and 'development risks' defences to allow such testing, innovation would be impaired.

There would also be some short term reduction in product innovation and availability if the ALRC's proposals were to cause excessive fears of litigation among businesses, irrespective of whether the fears proved to be warranted in the long term.

The implications for government policy

Given the finding that adopting the ALRC's proposals would reduce product innovation and availability (a possibility recognised by the ALRC itself), the question arises as to whether this would be good or bad.

Product innovation and availability are critically important to an economy: they enhance consumer choice and can contribute to growth. Further, there may be sound economic grounds for governments to support innovation, particularly given the 'external benefits' that it may confer on society: the Australian government already provides substantial financial support to encourage research and development.

Nevertheless, from an economic perspective, innovation and having access to a wide range of goods are only 'means' of enhancing society's well-being rather than 'ends' in themselves. While they can confer benefits on society, they can also impose costs in terms of both the resources expended in research and development and any loss or damage caused by innovative goods. This implies that there will be an optimal level of innovation and an optimal range of products. Hence, what should be important is not whether a policy change would increase or decrease product innovation and availability, but rather whether it would move the economy closer to these goals.

Reflecting its focus on optimal outcomes, the ALRC took a detached view of the direction and magnitude of possible changes in product innovation and availability:

> If research and development are seen to be worth the risk, manufacturers will carry it out. It is their decision. The proposals do not pretend to suggest what is the 'due' amount of research and development: that is a decision for manufacturers, not law reformers, courts or judges.
>
> ... There may be reductions in the availability of goods, but manufacturers will only withdraw goods from sale if they perceive that the cost of preventing losses is greater than the cost of the losses. This means that those goods which cause high losses are likely either to be improved or withdrawn from the market. In either case the overall costs to society through loss or damage will be reduced.

It should be noted, though, that adopting an efficient product liability regime will not give rise to an optimal amount of innovation if other relevant market and government incentives do not also promote economic efficiency. For example,

there would be too little innovation if government support for research and development was insufficient to 'capture' all of its external benefits, and too much innovation if government support was excessive.

The Commission considers that such problems are best addressed through direct means which will avoid the problems that arise if 'second-best' exemptions are made to product liability laws.[2]

However, deficiencies in the ALRC's proposals would result in reductions in product innovation and availability that would impair economic efficiency. As discussed in Chapter 3, particular problems would result from the removal of the fault/negligence concept in conjunction with the major difficulties that producers would likely face in invoking the ALRC's 'acceptance of risk' and 'development risks' defences. Reductions in product innovation and availability resulting from these deficiencies in the proposals would therefore be deleterious, as would any reductions resulting from uncertainty during the adjustment period.

6.2 Overall effects on safety

As discussed in Chapter 2, from an economic perspective, the goal for society is not to attain *maximum* safety. Rather, it is to attain optimal safety: that is, a level of safety which properly balances the benefits and costs of avoiding loss.

While recognising this, the ALRC considered it likely that safety would increase if its proposals were implemented.

Some aspects of the proposals would do this. For example, making producers more responsible for loss caused by faulty goods would provide incentives for them to make their goods safer or to take out more product liability insurance. As discussed earlier, the latter option generally would be the more cost-effective for producers.

[2] For example, if producers do not face economically efficient incentives to take into account the costs of loss caused by innovative products then, from an economic perspective, there will be too much innovation in the area of 'hazardous' goods relative to innovation in the area of 'safe' goods, even if the overall level of innovation is optimal.

Nevertheless, the increase in producers' insurance costs would be reflected in higher prices, and hazardous goods -- which would require the most insurance -- would incur the largest price increases. Hence, consumers would buy fewer of them.

However, there would also be some countervailing effects. As discussed in Chapter 3, there could be some perverse changes to buying patterns which would see consumers substitute into less safe second-hand goods, or go without certain goods altogether. For example, if the price of lightning rods increased substantially -- because manufacturers could not guarantee their effectiveness under all conditions -- then consumers might choose not to install them and instead bear the risk of lightning strikes with no protection. Similarly, Huber (1988, p. 166) claims that some consumers in the United States forgo purchasing higher priced ladders and instead undertake more precarious forms of climbing.

Whatever the direction, the Commission considers that the changes in safety under the ALRC's proposals would be small. This is principally because the impact of the proposals on the incentives facing producers and consumers would not be major.

6.3 Effects on international competitiveness

Because the ALRC's proposals provide for a different and stricter basis of liability than exists in many other countries, some participants expressed concern that the proposals could reduce the competitiveness of Australian industry, on two specific grounds. First, the proposals were seen as possibly necessitating unique production runs for the Australian market, which would reduce 'economies of scale' for local producers. Second, the proposals were seen as aggravating problems associated with 'forum shopping'.

To consider the first point in isolation, if the best commercial response to the ALRC's proposals were to modify the product (rather than take out insurance) then there would be both positive and negative effects on competitiveness. For import-competing industries relying solely on the domestic market, the opportunity to exercise this option would increase costs but nonetheless give them a competitive advantage over importers, for whom the only option might be the (more expensive) insurance. For exporting firms, the need to set up different production runs for the local and overseas markets could mean a loss of economies of scale and, as a consequence, increased costs and loss of competitiveness.

However, these adverse effects are unlikely because, as discussed in Section 6.1, producers would generally choose to take out greater insurance cover, rather than modify production runs, in response to the ALRC's proposals. In import-competing industries, both importers and domestic producers supplying the domestic market would have recourse to the insurance option. In the case of Australian firms that export part of their output, higher insurance premiums for their domestic sales would be recovered from domestic consumers rather than from export customers.

Nonetheless, Australian exporters could be adversely affected due to the second point mentioned -- 'forum shopping'.

Forum shopping occurs when people seek legal redress in the country where the legal system appears to offer the most favourable compensation awards. Under both the present law and the ALRC's proposals, consumers in overseas countries who were injured by Australian-made goods could sue either the importer of the goods in the overseas country or the Australian manufacturer in Australian courts.

Given the possibility of forum shopping, Australian exporters might need to take out increased insurance on exports as well as on domestic sales to cover their greater liability under the ALRC's proposals (if these laws were more stringent than the law in the country to which they export). Although foreign consumers would value the associated higher level of implicit 'insurance' in the Australian goods, they would not value it at its full cost: if they did, there would already be a commercial incentive for producers to provide it voluntarily. The liability of foreign producers selling in overseas markets would not change as a result of the ALRC's proposals, so their prices would remain unchanged. Hence, the competitiveness of Australian exports in foreign markets would fall.

The extent of this loss of competitiveness in export markets should be very small in practice. This is because most Australian exports are primary products or services. The former exports are generally not inherently hazardous and, in any event, as they are generally commercially traded goods, they would be subject to the contracting-out provisions of the scheme. The latter would not be covered by the ALRC's scheme. The effects could be more significant for manufactured goods but, even in this case, the small increase in production costs (discussed in Section 6.1) implies that the effects would not be major.

The ALRC claimed that competitiveness could be improved if the reputation of Australian goods was enhanced as a result of its scheme. For competitiveness to improve on this basis, the price that consumers are willing to pay for goods would need to increase by more than the extra insurance and production costs of the goods incurred by producers under the proposals. This seems unlikely given the fundamental proposition underpinning the ALRC's proposals: namely, that consumers undervalue the quality or safety of goods.

Overall, the Commission considers that the direct effects of the ALRC's proposals on the competitiveness of Australian industry would be adverse, but generally small.

7 EQUITY ISSUES

Equity, from an economic perspective, refers to the fairness of the distribution of a nation's resources amongst its people.

Economic analysis distinguishes between vertical and horizontal equity. Vertical equity refers to the distribution of resources between people in different circumstances. Horizontal equity refers to the treatment of people in similar circumstances. To illustrate, under the value judgment that disparities in wealth are inequitable, a policy which taxed all the rich but arbitrarily subsidized only some of the poor would improve vertical equity (between the rich and the poor) but would worsen horizontal equity (amongst the poor).

The ALRC's proposals would overcome the horizontal inequity in the current laws stemming from the different rights to compensation for the owners of goods compared to non-owners (often children). Under current laws, an owner suffering loss from a faulty product can obtain compensation under breach of contract. However, if the same loss or damage befalls a non-owner, that person faces the more difficult task of proving negligence on the part of the producer. Inquiry participants expressed widespread support for a more equitable regime as between owners and non-owners. The ALRC's proposals eliminate the distinction.

The ALRC argued that, by removing the requirement for claimants to prove producer 'fault' or product 'defect' that exists under current laws, its proposals would also result in a further horizontal equity improvement by allowing easier access to compensation for all who suffer loss from goods. It argued that, under present laws, some consumers who suffer loss from goods do not get compensation when they should.

As discussed in Chapter 3, the ALRC's proposals would indeed result in more cases in which consumers receive compensation for loss for which they were not to blame.

However, the proposals would have other effects -- also discussed in that chapter -- which could reduce equity. For example, there could be instances when consumers received compensation for product-caused loss even though they had voluntarily

accepted the risk of that loss. There could also be an increase in fraudulent claims made (and won) by consumers, because of the effects of easier access to compensation under the proposals. To the extent that some consumers would receive unwarranted compensation, there would be a consequent increase in product liability insurance premiums and thus in product prices. In effect, unwarranted compensation for some consumers would be funded by all other consumers.

The ALRC's proposals would also exacerbate a vertical inequity associated with the inclusion of product liability insurance in the price of a product. This would arise because the same insurance premium would apply to all classes of consumers. But the cost of providing compensation for product-caused loss increases with the income of the recipient because loss of future earnings is an important component of compensation payments. Thus, with a uniform premium, consumers on lower incomes would be overcharged, and those on higher incomes undercharged, for compulsory insurance. In effect, low-income consumers would subsidize those on higher incomes. This inequity already exists under current product liability laws but would be made worse under the ALRC's proposals insofar as they increase the total liability borne by producers.

In the absence of any generally accepted value judgment as to the weights to be given to these countervailing factors, the Commission is unable to determine whether the proposals would improve or worsen equity overall.

Whatever the direction, however, the Commission considers that any changes in equity consequent upon adopting the proposals would be small. This reflects its judgment that the overall impact of the proposals would not be large.

8 FINDINGS

In assessing the ALRC's proposals to change Australia's product liability laws, the Commission has looked at their likely effects on both economic efficiency and equity. It has considered both theoretical and practical arguments and has also examined the adjustment costs that would arise if the proposals were introduced.

Longer term efficiency effects

The Commission considers that the ALRC's proposals would more effectively impose liability on producers for loss caused by faulty products, thereby improving the incentives for producers to take full account of the loss their goods may cause (p. 22).

But in so doing, the proposals would create new inefficiencies. The proposals would impose excessive liability on producers. This raises the possibility that producers would be held liable for more loss attributable to product misuse, despite the provisions in the proposals aimed at ensuring that the way in which a product is used is considered in every product liability action (p.ÿ23).

Relative to the current law, the proposals would also provide inferior mechanisms for transferring liability for product-caused loss from producers to consumers when

- consumers know the risks and choose to accept them (p. 25),
- consumers have a strong desire to accept unknown or ill-defined risks -- for example, the use of life saving drugs which may have severe side effects (p. 26), and
- the risks are so remote that, despite careful investigation, discovery would be unlikely before their realisation (p. 26).

In large measure, these adverse efficiency effects stem from the inadequacies of the defences available to producers under the ALRC's proposals and the absence of a standard of `defect' when assessing whether a producer was at fault. Under current laws, reference to a standard of defect can help ensure consumers are liable in the circumstances outlined above.

The ALRC’s proposals would also impose a number of other costs on the community:

- there would be incentives for consumers to use less safe second-hand goods, or to forgo safety enhancing goods altogether, to avoid the price increases for new goods (p. 30);
- Australia's export competitiveness would be adversely affected, albeit generally in a minor way (p. 31); and
- the competitiveness of the economy would be reduced if, in addition to receiving safer products and/or better accident compensation, consumers were to receive wage increases to compensate them for higher prices (p. 31).

Setting the efficiency benefits of the ALRC's proposals against the costs is difficult, but the Commission believes that it is unlikely that either would be major. Irrespective of the product liability regime, competition among producers for consumers' business, and the natural desire of consumers to avoid personal injury, will go a long way to ensuring that proper account is taken of the benefits and costs of avoiding product-related loss (p. 35).

Information presented in Chapter 4 supports this view in relation to the benefits of the proposals -- the better assignment of liability for faulty products would not have a major impact on the incentives facing producers and consumers to avoid product-related loss (p. 36).

The Commission also investigated whether the impact of more stringent product liability laws in overseas countries provides an indication of the size of the efficiency costs associated with the ALRC's proposals. Many participants argued that the experience in the United States suggests that these costs would be significant. However, having regard to the many other factors which have contributed to the problems in the United States, the Commission believes that the experience in that country would not be replicated in Australia under the ALRC's proposals (p. 41).

Adjustment costs

Implementation of the ALRC's proposals would impose adjustment costs as producers and consumers adapted to the procedures and precedents established under the new regime. The adjustment period could be many years. However, in the Commission's view, the adjustment costs are unlikely to be of major proportions (p. 45).

Impacts on insurance costs, product innovation and availability

Implementation of the ALRC's proposals would increase product liability insurance charges and hence product prices, but not to the extent forecast by many in the business community. For most products, liability insurance would continue to represent a small proportion of production costs (p. 49).

The Commission considers that the ALRC's proposals would not, in aggregate, have a major impact on product innovation and availability although, for some products such as pharmaceuticals, the impact could be significant (p. 54).

Equity effects

The ALRC's proposals would overcome inequities in the current laws stemming from the inferior rights to compensation for non-owners of goods and the difficulties faced by consumers in pursuing legitimate claims for compensation against producers of faulty products.

However, the proposals would exacerbate an existing inequity of low income consumers subsidising the product liability insurance costs of high income consumers. They would also create new inequities by making it more difficult for producers to defend unjustified claims for compensation. The costs of these claims would be borne by consumers as a whole in the form of higher prices (p. 61)

Overall assessment of the ALRC's proposals

The task of examining the economic effects of the ALRC's proposals raises complex economic and legal issues. It is difficult to quantify the effects of such a major change to the legal system before the proposals have been tested by the courts.

The proposals would bring both efficiency gains and losses. The theory of product liability provides no indication of the magnitude of these gains and losses. Nor does it help in assessing the trade-off between efficiency and equity effects.

Given the longer term efficiency costs, the adjustment costs that a new legal regime would entail, and the evidence that the benefits would be small, the Commission judges that the ALRC's proposals would reduce economic efficiency.

The reform options put forward by inquiry participants from the business, consumer and legal sectors suggest that the more important inefficiencies and inequities which the ALRC's proposals aim to address could be overcome by relatively minor amendments to current laws (see Appendix F). This approach would avoid many of the costs which the ALRC's overhaul of the current laws would entail.

For these reasons, the Commission considers that the ALRC's proposals should not be implemented.

Future reform

Precisely specifying the nature of reforms within the current legal framework is a task beyond this inquiry, but based on what it has learnt during the inquiry on the positive and negative aspects of current laws, the Commission considers that, to enhance efficiency and/or equity, a revised regime should have regard to the following.

There would be advantages in a single regime to deal with product liability cases. The current range of remedies available to people who suffer product-related loss creates uncertainty, involves high legal costs, and means that different standards of producer and consumer behaviour are imposed under different causes of action.

Both efficiency and equity objectives would be served by making producers and consumers fully liable for their actions. This would involve, inter alia, removing the current distinction between owners and non-owners of goods and ensuring that product misuse was taken into account in all product liability cases.

A regime should incorporate both 'acceptance of risk' and 'development risks' defences. For the reasons outlined in the report, these defences should not be as stringent as those proposed by the ALRC. A standard of producer behaviour or a product standard is an important supplement to these defences in facilitating an efficient assignment of liability.

When loss is caused by compliance with mandatory standards, there would be efficiency benefits from imposing liability on the government responsible for those standards. The liability should be directly related to that portion of the loss attributable to compliance with the mandatory standard.

In the case of loss associated with product deterioration, producers should be liable only for losses from deterioration caused by defects in the product.

The case for reversing the onus of proving a breach of the product standard or standard of producer behaviour needs to be considered further. A number of the reform options put forward by inquiry participants would reverse the current onus. But regardless of where the onus is imposed, at the margin, there will inevitably be cases of inappropriate assignment of liability.

A INFORMATION SOURCES

During the inquiry, the Commission consulted many interested parties. The Commission received its terms of reference on 18 October 1989. It held informal discussions with the ALRC, the Insurance Council of Australia, the Australian Consumers Association, the Business Council of Australia, Dr Richard Braddock, economic consultant to the ALRC, and Mr Frank Hoffman, legal consultant to the ALRC. It released an issues paper in November 1989 calling for submissions on matters raised. About 80 submissions were received: from producers, industry associations, legal firms, Commonwealth and State government departments, consumer organisations, and a number of individuals. The Commission held public hearings to discuss submissions in Sydney on 11 and 12 December 1989 and in Melbourne on 14 and 15 December 1989. The Commission released its Draft Report in April 1990. It received about another 40 submissions commenting on the Draft, and held a second round of public hearings in Sydney on 21 and 22 May 1990 and in Melbourne on 28 May 1990. Participants that made written submissions to the inquiry are listed below.

The Commission also engaged two consultants. Economic Concepts Pty Ltd was engaged to examine the effects on product safety with the introduction of a no-fault accident compensation scheme in New Zealand (Porter 1990). Dr Ron Somers, of the South Australian Health Commission, was engaged to investigate product-caused accidents in Australia with a view to determining the differential impact on compensation claims between current laws and the ALRC's proposals (Somers 1990).

A.1 Inquiry participants

Agriculture & Veterinary Chemicals Association of Australia Ltd
Association of Consulting Engineers Australia
Association of Risk and Insurance Managers of Australia
Atkinson, Angela
Australian Chamber of Manufactures

Australian Chemical Specialities Manufacturers Association
Australian Consumers Association
Australian Council on Smoking and Health
Australian Equipment Lessors Association Inc
Australian Federation of Consumers Organisations
Australian Finance Conference
Australian Information Industry Association Ltd
Australian Institute of Quantity Surveyors
Australian Law Reform Commission
Australian Organisation for Quality
Australian Pharmaceutical Manufacturers Association Inc
Australian Small Business Association
Australian Sport Aviation Confederation Inc
Australian Tyre Manufacturers Association
Blake Dawson Waldron
Braddock, Richard
Business and Consumer Affairs, New South Wales
Business Council of Australia & other national business associations
C E Heath Casualty & General (Liability) Pty Ltd
Chemical Confederation of Australia
Chemplex Australia Ltd
Confectionery Manufacturers of Australia Ltd
Consulting Engineers Advancement Society of Australia Ltd
Cox Mower and Machinery Company
Cramb Consulting Group
CRITEC Corporation Pty Ltd
Department of Community Services and Health
Design Institute of Australia
Farm Machinery Dealers Association of Australia
Federal Bureau of Consumer Affairs
FISONS Pty Ltd
Glass Packaging Institute of Australia
Glaxo Australia Pty Ltd
Hatma Designs
Institution of Engineers, Australia
Insurance Council of Australia
J S Engineering Company Pty Ltd
Kentucky Importers Ltd

Law Council of Australia
Law Reform Commission of Victoria
Law Society of Western Australia
Litigation Lawyers Section
Luntz, Harold
M G O'Brien Pty Ltd
Mallesons Stephen Jaques Melbourne
Master Builders' Construction & Housing Association Australia Inc
Mayne Nickless Ltd
McKendrick Alexander
McPherson's Ltd
Merck Sharp & Dohme (Australia) Pty Ltd
Metal Manufactures Ltd
Metal Trades Industry Association of Australia
Minister for Business and Consumer Affairs, New South Wales
Miracle (Australia) Pty Ltd
National Consumer Affairs Advisory Council
National Mutual Life Association of Australasia Ltd
Non-Smokers Movement of Western Australia Inc
NRMA
Nutritional Foods Association of Australia
O'Brien Glass Holdings Pty Ltd
Phillips Fox Solicitors
Richter, Edwin
Royal Federation of Aero Clubs of Australia
Ryssenbeek, Michael
SBP State Council
SBP Sutherland Inc
Serry, Leon
Small Business Corporation of South Australia
Small Business Development Corporation (Qld)
Small Business Development Corporation (Vic)
South Australian Brewing Company Ltd
South Australian Health Commission
State Electricity Commission of Victoria
Suncorp Insurance and Finance
Tobacco Institute of Australia
WDT (Engineers) Pty Ltd

B PRODUCT LIABILITY THEORY

Changes in product liability laws will affect the quantity and price of goods marketed, particularly hazardous products. Any extension in producer liability will raise the costs of supplying products, both at the individual firm level and, more importantly, at the industry level. On the other hand, the value of goods to consumers will increase because they will have greater recourse to compensation for product-related loss. Hence, they should be willing to pay more for goods. Changes in the price and quantity of products sold will depend on the relative size of these two effects. If the two effects are equal then the quantity of goods sold will remain unchanged, even though a higher price will be charged. However, if the costs of producing goods increase by more than the extra value that consumers put on these goods then, although prices will increase, the quantity of goods sold will contract and, in some cases, goods may be withdrawn from the market.

Given these possible outcomes, it is important that product liability laws provide appropriate incentives for the producers and consumers.

The ALRC relied heavily on the economic theory of product liability to develop its proposed laws. That theory examines the way in which liability should be assigned to enhance economic efficiency, particularly as it relates to product safety.[1] As discussed in Section B.6 overleaf, the theory abstracts from a number of real world complexities: it provides only general insights into the effects of assigning liability.

In this appendix, the basic theory is outlined and reviewed. No attempt is made to provide a comprehensive discussion of all work in the area. A more extensive treatment of the economic literature on product liability can be found in Braddock (1989a).

[1] The theory's treatment of the costs of product-related accidents has general application for all forms of loss associated with goods (for example, the failure of the product to perform its intended function).

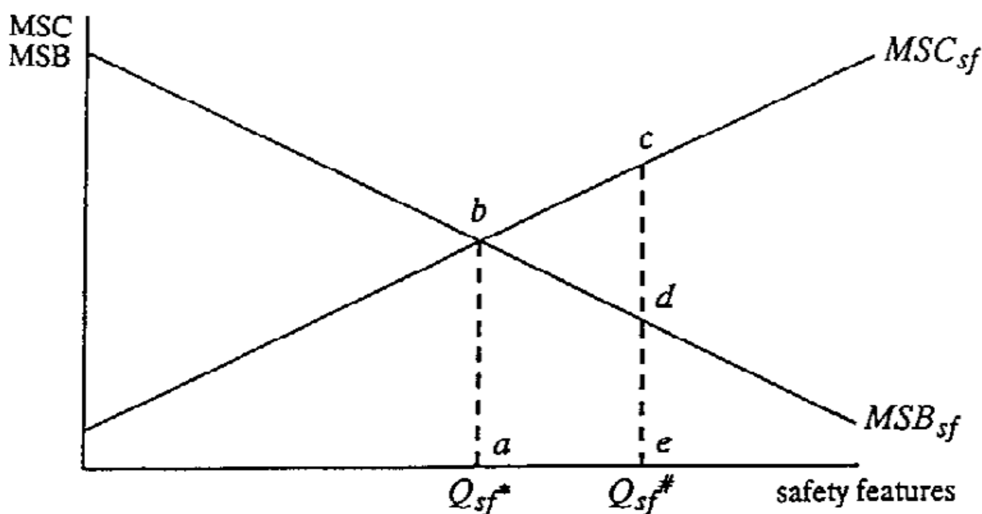
B.1 Optimal loss prevention

'Optimal loss prevention' uses standard concepts of economic efficiency to determine the amount of resources that society should devote to avoiding product-related loss.

One aspect of optimal loss prevention is that goods should embody an economically efficient level of safety. For a particular product, this depends on the benefits and costs of including additional safety features in that product. The benefits of extra safety features (marginal social benefits) derive from the features' prevention of accidents. The costs of additional safety features (marginal social costs) are essentially the costs of the material inputs needed to make them. The optimal degree of safety in a particular product will be found where the benefits of an additional safety feature are just offset by the costs.

This is demonstrated in Figure B.1. The marginal social benefits from additional safety features are represented by MSB_{sf} while their marginal social costs are represented by MSC_{sf} . The optimal level of safety in goods is given by point b, with $Q_{sf}*$ safety features embodied in the product. If more safety features were built into the product then society would be worse off because the additional costs would exceed the extra benefits. To demonstrate, if safety was increased from $Q_{sf}*$ to $Q_{sf}\#$ then the total social benefits would increase by the area abde, but total social

Figure B.1: **The optimal degree of safety in goods**



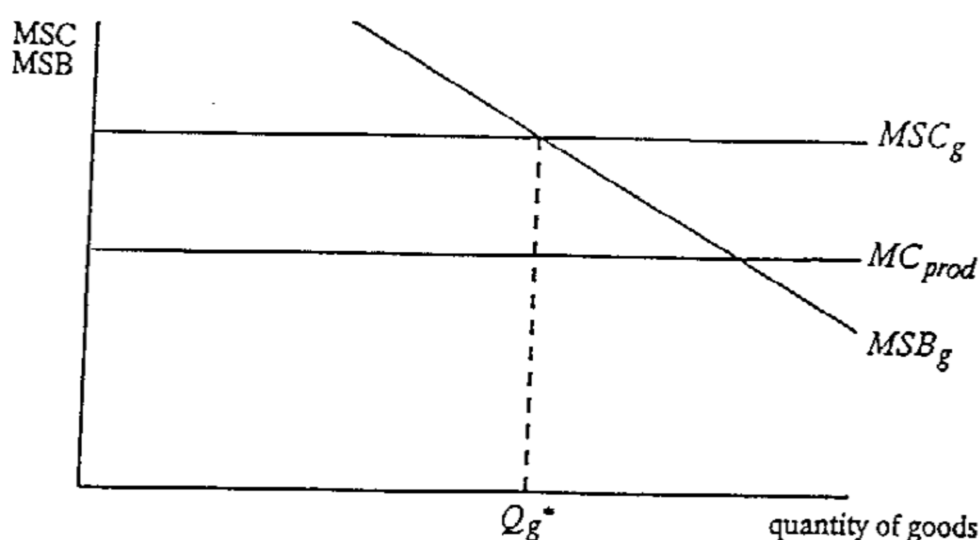
costs would increase by the larger area *abce*. The net loss to society would be given by the area *bcd*. A similar exercise can be conducted for levels of safety less than Q_{sf}*.

This analysis suggests that, from an economic efficiency perspective, it is not in society's interests to make goods as safe as possible.

Another aspect of optimal loss prevention is that consumers should consume an economically efficient number of goods, including hazardous goods. That is, accepting that there will be some goods on the market that could cause accidents, it is still desirable that people should take into account the costs of possible accidents when deciding how many goods to consume. Again, this will occur where the marginal benefits of a product are just offset by the marginal costs (including the marginal costs of accidents).

This is shown in Figure B.2. The benefits to society from additional consumption of goods are represented by MSB_g. The marginal costs are given by MSC_g, which is equal to the costs of building the goods, MC_{prod}, plus the costs of accidents -- the latter being shown by the vertical distance between the two lines. The optimal consumption of goods is given at the intersection of MSC_g and MSB_g, with quantity Q_g* being consumed. Again, it can be shown that more or less consumption of the product would make society worse off.

Figure B.2: **The optimal consumption of goods**



T^his analysis suggests that, from an economic efficiency perspective, there will be some accidents that it is not in society's interests to avoid.

A further aspect of optimal loss prevention is that consumers should exercise an economically efficient level of care when using particular products. This level of care will depend on the benefits and costs of exercising care. The benefits of exercising care derive from the consequent reduction in the number of accidents. The costs mainly reflect the loss of amenity that results from using goods more cautiously. The optimal level of care will be found where the marginal benefits of exercising care are just offset by the marginal costs.

As in the earlier analyses, from an economic efficiency perspective, it is not in society's interests for consumers to exercise unlimited care when using goods.

B.2 Assigning liability with symmetric information

The Coase theorem provides the starting point for examining how the assignment of liability will influence the incentives for optimal loss prevention. The theorem's main assumptions are that information is costless and freely available to consumers. In effect, information is assumed to be 'symmetric' between producers and consumers. Coase argues that, provided that property rights are clearly assigned, bargaining between the parties in the marketplace will result in the same outcome in terms of economic efficiency, irrespective of the initial assignment (Coase 1960).

The application of the Coase theorem to optimal loss prevention is presented in Figure B.3. The treatment follows closely that of Shavell (1980). The analysis assumes perfect competition and that the risk of product-related accidents is dependent solely on product characteristics, as distinct from the way in which they are used. (This limiting assumption is relaxed in Section B.5).

The price necessary to induce producers to market goods is shown by the relevant supply curve. When producers are not liable (caveat emptor), they will only need to cover their costs of production, so the supply curve, S_{ce}, will be the same as MC_{prod} in Figure B.2. When they are liable (caveat venditor), they will also need to take into account the costs of accidents, so the supply curve, S_{cv}, will be the same as MSC_g from Figure B.2.

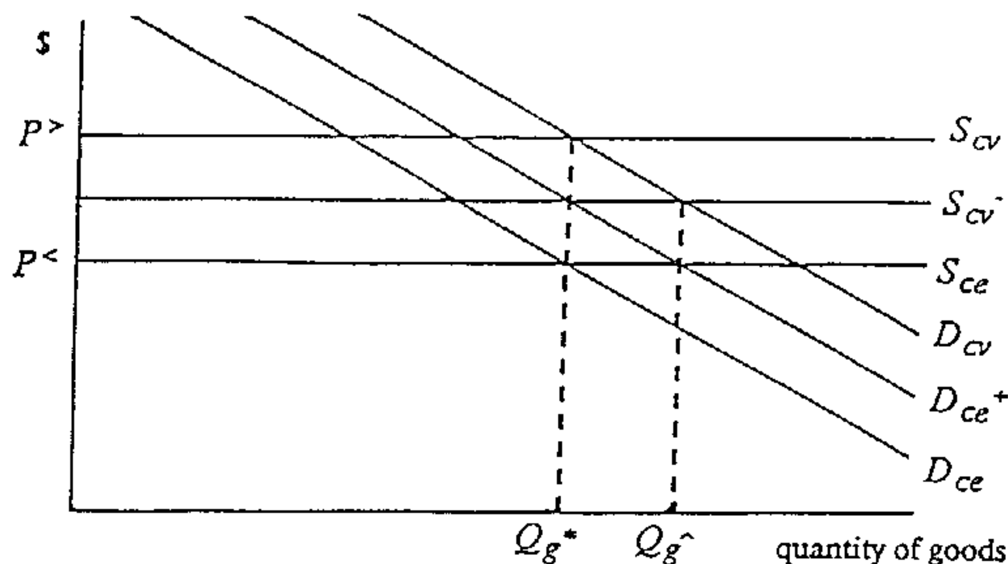
Consumer willingness to pay for goods is shown by the relevant demand curve. Under caveat venditor, demand will depend only on the benefits consumers derive from goods (that is, consumers need not consider the costs of accidents because they will be fully compensated by producers), so the demand curve, D_{cv} , will be the same as MSB_g from Figure B.2. Under caveat emptor, consumers will also need to take into account the costs of accidents, so demand will equal the benefits they derive from goods minus the costs of accidents. Hence, the demand curve, D_{ce} , will be less than D_{cv} -- the vertical distance between the two reflecting the costs of accidents.

The intersection of the relevant supply and demand curves indicates the market outcome. Where S_{ce} intersects with D_{ce} , quantity Q_g * is consumed at price P<. Where S_{cv} and D_{cv} intersect, quantity Q_g * is consumed at price P>.

In both cases, the optimal consumption of goods results although, under a caveat venditor regime, economic efficiency is obtained at a higher nominal price level. Importantly, the higher price level has no impact on efficiency: it merely results because consumers are paying for 'accident insurance' in the form of higher product prices, and then receiving compensation from producers for accidents.

This analysis implies that, if the assumptions of the Coase theorem hold in the real world, the assignment of liability would have no impact on efficiency.

Figure B.3: **The effects of assigning liability on the market outcome**



B.3 Assigning liability with asymmetric information

The analysis can be extended by relaxing the assumption that producers and consumers have symmetric information: that is, to allow for asymmetric information.

In general, the economic literature presumes that, for two reasons, producers have better/cheaper access to information about the risk of accidents caused by product characteristics than do consumers. The first is that producers have access to information about the design features of goods as part of normal business, or they can collect more information about product design at lower cost. The second reason is that consumers can experience difficulties in assimilating or understanding information.

Braddock (1989a, p. 29) discusses the implications of imperfect consumer knowledge when there is no assignment of liability to the producer:

> ... in the real world consumers do not possess perfect knowledge, nor are they able to assess perfectly the characteristics of the goods on offer in a market. Since it is accepted that consumers classically tend to underestimate the risk inherent in an activity (the 'it'll never happen to me' belief), consumers' expected damage costs will generally be observed to be less than the average actual costs which can be calculated from empirical evidence by producers, insurers and (in the US) regulation agencies. Consequently, because they underestimate risk, they will buy more of the risky product than they would if they could have perceived and evaluated the risk. Additionally, firms will produce too many (a more than optimal number of) risky products and there will be a higher level of injuries.

In analysing the effects of assigning liability under asymmetric information, the economic literature generally considers a limiting case in which producers have perfect knowledge about the risk of product-caused accidents but consumers have imperfect knowledge.

Figure B.3 demonstrates the outcome of assigning liability to producers when they fully perceive the risks of product-related accidents. As previously discussed, it results in an optimal consumption of goods. The fact that consumers underestimate the risk of product-related accidents does not modify the result because, when consumers are not liable, the level of demand is not dependent on consumers' assessment of risk.

Figure B.3 also illustrates the effects of assigning liability to consumers if they underestimate the risk of product-related accidents. In these circumstances,

consumers would effectively give insufficient weight to the costs of product-related accidents. Because the demand for goods when consumers are liable equals the marginal benefits of goods minus the expected costs of product-related accidents, the smaller value given to the expected costs of accidents means that consumer demand would be higher than optimal. In this case, the consumer demand for goods, D_{ce} +, would lie above that which would exist if they were liable and fully aware of the risks (D_{ce}). The relevant supply curve is Sceÿ. The intersection of D_{ce}+ and S_{ce} indicates that Q_g^ would be purchased. This exceeds the optimal level of consumption.

This analysis indicates that, when consumers underestimate the risk of product-related accidents but producers fully estimate it, assigning liability to consumers will result in an excessive consumption of goods while assigning liability to producers will result in an optimal consumption of goods.

The effects of assigning liability to producers when they underestimate the risk of product-related accidents are also illustrated in Figure B.3. Producers would effectively give insufficient weight to the costs of accidents. Because the supply price of goods when producers are liable equals the marginal cost of production plus the expected costs of accidents, the smaller value given to the expected costs of accidents means that the supply price would be lower than optimal. In this case, the supply curve, S_{cv}-, would lie below that which would exist if producers were liable and fully aware of the risks (S_{cv}). The relevant demand curve is D_{cv}. As drawn, the intersection of S_{cv}- and D_{cv} indicates that Q_g^ would be purchased: this is the same level of consumption as when consumers were assumed liable and to underestimate risk.

This analysis indicates that, if producers and consumers underestimate the risk of product-related accidents to the same degree, the assignment of liability will have no impact on economic efficiency.

The above results can be generalised: assigning liability to the party with the best/cheapest access to information about risk will move society closer to the optimal level of loss prevention. This is important because, as discussed in Section B.5, if consumers have superior access to information about accidents caused by improper product use (as opposed to product characteristics), liability for such accidents should be assigned to them.

B.4 Negligence versus strict liability

The foregoing model can be used to demonstrate that, at least for accidents caused solely by product characteristics, a strict liability regime should provide incentives superior to those provided by a negligence-based regime.

Under strict liability[2], producers would be faced with incentives to embody the optimal level of safety features in their goods. They would have to pay the costs of safety features, but they would also receive the full social benefits of those safety features. This is because the social benefits of safety features reflect the reduction in the costs of product-caused accidents that they allow[3], and it is these costs that the courts are assumed to measure when awarding damages.

Under negligence[4], however, the level of safety embodied in goods would depend on the reasonable standard of care set by the courts.[5] That is, producers would only need to meet the standard set by the courts to avoid liability. As the Victorian Law Reform Commission argued:

> A negligence standard is like the standard of unsafe or defective in the Trade Practices Act: both involve the courts in setting a standard that is absolute. If the manufacturer fails to meet the standard set by the court, the manufacturer is liable for damages. If the manufacturer meets the standard set by the court (as to care or product) it is not liable.

Under these conditions, economic efficiency would be achieved only if the standard of care set by the courts is the same as the optimal level of safety. If the courts did not set the appropriate standard then efficiency would be impaired. For example, if the courts set the standard at a point such as Q_{sf} # in Figure B.1 then producers

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[2] Under strict liability, the plaintiff has only to prove that a defect of the product caused the loss in order to obtain redress from the producer (Braddock 1989a, p. 40).

[3] A cost can be thought of as a negative benefit.

[4] Under basic negligence, a standard of reasonable care is imposed on producers. Failure to meet this standard renders the producer ‘negligent’ and hence liable (Braddock 1989a, p. 31).

[5] Except where the standard of safety set by the court is less than the level of safety that would result from firms meeting consumer demand.

would incorporate too much safety in their goods. Hence, the achievement of efficiency under a negligence regime would depend on the ability of the courts to determine the social benefits and costs of additional safety features, and thus the optimal level of product safety.[6]

B.5 Product use and contributory negligence

While the basic theory considers the case in which accidents can be affected only by changing product characteristics, the analysis can be extended to allow consideration of accidents caused by product misuse. That is, accidents can be caused either by product characteristics or by product misuse. Information is assumed to be asymmetric -- producers have greater access to information about the characteristics of goods while consumers have greater access to information about the use of goods -- and producers cannot influence how consumers use the goods.

Under these conditions, the assignment of strict liability alone is not economically efficient. Producers would face correct incentives in relation to product-caused accidents but, because producers would be liable for consumers' misuse of goods, both parties would face incorrect incentives in this regard. Consumers' incentives to take care would be diminished and this would contribute to an excessive number of accidents caused by the misuse of goods. Producers would have an incentive to increase the level of safety in goods (above the otherwise optimal level) to cover their liability for product misuse. This would tend to reduce the number of accidents. As far as the Commission is aware, the economic literature does not suggest which effect would predominate and hence whether the number of accidents would be greater or fewer than the efficient level. However, economic efficiency would not be obtained because there would be too many accidents resulting from product misuse and too few due to product characteristics.

The economic literature indicates that these problems could be overcome by adopting a split liability rule (such as contributory negligence) under which producers would be liable for accidents caused by the characteristics of their goods, but consumers would be liable for accidents caused by the misuse of goods. This would place the legal incentive to take care on the party in the best position to know

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[6] The economic literature on product liability discusses a number of mechanisms that might enhance the ability of the courts in this regard -- see Braddock (1989a, pp. 35-40).

the risk of an accident and, according to the theory, would enhance economic efficiency.

B.6 Practical limitations of the theory

The foregoing exposition focuses on the basic theory of product liability: it does not look at any of the many extensions that build on this basic framework. These extensions consider the implications of relaxing assumptions upon which the theory is based. The areas covered include multiple-cause accidents, product durability, risk aversion, the availability of insurance, alternative market structures, legal costs, and the interaction of product liability regimes and product safety standards.

The theory of product liability abstracts from reality in various ways. Braddock (1989a, p. 28) qualified it thus:

> Models are limited by the restrictiveness of the assumptions as to the circumstances of the parties acting in the model, the nature and risk of injuries or losses which may occur and the specific set of legal rules being applied. The circumstances of the parties will include assumptions as to their financial positions, the presence and type of insurance available, attitudes to risk, whether the rules are optimally applied, the state of knowledge of the parties as to the risk and similar matters and the ease with which rights can be enforced ... even the normal assumptions made do not generally accord with reality. The understanding of reality gained from these models must therefore be inexact and consequently rough judgements must be made as to the applicability of their predictions and evaluations. Nevertheless, they constitute a valuable tool in attempting to understand the likely impacts of alternative liability regimes by revealing fundamental tendencies of the various alternative regimes to produce specific outcomes, even if this must then be re-evaluated in the conditions of reality.

One important practical limitation is that the theory approaches the problem from a 'partial' economic perspective: it looks at the decisions to produce and consume goods at the individual product level. In reality, producers and consumers have a vast array of goods from which to choose. Many of these are potential substitutes, and changes in the price of one product may affect not only that product but also other goods marketed. As discussed in Chapter 3, when a product liability regime does not directly affect all goods (or actions), there may be reductions in economic efficiency if price distortions cause substitution away from goods directly affected by the regime.

A second practical limitation is that, although the theory indicates how assigning liability can improve economic efficiency, it does not indicate the magnitude of efficiency gains. It can be determined from Figure B.3 that the extent to which efficiency is enhanced by assigning liability will depend, in part, on the difference between the knowledge of the particular parties. For example, the efficiency gains from assigning liability to producers when they have superior access to information would be greater the more imperfect is consumer knowledge. However, the theory itself gives no indication of the extent to which this is the case because the assumptions about whether producers or consumers have superior access to information about the risk of product-related accidents are made independently of the model. As discussed in the body of the report, the size of the efficiency gains that might be expected from alternative liability regimes is important from a policy-making perspective because there are costs involved in adopting a new legal regime.

Further limitations of the theory, particularly as they affect assessment of the ALRC's proposals, are discussed in Chapter 2.

C CURRENT LAWS AND THE PROPOSALS

This appendix outlines the essential features of the current laws of product liability and of the ALRC's proposals, and discusses the likely practical effects of the proposals in terms of both the individual provisions and their combined impact. The intention is to provide a guide for non-lawyers, rather than a rigorous legal assessment.

C.1 Current laws

Australian consumers who suffer loss caused by goods are entitled to compensation if they can establish one or more of the following:

- a breach of an express or implied term of a contract;
- a breach of a duty of care;
- the contravention of a specific provision of Federal, State or Territory consumer protection laws conferring a direct right of action;
- a breach of a statutory duty conferring a civil right of action.

Laws covering these areas are complex and overlapping. Despite this range of potential avenues for redress, there are gaps in the provision of compensation.

Contract

Any transaction between a buyer and seller of a product involves a contract.

The terms of contracts may be expressed or implied[1] or a combination of both. Usually, most of the terms of contracts are implied. Buying the morning paper, for example, may not require any exchange of words. On the other hand, more formal agreements may explicitly cover aspects of the agreement, such as liability if the product is found to be unsafe or defective.

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[1] When the intention of the parties is inferred from their conduct and the circumstances of the transaction, rather than from explicit and direct words.

The common law[2] has developed implied terms covering a product's merchantable quality[3] or fitness[4] for its intended purpose. Territory, State and Federal legislation (statutory law) also implies similar terms into contracts and often bars the exclusion of those terms by the parties.

A person suffering loss from a defective product may thus sue for breach of an actual or implied term of a contract.[5] To succeed, a claimant currently must establish

- the existence of a contractual relationship,
- a breach of an express or implied term of the contract by the defendant,
- that the claimant suffered loss, and
- that the breach was a cause of the loss in question.

Contractual relationships

Rights that arise under a contract generally can only be enforced by and for the benefit of the parties. Victims of defective products who are not parties to the contract have no rights to compensation, even if they were intended beneficiaries of the products. The Federal Trade Practices Act has, in the case of consumer goods[6], extended contractual rights beyond retailers to manufacturers on the one hand and beyond initial owners to subsequent owners on the other. Similar extensions have also been provided in complementary legislation in some States and Territories.[7]

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[2] Law developed through successive court decisions that are then binding on, or at least authoritative in, subsequent proceedings.

[3] Saleable and fit for the market; sound and undamaged; such as is generally sold in the market.

[4] 'Fit' in this context means suitable or appropriate.

[5] Most actions in contract involve goods that are deficient in terms of their performance, rather than the cause of personal injury or damage to property (Young 1988, p. 3).

[6] Consumer goods are defined as those of a kind ordinarily acquired for personal, domestic or household use or consumption, or that have a value of less than $40 000.

[7] *Manufacturers Warranties Act 1974* (SA), *Law Reform (Manufacturers Warranties) Act 1977* (ACT), *Sale of Goods Act 1923* (NSW). This legislation is important where the Trade Practices Act does not apply due to, for example, constitutional constraints.

People suffering loss from defective products who do not own the goods -- or where either the manufacturer, its agent or the retailer was not responsible for the defect that caused the loss -- remain without rights under contract.

Other requirements

With a contractual relationship established, the claimant bears the onus of proving that a breach of contract caused the loss for which compensation is claimed. This may involve breach of actual terms in a contract but, generally, it will involve terms implied by statute.

Implied terms governing standards of quality were first included in contracts for the supply of goods by a presumption established under common law that, in the absence of agreement to the contrary, goods should be of 'merchantable quality'. Legislation relating to sales of goods subsequently codified the circumstances in which this condition would be automatically implied by a contract.

The Trade Practices Act applies Australia-wide to contracts between 'corporations'[8] and 'consumers'.[9] The Act provides mandatory implied terms for contracts for consumer products, specifying that the goods be

- of merchantable quality,
- fit for a purpose communicated by the consumer to the manufacturer, or
- in accordance with a description or sample, if provided.

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[8] Specifically, the Act applies to dealings made by 'foreign corporations, and trading and financial corporations' formed within the limits of the Commonwealth'; in interstate and overseas trade and commerce; or within or with a Territory. The Act is limited to these areas due to constitutional constraints on the scope of Federal legislation.

[9] See Note 6 for the definition of 'consumer goods'.

Some State or Territory consumer laws may provide coverage where the Trade Practices Act does not, either because of a broader interpretation of 'consumer' or because a corporation is not involved.[10]

Defences and counterclaims

Federal, State and Territory legislation absolves producers from responsibility if the buyer has examined the goods and the defect ought to have been revealed by that examination[11], or if the defect has been specifically pointed out to the buyer.[12]

A manufacturer is not liable under the Trade Practices Act if someone other than the manufacturer (or its servant or agent) caused the goods to fail to

- be of merchantable quality,
- be fit for the purpose, or
- correspond to the description

after they left the manufacturer's control.[13] In such cases, the retailer bears responsibility under contract law, even if the fault occurred as the goods passed from manufacturer to retailer.[14] Under legislation in South Australia and the Australian Capital Territory, the implied manufacturer's warranty does not apply if the reason the goods were not of merchantable quality was independent of human control or due to an act or default of the consumer or a third party. The New South Wales provisions in this area are largely discretionary and there are no specific defences.

The common law in contract actions has developed in such a way that full account is not always taken of negligence on the part of the claimant, especially in product liability cases. This is because a specific defence of contributory negligence is usually not available. There are, however, other aspects of contract law that may take contributory negligence on the part of the claimant into account. For example, contributory negligence can `in effect be treated as a break in the chain of causation,

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10 *Consumer Transactions Act 1972* (SA), *Sale of Goods Act 1923* (NSW) Part VIII, *Goods Act 1958* (Vic.) Part IV, *Fair Trading Act 1987* (WA) Part III.

11 For example, *Trade Practices Act* s. 71 (1)(b); Sale of Goods Act (Qld), s. 17 (2).

12 For example, *Trade Practices Act* s. 71 (1)(a).

13 *Trade Practices Act* ss. 74 B(2)(a), 74 D(2)(a).

14 *Trade Practices Act* ss. 71 (1), 71 (2).

thereby denying all right of recovery' (Masel 1989, p. 77).[15] Further, it might be argued that careful use of the product was a condition precedent[16] in the purchase contract.[17] Breach of such a condition, if upheld, would bar a claimant from seeking redress under that contract. Finally, individual elements of a damages claim might be attributed to different causes so that, in effect, the product would be found to have caused only some of the claimant's loss.

Negligence

The rules of negligence impose on everyone a duty to take reasonable care to avoid harm to those whom they should foresee as likely to be injured because of their actions.[18] To establish liability, a person must show that

- the defendant owed a duty of care to a class of people of which the claimant was a member,
- the defendant breached that duty, and
- the loss was caused by that breach.

The concept of owing a duty of care to one's `neighbour', independent of any contractual relationship, means that liability under this area of the law is extended to a wider group of persons than under the law of contract. A producer, for example, owes a duty of care to any person it can reasonably foresee may be harmed if it fails to take reasonable care. Thus, responsibility in negligence extends beyond the purchaser or owner of goods to the user or even a bystander.

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[15] The question of causation can be a difficult legal issue which the courts approach differently in actions in negligence and contract -- *Alexander v Cambridge Credit Corporation Ltd.* [1987] 9 NSWLR 310.

[16] A condition that must be satisfied before other rights under the contract can be claimed.

[17] *Harper v Ashton's Circus Pty Ltd* [1972] 2 NSWLR 395.

[18] These actions are traditionally concerned with personal injury and property damage, rather than with goods that do not work. However, the distinction is becoming blurred (Young 1988, p. 52).

However, proving liability due to negligence can be difficult in practice: for example, establishing a breach of a duty of care where events leading to the incident are difficult to explain and/or where there is more than one defendant. In Australia, a claimant who can do no more than show that the loss was caused by the negligence of somebody in the supply chain will probably fail.

This is due largely to the interpretation of the legal doctrine of *res ipsa loquitur* in Australia. Literally, this doctrine means 'the thing speaks for itself'. It may be raised by a plaintiff who cannot explain a set of circumstances or events, which nonetheless suggest negligence on somebody's part, to draw an inference of negligence on the part of the defendant. In the United Kingdom, *res ipsa loquitur*, if successfully invoked, shifts the onus of proof to the defendant and can therefore be a powerful weapon in the plaintiff's armoury. Similar approaches are also adopted in other countries, including the United States and Canada. In Australia, however, it is merely an evidenciary tool for establishing a prima facie case and thus is far less favourable to the claimant.[19]

[19] Kilgannon v Sharp Bros. [1986] 4 NSWLR 600 is a good example of the operation of *res ipsa loquitur* in Australia in comparison with other countries. The case concerned a child seriously injured as a result of an exploding bottle of aerated soft drink purchased by his mother. Burdened by the evidenciary difficulties of proof against multiple defendants at trial, the plaintiff failed to establish, under the principle of *res ipsa loquitur*, that either the manufacturer or the bottler were negligent whilst the bottle was in their 'control'. In the United Kingdom *res ipsa loquitur* may have put the onus on the bottle manufacturer and the bottler to establish that there was no negligence on their part to cause the explosion. In Australia, however, it merely helped to establish that there was probably negligence of some sort involved but it was still up to the plaintiff to establish which defendant, if any, was responsible. Even if the claimant succeeded in this, in Australia the defendant would only be required to partially explain the occurrence -- 'the bottle exploded because of an inherent weakness in the glass' might be sufficient -- rather than satisfy the court that it was not negligent.

Defences and counterclaims

There are two main defences in actions in negligence:

- contributory negligence; and
- voluntary assumption of risk.

In a negligence action, it is open to defendants to argue that claimants contributed to the loss by their own negligence. Under common law, this constitutes a complete defence, so that claimants would receive nothing if their negligence contributed to the cause. However, statutory provisions now require courts to merely reduce damages to reflect the extent to which the claimant failed to take reasonable care for his or her safety.[20]

A defendant in a negligence action can also argue that the claimant, knowing that the goods posed an abnormal risk, voluntarily accepted that risk. If successfully invoked, this is a complete defence but, according to the ALRC, it has proved difficult to establish in Australia and is seldom raised.

Although the common law in negligence actions does not make any special provision for liability in regard to new or innovative products, it has developed some rules of thumb that take into account both the benefits to society from the development, manufacture and sale of new and innovative products and the costs to the individual consumer of product-related losses. The courts generally weigh the likelihood and possible extent of loss resulting from any activity (including the manufacture and supply of goods) against the value or utility of the activity and the cost of avoiding such loss.[21]

Trade practices

In addition to implying certain terms into contracts for the supply of consumer goods, the Trade Practices Act and some State and Territory legislation also confer rights on users of products directly. Such rights are quite separate from causes of

[20] Various State and Territory Law Reform (Miscellaneous Provisions) Acts.

[21] An example of the operation of this principle might be found in the pharmaceutical industry. A producer of a drug that caused the death of a small proportion of its users would be less likely to be in breach of a duty of care if the product was designed to alleviate a life-threatening rather than a minor illness, especially if no alternative cure was available.

action in either negligence or contract. The Trade Practices Act allows individuals to sue for damages for contraventions of consumer product safety or information standards or for misleading or deceptive conduct. The remedy is available to any person suffering loss as a result of the breach, and so also provides an ancillary means of extending privity of contract. Similar provisions exist under consumer protection laws in New South Wales, Western Australia, Victoria, South Australia and the Australian Capital Territory.[22]

Defences and counterclaims

The Trade Practices Act provides a defence where

- the producer could not reasonably have known or was not in a position to know of the breach, or
- the defendant acquired the goods from an Australian firm for the purpose of resupply.

This defence is duplicated in the New South Wales, Western Australian and the Australian Capital Territory provisions, but not in other State and Territory legislation.

Breach of statutory standards

Australia has a range of Territory, State and Federal laws and regulations governing standards of consumer goods. Breaches of these standards usually involve some form of criminal sanction, and may also be used as (by no means conclusive) evidence of a breach of a duty of care in an action in negligence. Contravention of a general standard may also give rise to a separate civil action for breach of statutory duty if the breach has caused loss to the claimant and `where it can be inferred from the legislation that a private right of action for a breach was intended to be given to a class of persons of which the claimant is a member' (Young 1988,

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[22] *Fair Trading Act* (NSW) Part III, Part IV Div 1, Part V; *Fair Trading Act* (WA) Part II, Part V, Part VI Div 2; *Consumer Affairs Act 1972* (Vic) s. 61(1); *Fair Trading Act* (Vic.), Part II Div 1; *Trade Standards Act* (SA) s. 44(1); *Fair Trading Act* (SA), Part X Div II; *Consumer Affairs Act* (ACT), Part IIIA.

p. 91). Like an action in contract, the claimant would only be required to prove that the goods did not meet a prescribed standard and that loss resulted. An action for breach of statutory duty may therefore provide a claimant with an alternative remedy, although these cases would probably be rare.

Jurisdiction and procedure

Legal rights in product liability cases may be enforced in a variety of Federal, State and Territory courts. The jurisdiction will depend on the source of those rights, particular legislation relating to the conferral of jurisdiction, and considerations concerning the exercise of Federal judicial power arising from the Constitution.

Every State and Territory in Australia has a small claims forum of some type. In some States there are small claims tribunals (such as the Consumer Claims Tribunals in New South Wales). In other States and the Territories, there are special small claims divisions in the lower courts. All have jurisdiction over actions for damages under current product liability law. Fees for instituting proceedings in small claims forums are nominal and maximum limits on claims range from $2000 to $10 000.[23] Where proceedings entail complex technical issues, small claims courts and tribunals are empowered to refer the matter to a properly constituted court.

The Trade Practices Act currently includes a ten-year statute of repose provision applying to actions for the breach of an express or implied term of a contract and to specific statutory actions under the Act. A 'statute of repose' refers to the time limit (after purchase of the goods) for which a producer can be held liable for loss caused by its products.

Interlocutory and discovery processes available to both sides in litigation under the current law are designed to expedite court appearances and help the parties decide whether to settle or contest a claim. The former requires each party to answer questions posed by the other party concerning the circumstances of the loss, while the latter provides access to relevant documents held by the other party.

[23] In New South Wales, the limit is $20 000 for claims involving motor vehicles.

C.2 The proposals

The ALRC concluded that the existing laws are an unsatisfactory platform for reform. In its opinion, while the problems facing non-owners could be resolved by relatively minor changes, resolving the current regime's complexity, evidenciary difficulties and associated high legal costs would require more fundamental change.

Accordingly, the ALRC proposed a new product liability regime that seeks to achieve a number of goals, including

- fairness,
- economic efficiency, and
- lower legal costs.

The ALRC's approach

The ALRC has prepared a draft Bill to amend the Trade Practices Act and proposes that all current rights of action in product liability cases be withdrawn and replaced by this single regime. This would mean a total overhaul of the law.

The proposals have been drafted with a new broader aim for a product liability regime -- which the ALRC terms `risk matching' -- whereby the `risks of losses caused by goods should be "matched" with the benefits derived from those goods, so that those who benefit pay the full cost of their benefit' (ALRC 1989, p. xviii). The ALRC argues that the producer is likely to know more than users about the risk that the product will cause harm and that, therefore, the objective of risk-matching is best met if liability for any loss `caused by what goods do' resides with the producer (see Chapter 3 and Appendix B for a discussion of this argument). This is in contrast to the current product liability regime in which either a breach of contract or some form of wrong-doing (that is, breaching a duty of care or a statutory duty) must be proved. Where, however, the loss is caused by the way the goods are used, the ALRC's proposals aim to assign liability to the user. For those losses attributable to a mandatory standard, liability is imposed upon the government responsible for the standard. For losses caused by factors beyond human control liability lies where it falls -- generally with the consumer. As a

result, the main issue under the ALRC's proposals would be whether the loss was caused by the way the goods acted, the way the goods were used or some external influence.

Details of the main aspects of the ALRC's proposals are set out in Chapter 3.

C.3 Effects of individual provisions

Coverage of proposals

The ALRC's proposals cover 'goods' as defined in the TPA, with some exclusions. The proposals would not apply to human blood and tissue, or to electricity. Nor would they apply to buildings, although goods that are affixed to buildings would be included. Electricity is excluded from the definition because the ALRC perceived that its inclusion might lead to the anomalous outcome of power-generating authorities being held liable for defects in electrical fittings and appliances.

Some inquiry participants argued that the use of different definitions within the same Act may risk the complexity and confusion in the law that the reform proposals seek to remedy. Perhaps more importantly, the ALRC's definitions raise problems at the margin. The Institution of Engineers argued that, in its understanding, reinforcing rods incorporated into a building could, individually, be considered 'goods'. Other participants questioned whether the definition would include computer software, which may alternatively be considered a service.

The proposals do not apply to any claim falling within Federal, State or Territory workers compensation legislation, which provides cover for employees injured at work by goods or otherwise. On advice from the insurance industry, the ALRC assessed that, if workplace injuries were included, the associated increase in product liability insurance premiums probably would not be fully offset by a corresponding fall in workers compensation costs. Excluding workers compensation from the proposals would mean that the current law would continue to cover workplace loss. Thus, where workers compensation law currently allows, an employee injured at work by faulty goods would be able to sue the employer or producer of the goods

for negligence, or an employer or insurance fund would be able to seek compensation in either a contract or negligence action against a producer of goods that had caused an injury to an employee.

The same approach was not taken to loss resulting from motor vehicle accidents. These would be covered by the ALRC proposals.[24]

General basis of liability

The general basis of establishing liability in the ALRC's proposals has two important consequences. First, a claimant would not have to prove as much as is currently the case -- especially in a negligence action -- to establish a right to compensation. Second, the proposals provide a remedy to a wider class of people suffering loss caused by unsafe or defective goods. Both these factors would encourage more claims and enhance the likelihood of success in those claims.

The words 'the way the goods acted' may require an extended settling period for interpretation following enactment. The ALRC intended 'the way the goods acted' to be broadly interpreted, and has referred to notions, such as 'failure of the goods to act or behave in a particular way', that are included in its meaning. The intention is to 'encompass all things that goods do or do not do'. Some inquiry participants suggested that such an approach would offer the courts considerable flexibility in the application of the provisions, possibly adding to uncertainty in terms of outcome. Another view is that 'the "way the goods acted" can only be determined by reference to all the surrounding circumstances' (Simpson 1989). These would include, for example, the manner in which the goods were used or the use to which they were put. According to some participants, this would raise similar issues to those currently considered under, for example, the concept of 'fitness for purpose'. Such considerations may also include comparisons with how the goods might have

[24] Currently, personal injury caused by motor vehicle accidents is subject to a variety of State and Territory compulsory statutory accident insurance schemes. Some of these are no-fault schemes; others are based on common law actions for negligence. On the other hand, common law rules and optional insurance apply universally to property damage resulting from motor vehicle accidents.

performed had they been designed differently. Mr Masel said that ‘the attempt to prevent judges embarking on detailed examinations of the circumstances of particular cases will not in fact succeed’. Ms Kellam (representing Blake Dawson Waldron) referred to the phrase ‘the way the goods acted’ as a ‘new, very nebulous, and to date untested concept’. The NRMA described it as ‘very open and undefined’.

The ALRC also intended ‘manufacture’ to be interpreted widely: it includes ‘grow, extract, produce, process and assemble’. Some participants see this definition as being so broad as to have unintended consequences, while others were uncertain about the likely interpretation.

Although questions of defects in goods, or any specific notion of fault on the part of the producer, are not necessary elements in establishing a case under the reform proposals, the ALRC’s proposals are still, in the Commission’s view, conditioned by fault (in a general as distinct from the strict legal sense). Fault on the part of the producer for all the loss would effectively be inferred if no other cause were established, unless the producer could prove that the risk that the goods would act in the way they did was either unknowable, accepted by the consumer, or increased by unreasonable use.

This runs to the heart of the ALRC’s approach, but was a contentious issue among some participants. There was considerable concern, particularly within the business community, that the effective presumption of producer liability under the proposals would result in a dramatic increase in damages awards. There was also concern that producers would have no control over the extent of their liability. The Australian Consumers Association (ACA), however, agreed with the ALRC that merchantable quality, along with other aspects of the current law, involve vague and out of date concepts and should be replaced. It put forward the concept of ‘unsafe or defective’ as an alternative, but nonetheless endorsed the ALRC’s approach.

Defences

The majority of participants were of the view that the defences available in the reform proposal would give producers only limited protection. The ‘acceptance of risk’ defence was considered by several to have some application, but that it might prove difficult to establish against a young, incompetent or ‘clever’ claimant. The

remaining two defences -- the ‘development risks’ defence and the ‘mandatory standards’ defence -- were generally considered difficult to establish under any circumstances.

Acceptance of risk. This defence would apply ‘if what the claimant knew about the goods before the loss occurred would have enabled a reasonable person to assess the risk that the goods would act in the way they did’. The requirement that the defendant prove what the claimant knew was considered by some participants to be particularly onerous; for example, claimants may be able to preclude application of the defence by claiming that they had not read warnings attached to the goods. By contrast, Mr Masel said that the defence would substantially reduce liabilities. However, he went on to add that ‘my fundamental objection to it as a basis of defence is its arbitrariness’; and further, since the provision would encourage consumers to ignore warnings, ‘I do not think that the "acceptance of risk" defence and its belief in the efficacy of warnings is going to work’.

The proposal takes no explicit account of a claimant’s limitations, such as youth or mental state. Several participants suggested that the courts would probably add this type of subjective qualification. In this case, to avoid liability, a producer would have to take into account possible handicaps suffered by consumers and ensure that they understood any risks involved. This may prove a difficult duty. Similar difficulties already arise in relation to the duty imposed on producers by the current law. However, the focus under the current law is whether claimants should reasonably have understood the facts, rather than whether they actually knew (see Chapter 3).

The Australian Pharmaceutical Manufacturers Association expressed concern with regard to unavoidable side-effects that prescription medications cause to some patients. Many of these side-effects were said to be unpredictable and not an indication of whether the goods are unsafe or defective. The Association was concerned that its members would not be able to bring themselves within the ‘acceptance of the risk’ defence.

Development risks. This defence aims to minimise any adverse effects on innovation by shifting liability from producers to consumers where risks are ‘unknown’ and ‘unknowable’.

The absolute standard -- whereby a producer would avoid liability if it ‘could not have discovered, using any scientific or other techniques then known or in any other

way, that the goods could act in the way they did' -- is onerous. The ALRC provided an example of where this defence might be available.[25] Even in that instance, some participants doubted that the circumstances of that case could be brought within this 'development risks' defence. They argued that the ALRC's proposal sets a test of what was 'knowable' 'using any scientific or other techniques then known or in any other way'. Thus, in the example provided by the ALRC, participants suggested that the claimant would have argued that trials could have been conducted to reveal the problem.

This defence is so restricted in application that it may provide less protection to producers than is available under the current law. As already discussed, issues relevant to a 'development risks' defence are currently included in court deliberations in negligence actions. Further, in contract cases under existing law, goods that fall within the proposed 'development risks' defence might not be found to be defective.

Mandatory standards. Some participants claimed that the 'mandatory standards' defence would be difficult to raise successfully. It would be available if the 'goods acted in the way they did only because they complied ... with a mandatory standard'. The existence of any other contributory cause would defeat this defence.

The ALRC suggests that, where a mandatory standard is a contributing factor only, the producer would not be liable for that proportion of the loss attributable to that standard, because of the provisions reducing compensation when other factors also caused the loss. In these circumstances, the claimant would be in the same position in regard to such a reduction in compensation as under current laws (see below).

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25 *Ashington Piggeries v Christopher Hill* [1971] 1 All ER 847, where Ashington Piggeries ordered a mink feedstuff formula from Christopher Hill. A commonly used preservative in the formula proved to be toxic to the mink and caused heavy losses. Despite the fact that the possibility of the chemical reaction had not been envisaged, and that in the existing state of scientific and commercial knowledge no deliberate exercise of human skill or judgment could have prevented the meal from having its toxic effect on the mink, the meal was held to have failed the 'fitness for purpose' test in the Sale of Goods Act and Christopher Hill was held to be liable.

Some participants suggested that the effect of the mandatory standards provision would be to deter governments from promulgating standards. In their view, this would not improve loss prevention.

Although the existing law does not contain an equivalent defence, compliance with a mandatory standard currently would negate any argument that there was a defect in the goods or negligence on the part of the producer, if there were no other means of effectively meeting that standard. Thus, liability now lies where it falls in circumstances where this proposed defence might apply, unless an action in negligence can be established against the authority that set the standard. There is no general bar to such an action against a government entity, although there may be specific restrictions in regard to actions against particular authorities as well as some likely practical difficulties.

Compensation

In discussing what compensation should be payable for loss, the ALRC noted that this question is complex and that its resolution necessarily requires a number of arbitrary judgments. It suggested that all rules for the awarding of damages and costs should be reviewed in a separate inquiry.

For the purposes of its inquiry, the ALRC proposed that all losses be compensated in accordance with current provisions in section 82 of the Trade Practices Act. Damages claims generally fall into two categories:

- Economic losses, which include the cost of incidentals, such as medical expenses, loss of past earnings, loss of future earning capacity and damage to property; and
- Non-economic losses, which include loss of enjoyment of life, and pain and suffering.

As with the present law, compensation for loss of future earning capacity in the case of death caused by `the way the goods acted' would be available only to dependants of the deceased. Compensation to the estate of the deceased is (and under the proposals would be) limited to funeral expenses. Also as at present, only the owners of the goods would be able to recover lost expected profits or premature capital depreciation -- referred to as `pure economic losses'. There would be no

provision for punitive or exemplary damages, which are designed to punish a wrong-doer rather than compensate an injured party.

Reductions in compensation

The calculation of reductions in compensation would be divided into three stages. First, the total amount of loss suffered would be ascertained. The second stage is implied from the central provision making producers liable for loss caused by the way goods acted. Producers would thus not be liable for that proportion of the loss caused by other factors. Third, the ALRC's proposals provide for a reduction in compensation payable to the claimant on the basis of unreasonable acts or advice that increased the risk of the goods causing damage. Overall, these provisions are intended to impose liability on the parties responsible in accordance with their contribution.

As explained by the ALRC, considering the unreasonableness of acts or advice in relation to the use of goods diverges from the approach taken in the current law of contributory negligence. The ALRC accepted that this difference would result in some uncertainty. However, it argued that the concept of reasonableness was introduced to acknowledge the fact that all uses of goods increase risk but that only some should reduce the compensation payable. The ALRC also argued that judging unreasonableness would not require investigating whether the producer exercised due care, although that is what the law does at present. The ALRC considered that restricting any examination of reasonableness to the conduct of claimants and third parties, and not considering the conduct of producers, is necessary to limit the costs of resolving disputes.

Allocating liability

Where more than one producer contributed to the cause of the loss, the ALRC's proposals would allocate liability, at the court's discretion, according to one of two arbitrary formulae. Initially, contributions would be allocated equally among the responsible producers. If, however, the court concludes that such an allocation would be unfair, contributions would be allocated in proportion to the value of the respective inputs of the contributors to the goods.

Some participants suggested that either method may impose an inefficient and unfair burden on a manufacturer whose contribution to the cause of the loss was small.

The ALRC countered that the question of fairness should also take into account delays in dealing with the issue; that is, there is a trade-off between an arbitrary solution and the prolonged litigation process likely under the current law. In addition, the ALRC pointed out that, under the proposals, producers would be able to agree to their own means of allocating liability between themselves (that is, by contracting-out of the regime) thus avoiding this arbitrary solution.

Jurisdiction and procedure

The ALRC recommended that the Federal Court of Australia and State and Territory courts continue to have jurisdiction to hear proceedings involving claims for compensation or contribution under the proposals. In addition, the jurisdictional limits of State and Territory courts (concerning locality, subject matter or otherwise) should, according to the ALRC, be retained. The small claims divisions of courts would retain jurisdiction over product liability cases under the proposals, but the ALRC has recommended against extending jurisdiction to tribunals because of the uncertainties of enforcing tribunal decisions. A number of participants said that continued access to small claims courts would exacerbate opportunities for fraudulent and nuisance claims under the proposals.

The notice before action provision in section 75AN of the proposals adds another pre-trial procedure designed to expedite claims. It requires the claimant to disclose certain facts at least 28 days before commencing proceedings in court. This is relevant to some defences under the proposals. It is also intended to help producers 'weed out' dubious claims. In its submission to the Draft Report Hearings, the ALRC proposed strengthening this provision by extending the period available to the defendant to cross-examine the claimant under oath from four to six weeks.

The ALRC's reforms do not include a statute of repose. The ACA submitted that any such constraint would give free reign to producers whose products cause long term effects (such as cancer), or allow a producer to market goods on the basis of longevity and then rely on a repose period to avoid claims. However, other participants said that, by avoiding a statute of repose, the proposals fail to take into

account the limited life of goods. As a consequence, producers would never be able to close their books on goods and the insurance risk would be incalculable.

Although the reform proposals do not include a statute of repose, some of their provisions may be relevant to the question of product age. A court may decide that loss suffered as a result of the way 'old' goods 'acted' was caused not by the goods but by use beyond the design life, by deterioration of the product through use and/or by lack of maintenance. Similarly, a producer might seek to impose its own repose period (under the 'acceptance of risk' defence) by adequately informing consumers of the safe life of the goods.

Under the current law, the concepts of defect and negligence tend to negate producer liability for loss occurring long after manufacture of the goods, reinforcing the statute of repose contained in the Trade Practices Act.

C.4 Legal costs

The ALRC claims that implementation of its reform proposals would lead to a significant reduction in legal costs in product liability cases. Ways in which the reforms may reduce legal costs are discussed in the following paragraphs.

Unifying the law

Although the common law of negligence and contract, and the Trade Practices Act, are largely the same nation-wide for product liability cases, each State and Territory has different 'sale of goods' and consumer legislation.

Unifying the law (whether the current regime or the ALRC's proposals) would offer significant gains to both producers and consumers by enabling national organisations to rationalise resources and reduce the specialisation currently involved in providing legal services. There was widespread support among inquiry participants for unification of product liability laws throughout Australia.

The ALRC addresses this by proposing that the Commonwealth, States and Territories all enact its reform Bill.

One product liability law

The ALRC also seeks to reduce legal costs by replacing the four separate causes of action currently available (none of which is specifically designed to deal with product liability cases) with a single regime dedicated to this area. It is argued that this would reduce the burden on both parties in resolving disputes and would expedite resolution. This would work, according to the ALRC, not only in fully contested cases: the simplified and more certain regime would lead to settlement much earlier in the process than currently happens, because all parties would be able to assess more accurately the likely outcome.[26]

This claim was questioned by a number of participants who submitted that there would be little, if any, reduction in transactions costs, particularly in the settling period as concepts and interpretations were resolved.

Shifting the difficult issues

The ALRC also argued that, under its proposals, the more controversial aspects of cases would become issues at a later stage in the legal process, but an alternative view is that this would be achieved largely because most of the more difficult legal and evidenciary issues would be transferred from the claimant to prove to the producer to disprove.

The ALRC said that its procedures for apportioning liability between defendants would result in cost savings. This would depend on whether the provision allowing 'contracting-out' between producers was used to reduce the role of litigation in these disputes.

Blake Dawson Waldron suggested that allocating liability among producers would be more difficult for the courts where there is no concept of fault, thus increasing the costs involved.

[26] Approximately 80 per cent of product liability cases are settled before they reach court.

Settling claims

Section 75AN of the proposals, which requires that the claimant give particulars of the circumstances of the loss at least 28 days before commencing proceedings, is also intended to reduce legal costs by facilitating earlier settlement of some cases. There may be some matters that, having not been resolved in informal negotiations, would be settled in such a process.

However, the extra costs of adding another layer to the formal process in all disputes must be set against any savings where this layer succeeds.

Problems of interpretation and uncertainty

Although the ALRC's proposals are intended to provide a less complex yet more comprehensive product liability regime, this is achieved at the risk of considerable uncertainty in their application, and possibly higher costs, at least in the phasing-in period.

As the diverse range of views on the implications of the reform proposals shows, it is probably too much to expect that the apparent simplicity will avoid legal argument. Mr Masel described the proposals as 'obscure and complex and will, as a result of this, fail to provide certainty and predictability or to reduce transactions costs'. Successive applications of terms such as 'the way the goods acted' by the courts may cloud the new regime. Professor Luntz indicated 'grave doubts that the novel concept of how a product "acted" is any clearer than whether it is defective'. Further, he said that the ALRC 'acknowledges that "unreasonable conduct" is a vague basis of liability', and yet 'it is precisely the reasonableness of other persons' acts that will determine the extent of the manufacturer's liability under clause 75AG'. As several participants indicated, 'unsafe', 'defective', 'fitness for purpose' and 'merchantable quality' are all superficially simple concepts in the current law. Only judicial application of these terms to specific situations in accordance with binding or authoritative precedent causes difficulty.

The ACA distinguished between two sorts of legal interpretation. The first is where a new legal concept is introduced and its interpretation may be somewhat uncertain until the first authoritative interpretation is made by the courts. The ACA submitted that such problems occur with any law reform but that they would be minimised

under the ALRC's proposals because of the emphasis on the established concept of causation. The second type of interpretation is where legal principle gives courts a wide discretion, such as in the notions of negligence. These require a court to decide, on each occasion, whether a case fits within the principle and represents an ongoing area of uncertainty. The principle itself can be stated with certainty, but whether a court will apply the principle to a particular case is far less certain, even though the legal profession is skilled in forecasting likely outcomes.

Further, the ACA suggested that there will, under any legal regime, be examples of injustice that are not evidence of vagueness in a legal principle: a small proportion of unfair outcomes is inevitable. It said that, to date, consumers in product liability cases have borne the brunt of such unfairness because of the difficulties imposed on the claimant in establishing a case.

The ALRC argues that the reform proposals would effectively direct the courts to do what courts of law do best: decide what happened.

However, many participants said that the emphasis upon causation may not lead to less complex legal argument. Mr Masel expressed the view that levels of uncertainty and legal costs in the long term under the new regime would be much the same as at present, with the likelihood of some early explosion in uncertainty and legal costs during the period in which the regime, if implemented, was settling down.

Overall, there is little evidence (but considerable opinion) to support or reject the ALRC's claim that its proposals could lead to significant reductions in legal costs in product liability cases.

However, since the ALRC's views on the likely judicial interpretation of its provisions are not widely accepted by participants from the legal fraternity, or by insurers, manufacturers and the business sector generally, the result may well be some uncertainty and increased litigation to resolve contentious issues. Thus, legal costs might well increase in the settling period, when competing interpretations of the new regime are resolved.

C.5 Impact on the number and success of claims

Legal costs aside, changes in the level of producer liability resulting from the reform proposals can be expressed as the change in the total of damages awarded in all product liability cases compared to the total awarded under the current regime. This will depend on both the change in the number of successful claims and the amount of damages awarded for each successful claim.

The non-owner problem

The broader coverage of the ALRC's proposals to include people who previously found it difficult to obtain compensation (such as family members and bystanders) would result in a larger number of claims being presented but, as discussed in Chapter 6, this would be offset to a degree by producers supplying safer products to cover their increased exposure.

Shifts in bargaining power

Claimants and defendants respond to similar incentives in deciding whether to proceed or to settle product liability disputes. Claimants implicitly assess any expected damages award against the costs of the action, taking into account any settlement offer as it arises. Defendants assess settlement costs against the risk of paying more in damages and legal costs.

Claimants' and defendants' expectations of the likelihood of success, and of their liability for costs in the case of either success or failure, provide each party with a means of estimating the value of contesting an action. Usually, these values would be positive for claimants and negative for defendants.

Increasing the expected value of actions to claimants would enhance their bargaining power and increase both the number and success rate (because of more settlements in the claimant's favour) of claims. Increasing the level of expected losses to defendants would have the same effect.

Likelihood of success

The ALRC's proposals reduce the burden on the claimant to establish a case and shift most of the more difficult issues to the defendant. Transferring the onus of proof in this fashion may have little impact where there is no shortage of admissible evidence of the events leading to the loss but, in those cases where the precise cause of the loss is difficult to discern, legal onuses in favour of claimants will work to their benefit. Further, transferring the burden of proving most technical issues to the defendant and removing, from the realm of the claimant, the process of apportioning liability between defendants would increase the proportion of the legal costs of resolving disputed claims borne by producers vis-a-vis claimants.[27] These aspects would increase claimants' bargaining power.

However, not all the defences available under the ALRC's proposals apply to all current causes of action. This may reduce the prospects of success for the claimant under the proposed regime.

Under present negligence actions, defendants may have recourse to arguments equivalent to those available under the reform proposals, and in a manner that is at least as favourable to them. This is not the case for actions in contract. As already discussed, contributory negligence is not always fully taken into account in actions in contract, especially in product liability cases. But there are arguments available in contract actions which, if successful, may have the effect of taking the claimant's negligence into account.

Further, rough parallels might be drawn between some of the ALRC's defences and aspects of current actions in contract, bearing in mind the different approaches of these actions. The acceptance of the risks defence in the ALRC's proposals might, for example, be equated with a defect in the goods that was pointed out to consumers or that they should have noticed.

[27] As the ALRC explained, transferring the burden of proof to a party does not transfer all the costs of leading evidence on that issue. The opposing side may want to lead evidence in rebuttal. In addition, onuses of proof can shift from one side to the other as evidence is presented during the course of a hearing. But in general, the cost of establishing an issue will be greater for the party bearing the onus of proof. At present, disputed claims are contested on a loser-pays principle. The award of costs, however, rarely reflects the full costs of prosecuting a claim. Therefore, since all parties inevitably bear a significant proportion of their own legal costs, regardless of the outcome and any award of costs, where the costs of contesting claims initially fall is an important consideration.

Although it is difficult to quantify these countervailing influences, the Commission, in accord with most inquiry participants, is of the view that the general transferral of the onus from the claimant to the defendant is likely to lead to an increase in the bargaining power of claimants; thus increasing the number and success rate of claims.

Many inquiry participants shared the view that the increased bargaining power of claimants would result in a proliferation of claims at the lower end of the damages spectrum, especially in fraudulent and nuisance actions. Access to small claims courts in such cases would be significant because court fees are subsidised and the parties bear their own costs. Thus, claimants instituting proceedings in this forum risk very little but their own time.

The ALRC has referred to its 'notice before action' provision as a means of reducing the imbalance in the imposition of legal onuses in its proposals and help defendants 'weed out' dubious claims. Mr Masel also commended the provision to any product liability law reform. The Commission agrees that such a provision would help alleviate the problems created by shifts in evidenciary burdens and would confer benefits to any product liability regime which reversed the onus of proof in the way proposed by the ALRC. But the Commission does not consider that the provision would substantially offset the impact of the proposals' presumption in favour of producer liability.

Payments per successful claim

The ALRC's proposals would extend a form of contributory negligence to all product liability actions. Prima facie, this would be expected to reduce average payments per successful claim, but whether this would in fact be the case would depend on whether the ALRC's product misuse provisions were as generous to producers as those applying currently in negligence actions and, if not, whether extension of the provisions to all actions would more than offset the impact of less generous provisions.

There was some disagreement among inquiry participants about this aspect of the proposals but the more authoritative opinion seemed to lean towards some reduction in payments per successful claim.

Summary

Overall, there was a widespread view among participants that total producer liability would increase under the proposals. In particular, the Insurance Council of Australia believed that it is 'unarguable that the overall cost of such compensation will rise' and that it 'follows, therefore, that the cost of insuring against such risk will rise'. This suggests that increased liability stemming from the improved bargaining position of claimants under the proposals -- leading to a higher number of and success rate for claims -- will more than offset any tendency toward lower awards per successful claim. It also means that compensation payments per product-related incident occasioning loss would increase.

D PRODUCT LIABILITY LAWS IN OTHER COUNTRIES

Australia is not alone in considering changes to its product liability laws: many other countries have wrestled with proposals for changes in liability laws in recent years.

Many participants drew on the developments and experiences of other countries to support arguments for change. A number of participants looked to recent European Community legislation as a model for Australia to follow. One participant suggested that Australia should adopt the type of no-fault accident compensation scheme applying in New Zealand. Many other participants expressed concern that Australia should not take steps which might replicate the problems that have accompanied more stringent product liability laws in the United States.

D.1 European legislation

A number of inquiry participants cited the 1985 European Community Directive on Product Liability as an example of an efficient and fair regime. The proposal advanced by the Business Council of Australia (BCA) follows closely the European legislation (see Appendix G).

The Directive is based on the concept of strict liability, specifying that 'a producer shall be liable for damage caused by a defect in his product'. A product is judged to be defective when 'it does not provide the safety which a person is entitled to expect, taking all circumstances into account'. This expectation of safety is more what the public as a whole, rather than any particular plaintiff, is entitled to expect. The onus is on the plaintiff to prove that there is a defect in the product that caused the damage.

The United Kingdom was first to adopt the Directive, in early 1987; and all member states were required to follow suit by June 1988. By prescribing the elements of strict product liability legislation, the Directive sought to ensure a uniform approach throughout the community. The preamble states that one of major purposes of this

is to facilitate trade. However, the regimes have not been in operation for long enough to allow their effects to be assessed.

The Directive contains a 'mandatory standards' defence and a 'state of the art' defence. Under the 'mandatory standards' defence, a producer is not liable if 'the defect is due to the compliance of the product with mandatory regulations issued by the public authorities'. This differs from the ALRC's proposals in that it does not require the compliance to be the sole cause of defect. Under the 'state of the art' defence, a producer is not liable if 'the state of scientific and technical knowledge at the time when he put the product into circulation was not such as to enable the existence of the defect to be discovered'. The ALRC's proposals differ from this by imposing liability on the producer unless the defect 'could not have been discovered by any other means'. Member countries can choose whether or not to include the 'state of the art' defence in their enactment of the Directive.

The Directive is less comprehensive in its coverage of damages than is the ALRC's proposal. Compensation may only be received for private rather than commercial goods. Also, the Directive does not constitute the sole means of compensation for product-caused loss. Injured parties can still take action under other national laws. Member states also have an option to place a cap of 70 million European Currency Units on total compensation payable for damages caused by any single type of product.

Like the ALRC's proposals, the European Community Directive does not allow consumers to contract out of the regime while, unlike the proposals, the Directive has a statute of repose: a producer is only liable for a period of ten years for a defect in its product.

D.2 New Zealand

New Zealand dispensed with its product liability laws in 1974. Since then, compensation for product-related injuries has been covered by a general accident compensation scheme, which provides those injured with up to 80 per cent of lost earnings for as long as they are unable to work.

The New Zealand scheme has relevance to the Commission's inquiry insofar as it provides an indication of how quite drastic changes in incentives to producers and

consumers affect behaviour and ultimately the level of product-related loss. As part of its inquiry, the Commission initiated a consultancy to examine the New Zealand scheme and these incentive effects (Porter 1990).

D.3 Canada

Some Canadian provinces[1] have extended strict liability for products under contract law, or equivalent civil law, to all persons whom it might reasonably have been foreseen could be affected by a product.

New Brunswick, as with other Canadian provinces[2], has a similar legal system to Australia. In 1978, this province introduced product liability laws modelled on the Restatement of Torts, which is the main basis of strict liability in the United States. The Commission approached the Office of the Law Clerk and Parliamentary Counsel of the Canadian Government to ascertain whether New Brunswick has experienced any liability problems akin to those occurring in the United States (see below). It advised that the system in New Brunswick works efficiently, and there are no complaints from manufacturers about the cost or availability of liability insurance. It considered that two reasons that problems have not occurred are that Canada is far less litigious than the United States and does not have jury determined compensation awards.

The ALRC (1989) stated that other provinces and the Canadian Federal Government are considering adopting similar legislation to overcome perceived trade disadvantages with the United States.

D.4 The United States

Many inquiry participants, including the ALRC, cited aspects of the United States product liability regime that they considered were neither efficient nor fair.

[1] New Brunswick, Saskatchewan and Quebec.

[2] Except Quebec which is a civil law province.

As in Australia, product liability laws in the United States are primarily State based. The legislation varies between States, but all have strict product liability. Most States are in the process of reforming aspects of their product liability laws.

The basis for United States legislation is generally the Restatement of Torts, although a few States have adopted the virtually analogous Greenman principle. The core of the Restatement reads, 'One who sells any product in defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property.' A product is defective if it is not in the condition 'which would be contemplated by the ordinary consumer ... with the ordinary knowledge common to the community as to its characteristics.'

Most States allow bystanders as well as consumers to bring actions. To be successful, a bystander would have to demonstrate that his or her presence could have been reasonably foreseen by the defendant.

A claim may be based on defects in design, manufacture, or warning. Actions for design or warnings entertain some notions of reasonable care.

The available defences include voluntary assumption of risk, misuse of the goods, and alteration or modification of the goods after they left the seller's control. The 'state of the art' defence is allowed in some jurisdictions, and some courts have allowed contracting-out of liability in the case of parties in positions of equal bargaining power.

Some participants argued that there were similarities between the form of strict liability applying in the United States and the ALRC's proposed legislation and that, if the ALRC's proposals were adopted, problems similar to those arising in the United States would be experienced in Australia. That is, liability awards would become much larger and more frequent, and liability insurance cover would become less readily available and more costly.

By contrast, the ALRC argued that peculiarities of the American legal system rather than the product liability regime have caused most of the problems in that country and that, therefore, the United States experience is not directly relevant to Australia. The peculiarities listed by the ALRC include the use of punitive damages and trial

by jury, a politicised judiciary (United States citizens elect their judges in the same way they elect their politicians), the doctrine of joint and several liability (whereby liability can be imposed disproportionately to fault), and disregard of precedent (ALRC 1989, para 1.22).

Problems experienced

The Commission received a large amount of evidence on features of the United States liability 'crisis'. In addition to the material reported in the following paragraphs, further evidence is presented in the body of the report.

A report by the United States Conference Board (1988) documented the responses of 500 company chief executives on the impact of United States liability laws.

A significant number of these executives claimed to have laid off employees, ceased manufacturing some products, cancelled plans for new products, or curtailed new product research in response to concerns about the risks and costs of product liability litigation. Half of the firms surveyed believed that United States liability laws have had a major impact on the international competitiveness of United States firms.

Virtually all companies surveyed reported increases in their insurance costs whether or not they had ever had to defend a product liability case. Many also reported problems in obtaining insurance. Of the companies surveyed, 15 per cent had chosen to self-insure because of the cost of liability insurance.

About a third of firms surveyed had decided against introducing new products because of liability fears; about half the firms surveyed stated they had improved their warnings as a result of liability fears; and about a third had redesigned their products to enhance safety.

The Conference Board noted, however, that firms believed there may not be a causal link in the case of enhancing safety since there has been a trend toward greater safety in any case. Protecting the image of the firm and the product were seen to be as important a motivation as fear of liability payouts. To the extent that the United States liability system had resulted in increased safety, producers felt it had not done so efficiently or justly.

A major problem was seen to be the need to defend claims against old products, where such claims were totally unforeseen at the time the products were manufactured and insured. The Conference Board claims that, in a perverse way, those who make quality long-lasting products may be penalised by the liability system simply because their products have more years in which to accumulate potential claims. Cessna, which recently settled a suit for an aircraft manufactured in 1953, has not made a single-engined light aircraft in the United States since 1985, apparently because of the growing incidence of law suits.

Furthermore, liability laws were seen as causing some unintended reductions in safety. For example, since new aircraft are now more expensive, consumers are apparently substituting into older planes. This increases the average age of the aircraft fleet, so overall product safety is said to have declined. Similar effects have been reported for goods such as ladders and protective safety equipment: in response to higher prices attributed to product liability insurance charges, some consumers have chosen to forgo using these goods altogether. It was also claimed that, in relation to pharmaceuticals, product liability laws are having a detrimental effect on health and safety. Vaccine production in the United States (and, in particular, development of an AIDS vaccine) has allegedly been retarded due to liability concerns.

Nuisance law suits are claimed to be a major problem and to be generally settled irrespective of their validity because of the legal costs of defending actions.

Possible causes

Various factors have been cited to explain the liability 'crisis' in the United States.

Is the insurance industry at fault?

Some participants argued that deficiencies in the United States insurance market have contributed to the problem. The BCA acknowledged that some of the recent insurance increases could be explained by cyclical factors in the industry. The

Australian Consumers Association referred to a report which it claimed showed that the insurance 'crisis' in the mid-1980s was the result of a coordinated industry effort to manipulate the insurance market so as to secure reforms in product liability laws.

Harrington (1988, p. 43) reports, however, that economic analysis of the liability insurance industry shows it to be one bearing the hallmarks of competitive discipline: the market is not dominated by large players, the minimum efficient operating size is small relative to the size of the total market, there do not appear to be any major barriers to new firms entering the market, and there is little evidence of above normal profits.

Harrington also reports that the product liability market is characterised by fairly regular cycles, and Litan, Swire and Winston (1988) report that 'public concern over the efficiency and fairness of the civil liability system ebbs and flows with the apparently cyclical performance of the property and casualty industry.'

The cyclical movements in insurance premiums and incurred losses have very closely matched the changes in average product liability awards with a slight lag. This reinforces the view that the United States insurance industry is competitive.

Is strict liability the cause of these problems?

The majority of inquiry participants who expressed concern at developments in the United States considered that the doctrine of strict liability lay at the heart of the problem.

However, a number of countries with regimes similar to that applying in the United States have not experienced the sorts of problems identified in that country. Beerworth (1989), the ALRC and others have noted that strict liability has become the predominant doctrine in product liability law in the majority of Western countries during this century.

As mentioned, the province of New Brunswick in Canada has had liability laws based on United States legislation for over a decade. The Commission has been informed that there are no significant liability problems in this province.

The European Community Directive imposes strict liability for defective products, in much the same manner as the United States legislation. Some aspects of the European Community product liability law are harsher than the United States legislation. For example, the Directive defines ‘defect’ in virtually the same terms as the United States legislation, but imposes liability without the requirement that the products also be ‘unreasonably dangerous’. Further, the liability of the producer remains unaffected by acts or omissions of other persons who may have contributed to the cause of the damage.

The legislation giving effect to the European Community Directive has been in force for nearly three years in the United Kingdom, without any evidence of problems of the kind experienced in the United States. The ALRC said in evidence that the many predictions of European liability insurance costs soaring to United States levels have not been realised. The ACA stated that there have been no insurance rises in other member countries following the introduction of strict liability under the Directive.

Australia, together with other common law countries, has had a form of strict product liability under contract law since last century. The Trade Practices Act imposed statutory strict liability in 1978, which the ALRC described as a ‘major change’. In some respects, it could be easier to obtain compensation under the Trade Practices Act -- where a product is defective if it fails the test of ‘merchantable quality’ -- than under United States legislation where the product must instead be found to be ‘unreasonably dangerous’. The ALRC noted that there were forecasts of significant increases in insurance costs at the time of the 1978 amendment to the Trade Practices Act. The Commission received no evidence to suggest that these increases occurred.

The problems in the United States extend to other areas of liability law in which right of action is not premised on strict liability. Such areas include medical malpractice liability and occupier’s liability, where liability is based on tort laws that are similar to those applying in Australia. The American Medical Association reports that one-fifth of the obstetricians in Massachussetts have ceased practice due to litigation and insurance costs (OECD 1989). Huber (1988, p. 9) reports that ‘more medical malpractice suits were filed in the decade ending in 1987 than in the entire previous history of American tort law."

The absence of problems in other countries with strict liability, and the problems experienced with tort-based liability laws in the United States, suggest that product liability problems experienced in that country are not due to strict liability per se.

Are peculiarities of the United States legal system to blame?

The legal system in the United States differs from systems in other common law countries in several respects.

The United States is widely acknowledged as the most litigious country in the world, and spends ten times as much per capita on litigation than does the United Kingdom (OECD 1989).

The contingency fee system in the United States, coupled with the fact that each party bears its own court costs, acts to encourage litigation. Under the contingency fee system, a claimant only pays legal fees if a claim is successful. Given that the defendant must always meet its own costs, there are few cost disincentives on claimants to initiate actions. This encourages fraudulent and nuisance claims. The ALRC has also noted that, since there is little cost to the plaintiff of conducting lengthy suits, it will often be cheaper for a defendant to pay a claim without defending it, even if it has a strong case. Some companies are said to simply pay out any claims for less than $25 000, in order to avoid the time and money involved in settling disputes.

The court system in the United States contributes to a lack of predictability in judgments. Jury trials in product liability cases are the norm rather than the exception in the United States, and juries determine the award as well as the verdict: they decide whether the goods are safe, as well as how much compensation should be paid. Juries may have little expertise or experience on which to base these decisions. Further, according to the ALRC (1989, para. 4.36), judges in the United States do not have a high regard for precedent: 'Little if any guidance is given as to the appropriate weight to be given to the values to be considered'. Thus, there are no established guide-lines covering such factors as the age of the plaintiff and the severity of injury for awards for pain and suffering.

A number of factors in the United States system tend to inflate damages awards. First, as noted, juries generally determine the awards. Overseas evidence suggests that juries make higher damages awards than judges: in the Republic of Ireland, which also allows juries to award damages, the average award is six times greater than in the United Kingdom, which does not (Beerworth 1989). Second, because the plaintiff's lawyer receives two-thirds of the compensation paid on average under the contingency fee system, juries' judgments are also beginning to take into account the proportion of the award the claimant will not receive. To ensure that plaintiffs (and their lawyers) are paid, some States have introduced a system of 'joint and several liability'. Under this system, the richest defendant has to pay if the others cannot, irrespective of the proportion of the loss attributable to the defendant. Third, damages awards in the United States usually include more generous provision for lost earning capacity, pain and suffering, and loss of enjoyment of life. Fourth, there is greater use of punitive damages than in other countries.

Overall, damages awards in the United States have increased to very high levels and are unpredictable. Priest (1988) notes that, over the last twenty years, there has been little evidence of major change in the severity of injuries but the size of the average product liability award, after inflation, has increased tenfold. In one large metropolitan area, the average punitive damage is over one hundred times as large as it was twenty years ago, in constant dollars.

These features of the United States legal system appear to underlie many of the problems experienced in that country. A United States Department of Commerce (1978) report on product liability concluded that the rise in liability insurance premiums seemed to be due far more to large and unpredictable jury awards than to the legal basis of liability. According to Huber, up until about the 1970s, juries and judges were largely self-restraining and the legal system worked reasonably well, but major social changes in the United States during the mid-seventies were reflected in the disposition of juries and judges, and were a major factor in the 'explosion' of jury awards at that time.

Reform measures

Recent reforms to the United States system are designed to limit some of the excessive litigation and damages payouts. Apart from strengthening existing defences, many States have placed limits on the proportion of plaintiffs' compensation that lawyers can appropriate. Some States have limited joint and several liability to economic loss only, and some have introduced provisions for awarding costs against the claimant in clear nuisance claims. Several States have introduced legislation severely restricting the circumstances in which punitive damages can be applied.

None of these reforms alters the strict liability of the regime: rather, the majority act to moderate jury excess.

E MEASURING SOME EFFECTS OF OVER-COMPENSATING CONSUMERS

Some specific effects of adopting the ALRC's proposals are discussed in Chapter 6. Amongst other things, product prices would rise because producers would need to increase their product liability insurance cover or, in some cases, build more safety into their goods. Against this, the improved safety and greater insurance component in goods would provide benefits to consumers. Whether these benefits would offset the costs entailed in the ALRC's proposals is the main subject of this report.

However, as discussed in Chapter 3, an additional consideration is whether wages would increase in response to the increase in prices: if they did, there would be an additional cost on the operation of the economy for which there would be no offsetting benefit. In effect, workers would be over-compensated for the increase in prices: they would receive more valuable goods and higher wages. These wage increases would, amongst other things, further increase business costs and reduce competitiveness.

In practice, to the extent that the increase in prices under the proposals would be reflected in the CPI, at least a partial flow-on to wages could be expected.

This potential problem arises partly from the way the CPI is measured, rather than from the proposals per se. If the CPI were to make allowance for all changes in product characteristics, then the ALRC's proposals would not show up as an increase in the 'real' price level. Practical considerations suggest, however, that such precise adjustment would be technically extremely difficult. For this reason, at the Draft Report Hearings, Dr Braddock argued that a case could be made for attempting to adjust the CPI (downwards) should the proposals be implemented.

The Commission has examined the extent of the costs that would arise from any over-compensation of consumers by simulating the impact of increased product liability insurance costs with an almost total flow-on to wages. In so doing, the simulations do not purport to measure the overall net cost to the community of adopting the ALRC's proposals.

The modelling and simulations in this appendix update the econometric work undertaken for the ALRC as part of its examination of product liability. In a research paper commissioned for its inquiry (Braddock 1989a), a simple macro-economic model (hereafter called the Tonkin model[1]) was used to assess the short run impact on selected macro-economic variables of the introduction of the ALRC's proposals. The Tonkin model is reviewed and, in the light of this review, is revised so that it can more readily determine aggregate output and input demands. The ALRC's proposals are then simulated in the revised model and these results are contrasted with results obtained from the Tonkin model.

E.1 Model structure and suggested modifications

Of the 11 equations comprising the Tonkin model, five are used to determine the percentage changes in labour supply, labour demand, labour productivity, the unemployment rate, and the wage rate. These equations are satisfactorily constructed and are retained in the revised model. The labour demand equation is, however, amended to allow for capital-labour substitution.

Although described as an aggregate output equation, Equation 6 in the Tonkin model appears to be an aggregate demand equation. The equation incorporates a negative relation between the level of output and prices

$$Y = f*Pd, \quad (1)$$

where Y denotes the percentage change in output, and the parameter f is negative. As well as incorporating switching between domestic and imported brands, the equation may be intended to include the income effect of changes in the price of domestic output, whereby rises in the price of domestically produced consumption items reduce real income, inducing a fall in consumption. Indeed, this appears to be the major reason for the negative price-output relation since it is evidently regarded

[1] The modelling work reported in Braddock (1989a) was attributed to Roger Tonkin; hence, the model is referred to as the 'Tonkin model'.

as essentially a consumer reaction (because the price variable is the price of domestically produced consumables), while the substitution effect is mentioned only as an additional reason.

There are two problems with this. First, real income depends not only on the price of domestically produced consumption items, but also on the price of imported consumption items and on money income, which depends partly on the average wage rate and the level of employment. These additional variables should be included in the equation as determinants of output. As the equation stands, it incorporates money illusion: a rise in the price level leads to a fall in demand, even if the average wage rate keeps pace with prices. Second, although aggregate demand includes export demand which depends on the price of exports, the Tonkin model contains no variable representing the price of export items. Since exports are only minimally affected by Australian product liability legislation compared to goods sold domestically, such legislation would lower the price of exports relative to the price of domestically produced consumption items. Thus, the price of domestically produced consumption items is not a satisfactory proxy for the price of exports in determining aggregate demand.

To overcome these problems, it is assumed that the outputs of the economy are either exported, used as intermediate inputs, sold to consumers, or used as investment or government inputs ('other demands').

The 'ex-factory' cost of producing these goods is represented as

$$\text{Pd} = b*Pd + c*Pmp + d*PUC + e*(W\text{-}Q) + (1\text{-}b\text{-}c\text{-}d\text{-}e)*ITM, \quad (2)$$

which weights together the percentage changes in the price of domestically produced goods *Pd* used as intermediate inputs, imported intermediate inputs *Pmp,* the cost of capital inputs *PUC,* effective wages *W-Q*, and indirect taxes plus margins *ITM.* The weights are the respective shares of these inputs in gross domestic product (GDP).

The 'ex-factory' prices of consumer goods, exportables and other demands are assumed to be equal, but prices paid by users or consumers of domestically produced goods are assumed to differ depending on the assumed impact of the ALRC's proposals on ex-factory costs. To accommodate these effects, equations are first added to determine the fob price of exports and the purchaser's price of

'other demands'. These are defined as weighted averages of the 'ex-factory' price and the percentage change in the cost of product liability insurance for each good.

The export price equation is given by

$Pexp = (1\text{-}g)*Pd + g*(W+Iexp),$ (4)

where g is the share of product liability premiums in the fob value of exports, *Pd* is the ex-factory cost of exportables, and *Iexp* is a shift variable that can be used to model increased product liability insurance costs on exportables.

The price equation for 'other demands' is similarly specified as

$Po = (1\text{-}h)*Pd + h*(W+Io),$ (5)

where *Po* is the purchaser's price of other demands, h is the share of product liability premiums in the purchaser's price of 'other demands' and *Io* is a shift variable that can be used to model increased product liability insurance costs on 'other demands'.

Additionally, the Tonkin model's equation for the price of domestically produced consumer items (Equation 2) is then respecified. It has a structure similar to that of the above equations:

$Pc = (1\text{-}f)*Pd + f*(W+Ic),$ (3)

where f is the share of product liability insurance in the cost of consumables and Ic is a shift variable that is used to model increased product liability insurance costs for consumable goods.

In respecifying aggregate demand in the model, further equations are added to explain consumer demands, exports and other demands.

The equation for domestic consumer demand DD is specified as

$DD = C - r*Pc + r*Pmc,$ (14)

where *C* is the percentage change in aggregate real consumption, *Pc* is the percentage change in the price of Australian-produced consumer goods, and *Pmc* is the percentage change in the price of imported consumer items. The parameter *-r*

is the compensated own price elasticity of demand for domestically produced consumables, and r is the corresponding elasticity of demand with respect to the price of imports.

The percentage change in export demand $DEXP$ is specified as a function of the percentage change in the fob price of exports $Pexp$

$$DEXP = -t * Pexp. \quad (16)$$

where the parameter $-t$ is the aggregate export demand elasticity for Australian-produced exportables.

The percentage change in 'other demands' DO is specified as a function of the percentage change in real output Y, the percentage change in the price of 'other demands', Po, and the price of imported inputs Pmp. That is,

$$DO = Y - s*Po + s*Pmp \quad (15)$$

where the parameter s can be considered as the compensated price elasticity of 'other demands'. In this specification, if the price of the domestic good and the imported good change by the same amount, 'other demands' will not alter unless the level of output moves.

This completes the respecification of aggregate demand in the model.

The percentage change in real output is calculated as a weighted average of the percentage changes in demand for consumer items, exports and other demands. That is, real output is given by

$$Y = u * DD + v*DEXP + (1-u-v)*DO \quad (17)$$

where u is the share of consumables in GDP, v is the share of exports in GDP and $(1-u-v)$ is the share of other demands in GDP.

Real consumption C is set equal to aggregate supply. That is, $C = w*Y$ where w is a parameter that could be used to model less than full transmission of aggregate output movements to real consumption.

To determine the cost of capital, which is included as a variable in the respecified model, the Tonkin model's labour demand equation is amended to allow for capital and labour substitution, an equation is added to explain capital/land demand, and an equation implying zero pure profits is added to link output price movements to movements in a weighted average of per unit input prices.

The labour demand equation is respecified as

$$Nd = Y - k*(W-Q) + k*PUC, \quad (8)$$

where *PUC* is the user cost of capital and other variables are as previously defined. In this specification, labour demand changes in proportion to output movements *Y* unless relative prices vary between the capital/land bundle *PUC* and effective wages *W-Q*. The parameter *-k* is the compensated price elasticity between the capital/land bundle and labour and *k* is the cross price elasticity between the inputs.

A similar equation is specified to determine the demand for capital/land bundle:

$$NKLd = Y + l*(W-Q) - l*PUC, \quad (9)$$

where *l* is the compensated price elasticity of capital and land demand with respect to effective wages, and *-l* is the own compensated price elasticity of capital and land demand.

In keeping with the short-to-medium-term nature of the Tonkin model, the supply of capital/land is assumed to be fixed.

The variable *PUC* can thus be determined by setting *NKLd* exogenously and solving for the value of *PUC* to clear the capital/land market.

With labour demand and capital/land demand determined, nominal *GDP* from the factor income side can be calculated as

$$YSNOM = x*(W+Nd) + y*(PUC + NKLd) + z*IT, \quad (22)$$

which weights together the percentage changes in labour income, capital and land income, and movements in indirect taxes *IT*.

Real output from the income side is then given by

$$YS = YSNOM - Pb. \quad (18)$$

This completes the respecification of the supply/demand links in the model.

The final Tonkin model equations to be amended are the equations explaining the price of imported consumer items and the price of imported inputs.

Equation 10 in the Tonkin model relates the price of imported consumption items to the price of domestically produced consumption items:

$$Pmc = j*Pd$$

where Pmc represents the percentage change in the price of imported consumption items and *j* is a behavioural parameter greater than zero but less than one. Tonkin states that the equation is partly intended to take account of product liability insurance costs imposed on importers. But it does not do that satisfactorily since product liability insurance costs to importers include only the direct costs; not the indirect costs arising through the price-wage spiral included in the change in the price of domestically produced consumption items. It is therefore desirable to add to the equation an exogenous shift variable, so that a shock can be applied to represent the direct effect of product liability legislation on costs to importers.

Equation 11 links the prices of imported inputs to prices of domestically produced inputs:

$$Pmp = j*D,$$

where j is a parameter lying between zero and one. To model the prices of imported inputs as including only the direct costs of the introduction of product liability insurance, a shift term needs to be added to Equation 11.

Equations (10) and (11) are therefore respecified as:

$$Pmc = n*Iimc + o*Pc, \quad (12)$$

$$Pmp = p*Iimp + q*Pd, \quad (13)$$

where n and p are the shares of product liability insurance in the costs of imported consumer goods and imported inputs respectively. These equations link movements in import prices to movements in insurance costs. Through the parameters *o* and *q*, import prices can also be linked to movements in the respective input prices if

Table E.1: **Equations in the revised Tonkin model: parameter range**

No.		Equation	Parameter range
1.	#	P = a*Pc + (1 - a)*Pmc	0<a<1
2.		Pd = b*Pd + c*Pmp + d*PUC + e(W-Q)	
		+ (1-b-c-d-e)*Itm	0<b<1
			0<c<1
			0<d<1
3.		Pc = (1 - f)*Pd + f*(W + Ic)	0<f<1
4.		Pexp = (1 - g)*Pd + g*(W + Iexp)	0<g<1
5.		Po = (1 - h)*Pd + h*(W + Io)	0<h<1
6.	#	W = i*U + j*P	i<0, j>0
7.	#	Q = Y - Nd	
8.	#	Nd = Y - k*(W-Q) + k*PUC	0<k<1
9.		NKLd = Y + l*((W-Q) - l*PUC	0<l<1
10.	#	Ns = m*(W-P)	m>0
11.	#	U = Ns - Nd	
12.	#	Pmc = n*Iimc + o*Pc	o<n<1, o<1
13.	#	Pmp = p*Iimp + q*Pd	o<p<1, q<1
14.		DD = C - r*Pc + r*Pmc	
15.		Do = Y - s*Po + s*Pmp	
16.		DEXP = t*Pexp	t<0
17.		Y = u*DD + v*DEXP + (1-u-v)*DO	0<u<1, 0<v<1
18.		YS = YSNOM - Pd	
19.		CNOM = P + C	
20.		C = w*Y	o<w<1
21.		YNOM = Y + Py	
22.		YSNOM = x*(W + Nd) + y*(PUC + NKLd) + z*IT	0<x<1, 0<y<1
			0<z<1
23.		Py = aa*Pexp + bb*Pc + (1-aa-bb)*Po	0<aa<1
			0<bb<1

Note: # indicates an equation contained in the Tonkin model.

Source: Industry Commission.

desired. Parameters *o* and *q* are Tonkin's parameters used to index movements in the prices of imported goods to movements in prices of comparable domestically produced goods. *Iimc* and *Iimp* are variables that could be increased to represent the direct impact on costs of imported goods of increased product liability insurance costs.

To complete the revised model, three equations are added to calculate nominal consumption (*CNOM*, Equation 19) nominal output from the expenditure side (*YNOM*, Equation 21) and a GDP deflator (*P*y, Equation 23).

The revised model, which is summarised in Table E.1, contains 23 equations with 31 variables. Of the 23 equations, eight are as originally specified in the Tonkin model or are slightly amended versions of original equations. Equations 2 to 5 replace equations in the Tonkin model explaining domestic consumer prices and the equation explaining the price of domestically produced inputs. Equations 14 to 17 explain final demands while Equations 6 and 11 are the model's labour demand/supply module. They also explain demand for capital/land and help determine the user cost of capital, labour demand and capital/land demands. Equations 18 to 23 calculate various variables of interest.

Parameter selection

The choice of parameters for the model is largely based on those implied by the data base in the ORANI model of the Australian economy. These are supplemented by the data provided in the Tonkin model. The revised model's parameters and their values are presented in Table E.2 overleaf.

The parameters that have the greatest impact on model results are *j, r, s*, and *t*. The parameter j indexes nominal wages to movements in the model's consumer price index *P*. Following Tonkin, this parameter has been set at 0.9, implying almost full indexation of wages to the CPI. As in the Tonkin model, setting this parameter at close to one effectively compensates employees twice for the first-round increase in costs caused by higher product liability insurance costs. The parameters *r, s,* and *t* are final elasticities of demand with respect to final demand prices. They are derived from the ORANI model's data base. The parameters *r* and *s* are the compensated price elasticities of demand for consumer goods and 'other demands'

respectively. They are set at -0.19 and -0.05 respectively and are of a similar magnitude to Tonkin's aggregate final demand elasticity of -0.2. However, the export demand elasticity t is set at -7.5, which implies an aggregate final demand elasticity in excess of one. Thus, the parameter settings chosen for the revised model assume the economy is far more price-responsive than in the Tonkin model.

Table E.2: **Parameters in the revised Tonkin model**

a	=	0.915	h	=	0.0	o	=	0.0	v	=	0.156
b	=	0.36	i	=	-0.1	p	=	0.0	w	=	1.0
c	=	0.06	j	=	0.9	q	=	0.0	x	=	0.71
d	=	0.12	k	=	0.14	r	=	0.19	y	=	0.28
e	=	0.33	l	=	0.14	s	=	0.0515	z	=	0.01
f	=	0.007	m	=	0.1	t	=	-7.5161	aa	=	0.156
g	=	0.0	n	=	0.007	u	=	0.544	bb	=	0.544

The parameters k and l are compensated own price elasticities of input demand for labour and the capital/land bundle respectively. They are both set at -0.14 and are based on a compensated elasticity of substitution of 0.5, which is the short run substitution elasticity between capital and land in the ORANI model. The elasticities are small by most standards and imply that producers have little short term scope to avoid input price rises by substituting away from inputs whose prices have risen. With the stock of capital fixed in the short-term, these elasticities imply a very steep slope to the economy-wide aggregate supply curve.

The parameters *f, g, h, n* and *p* are shares of product liability insurance in the cost of consumer goods, the fob value of exports, the purchaser's price of other demands, the *cif* value of imported consumer goods, and the *cif* value of imported inputs respectively. The parameters f and g are determined from data provided in the research paper (see Table E.2). In the absence of information, the remaining share parameters were set to zero.

Finally, the parameters *a, b, c, d* and *e* are shares in GDP of domestically produced intermediate inputs, imported intermediate inputs, capital costs, labour costs and indirect taxes plus margins respectively, while the parameters *x, y* and *z* are shares of labour income, capital/land income and indirect taxes in GDP.

E.2 Simulating the effects of increased product liability insurance

To simulate the introduction of the ALRC's proposals, an estimate is required of the current cost of product liability insurance[2] and what this would rise to if the proposals were implemented.

In its submission, the Insurance Council of Australia (ICA) estimated the total insured and uninsured pool of premiums for Australian product liability business at around $170 million in 1988. The total cost (damages plus transfer costs) of product liability claims was estimated at $213 million. The Council estimated this would rise to $724 million if the ALRC's proposals were implemented. This is equivalent to over 2 per cent of the estimated value of goods consumed in Australia in 1988.

The ICA's estimate of the impact of implementing the ALRC's proposals seems very high. Braddock (1989a), for example, noted that United States studies indicate that liability insurance amounted to between 0.1 per cent and 1.8 per cent of costs of production in that country. Even given the peculiarities of the United States legal system which have led to very high damages payouts and which encourage firms to settle small claims even if no fault is involved (see Appendix D), product liability premiums only exceed 1 per cent of sales in three high risk industry groups (pharmaceuticals, medical devices and aircraft components).[3]

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[2] As discussed in Chapter 6, producers would generally take out additional product liability insurance, rather than increase the safety in their goods, in response to the ALRC's proposals.

[3] As noted in Section 6.1, for individual products such as ladders and vaccines, cost imposts may be much greater.

Insurance cost increases of between 50 and 150 per cent are therefore simulated in this appendix.

Based on current production costs, these would see product liability insurance as a proportion of costs increase from an average of 0.7 per cent to 1.05 per cent and 1.75 per cent respectively.

The effect of the proposals would not be uniform across Australian industry, with exports being least affected. As discussed in Chapter 6, exporters could be disadvantaged under the ALRC's scheme if overseas consumers were to bring action for product-related loss in Australia rather than in their own country, although this problem also applies to lesser extent under current laws. However, many of Australia's exports would also require little if any product liability insurance simply because they are largely exported in unprocessed form, while services are not covered by the ALRC's proposals. For this reason, the introduction of the ALRC's proposals is assumed in the model to have no direct effect on the competitiveness of Australian exports.

The direct effect of the proposed reforms on the cost of imports would be almost as great as the effect on the price of domestically produced goods. With the exception of imports from the United States, action in the exporting country is practicable only for claims of unusually high value. While many United States firms that distribute their goods in Australia through subsidiary companies apparently arrange product liability insurance for their subsidiaries, premiums for Australian sales reflect Australian claims experience. For these reasons, the relevant product liability regime for imported goods is usually the Australian regime. The introduction of the ALRC's proposals is therefore assumed to have the same direct impact on the cost of imported consumer goods as it would on Australian produced consumer goods.

The results of the Commission's simulations, using both the Tonkin model and the revised Tonkin model, are reported in Table E.3.

As can be seen from the table, the two models imply different macro-economic effects following the simulated rise of 0.35 per cent in costs of consumer goods. In the Tonkin model, output shrinks by well under 1 per cent, with cost pressures being reflected in a 1.75 per cent increase in the CPI and a small rise in the unemployment rate. In the revised Tonkin model, final demand is more price-

responsive. Hence, the cost pressures initiated by increased product liability insurance are less able to be passed on to consumers and overseas buyers. The cost pressures are thus reflected in reduced capital costs, which fall by 0.5 per cent. These falls keep prices down and so output falls by less in the revised model. The fall in capital costs would flow into lower returns to capital which would, in the long run, lead to an exodus of capital from Australia. This suggests that further output falls would be expected in the long run as a result of the need to take out increased quantities of product liability insurance.

Table E.3: **Estimated macro-economic effects of a 0.35 per cent and a 1.05 per cent increase in the cost of consumer items (% change)**

	Tonkin model		*Revised Tonkin model*	
Variable	*0.35 per cent increase*	*1.05 per cent increase*	*0.35 per cent increase*	*1.05 per cent increase*
CPI	1.57	4.71	0.36	1.09
Nominal wage rate	1.39	4.16	0.31	0.92
Real wage rate	-0.18	-0.55	-0.05	-0.17
Demand for				
Australian consumer goods	na	na	-0.10	-0.31
Exports	na	na	-0.09	-0.27
Other	na	na	-0.10	-0.30
Total output	-0.33	-0.99	-0.10	-0.30
Labour demand	-0.30	-0.89	-0.20	-0.60
Labour supply	-0.02	-0.06	-0.01	-0.02
Unemployment rate	0.28	0.84	0.19	0.58
Cost of capital	na	na	-0.51	-1.52

na not available.
Source: Prepared by the Industry Commission.

The large drops in capital and land income implied by the results of the revised model would significantly contract consumption. These effects are captured by tying real consumption to movements in real output levels. Consequently, real consumption fell significantly in the revised model, even though demand for consumables is relatively unresponsive to price movements.

Table E.3 also shows the results of a 1.05 per cent increase in the costs of consumer goods. Since the models are linear, the results are a linear transformation of the results of the 0.35 per cent increase in costs of consumer goods. Thus, the forces driving the results in both simulations are identical.

E.3 Summarys

In this appendix, the Commission has examined some effects of over-compensating consumers for price increases under the ALRC's proposals by modelling the possible effects of increasing product liability insurance charges with an almost total flow-on to wages. An assumed increase in premiums of 50 per cent and 150 per cent was in turn assumed to raise costs of production in Australia by between 0.35 and 1.05 per cent. In the short run, these cost increases were simulated to reduce output of the economy by between 0.1 and 0.3 per cent. This would translate into a loss in output of between $336 and $1009 million in 1988-89 dollars.

F ALTERNATIVE PRODUCT LIABILITY SCHEMES

During the inquiry, several parties put forward alternatives to the regime proposed by the ALRC. Most of the alternative proposals refine the strict liability currently entailed in the Trade Practices Act: they range from modified negligence-based schemes to a no-fault product-related accident compensation scheme. Two of the alternative proposals had been developed to the stage of draft Bills, while others were submitted in outline.

All parties who submitted alternative proposals agreed that among the deficiencies in the Trade Practices Act (TPA) are the narrow coverage of goods and the limited class of persons allowed to bring actions. All the alternative proposals deal with these specific deficiencies.

The key differences between the alternatives essentially relate to whether the onus of proof would be imposed on the claimant or the defendant, and whether the cause of action would be based on the negligence of the producer, or a defect in the goods. Table F.1 lists the proposals according to who bears the onus of proof and by what has to be proved.

Table F.1: **Current legislation and proposed alternatives**

Legislation	*Onus of proof*	*Damage caused by*
Trade Practices Act	Claimant	Defective product
Law Council of Australia	Claimant	Defective product
Business Council of Australia	Claimant	Defective product
Australian Chamber of Manufactures	Claimant (and Defendant)	Defective product (and negligence)
Blake Dawson Waldron Solicitors	Defendant	Negligence
Phillips Fox Solicitors	Defendant	Negligence
Australian Consumers Association	Defendant	Defective product
Australian Pharmaceutical Manufacturers Association	Defendant	Defective product
Australian Law Reform Commission	**Claimant/Defendant**	**Product**
Professor Harold Luntz	Not necessary to establish cause	

Source: Prepared by the Industry Commission.

F.1 The proposals

Law Council of Australia

The proposal of the Law Council of Australia would maintain virtually the whole of the TPA as it stands, replacing only section 74D. As under the Act, the onus of proof would rest on the plaintiff to prove that the goods were defective and that the loss was caused by the defect.

Goods would be considered defective if they were either ‘not of merchantable quality’ (as defined by the current Act) or ‘unsafe’. Goods would be defined as unsafe if they did not ‘provide the level of safety which people are generally entitled to expect’. This definition would consider the presentation of the goods (including any statements on intended use, instructions and warnings). Other considerations would be the ways in which the manufacturer could reasonably have expected the goods to be used and how long the goods had been in circulation.

This proposal would provide a remedy to any person able to demonstrate a loss caused by a defective product, thus remedying the limited application of the TPA. Coverage of the proposal would not be limited to ‘consumer’ goods, as is currently the case under the TPA.

Mr Argy, the author of the proposal, claimed that, under both present law and his proposal, while technically the onus of proving whether or not a product was faulty would be imposed on the claimant, in practice it would pass to the defendant if the plaintiff could prove he or she had not misused the product.

Professor Luntz considered that the Law Council’s proposal retains the satisfactory aspects of the TPA, while at the same time extending coverage to all persons injured and clarifying the concept of ‘merchantable quality’.

Business Council of Australia

The proposal put forward by the Business Council of Australia (BCA) is based upon the European Community Directive on Product Liability, 1985, and was developed in consultation with major business and consumer groups. The major issue on which the two groups could not reach agreement involved the onus of proof. In most other respects, the BCA proposal is similar to the proposal of the Australian Consumers Association.

The BCA proposal would be implemented as an amendment to the TPA. As under the Act, the plaintiff would have to establish that a defect in the goods caused the loss. The definition of 'defective' or 'unsafe' goods is identical to that in the Law Council of Australia's proposal.

Any person able to establish loss caused by defective goods would be entitled to claim for compensation. The proposal would apply the legal principle of remoteness, which limits liability in 'chains of disaster' to those damages that would have been 'reasonably foreseeable'.

The proposal has 'compliance with mandatory standards' and 'state of the art' defences which are similar to but less restrictive than those in the ALRC's proposals. Component manufacturers would not be liable if the defect was found to lie in the design of the final product. Further, manufacturers would not be liable for defects that did not exist at the time of circulation of the product. As under the ALRC's proposal, liability could be reduced by contributory negligence on the part of the plaintiff.

The BCA's proposal would retain the current ten-year statute of repose for defects occasioning damage to property. For defects causing personal injury, such as cancer or birth defects, this statute of repose could be waived.

The BCA considers that, by relying on standards of 'safety' which are already contained in the TPA, its proposal would involve less uncertainty than the ALRC's concept of 'the way the goods acted'. The Council also stated that the proposal would protect the rights of producers who take reasonable care to supply goods without defects.

The BCA claimed that, since its proposal does not deviate radically from current legislation, it would be more likely to gain uniform acceptance among the States and Territories than would the ALRC's proposals. Similarly, since its proposal is based on European Community legislation, the BCA claimed that benefits would accrue from following the increasing trend to harmonisation of international laws. The BCA claimed that the ALRC's proposals are 'out of step' with developments overseas.

The ALRC's assessment of the BCA proposal was that it does not overcome many failings of the TPA: some persons would still go uncompensated, even though their actions did not contribute to their loss, because liability would be based on breach of indeterminate standards. The ALRC also claimed that the BCA's proposal would maintain high legal costs as a result of retaining the notion of a product standard.

Australian Chamber of Manufactures

Although a participating business group in the BCA's submission, the Australian Chamber of Manufactures (ACM) developed its own proposal. The ACM stated that the developing of its draft Bill was 'not purely in response to' the work of the ALRC.

The ACM proposal also takes the form of amendments to the TPA. The modifications are of greater scope than those proposed by the BCA, having the effect of codifying existing aspects of negligence and contract law into the TPA.

The cause of action and onus of proof are somewhat mixed under this proposal; both defect and negligence must be established. In order to receive compensation the plaintiff would need to show that the loss or damage was caused by 'reason that the goods were defective'. But the proposal further provides that goods would be regarded as defective only if somebody involved in the manufacturing chain failed to take 'reasonable care' to guard against 'reasonably foreseeable' risks of loss or damage, and, as a result, the goods caused loss or damage.

Inasmuch as negligence must be shown, this proposal represents a departure from the strict liability of current trade practices legislation. The plaintiff would not have to show which specific defendant or defendants had been negligent, simply that there had been negligence somewhere along the chain of production.

All goods are covered by the proposal, but with different treatment of 'consumer' and 'commercial' goods. In the case of commercial goods, the onus of proof remains entirely with the plaintiff. In the case of 'consumer' goods, if the plaintiff establishes that the goods caused the loss, it would then be presumed that the goods were defective in the respects claimed by the plaintiff. The onus would be on the defendant to rebut this presumption by showing either that the loss was not caused 'by reason of the defect in' the goods or that the defect was not due to negligence.

Purchasers and their successors in title, bystanders, and 'legitimate' users would be entitled to bring action for compensation under the ACM proposal and the legal concept of remoteness would apply.

There would be a 'state of the art' defence based on the concepts of 'reasonable foreseeability' and 'due diligence'. Contributory negligence on the part of the plaintiff, and a defence based on a reasonable assumption of risk on the part of the user, would also be available.

In cases involving multiple defendants, the courts would have discretionary power to apportion liability but the joint and several liability approach, which can make the richest defendant pay disproportionately to the degree of fault, would be explicitly prohibited.

The ACM claimed that its proposal, in using established notions such as foreseeability and defect, contains less uncertainty and would be more easily understood than the ALRC's proposals. The presumption of negligence is also not novel -- more a strengthening of the doctrine of *res ipsa loquitur*.

The Chamber stated that its proposal would not represent a major upheaval of present laws. By codifying existing common and statute law into a modified TPA, the ACM believes its proposal would be simpler and more certain than the existing laws. It stated that the proposal would 'represent a reasonable balance; at the horizontal level, between suppliers of goods; at the vertical level between manufacturers and distributors and retailers, and between them and consumers'.

The proposal contains 'in effect' a reversal of the onus of proof, since the ACM recognises 'the practical difficulties that would face private litigants in proving negligence'. This, it hopes, should find acceptance with the consumer groups. However, the Australian Consumers Association (ACA) stated that it considers the ACM proposal unacceptable, since 'it makes minimal changes to the present, unsatisfactory, laws'. The ACA also interpreted the ACM's proposal as effectively meaning that 'manufacturer's liability would be reduced from strict liability to negligence'.

Blake Dawson Waldron Solicitors

Ms Kellam is a solicitor with the firm Blake Dawson Waldron. Although contained in the firm's submission to the inquiry, the proposal she put forward is her personal view only. She proposed an amendment to the law of negligence whereby the burden of proof would lie mostly with the manufacturer to show that it was not negligent.

The proposal suggests extending the doctrine of *res ipsa loquitur* in some circumstances to infer negligence by the manufacturer if it is established that the goods caused loss or damage. The proposal is thus similar to, but less demanding on the plaintiff than, the ACM proposal. Abrogating the doctrine of privity in the law of contract and under relevant sections of the TPA is also suggested, so that a wider class of person than under the present legislation would be allowed to bring an action for damages. This could be achieved by an amendment along the lines of the United States Uniform Commercial Code, which allows actions by any person whom the manufacturer 'might reasonably have expected' to use, consume or be affected by the goods. In support of the proposal, Ms Kellam stated that the High Court of Australia is already prepared in some cases to depart from the doctrine of privity.

Ms Kellam advocated retaining use of the terms 'merchantable quality' and 'fitness for purpose' since they are used in the laws of trading partners such as the United Kingdom, the United States and Canada; they are used in the 1980 United Nations Convention on Contracts for the International Sale of Goods; and 'voluminous' case law exists regarding their definition. The ALRC and the ACA argued that such terms are vague and out-of-date concepts.

Phillips Fox Solicitors

The Phillips Fox proposal is similar to, but broader than, that of Ms Kellam. It would allow anybody injured by goods to bring an action for compensation and, under all circumstances, the onus would be on the producer to prove it was not negligent. As under the ALRC's proposals, the plaintiff would have to show that the loss was caused by the 'way the goods acted'.

The only defence available to the manufacturer would be to prove it was not negligent. For the manufacturer to claim in defence that the loss was due to the

negligence of some other party, the other party and the nature of the negligence would have to be identified.

Mr Masel, the author of the proposal, agreed that the ALRC has recognised the ‘mischief’ in the current law but considers that the manner of its remedy is not readily understandable. The Phillips Fox proposal, on the other hand, in his assessment meets the ‘necessary objectives ... very simply’.

Australian Consumers Association

The ACA stated that the ALRC’s proposals are the preferred option, but that its own proposal represents a fair compromise should the ALRC’s proposals not be accepted.

As noted, the ACA’s proposal was developed in consultation with major business groups. The principle departure from the BCA proposal is that the burden of proof would fall on the defendant. Thus, establishing a product-caused loss or injury would raise a rebuttable presumption that the goods were defective.

There are some other differences. Under the ACA’s proposal, if a retailer, after being requested, does not supply the identity of a manufacturer or importer within a reasonable time, it would assume liability.

A statute of repose is opposed in principle, but the ACA considers it may be acceptable for cases involving property damage.

A ‘state of the art’ defence would be limited to the latest available technology, not the technology available at the time of first circulation of the goods. According to the ACA, this would have the effect of forcing manufacturers to remedy defects as they became aware of them, if they wished to avail themselves of this defence.

Australian Pharmaceutical Manufacturers Association

Under the Australian Pharmaceutical Manufacturers Association (APMA) proposal, for a producer to be liable there must be a ‘defect’ or ‘lack of safety’ in the goods. The APMA claims that inclusion of such a provision would help both producers and consumers ‘determine how any loss caused by the goods will be allocated’. Goods

would not be considered defective if they had been ‘manufactured in accordance with the state of the art and are accompanied by proper warnings’.

The APMA’s proposal has a ‘state of the art’ defence under which the manufacturer would not be liable for any ‘defect’ or ‘lack of safety’ which could not be reasonably detected at the relevant time. The APMA considers that the exclusion of the concept of reasonableness in the ALRC’s proposals makes it too restrictive.

The APMA considered that, in the case of pharmaceuticals and to an extent other goods, the ALRC’s assignment of liability for loss caused by the conduct of the claimant and other persons needs adjustment. Under the APMA’s proposal, warnings would be attached to products or contained in product information papers, which would describe the known risks associated with the product. This promulgation of all identifiable risks, based on the best scientific knowledge then available, would allow the manufacturers to contract out of liability. This would take effect under the ‘acceptance of risk’ defence in the ALRC’s proposals. Use of the product would then entail the user’s acceptance of responsibility for any risks associated with that use.

The APMA’s proposal would also alter the procedure that would make the manufacturer the primary defendant under the ALRC’s proposals. If a person could be identified as responsible for the ‘defect’ or ‘lack of safety’, that person would join the manufacturer in the action as a co-defendant.

Professor Harold Luntz

Professor Luntz argued that, since both the present system and the ALRC’s proposals aim only to compensate individuals rather than the community, neither internalise the full cost to society of product-related losses in the prices of goods. This being the case, the price mechanism does not act as an efficient deterrent against producing unsafe goods.

Professor Luntz argued that the functions of compensation and deterrence should be separated. The community should be responsible for compensation, while regulations, education, sanctions and taxes should be used for deterrence. He advocates a no-fault scheme along the lines of that operating in New Zealand.

In order to receive compensation, a person would need only to establish the existence of product-related loss or injury. There would be no requirement to prove negligence or defect, or even to show that the loss or injury was caused by the goods. This regime would replace all current product liability legislation. Compensation would be paid by government and funded from a levy on producers and other groups.

Professor Luntz recommended that, if this proposal is 'too far reaching for this inquiry', the next best solution is to extend the existing provisions of the TPA, particularly to cover harm caused to non-owners of goods.

The ACA regarded Professor Luntz' proposal as having some merit, but stated:

The political reality is that a general accident compensation scheme is not on the current agenda, because of the revenue implications. Reforms to product liability should not be delayed because a distant option may be better.

F.2 The ALRC's assessment of the alternative proposals

In its assessment of the proposals advanced by other inquiry participants, the ALRC claimed that, with the exception of the proposal of Professor Luntz, 'the alternatives all depend, in the last resort, on a judgement by the court that the manufacturer took reasonable care'. The basis of this legal argument is the use of the phrase 'what people are generally entitled to expect' to define safety of products. The ALRC commented that it follows from this that people are not entitled to expect that goods will be any safer than reasonable care can make them. Under the current form of the TPA, products are only unsafe if they fail to meet the relevant standard.

The ALRC claims that safety standards based on decisions made by courts would not provide an adequate mechanism to bring about optimal product safety. It asserted that United States courts taking this role is one of the reasons for the failure of the American system.

Concerning the issue of proof, the ALRC argued that a 'rebuttable presumption' mentioned in some of the proposals does not equate to a reversal of the onus of proof. In Australia, the effect of *res ipsa loquitur* is to create a rebuttable

presumption, but overseas its effect is to reverse the onus of proof (see Appendix D). The ALRC states that under a rebuttable presumption, if the defendant comes up with any evidence to rebut lack of reasonable care it is then up to the plaintiff to disprove that evidence. This argument implies that, under nearly all the alternative proposals, the claimant would need to amass as much evidence as for a conventional negligence case. The ALRC also stated that substantially more evidence is required in negligence cases than is required under the strict liability regime contained in the current TPA.

With regard to Professor Luntz' proposal, the ALRC briefly stated that it did not recommend such a scheme, since private schemes could compensate the individual without the need for the 'extra machinery'. The ALRC did not enter into a full consideration of a general accident compensation scheme because it considered that such schemes did not fall under its terms of reference.

F.3 Summary

There are some deficiencies in current law that all the authors of alternative proposals agreed need rectification, particularly the rights of third parties and the limited coverage of goods. Some of the proposals -- for example, those of the Law Council, the BCA and the ACA -- set out to remedy these deficiencies without any major overhaul of the current laws.

Other authors (including the ALRC) see further shortcomings in the TPA, and their proposals advance more sweeping remedies. Of these proposals, that of Professor Luntz is the most far-reaching. He considers the shortcomings are such that to deal fully with them would require an entirely new approach to accident compensation.

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