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Back to basics: managing supply chain risk from an Australian product liability perspective

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Introduction

Manufacturers and suppliers of goods face a range of supply chain risks, an important one of which is product liability risks arising from safety defects linked to goods' components. This is heightened for manufacturers that have substantial global supply chains where, potentially, there are the added challenges of limited visibility over the supply chain and lower product quality procedures and standards.

The consequences of supplying goods to consumers in Australia containing a safety defect are significant. Statutory remedies are available to Australian consumers against a manufacturer of goods that contain a defect. Depending on the circumstances, consumers may also bring actions against a manufacturer in contract or in tort. Non-consumers may be able to bring actions against manufacturers in respect of product liability issues, such as claims for misleading and deceptive conduct. Safety defects may necessitate a recall, the costs of which may be substantial, not to mention the possible reputational impacts.

While a manufacturer has limited means available to limit its liability for the supply of defective goods vis-a-vis consumers and others, one way in which these risks can be managed is through the contractual relationship between the manufacturer and its suppliers. This article addresses some of the practical measures for managing product liability related supply chain risks through the contractual relationship.

Safety defects and the Australian Consumer Law

This section sets out a high level summary of the key provisions of the Australian Consumer Law[1] (ACL) that are relevant to addressing safety defects in goods.[2]

The ACL provides protections for consumers against manufacturers who supply goods that have a safety defect (being where the safety of the goods is not such as persons generally are entitled to expect). "Manufacturer" is defined broadly and includes not just the person or business that makes or assembles the goods, but also the person or business that holds themselves out to be the manufacturer of the goods, has their name on the goods, or imports the goods (if the actual importer does not have an office in Australia). This broad definition means that in some situations the supplier of the good to the Australian market can be held liable for a safety defect (although in such situations the supplier may have the benefit of the statutory indemnity under s 274 of the ACL).

Under the ACL, a manufacturer is liable to compensate an individual if: that manufacturer supplies goods in trade or commerce; the goods have a safety defect; and because of that defect an individual suffers injury, loss and/or damage. There are four statutory defences to a defective goods action brought under the ACL, including what is commonly referred to as the component manufacturer defence.[3]

Manufacturers have obligations to ensure their goods meet a range of statutory consumer guarantees, including that the goods are of acceptable quality and are reasonably fit for any disclosed purpose. Manufacturers may face action from consumers to recover damages for a failure to comply with the consumer guarantees.

Manufacturers may also be exposed to liability for making false or misleading representations about goods (eg, that goods are of a particular standard or quality) or for misleading the public about the nature, manufacturing process, characteristics or suitability for purpose of goods.

Contractual mechanisms for managing supply chain risk

The contractual relationship between the manufacturer and suppliers of components is a key means by which a manufacturer can manage product liability supply chain risks. To do this, in an appropriate and commercially viable way, it is important for a manufacturer to understand the potential risks associated with each component. For example, certain components, due to their characteristics and function or because of the environment in which they are produced, carry greater

potential product liability risk than others. Undertaking this sort of analysis at the outset is critical to managing product liability risks and may inform how certain contractual terms are negotiated.

There are a number of contractual terms by which a manufacturer can seek to manage its exposure arising from product liability issues, subject to consideration of the appropriateness of their inclusion on a case by case basis.

Quality assurance and acceptance testing

A crucial way to reduce the risk of a safety defect is to identify the defect before the good is supplied to the market. One way to do this is by requiring suppliers to undertake appropriate testing and have a quality assurance system in place in respect of the component they are supplying. The contract can set out specifications for the component being supplied, the quality assurance system the supplier must have in place, and a detailed testing procedure the supplier must complete before the manufacturer will accept (ie, pay for) the goods. A quality assurance system ensures that the component matches the agreed design and that its manufacture is carried out to standard or agreed procedures and specifications.

It is also prudent to clearly set out the consequences for the supplier failing to meet its obligations under the quality assurance/testing clauses. For example, the supplier could be required to pay someone else, or compensate the manufacturer for having to pay someone else, to supply to the manufacturer an acceptable component if the supplier's component fails acceptance testing.

A manufacturer may also consider including timelines for compliance with testing procedures, as well as specifying the time frames in which the manufacturer is able to reject a delivered component on the basis of its failure to meet agreed standards.

Reporting and auditing

A reporting clause can be included to ensure the manufacturer is able to monitor the supplier's compliance with the quality assurance/testing requirements.

Along with a reporting clause, an auditing clause can be included so that the manufacturer has a contractual right to audit that the supplier is complying with its quality assurance obligations. The supplier could be required to pay for the cost of the audit if the audit reveals it has not complied with its obligations, and/or the manufacturer could have a right to terminate the contract for a breach of the clause.

Supplier's liability for loss

The contract between the supplier and manufacturer should clearly allocate liability for loss arising from product liability issues.

In an ideal situation, and to the extent permissible under law, the supplier's contractual liability to the manufacturer would be unlimited in regards to any claims relating to a safety defect in the final product caused by or attributable to the supplier's components, including requiring the supplier to indemnify the manufacturer for any claims brought against the manufacturer that are attributable to the supplier's component. Whether this can be achieved may depend on a range of factors, including the relative bargaining power of each party and the circumstances surrounding the commercial relationship.[4]

An example of a compromise position is where it is agreed that if a component meets certain standards and has been accepted by the manufacturer, then no claim can be made against the supplier because of product liability issues even if those product liability issues are the result of that component. Where the supplier's liability is excluded in such a way, what becomes critical is that the manufacturer has processes in place that allow the manufacturer to be comfortable the required standards have been met before accepting the components.

Any exclusion of, or cap on, the supplier's liability should be carefully considered. The manufacturer should undertake a thorough risk analysis of how a defect in the component could ultimately affect the safety of the product, and what would be the resulting costs to the manufacturer. This will assist the manufacturer in determining what may be an acceptable limitation for the manufacturer.

Consequential or indirect losses

The line between consequential (or indirect) loss and direct loss is fluid under Australian law. It is thus preferable to precisely define in the contract what is meant by consequential loss, particularly to include the types of losses the manufacturer may suffer as a result of a being held liable for a product liability issue, and expressly stating that consequential loss is not excluded from the supplier's potential liability for loss. Types of loss that could be included in the definition of consequential loss are:

- loss of profits;
- damage to goodwill or reputation;
- loss of access to markets; and
- loss of opportunity.

Indemnities and compliance

A manufacturer may wish to consider whether it is appropriate and desirable to include a clause that requires a supplier to indemnify and fully compensate the manufacturer for any fines or other pecuniary penalties

imposed by the Australian Competition and Consumer Commission, where such pecuniary penalties are because of a negligent or unlawful act or omission of the supplier, or a failure of the supplier to comply with the requirements of the contract. Subject to considering questions that may arise regarding the enforceability and validity of such a clause, this may provide the manufacturer with a contractual right to payment from the supplier for any fines the manufacturer must pay due to the supplier's action.

The supplier can also be required to comply with all relevant laws and regulations in the supply of the component. Such a clause is particularly important where the supplier, or the place the component is manufactured, is outside of Australia.

Insurance

In addition to the manufacturer having insurance, the manufacturer may wish to require that certain suppliers in the manufacturer's supply chain also take out specific types of insurance. Particularly relevant to safety defects are product liability insurance and product recall insurance. Such a clause can:

- set the minimum policy value;
- require the policy to be endorsed to note the interests of the manufacturer;
- require the supplier to provide evidence of the insurance policy; and
- require the length of the insurance policy to survive the termination or expiration of the agreement by a set period.

Potential consequences of inadequately managing supply chain risks

The costs of supplying a good containing a safety defect to the Australian market can be substantial. There are the costs of conducting a recall (not just the financial costs but also the costs associated with the distraction of management), should that be necessary, as well as potential civil penalties, the damages that may be payable as a result of the statutory and other remedies available to consumers, and litigation costs.

The damage to a business' reputation, and subsequent loss of business, can be significant, even if difficult to quantify. For example, in 2010, Toyota estimated its global recall of vehicles due to accelerator problems would cost the company US$2 billion. Half of that was the cost estimate of repairing the vehicles. The remaining US$1 billion was the estimated loss of profits due to lower sales and reduced value of leased vehicles. Analysts, including JP Morgan, estimated the total cost of the recall to be closer to US$5 billion. Further, Toyota experienced a substantial drop in its share price. The extent to which the recall contributed to the fall in Toyota's share price is difficult to determine, but it likely played a role.

For these reasons, it is important that manufacturers turn their minds to managing supply chain risks through their contractual relationships and hopefully, by doing so, avoid or minimise this risk.

Conclusion

The costs and consequences of product liability claims can be significant and damaging, both in the short and long term. By taking the time to analyse, plan and allocate risk in the supply chain at the contractual stage, manufacturers can better manage and reduce this risk. The contractual mechanisms highlighted in this article are all matters worthy of consideration, but of course must be considered in the particular circumstances of each contractual relationship.

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Footnotes

1. The Australian Consumer Law is a Commonwealth law. It is also applied in each state and territory of Australia through laws in those jurisdictions.
2. It is not intended to provide a comprehensive review of all actions that may be available under the ACL in a situation where a manufacturer has supplied to consumer a good with a safety defect.
3. This may be available to a component manufacturer where the safety defect is attributable to the design of or markings on the final product, or because of the instructions or warnings given by the manufacturer of the final product.
4. There may also be considerations pertaining to the applicable proportionate liability regimes and the ability to contract out of them.

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Developments in United States consumer class actions

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There has been a major increase in the United States of consumer class actions. The wrongful conduct claimed often involves untrue statements made about a product, such as that it was free of GMO (genetically modified organism), or that a wipe was flushable.

The laws violated which give rise to a remedy here are generally the consumer protection law of a particular state. Every US state (we have 50) has such a statute, but no two are the same. The laws vary widely, some being much friendlier than others in defining allowable suits. For example, some require proof of reliance by the particular plaintiff, whereas in others it is assumed.

The damages sought in these class actions are usually to recover the purchase price paid, or the "unjust enrichment" the defendant received by selling the product with false labeling.

These recent suits are almost always brought in the Federal Court, pursuant to r 23 of the Federal Rules of Civil Procedure (US). However, few seek to establish a national class. Instead, they seek a class pursuant to a particular state's consumer protection law — most often California and New York, which have more liberal provisions for recovery.

With the above as background, let us look at some of the major issues which have arisen recently in consumer class action litigation.

Ascertainability

The issue here is what degree of proof is required at the onset of a class action claim as to who is a bona fide member of the proposed class. Defendants upfront want direct proof, such as proof of purchase of the product. Plaintiff's lead counsel point out that many of these products, such as a box of crackers, or an over-the-counter drug, are bought casually with no way to prove purchase. *Mullins v Direct Digital* is a recent case rejecting special scrutiny of who the class members are.[1] Since there is a split among the Federal Circuit Courts, the Supreme Court may ultimately decide the issue.

Review of merits

Defendants have sought to have the courts closely scrutinize a proposed class action on its merits, such as examining whether the plaintiffs could prove causation or some other essential element of the cause of action. Their argument is a practical one: waste of time and expense will be avoided if the class action is throttled at the inception. The plaintiffs' response is that this is all very premature; all the court is being asked to do is approve a proposed class and such concerns should be decided after full discovery. Courts have gone many different ways in resolving the merits issue. An example of a decision which did allow some examination into the merits but not go so far as try any causation issues on the pleadings is *Cox v Zurn Pex Inc*.[2]

Arbitration

Sometimes after a class action is sought, the defendant seeks to dismiss it on the grounds that the plaintiffs had signed arbitration agreements. Obviously the defendant prefers to resolve any complaints via arbitration since it is one-by-one, and, since the amount claimed per person is small, most will not spend the time and money to arbitrate. (The fight may also be between plaintiffs seeking class-wide arbitration and individual arbitration.) The Supreme Court has decided a number of cases recently dealing with the dual between arbitration agreements and the right to maintain a class action. In most of its decisions, by a 5–4 vote, the court has enforced arbitration agreements. A leading case is *AT&T Mobility LLP v Concepcion*.[3]

Effect of settlement offer

On occasion, the defendant in a class action lawsuit seeking court approval will make an offer to the named plaintiff to settle the case. Even assuming that the offer is fair but that the plaintiff does not accept it, defendants argue that the class action is moot. Plaintiffs argue that the class should be allowed to continue. The Supreme Court stepped into this issue recently in *Campbell-Ewald Company v Gomez*,[4] holding that the action is not mooted where the named plaintiff refuses to accept an offer to settle in the amount which he sought in the suit.

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**Many of these issues are covered in chapter 2 of my book, Litigating Mass Tort Cases, 2006 with annual supplement (Thomson Reuters).*

Footnotes

1. *Mullins v Direct Digital* (2015) 795 F 3d 654.
2. *Cox v Zurn Pex Inc* (2011) 644 F 3d 604.
3. *AT&T Mobility LLP v Concepcion* (2011) 131 S Ct 1740.
4. *Campbell-Ewald Company v Gomez* 577 US __ (2016).

The future direction of driverless cars in the UK

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Driverless cars used to be confined to the realms of science fiction. However, they are fast becoming a reality, with trials taking place in various cities around the world. Such cars have many promised advantages. With over 90% of road accidents in the United Kingdom (UK) estimated to be caused by human error, the development of driverless cars has huge implications for road safety. The technology promises to reduce emissions, ease congestion, improve mobility and enable drivers to safely choose to do other things during a journey, such as surf the web or even take a nap!

Many modern vehicles already have features providing a degree of autonomy such as cruise control, intelligent parking, lane keeping assistance and advanced emergency braking systems. These show that the concept of allowing a computer to actively control a vehicle's systems in the interests of safety isn't new. All these examples still have the driver monitoring conditions and ready to assume full manual control if needed. Truly driverless cars, capable of fully autonomous operation without a driver's involvement, are considered by many to simply be a natural progression from these existing technologies.

Testing in the UK

The UK has become a world leading centre in testing driverless vehicles, as it is considered to have a very favourable regulatory environment for the development of the technology. There is a UK code of practice for testing of driverless cars, published in 2015, which states that the test driver (and the testing organisation for whom they are acting), is expected to take responsibility for ensuring the safe operation of the vehicle at all times during testing, whether the vehicle is operating autonomously, or in manual mode. There are currently driverless car projects in place in various UK cities. Trials of driverless lorries in convoys are planned to take place later in 2016 and driverless cars will be tested on UK motorways from 2017.

Liability questions

A commonly asked question is how will product liability law deal with claims involving driverless cars once they hit the consumer market? It is anticipated that the legal position for liability in relation to features on highly automated vehicles will not be significantly different to those for the semi-autonomous elements which exist at present. It will still be necessary to consider whether a collision was caused by a design or manufacturing defect (such as programming and software malfunctions or the failure of integral components like sensors, radars or cameras), by human error if the vehicle was being manually operated at the time of the crash, or by other factors such as a failure to service or maintain the vehicle in accordance with the manufacturer's instructions.

In England and Wales, a Claimant is likely to bring an action directly against a car manufacturer or importer under the Consumer Protection Act 1987 (UK) which imposes strict liability for injury or damage where the vehicle is found to be defective. The Consumer Protection Act defines a defective product as one where its safety is not such as people are generally entitled to expect.

Manufacturers will wish to ensure that consumers do not have unrealistic expectations of what the driverless car technology they have purchased is actually capable of. They will need to communicate very clearly how to safely use the automated features of the vehicles and provide clear explanations of any potential risks. The instructions and warnings provided with such cars and the content of the owner's manual will be very important to questions of liability.

Another key area will be managing those situations in which a driver may need to take over and manually control the car. It may be that car buyers will need to be given specific training on safe use of their new vehicle, rather than just rely on written warnings and explanations. It is possible to imagine a scenario where an automated feature fails on a vehicle, resulting in a crash, and a manufacturer may allege that the driver should have taken back control of the car when it was possible and reasonable to do so, thereby avoiding the collision. The driver may, in turn, argue that he or she was relying on the automated driving mode to perform other tasks and therefore was not aware that an accident was imminent, or that it was simply impossible to respond in sufficient time to intervene. It has been suggested that black box type software may even need to be introduced

for accident reconstruction purposes to help determine what the exact circumstances were in individual cases.

The UK Department of Transport prepared a report in 2015 called *The Pathway to Driverless Cars* that explored some of the liability questions surrounding this new technology. The initial view expressed in the report is that it would be reasonable for liability to only pass back to a driver if and when the driver willingly chooses to resume manual control. The report says it would not be considered appropriate for a vehicle manufacturer to design a system that attempted to switch back to manual control without the driver's consent. If for some reason, the driver does not resume control, the report suggests that the vehicle's automated system should be designed to ensure that it could safely bring the vehicle to a stop.

The UK Government has indicated that by summer 2017 it will conduct a review of existing legislation and provide clarity on how liability should pass between the driver and the vehicle manufacturer according to the mode of operation. The government is also considering if changes should be made to existing licensing requirements for users of highly and fully automated vehicles and whether the Highway Code should be updated to help guide road users on how they should interact with these vehicles.

Insurance implications

A group of 13 UK motor insurers, led by the Association of British Insurers (ABI) and Thatcham Resarch, has been formed to consider key issues relating to driverless cars on UK roads, particularly concerning insurance and liability questions. The Automated Driving Insurer Group, as it is called, will feed into ABI policy and work with the UK Government on shaping the future of driverless cars in the UK.

In May 2016, the Queen announced in her speech a Modern Transport Bill (UK) which aims to put the UK "at the forefront of technology for new forms of transport including autonomous and electric vehicles". The Bill has been described by the Department of Transport Minister, Andrew Jones, as "the world's first driverless car insurance legislation". In a speech he delivered on 26 May 2016, Mr Jones explained that compulsory motor insurance will be extended to cover product liability for accidents where the motorist has handed over control of the vehicle and it is operating in autonomous mode. He stated that "where the vehicle is at fault, then the insurer will be able to seek reimbursement from the manufacturer". For affected individuals, the insurance process will feel much the same as it does at present.

Since the Queen's speech, one insurer in UK has launched what it claims to be the UK's — and maybe the world's — first personal driverless car insurance policy, designed for consumers who purchase cars with some automated features, such as self-parking. The policy includes coverage for loss or damage caused by a failure in the manual override or if the vehicle's computer is hacked.

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