Defects Cases: What Legal Theories, Evidentiary Standards and Remedies Should Apply?

by

MARY L. AZCUENAGA
COMMISSIONER

FEDERAL TRADE COMMISSION

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Thank you. I appreciate the opportunity to speak at this annual meeting of the National Advertising Review Board. On more than one occasion, I have cited the work of the NARB, the NAD, and the Council of Better Business Bureaus as an example of a successful industry self-regulatory program. Although I must note that the views I express today are not necessarily shared by the other members of the Commission, I am sure that my colleagues agree that the BBBs deserve special thanks for their hard work as administrators of the consumer complaint arbitration program created pursuant to an FTC consent order with General Motors.

The General Motors case is perhaps the best known of the Commission's product information cases, more commonly called "defects" cases. The defects program has resulted in complaints against and consent agreements with the "Big Three" American automobile makers, plus Honda, Saab, and Volkswagen. Because all these cases have been settled before the litigation has run its course, there are no Commission or appellate court opinions discussing the products defects program. This may help explain why these cases have not received publicity commensurate with the hundreds of millions of dollars that have changed hands or will change hands as a result of those settlements. Today, I am going to discuss some of the difficulties the Commission has faced in developing an approach to this kind of case. The debate over what legal theories, evidentiary standards, and remedial provisions are appropriate in a "defects" case presents complex

and subtle issues that provide a more than ample intellectual challenge. Not surprisingly, it is much easier to identify the hard questions than to answer them.

As you may have noticed, all the defects cases I mentioned a moment ago involved car manufacturers. The FTC receives an enormous number of consumer complaints about car problems. Many of the complaints we receive concern major breakdowns in relatively new cars -- problems that not only disappoint the reasonable expectations of the buyers, but also result in considerable inconvenience and expense. I remember one particularly egregious situation that was brought to the Commission's attention a few years ago. A family complained that their Christmas vacation trip to Florida was ruined when the transmission in their two-year-old luxury sedan broke down six times in three weeks in three different states. During that time, the transmission was rebuilt four times and completely replaced twice.

When you buy a five-year-old used car, you probably expect to have some major repairs in the not-too-distant future. With a new car, which costs a lot more, people expect a lot more. When their expectations are not fulfilled, not surprisingly, they want someone to do something about it. Often they turn to the FTC.

The Commission's response to the all-too-familiar problem of the product that unexpectedly fails shortly after its warranty expires is the "product information program," which is often referred to as the "defects program." Let me emphasize the phrase, "after the warranty expires." The FTC may step in when warranty coverage is advertised in a deceptive fashion, or when a manufacturer fails to live up to its warranty obligations. But a product defects case does not rely on the existence of a warranty -- it is based on a theory that the manufacturer failed to disclose certain information about the product. The companies that have been the subjects of our product defects cases have not been guilty of false advertising in the usual sense. Instead of saying things that were not true, these companies stand accused of unfairly or deceptively not saying things.

The defects program is based on the legal theory that a manufacturer's failure to disclose information about product defects is, in certain circumstances, an unfair or deceptive act or practice in violation of Section 5 of the FTC Act. We believe that markets usually work well when consumers are well informed. Our defects cases represent an attempt to require sellers to provide more information -- and often more negative information -- about their products than they might ordinarily choose to provide. That approach runs up against one obvious problem. As

we all know, no manufacturer wants to volunteer any negative information about its products.

Another approach to the problem would be to require sellers to offer longer or more comprehensive warranties. But even if the Commission had clear legal authority to dictate warranty terms, there is reason to question this approach. Warranties are not free. The cost of a warranty is reflected in the purchase price of the product. Some consumers are willing and able to pay for increased warranty coverage, but others are not. There is no reason to believe that the FTC or any other government agency would do as well as the market in deciding what warranty terms best suit consumer needs. The recent warranty "wars" among Ford, General Motors, Chrysler, and other automakers are evidence of the market's ability to respond to consumers and to provide additional warranty coverage when consumers want it. So the Commission has chosen to deal with product defects not by dictating the circumstances under which a defective product must be repaired or replaced, but rather by requiring the manufacturer to tell consumers up front about some of the problems with its product.

Let me turn for a moment to the legal standard for defects cases. Our complaints usually allege that the failure to disclose information about a product defect is "unfair or deceptive." When a manufacturer makes a false claim about a

defective product's quality or reliability, a theory of liability based on deception clearly applies. But our product defects cases are not usually grounded in false claims or even half-truths -- they are based on the manufacturer's silence. Silence can be deceptive if the circumstances surrounding the silence create an implied representation that turns out to be false.

For example, it is deceptive to sell an abridged version of a well-known book without disclosing that it is an abridged edition. The mere offering for sale of the book under its original title implies that it is an unabridged edition of the original book, and the seller's failure to disclose otherwise is deceptive. But silence usually is not deceptive, and the Commission has found that unfairness rather than deception will usually be the proper legal theory to apply in cases involving a seller's failure to disclose unfavorable information about his product. [1]

My reservations about bringing defects cases solely on a deception theory proceed from my belief that the cost-benefit analysis, which is an element of an unfairness case but not required in a deception case, is particularly useful in the defects area. Although the Commission takes pains to ensure that each of our efforts provides a net benefit to consumers, we do so

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[1] See, e.g., International Harvester, 104 F.T.C. 949, 1055-62 (1984).

by making certain presumptions in certain kinds of cases. In cases involving violations of FTC rules, we presume that rule violations harm consumers. In cases involving false advertising claims, we presume that certain misrepresentations harm consumers. For reasons I will discuss, we cannot always assume that it is a violation of the law to fail to provide information about a product defect at the time of sale. Making such a presumption might lead to Commission action that harmed rather than helped consumers. The balancing process that is characteristic of our unfairness analysis should help prevent any such perverse result.

Let me offer a hypothetical example. After investigating numerous consumer complaints about premature engine failure in the First Rate Motor Company's Ultra Gamma GTX sports coupe, the FTC discovers two things: first, that the Ultra Gamma GTX engines would last much longer if the car owners used high-octane premium gasoline; second, that First Rate Motors had that information but continued to sell the Ultra Gamma GTX without telling its customers. At first, that looks like a deceptive failure to disclose material information. The usual remedy for a deceptive failure to disclose material information would be a warning label or a bold-print statement in the owner's manual that said something like: "Important Notice: To Avoid Costly Engine Damage, Use Premium-Grade Gasoline Only!" But what if

further investigation revealed that, for the typical consumer, the additional cost of using premium gasoline over the lifetime of the car is twice the cost of the engine repairs that would result if economy-grade gasoline was used? My hypothetical disclosure might then be deceptive and would certainly be as harmful to consumers as the manufacturer's silence in the first place. If the investigation was based solely on a deception theory, it might have stopped short of the thorough cost-benefit analysis necessary to reveal the potential harm to consumers that might result from certain disclosures.

I am not saying that failure to disclose information about known product defects is never deceptive. What I am saying is that in this area the traditional Commission analysis used in straightforward deception cases may not be sufficient to ensure that we come up with the solution that helps consumers the most. An analysis of liability based on the Commission's authority to challenge unfair acts or practices is more likely to lead to the right outcome in product defect cases.

So much for the legal standard. Let me turn now to the evidentiary prerequisites for a showing that a failure to disclose information about a defect was unfair under Section 5. In essence, the Commission staff must prove three things to prevail in a defects case. First, they must demonstrate that there was a defect. The definition of a defect that is used in

Commission complaints is "the occurrence . . . of an abnormal number of failures or malfunctions . . . [that] are costly to correct or may substantially affect the quality, reliability, durability, or performance" of a product. Second, the staff must establish when the manufacturer became aware of the defect. Third, they must show that the manufacturer could have disclosed useful information at the time the product was sold but failed to do so.

All that may sound simple, but it is not. Let's start with the definition of a defect -- "an abnormal number of failures or malfunctions." How do we know what an "abnormal number" of failures is? Is it 5% more failures than average? Twenty-five percent more? How do we know what the average failure rate is in the first place? Consumer complaints alone certainly will not tell us. The manufacturer's internal records may not either.

More significant is what we sometimes call the "whole car" problem. Assume that each of three rival automobiles has an average repair cost during the first 50,000 miles of use of $500. The $500 spent by the owners of the average Brand X and the average Brand Y cars goes for various, relatively inexpensive repairs -- everything from adjusting the brakes to realigning the front end to replacing a burned-out headlight. In contrast, nearly every Brand Z car develops serious transmission problems that require $500 to fix -- but nothing else goes wrong with the

Brand Z car in the first 50,000 miles. It seems obvious that the Brand Z transmission is defective compared to the transmissions in Brands X and Y. Should the Commission sue to force the manufacturer of Brand Z to disclose that the average Brand Z owner will face $500 in transmission repairs? That kind of disclosure would, no doubt, cause some potential Brand Z customers to buy X and Y cars instead. If the average total expected repair costs for X and Y were higher -- say $600 or $700 -- then the disclosure of Z's transmission problems would result in net monetary harm to the consumers who switched brands to avoid the problem.

Some observers claim that some of the Commission's defects cases have themselves been defective for this very reason. According to these critics, frequency-of-repair data published in Consumer Reports indicate that some of the cars under attack by the Commission for having defective components actually had average or lower than average overall repair costs. It seems inappropriate to term a car "defective" unless its overall repair costs are significantly greater than those of comparable cars.

Let's assume for a minute that we have established to our satisfaction that a car is defective. The next question we must answer is what the manufacturer knew or should have known about the defect -- and when. A manufacturer cannot very well disclose the existence of a defect unless he knows about it. By the time

the Commission gets involved in a defects matter, we have the advantage of hindsight. But we cannot simply count the number of times a particular product eventually fails and proceed on the assumption that the manufacturer should have known what the failure rate was going to be in time to disclose it. Instead, we need to ascertain when the firm should have been sufficiently certain of the facts to inform consumers of the problem.

Making that judgment requires us to consider what information was available and how it appeared to the firm at the time. Repairs of unusual failures, such as major engine repairs on a relatively new car, prompt dealer service department complaints and abnormal numbers of warranty claims. Since warranty claims are costly to the manufacturer and defective parts hurt the reputation of the manufacturer, the manufacturer usually devotes considerable resources to monitoring the problems that show up in cars that were recently sold. All automobile manufacturers have quality-monitoring personnel whose job it is to sound the alarm when problems arise.

But sounding the alarm is only the beginning of the process. Evidence of a possible defect will arise frequently. Management must determine whether the apparent problem is both serious and widespread. Warranty reports are usually sketchy; they may not itemize each component repaired during a single service visit. The process by which early indications of

performance problems lead to a conclusion that the component is really defective is likely to take considerable time and effort.

In making the determination of when the manufacturer knew (or should have known) of a defective component, we must ask when should someone in authority have decided that a component was defective? The fact that someone at some level in the corporate bureaucracy had relevant information does not necessarily mean the manufacturer had the information, and the documents created by quality-control employees that are produced in discovery should be understood in this context.

Evidence may sometimes suggest that a manufacturer was in fact unaware of a defective product, but should have known of the defect. I think a should-have-known finding should be reached only on the basis of compelling evidence. Deciding that a corporation should have known about a defect is tantamount to deciding that the corporation had not implemented reasonable internal procedures for communicating information and making decisions about defects. Manufacturers have incentives to construct such systems. Second-guessing their internal procedures is something that any outsider, including a government agency, should be reluctant to do.

Our third evidentiary burden, which is closely related to the first two, is to show that the manufacturer could have disclosed useful information but did not. The toughest question

to answer in a defects case may be when the disclosure should have been made. For a disclosure to be of value to prospective purchasers, it has to be made while the particular product that exhibits the problem is still being sold. Another reason that timing is important is that early disclosure reaches more prospective purchasers and confers greater benefits. On the other hand, waiting to disclose may mean that a disclosure can be more accurate and useful, because a manufacturer will have obtained more information about the problem. Estimating the likelihood of failure or the cost of repair may require waiting until a large number of units have been in use long enough to provide a reasonable estimate.

If the firm has attempted to fix the problem, then the likelihood of failure may be reduced and may require additional time to evaluate. For example, suppose that the manufacturer has a reasonable basis to conclude in 1987 that the 1985 model was defective. If the 1987 model is exactly the same as the 1985 model, the firm would have a duty to disclose that the 1987 model is defective. But suppose, as is usually the case, that the firm made a number of modifications in the 1987 model in an attempt to cure the problem. The manufacturer no doubt believes it has at least partially solved the problem. How then is it possible to conclude that the manufacturer has a reasonable basis for knowing that the 1987 model is defective? That conclusion would only be

possible if it could be shown that the manufacturer knew that the modifications were insufficient to cure more than an insignificant aspect of the defect. It takes time to learn if modifications work or not. One possible way to speed things up is to require the firm to disclose the worst possible estimate of repair costs, but that may not be very helpful. As I mentioned earlier, overstating potential repair costs can be just as harmful as understating them.

Let me note two ironies in our defects program. The first irony is that our cases have typically involved large, long-established firms with good reputations. Even the best firms make mistakes, and their reputations suffer when they make a mistake whether the FTC takes action or not. The fly-by-night firms that market really shoddy products have not been the targets of our defects investigation -- possibly because the market usually punishes those firms so quickly and severely that we could do little more that was helpful.

Second, it does not appear that manufacturers are making more negative disclosures about their products, although they may be taking greater pains to detect and cure problems as soon as possible. The irony here is that the defects program is, in theory, about giving consumers more information before purchase decisions are made. But the practical effect may have been to raise quality-control standards, with redress to consumers in

cases where those standards are not met. That may be a good thing, or it may not. If the improvement in quality does not add too much to the cost of the product, consumers may come out ahead. But the increase in quality may result in a price increase that hurts consumers more than the additional quality helps them.

As advertised, I have asked a number of questions but offered very few answers about our defects program. I agree that the Commission should not be in the business of setting the substantive terms and conditions of product warranties, but I wonder if manufacturers other than those under order will disclose significant negative information about their products as a result of any of our cases. And even if the best approach is to require manufacturers to disclose more information, we still face a number of issues in framing a remedy. What negative information must be disclosed? When and how should it be disclosed? If the proper disclosures are not made, is an arbitration program a suitable remedy or should we insist on direct consumer redress? The family who had all the transmission problems on the way to Florida may deserve some help from government agencies like the FTC, but it is far from clear precisely what that help should be.

Thank you.