ADDRESS

PRODUCT LIABILITY:
CURSE OR BULWARK OF FREE ENTERPRISE

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IN JULY OF 1978 the Secretary of Commerce, Juanita Kreps, speaking for the Carter Administration, proposed a “comprehensive program to attack the problem of escalating product liability premiums and costs.”1 The administration felt compelled to become involved because:

Serious product liability problems have affected thousands of small businesses that have had great difficulty in obtaining affordable product liability insurance. The problem has also affected consumers because insurance costs have been passed on to them in terms of higher prices. Consumer groups have also been concerned about restrictive new state laws that have attacked the problem by limiting the rights of persons to recover damages for injuries caused by defective products. Finally, insurers have expressed concern about court rulings imposing substantial damages in product liability cases.3

Despite the inconsistencies which abound in the government’s statement of why it is troubled, there is no question that the administration’s intervention reflected a serious concern, among many quite disparate groups, that the increase in size and frequency of product liability judgments somehow was undermining the capacity of American business to function as it should in a free enterprise system. Typically, the government’s proposed approach involved tax changes as a short-range measure (a quite sensible ten year loss carry-back), and a “balanced program that will relieve the product liability problem for American businesses while fully respecting the rights and interests of consumers”3 as a longer run solution. The keystone of this last approach would be a uniform “balanced code that will add needed stability to product liability law” to control the “uncertainties in the tort system.”4

What the government and the various states which have also reacted to the product liability “crisis” by passing “codes” have not faced, however, is the fact that the “uncertainties” they would abolish to a large extent only reflect

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3 U.S. DEP’T OF COMMERCE, supra note 1, at 1.
4 U.S. DEP’T OF COMMERCE, supra note 2, at 3.
the risks inherent in the manufacture and use of complex and even of simple products. Uncertainty and risk are allocated and occasionally misallocated by the tort system, but they are not caused by it. As a result, the proposed codes may well reallocate or shift the burdens of accident risks and uncertainty, in part or in whole, from the manufacturer (on whom tort law has increasingly placed it) back to the consumer, under the guise of creating standards, but they are unlikely to diminish the actual degree of uncertainty and risk being borne by manufacturers and consumers jointly. They are unlikely to do so unless, of course, they go considerably further and attempt to remove the risk from both manufacturer and user and socialize it, that is, spread it through some kind of governmental insurance program paid out of general revenues.

This last possibility, though certainly not in the forefront of current legislative efforts, is never to be excluded. For it is only in this way that the government can in fact achieve what it claims to be striving for: to "relieve the product liability problem for American businesses while fully respecting the rights and interests of consumers." Thus, government intervention can too readily become the easy compromise when organized consumer groups and manufacturer associations each try to avoid bearing risk and uncertainty and, at the same time, refuse to pay the price of having the other group bear that same risk and uncertainty.

It is worth emphasizing that in the government's explanation of why there is a crisis, the phrase "[t]he problem has also affected consumers because insurance costs have been passed on to them in terms of higher prices," immediately precedes the phrase "consumer groups have been concerned about . . . state laws . . . limiting the rights of persons to recover damages for injuries caused by defective products." In other words, consumers would prefer neither to bear the risk of having some accidents for which no compensation is available, nor to bear the cost of paying for someone else—the manufacturer—to bear analogous risks. Manufacturers feel the same way about it. Thus, when the government says "small businesses . . . have had great difficulty in obtaining affordable product liability insurance," what it actually is saying is that small businesses do not wish to bear the cost of having insurance companies take over the burden of risk from them.

The "solution" of shifting the loss to the government, unlike the current product liability "crisis," would, however, have serious implications for a free enterprise system. To see why, one must consider: (a) the ways in which a society can "manage" risk and uncertainty; (b) which of these ways are consistent with free enterprise; and (c) which, instead, at least in the long run, tend to undercut such a system. In considering these, it is important to remember that risk and uncertainty, and, therefore, defective products and accidents in their use, exist in all societies whether "free enterprise" or "socialist" or "mixed." The question, then, is not whether risk will exist but

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5 See id., at 1. "[T]he overwhelming majority of businesses [are] not looking for a "federal handout" to resolve the problem. These businesses [agree] with the Commerce Department that a federal insurance or reinsurance program [is] not the solution." Id.

6 U.S. DEP'T OF COMMERCE, supra note 1, at 1.

7 U.S. DEP'T OF COMMERCE, supra note 2, at 1.

8 Id. (emphasis added).
rather how societies will choose to "manage" that risk, how they will decide to control it and limit it, and whom they will wish, in the end, to burden with it.

I. THREE WAYS OF CONTROLLING RISK

There are, in essence, three different approaches to the control and allocation of risk. The first is what I have elsewhere called the "contractual" or "property" approach. The second is the regulatory criminal law way. And the third is the "torts" or "liability rule" method.

In the first approach, the government, in effect, lets the parties themselves decide who is best suited to manage the risks and uncertainties inherent in a situation (for example, in the manufacture and use of products). The government's principal role here is to enforce the solutions, or more specifically, the contracts, at which the parties have arrived. A starting point, where the loss lies in the absence of a contract, must be established either implicitly, as by custom, or explicitly, as by law. This is necessary because, without such a starting point, it would be difficult for the parties to arrive at an agreement as to who should bear or manage the risks they jointly face.

In product liability situations, however, the starting point itself is relatively unimportant. This is in contrast to situations like auto accidents, where the starting point is bound to become the end point — since even nominal negotiations as to who ought to bear the risk between the potential injurer and the potential victim, pedestrian and driver for example, are usually impossible — and where as a result this first approach inevitably transforms itself into the third, or tort, method. In the product liability area, the parties could, in theory, by explicit or implicit contract, reverse that starting point and, also in theory, would do so whenever it suited their joint interest, whether one began with strict producer liability or caveat emptor. The function of the courts, under this approach, would be no more than to determine, as they supposedly did in the probably mythical and in any case long-dead world of pure contract, the intent of the parties as to where the risk should lie for a price paid.

The key to this approach is the belief that the government knows very little. It does not know who is relatively unaverse to risk and hence wishes to bear risks for a price. It does not know who can best act to reduce risks by adding or designing safety devices or by being more prudent in the use of a product. And certainly it does not know, better than the parties themselves, what risks ought to be avoided or forbidden and what risks are, instead, worth bearing. Despite the obvious problems with this approach in the raw, elements of it remain an important part of any legal system which reflects a "free enterprise" society, at least in those areas like product safety where, nominally, transactions between the parties are possible.

The second approach represents the other ideological extreme. The assumption made under it is that the government or its agents know better

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9 See Calabresi and Melamed, Property Rules, Liability Rules and Inalienability: One View of the Cathedral, 85 Harv. L. Rev. 1089 (1972), which examines society's use of property, criminal, and liability rules to protect and regulate "entitlements." Conceptually, allocation of risk is the converse of protection of entitlements.

than the parties themselves not only who can best manage risks, but even what risks are worth taking and what risks are too great. Under it, risk is not abolished, but it is socialized. A decision is made as to which safety measures will be required and which instead are too costly. This decision is then enforced criminally, and compensation, out of general revenues, is given to those who lose as a result of the decision. For the parties, uncertainty is ended, but they are given in its place the certainty of the bureaucratic decision, whether they like it or not.

Even the most "free enterprise" of societies adopts this regulatory-criminal approach in some situations. (Two-year-olds are forbidden to drive cars and might well be even in a totally laissez-faire state.) To the extent, however, that a society believes in free enterprise, it is likely to look skeptically on this solution. For if the government is the best assessor of what risks and what innovations are worthwhile, as well as of who ought to bear the burdens of risk and innovation, there is very little reason to permit private enterprise to exist at all. After all, the raison d'être of private enterprise is that it can respond to the needs and desires of the people in a society better than the government can, and it can and will take risks which a bureaucrat might be inclined to reject but which, nonetheless, will benefit society and are worth taking. Any society which too readily assumes that accident risks are best managed and borne by the government, through regulation and compensation, is by that very assumption casting deep doubts on the utility, and hence, inevitably, on the viability of private enterprises.

This is not to say that such an approach may not be adopted through near-sightedness and even with the support of those who, in theory, should be most concerned to fight it, the entrepreneurs themselves. In the short run, this approach can protect the entrepreneurs from risks which both they and consumer groups would rather avoid. For many an existing enterprise the socialization of a risk and its removal from it or its customers is a net benefit, even if it entails regulation (as Adam Smith himself noted two centuries ago). At the very least it makes entry of new competitors more difficult. As a result, the fact that this second approach in the end undermines the enterprise system and its possible benefits, unfortunately, is all too often the concern only of the theoretician.

The third — or torts — method is, as I have elsewhere noted, an ideologically mixed approach. The government is assumed to know, better than the parties, at least in some instances, who can best manage the risks and uncertainties involved. It, or its agents, can best decide — under this method — who ought to bear a loss and who can act, either through precaution or inventiveness, to reduce loss or the risk of loss in the future. In this sense, the torts method resembles the regulatory approach since it does not necessarily let the parties reverse that decision simply because they believe otherwise. It also determines the level of compensation and damages in a collective way, rather than letting the parties determine what the costs of an accident are or set limits on recoverable losses.


12 In effect this last step is the same as the previous one since a limit set on a recoverable loss is no different from a decision to put part of the loss on one party and the rest on the other.
Once it has decided the level of loss and who should bear the risk of that loss, however, the torts approach steps back and lets the party on whom the risk is placed "manage" it. It does not decide for the parties what risks are worth bearing, but rather lets those on whom it has placed the risk make the decision between risk avoidance and risk bearing. It establishes, collectively, who bears the incentive to manage the risks and uncertainties, but lets those risks and uncertainties be controlled in a free enterprise way. In this sense, it starts to resemble the first, or contractual, approach, which also leaves the management of risks to non-governmental bodies, and is, like it, consistent with an ideology which believes that risks are best evaluated by private rather than governmental entities.

II. PRODUCT LIABILITY: A MIXED APPROACH

Product liability today is an interesting mixture of the first (the contractual) and the third (the tort) approaches. As such, it would seem to be eminently suited to the kind of free enterprise society we have adopted in our society. Indeed the analogue between the theory of product liability, and the way our society decides the questions of what goods and services are worth producing, is striking and merits examination. What then is wrong; why are we facing a crisis?

Before considering this issue further, I would like (a) to describe more precisely the mixture between the first and the third approaches which product liability represents; (b) to consider the basis for the judgment made in the "tort" side of that mixture as to who should bear and manage uncertainty and risk; and (c) to draw an analogy between the above points and how our society decides the questions of innovation and entrepreneurial entry generally. Only then can I return, briefly, to the question of what is wrong and why people are troubled enough to cause me, at least, to fear that we may move increasingly toward the second or regulatory approach, however much we may, in theory, eschew it.

Product liability, unlike many areas of torts where the initial decision (as to who is best suited to bear the risk of loss and to decide between spending money to avoid the loss and paying for the loss if it occurs) is not reversible by the parties either as a practical matter or as a result of legal rules, gives the parties considerable room to alter the collective decision on risk bearing. But unlike the contractual approach, which in theory lets the burden of risk be decided entirely by the parties, product liability regularly limits the use even of express agreements to shift the loss from where it was placed by the "tort" approach. The occasional willingness to let the parties rearrange by contract — so to speak — some of the allocation of risk does not result solely from the fact that negotiations are, at least nominally, feasible in product liability and are not in many other areas of law. There are simply too many other tort situations, such as workmen's compensation, where transactions between the parties are just as feasible and where a case-by-case renegotiation of the allocation of risk is forbidden for that explanation to be acceptable.

I would suggest, instead, that the "tort" decision to make the producer bear the risk of loss is in many instances a sufficiently fragile one so that the society believes that in these instances the parties are best suited to decide the allocation of the risk themselves. Thus, the existence of a "defect" (especially
of a design defect) is inexorably linked to adequacy of warning, obviousness of risk, and expectations as to the use to which a product will be put. And the meaning of all these terms is, inevitably, affected by express, and even implied, agreements among the parties. The suggestion inescapably is that the collective decision as to who can manage the risk best in this area, unlike workmen's compensation, at times depends on which of the parties “prefers” to take on the risk.

Yet the approach is far from the first or contractual one, as the manufacturers who complain about what has happened to product liability in the last years know all too well. Whether the discussion is put in terms of the “fairness” of disclaimers and of exculpatory agreements, as it was in Henningsen, or in other forms of words, the fact remains that many an attempt to rearrange the allocation of risk will be deemed void. And while at times it will be deemed void because the parties didn’t really agree to the reallocation, it will often be barred because, in our ideologically mixed society, it was thought that the parties did not know (perhaps could not know?) as well as the lawmakers who was best suited to bear and manage the risk. In other words, it was thought that, as to that attempt to restructure the allocation of risk, the tort approach rather than the contract approach should prevail.

At times, and rather foolishly, the distinction between areas where the tort and contract approaches should govern is put in terms of “property” damage as against “personal” injury. The risk of loss in the first, it is said, can readily be reassigned contractually, while as to the second disclaimers are not acceptable. Let us, however, consider a potential consumer and a pair of toasters, a cheap one which involves a slight risk of a minor burn on one’s finger when one removes the toast and an expensive one which avoids that risk for a substantial price. The cheap toaster, let us also assume, clearly spells out the minor risk of “personal” injury. It is easy to conclude that product liability ought to decline to find a defect if a buyer decides to buy the cheap toaster and take his chances. The case seems close to that of a cheap toaster which, being cheap, is expected to break sooner than a fancy one.

Conversely, consider another, more fanciful, case of a cheap and an expensive toaster. The cheap toaster, this time, entails risk of fire in one in a million cases but has a built-in alarm so that personal injury is virtually ruled out. The likelihood of major property damage (destruction of a whole house) is, nonetheless, great if a fire occurs. Would we think that a statement in a warranty that occasionally such toasters can overheat and result in fires would avoid manufacturer liability for such a fire? Would our new hypothesis change simply because the consumer chose to purchase the cheap toaster despite the existence of a more expensive toaster which would have avoided the problem? I think not.

Perhaps my instincts on such hypotheticals are wrong, but I doubt it, particularly when I think of the language which would be used to describe the situation in many of those cases if they ever came to court. Perhaps, the line drawn in such cases is not a desirable one. But, even if this were so, it would, for the moment, be beside the point I am making. The point is that the system we have come to, which we call product liability, seems, at times, but only at

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times, to impose liability on manufacturers in the face of the parties' seeming willingness to reallocate the risk, while at other times it seems quite ready to let the user take the burden on him or herself. Moreover, the distinction between when it will and when it won't, though one which we can often predict, is not one that can easily be described by catch words like "property" and "personal injury." Rather, it seems to reflect a deeper notion of the kinds of situations in which our mixed society believes that individuals are best suited to determine who can manage risk and the kinds of situations in which that choice is best made collectively. In either case, however, if the product liability approach prevails, the risk, once allocated, is managed by the individuals involved and not by some collective entity. They, and not the government by regulation, decide whether to spend to avoid the risk or to bear it.

Having said that sometimes product liability does let the risk be "reallocated" by the parties, it is important to emphasize again that both the starting point and the reluctance to permit shifting in many instances indicate that the "tort" side of product liability is not only crucial but does tend today to put and keep the risk of loss on the producer rather than the user. The tort decision made by current product liability law is the opposite of the standard tort position of one hundred years ago, both in and outside the "product" field. In fact, this may be understating the situation as it exists today, since even user negligence is frequently no defense. Traditional tort law, even apart from the special defenses accorded to remote contractors, put the risk of loss on the victim unless some rather special circumstances, like injurer fault (strictly construed), existed. Today, in product liability, the risk is initially placed on the producer and remains there unless complex circumstances, more powerful than user fault, justify a shift in riskbearing from producer to user.14

What is the justification, in an enterprise or mixed society, for this initial allocation of risk and for this reluctance to allow it to be shifted? What, in other words, is the relation between producer liability, as a starting point, and the theory of free enterprise? It is to that question which I will now briefly turn.

III. PRODUCER LIABILITY AND THE THEORY OF FREE ENTERPRISE

A free enterprise system, which is not concerned with distributional or spreading issues as grounds for loss allocations,15 will assign the risk of accident losses on the basis of four factors: relative knowledge of the risk among the relevant parties, relative capacity to control or reduce that risk, relative lack of aversion to risk taking, and relative capacity to enter into transactions to correct an error in risk allocation if the first three factors were incorrectly evaluated. These four factors combine to define the cheapest possible cost avoider to whom the incentive-based enterprise society assigns risk.16

In a product liability situation, the fourth factor enters in a somewhat

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15 For a discussion of the distributional and spreading concerns which do affect our loss allocation systems, see Calabresi, The Costs of Accidents (1970).
16 See id.
unusual way, for “transactions” of some sort between buyer and seller are almost always possible. In such instances, the factor then asks us to look not to whether there is an asymmetry in capacity to initiate transactions, but rather to whether there is an asymmetry of knowledge among the parties so that meaningful transactions are more likely to occur if the burden is initially placed on one rather than on the other party. Thus stated, the fourth factor becomes readily conflated with the first, which already asks about asymmetries in knowledge, or what is the same thing, relative knowledge of risk among the parties. It is, in fact, this combined factor which often underlies the current legal tendency to allocate risks of losses to producers rather than users. Producers are thought to be more likely to know the risks involved in complex products and more capable of initiating meaningful transactions to shift these risks to users (if “meaningful” transactions are possible at all) in those cases in which users are the better risk bearers.\(^{17}\)

The second factor is the most contradictory one. On the one hand the producer frequently has available the best means of controlling the risk, both because knowledge of risk is a prerequisite to control and because he or she can introduce safer, albeit more costly, alternatives either by applying current technology or by investing in research. On the other hand, the user frequently can also control risk by avoiding foolish uses or by making use of some specific knowledge about significant alternatives that are in his or her control.\(^{18}\)

There is considerable doubt, of course, as to whether financial incentives, like letting the loss lie on the user, significantly affect user care. The argument is frequently made that if the user understands the risk, \textit{that}, by itself, will lead to care, regardless of any compensation rule, while if he or she doesn’t understand the risk, placing the loss on the user will have little effect. It will be like putting a handkerchief on a blanket, only worse, since the handkerchief, if left on the other side, would be an effective cover. But this argument — in practice — amounts to no more than the statement that the first factor, “relative knowledge” of risk (in the full sense of \textit{psychological understanding} of it), is so dominant that except in unusual situations, it should control and lead to a general starting point of producer liability. Under this hypothesis, the starting point could be altered — even by transactions — only when the negotiations seemed truly to give the user a full understanding of the risk.

Unless, however, one is clearer than I am prepared to be on the relative significance of the first and second factors and on the capacity of individual

\(^{17}\) By “meaningful” I mean transactions in which there is a rough parity of knowledge. Liability on the party who has greater knowledge, together with a requirement that transactions designed to shift that liability be meaningful, induces the party with knowledge to share it with the other party.

\(^{18}\) Consider, for example, the area of contraceptive devices and techniques. Each device or technique has a different risk of pregnancy and a different risk of side effects. The producer may be in a better position to know the statistical risks — both of pregnancy and of side effects — and would seem to be more capable of sponsoring further research and improvements on contraceptive products. The user, however, is surely in the best position to evaluate the harm caused by contraceptive \textit{failure}, for the user knows whether a pregnancy is unwanted merely because of timing preference or because it would be a major catastrophe. In addition the user may be in a better position to determine whether a particular contraceptive presents a substantial risk of side effects to \textit{him} or \textit{her}. Finally, the consumer is almost certainly better placed to control faulty or careless use. All of this is quite apart from the evident danger of “moral hazard” — in the technical sense — which would result from producer liability in such cases.
users to respond to incentives, there are bound to be situations in which the first two factors leave us perplexed. Cases will arise in which we are not sure which of the parties is likely to be the cheapest cost avoider and in which we have no faith in the parties’ capacity to decide the question of who is the best manager of the risk for themselves by contract. This last is especially true if we doubt that the user, for example, has enough knowledge to determine intelligently whether or not he or she can manage the risk, while we do not see any product or research alternative available to the producer to control the risk. But there are analogous situations in which the first two factors leave us perplexed, and yet we are unwilling to give much weight to a determination by the parties as to who is best suited to bear the risk.

In all such situations, and even in some in which the first two factors do give us some guidance, we are likely to look to the third factor — the relative risk aversion of the parties, the relative willingness of the parties to take a chance, for a price. At first blush, this factor would always seem to suggest a dominance of the contractual element in product liability. Who, after all, knows best their willingness to gamble except the parties? But that knowledge can only find useful expression in a negotiation if the parties understand the risk as to which they are gambling. As a result, the contractual approach leads us right back to the first factor — that of the relative knowledge of the risk among the parties — and, therefore, to our hypothesized perplexity.

There is, however, something which can be said about the third factor which is independent of knowledge of risk in the individual case and which depends, instead, directly on the status of the parties. It is, I would suggest, a fact that is crucial to an understanding of the link between a rule favoring entrepreneur liability in product injury cases and the permanence of the free enterprise system.

Bearing risk is both the function of, and justification for, private enterprise in a free enterprise society. Profits, as against monopoly returns, rents, or simple compensation for use of labor or capital, accrue to those who have taken uninsurable risks and won the gamble. Free enterprise is prized, in classical economics, precisely because it fosters the creation of entrepreneurs who will take such uninsurable risks, who will, in other words, gamble on uncertainty and demonstrate their utility by surviving — by winning more often than others. Whether they do so through skill or luck, such “minimizers” of the costs of uninsurable risks are worth their pay because only through them can any headway be made in reducing such uninsurable costs. Frequently, the accident costs involved in product liability situations are exactly of this sort. That is precisely why we often are not able to say that the producer or the user is best suited to manage the risk; in these situations, the means of managing the risks are not currently available and require skills of innovation or invention. This is exactly the reason why insurance is dear or unavailable in such instances.

All this is not to say that enterprises are anxious or even willing to bear such entrepreneurial risks; far from it! They are often very averse to risk bearing. And they will try hard to shift the loss to the user, who may take it — if permitted to — occasionally because he or she really is a gambler and likes the risk for the fee, but who more often accepts the risk for a price acceptable to the producer only because he or she does not understand, does not know, how
great the risk in fact is. It is here that the law frequently steps in and refuses to allow that kind of risk shifting. Thus, where the transaction clearly bespeaks a genuine difference in willingness to take risk, the third factor — which of the parties is less averse to bearing the risk — would favor allowing a contractual view to prevail. But where there is doubt, the third factor will tend, instead, to insist that the risk be placed, and be kept, on the entrepreneur — who most often is the producer.

It does not matter, from this point of view, that there may be a particular buyer/user who may enjoy risk taking. He or she is not really deprived by being denied this chance to take a risk. For he or she can always become an astronaut or racing driver or find other ways of satisfying his or her desire for risk. Indeed, he or she can even become an entrepreneur. There is no lack of demand, need, and pay for willing risk takers in our society. Nor does it matter that the particular producer may hate to take risks — may be highly risk averse. If so, he or she should get out of a business which entails uninsurable risks or risks which can only be shifted to others at extraordinarily high prices. For it is these extraordinarily high prices which permit the willing taker of the risk to make the profits appropriate to the fact that he or she is fulfilling an entrepreneur’s role.

What is not permitted, in a free enterprise society, is what all too often producers, and equally often consumers, seek: to avoid both the bearing of the uninsurable risk and the payment of a price sufficient to induce someone else to bear that risk. That is, however, exactly what the complaints of the consumers and small manufacturers mentioned by the Secretary of Commerce amount to.19

That the consumer wishes to duck both is not a matter of great concern to the free enterprise system — unless, as we shall see, the producer succeeds in shifting the risk to him. It is not necessary to an enterprise system that consumers be willing to bear uninsurable risks. Consumer complaints about prices, moreover, are inevitable in an enterprise system (since all prices are, in a sense, regressive taxes) and will not be much diminished whatever is done with accident cost related price increases.20

That the producer wishes to avoid bearing such risks or paying a price sufficient to shift them to a knowledgeable purchaser (like an insurance company which would have to be permitted to charge entrepreneurial rates), is far more serious. For it represents an unwillingness of the private sector to take on the function of bearing incentives to innovate and thus to diminish those costs which cannot be given an actuarial basis. It represents, in other words, an unwillingness to take on the very task which a free enterprise society, classically, does not believe the government does well: the management of risk, uncertainty, and innovation. And if the private sector is unwilling to take on the task which ultimately justifies its existence, it will not

19 The consumer is described as “affected” by product prices that are too high, yet — when he has knowledge, that is, speaks through organized consumer groups — he objects to bearing the risk. At the same time, the producer complains that he cannot afford insurance against the equivalent risks. See U.S. Dep’t of Commerce, supra note 2, at 1.

20 It is significant that the “Background Paper,” supra note 2, did not describe consumers as complaining as a result of higher prices stemming from product liability judgments, but, correctly, as “affected” by these.
be long before people will ask, with good reason, why should we have it at all? There are, they will say, some things which government does better than private enterprise. If private enterprise ducks those tasks, like risk taking, which it can do better than government, in order to gain an admittedly short run economic advantage, it will jeopardize its long run survival. For at that point, private enterprise will be left to do only those things which it does not do especially well.

This undermining of free enterprise as a result of the unwillingness of producers to be the risk-prone parties (in those situations where the other factors which govern the allocation of product risks are not determinative), moreover, can occur even more directly. Producers who are unwilling to bear product liability risks and to face bankruptcy (an old free enterprise result, after all) when they manage such risks worse than their competitors, and who are also unwilling to pay entrepreneurial rates to insurance companies for bearing those risks to which actuarially-based rates cannot be given, will seek, as they are seeking, to reduce their risks to levels which can be covered actuarially. But this entails shifting the “uninsurable” part of the risk to the user. That is both what many currently proposed laws seek to do and what consumers will ultimately refuse to accept. They are no more willing to accept risk than are entrepreneurs. Just as “organized consumer groups” object to such a shifting now, because they understand the risks involved, so will disorganized consumers object when some of them are destroyed as a result of being burdened with huge, uncompensated product injury costs.

It is at this point, with no one willing to bear the “uninsurable risk,” that such catastrophe costs will, inevitably, be placed on the government. The consumers, who have no short run interest in preserving the private sector, and who have a great interest in avoiding such uncompensated losses, will accept no less. And, just as inevitably, the government will try to “manage” the risks by issuing ever more safety regulations. Since there will be no financial incentives to minimize the sum of accident and accident avoidance costs, regulatory ones will be demanded! We will then have moved, perhaps without full consciousness but inexorably, from the current mixed tort-contract approach to the regulatory-criminal one. We will have shifted, as a result of an unwillingness on the part of entrepreneurs to bear, and hence to manage, uncertainty, to governmental control of uncertainty. This type of risk management is neither effective nor desirable, at least when applied across the board, and whether desirable or not, it is fundamentally inconsistent with a free enterprise approach.

IV. Free Enterprise as a General System of Strict Liability

The problem facing industry in the product liability context is not, in the end, very different from the problem which faces a free enterprise society generally in deciding what goods are worth producing and what new entrants into an industry are worth having. These decisions, like the ones we have been discussing, can be made governmentally, or they can be made by private entrepreneurs, who bear the losses and get the gains of the risks and gambles they take. Indeed, the whole free enterprise system can be described as a system of strict liability designed to provide incentives to the appropriate
parties to bear and manage the uninsurable risks of innovation in the production of goods and devices.

As such, it can be contrasted with a "regulatory" system, which would instead decide collectively what new entrants and what new goods are worth having. Those goods or entrants deemed desirable would be issued the equivalent of a certificate of necessity and utility (which today governs entry in those relatively few areas of our economy in which free enterprise is not admitted).21 Once such entry was allowed or deemed desirable at a collectively-governmental level, neither profits nor bankruptcy would be necessary. The decision that the product or entrant was wanted and was worthwhile would have been made by the the government; both positive and negative incentives (profits and losses) for private parties to make that decision well would be superfluous. And, once again, that absence of profits, and the unwillingness to let individual enterprises suffer bankruptcy, characterizes those areas of our economy in which entry is governmentally determined.

In most areas of the economy today, the approach is different. Entrepreneurs are encouraged to take their chances. If they guess right and a product or service is desired in the market — that is, if it somehow creates benefits greater than its costs — they will be called successful innovators and reap often quite spectacular profits. If they guess wrong and the costs of the product — again as determined in the market — are greater than its benefits, they may suffer huge losses and even be wiped out.

Although this discussion has concerned regular entrepreneurial-product risks, not accident risks, the analogy is extraordinarily close. As with product-accident risks, our society starts out by allocating ordinary product-production risks in ways which try to maximize the chances that incentives will be placed on those most suited to "manage" these risks. Thus most, but not all, of the risk is put on the entrepreneur (the investor); some, as a result of bankruptcy and limited liability laws, is put on creditors. This is only wise, for there are situations in which the creditor is in the best position to manage the risk, to blow the whistle as it were, and in that way to reduce the social cost of a mistaken entrepreneurial decision.

The allocation of entrepreneurial risks in a free enterprise society is thus similar to product liability risk allocation. In both areas, some risks are best handled by a party other than the entrepreneur. The starting point, however, remains entrepreneur liability. Some contractual modifications of this initial starting point are permitted, but, as in product liability, not all. Here too, sometimes the contracting parties are well suited to decide who can best manage the product-production risk, while at other times the allocation of that risk is thought to be best decided by the society, and individuals are barred from shifting it.

All this, like product liability, is not only consistent with free enterprise, it is in fact the legal context which defines our free enterprise system. What would not be consistent with free enterprise would be general governmental action to prevent failures and bankruptcy, that is, a general governmental taking over of entrepreneurial losses. For this, no less than a confiscation of profits, would amount to a removal of the incentive from the private sector to

21 Typically this occurs in such "non-profit" areas as the construction of a new hospital.
“manage” uninsurable risk in product-production wisely. What, in the long run, would also be inconsistent with the survival of private enterprise, would be limited liability rules which shifted much of the entrepreneurial risk to the non-entrepreneur consumer (in contradistinction to rules which correctly allow such shifting to different entrepreneurial groups, like banks). Consumers who bore too great an entrepreneurial burden, like consumers who bore the risk of major, uncompensated, product-related injuries, would soon enough question a system which gave entrepreneurs so little incentive to avoid losses and yet let them enter freely and keep the profits when things worked out well. They would clamor for government compensation, risk management, and inevitably control of entry and profits. The analogy to what I see as a danger in current reactions to the product liability “crisis” would then be complete.

V. THE CURRENT CRISIS

If I am correct and product liability is not only an appropriate way for an enterprise society to handle product-related accident risks, but is a close analogue to the way in which such a society handles entrepreneurial risks generally, what is wrong; what is the reason for the current crisis? Is it no more than the disheartening fact that many of those who ought to be the staunchest defenders of the enterprise system are too near-sighted and would trade that system for immediate advantage? Or worse, is it that they have lost the willingness to gamble, to take those risks which place them at the core of the enterprise system?

Each of these reasons has certainly contributed to the product liability crisis as is suggested by attempts by business in other areas to look to the government and to regulation for protection from risks.

But that is not the whole answer by any means. There are things wrong with the product liability system which can and should be corrected, and the correction of which would in no way impugn the willingness of producers to bear product-related accident risks. This lecture does not permit a thorough discussion of these weaknesses, but some of them can be listed.

The first and most obvious are the unnecessarily high administrative costs of the system. These costs are not only a burden in themselves but create yet further costs. A system sufficiently complex to require expensive lawyering entails, if it is to be fair, that lawyers be available to rich, poor, and middle income people alike. In the torts context, this means the necessary persistence of contingent fees. Contingent fees, in turn, mean that there must be some item of damage which can be “larger than life” and sufficiently expandable to cover not only actual damages and fees in the particular case but also the fees in all the cases the lawyer loses. That item of damages, unlimited pain and suffering, inevitably takes on a life of its own and becomes both a source of further administrative expense and a basis for legal-blackmail which jacks up small injury claims.

I do not wish to be taken as criticizing contingent fees, or even pain and

22 An example is Lockheed Aircraft Company’s flight to government support, and the reluctance of the airline industry to accept de-regulation.
suffering damages. Far from it, for once we admit as the starting point the current techniques for determining product liability, they are no more than a private mutual insurance system to cover legal fees. As such, they are the best we can do, and are even admirable when compared to most government legal aid programs. That, however, is not the issue. Rather, it is whether some simpler starting point which would give more automatic no-fault product compensation could be developed. The lack of political success of true automobile no-fault plans has made one reluctant to develop equally “simple” approaches in product liability, but the absence of these represents a root cause of our current crisis.

The second problem with our current system deals with insurance. To the extent that the risk in product liability is increasingly becoming an entrepreneurial risk, businesses must either bear it or pay entrepreneurial rates to induce others to bear it. It is ridiculous to expect insurance companies to take on risks which have no sound actuarial basis and yet to charge ordinary “insurance” rates. If they are to function in this market, they must be able to act like the old maritime companies which were risk takers, gamblers, if you wish, and charged gamblers’ prices. Yet the all too often mindless system of insurance regulation in which we persist makes that extraordinarily difficult. The result is that insurance companies will refuse certain risks as uneconomical. This, of course, leaves the manufacturer in the position of having to “go naked,” and bear the risk himself, even though, if rates were more flexible, he would prefer to shift it to another “entrepreneur” — the “risk-taking” rather than “actuarial” insurer. What happens is analogous to what would occur in our enterprise system generally if the only form of “outside” investment permitted were regulated-fixed income bonds, and no “outside” investor could get a “piece of the action,” of the profits, in exchange for bearing an investor’s risk.

The third problem compounds the second. Our tax system makes it very hard for the producer to bear the entrepreneurial risk himself. Insurance fees are tax deductible, but payments into a reserve for product liability losses are not! And indeed such losses, when they occur, are currently deductible against past “profits” only to a very limited extent — three years. It is because the government’s “short-run” proposal addresses this last issue, by allowing a ten year loss carry-back, that I called it admirable. It should be obvious that if we wish to have entrepreneurs bear the entrepreneurial risk involved in product safety, we must give them the incentive to do so. If insurance companies are to take some of it, they must be allowed to charge entrepreneurial rates, while if producers prefer to bear it themselves, they must not be taxed on what are (at least in retrospect) only false profits.

The fourth problem with our existing system is, of course, the notorious


24 It is interesting to note that in the latter situation one result would be that bond rates generally would increase to somewhere between the appropriate “loan” and “entrepreneur” risk levels. An analogous price increase is likely to occur in the regulated insurance market. Regulated insurance rates tend to rise to a point which, while perhaps insufficient to cover true entrepreneurial risks, is higher than is justified to cover areas in which no such risks are involved. Under these circumstances, it is not surprising that both insurance companies and those they insure are unhappy!
end-run which product liability currently permits around workmen's compensation, especially in machine tools. I need not spend time on this. What is disturbing about it is not that injured workers receive higher awards than those provided by compensation laws which are often ridiculously outdated and inflation-gutted. The problem arises because the end-run entails enormous and unnecessary administrative costs and legal fees, while at the same time creating precedents which may make little sense in other product liability areas. It seems patently ridiculous to fail to update a relatively efficient, if still unnecessarily complex, system like workmen's compensation and then permit the use of a far more costly approach to give the recoveries which the first system precludes. This last problem is the most easily correctable of all, and the fact that it has persisted and worsened is a basis for serious pessimism as to our capacity to enact any reforms.

I could go on and list other unnecessary crosses which we bear in this area of law. But I would quickly descend to too many minor particulars. The point remains the same. There are corrections and improvements which can be made and which do not imply any shift in the basic notion that entrepreneurial risks, which often include product safety risks, should be borne by entrepreneurs, and not by users.25 These changes basically go to creating a legal climate, through reform of our tax regulation, and even workmen's compensation laws, which encourages entrepreneurs — both producers and insurers — to take on such entrepreneurial safety risks in an efficient manner. If this is not done, entrepreneurs will increasingly shift them to the government. At the same time, if, while the needed changes are being made, short-sighted producers are able to take advantage of the confusion and get a short-term benefit by shifting such risks to the users, the users will in the longer run move these to the government. Either of these would result in a serious undermining of the function and hence the viability of private enterprise in our society. In that case we will look back and say, regretfully, that product liability, which should have been a bulwark of the free enterprise system because it is a fundamental manifestation of entrepreneurial risk taking, became, in the end of the twentieth century, its curse!

25 As I said earlier, there are risks which, from a purely cost avoidance point of view, are best borne by users. If, however, users are highly anxious to "spread" such risks, and have the political capacity to have the government take over these risks, then to compare the user potential for cost avoidance with the producer's ability to diminish costs is simplistic. What must be compared in that context is the incentive effect of government loss bearing with the incentive effect of producer liability, since these become the politically realistic alternatives. See Calabresi, THE COSTS OF ACCIDENTS (1970).