ALM LAW JOURNAL NEWSLETTERS

The Insurance Coverage Law Bulletin®

Volume 6, Number 9 • October 2007

Insuring Against Disaster: Coverage for Product Recalls

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In recent months, it has seemed that barely a week has gone by without the announcement of a major product recall, whether it be of pet food (tainted with a wheat gluten additive), toothpaste (containing poisonous diethylene glycol, a solvent used in antifreeze that imparts a sweet taste), millions of children's toys (the subject of four major recalls, several of which involved lead paint), almost half a million light truck tires (lacking a safety feature that guards against tread separation), or 3.6 million Ford cars, trucks, and SUVs (containing a cruise control switch linked to vehicle fires). Recalls have become so common of late that satirical magazine *The Onion* "reported" in late July that shares of Constitution Solutions, LLC ("COSO") "fell sharply Tuesday after several Eastern bloc constitutions written by COSO were recalled due to loopholes that allowed Vladimir Putin to re-form the Soviet Union." Stockwatch, *The Onion*, July 26-Aug. 1, 2007, at 2.

Product recalls have, of course, been with us for many years. The Department of Transportation, for example, acquired the statutory authority to order recalls some 40 years ago. Since that time, more than 390 million cars and other vehicles have been recalled, as have 46 million tires, 66 million pieces of motor vehicle equipment, and 42 million child safety seats. *See* National Highway Traffic Safety Administration, *Motor Vehicle Defects and Recall Campaigns* (undated) (document available on the Administration's Web site, *www.nhtsa.gov*).

Recalls are not new, but they are becoming more frequent. In 1990, there were 208 auto recalls. Thirteen years later, in 2003, there were 529, or more than twice as many. *See* Carolyn Aldred & Bradford Wernle, "Suppliers Face Rising Risk Without Recall Insurance," *Automotive News*, May 31, 2004, at 38F. Moreover, businesses and the public are paying increased attention to recalls, as illustrated by the extensive press coverage in recent months concerning various products imported from China.

In hindsight, this is perhaps not surprising, as China, with its relatively rudimentary systems of safeguards, inspections, regulations, and enforcement — some commentators have called it "the Wild, Wild East" — has taken on great prominence as a source of low-cost raw materials, components, or products for many American manufacturers and consumers. *See generally, e.g.*, David Barboza, "China Moves to Refurbish a Damaged Global Image," *N.Y. Times*, July 29, 2007, at A9; Jane Spenser & Nicholas Casey, "Toy Recall Shows Challenge China Poses to Partners," *Wall St. J.*, Aug. 3, 2007, at A1. Indeed, given the dramatic expansion of Chinese production, the enormous rise of American reliance on goods from China, and the increased scrutiny now being given to Chinese imports, it seems likely that we will see a number of additional recalls involving Chinese manufactured goods or raw materials in the near term.

The High Costs of Product Recalls

The effects of a recall on the company or companies involved can be enormous. After the rollover problems of Ford Explorers equipped with Firestone tires emerged in the summer of 2000, Bridgestone/Firestone Inc. voluntarily recalled some 6.5 million tires. Ford Motor Company announced that it would replace 13 million additional Firestone tires at a cost of nearly $3 billion — for which it planned to bill Firestone. As a result of that announcement, Firestone severed its 100-year relationship with Ford. *See* Joann Muller, *Ford — Why It Is Worse Than You Think*, Business Week, June 25, 2001, at 80.

Despite the enormity of the recall expenses, narrowly defined, the quantifiable costs to Ford and Firestone do not account for what might have been the greatest losses of all — damage to their brands and their goodwill in the market. Explorer sales went down more than 20% after the Firestone crisis erupted, *see* Keith Naughton and Mark Hosenball, *Facing Falling Sales and Legal Jeopardy, Ford Splits with Firestone and Orders a Big Tire Change*, Newsweek, June 4, 2001, at 38, and Firestone's stock value plunged more than $10 billion following the recall, *see* Daniel Eisenberg, *Firestone's Rough Road,* Time, Sept. 18, 2000, at 38. The stock price of parent Bridgestone did not approach its pre-recall high until 2005. *See* Bridgestone 2005 Annual Report at 73. Indeed, a recall often damages a company's brand name even more than its day-to-day finances, and at no time in American history have intangibles, including product reputation, driven such a significant share of corporate worth. *See* Julian James, *Insuring the Brand*, Ivey Business Journal, March/April 2001, at 12.

Companies that manufacture or distribute products regulated by the Food and Drug Administration are particularly

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mindful of the out-of-pocket and reputational costs associated with a recall. Strictly speaking, the FDA has the power to order a recall only when a medical device, human tissue product, or infant formula poses a human health risk. Nonetheless, even where the FDA lacks the power to order a recall, in the great majority of cases where the FDA recommends that a company withdraw its product, the company complies. If the manufacturer or distributor does not comply with an FDA request, the FDA can seize the product or seek injunctive relief. *See generally,* U.S. Food and Drug Administration, *FDA Recall Policies* (June 2002), *available at http://vm.cfsan.fda.gov/~lrd/recall2.html*. FDA can also issue statements warning the public about the product in question. *See* 21 C.F.R. §7.40. Any of these alternatives can of course be worse for the company in question than a voluntary recall, especially because of the added damage to the company's goodwill that any of them would inflict.

Coverage for Recall Costs Under CGL Policies

Many companies do not realize that their comprehensive general liability ("CGL") policies do not cover many of the costs associated with product recalls. A look at some of the common losses inflicted by a products recall and a quick review of the CGL policy, however, make it clear that companies cannot afford to be complacent simply because they have purchased CGL coverage.

The out-of-pocket expenses that a company may incur when it undertakes a recall fall into many categories. Among them are:

- Costs to publicize the recall;
- Costs of added staff to field consumer inquiries;
- Shipping and transportation costs for recalled items;
- Storage and/or disposition costs for recalled items;
- Costs of labor to remove recalled parts and install replacement parts;
- Refund expenses or the costs of replacement products, including shipping;
- Engineering or investigational costs to determine the source of the problem;
- Costs of redesigning the product or finding a new manufacturer or source;
- Legal costs; and
- Public relations and crisis management costs.

Although a CGL policy would probably provide an insured with a defense to third-party claims alleging bodily injury or property damage caused by the faulty product in question, and, depending on the facts and the policy terms, could well cover settlement costs or a judgment entered upon such a claim, many of the other costs associated with a recall might not be covered by the typical general liability policy. As the Illinois Supreme Court put it, "liability policies are not intended to provide protection against the insured's own faulty workmanship or product, which are normal risks associated with the conduct of the insured's business. Rather the policies are meant to afford coverage for damage to other property caused by the insured's work or product." *United States Fidelity & Guaranty Co. v. Wilkin Insulation Co.*, 578 N.E.2d 926, 934 (Ill. 1991).

In the Firestone example, if the company had a standard CGL policy, that policy likely would have provided defense and indemnity coverage for bodily injuries and property damage sustained as a result of the defective tires. The policy probably would not compensate Firestone for the costs of recalling and replacing tires that had not failed, or for many of the other out-of-pocket expenses in the list above, or for lost profits arising out of damage to Firestone's reputation.

The CGL form used by members of the Insurance Services Offices, Inc. ("ISO") is armed with exclusions that have the potential, depending on the facts, to bar recovery for many recall costs. For instance, the standard form contains a "sistership exclusion," so nicknamed because of its application to aircraft: Following a major accident with a particular model, its "sister ships" (planes of the same model) would be withdrawn from use. The exclusion, actually titled "Recall of Products, Work or Impaired Property," precludes coverage for:

> (d)amages claimed for any loss, cost or expense ... for the loss of use, withdrawal, recall, ... replacement, ... or disposal of ... 'Your product' ... if such product ... is withdrawn or recalled from the market or from use ... because of a known or suspected defect, deficiency, inadequacy or dangerous condition in it. ISO CGL Coverage Form (CG 00 01), Excl. n.

Although the exclusion does not apply to injury or damage to third parties caused by particular defective products (such as a plane that has crashed), the costs incurred to pull an entire product line from the market — including those units that have not caused injury or damage — may be barred by this exclusion in at least some recalls. For instance, in Firestone's case, the tire maker recalled 6.5 million tires because they *might* have contained defects. A Firestone insurer with a "sistership" exclusion could be counted on to raise that exclusion as a defense to coverage.

Similarly, the so-called "business risk exclusion" (formally called the exclusion for "Damage to Impaired Property or Property Not Physically Injured") bars recovery for "'Property damage' to 'impaired property' or property that has not been physically injured, arising out of ... [a] defect, deficiency, inadequacy or dangerous condition in 'your product' ... " ISO CGL Coverage Form (CG 00 01), Excl. m. International Risk Management Institute, Inc. This exclusion might, for example, bar coverage for Firestone's liability to Ford if Ford were to claim that it suffered "property damage," in the form of diminution in value, to unsold (and thus at least arguably not "physically injured") Explorers that were fitted with Firestone tires.

Policyholders may dispute the application of these and other exclusions in a given case, but the net effect of the coverage grant of the CGL policy and its standard exclusions is to render the CGL policy unlikely to mitigate some of the highest costs associated with many product recalls. In recent years, insurers have begun offering specialized policies or endorsements designed specifically with recalls in mind.

Product Recall Insurance

Product recall insurance was first widely available only for a few types of products, namely, food and beverages, pharmaceuticals, cosmetics, and tobacco products. For the most part, these items fell within the purview of the FDA.

In the food and drug context, among the most common types of coverages

available are "malicious product tampering" and "accident-contamination" coverages. Malicious tampering coverage, developed in the years since the infamous Tylenol® poisonings, insures against criminal actions that sabotage a company's products. Accidental contamination policies, on the other hand, as their name implies, cover instances where a company's product is contaminated unintentionally.

Outside the food and drug context, product recall insurance has become more available only in the last few years and is far from widespread. There appear to be a number of reasons why relatively few companies carry specific product recall insurance. Some simply do not buy it because "'[t]hey believe that their research and development and quality control procedures are such that won't lend to a large type of product recall situation.'" Lee Fletcher, *Tire Problems Drive Interest in Recall Cover*, Business Insurance, Sept. 4, 2000, at 1 (quoting Tony Defelice, Senior Vice President and Director of Willis North America, Inc.). Others do not know that such insurance exists. And even those that are aware of the product might not have purchased it because, in the past, product recall premiums have been extremely high compared with other insurance premiums. With the ever-increasing focus on product recalls, both demand for such policies and the number of insurers willing to write such coverage may increase, although prices may remain high.

Although recall coverage for food and drug products is often written to provide insurance only if the recall is due to specified risks, in other contexts the coverage can be more akin to an "all risks" policy. One example is the ISO "Limited Product Withdrawal Expense Endorsement." Coverage is provided if the insured "determine[s] that the 'product withdrawal' is necessary" or if "[a]n authorized government entity has ordered [the insured] to conduct a 'product withdrawal,'" ISO Endmt. CG 04 36 12 04. These are broad coverage grants. As in an "all risks" policy, the coverage is of course subject to various exclusions.

Product recall policies or endorsements generally provide coverage in any or all of four major areas: 1) recall expense; 2) loss of profit; 3) product rehabilitation; and 4) crisis communications and response. The first two of these address near-term issues: the out-of-pocket expenses that the insured must incur in order to implement the recall, and the financial impact directly attributable to the fact that the recalled product is not generating the profits it would have engendered had it not been recalled. Specifically, the "recall expense" coverage typically includes the costs of inspecting, withdrawing, warehousing, destroying, and replacing the recalled product, as well as costs of publicizing the recall. "Loss of profit" protection covers the insured for the net profit loss attributable to the recall. This coverage may have a time limit, such as one year.

The other two categories of coverage are more forward-looking. "Rehabilitation expenses" include the costs of re-establishing the brand's reputation and market share. These can include marketing campaigns, promotions, and advertising. Finally, "crisis management" or "crisis communications" coverage defrays the costs of consultants retained solely in order to address issues raised by the recall. This coverage is often subject to a sublimit.

Any company investigating the purchase of product recall insurance should undertake a two-part analysis: First, the company must assess its particular risks and needs. For example, a startup company with relatively little brand recognition or goodwill may place less emphasis on crisis management or public relations coverage and more on the more straightforward, direct expenses necessary to conduct a product recall. By contrast, a distributor that can recoup the direct expenses of a recall from its suppliers — that is, with a clear contractual entitlement to such recoupment and confidence in the continued viability and solvency of those suppliers — may care more about the reputational effects of a recall, and thus place more value on the crisis management/PR coverage and the coverage for re-establishing market share in the aftermath of a recall.

The second step of the analysis is, of course, to review the policies or endorsements proposed by a broker or insurer with the company's particular needs in mind. Not every policy offers coverage for all of the costs or losses described earlier in this article. For example, the "Limited Product Withdrawal Expense Endorsement" drafted by ISO contains an exclusion for "[t]he costs of regaining goodwill, market share, revenue or 'profit' or the costs of redesigning 'your product.'" ISO Endmt. CG 04 36 12 04. Accordingly, while that endorsement might meet the needs of some insureds, for many it would be a mistake to consider it a complete solution to the risk of a product recall.

Conclusion

Regardless of whether a company ultimately purchases product recall insurance, it should take steps to minimize the chances that it will need to effect a recall, and to minimize the impact from any recall that it cannot avoid. Product recall insurance may not be for every company and, even for those companies that purchase it, this insurance should not be more than a prong of the larger risk management strategy for coping with potential product recalls. But given the rising numbers of product recalls, the fact that recalls have been undertaken by manufacturers and distributors of all sorts of products, the increased attention being paid to recalls, and their potentially devastating effects, insurance should no longer be left out of the puzzle either in the mistaken belief that it is already in place or because the company simply assumes that product recall policies are not available.

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