

Managing The Risks Of Chinese Manufacturing And Imports

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All companies must live with the risks and uncertainties inherent in their businesses. Doing business with Chinese manufacturers, however, recently has proven to be more risky than some companies had anticipated.

In 2007, recalls and other problems related to Chinese-manufactured products affected companies in a wide array of businesses. Perhaps the most widely reported recalls were of pet food products allegedly tainted with melamine and of lead-tainted toys. These well-publicized recalls were joined in 2007 by recalls of dozens of other products, including recalls of approximately 300,000 oscillating fans found to have bad wiring that created a fire hazard, approximately 240,000 battery packs for toy vehicles after reports of the batteries melting or catching fire, and 450,000 tires after reports that the treads on light-truck radials may have manufacturing defects.

These incidents involve only a tiny percentage of the products used by Americans that are in whole or in part produced in China. The vast majority of Chinese-produced products have been safe and have not caused product liability or product recall issues. Nonetheless, the recent problems with some Chinese products highlight the fact that using these imports carries risks regardless of the quality-assurance safeguards that even the most responsible American companies have in place.

As a result, companies relying on imported Chinese goods must be careful to evaluate these risks and to put into place an appropriate risk management program.

1. Protection Through A Chinese Manufacturer's Insurance

When faced with liability, recall costs, or other losses resulting from Chinese imports, an American company's first recourse may be the pursuit of the Chinese manufacturer. However, it is notoriously difficult to collect damages from a Chinese company because of impediments in the Chinese court system, the challenges of enforcing American judgments in China, and the fact that many Chinese companies are insufficiently capitalized to pay the often monumental costs resulting from even small product recalls and product liability cases.

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Consequently, an American company's recovery can depend on pursuing the Chinese company's insurance coverage. Such an effort is fraught with its own perils. The same limitations in pursuing Chinese companies also can apply to a Chinese insurance company. And, just as Chinese companies can be undercapitalized, Chinese companies also often are underinsured, if they are insured at all. These difficulties can be ameliorated by taking measures early in the process of contracting with Chinese manufacturers.

For instance, while contracting with a Chinese producer, an American company should require its Chinese partner to maintain insurance coverage that is adequate both in the scope and amount of coverage it provides. An American company should require that the Chinese company demonstrate that it has obtained the requisite insurance by presenting certificates of insurance, and further require that the Chinese company notify the American company of any changes in the status of the insurance in an agreed-to timeframe. The contract should spell out specific requirements that the Chinese company's insurers must satisfy, potentially including a requirement that the insurers be based in North America or Europe with at least a specified minimum rating. The contract should allow the American company to terminate the contract if the Chinese company does not maintain insurance that meets the specified criteria.

Even if appropriate insurance exists, enforcement against a Chinese company and its insurers may be difficult. Again, American companies can avoid some of these difficulties by taking affirmative steps in negotiating contracts with their Chinese business partners. For example, American companies should seek to be named as an additional insured on the Chinese company's insurance policies, either as a named insured or through a vendor endorsement. As an additional insured, an American company can pursue the insurer directly without first pursuing a claim against the Chinese company. Being an additional insured can make the pursuit of coverage easier and can reduce the likelihood of litigation with valued Chinese suppliers or business partners.

When an American company must rely on insurance that was issued by a Chinese insurance company, the American company should insist that the policy provide that the Chinese insurer will submit to jurisdiction in the United States. The American company should insist that the Chinese insurer have assets in the United States sufficient to allow enforcement of any judgment against it. Additionally, an American company should consider the inclusion of arbitration provisions in the insurance policy. Chinese courts are more likely to enforce certain types of arbitration awards than judgments of an American court.

An American company may be able to take advantage of its Chinese partner's insurance even if the American company is not an additional insured under the Chinese partner's insurance policies. Some state statutes (known as "direct action" statutes) allow an injured party to sue an insured defendant's insurer directly if the insured defendant defaults on a judgment or otherwise fails to pay. If the Chinese partner's insurer is also American (or at least does substantial business in the United States), the American company can maximize the likelihood that it will be able to pursue the insurer under such statutes.

If insurance either is too costly or unavailable to cover the risks of Chinese manufacturing, companies should consider alternatives to insurance. For example, in some

situations, American companies can obtain an extra layer of protection by requiring their Chinese partners to bond against risks of business interruptions caused by the discovery of product contaminations or flaws.

Through these steps, an American company can maximize the protection available from its Chinese partners in case of a product liability or recall.

2. The Sufficiency Of An American Companies' Own Coverage

Despite all efforts to the contrary, an American company ultimately may be inadequately protected by the Chinese producer's insurance. As a result, American companies should verify that their own insurance program provides independent protection against risks of doing business with a Chinese exporter.

When a product-related problem arises, American companies often look to an array of insurance policies to protect against the various claims and losses that may result. American companies typically maintain general liability policies to protect against third-party claims that their products caused bodily injuries or property damage, as well as first-party policies to protect against damage to a company's own property.

Because different product-related risks are covered under different policies, companies should be careful in acquiring coverage to ensure that unacceptable risks do not fall into gaps between the coverage afforded by their different policies. For instance, many general liability and first-party property policies contain a recall exclusion (sometimes called the "sistership" exclusion) that excludes certain costs arising from a product recall. Similarly, many policies contain exclusions that exclude recovery of lost profits caused by trade disruptions. In the current environment, companies doing business with Chinese companies may find it worth the cost to acquire additional, specialty policies to protect against these potential gaps in coverage. In placing such coverage, companies should strive to obtain specialty policies that fit hand-in-glove with their general liability and first-party policies to create seamless protection.

American companies also should recognize that their insurance policies may provide more coverage than their insurers initially acknowledge. For example, courts have rejected insurer arguments that the recall exclusion applies to all costs associated with all recalls. Instead, depending on the specific language of the exclusion at issue, courts have sometimes held that coverage is available – and recall exclusions do not apply – when a third party (such as a government agency) initiates or mandates the recall of the insured's product, or when the recall applies only to products known, rather than suspected, to be defective. Similarly, some courts have held that the recall exclusion does not apply to bar coverage when the insured's products actually have harmed a third party, and that third party seeks recall costs as damages.

American companies also should focus on their first-party property policies to ensure that they provide sufficiently broad protection for business interruptions and other product-related losses. Major losses often result from the destruction of inventory, the inability to deliver product to satisfy orders, or the inability to use facilities and equipment. In addition, although there may be more press coverage for high-profile recalls, many product-related losses derive

from product failures or contaminations that are identified before the product ever reaches the market.

Although general liability policies often do not provide coverage for damage solely to the insured's product, a company's first-party property policy may cover such losses. Indeed, depending on the policy language, courts have found coverage for "loss of use" when products or other property cannot be used as a result of potential contamination. Some courts have held that property coverage can be triggered without actual destruction of property or structural damage to property, so long as there is some contamination or other injury to the insured property. Some courts also have found that first-party property policies cover product lots destroyed because of potential defects or contamination, even if the product lots are destroyed before they are shipped.

Even the best insurance portfolio may prove insufficient if a company does not act effectively in the face of a product liability or recall crisis. Insurance policies impose a variety of claims handling requirements that can be onerous but are extremely important. If a policyholder fails to provide timely notice of claims or losses to its insurers, or the policyholder otherwise fails to meet the terms and conditions of its insurance policies, some or all of the policyholder's insurance coverage may be forfeited. Dealing with these insurance issues can require careful coordination among the company's internal personnel, its outside defense counsel, and its risk management personnel and coverage counsel.

Efforts to recover losses from insurers often require a delicate balancing of legal strategies with business realities. Because of the recent media attention on Chinese products, American companies doing business with Chinese manufacturers should be particularly conscious of how an insurance dispute may create or extend bad publicity surrounding a product recall. To avoid further damage to its corporate reputation and product brands, an American company may choose to focus on resolving insurance disputes quietly, without litigation and additional resulting media attention. Even without litigation, substantial insurance recoveries are often possible, notwithstanding the initial recalcitrance of many insurers.

3. Conclusion

The unusual issues that arise in pursuing coverage for a Chinese-related product liability or recall make it critical that companies focus on their insurance strategy before a product recall occurs and before particular problems are identified. When a recall does occur, decisions made in the earliest days after learning of the problem can make a major difference in how successful a company will be in obtaining payment from its insurers. By including insurance expertise in early decision-making, companies can avoid missteps in designing insurance programs and pursuing coverage, and can ensure that there is sufficient coordination among defense, business, and insurance teams.