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Protecting Against Product Liability and Recalls

Throughout 2007, almost daily announcements of recalls appeared in the news. These recalls affected almost every economic sector, involving products such as pet food, contact lens solution, pharmaceuticals, spinach, household appliances, home electronics, jewelry, furniture, clothing and toys.

By Jonathan M. Cohen and Kami E. Quinn

Although many companies have put into place rigorous quality-control procedures, no amount of quality control or care can eliminate all risk that a company's products might become contaminated or dangerous. If that risk turns into a product liability or recall crisis, the financial consequences to an affected company can be devastating.

For example, only two weeks after it initiated a product recall due to allegedly contaminated beef, Topps Meat Co. was out of business. Even in less extreme circumstances, the financial consequences of a product recall can be severe.

The risk of product liability and recalls can be mitigated by spreading those risks through the prudent acquisition and effective pursuit of insurance proceeds. Before it faces a potential product-related incident, manufacturers and distributors should look hard at what insurance they already have to ensure that the coverage protects them adequately from the specific risks that they face. Then, when facing a potential product liability or recall, the company should act promptly to marshal all of its potentially applicable insurance.

THE INSURANCE POLICY PUZZLE

Losses resulting from product-related issues can vary widely. In addition to the costs of the recall itself, a product that becomes dangerous can result in claims both by consumers and other companies in the product's supply chain. It also can cause business interruptions and damage to or loss of a company's own property and inventory.

Product-related losses might also result in shareholder suits against a company's directors and officers. Each of these types of losses might implicate different policies that companies have or can acquire.

Even before a company faces product liability or a product recall, it should evaluate whether its potential risks are covered by the insurance coverage it has in place. In acquiring insurance coverage, companies should ensure that the multiple insurance policies that might apply work together, leaving as few gaps in coverage as possible.

Companies should understand, for example, that many general liability policies contain exclusions that apply to certain costs and expenses of a product recall. As a result, companies that face an unacceptable risk of a product recall should consider whether to acquire a separate product-recall policy.

Companies also should recognize that, in many cases, the product-recall exclusions in their general liability policies may not exclude losses arising out of recalls where those losses are incurred as damages required to be paid to other companies in the supply chain.

Once a product-related loss or recall occurs, a company will face the challenge of matching the costs and expenses it incurs against its many potentially applicable insurance policies. The company will need to identify which costs are covered under which of its interlocking insurance policies.

Some types of claims and losses will fall neatly under a particular policy. For example, first-party property damage coverage typically provides coverage for any physical damage to plants or production equipment and the consequences of that damage. Where damaged or malfunctioning equipment led to the product's defect or failure, first-party property damage coverage may provide a significant resource to recover for the consequential losses. These policies also often cover professional inspection of equipment to determine the cause of the product defect and the best solution.

Other types of costs potentially implicate more than one insurance policy. For example, liability that potentially falls within the scope of a company's general liability policies may result from suits by supply-chain customers that incorporate that company's damaged product. These costs also sometimes may be covered under a product recall policy. The events or acts that gave rise to the loss also may stretch back in time and implicate a company's older policies.

Still another source of recovery may be from coverage available under policies issued to another company in the supply chain, under whose policy the company is covered either as an additional insured or under a vendor endorsement.

Where multiple policies may be implicated, insurers sometimes will refuse to cover a claim by arguing that the claim properly should be paid by another insurer. While the insurers point at one another, they may try to leave the policyholder to carry the costs and liabilities. Policyholders have the right to have their covered claims paid promptly, and they should not let their financial interests be held hostage while insurers play a game of hot potato with their policyholders' losses.

AVOID MISSTEPS THAT CAN JEOPARDIZE INSURANCE COVERAGE

Once a company identifies which policies may apply to its product-related costs, a company should act quickly to secure that coverage. Companies quickly should determine the nature and extent of their rights and obligations under all potentially relevant policies.

In some cases, a policyholder's obligations arise shortly after the discovery of a problem. For example, many policies require a policyholder to provide notice promptly after a claim is made or a problem is discovered. Property policies also often require that the policyholder provide a detailed "proof of loss" within a certain timeframe.

The characterization and quantification of losses in the policyholder's proof of loss can become the platform from which the policyholder's claim is resolved with the insurer. As a result, a company should thoroughly consider its coverage positions before submitting its proof of loss.

If claims are asserted against the company as a result of an allegedly defective product, many liability insurance policies impose on the insurer the duty and right to defend against those claims. These policies also may require the policyholder to cooperate with the insurer in the defense even where the insurer has no right to control the defense. Policyholders must address the role of the insurer in its defense early with their carriers to ensure that mutually agreeable defense counsel can respond effectively to the claim.

In certain cases, where the interests of the policyholder and the insurer diverge--for example, because the insurer is defending under a reservation of rights, or because opinions differ with

respect to whether to accept settlement demands--the insured may be entitled to separate independent counsel paid for by the insurer.

Every company that manufactures or distributes products faces the risk that their product may become contaminated or dangerous. By paying careful attention to their insurance portfolio, companies can protect themselves from the financial consequences of product liability and recalls.

JONATHAN M. COHEN and **KAMI E. QUINN** are attorneys in the Washington, D.C., office of Gilbert Randolph LLP.

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