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## PRODUCT RECALL INSURANCE FIVE REASONS WHY COMPANIES SHOULD STRONGLY CONSIDER ITS PURCHASE

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# PRODUCT RECALL INSURANCE

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### Introduction

Product recall insurance is one of the most important insurance policies that should be purchased by companies who put products into the global stream of commerce. While most large organizations purchase the insurance, many other businesses do not.

The risk of a product recall has increased exponentially. Global regulatory standards have increased in number and are stricter, and new product safety rules are implemented constantly. These are positive developments, but for companies they produce more stringent product quality obligations. This is not easy when supply chains are geographically widespread and manufacturing protocols and standards are not synchronized on a global basis. Human error being what it is, mistakes inevitably will occur.

This has been the case with many major companies, one of which is grabbing headlines at the moment. According to Ernst & Young in its October, 2011 survey of 34 major companies in the food, beverage and consumer product sector, more than half the companies (55 percent) had experienced a product recall event in the past five years. In the survey entitled "Capturing Recall Costs, Measuring and Recovering the Losses", these companies rank the risk of a product recall as among their severest strategic threats, with 81 percent of respondents deeming this financial exposure as "significant" and "catastrophic." More than three quarters of the companies (78 percent) purchased product recall insurance.<sup>1</sup>

Product recall insurance is a unique policy that reimburses insureds for financial losses they confront because of evidence indicating a product has caused or would cause bodily injury or property damage (the insured event). The insurance "trigger" for a food and beverage company, for instance, would be the knowledge that an accidentally or maliciously contaminated product would cause bodily injury were it consumed by the public. Even if the product results in no liability, the insured is reimbursed for certain financial costs related to the incident.

Here are five critical reasons why companies should exercise greater due diligence when considering the risk of a product recall, and support for the need for this vital insurance coverage:

### Reason #1:

#### **It happens more than you think**

Product recalls are pervasive. Rarely does a day pass without news that some company's food, beverage, automobile, toy or equipment has been recalled for safety or illness reasons. In the first two weeks of March 2014, the U.S. Consumer Product and Safety Commission (CPSC) recalled the following products under its regulatory supervision:

- Light-up Christmas wreaths due to a potential fire hazard.
- A bicycle due to the possible breaking of the fork, causing crash and injury hazards.
- A line of dining tables because of lead paint violations.
- Wristbands alleged to cause allergic reactions.
- A zip line trolley because of a fall hazard.
- A line of small refrigerator magnets due to ingestion risks causing perforations of the intestines.
- A series of electric space heaters due to fire and burn hazards.

This is the abridged version for this period. The site lists 34 recalls in all — more than two a day. That's just in the United States.<sup>2</sup>

CPSC is one of many different U.S. governmental agencies with the power to recall a product in the U.S. Several others include the Food and Drug Administration (FDA), the National Highway Traffic Safety Administration (NHTSA), the U.S. Department of Agriculture, and the Environmental Protection Agency.

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Last year, the NHTSA recalled 22 million automotive vehicles in 632 separate actions (up from 16.4 million vehicles in 581 actions in 2012). The reasons ran the gamut from faulty airbags to the risk of fire in a rear-end collision.

The FDA recalled 9,469 products in 4,075 events in 2012, the highest total in history, up from 5,585 products recalled in 2007. Were one to add up all the recalls by all of the U.S. governmental agencies in a given year, the aggregate sum is substantial.<sup>3</sup>

Combined with recalls by other governments, the global tally indicates the severity of this major strategic, financial and reputational risk. Two years ago, for example, serious product quality problems emerged from materials and components that were sourced overseas. A major U.S. toy manufacturer was forced to recall nearly one million toys — 83 products altogether — that had been assembled overseas using lead paint. In just one month in 2007, more than 1.2 million space heaters, 5,300 earrings, 19,000 children's necklaces, 68,000 folding chairs, 2,300 toy barbecue grills, and 1.5 million toy trains were recalled, all of them manufactured overseas.<sup>4</sup>

Product safety problems, which can be caused by lower cost manufacturing overseas in countries that may not have the same standards and enforcement as does the EU and the U.S., explains, in part, why product recall risks are a growing exposure. Other factors include the globalization of supply chains, and stricter product safety rules and regulations.

### **Reason #2: Governmental oversight is stronger**

Few dispute the need for strong regulations mandating the highest standards of product safety and security. The health and well-being of the consuming public depends on assurances that what we eat or drink is free of contaminants, the cars we drive are safe, and that our children's toys won't injure them. These basic sentiments have compelled governments across the world to implement stricter product safety regimes.

Among the new laws is the Consumer Product Safety Improvement Act of 2008. The law reinforces regulations regarding products with lead and phthalates; enhances provisions around many imports, as well as toddler products, children's toys and ATVs; and requires third party testing,

certification and tracking labels for an array of goods. Civil and criminal penalties have been significantly increased and enforced.

Another new piece of legislation is the U.S. Food and Drug Administration's Food Safety Modernization Act of 2011, which the FDA calls the "most sweeping reform of the country's food safety laws in more than 70 years."<sup>5</sup> Prompted after a shocking series of foodborne illnesses during the 2000s, the legislation gives the FDA vast new powers to regulate how foods are grown, harvested and processed.

New regulations have also been implemented in Europe. In 2010, the European Union established RAPEX, a rapid alert system that facilitates the quick exchange of information between Member States and the European Commission concerning products posing a serious risk to the health and safety of consumers. When a product like a toy or household appliance is found to be dangerous, the relevant national authority takes immediate action to eliminate the risk, from issuing warnings to manufacturers to requiring the withdrawal of the product from the market. RAPEX excludes food, pharmaceutical and medical devices, as these products are addressed by other similar mechanisms.

Other new rules govern children's products and substrate materials, making it riskier for companies to source components and products from overseas.<sup>6</sup> The Ernst & Young survey indicates that the respondents believe product recalls are both more common and likely to increase in frequency and severity going forward.

### **Reason #3: The costs are prohibitive**

The recall of a product sets in motion a series of possible significant corporate expenses, beginning with the actual cost of pulling the item out of the stream of commerce. In many cases, depending on the facts and circumstances, the product must be destroyed, disposed and replaced. Media relations specialists often are needed to communicate the details of the incident to the public. Lawyers and/or government affairs professionals are necessary to interact with the relevant government agency. Finally, someone must be charged with the responsibility to audit the recall to ensure all the above has been fully addressed and resolved.



Several studies indicate that the aggregate total of these varied expenses is significant. In the Ernst & Young survey, 77 percent of the companies that endured a recall in the past five years estimated the financial impact to be up to \$30 million dollars. Twenty-three percent reported even higher costs. An earlier study of the average cost of a product recall gauged this expense at \$540,000, more than double the average settlement in product liability lawsuits (\$217,000).<sup>7</sup> The study took into account companies of all different sizes.

It is not uncommon for many companies today to endure product recall costs in excess of millions of dollars, depending on the company and the particular product recall. There are cases of extreme examples that go well beyond this, due to the brand impact — the enduring memory the event creates in the minds of business customers and the public about the quality of the affected organization's complete line of products.

An entire industry can suffer financially from a single company's product recall, the case with the 2010 recall of more than 500 million shell eggs distributed by an egg producer. Approximately 2,500 illnesses were associated with the contaminated eggs, the largest outbreak of Salmonella Enteritis since records on this illness have been kept. Although the total costs to the egg producer are not known, the adverse media attention given the subject produced a drop in egg prices that cost the egg industry more than \$100 million in lost income opportunity in September 2010 alone.<sup>8</sup>

When companies recall a product, there is a statistically significant adverse impact on their future stock performance, according to another study.<sup>9</sup> The study reveals that an organization's sales decline, as does its fair market value.<sup>10</sup> Future cash flow and forecasted revenue are further impeded by the substantial loss of confidence in the company's reputation and brand.

Many believe the negative impact of a recall on a company's brand is a significant outcome of the event. Many business and financial newspapers have reported stories about companies that failed under the weight of a major recall. The companies could not absorb the financial costs of the physical recall of the product; they could not survive the impact on their brands — despite being a market leader.

The nation's largest producer of organic peanut butter had a Salmonella outbreak in 2012 that sickened 42 people in 20 states. The company filed for Chapter 7 bankruptcy protection. The company continues to confront several civil lawsuits arising from the incident. A major meatpacking company was the second largest meat processor in the nation, declared bankruptcy following a massive recall of contaminated meat in 2008. One of the largest producer of pet foods in the U.S., recalled more than 60 million units of pet food in 2007 at a cost of \$42 million, causing its share value to plummet (it was eventually bought out).<sup>12, 13, 14</sup>

**Product recall insurance indemnifies the insured for certain financial losses produced by the insured event. These include the actual physical recall expenses, as well as loss of profit, product replacement costs, extra expenses, and rehabilitation expenses.**

The financial impact of a product recall also extends to retailers that sell the defective or contaminated product, and to the manufacturers that use it within their own products. When another peanut butter company, discontinued operations after a salmonella outbreak at its plant resulted in more than 700 cases of a serious illness and at least nine deaths, the bad publicity did not end there.<sup>15</sup> The economic impact of the recall caused tens of millions in losses for companies that used its peanuts in their products. These companies lined up as creditors post-bankruptcy and a few suffered irreversible brand and financial damage.<sup>16</sup>



Major retailers compelled to remove a defective or contaminated product generally are reluctant to continue business with the manufacturer. Often, they will pull not just the defective or contaminated merchandise off the shelf, but the manufacturer's entire product line. These goods are replaced with competitors' products. To win back the trust and confidence of consumers, the company often must lower prices, impairing its profit margins.

Many large companies have the financial wherewithal and other resources to address product recall costs, such as internal public relations staff and legal counsel. Other companies generally do not, requiring that they retain external media, auditing, legal and crisis management assistance. Just one small component or ingredient that is defective or contaminated creates a vast product recall exposure potentially costing millions of dollars.

#### **Reason #4: The mistaken belief it won't happen to our company**

No organization is immune to the risk of a product recall — even those with the best safety records, manufacturing and operational controls. A significant reason is human error. Yet, many companies simply deny the possibility that human error will affect the quality of the goods they manufacture. There is a tendency, particularly among companies who put products into the global stream of commerce, to downplay the risk.

In addition, the far reach of global supply chains and the limited control over these suppliers' activities, add to the pressures within organizations to conserve capital expenditures, which may significantly contribute to the fact that something may go wrong. And when it does, in today's fast paced business economy, the organization's survival is jeopardized.

Choosing to believe that bad things won't happen, or if they do, they will happen to others, is basic human psychology — the powerful construct of denial. Despite considerable evidence demonstrating the likelihood and costliness of a recall, many companies under estimate the likelihood and the degree of the financial impact. This behavior breeds insufficient preparation for the potential crisis and an ineffective response to it.

No one is arguing that companies lack the expertise and skill to make and market great products. What is lacking is the knowledge of how to recall a product to limit the financial brand repercussions and the important role played by insurance.

**The premium cost for product recall insurance is a worthwhile expense as a cost of doing business which may protect a company from financial ruin.**

#### **Reason #5: Product Recall Insurance is the first line of defense**

Few readers would disagree that product liability coverage, which absorbs third-party financial losses from bodily injuries and property damage caused by a defective or contaminated product, is a vital insurance coverage. The same should be said for product recall insurance.

The insurance reimburses the financial costs emanating from an insured event, preserving the ability of the organization to continue forward in its business. The insurer also provides crisis management consulting services on both a pre- and post-incident basis to limit the adverse impact on the insured's brand and reputation.

How important is product recall insurance? Many of the companies that were forced into bankruptcy because of a recall did not have product recall insurance. While many large organizations have the resources to address the impact of a product recall, most organizations simply cannot absorb the related financial loss and frequently fail from the consequences.



Product recall insurance indemnifies the insured for certain financial losses produced by the insured event. These include the actual physical recall expenses, as well as loss of profit, product replacement costs, extra expenses, and rehabilitation expenses. The coverage may also include an option to insure third-party losses, such as a customer's loss of gross profits, rehabilitation and/or its extra expenses.

The insurer reimburses these various expenses, even if the product has yet to cause an actual liability and may never result in such litigation. The trigger for the insurance is the insured event — not the recall itself. For instance, if a product is learned to be defective and has yet to leave the manufacturer's premises or enter the marketplace, the insurance is automatically triggered.

Generally, there are three different types of product recall insurance policies, based on the types of products manufactured:

#### **Consumable Products**

Any product that is ingestible and / or topical for human consumption, such as food, beverages, pharmaceuticals, cosmetics and tobacco are generally addressed in this category.

Coverage triggers of the policy are an accidental contamination or malicious tampering. Knowing that consumption of the product would cause bodily injury or property damage is sufficient for the insurance to trigger. By detecting the issue early and reacting immediately, the company may avoid liability. This alone makes product recall insurance a first line of defense against possible litigation.

#### **Consumer Goods**

Finished products such as appliances, electronics, furniture, clothing, and other household items excluding components, that are not consumable fall into this category. The trigger for coverage is knowledge that the product is defective and the use would cause (or has caused) bodily injury or property damage.

#### **Component Parts**

Components used to manufacture non-consumable merchandise like cars, machinery and airplanes are addressed in this category. There are three coverage triggers — the use of the product has caused bodily injury or property damage, the product poses an actual and imminent danger of causing bodily injury or property damage, and the product has impaired property (this coverage is typically excluded in general liability policies).

#### **Conclusion**

The premium cost for product recall insurance is a worthwhile expense as a cost of doing business that may protect a company from financial ruin.

The risks of a product recall occurring is substantial. As noted above, the outcome of a recall, in many cases may be financially devastating. We believe that, one of the worst things that a company can do is stick its head in the sand and think, "This will never happen to us." chances are, it may.

#### **About the Author**

Florian Beerli, Senior Vice President, Product Recall joined Westchester in June 2012 to launch the Product Recall Division for Chubb in North America. He has more than 20 years of insurance industry experience with particular emphasis in crisis management. With more than 12 years of experience in Product Recall, Florian Beerli is a leading Product Recall underwriting specialist, domestically and internationally.

## CONTACT US

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## Endnotes

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