

# Managing the Risks of a Defective Product

Product recalls are an extreme action, but they help companies to protect their customers, reduce their litigation costs, and preserve their reputation.

BY KELLY M. LIPPINCOTT

**A** company's brand name is often its most valuable asset. A brand name takes years to develop but can be irreparably harmed in an instant if a trusted brand causes harm to the consumers who have grown to rely on it. When a company learns that one of its products has caused harm to one or more of its customers, it needs to take swift action to prevent future harm to its consumers and to salvage its brand name.

A company may learn of problems with its products through a number of sources, including customer complaints, claims, news coverage, and regulatory agencies such as the U.S. Consumer Product Safety Commission or the U.S. Food and Drug Administration. The problem may be the result of a design defect, manufacturing defect, malicious tampering, accidental contamination, misbranding, or mislabeling. Whatever the reason for the defect, the company must decide what it will do to address the problem. Immediate action is necessary to protect customers, to protect the brand name, and to comply with the requirements of the regulatory agencies that have jurisdiction over the specific product.

## Recalls Are Rising

Product recalls are an extreme and expensive remedy, but in recent years they have occurred with increasing regularity. In January 2008, the Consumer Product Safety Commission's Web site listed more than 30 recalls of a variety of products—from air compressors to toy train sets. During that same month, FDA's Web site listed more than 20 recalls, market withdrawals, and safety alerts.

The number of recalls has increased dramatically in the past decade. In 2000, FDA reported approximately 80 recalls, market withdrawals, and safety alerts. In 2007, that number rose to 375. The reason for the increase is unclear. The cynical view is that product quality is in a steep decline. Alternatively, it might be that companies

are taking a more proactive approach to warning their customers of known defects. Although they constitute an extreme action, product recalls help companies to protect their customers, reduce their litigation costs, and preserve their reputation and brand name.

## Deciding Whether to Recall a Product

The decision of whether a company should initiate a product recall depends on a number of factors, including whether the defect affects safety, the risk of physical harm to customers, the involvement of regulatory agencies, and the cost of the recall. While a product recall can be a costly endeavor for a company—often, much higher than production costs—the cost of not conducting a recall can be even greater. The longer a dangerous and defective product remains in the market, the greater the risk of product liability lawsuits and the potential for both civil and criminal action by regulatory agencies.

If a product is monitored by federal agencies, there may be mandatory notification requirements. Many federal agencies regulate products, including CPSC; FDA; the National Highway Traffic Safety Administration; the Bureau of Alcohol, Tobacco, Firearms and Explosives; the Food Safety and Inspection Service of the U.S. Department of Agriculture; the U.S. Department of Housing and Urban Development; the U.S. Environmental Protection Agency; and the Federal Aviation Administration. Each agency has rules and regulations that producers of certain products must follow in the manufacturing of their goods, and in some instances, the agency provides guidelines regarding product recalls.

## First-party costs

In August 2007, Castleberry Food Company faced a product recall following a botulism scare. Castleberry's parent company, Connors Bros., estimated the recall of 90 different brands of the company would cost approximately \$40 million.

The cost of a recall can be very high, depending on

## RISK MANAGEMENT

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the size of the company, the number of products affected, and the number of its consumers. The cost of not taking a proactive approach to guarding the health and safety of your consumers from a known danger, however, can be much higher, a determination Castleberry made in deciding to go ahead with its recall.

#### **Liability to third parties**

When a product is the subject of a recall, the first concern is often liability issues related to the consumers of that product. In addition to the purchasers and users of its products, however, a company might be liable to its distributors and other third parties, such as other companies that incorporate the component or ingredient into their own product. A recall of that component or ingredient may cause the third-party manufacturer to suffer an interruption to its business, loss of

profits, and damage to its reputation because of the recall of the product.

Third-party liability might not be a concern if the company only sells its products under its own label or sells its product directly to consumers. If the product is incorporated into other products, however, then the recall's affect on other manufacturers will likely increase the associated expense.

#### **Protection through Insurance Coverage**

Some of the steep costs associated with product recalls can be defrayed by insurance coverage. General product liability coverage, however, does not usually cover the costs associated with a product recall. While general product liability coverage is still essential for claims brought by consumers, there are many other risks associated with a product recall that a company must mitigate.

To alleviate those risks, a growing number of insurance carriers offer product recall coverage. To be properly prepared, a company should organize a corporate team that will be responsible for identifying triggers to determine when a recall might be necessary. The team also should be organized to implement the recall process swiftly if necessary. Having a crisis management plan in place before a company is confronted with the decision of whether to conduct a recall can minimize the costs of a recall, reduce litigation, and prevent adverse publicity that can scar a brand name. In addition to proper protocol preparation, a company's quick response to a defective product is the key to reducing the risk of others being harmed by the product, thus reducing the company's exposure to liability. **OKS**

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