

PRODUCT RECALLS AND MANAGING THE RISKS OF A DEFECTIVE PRODUCT

By Jan E. Simonsen and 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 that 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 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, protect the brand name, and apply with the requirements of the regulatory agencies that have jurisdiction over the specific product.

Rise in Number of Recalls

Product recalls are an extreme and expensive remedy, but they happen frequently and, in recent years, with increasing regularity. The U.S. Consumer Product Safety Commission's website lists over 30 recalls in January 2008 of a variety of products from air compressors to toy train sets. The U.S. Food & Drug Administration's ("FDA") website lists over 20 recalls, market withdrawals and safety alerts in January 2008. The number of recalls has increased dramatically over the years. In 2000, the 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. Product recalls help companies to protect their customers, reduce their litigation costs, and preserve their reputation and brand name.

Deciding Whether to Recall

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 doing 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. There are many federal agencies that regulate products, including Consumer Product Safety Commission, Food and Drug Administration, National Highway Traffic Safety, Bureau of Alcohol, Tobacco and Firearms, Food Safety and Inspection Service of the U.S. Department of Agriculture, U.S. Department of Housing and Urban Development, Environmental Protection Agency, and Federal Aviation Administration. Each agency has rules and regulations that producers of certain

products must follow in the manufacturing of their products, and sometimes, guidelines regarding product recalls.

The Costs of a Recall

There are many costs associated with a product recall. Besides the actual costs of conducting a recall, there is the cost of losing customer goodwill, damage to the brand name, and liability to third parties. Third parties include customers who are harmed by the product, as well as, other parties, such as distributors and other manufacturers, who incorporate the subject product into their own product. These other third parties may suffer loss of income or damage to their own reputation or brand as a result of the recall.

First Party Costs

In August 2007, Castleberry's Food Company faced a product recall following a botulism scare. Castleberry's parent company, Connors Bros., estimated that 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 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.

Liability to Third Parties

When a product is the subject of a recall, the first concern might be liability to the consumers of that product. In addition to the purchasers and users of its products, a company might be liable to its distributors and other third parties. There may be other companies that incorporate the component or ingredient into their own product. A recall of that component or ingredient may cause the other manufacturer to suffer an interruption to their business, loss of profits, and damage to their reputation due to the recall of their 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 could also affect other manufacturers. This of course will increase the expense associated with any recall. Not only does the original producer need to recall the product, but any other manufacturer that uses the component will need to recall all of its products that incorporate the subject component. As the network of other manufacturers and distributors branches out, the cost and the effect of a product recall has a growing impact, thus increasing the potential liability to third parties.

Protection through Insurance Coverage

Some of the steep costs associated with product recalls can be defrayed by insurance coverage. General product-liability coverage 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.

A growing number of carriers offer Product Recall Coverage. Product recall insurance can provide coverage for the costs of removing the product from the market, radio and television announcements, newspaper advertising, overtime for employees involved in the recall process, hiring additional employees to assist with the recall,

inspection, destruction, repair, or replacement of the defective product, shipping costs, disposal costs, redistribution costs, lost profits, and business interruption.

Some policies go a step further and provide coverage for claims by third parties for when a company's ingredient or component has made another product less useful. This type of coverage is particularly important for manufacturers of components and ingredients.

There are other coverages that are designed for specific industries. For instance, contaminated products insurance is designed for the food and beverage industry. This insurance covers losses associated with malicious product tampering and accidental product contamination. Often, general products liability insurance does not protect against such losses.

An Ounce of Prevention...

Developing a protocol through which to handle product recalls is essential for any manufacturer. A company should be diligent in looking for triggers that might indicate the need for a recall. Triggers include product liability claims, customer complaints, and test and inspection results. A system for identifying when a product recall may be necessary, assessing the need for a recall, and implementing the recall must be in place before a company is faced with the decision of whether to recall a product. Responsive action is necessary for a recall to be effective and to preserve the brand. A company that waits until it is faced with a recall to figure how it will handle a recall will cost itself valuable time.

A company should have a corporate team organized in advance that will be responsible for identifying triggers, such as product liability claims, customer complaints, and test and inspection results, to determine when a recall might be necessary. The team should also be organized to, if it determines a recall is needed, to swiftly implement the recall process. 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 which can scar a brand name. 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.