

August 2013  
**DO YOU RECALL?**

*It seems hardly a week goes by without a news story about some product being recalled – everything from autos, to toys, to foodstuffs. Indeed, as the table below shows, recalls, advisories, and safety alerts involving consumer products, vehicles, food, and health products are on the rise.*

*Given the number of these incidents, it's not surprising that some consumers might see this as a sign of shoddy manufacturing or poor quality control. But, the increase in such notifications can be looked at in a more positive light, says Bill McCarthy, Senior Risk Management & Business Development Consultant at Jardine Lloyd Thomson (JLT) Canada. "The fact we have more recalls is a sign of the system is working," says McCarthy, who specializes in product recall insurance for the food and beverage industry. "The quality control people at most manufacturers are really on the ball. They want to produce safe products and so if they catch a problem with their manufacturing, they'll stop production to figure out the problem and fix it. And, when they hear about concerns or a potential problem from the Canadian Food Inspection Agency, for example, they realize it's in their best interest to cooperate and address the issues and they do," he says.*

**Table**

<b>Recalls, Advisories, and Safety Alerts Tracked by the Canadian Government*</b>						
	<b>Jan. 1-Dec. 31</b>					<b>2013 Year-to-date</b>
	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>(Jan. 1-July 31)</b>
Total Recalled Items**	1005	1070	1256	1528	2149	1276
<b>Recalls By Product Type</b>						
Consumer Products	255	319	330	277	268	152
Food	18	24	28	311	516	261
Health Products	274	349	432	496	838	631
Vehicles	461	381	476	449	537	237

\*Information compiled from the Healthy Canadians<sup>1</sup> website

\*\*Note that the sum of the four product types for each year shown is different from the amounts under the "total recalled items". The reason for this discrepancy is unclear: it could be because some incidents are counted in more than one product type category.

<sup>1</sup> <http://healthycanadians.gc.ca/index-eng.php>.

## Background

### Product Recalls Are Harmful to Businesses

Product recalls can be costly and can be devastating to a business. One industry expert, Florian Beerli of ACE Group, has equated the potential impact of a recall to that of an earthquake. "There's no frequency, but there's severity. A product recall can put a business out of business."<sup>2</sup> According to Towers Watson, an automotive product recall, for example, "costs more than five times the original distribution, making this a potentially debilitating financial loss for automotive part manufacturers."<sup>3</sup>

In addition to the obvious direct costs, which JLT's McCarthy and others<sup>4</sup> estimate as usually representing only about 10% of the total cost of a recall, there are significant indirect costs. Such costs are much harder to quantify and they can impact the business' financial statements long after the recall is completed. Indirect costs arise from things like distributors refusing to continue carrying the company's product(s) or imposing conditions (such as the requirement to carry recall insurance); increased cost of borrowing because of damage to the company's reputation, and even loss of market share to competitors while a product is off the market because of a recall.<sup>5</sup> "The time a product is off the market is a very important indirect cost – even if it's just a couple weeks," says McCarthy. "And the time off the market need not be an eternity. A two week period can be enough time for a competitor to come in and make big inroads in the market share. We saw that happen in back in 1990 when Perrier was recalled. In a very short time Coke and Pepsi moved into the market. It's taken years for Perrier to come back from that," McCarthy explains.

But, beyond all these costs, damage to reputation and brand in the short and long term can sink a company. Doing business in the digital era means that negative publicity from a recall can be disseminated quickly around the globe.

### Complex Supply Chains Increase Risk of Recalls

Because so many consumer products are made up of a number of parts, the supply chain for a given end product is often complex. The more components or ingredients in a product, the more chance there is for exposure to recall risk.<sup>6</sup> A good example was the 2006 recall that impacted major computer manufacturers Dell, Apple, Matsushita, Toshiba, IBM/Lenovo, Hitachi, Fujitsu, and Sharp as a result of problems with batteries that could overheat and catch fire. Sony manufactured the problem batteries, but the computer companies were caught up in a recall as a result.<sup>7</sup> Similarly, in the food and beverage industry, "risk of contamination has increased as the number of stages in the . . . industry supply chain has developed which inevitably increases the risk of product recall."<sup>8</sup>

<sup>2</sup> See comments by Florian Beerli, SVP of the ACE Group's product recall underwriting unit as reported in "Comprehensive Recall Protection, Inside and Out", a blog post by Joel Hans, Managing Editor, Manufacturing.net, at: <http://www.manufacturing.net/articles/2013/06/comprehensive-recall-protection-inside-and-out>. [Hereafter referred to as Comprehensive Recall Protection, Inside and Out]

<sup>3</sup> Towers Watson's Automotive Recall Insurance Overview, which is available at: <http://www.towerswatson.com/en/Services/Services/automotive-recall-insurance>.

<sup>4</sup> See also: <http://www.propertycasualty360.com/2009/08/28/from-peanuts-to-pet-food-coverage-available-for-rising-recall-exposures>.

<sup>5</sup> See, "Product Recall: The Developing Story", A Catlin Group Limited Report published in April 2012, at p. 14, [http://www.catlin.com/en/newsandviews/~/\\_media/downloads/thought-leadership/product%20recall%20-%20the%20developing%20story.ashx](http://www.catlin.com/en/newsandviews/~/_media/downloads/thought-leadership/product%20recall%20-%20the%20developing%20story.ashx). [Hereafter referred to as Catlin April 2012 Report].

<sup>6</sup> See Comprehensive Recall Protection Inside and Out, supra note 2

<sup>7</sup> See Catlin April 2012 Report, supra at note 2 at p. 5.

<sup>8</sup> See March 6, 2013 blog post, [The next evolution of product recall and contamination cover](http://specialtyblogs.iltgroup.com/2013/03/06/the-next-evolution-of-product-recall-and-contamination-cover/), by Jon Miller of JLT, <http://specialtyblogs.iltgroup.com/2013/03/06/the-next-evolution-of-product-recall-and-contamination-cover/>. [Hereafter referred to as March 2013 blog by Jon Miller of JLT]

Another noteworthy trend is the increase in recalls related to mislabelling. “We are seeing a significant increase in claims relating not to contaminated products as such, but to inaccurate or incomplete ingredient lists – basically mislabelling – that can lead to allergic reactions,” says JLT’s McCarthy. A good example of such situation was the Dutch recall of beef products in April 2013 after it was discovered that some of the products contained horsemeat that was not listed on the label.<sup>9</sup>

### **Initiation of a Product Recall**

Recalls can be initiated voluntarily, for example, by a manufacturer that discovers there is some problem with its products. As noted in the BLG Canadian Product Liability Handbook 2013, “Voluntary recalls are typically initiated to save money, maintain corporate trust and product integrity and to avoid or limit potential litigation – especially class action.”<sup>10</sup> This is true even for companies whose products are not regulated. But, Michael Smith, a partner at BLG, says that in his experience, it isn’t just fear of litigation that drives voluntary recalls. “Companies have a good attitude and voluntary recalls are often made because the manufacturers and distributors don’t want people harmed by their products.”

Of course, recalls can also be mandated by a government agency exercising its regulatory power under a statute or regulation. And, though there have been some reported cases where manufacturers have rejected recall requests, BLG’s Smith says that doesn’t happen too often.<sup>11</sup> “For the most part, companies have a professional attitude. They don’t feel that the government is trying to put a spike in industry or make a political point. When a regulator contacts a client about a potential recall there’s a dialog with the regulator but, in the end, no one wants people injured by their product and that is what usually drives company decision-making,” says Smith.

### **Mechanics of Product Recall Coverage**

Though each product recall insurance policy is unique and tailored to the specific insured’s business, there are three basic elements to comprehensive product recall insurance policies:

- Indemnification for recall costs
- Lost revenue
- Crisis management services

Product recall policies have a deductible, which can be high. “The deductible on recall policies can be quite significant,” says JLT’s McCarthy. “Of course, the amount of deductible a manufacturer may accept in exchange for a lower premium depends on the manufacturer’s appetite for risk,” he says.

### **Recall Cost Indemnification**

The types of costs related to a recall can vary and depend on a host of factors, such as the type of product or products involved, how widely the products are distributed, the ease or difficulty of pinpointing the problem that led to the recall, what it takes to remedy the problem, the time it takes to manufacture and restock replacement product(s), and so on.

<sup>9</sup> See Horse Meat Scandal Spreads; Dutch Officials Recall 50,000 Tons of Meat”, by Judie Bizzozero, Senior Editor, Food Product Design at <http://www.foodproductdesign.com/news/2013/04/horse-meat-scandal-spreads-dutch-officials-recall.aspx>

<sup>10</sup> See Canadian Product Liability Handbook 2013”, by Borden Ladner Gervais, p. 33, [http://www.blg.com/en/NewsAndPublications/Documents/publication993\\_EN.pdf](http://www.blg.com/en/NewsAndPublications/Documents/publication993_EN.pdf). [Hereafter referred to as BLG Handbook]

<sup>11</sup> One of the most recent, high profile cases was Chrysler’s refused a request by the National Highway Traffic Safety Administration (NHTSA) that it recall 2.7 million Jeeps the government agency contended are defective and prone to fires. ([http://www.nytimes.com/2013/06/05/business/chrysler-declines-us-request-to-recall-jeeps.html?\\_r=0](http://www.nytimes.com/2013/06/05/business/chrysler-declines-us-request-to-recall-jeeps.html?_r=0)) Not long after its public rejection of the sweeping recall request the automaker came to a compromise with NHTSA that resulted in about 1.2 million Jeeps originally included as part of the recall being excluded from the recall. (<http://www.cnn.com/id/100828344>)

Here are some of the direct recall costs that generally are covered under comprehensive recall insurance policies<sup>12</sup>:

- Costs related to determining the scope of the recall – for example, what product(s) are involved;
- Costs involved in tracing the products;
- Transportation costs to remove recalled product(s) (and perhaps costs to destroy recalled items);
- Transportation costs associated with distributing replacement product(s);
- Costs related to investigating the problem that led to the recall;
- Costs to remediate the problem – for example, cleaning contaminated production facilities or redesigning or re-engineering the product;
- Costs for repair or replacement of recalled products;
- Temporary additional labour costs – for example, to staff consumer phone lines or to increase production to manufacture replacement products;
- Costs associated with additional regulatory burdens – for example, if products have to be re-tested or inspected;
- Costs for legal and other professional advice;
- Advertising and promotion costs to help restore reputation and the value of the brand.

Determining the amount of revenue lost as a result of a recall is mainly done through forensic accounting, much as it is done for a business interruption claim. A recall can require shutting down a production line for an extended period while the problem is pinpointed and corrected. Indeed, when it comes to estimating the potential costs of a recall, Catlin Group warns that many companies “significantly underestimate the cost of a recall, particularly the business interruption aspect”.<sup>13</sup>

### **Crisis Management**

As noted, one of the reasons recalls can be catastrophic is because of the negative impact on the company’s brand and reputation. Crisis managers can help organize the logistics, including scoping the recall, notifying others in the supply chain, spending on public relations efforts, and so on, as well as help guide the business with key decisions, some of which might have to be taken based on limited information.<sup>14</sup>

To mitigate the risk, timely and effective crisis management is key. “With any recall incident maintaining confidence of regulators and consumers is a primary concern, as is maintaining customer loyalty,” says McCarthy. Though a company’s management may have experience managing complex projects, for example, they usually do not have internal crisis management expertise so such coverage provided under recall insurance is key. “The crisis managers on product recalls are specialists – they’re not insurance people,” explains JLT’s McCarthy. “You want folks that have a real expertise in dealing with a crisis. For example, when you’re working with a U.K insurer, they’ll typically be folks who worked for MI-5 or the military. In the U.S. they’re often former FBI agents. Here in Canada many are retired military,” McCarthy says.

And, because the point of crisis management is loss mitigation, to help ensure that crisis management expertise is brought in immediately, there is no deductible related to crisis management services, says McCarthy.

In addition to active crisis management, as part of the product recall coverage the crisis management often includes education and assessment services. “Because no one wants to have a loss, the crisis managers hired by insurers do a lot to educate employees about things like quality control, supply chain management best practices, and so on,” says Lee Weitman, managing partner of Axis Insurance Mangers Inc.. “The way insurers see it,” says Weitman, “helping educate clients and

<sup>12</sup> See, for example, Catlin April 2012 Report, supra note 5 at p. 13.

<sup>13</sup> See Catlin April 2012 Report, supra note 5 at p. 12.

<sup>14</sup> Id. at p. 11.

helping them find ways of improving the manufacturing process can prevent many recalls and so the expense comes to a fraction of the cost of paying out a large recall claim.”

### **What Underwriters Look At**

As with any type of insurance, underwriters consider a number of factors when assessing recall insurance risk, including:

- The type and nature of the product;
- Whether the product is subject to government inspection;
- The company’s safety record;
- The company’s recall history;
- The company’s quality control processes and procedures;
- The jurisdictions the company’s product ends up in;
- How well the company manages and controls vendors – for example, whether there is a formal vendor approval process;
- Whether employees are well trained and capable;
- Whether the company is vulnerable to malicious actions being taken against their products<sup>15</sup>;
- Whether the company has a recall plan and how well developed the plan is.

### **Pros and Cons of Product Recall Insurance**

#### **Product Recall Insurance vs. Product Liability Insurance**

Product liability insurance and product recall insurance are sometimes confused. Product liability insurance is coverage for third party liability claims for physical damage or bodily injury<sup>16</sup> that arise from defects or problems related to products an insured manufactures. Product liability coverage is typically part of an insured’s coverage under a commercial general liability (CGL) policy. Extensions to cover product recall are sometimes available on product liability policies, but they only cover recall expenses.<sup>17</sup>

Comprehensive product recall insurance is separate, first party coverage designed to cover the insured’s economic losses that result from product recalls.<sup>18</sup> Comprehensive recall policies also cover third party liability related to financial loss resulting from recall of the insured’s product. Standard form CGL policies generally do not cover losses and expenses associated with product recalls.<sup>19</sup>

Some in the insurance industry point to the 1982 Tylenol voluntary recall Johnson & Johnson instituted after seven people died in Chicago from tainted Extra-Strength Tylenol capsules as the incident that led to the development of recall insurance.<sup>20</sup> That recall, which cost Johnson & Johnson more than U.S. \$100 million, was not covered by insurance.<sup>21</sup>

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<sup>15</sup> See, for example, Marsh Canada’s information about product liability and recall at: <http://canada.marsh.com/RiskIssues/ProductLiabilityRecall.aspx>.

<sup>16</sup> See, Catlin April 2012 Report, supra note 5.]

<sup>17</sup> Id. at p.2.

<sup>18</sup> See, for example, Lockton (UK) on Protecting against the threat of Automotive Product Recalls, [http://www.lockton.com/Resource\\_/PageResource/MKT/Protecting%20against%20the%20threat%20of%20Automotive%20Product%20Recalls.pdf](http://www.lockton.com/Resource_/PageResource/MKT/Protecting%20against%20the%20threat%20of%20Automotive%20Product%20Recalls.pdf).

<sup>19</sup> See BLG Handbook, supra note 10 at p. 33.

<sup>20</sup> See, for example, Catlin April 2012 Report, supra note 5, at p 18.

<sup>21</sup> “Product Recall Insurance: Why Offer It At All”, by Indrani Nadaraja, CIP Society Trends Paper November 2008.

### **Who Needs Product Recall Insurance?**

Whether a manufacturer or supplier needs product recall insurance depends on a number of factors. The first consideration is the likelihood the company will be subject to a recall. Determining the likelihood is not always straightforward. For example, just because a company supplies a component that is used in another good does not mean the company doesn't have to worry about recalls. As well, if a company's product includes components or ingredients supplied by others, the likelihood of being subject to a recall are higher because the company cannot control the entire production process. Indeed, given the complex nature of the modern supply chain, some manufacturers are requiring their component part suppliers to provide proof of recall insurance.

The second consideration is whether the company can self-insure the risk. Very big companies, for example the big automakers, frequently decide against taking out product recall insurance, opting to self-insure instead. "If a company is really big it may choose not to take out product recall insurance because the risk can be spread over different lines of business," says JLT's McCarthy.

But, for companies that are not big enough to self-insure, BLG's Smith sums up the decision as boiling down to whether a recall might be a death-of-the-company event. If so, recall insurance should be considered.

### **Cost and Availability of Recall Insurance**

Recall insurance can be relatively expensive, but when looked at as a risk transfer solution for manufacturers that face exposure to recall but that cannot afford to self-insure, recall insurance can make commercial sense, says Axis' Weitman. As well, as JLT's McCarthy points out, recall insurance is tailored and a broker with specific expertise in product recall insurance can work with the insured and insurer to keep premiums reasonable in light of the risk.

In terms of availability, more insurers are offering coverage. "The good news for companies seeking recall insurance is that there's a growing and increasingly diverse insurance market that caters to their needs. Five years ago we had only three potential lead insurance carriers to choose from," says McCarthy. "Today there are at least 10 primary markets to underwrite such risks," McCarthy adds. As a result of insurers writing recall policies, the rates are increasingly competitive.<sup>22</sup>

### **Conclusion**

Though recalls are a fact of life for many companies, the risk that a recall will result in the collapse (or sale) of the company can be mitigated through product recall insurance.

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<sup>22</sup> See March 2013 blog by Jon Miller of JLT, *supra* note 8.

## Legislation Authorizing Recalls

In the name of consumer protection, a number of statutes give Canadian authorities the power to regulate manufactures, importers, and distributors of various products. Some statutes require mandatory safety inspections, some require manufacturers and importers to notify the government (and sometimes the public) about safety problems, and some provide authorities with the power to issue recalls.

Here are some of the main consumer protection statutes in Canada<sup>23</sup>:

- Canada Consumer Product Safety Act<sup>24</sup> (CCPSA) – This act gives the federal Minister of Health power to recall certain types of consumer products the Minister believes may be “a danger to human health or safety”. It should be noted that the CCPSA does not apply to autos, food, drugs, and cosmetics, as these are regulated under other statutes.<sup>25</sup>
- Motor Vehicle Safety Act<sup>26</sup> (MVSA) – This act requires manufacturers and importers of cars, trucks, trailers, motorcycles, and so on, to notify Transport Canada, as well as owners, of safety problems. Interestingly, under the MVSA Transport Canada does not have authority to mandate a recall; the legislation simply requires notification of safety problems. But, if a recall is undertaken on a motor vehicle (as a result, for example, of a foreign authority mandating a recall), Transport Canada has the right to audit the results of the recall.
- Canadian Food Inspection Agency Act<sup>27</sup> – This act established the Canadian Food Inspection Agency (CFIA); the CFIA has power under the Food and Drugs Act to order recalls of foods.
- Food and Drugs Act (FDA)<sup>28</sup> – This act is administered by the Canadian Food Inspection Agency and Health Canada. The CFIA’s authority is over food while the Health Products and Food Branch (HPFB) of Health Canada looks after the regulation of drugs under the FDA. The regulations to the FDA contain recall provisions applicable to drugs and medical devices.
- Hazardous Products Act<sup>29</sup> – This act does not provide the federal government with power to order recalls, but it does provide authority for the government to prohibit, restrict, or control products, materials, and substances.

Canadian companies can also find themselves subject to foreign consumer product safety regulation if, for example, they distribute products overseas or if they use foreign-sourced components. In the U.S., for example, the Consumer Product Safety Commission (CPSC) has recall authority with regard to nearly all consumer products.<sup>30</sup> Similarly, the U.S. Department of Transportation’s National Highway Traffic Safety Administration (NHTSA) has the authority to issue vehicle safety standards and to order recalls.<sup>31</sup>

Of course, North America isn’t alone in its concern for consumer safety. The European Union’s Product Safety Directive<sup>32</sup> and Australia’s Consumer Law<sup>33</sup>, for example, are proof of the growing international scope of government regulations that businesses with products in the global supply chain can find themselves subject to.

<sup>23</sup> For more details on these and other laws, see the BLG Handbook, supra note 9 at pp. 29-31.

<sup>24</sup> A copy of the Canada Consumer Protection Safety Act can be found at <http://laws-lois.justice.gc.ca/eng/acts/C-1.68/index.html>.

<sup>25</sup> For more information, see Health Canada’s web site at <http://www.hc-sc.gc.ca/cps-spc/legislation/acts-lois/ccpsa-lcspc/index-eng.php>.

<sup>26</sup> A copy of the Motor Vehicle Safety Act can be found at: <http://laws-lois.justice.gc.ca/eng/acts/M-10.01/index.html>.

<sup>27</sup> A copy of the Canadian Food Inspection Agency Act can be found at: <http://laws-lois.justice.gc.ca/eng/acts/C-16.5/>.

<sup>28</sup> A copy of the Food and Drugs Act can be found at: <http://laws-lois.justice.gc.ca/eng/acts/F-27/index.html>.

<sup>29</sup> A copy of the Hazardous Products Act can be found at: <http://laws-lois.justice.gc.ca/eng/acts/H-3/FullText.html>.

<sup>30</sup> See the CPSC web site at: <http://www.cpsc.gov/en/Regulations-Laws--Standards/CPSCIA/The-Consumer-Product-Safety-Improvement-Act/>.

<sup>31</sup> See the National Highway Safety Administration’s website at:

<http://www.nhtsa.gov/Vehicle+Safety/Recalls+&+Defects/ci.Motor+Vehicle+Safety+Defects+and+Recalls+Campaigns.print>.

<sup>32</sup> [http://ec.europa.eu/consumers/safety/prod\\_legis/](http://ec.europa.eu/consumers/safety/prod_legis/).

<sup>33</sup> For a plain language explanation of Australia’s Consumer Law, see:

[http://www.consumerlaw.gov.au/content/the\\_acl/downloads/ACL\\_an\\_introduction\\_November\\_2010.pdf](http://www.consumerlaw.gov.au/content/the_acl/downloads/ACL_an_introduction_November_2010.pdf).

**Preparing for the Worst – Recall Planning**

Any manufacturer can run into problems that can lead to the need to recall a product. Problems most often occur as a result of mistakes employees make or as a result of something that goes wrong with one of their suppliers.<sup>34</sup> But, many things can be done to minimize the potential damage a recall can cause, including having a recall plan.

When crafting a recall plan, experts suggest the following measures be addressed<sup>35</sup>:

- Ensure there are written procedures for identifying problems early and for addressing them quickly.
- Put in place a communications network to disseminate safety information to all who need it, including regulators, those in the supply chain, and end users.
- Identify a recall task force and make sure everyone on the task force knows of, and accepts, their role and responsibilities.
- Create a crisis communications plan and designate a media spokesperson (and ensure the spokesperson has media training).
- Identify consultants that can be called in to help manage the crisis, such as PR and media experts, investigators who can help determine the cause and remedial actions, etc.

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<sup>34</sup> See, for example, the comments of Florian Beerli in Comprehensive Recall Protection, Inside and Out, supra note 2. It should also be noted that problems that can lead to a recall can be caused by other things, like malicious contamination or product tampering.

<sup>35</sup> Most of these suggestions come from Advisen's "Product Recall: Reducing the Impact of Product Recalls on Financial Statements and Brand Reputation", November 2012, at page 8, [http://corner.advisen.com/pdf\\_files/ACE\\_2012Product\\_Recall\\_Whitepaper.pdf](http://corner.advisen.com/pdf_files/ACE_2012Product_Recall_Whitepaper.pdf).

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