Alleviating The Nightmare: Insurance For Product Recalls

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Introduction

Recalls of Bridgestone/Firestone tires and other consumer products have been in the news since last summer. Tread separation on certain tire models, particularly those mounted on Ford Explorer sport utility vehicles, allegedly caused blowouts and rollover accidents injuring several hundred people. In addition, 174 fatalities in the United States reportedly have been linked to these accidents. Last August, Bridgestone/Firestone announced a campaign to recall an estimated 6.5 million of these tires still believed to be in use. Other major recalls involving food, medical devices and infant products also have garnered widespread scrutiny recently. Without doubt, product recalls of such magnitude can severely impact a company's bottom line and its reputation.

Furthermore, when the recall concerns a matter of public safety, it can set in motion government investigations and litigation against the manufacturer. In the tire situation, for example, Congress has held hearings, and plaintiff lawyers have filed a multitude of individual and class actions against Bridgestone/Firestone and Ford. Recalls also may become a form of relief in product litigation. In an unprecedented decision last fall, a California state court ordered a manufacturer to recall up to 1.7 million automobiles with alleged ignition-system design flaws.

Putting aside these serious concerns, the costs of a recall campaign alone can be staggering, and businesses must ask the question: Are at least some recall costs recoverable through insurance? The answer, though not without qualification, is yes. Policyholders should look to their commercial general liability ("CGL") insurance or, alternatively, consider purchasing recall insurance which is now more readily available in the marketplace.

CGL Insurance

Insurance for products liability is an integral part of CGL insurance and, in fact, motivated its development and widespread acceptance. Beginning in 1966, insurance companies added to the standard-form CGL policy exclusions that sought to preclude coverage for activities that the insurance industry believed were business risks of developing and marketing a product. These included the "sistership" exclusion and the "loss-of-use" exclusion.

Neither of these exclusions, however, applies to preclude coverage if bodily injury or property damage has *already* taken place. In addition, under generally accepted principles of insurance law, insurance companies bear the burden of showing that an exclusion applies to bar coverage for all facets of a claim. Therefore, these exclusions may not apply, and CGL coverage may be available even if a product recall is involved.

The Sistership Exclusion: The"sistership" exclusion bars coverage only for the costs incurred when a policyholder recalls a product that, it is suspected, may cause injury or damage. As one court observed:

> The sistership clause was developed to protect insurers against liability for the cost of recalls. The clause's name, in fact, reflects this purpose. Following an accident involving a defective airplane, the airplane manufacturer became obligated to recall the airplane's sisterships in order to correct the common defect that caused the crash of the first airplane. Insurance companies . . . developed the "sistership" clause to make clear that, while they intended to pay for damages caused by a product that failed, they did not intend to pay for the costs of recalling products containing a similar defect that had not yet failed.[1]

Similarly, the sistership exclusion does not limit coverage where the policyholder has not withdrawn the product and its product has caused damage to the property of others: "The effect of . . . [the sistership exclusion] is to exclude claims for damages caused by the purchaser's withdrawal of the insured's products from use due to a deficiency in them. Such a result does not affect other possible instances of product liability, such as those in which damage occurs to a person, or to property other than the product of the insured itself."[2]

Insurance industry documents written at the time the exclusion was first added to the standard CGL policy confirm this point. In 1966, a policy drafter for the Hartford Insurance Group confirmed that the exclusion does not apply when the product has injured or damaged others: "This exclusion applies only to products which are withdrawn prior to causing injury. It does not apply to particular 'items' which have actually caused bodily injury or damage to property other than the 'item' itself."[3]

Under the case law, the sistership exclusion generally does not apply unless two requirements are met: (1) the withdrawal must be made by the policyholder, and (2) the withdrawal must take place before actual injury or damage arises.

For example, in *Stonewall Insurance Co.* v. *Asbestos Claims Management Corp.*, a federal appeals court found that the sistership exclusion did not apply under New York and Texas law because the policyholder had "not itself withdrawn or removed its products from the market."[4] The court also held that the exclusion did not apply because property other than the policyholder's product had been damaged:

> Moreover, even if damage caused by asbestos precipitated a discontinuance of NGC's [the policyholder's] products, the exclusion would not preclude coverage for damaged property other than NGC's products. [Citations omitted.] The District Court recognized that NGC's liability, as alleged in the complaints, arises out of damage that its products have caused to third-party property.[5]

The sistership exclusion has been applied to preclude coverage in classic-recall situations. For example, a federal district court relied on the exclusion, in part, to deny coverage for the policyholder's costs of recalling pain-relief capsules nationwide after seven people had died from ingesting them. In *McNeilab, Inc. v. North River Insurance Co.*, the insurance companies argued that these facts involved a classic recall. In rejecting coverage, the court ignored the seven deaths and the fact that the policyholder sought to prevent further injury. Instead, the court noted that the policyholder years earlier had rejected an opportunity to buy insurance coverage specifically to apply to product recalls.[6]

The "Loss-of-Use" Exclusion: This exclusion first appeared in 1973. It was intended to limit CGL coverage available for loss of use of property damage. Thus, the exclusion does not apply if:

1. Tangible property other than the policyholder's product *has* been physically damaged.
2. The policyholder's product has broken down physically.
3. The policyholder's product has been put into use by someone other than the policyholder.
4. The product has sustained a "sudden and accidental" physical injury.[7]

As with the sistership exclusion, insurance companies have invoked this exclusion to deny coverage for product recalls even in situations where it was not intended to apply.

Policyholders must be aware that these exclusions are not absolute and may not bar coverage merely because a product was recalled. CGL coverage therefore may be available despite the presence of these exclusions.

Recall Insurance

Clearly, however, CGL insurance will not cover all product-recall costs when these exclusions are found to apply. Other than retaining the financial risk for a product recall through self-insurance or a reserve for the anticipated expense, is there any other kind of insurance that a company then can rely upon to provide recall coverage?

The answer is yes: "product-recall insurance." Until recently, recall coverage was not widely available to manufacturers outside of the food and beverage industry. Now, other kinds of manufacturers are purchasing or considering recall coverage for their insurance programs. In fact, insurance industry sources report that interest in product-recall insurance doubled in the weeks following the Bridgestone/Firestone recall.[8]

The cost of product-recall insurance and its coverage limitations are factors that companies must consider in deciding whether to purchase it. Product-recall insurance can be expensive, although premium costs vary widely depending on a company's exposures. Typical recall insurance covers a variety of major recall-related expenditures such as advertising, transportation and disposal, but not the replacement of the product itself, which can be the largest component of recall costs.[9]

Companies assessing product-recall insurance must decide how much to purchase. This is not an easy decision as most manufacturers do not have experience with product recalls. Recalls also vary depending on the kind of product a company makes and whether it can cause serious harm. In addition, manufacturers take great pride in the products they make. They believe that their research-and-development capabilities and quality-control procedures are likely to make a large-scale product recall remote.

The Bridgestone/Firestone recall and its aftermath could drastically change this way of thinking. Bridgestone/Firestone reportedly did not have insurance to cover the costs of the tire recall and has been paying for it through a $450 million reserve against corporate revenues. The ultimate cost of the recall could be much higher than that. In the wake of this highly-publicized incident, a sober assessment of risk potential could lead more companies to consider product-recall insurance as a method of containing this kind of catastrophic expense

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[1] Forest City Dillon, Inc. v. Aetna Cas. & Sur. Co., *852 F.2d 168, 173 (6th Cir. 1988).*

[2] Commercial Union Assurance Co. v. Glass-Lined Pipe Co., *372 So. 2d 1305, 1309 (Ala. 1979).*

[3] Letter from Harold Schaffner, Hartford Insurance Group, to Robert F. Bauer, Assistant Secretary, Johnson & Higgins 2 (Aug. 5, 1966).

[4] *73 F.3d 1178, 1211 (2d Cir. 1995),* modified, *85 F.3d 49 (2d Cir. 1996).*

[5] *73 F.3d at 1211.*

[6] *645 F. Supp. 525, 540 (D.N.J. 1986),* aff'd without opinion, *831 F.2d 287 (3d Cir. 1987).*

[7] See, e.g., *3 Robert Long,* The Law of Liability Insurance *§ 11.09 (2000).*

[8] *L. Fletcher*, Tire Problems Drive Interest in Recall Cover, *Bus. Ins., Sept. 4, 2000, at 1.*

[9] Id.

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