Axis Insurance Group

# Product Recall Manufacturing

Axis Insurance understands the impacts of a product recall event can not only cost up to millions of dollars, but the long-term term effects from falling sales due to poor consumer confidence, brand rehabilitation, and potential lawsuits can be devastating.

Despite the frequency of recalls and potential for extraordinary costs, most companies don't adequately plan, prepare, or protect against product recall events.

This risk management guide will provide you with an overview for avoiding and dealing with the consequences of a product recall loss. By understanding your obligations and the important coverage points, we can address the coverage issues facing the industry today.

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## Executive Summary

On average, the Canadian Food Inspection Agency (CFIA) conducts 3,000 food safety investigations each year. The CFIA coordinates food recalls with external food safety partners and manages about 350 recalls each year.

The goal of a food safety investigation is to determine whether a food safety hazard exists, assess the nature and extent of the issue, and take appropriate actions to eliminate or minimize potential risks to consumers.

**This paper covers the following topics:**

- Legislation facing manufacturing companies in today's working environment
- Exposures you should be concerned about
- Understanding product recall and the basic threats associated with it
- Coverage available in the insurance market to protect you from a product recall
- Risk management strategies for manufacturers

## Product recall is typically excluded

Business owners sometime believe product recall is covered under a general or product liability policy, but it's not. Although those policies cover bodily injury and property damage, they generally exclude "Business Risk" including contamination and recall events.

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## What legislation faces manufacturing companies?

The Canada Consumer Product Safety Act applies to suppliers of consumer products in Canada, including manufacturers, importers, distributors, advertisers and retailers. The Act recognizes the suppliers of consumer products have an essential role to play in addressing any dangers to human health or safety that may be posed by these products in today's global marketplace.

### Under the act they have identified several important injunctions regarding consumer products:

- Prohibited Products
- Products that do not comply with the regulations
- Products that are dangerous to human health or safety
- Products that have been recalled
- Products that require corrective measures
- Products packaged or labeled with misleading claims
- Products providing false or misleading information
- Voluntary compliance is often the most efficient and effective approach for everyone — the public, industry, and government

### What exposures should you be concerned about?

Your company can face "first party" or "third party" exposures when supplying consumer products.

A first party exposure — which is often overlooked — relates to recall expenses and potential long-term losses from damage to a company's reputation. Because of this, losses from a recalled sale may continue for months or even years after a recall has occurred. The Grocery Manufacturers Association noted 81% of survey respondents described these financial consequences as either "significant" or "catastrophic".

A third party exposure refers to liability losses resulting from injured or sick individuals who have been affected by a product.

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## Product Recall

Insurance for first-party losses caused by product tampering and contamination incidents are broadly labeled as product recall insurance. Product recall policies help to cover the additional costs of a recall, including product loss, costs to withdraw the product from the market, product disposal, product testing, overtime wages and crisis management — costs that can be devastating because they arise at a time when a company's revenues are typically hit hardest.

## Basic Threats

There are three threats suppliers of consumer products will face when being manufactured.

1. **Malicious tampering** - Intentional contamination is prone to publicity, so it may seem common. In reality, malicious tampering is rare, but when it strikes, it tends to be a very severe loss. Managing this risk exposure can be difficult, as motives vary widely.
2. **Product extortion** - This is the most difficult peril to characterize. Its frequency is between that of malicious tampering and accidental contamination. However, its severity is more difficult to quantify. Most extortions are amateurish hoaxes but may evolve into outright tampering cases, which can be very costly.
3. **Accidental contamination** - An unintentional error in the manufacturing, packaging or storage of a product. This could include mislabeling ingredients, contamination by a foreign object or chemical, ect. This peril is the most common, but the majority of incidents are discovered prior to shipment, so they receive very little publicity. As opposed to malicious tampering, this peril has very high frequency but usually relatively low severity. While most accidental contaminations are small events, the largest losses have historically been due to accidental contaminations.

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## What are your coverage options?

There are several coverage forms, each designed to isolate some component of first party product exposure. Some existing manufacturing policies may provide small sub-limits with narrow coverage. Working with the professional team at the Axis Group will allow you to evaluate your options and decide what coverages suit your needs best.

### Some of the major coverages we review can ensure your product recall policy provides indemnity for:

**Recall expense** - This out-of-pocket expense is associated with executing a large-scale product withdrawal. It includes costs like extra temporary employees, over-time, public safety messages, special testing and handling, destruction and disposal costs and crisis management and/or PR consulting fees.

**Replacement cost** - As the name implies, this is the cost of replacing any product that had to be destroyed. This includes the cost of materials, labour, and overhead directly associated with producing the product.

**Lost profits** - This indemnifies the insured for profits which would have been earned on the withdrawn products and also for profits that would have been earned on future product sales but which were not earned because of resultant future sales declines. This is usually limited to a specified time period.

**Brand rehabilitation expense** - Most underwriters will also indemnify the insured for necessary rehabilitation of the recalled product's consumer image. This includes costs like extra advertising, extra expense to rush a new product to market, and special promotions to rebuild public trust in the manufacturer and its products.

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## Risk management strategies

When it comes to the manufacturing industry, insurers typically prefer to cover businesses that have considered a risk management strategy. Here are some strategies recommended by insurance underwriters:

**HACCP (Hazard Analysis Critical Control Point):** A risk management system that identifies the major risk points in a production process and allows for a constant measurement, reporting and control mechanism.

**Recall/Crisis plan:** Essential for rapid response to a product issue, outlining key steps and personnel responsible for different parts of the crisis response.

**Positive release systems:** Products are only released for distribution when they have been tested for contamination (by an internal or external lab) and confirmed as containing no pathogens or foreign bodies.

**Traceability systems:** Modern traceability systems are capable of tracing when products are manufactured to the hour of production. It is not uncommon to see businesses with 100% traceability to hour of production, this helps to mitigate the size of a potential recall (fewer target products to recall).

Even the best companies who are prepared for a recall can suffer substantial financial losses. In spite of all precautions, a large-scale public recall may cost millions of dollars in extra expense, lost profits, lost inventory, lost shelf space and lost market share. If it comes to this, the last line of defense is a solid product recall insurance program—one that indemnifies for the host of extra expenses and losses in revenue that come with product withdrawals.

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