UNDERSTANDING RECALL ISSUES

A major recall in the food manufacturing and retailing sector was once a rare event guaranteed to make the news headlines. Not anymore. Hardly a week passes without some new eruption of salmonella, listeria, E. coli, or other noxious contaminants cropping up somewhere along the food production and distribution chain. When the source is far back along the chain, and contaminated ingredients find their way into multiple products and outlets, major recall incidents routinely take a toll on food sector firms’ profits, operations, and reputations.

The reasons for the steady escalation in the number of contamination incidents and recalls seen in recent decades are essentially threefold. Perhaps most obviously, there is increased complexity in the supply chain. Where once food and drink manufacturers might have used just a handful of suppliers, many of them well known to their clients and locally based, today’s food industry firms could be sourcing ingredients from 50 or 60 different suppliers around the world, as consumers’ increasingly exotic tastes and price sensitivity prompt them to search ever further afield for new and competitively priced raw materials.

In parallel with the greater number of players involved in a typical food-industry supply chain, we have seen the emergence of
highly dominant players in the production of some raw materials and processed ingredients. As we saw with incidents such as the Plainview milk products recall in 2009, this can quickly lead to widespread contamination issues distributed across multiple customers. Combine global producers with less familiar source countries, and you have the potential for something like the melamine in Chinese milk products panic that arose in 2008. The introduction of this highly unorthodox and illicit bulking agent made 3,000 people sick around the world, caused the deaths of a number of infants from acute liver problems, and provoked widespread concerns in the U.S. and Europe after trace amounts of melamine were detected in a number of products.

This leads logically to a second important factor in the growing number of recalls today: the increasing sophistication and availability of scientific equipment capable of detecting ever more microscopic amounts of contaminant in foods and drinks. Bacterial infections at such a low level that harm to human health is highly improbable now set alarm bells ringing that producers and manufacturers cannot afford to ignore. If foreign bodies show up even at one or two parts per million or billion, the affected organisations have hard decisions to make. Any decision to expose consumers to a known risk, however remote, can easily come back to haunt a firm. The recall from Cadbury’s Birmingham facility in 2006 was a classic and expensive example of this.

A third and closely related factor is the increasingly hard line taken by regulators. Castigated for perceived laxity in the past over incidents like the Peanut Company of America Salmonella contamination in 2009, which spread far and wide within the food chain and killed at least six people in the U.S. (see previous Lockton white papers), the FDA now has new powers, new legislation (in the shape of an updated Federal Food, Drug, and Cosmetic Act [FDCA] and its Reportable Food Registry and Food Safety Modernization Act [FSMA] signed into law in January 2011), and a new remit to intervene proactively to forestall any future such incidents.

Under increasing political and consumer pressure to do more about the foodborne illness that affects around 5,000 people each year in the U.S., the FDA now has little option but to adopt a zero-tolerance approach. Budgetary constraints through the current worldwide economic downturn appear to be all that is holding the agency back from ever more intrusive intervention. For now, the FDA’s main focus appears to be on those firms unfortunate or incautious enough to find themselves on the list of “high risk” producers. But all food and beverage sector companies now need to be vigilant and scrupulous in enforcing and documenting safe working practices and in their choice of suppliers.

Whilst commercial general liability insurance may provide cover against third-party claims for bodily injury or property damage caused by contaminated products, and commercial property insurance policies can include a degree of protection for losses arising from contamination due to fire, flood, or accidental treatment with inappropriate chemicals, more and more firms are now turning to specialist contaminated products insurance (CPI) policies, the best of which now offer rounded cover against a range of risks, including business interruption/lost profits, the costs of carrying
out a recall, and in some cases, financial costs and losses due to reputational damage. The generic term for the market is “recall,” but a recall is actually a covered consequence of the trigger event of “contamination,” which can give rise to misconceptions.

However, CPI is becoming an accepted coverage for food and beverage companies. A survey conducted among members of the Grocery Manufacturers of America last year found that 58 percent had made some use of specialty CPI insurance products. The CPI market is now reckoned to generate around $300 million in premiums, with demand only increased by the advent of the FDA’s more proactive new stance and the passing of the FSMA early last year. Welcome as the protection afforded by this new market may be—and competitively priced as it currently remains for clean renewals in the absence of systemic marketwide losses—an element of unpredictability persists over what is, in many of its more innovative aspects, still a relatively new and untried market. The growing incidence of contested claims emerged as a talking point among product recall specialists at the most recent RIMS conference. A number of recent cases clearly illustrate that food business firms are not always getting what they thought they were paying for when it comes to what they interpreted as “recall” cover.

One such contested claim involved burritos produced by Little Lady Foods, where routine testing required by the U.S. Department of Agriculture (USDA), following the introduction of a new manufacturing process, had uncovered traces of a bacterium of the genus listeria. Fearing the potentially deadly listeria monocytogenes, Little Lady put a hold on 60,000 cases of the product and attempted to claim on an accidental product contamination policy with insurer Houston Casualty. The insurer rejected the claim on the basis that a positive test for the harmful listeria monocytogenes was required. By the time subsequent test results determined that the strain of listeria present was not harmful, the on-hold consignment was compromised and had to be sold on the secondary market or destroyed. The court subsequently upheld the insurer’s interpretation, leaving Little Lady, no doubt, feeling more than a little let down.

In the separate case of Fresh Express v. Beazley, the former attempted to claim for losses arising from its recall of bagged fresh spinach after a widespread E. coli scare was linked to spinach, and the FDA issued numerous advisory notices recommending its precautionary withdrawal from sale. Spinach subsequently proved not to have been the source of the E. coli outbreak, too late, however, for Fresh Express to avoid incurring recall-related costs of $12 million. Although the policy wording required only that Fresh Express had “reasonable cause to believe” that its products might cause harm—where prior to the PCA recalls, CPI policies normally required evidence of actual harm being caused (see previous Lockton white papers)—Beazley denied the firm’s claim on the grounds that the policy required that the insured firm’s “reasonable cause to believe” be based on an error that it had committed. An initial hearing found for Fresh Express, but, on appeal, Beazley’s strict interpretation of the policy wording was upheld and, once again, the insured party discovered it had not held the cover it thought it had.
These cases and others like them highlight the vital importance of closely interrogating policy wordings to ensure the chosen product gives the policyholder the cover they are looking for. This is where a specialist broker like Lockton comes into its own. No two policies are alike in this evolving market, but an expert broker who really knows the market will now be able to source and tailor a policy to match virtually any need, provided that need is properly crystallized at the outset. Again, the broker can help, as indeed they can in the vital business of determining appropriate contract wording for use with suppliers and customers. Today’s complex supply chains are fraught with companies attempting to transfer risk up or down the chain, e.g., by requiring indemnities or undertakings to hold harmless or through requiring business partners to name a third party as additional insureds on their own insurance policies. It is clearly essential to understand where such risk transference manoeuvres would leave you in each of a full range of potential loss scenarios.

In the light of the comments above concerning disputed claims, experienced specialist brokers can also add value through their informed understanding of how different markets are likely to respond in the event of a claim. The number of markets operating in the CPI space continues to grow. Recent entrants include ARK and Talbot underwriting both in Lloyd’s with Novae set to join in the fall. Ace looks set to join the fray also. All of this is, broadly speaking, good news from an insurance buyer’s perspective—helping to fuel a competitive marketplace in which rates look set to remain flat to falling in the absence of a sharp marketwide upturn in claims experience.

The causes of this proliferation relate not so much to profitable opportunities in CPI as to the continuing depression of rates in other sectors of the property and casualty market, to a desire to diversify into new noncorrelated areas of the market and, somewhat bizarrely, to regulatory pressures. European insurers are under considerable pressure in the run-up to the implementation of the EU’s Solvency II regime to include a broader range of business classes within their portfolios. Essentially, the assumption is that it is less risky to spread your eggs between a number of baskets. The counter argument, of course, is that diversifying outside your core expertise creates risks of its own.

One outcome of this influx of new and untried carriers to the CPI space is that the claims-paying philosophy of many current carriers remains untested, and there would appear to be some value in insuring with more established specialist carriers whose attitude to claims is less of an unknown quantity.

As with many other highly specialised commercial insurance products, expert practitioners in the product recall insurance market tend to be heavily concentrated in the London market. So from an underwriting point of view, London certainly has little difficulty incubating a continuing multiplication of markets—with one firm’s junior underwriter remerging in a senior role at a new competitor. What is less certain is the long-term commitment and attitude of some new capacity providers.

London’s dense cluster of expertise offers a number of advantages for purchasers of CPI insurance and their advisors. The close proximity of so many specialist
carriers creates an atmosphere both of innovation and of healthy competition on price. At Lockton, we have often been able to secure significantly better value for the money by shifting from a U.S.-sourced to a London-sourced programme. At the same time, London’s distinctive subscription market structure makes it relatively straightforward to secure a larger capacity programme with a number of carriers all providing capacity under a single policy wording. The concentration also allows brokers to develop a detailed working understanding of the risk appetite and claims philosophy of a broad range of carriers and to get decisions quickly.

One specialised area in which London has proved particularly flexible and innovative—and in which Lockton’s London team has emerged as a lead player—is the modified version of CPI cover developed to protect the brand names of restaurant and food outlet chains and franchises. Such establishments are very much in the public eye, and a widely publicised incident can seriously affect a brand’s image and outlet footfall. An example of the negative publicity generated—and the importance of expert public relations in the aftermath—that is playing out as this paper goes to press relates to a human fingertip discovered by a 14-year-old Michigan boy in a meal served at one of the 3,600 fast-food outlets of beef sandwich specialists Arby’s. Dedicated brand protection cover not only can compensate economic losses consequent to such incidents but also can provide funded access to expert public relations specialists able to act quickly and decisively to minimise reputational harm.

Arby’s has been criticised by some commentators for attempting to duck the issues raised by this incident, but a clearer example—albeit from a somewhat different area of the market—of how not to handle a contamination incident can be seen in the shape of the rolling disaster that is the Diamond Pet Foods recall, also in play as we go to press. Here an initial limited recall notice relating to one batch of listeria-contaminated dry dog food has since been extended on at least eight occasions, as the firm underwent a weeklong FDA inspection (highly critical), and pets continued to become ill and die. The recall notices only extended to cat food after a number of cats were reported dead after consuming Diamond products. The full facts have yet to emerge, but at first sight, this looks like a classic example of a company’s good name and the trust of its customers being needlessly squandered. Some commentators now publicly doubt whether the Diamond brand can survive the negative publicity generated. With better advice and better coverage, this could have been avoided.

As leading players in the CPI market with a comprehensive knowledge of the market and policy wordings available, Lockton’s specialist team in London and the U.S. are ideally positioned to advise organizations on protecting themselves against the full range of negative effects that can arise from product contamination and recall incidents.

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