The true cost of product recall

April 2015

Ian Harrison and Adrian Parker discuss how consumer-facing industries can ensure they are properly covered for product recall.

These sectors are mostly heavily regulated by government bodies, and have to act quickly to remove faulty products from the market or supply chain. However, many companies overlook the size of losses that can mount up a long time after the crisis has passed.

Ian and Adrian share examples that they have worked on, to illustrate the size of these potential risks, and the appropriate financial protection that can be put in place.

Your contacts at Lockton:
Ian Harrison leads Lockton’s team of product recall specialists, based in London. Together, they place over US$20 million into global markets each year. They also work with our claims specialists, to negotiate payments to clients that have suffered loss through product recall. These matters are normally very complex, and require careful liaison with insurers. Adrian Parker specialises in claims. In the last 12 months, Lockton’s specialist claims team has handled product recall claims valued over US$60m.
**SOME COMPANIES** still think only their recall costs need to be covered, not the wider cost of rebuilding the business.

Marketing product recall insurance has now moved from agreeing the concept of cover (‘Why should I buy this?’), through to cost of coverage (‘What value do I get from this?’), to the final stages of clarity (‘Will the cover perform?’), and claims (‘Will all my financial losses be reimbursed?’).

Despite that, many buyers of product recall insurance - and brokers who have not handled a lot of product recall cases - concentrate on the trigger. They put a lot of effort into understanding the detailed definitions around what might cause products to be recalled, and define the likely costs they will incur in the moment of crisis.

These would generally be termed an increased cost of working rather than a catastrophic financial expense.

We estimate, however, that some 80% of the total financial losses are incurred long after the offending products have been discarded. As well as being long-term, these costs are also very difficult to define. For example, how can you prove why customers still don’t buy the product a year later..?

A forensic accountant can relate the policy language to resultant loss of profit. This can yield significant extra value beyond the immediate increased costs of working.

When a product is withdrawn, the immediate costs are usually very easy to anticipate:

- bringing together the crisis team;
- removing the product from the market;
- investigating the cause, and
- managing the PR.
REGULATORS are looking at the causes of recall more closely than ever before. They are imposing costly fines, which add to the overall costs of a recall.

Added to that, regulators in other countries are very likely to follow a similar path, where a product is distributed in multiple territories. It’s not always possible to insure against this, but underwriters will want assurance that operations are compliant.

“In 2014, the US National Highway Traffic Safety Administration (NHTSA) issued $126 million in fines; a total which was more than all 43 years of the agency’s fine history combined…Since the passing of the Consumer Product Safety Improvement Act in 2008 (in the US), which enabled the agency to issue higher fines than previously allowed, Consumer Product Safety Commission (CPSC) fines have steadily increased each year…Many of these fines stem from infractions committed in prior years, underscoring that legal and financial repercussions of recalls extend far beyond the initial recall date.”

Source: Quoted in Stericycle Recall Index, Q4 2014, Stericycle Expert Solutions, available via www.stericycleexpertsolutions.com

Top causes of product recall under the US Food and Drug Administration (FDA) in 2014:

- **Medical devices:**
  - Packaging, leaking and labelling: 30 million

- **Pharmaceutical:**
  - Particulate/foreign matter and failed specs: 15.6 million

- **Food:**
  - Undeclared allergens: 8.5 million

Source: Quoted in Stericycle Recall Index, Q4 2014, Stericycle Expert Solutions, available via www.stericycleexpertsolutions.com
A KEY FEATURE of the London market is that most agreements are reached face-to-face, which can be invaluable in complex claims situations.

Clearly, claims handling is the true shop window of any sophisticated coverage, and is how a specialist claims team creates true value for clients. Claims are complex, and it takes time - often more than a year - to understand the full extent of losses. The trigger needs to be identified correctly, but also the complexity of losses that mount up after the event.

There are many things you can do in advance to be well prepared, including:

1. Anticipate what a loss adjuster would want to know. Take advice, and rehearse your reporting.
2. Simulate a recall, and see how ready your company is to handle communication.
3. Identify your key people - lawyers, PR, recall specialists - who would have a role to play if one of your products were recalled. Your insurer may pay for these advisors.
FAMILIAR SCENARIOS

Here are examples of that we have worked on, which illustrate the most common losses.
To protect client confidentiality, we have removed the names of the companies:

1. **The raw product goes up in value.** When a supplier of raw meat had to recall its products, it sourced them from elsewhere so it wouldn’t breach obligations to the customer it was supplying. The spot price of those meat products was five times higher, and our client successfully claimed for the difference in those costs.

2. **The rejected stock is used for another purpose, which sells for less.** Our client, a supplier of fresh produce, turned its consignment into animal feed (which sold at a much lower price) after a small amount was found to be contaminated with salmonella. The insurers covered the full difference in value.

3. **Despite a small problem, a whole consignment has to be discarded.** Weevils were found in large sacks of rice, so the entire consignment was thrown away to maintain the brand’s reputation.

Even though only a small amount of the stock had been infected with the weevils, the insurers paid for the full loss of stock to maintain the brand’s reputation.

4. **A supplier is forced to reimburse their customer’s total losses, including marketing campaigns that have been cut short.** A large fast-food restaurant brand had created a marketing campaign around a special ingredient. When that ingredient suddenly had to be recalled (and the campaign abandoned), the restaurant brand demanded full reimbursement of the costs of the campaign. We argued successfully to the insurer that their short-term loss would be in the client’s long-term interest: this was a sensible strategy to keep in place its contract with an important customer.
Scenarios continued...

5. **The loss was caused by physical damage to a property.**
   Rain fell through a hole in a warehouse roof and spoiled a consignment of cheese underneath. The property insurer quickly paid for the roof to be repaired, but we led lengthy negotiations between all the insurers over consequential losses (e.g., the spoiled stock of cheese). We reached a satisfactory compromise.

6. **A product was mislabelled, and has to be repackaged.**
   A product contained peanuts, but this was not mentioned on the original labelling. The insurer covered the cost of re-labelling the full consignment.

7. **The loss was caused by damaged packaging, usually supplied by a different company.**
   Faulty lamination meant that snack packets were not sealed properly, allowing air into the product, which would have made the snacks go stale. The snack company successfully argued that the packaging supplier should cover the costs of the full recall and replacement of all the damaged products.

8. **The loss was caused by a relatively small component in a complex supply chain that led to much greater losses further up the supply chain.**
   A relatively small component ($2 each) in a car’s catalytic converter was faulty. The car company successfully argued for compensation to cover the full cost of recalling all new cars and replacing the full exhaust system on each one ($100 each).
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