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ATTORNEYS AT LAW

***Total Recall – Current Coverage Issues in
Product Recall Claims***

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I. Introduction to Product Recall Claims

Products ranging from food items and pharmaceuticals to baby carriages, toys and television sets are routinely recalled by retailers and manufacturers in the United States for defects or contamination that affect the safety of the products for human use or consumption. Many recalls stem from initial complaint or claims of injuries or product defects but increasing U.S. governmental regulation and monitoring is prompting earlier recalls of foods, pharmaceuticals and consumer products. A single recall can cost a manufacturer and its customers into the millions of dollars. These companies will frequently seek insurance coverage for recall claims under their general liability policies and to the extent specialty recall policies were purchased, they will also seek coverage under such first party policies. These coverage claims can be extremely complex and may require retention of experts to assist in both the coverage determination and the categorization and valuation of first and third party damages.

In 2012, the Consumer Product Safety Commission recalled 59 million products. Product recalls can reach over a million dollars in losses per recall. The chart below depicts the top ten product recalls in the U.S. in 2012¹:

Product	Reported Claims	Number of Units Recalled
Map Pro, Propylene, and MAPP Gas Cylinders used for soldering, brazing, cutting and welding – seal on the cylinders can leak posing a fire hazard.	none	29 million
Bumbo Infant Seat – risk of injury from babies being able to maneuver out of the seat.	50 injuries including 19 skull fractures	4 million
Flushmate III Pressure- Assist Flushing System for Toilets – reports of pressure building causing unit to burst. Pressure can lift tank lid and shatter the tank.	304 reports of property damage and 14 reports of impact or laceration injuries	2.4 million
Tassimo Coffee, Latte, Espresso T Discs/Packets – potential burn hazard from T discs that can become clogged and spray hot liquid and coffee grounds.	21 reports of incidents of spraying, including 4 reports of second-degree burns	2.1 million

¹ Caterina Pontoriero, “Top 10 Product Recalls of 2012,” PropertyCasualty360.com, June 6, 2013. (last accessed September 11, 2013).

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Product	Reported Claims	Number of Units Recalled
Mothers' Touch Deluxe Baby Bathers – side hinge can suddenly disengage from the unit, dropping the baby.	7 reports of injuries, including 4 head fractures and 1 child in intensive care	2 million
Kennedy Home Collection Folding Step Stools – potential fall hazard from stool cracking or breaking.	15+ reports of injuries including back injuries and fractured leg	1.6 million
GE and Hotpoint Dishwashers – potential of electrical failure in heating element posing a fire risk.	15 reports of heating element failure	1.3 million
Hewlett Packard Fax Machines – internal electrical component failure causing overheating and potential fire and burn hazard.	7 reports of units catching fire	928,000
Safety 1st Push 'N Snap Cabinet Locks – Young children can disengage the lock allowing access to cabinets.	200	900,000
Cryofreeze and Arctic Zone Ice Gel Packs – potential risk of illness from leaks of diethylene glycol and ethylene glycol	none	880,000

An increasingly prominent subset of U.S. product recalls occurs in the food and pharmaceutical industries. U.S. product recalls are classified into the following three categories²:

- **Class I Recall:** There is a reasonable probability that the use of, or exposure to, a violative product will cause serious adverse health consequences or death;
- **Class II Recall:** Use of, or exposure to, a violative product may cause temporary or medically reversible adverse health consequences or where the probability of serious adverse health consequences is remote;
- **Class III Recall:** Use of, or exposure to, a violative product it not likely to cause adverse health consequences.

² FDA Investigations Operations Manual 2013, p. 351.

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A company may voluntarily recall a product falling into any of the above classes. A potentially violative product that may result in a Class I or Class II recall requires the FDA's investigation and possible regulatory action against the responsible party.³ Recalls may also be ordered by the FDA following its investigation.

Pursuant to Section 1005 of the Food, Drug and Cosmetic Act, the U.S. Food and Drug Administration (FDA) established a Reportable Food Registry (RFR or Registry) that provides an electronic portal for reporting of "reportable food" by responsible parties and public health officials.⁴ Reportable Food is "an article of food/feed for which there is a reasonable probability that the use of, or exposure to, such article of food will cause serious adverse health consequences or death to humans or animals." The Registry has been active for three years and provides the FDA with information concerning the cause of the food reporting and the corrective actions taken. The greatest number of reports over the three year period the Registry has been in operation have related to listeria monocytogenes in widely distributed fresh cut onions, salmonella in imported mangos and undeclared milk as an allergen in a nationally distributed snack bar.

Reports to the Registry totaled 2,600 in the first years collected (2009-2010). This reported number decreased to 1153 in the second year (2010-2011) and increased slightly to 1,471 in the third year (2011-2012). Of these reports, approximately 10% were attributable to animal food and feed.

The largest percentage of reports to the Registry was due to undeclared allergens in foods, such as nuts, dairy or wheat. (37.9% in year 3). The second largest percentage of reports was due to listeria monocytogenes (21.4%) and salmonella (28.1%). Smaller percentages were attributable to nutrient imbalance (3.6%); unviscerated fish (2.7%); drug contamination (1.8%); E. coli (1.8%); other (1.8%); foreign object (.5%) and undeclared sulfites (.5%).⁵

In response to the data collected through the Registry, in January 2013, the FDA proposed regulations to address issues of microbial contamination. According to the FDA these regulations will "establish the foundation of and central framework for the modern food safety system envisioned by Congress in the Food Safety Modernization Act (FSMA)."⁶ The FSMA was enacted in 2011 and as recently as August of this year, the FDA had still not fully issued its rules implementing this Act. On August 13, 2013, in the suit titled *Center for Food Safety v. Margaret A. Hamburg, M.D.*, [Commissioner of the U.S. FDA], filed in the United States District Court for the Northern District of California, No. C 12-4529, the court refused to grant a further extension of the FDA's deadlines to issue rules implementing the FSMA.

As indicated above, there can be a significant number of claims against a manufacturer and/or retailer of a defective or contaminated product, many of which may be covered under the insured's general liability policy. In addition, the cost of the recall itself may range in the

³ *Id.* at 352.

⁴ U.S. Food and Drug Administration, "The Reportable Food Registry: Targeting Inspection Resources and Identifying Patterns of Adulteration. Third Annual Report September 8, 2011 – September 7, 2012," May 1, 2013.

⁵ *Id.* at 14.

⁶ *Id.* at 16.

hundreds of thousands and into the millions of dollars. Such costs include the lost profit and market share from the withdrawal of the product, testing costs, return of the products from customers, warehousing and product destruction. As discussed below, these costs are typically not covered by the standard general liability policy in the absence of a specific recall coverage endorsement, but may be covered under first party specialty recall policies. The terms of these specialty recall policies are quite specific and insureds cannot look to their recall policy for coverage for all possible recall scenarios or for costs related to an Insured Event.

II. Product Recall Claims under CGL Policies

A. Fitting Product Recall Claims into the CGL Insuring Grant – Is there an “Occurrence” Causing “Property Damage”?

Suits alleging strict liability, negligence, breach of warranty and breach of contract arising from an insured’s product recall may not be deemed to allege an “occurrence” causing “property damage” as those terms are defined in CGL policies.

The New Jersey Appellate Division held in *Atlantic Mutual Insurance Company v. Hillside Bottling Company, Inc.*, 387 N.J. Super. 224 (App. Div. 2006) (“*Hillside*”) that no coverage existed under a CGL policy for downstream customers’ recall-related claims. Hillside Bottling Company (“Hillside”) sought coverage under its CGL policy for claims brought by its customers, Snapple and Briar’s, for a recall of their beverages caused by ammonia contamination of the drinks while being processed and carbonated by Hillside. The contamination had been detected by a quality control inspector at Hillside’s customer, Stewart’s, and the New Jersey Department of Health issued a notice requiring all soda produced at the Hillside plant to be detained and embargoed. Hillside advised its customers that the beverages were contaminated and should not be used. Briar’s and Stewart’s then recalled the affected lots, gave refunds to their customers, and sought indemnification from Hillside for “all costs, losses or damages relating to the contaminated products and the recall.” *Id.* at 228.

The Appellate Division reversed the trial court’s denial of the insurers’ motion for summary judgment, and held that the subject CGL policy did not provide coverage for Hillside’s own faulty product. *Id.* at 240-41. In so holding, the court rejected the argument that the contaminated beverages were not Hillside’s product because it only provided bottling services using the customer’s product. The court also rejected the argument that the resulting lost value of the product to the customers constituted third party property damage. Instead, the court found that Hillside itself created a product by using some materials provided by the customers and by supplying some of its own ingredients, including the carbonation that caused the contamination. The court held that no coverage existed for the subject recall-related claims since Hillside was seeking coverage for its own faulty performance. *Id.* at 235. The extent of the recall damages to the customers was in the court’s opinion not relevant where “this claim, arising as it did from Hillside’s work or its product, was not covered, regardless of the extent of the cost of the recall.” *Id.*

The *Hillside* Court also found that Briar’s and Stewart’s claims against Hillside did not claim third-party property damage and distinguished its prior decision in *Newark Insurance*

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Company v. Acupac Packaging, Inc., 328 N.J. Super 385 (App. Div. 2000.) In *Acupac*, the court found third-party property damage and coverage where the insured's defective foil paquettes, designed to provide lotion samples in Glamour magazine, caused lotion to leak from the paquettes and damage magazine advertising cards during the magazine binding process. Unlike *Acupac*, the court in *Hillside* found Briar's and Stewart's claims, that included costs of refunds to customers and destruction of contaminated product, were not claims for third-party property damage, but rather were merely claims for "costs associated with [Hillside's] own faulty work and its own faulty product..." *Id.* at 236.

The *Hillside* Court also found relevant that the insurer had agreed to pay the claims of third-party customers alleging injury as a result of consuming the contaminated beverages. The court noted that "[r]ecognizing that those claims were covered is entirely consistent with [New Jersey precedent], for the policy affords Hillside protection for the claims of others who were injured by its products as were those eventual consumers of the beverages." *Id.* at 235.

Similarly, in *Silgan Containers Corp. v. National Union Fire Ins. Co. of Pittsburgh PA*, 2010 U.S. Dist. LEXIS 30100 (N.D. Ca. Mar. 29, 2010), *aff'd* 434 Fed. Appx. 709 (9th Cir. 2011), the Northern District of California addressed a claim for coverage related to defective packaging. In that case, canned fruit manufacturer, Del Monte, asserted a claim for damages against the insured, Silgan Containers. Silgan manufactured containers with pull-tab lids that were sold to Del Monte to hold fruit cocktail. Del Monte received complaints that the cans suffered "openability" issues such that a certain percentage of the cans could not be opened. Del Monte advised Silgan of the defect and subsequently brought suit against Silgan to recover its costs as a result of the defective cans. Silgan tendered the suit to its insurer, National Union, for defense and indemnity.

Both the District Court and the Ninth Circuit Court of Appeals on appeal held that there was no physical injury to tangible property where there was "no alteration in the appearance, shape, or color of the fruit and the fruit remained edible." *Silgan Containers*, 434 Fed. Appx. at 710. The court further held that the defective lids were not so inherently dangerous that physical injury would be presumed by the mere fact of incorporation. *Id.* The court further held that Del Monte had not shown a "loss of use of property that is not physically injured" where there was no showing that the fruit inside the defective cups was completely unusable. *Id.* at 710-11. Instead the court found that Del Monte had merely made a business decision not to sell the fruit and "had not shown that the fruit was unsuitable for other purposes, such as sale on a secondary market." *Id.*

In *Sokol and Company v. Atlantic Mutual Insurance Company*, 430 F.3d 417 (7th Cir. 2005), the insured, Sokol, was a food products manufacturer that supplied sealed packets of peanut butter to its customer, Continental Mills, for inclusion in boxes of Continental's cookie mix. After the packets were sealed into the boxes and shipped to retailers, the peanut butter was found to be rancid. *Id.* at 419. Continental retrieved the boxes, replaced the peanut butter with packets from a different supplier and reshipped the mixes. Continental sought payment of approximately \$75,000 from Sokol. *Id.* Atlantic Mutual denied coverage for Sokol's claim under its CGL policy and litigation followed. The court found that there was no third party property damage as the rancid peanut butter was contained in separate packets that did not affect

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the other food products in the mix boxes. *Id.* at 422. The appellate court rejected Sokol's argument that Continental's need to open the boxes constituted third party property damage and further rejected the argument that Continental suffered a loss of use of its mixes by the delay in getting the cookie mix to market. *Id.* Thus, the court found that Atlantic Mutual had no duty to indemnify Sokol for the amounts it paid to Continental on the claim.

Other courts have found that product recall-related claims constitute an occurrence causing third party property damage. The likelihood of such a finding increases when the insured's defective part or contaminated ingredient is incorporated into its customer's product in a manner that precludes its later separation or removal. In *The Travelers Indemnity Company v. Dammann & Co., Inc.*, 2008 U.S. Dist. LEXIS 5759 (D.N.J. 2008) (hereafter "*Dammann*"), the court considered Travelers' motion for summary judgment under its primary CGL and excess policy for claims asserted by International Flavors and Fragrances ("IFF") against Traveler's insured, Dammann, a supplier of vanilla beans to IFF. IFF advised the FDA, which in turn advised Dammann, of detected mercury contamination of vanilla beans Dammann supplied to IFF. IFF's claims against Dammann alleged damages for clean up and remediation of IFF's machinery, damage to IFF's vanilla extract made from the contaminated beans and exposure to liability to other parties that would use the extract. *Id.* at *14.

Travelers argued that IFF's claims did not arise from an occurrence causing third party property damage such that no coverage existed under the Dammann policies. The *Dammann* Court rejected this argument, finding that the damage to IFF's equipment and vanilla extract (that integrated the contaminated beans) constituted third party property damage that was covered under the terms of the CGL policy. The *Dammann* Court further found that the alleged shut down of IFF's operations following the mercury contamination constituted a loss of use that is included in the definition of property damage in the subject policies. *Id.* at *24.

A California court also addressed an irreversible incorporation of an insured's contaminated product in *Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*, 78 Cal. App. 4th 847 (First Dist. 2000). In *Shade Foods*, the insured sold chopped almonds to General Mills that used the almonds to make nut clusters for its cereal product. General Mills advised Shade Foods that it found wood splinters in the nuts. General Mills then shut down production and recalled the cereal. The *Shade Foods* Court found third party property damage holding that "[w]hile the distinction may sometimes be a fine one to draw, we see no difficulty in finding property damage where a potentially injurious material in a product causes loss to other products into which it is incorporated." *Id.* at 865. Based on the irreversible incorporation of the nuts into the nut clusters, the court held that "the wood splinters in the diced roasted almonds caused property damage to the nut clusters and cereal products in which the almonds were incorporated." *Id.* at 866.

A similar result was reached outside the food recall context by the Illinois appellate court in *Elco Industries, Inc. v. Liberty Mut. Ins. Co.*, 90 Ill. App. 3d 1106 (Ill. App. Ct. 1980). In *Elco*, the court found that the negligent manufacture of engine pins was an occurrence under the policy and the damage caused by those pins to the gaskets and plugs in the customer's engine constituted third party property damage. Similarly, in *The American Insurance Company v. Crown Packaging International*, 813 F. Supp. 2d 1027, 1044 (N.D. Ind. 2011), the District Court

held that where the insured's customer was required to destroy the defective packaging to retrieve the customer's soap product, there was both physical damage to and loss of use of third party property required to find coverage under the subject CGL policy.

As demonstrated in the above sampling of U.S. decisions, a court's determination of whether an occurrence and third party property damage took place will be highly dependent on the facts of the underlying claims and to a lesser extent dependent on the jurisdiction in which the coverage dispute is pending. Once this initial coverage determination is made, a court will then consider whether any exclusions to the CGL policy will preclude coverage. We discuss the most significant exclusions below.

B. Application of Exclusions to Preclude Coverage for Recall Claims

1. "Your Product" Exclusion

The Standard CGL policy excludes coverage for damage to "Your Product" typically defined as "[a]ny goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by You..." Your Product also includes "warranties or representations made at any time with respect to the fitness, quality, durability or performance or use of 'your product'; and the providing of or failure to provide warnings or instructions..."

In the *Silgan Containers* decision, discussed above, involving the defective pull-top fruit cocktail cans, the California District Court found that there was no coverage for the \$1.8 million cost of the faulty cans themselves under the "Your Product" exclusion. 2010 U.S. Dist. LEXIS at *23.

In contrast, in *Watts Industries, Inc. v. Zurich American Insurance Company*, 121 Cal. App. 4th 1029 1046-47 (2nd Dist. 2004), a California appellate court did not find the analogous "Your Work" and "Impaired Property" exclusions applicable to preclude coverage where the insured's plumbing part leaked lead into the municipal water supply. The *Watts* court held that there was no coverage for the damages to the insured's own defective parts, but the exclusions did not preclude coverage for the alleged damage to the municipal water supply through incorporation of the insured's parts. *Id.* at 1047-48.

In *Lowville Producer's Dairy Co-Operative, Inc. v. American Motorists Insurance Co.*, 198 A.D.2d 851, 853, 604 N.Y.S.2d 421, 422-23 (4th Dept. 1993), an insured supplied milk to a silo at a cheese manufacturing plant. *Id.* at 851, 421. After six trucks were emptied into the silo, a dead mouse was found trapped in a filter in the hose leading from the truck to the silo. *Id.* The cheese manufacturer rejected all of that day's milk delivery. *Id.* To compensate the manufacturer, the insured granted a credit on its account in the amount of the value of the six truckloads of milk. *Id.* The insured then sought reimbursement from its liability insurer, and the insurer disclaimed under the "Your Product" exclusion. *Id.* at 851-52, 421-22. The court agreed that because the insured's loss was for property damage to its own product, the milk, the "Your Product" exclusion barred coverage. *Id.* at 853, 422-23; *see also Hartog Rahal Partnership v. Am. Motorists Ins. Co.*, 359 F. Supp.2d 331, 332-33 (S.D.N.Y. 2005) (holding that an insurer had

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no duty to pay for the sales price of impure apple juice concentrate that the insured had sold to food manufacturers).

In *Parker Hannifin v. Steadfast Insurance Company*, 445 F. Supp. 2d 827 (N.D. Ohio 2006), the insured, Parker Hannifin (“Parker”), manufactured gaskets that were incorporated into Zenith televisions. *Id.* at 828. After several Zenith television sets caught on fire, Zenith determined that the gaskets were defective and caused the fires. *Id.* Zenith repaired as many televisions sets containing the Parker gaskets as possible, incurring millions of dollars in costs. *Id.* Zenith brought suit against Parker to recover the repair and replacement costs, and Parker settled the claim for \$3 million. Parker’s insurer, Steadfast, refused to pay the amount of the settlement in excess of Parker’s self-insured retention. Parker subsequently filed a declaratory judgment action against Steadfast. *Id.* at 829.

Steadfast contended that the repairs were made to the defective gaskets themselves, and therefore all of those costs were barred by the “your product” exclusion. *Id.* at 833. The court disagreed, concluding that the disparity between the costs of actual damage to homes and furnishings and the comparatively miniscule costs for gasket repair made it “both fair and efficient to classify the repaired/replaced product as the Zenith televisions,” rather than the insured’s defective gasket. As such, the “Your Product” exclusion did not apply. *Id.* at 833-34. *See also Int’l Hormones, Inc. v. Safeco Ins. Co.*, 57 A.D.2d 857, 857, 394 N.Y.S.2d 260, 261 (2d Dept. 1977) (concluding that under New York law, the “Your Product” exclusion “does not apply where the product has become a part of, or has been integrated into, another product of a third party”).

The analysis of the application of the “Your Product” exclusion will frequently track the court’s analysis as to whether third party property damage existed. Where the claimed costs are limited to the costs of the insured’s own products it will likely be the case that there will be no coverage for this claimed cost both because there is no third party property damage and because the “Your Product” and/or “Your Work” exclusion applies.

2. “Impaired Property” Exclusion

The impaired property exclusion precludes coverage for damage to “Impaired Property” or property not physically injured that arises out of a defect, inadequacy or dangerous condition in “Your Work” or “Your Product.” CGL policies typically define “Impaired Property” as “tangible property other than ‘your product’ or ‘your work’ that cannot be used or is less useful because it incorporates ‘your work’ or ‘your product’...” or if the insured failed to fulfill the terms of a contract or agreement if the property “can be restored to use by the repair, replacement, adjustment or removal of your product or your work or your fulfilling the terms of the contract or agreement.”

The Impaired Property exclusion does not apply if the damaged property could not have been restored to use by the repair, replacement, or removal of the insured’s product. *Chubb Insurance Co. of New Jersey v. Hartford Fire Insurance Co.*, 1999 U.S. Dist. LEXIS 15362, *5-*7 (S.D.N.Y. 1999) (unpublished), *aff’d*, 2000 U.S. App. LEXIS 25712 (2d Cir. 2000) (unpublished) (finding coverage where the insured’s impure apple juice concentrate could not be

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removed from customers' juice blends once it had been mixed with other juices). One court has held that the impaired property exclusion did not apply where the cost to replace the defective part of a product exceeded the value of the product. *The American Ins. Co. v. Crown Packaging Int'l*, 813 F. Supp. 2d 1027, 1050 (D. Ind. 2011) (court refusing to apply the impaired property exclusion where the cost of removing the customers' soap from the insured's defective containers exceeded the value of the soap).

In *American Zurich Insurance Company v. Trans-Packers Services Corporation*, 2013 N.Y. Misc. LEXIS 645, (Sup. Ct – N.Y. Cnty Jan. 29, 2013), the court arrived at different results on the application of the impaired property exclusion based on the identity of the underlying claimants.⁷

The *Trans-Packer* case involved claims stemming from non-fat dry milk (“NFDM”) that was contaminated with salmonella. *Id.* at *3. The contaminated milk was produced by Plainview Milk Products Cooperative and distributed by Franklin Farms East. *Id.* Franklin sold the NFDM to Trans-Packers Services Corp. who incorporated the NFDM into a dry protein shake mix packaged in individual portions. *Id.* The protein shake mix packets were then sold to Wornick who included them in Wornick's military rations meal packs sold to the U.S. government. *Id.* at *3. Under these facts, the *Trans-Packers* Court held that the impaired property exclusion in Trans-Packer's CGL policy precluded coverage for the claims of Wornick because Trans-Packers' shake mix packets could be removed from the meal packs and replaced with non-contaminated shakes. *Id.* at **46-47. As to Trans-Packer's claims under the distributor, Franklin's, CGL policy, the court held the impaired property exclusion did *not* apply because the NFDM supplied by Franklin to Trans-Packers could not be removed or separated from the other dry ingredients of Trans-Packer's protein shake mix. *Id.* at *34. The shake mix could not be restored to use by the removal and replacement of the contaminated NFDM and therefore the definition of impaired property could not be met. *Id.*

Similar to the application of the Your Product exclusion, the application of the Impaired Property exclusion will depend on a detailed review of the facts of each case. Expert analysis may be required to determine if the manufacturing processes support the argument that the claimant's product can be returned to use by replacement of the insured's product, or whether the insured's product has damaged or been irretrievably incorporated into the claimant's product.

3. Product Recall – Sistership Exclusion

The standard CGL policy typically includes an exclusion for “Recall of Products, Work Or Impaired Property.” This exclusion, also known as the sistership exclusion, precludes coverage for damages claimed for any loss, cost or expense incurred by the insured or others for the loss of use, withdrawal, recall, inspection, repair, adjustment, removal or disposal of “Your Product”, “Your Work”, or “Impaired Property” if the product, work or property is withdrawn or recalled from the market or from use by any person or organization because of any known or suspected defect, deficiency, inadequacy or dangerous condition. Despite this standard exclusion, an insured can purchase a product recall expense endorsement to a CGL policy to cover such expenses. This endorsement typically reflects a substantially lower policy sublimit.

⁷ Our office successfully argued on summary judgment in this action.

Courts focus primarily on three issues when considering the application of a product recall exclusion. First, what is the scope of the recall, i.e. does the exclusion apply when the insured recalls both actually defective and potentially defective products? Second, does the exclusion apply when someone other than the insured orders the recall? And third, was the insured's or a third party's product recalled? We address the courts' approaches to these issues below.

a. What is the Scope of the Recall?

The New Jersey Appellate Division in the *Hillside* decision, discussed above, upheld the application of the recall exclusion to the beverage recall at issue in that case. *Hillside*, 387 N.J. Super at 239. The trial court below had determined that the recall exclusion was inapplicable because the recall was of Hillside's customers' beverages rather than Hillside's products. On appeal, the court held that the recalled products, customers' beverages that became contaminated with ammonia during the insured's bottling process, were in fact Hillside's products because the insured took ingredients from the customers, added other ingredients and carbonation and bottled the resulting product. The Court held the recall exclusion should have been applied according to its "unambiguous terms," noting:

Our analysis of the sistership [product recall] exclusion leads us to conclude that it separately bars Hillside's claim. The essential focus of this clause limits coverage by excluding the cost of recalling apparently undamaged products to search for damaged components otherwise not yet discovered. Historically, the so-called sistership doctrine required that a manufacturer discovering damage to part of one airplane (referred to as an airship) would automatically initiate a recall of all other similarly equipped airplanes, referred to as the "sister ships" as a precaution to search for the same defect for obvious reasons of public safety. Exclusion "n" [the recall exclusion] was devised to make it plain that in such circumstances, "while [the insurers] intend 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."

Id. (Internal citations omitted) The *Hillside* Court further held "[w]e have interpreted the sistership exclusion to mean that it limits coverage when the manufacturer recalls all of the products rather than only those with a defect. *Id.* Because the recall in *Hillside* was a general one "extending to all of the beverages that bore Hillside's plant code without regard to whether they were actually contaminated or not... [it] falls squarely within the sistership concept and the exclusion." *Id.* Thus, the New Jersey court applied the product recall exclusion even where the recall applied to both actually and merely potentially defective products. *See also Hi-Port, Inc. v. Am. Int'l Specialty Lines Ins. Co.*, 22 F. Supp.2d 596 (S.D. Tx. 1997), *aff'd*, 161 F.3d 93 (5th Cir. 1998) (applying sistership exclusion where the recall encompassed all packages of antifreeze that were from the same batch as the packages containing antifreeze that had been shown to be

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defective, under the suspicion that all of the antifreeze from that batch would be similarly defective).

In *McNeilab, Inc. v. North River Insurance Co.*, 645 F. Supp. 525 (D.N.J. 1986), the court quoted the following statement made by the Insurance Services Office (“ISO”) regarding the purpose of the sistership exclusion:

If the named insured’s product causes injury or damage and *identical products* are withdrawn from the market or from use because of a known or suspected defect (one airplane crashes and others are withdrawn from use), the cost of withdrawing or replacing products or completed work may be either a direct expense to the insured or liability to others. Such cost, whether damages or expenses, are not intended to be covered. Sistership liability or products recall insurance is the subject of a special form of coverage.

[*Id.* at 541 (emphasis added).]

The above cases support the argument that coverage for a recall of both defective and potentially defective products would be properly excluded in a CGL policy by the product recall exclusion. Nevertheless, other courts may refuse to apply the product recall exclusion where *only* defective products are recalled or *both* defective and potentially defective products are recalled. For example, in *Centillum Communications, Inc. v. Atlantic Mut. Ins. Co.*, 528 F. Supp. 2d 940, 950 (N.D. Calif. 2007), the court held that the insurer had a duty to defend where testimony conflicted as to whether the product recall of internet routers was merely preventative, such that the product recall exclusion would apply, or requested that customers send back only *defective* router units that would not be excluded from coverage. In *Parker Hannifin*, cited above, the insurer asserted that the product recall exclusion precluded coverage for the recall of Zenith televisions containing the insured’s defective gasket. The court disagreed, holding that the recall of defective gaskets was not merely preventative and the damage to home and furnishings was resulting third party damage that was not clearly excluded by the product recall exclusion. 445 F. Supp. 2d at 834. Accordingly, the court held that the exclusion did not apply. *Id.* at 835.

b. Who Must Initiate the Recall?

The second potential impediment to application of the product recall exclusion is whether the insured must have initiated the recall for the exclusion to apply. A number of courts addressing the form of product recall exclusions in effect prior to 1985 have held that the product recall exclusion does not apply if the recall is ordered or undertaken by a third party. Instead the exclusion only applies if the insured itself conducts the recall.

In *Thomas J. Lipton, Inc. v. Liberty Mutual Insurance Co.*, 34 N.Y.2d 356, 357 N.Y.S.2d 705 (1974), the insured sold contaminated egg noodles to Lipton, which incorporated the noodles into its soups. *Id.* at 358, 706. When Lipton discovered the contamination, it withdrew the

affected soups from the market and destroyed them. *Id.* The product recall exclusion in *Lipton* stated, “This insurance does not apply . . . to damages claimed for the withdrawal, inspection, repair, replacement, or loss of use of the named insured’s products or work completed by or for the named insured or of any property of which such products or work forms a part if such products, work or property are withdrawn from the market or from use because of any known or suspected defect or deficiency therein.” The court held that this exclusion applied only when the *insured* institutes a recall, not when a third party does so even though there is nothing in the wording of the exclusion that imposes this requirement. *Id.* at 360, 707. Because Lipton, not the insured, instituted the recall at issue in that case, the Court concluded that the product recall exclusion did not apply. *Id.* See also, *United States Fire Ins. Co. v. Good Humor Corp.*, 173 Wis. 2d 804 (Wisc. 1993) (ambiguity of the wording and the etymology of the exclusion supports Wisconsin Supreme Court’s holding that insured must initiate the recall for exclusion to apply); *Olympic Steamship Co. v. Centennial Ins. Co.*, 117 Wn. 2d 37 (Wash. 1991) (history of sistership exclusion supported court’s holding that the recall must be initiated by the insured for the exclusion to apply).

The holding in *Lipton* is unlikely to control the interpretation of the wording of the exclusion in more recent policies that specifically provides that it is applicable regardless of who institutes the recall. The exclusion in more recent policies bars coverage for “loss, cost or expense incurred by [the insured] *or others* for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal” of the insured’s product or “impaired property” if it is “withdrawn or recalled from the market or from use *by any person or organization* because of a known or suspected defect, deficiency, inadequacy or dangerous condition in it” (emphasis added). However, some courts addressing the new wording above continue to restrict its use to recalls initiated by the insured. See e.g., *Amerisure Mut. Ins. Co v. Hall Steel Co.*, 2009 Mich. App. LEXIS 2545, *16 (Ct. App. Mich. Dec. 10, 2009).

c. Was the Insured’s Product Recalled?

The wording of the product recall exclusion requires that the recall or withdrawal be of the insured’s product or impaired property. As discussed above, this determination will be fact specific and potentially dependent on the jurisdiction. For example, in *Elco Industries, Inc. v. Liberty Mutual Insurance Co.*, 90 Ill. App. 3d 1106 (1st Dist. 1980), discussed above, the Illinois appellate court held that where the customer recalled its engines that incorporated the insured’s defective pins and the pins were found to have caused damage to the gaskets and plugs in the customer’s engine, the policy’s product recall exclusion was not applicable. *Elco*, 90 Ill. App. 3d at 1110-11. See also, *Cytosol Laboratories, Inc. v. Fed. Ins. Co.*, 536 F. Supp.2d 80 (D. Mass. 2008) (where the insured manufactured a defective saline solution but packaged it in boxes with another company’s label and shipped it to that company for it to sell, the recall exclusion applied because the recall was of the insured’s product); *Sokol and Co. v Atlantic Mut. Ins. Co.*, 430 F.3d 417, 424 (7th Cir. 2005) (recall exclusion applied to preclude coverage for customer’s claim against insured for costs to remove from the market the customer’s cookie mix incorporating the insured’s packets of rancid peanut butter); *Silgan Containers*, 2010 U.S. Dist. LEXIS 30100 at *24 (holding recall exclusion precludes coverage for approximately \$340,000 claimed for the costs of “inspecting, gathering, sorting, and segregating” defective pull-top fruit cocktail cans).

C. Conclusions on CGL Coverage for Product Recall Claims

As is evident by the cases and issues outlined above, the application of a CGL policy to claims related to product recalls will be highly dependent on the particular facts of the case and the applicable law. The various state and federal courts addressing these claims are approaching the coverage issues from different perspectives and sometimes with an apparent agenda or bias in favor of the insured. A close examination of the case law in the appropriate jurisdiction is needed to guide an insurer's analysis and coverage position in response to the tender of a product recall claim. Experts in the relevant production processes may also be needed to determine the applicability of certain exclusions.

III. Product Recall Claims under Specialty First Party Recall Policies

A. Common Attributes of Recall Policies

The market has developed specialized first party recall policies to address retailers' and manufacturers' need to cover claims that do not fit within the scope of the available liability policies. One insurer's product profile marketed to brokers explains:

Product recalls present real threats to retailers and manufacturers: loss of sales, customer confidence, hard-won retail shelf space, and supply contracts. Skillful handling of a recall can minimize damage demonstrating reliability and professionalism to wholesale and retail connections. Our Product Recall Insurance for defective products covers the key expense areas and also provides the expertise of independent consultants to guide the company through the critical first few weeks of a product recall.⁸

The purpose of the first party recall policy is to cover the insured's own economic losses, and in some cases the economic losses of its customers, that are caused by the recall of a contaminated or maliciously tampered-with product. Such costs may include the cost of recalling the product from customers, lost profits as well as the cost to rehabilitate the brand from the bad publicity following a recall. Some policies may also cover expenses and even lost profit suffered by a third party, such as the insured's customers. However, the recall policy does not typically cover the insured's defense costs for any third party action. The recall policy also typically excludes the cost of any resulting litigation with or proceeding before any governmental body.

At first glance, it may appear that a recall policy is intended to cover what a CGL policy does not cover - damages associated with a recall of the insured's product. However, although the policy covers the insured's own costs related to an insured event, it does not cover all such costs. In fact, the first party recall policies are typically very specific as to the types of costs and losses that are covered under the policies. This is evidenced by a common exclusion that precludes coverage for "[a]ny financial, economic, or consequential Loss, other than Recall Costs, which you are legally obligated to pay or is incurred by any third party even if this arises

⁸ AIG UK Limited "Product Recall Insurance: Defective Products, Product Profile for Brokers," February 2008.

out of an Insured Event.” As a result, the insured’s claims must fit within the specific categories of covered losses. For example, overtime costs for employees to address the recall may be covered while the base salaries for such employees are not. Product destruction costs that are incurred in the ordinary course of the insured’ business would not be covered, but the special disposal for a particular contaminated product would be covered.

B. Insuring Agreement of the Recall Policy

The insuring agreement of a first party recall policy typically has several important parts that must be satisfied before coverage will attach. One recall form may state that the insurer will reimburse the insured for its “Loss” and “Consultant Costs” “caused by or resulting from an “Insured Event.” The term "Insured Event" means any "Accidental Contamination" or "Malicious Tampering." The term “Loss,” may be defined to include “(i) Pre-incident Costs; and (ii) Recall Costs” The term “Loss” may also be expanded by endorsement to include loss of gross profit, extra expenses, replacement costs, rehabilitation expenses and extortion costs.

The insuring agreement of other recall policies may include the following requirements:

1. “accidental or unintentional contamination, impairment or mislabeling of an Insured Product(s),”
2. “which occurs during or as a result of its production, mixing, blending, compounding, manufacture, packaging or distribution”
3. “use or consumption of such Insured Product(s) has resulted in or would result in Bodily Injury or Property Damage”

The wording of the insuring agreement is critical to the coverage determination and court decisions must be carefully analyzed to determine if they address the same or substantially similar wording.

In *Fresh Express Incorporated v. Beazley Syndicate 2623/623 at Lloyd’s*, 199 Cal. App. 4th 1038, 1058 (6th Dist. 2011), the California appellate court held that the insured, Fresh Express, a bagged spinach producer, was not entitled to coverage under its “TotalRecall+ - Brand Protection” policy where it had not met the requirements of the policy’s insuring agreement. The policy required that the insured’s claimed “Loss” arise from an “Insured Event.” *Id.* at 1053. The term “Insured Event” was defined as “Malicious Contamination, Products Extortion or Accidental Contamination.” The term “Accidental Contamination” was defined as:

error by [Fresh Express] in the manufacture, production, processing, preparation, assembly, blending, mixing, compounding, packaging or labeling (including instructions for use) of any Insured Products that has led or would lead to: i) bodily injury, sickness, disease or death of any

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person(s) or animal(s)...or ii) physical damage to or destruction of tangible property (other than the Insured Products themselves).

[*Id.* at 1053-54.]

Fresh Express' claims for recall coverage stemmed from a September 2006 advisory by the FDA to consumers to not eat bagged spinach following a wide-spread outbreak of E. Coli-related illnesses. *Id.* at 1040. The FDA could not immediately pinpoint the cause of the contamination but contacted Fresh Express and other manufacturers to recommend that they recall their bagged spinach products. *Id.* at 1045. In response, Fresh Express stopped production and distribution of bagged spinach and began an internal investigation of its own sourcing for its bagged spinach products. The investigation revealed that Fresh Express had not followed its own quality control procedures of inspecting the farms from which it purchased its spinach. Fresh Express asserted that because of its own errors, it was not able to request an exemption from the FDA's advisory. *Id.* at 1046, n.10. The FDA also advised that Fresh Express' spinach had been initially identified by two Kentucky consumers as a possible source of their e.coli related illness. *Id.* at 1046. The source of the spinach contamination was subsequently determined to be a supplier that had not been used by Fresh Express. The source of the Kentucky contamination was also determined not to be caused by Fresh Express' product. *Id.* at 1048. Fresh Express claimed losses in excess of \$12 million, the limits of its recall policy.

The *Fresh Express* Court rejected the insured's arguments that the Insured Event was the E. Coli outbreak and that it was entitled to all losses arising from the outbreak. *Id.* at 1053. The court held that under the definitions of Insured Event and Accidental Contamination, the claimed losses must have arisen from Fresh Express' error to be covered under the policy. *Id.* The evidence presented established that Fresh Express incurred losses from the E. Coli outbreak before, and independent from, its discovery of its own internal errors. *Id.* at 1057-58. As a result, the court held Fresh Express was not entitled to coverage under the TotalProtect+ recall policy. *Id.* at 1058.

1. "Accidental Contamination"

For recall policies in which coverage is conditioned on the existence of an "Accidental Contamination", the term is typically defined as follows:

Any accidental or unintentional contamination, impairment or mislabeling of an Insured Product(s), which occurs during or as a result of its production, mixing, blending, compounding, manufacture, packaging or distribution; provided that the use or consumption of such Insured Product(s) has resulted in or would result in Bodily Injury or Property Damage."

Under the above definition, the use or consumption of the Insured Product must result in (or would result in) Bodily Injury or Property Damage (meaning physical damage to or destruction of tangible property other than to the Insured Product). Under a recall policy, "Bodily Injury" typically means "death, or clear, identifiable internal or external visible physical symptoms of

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injury, sickness or disease sustained by a person." "Property Damage" is typically defined as "physical damage to or destruction of tangible property other than to Insured Product(s)."

In *The Limited, Inc. v. CIGNA Insurance Company*, 228 F. Supp. 574 (E.D. Pa. 2001), the District Court considered a definition of accidental contamination that required an accidental or unintentional adulteration of a covered product. The Insured, Bath and Body Works, a subsidiary of the named insured, The Limited, recalled a pressurized soap foam dispenser following claims of eye irritation caused by the inadvertent spray of foam from the dispensers. *Id.* at 577. The court held that the product was not "accidentally contaminated" or "adulterated." The container merely malfunctioned and there was therefore no coverage under the product recall policy at issue. *Id.* at 580.

Two reported decisions nationwide have addressed the issue of whether the subject contamination must occur during the insured's processing for coverage to exist under a recall policy. In both cases, the contamination was the result of prior contamination of ingredients supplied to the Named Insured. But the courts' holdings diverge. In *Caudill Seed & Warehouse Co. Inc. v. Houston CA's Co.*, 835 F. Supp. 2d 329, 336, the court found no coverage where contaminated peanuts were contaminated prior to the Named Insured's receipt. Conversely, in *Ruiz Food Products, Inc. v. Catlin Underwriting U.S.*, 2012 U.S. Dist. LEXIS 131031 (E.D. CA Sept. 13, 2012), under policy wording nearly identical to that at issue in *Caudill Seed*, the court rejected the *Caudill Seed* Court's holding on the grounds that it failed to consider the expanded definition of Insured Product that included ingredients.

2. "Insured Product"

As mentioned above, the insuring agreement of a recall policy requires that the contamination or tampering be of an "Insured Product." The definition of "*Insured Product(s)*" is typically as follows:

[A]ll topical and ingestible products for human use or consumption, including any of their ingredients, components and/or packaging, provided such products:

- i. are in production by the *Insured(s)*; or
- ii. have been manufactured, handled or distributed by the *Insured(s)*; or
- iii. have been manufactured by any contract manufacturer for the *Insured(s)*; or
- iv. are being prepared for or are available for sale by the *Insured(s)*; or
- v. were provided by the *Insured(s)* to a customer of the *Insured(s)* and have become an ingredient in a product

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manufactured, distributed or handled by such customer. However, coverage shall only apply if the *Insured(s)* would be legally obligated to reimburse the customer for such *Loss*.

Subsection v. of the definition of “Insured Product” in the recall policy cited above includes in the definition products that “were provided by the Insured(s) to a customer of the Insured(s) and have become an ingredient in a product manufactured, distributed or handled by such customer. However, coverage shall only apply if the Insured would be legally obligated to reimburse the customer for such Loss.” The Insured’s customers may assert that their product that incorporates the Insured Product is also an Insured Product under subsections other than Subsection v., and thus not subject to the “legally obligated” requirement of the final clause. For example, Subsection i for products “in production by the Insured” or Subsection ii. for products “manufactured, handled or distributed by the Insured” are certainly broad enough to encompass a combined product and would avoid the argument that there is no coverage due to the lack of a legal obligation by the insured to reimburse the customer.

3. “Property Damage”

Coverage may not exist under a product recall policy where the definition of Insured Product is broad such that it includes components provided to a customer of the Insured that have become an ingredient or component part in a product manufactured, distributed or handled by such customer. In such a case, a customer’s product may also be considered the Insured Product and there may arguably be no third party Property Damage caused by the Insured’s Product. As a result, if there is also no potential for bodily injury, the requirements of an “Accidental Contamination” may not be met.

4. “Bodily Injury”

The term “Bodily Injury” is typically defined within the recall policy as “death, or clear, identifiable, internal or external visible physical symptoms of injury, sickness or disease sustained by a person.” Where a recall is conducted as a precaution, and there is no actual contamination of the product, there is no possibility or probability that bodily injury could result. Under such circumstances, a few reported U.S. cases have found there is no coverage. Such cases would also arguably support the position that where confirmed contamination could not possibly cause bodily injury, there is no coverage.

In *Little Lady Foods, Inc. v. Houston Casualty Co.*, 819 F. Supp. 2d 759 (E.D. Ill. 2011), the court held that there was no recall coverage where testing revealed the presence of listeria genus bacteria in the burrito product samples, but not listeria monocytogenes (“LM”), the only strain that would cause “physical symptoms of bodily injury, sickness, disease or death in humans.” *Id.* at 761. Houston Casualty denied coverage under its recall policy on the grounds that in the absence of a positive test for LM, there was no Accidental Contamination, defined in the policy as requiring that within 120 days of use of the contaminated product such use resulted in or may likely result in physical symptoms of bodily injury, sickness or disease or death of any person. *Id.* at 760 - 761. The parties took conflicting positions as to whether the policy wording

required that harm to consumers be probable or merely possible. The court found “that debate misses the point” where the harm to consumers was neither “probable” nor “possible” as the products were not contaminated with LM, the only bacteria that could cause such harm. *Id.* at 763. As a result, the court found there was no coverage for the contamination claims at issue. *Id.* at 761.

Similarly, in *Ruiz Food Products, Inc. v. Catlin Underwriting U.S.*, 2012 U.S. Dist. LEXIS 131031, *16 (E.D. Calif. Sept. 13, 2012), the California District Court held that “[r]ecalls generally, even if related to a belief that a product has been contaminated, does not qualify [sic] as a contamination under an accidental contamination policy.” (citations omitted). In *Ruiz*, hydrolyzed vegetable protein (“HVP”), an ingredient in Ruiz frozen Tornados was the subject of a Class One recall by its producer, Basic Food Flavors. Equipment in the Basic facility and one lot of HVP tested positive for Salmonella. A different lot of HVP subject to the recall was sent to Superior Quality Foods and used to make the beef mixture contained in Ruiz’ frozen Tornados. Because of Basic’s recall of HPV, Superior issued a recall of its beef spice mix. Once Ruiz was notified of Superior’s recall, Ruiz placed its Tornados product on hold and tested samples. All tests were negative for salmonella. *Id.* at *6. The District Court found that because there was no actual contamination in Ruiz’ Tornados, there was no coverage under Ruiz’ recall policy that required that the use or consumption of the Insured Product “has resulted, or would result in clearly identifiable internal or external symptoms of bodily injury sickness, disease or death.” *Id.* at *17-18.

In *Hot Stuff Foods, LLC v. Houston Casualty Company*, 2012 U.S. Dist. LEXIS 92900 (D. S.D. 2012) the South Dakota District Court found that the requirement to find “accidental contamination” that the contamination “may likely result” in symptoms of bodily injury was ambiguous and would be interpreted against the insurer. In *Hot Stuff*, the insured manufacturer recalled frozen breakfast sandwiches whose labels did not indicate that they contained MSG, a flavor enhancer. *Id.* at *3. As the court found the term “may likely result” to be ambiguous, it held that if there was a possibility that MSG may cause symptoms of bodily injury to even a single consumer, it was sufficient to meet the definition of “accidental contamination.” *Id.* at *25-26. Summary judgment was granted in the insured’s favor. *Id.* at *23.

C. Recoverable “Loss” under a Recall Policy

The recall policy typically covers “Loss,” defined as i.) Pre-Incident Costs; ii.) Recall Costs; and iii.) Consultant Costs.” Loss may be further limited to expenses and costs incurred within 12 months of the Insured Event (typically the Accidental Contamination) first becoming known to the Insured. By specific endorsement, the definition of Loss may be amended to include Loss of Gross Profit, Rehabilitation Expenses, and Replacement Costs, among other resulting cost elements. We address several of these cost components below.

1. Testing Costs

Testing costs frequently constitute a significant percentage of an insured’s claims under a recall policy.

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Testing costs may be recoverable under a recall policy as Pre-Incident Costs. The term “Pre-Incident Costs” may be defined as “chemical analysis and/or physical examination in order to ascertain whether the Insured Product(s) has been contaminated and/or to ascertain the potential effect of Accidental Contamination or Malicious Tampering.” A court could broadly view this definition to find that it encompasses a wide array of testing.

A recall policy may provide that it “does not apply to any Loss arising out of, based upon, attributable to or involving, directly or indirectly ... Any costs associated with the expense to design or redesign, engineer or re-engineer any Insured Product(s).” This exclusion, standing alone, would preclude coverage for all claimed testing costs other than those incurred in connection with the investigation of the subject contamination. However, insureds may purchase an endorsement that covers expenses to re-establish the Insured Product to the reasonably projected level of prior sales.

2. “Recall Costs”

The majority of an insured’s recovery under a recall policy will in most cases be governed by the policy’s definition of “Recall Costs” which typically provides:

[T]he reasonable costs incurred by the Insured for the recall, withdrawal, removal, recovery of possession or control, or disposal of such affected Insured Product(s) pursuant to an Insured Event. These costs are limited to the following:

- i. The cost of newspaper, magazine or any printed advertising . . . radio and television announcements or commercials, as well as the cost of correspondence regarding or concerning the recall.
- ii. The cost of shipping the Insured Product from any purchaser, distributor or user to the place or places the Insured designates.
- iii. The cost to rent additional warehouse or storage space.
- iv. The cost of hiring additional person(s), other than regular employees of the Insured, to assist with the recall of the Insured Product(s).
- v. Overtime paid to regular employees, other than salaried employees, of the Insured for work devoted exclusively to the recall of the Insured Product(s).
- vi. Expenses (incl. transportation and accommodation costs) incurred by employees directly attributable to the recall of the Insured Product(s).

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- vii. The cost of disposal of the Insured Product(s), to the extent that specific methods of disposal other than those usually employed for trash discarding or disposal, are required to avoid Bodily Injury or Property Damage as a result of such disposal.
- viii. Expenses incurred to properly dispose of the unused packaging and point of purchasing marketing material of recalled Insured Product(s) if such packaging or material cannot be reused.
- ix. The actual cost to redistribute any recalled Insured Product(s).
- x. Retail slotting fees and cancellation fees for any advertising and/or promotion programs, which were scheduled but were unable to be executed solely because of an Insured Event.
- xi. Retailers' and other third party Recall Costs incurred during the recall of the Insured Product(s).

Very few reported cases address the components of Recall Costs and such claims will more frequently be resolved through party-to-party negotiations. One reported decision addresses various components of a product recall claim. In *Caudill Seed & Warehouse Co., Inc. v. Houston Casualty Co.*, 835 F. Supp. 2d 329 (W.D. Ky 2011), the court addressed claims by the insured for lost gross profit, in-house inventory, returned material from customers, freight costs for returns, labor costs, legal fees and consulting fees arising from a covered claim for alfalfa contaminated with salmonella. We address several key elements of Recall Costs below and the *Caudill Seed* decision where applicable.

a. Labor

Under a recall policy, labor costs are covered under certain circumstances. Recall Costs include the following:

- v. The cost of hiring additional person(s), other than regular employees of the Insured, to assist with the recall of the Insured Product(s).
- vi. Overtime paid to regular employees, other than salaried employees, of the Insured for work devoted exclusively to the recall of the Insured Product(s).

Insurers should pay particular attention to the insured's submissions on this cost element. Frequently, insureds will claim the cost of regular employees (using a per diem rate calculated

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based on the employee's annual salary divided by the number of work days). There is no coverage under the typical recall policy for the regular salary of existing employees. The employee must be hired specifically to assist with the recall or the amounts claimed must represent overtime payments to regular employees.

b. Employee Expenses

Under a recall policy, the definition of Recall Costs includes "Expenses (incl. transportation and accommodation costs) incurred by employees directly attributable to the recall of the Insured Products." Particular attention should be paid to the expenses submitted for reimbursement. The insured should document how the expense is directly related to the Insured Event and should provide sufficient documentation that the cost was incurred.

c. Product Destruction

Product destruction costs may be recoverable as a Recall Cost as "the cost of disposal of the Insured Product, to the extent that specific methods of disposal other than those usually employed for trash discarding or disposal, are required to avoid Bodily Injury or Property Damage as a result of such disposal." If the contaminated product can be disposed of in the regular course of the insured's business, there would be no coverage. The costs of disposal can vary greatly and the insurer should obtain both documentation as to the cost of the disposal and a written confirmation that the disposal actually took place.

3. Consultant Costs

A recall policy may allow recovery of consultants' costs only if the company's pre-approved consultants are retained. In *Caudill Seed Warehouse Co., Inc. v. Houston Cas. Co.*, 1835 F. Supp. 2d 329 (W.D. KY 2011) the Kentucky District Court upheld the recall policy requirement that outside consultants are limited to the consultant identified in the policy, with which the insurer had a relationship or a consultant retained with the insurer's consent. *Id.* at 338. The court found no coverage for the insured's retained public relations consultant retained without the insurer's consent. *Id.* Many insureds will attempt to submit the cost of unapproved consultants, including the insured's forensic accountant or broker who assists with the presentation of the recall claim to the insurer.

4. "Replacement Costs"

The definition of Loss may be amended by endorsement to include Replacement Costs. Such an endorsement may define Replacement Costs as:

- i. The total amount of refunds the Insured(s) gives to purchasers not to exceed the cost of goods sold.
- ii. The costs to repair the Insured Product(s), including the cost to return the Insured Product(s) to the purchaser, and the cost to repair unsold stock.

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- iii. If the Insured Product (s) cannot be replaced, the cost to produce or acquire a like replacement product, including the cost to return the Insured Product(s) to the purchaser, not to exceed the cost of goods sold.
- iv. If the Insured Product(s) cannot be repaired, reconditioned, decontaminated or otherwise treated so as to render it marketable, the cost of unsold finished stocks.

Insureds may seek to recover as Replacement Costs, the cost of affected materials that remain in their warehouse. From a coverage point of view, a claim for the cost of such held materials does not fit within the first three categories of the definition of Replacement Costs. Such claims do not reflect a refund to a customer (under subsection (i)); the costs to repair the products to return them to a customer (under subsection (ii)); or the cost to produce or acquire a like replacement product (under subsection (iii)). A held materials claim conceivably falls within the fourth category, i.e. if the product cannot be decontaminated, the cost of unsold finished stocks (under subsection (iv)). In *Caudill Seed*, discussed above, the Kentucky District Court broadly read the definition of Recall Costs, as amended by an Endorsement, to potentially include the value of destroyed in-house inventory and returned material from customers. 835 F. Supp. 2d at 338. However, the court declined to grant summary judgment on the issue of whether such claim items may also be “reasonable recall expenses that were necessarily incurred in the procedure of recall, inspection, examination, destruction or disposal” as this required a factual determination precluding summary judgment. *Id.*

5. “Loss of Gross Profit”

By endorsement, an insured may be entitled to claim profits lost as a result of a recall. A Loss of Gross Profit Endorsement may provide in relevant part:

1. It is understood and agreed that the definition of Loss under Section 2 is amended to include Loss of Gross Profit.

The term “Loss of Gross Profit” is defined in the endorsement as:

the Insured(s) sales revenue projected prior to the happening of the Insured Event, but which has been lost during a period of 12 months beginning after the decrease in sales attributable to and caused directly by an Insured Event:

- i. less the variable costs that would have been incurred during the same period, but which have been saved as a result of not making those sales (including the cost of raw materials and all other saved costs) and less.

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- ii. less the increased sales of another Insured Product(s) within the same product line as the affected product(s) claimed in the Loss as a result of the Insured Event.

The endorsement may also provide the method of computing the lost profit:

COMPUTATION OF LOSS

- iii. Loss of Gross Profit shall be assessed by the Insurer based on an analysis of the profits generated by the affected Insured Product(s) and other Insured Product(s) which lost sales as a direct result of the Insured Event, during each month of the twelve (12) months prior to the Insured Event and taking into account:
 - a) The future profitability of such product(s) had no Insured Event occurred; and
 - b) All material changes in the market conditions of any nature whatsoever that would have affected the future marketing of and profits generated by the Insured Product(s) or other affected insured Product(s).

The above provisions allow recovery of Loss of Gross Profit attributable both to the affected Insured Product and other Insured Products that lost sales as a direct result of the Insured Event. However, the calculation is also required to take into consideration the future profitability of the product if there had been no Insured Event and changes in the market conditions that would have affected the future marketing of, and profits from, the Insured Product.

Some recall policies may also provide coverage for the insured's customer's claimed lost profit. In either case, the insurer is well advised to retain a forensic accountant to address the method of calculation and factors other than the recall that may impact claimed profits.

D. Concluding Comments on Specialty Recall Policies

The product recall policy, perhaps more aptly referred to as an accidental contamination and malicious tampering policy, provides a specific type of coverage under specified circumstances. As discussed above, it clearly does not apply to all possible product recall scenarios and does not cover all related costs unless they fall within the specified contracted-for categories. There is no defense obligation under the recall policy and insurers should be careful to so advise insureds, claimants, and other insurers that the policies do not have a defense obligation and do not indemnify for defense costs. The policies are at times misunderstood in

the market generally and this can lead to unsupported claims for contribution against the recall insurer.

Insurers should require adequate documentation concerning the above categories of claimed losses, including invoices where appropriate. Many insurers will retain an outside forensic accountant and an attorney to assist in their review of voluminous cost submissions. This type of review by accountants or attorneys may be necessary to prevent the submission of unsubstantiated costs or costs not directly related to an Insured Event.

IV. Conclusions

As discussed at length above, there are a number of issues that arise in considering a particular tender of a product recall claim. If the claim is tendered to the CGL policy, the insurer will need to determine if there have been allegations of an occurrence and third party property damage. The incorporation of an insured's products into other products may complicate this analysis. The application of various business risk exclusions (including the "Your Product", "Impaired Property" and "Product Recall" exclusions) also come into play, and may be interpreted differently depending on the applicable jurisdiction's laws. A close analysis of the underlying demand or suit, the policy wording and the jurisdiction's applicable case law will be necessary to reach the appropriate coverage determination.

If the product recall claims is tendered to the first party product recall policy, the insurer should pay particular attention to the submitted claims, requiring invoices and other documentation where appropriate, to allow the insurer to understand the types of costs being claimed, the method of their calculation and how they are recoverable under a specific provision of the recall policy. Insurers should be particularly mindful of the wording of the applicable insuring agreement to ensure that the type of contamination at issue has actually caused property damage or, subject to the policy's wording, has or would result in bodily injury. As these policies do not typically have a defense obligation, particular attention should be paid to any claims for a defense or reimbursement of defense costs from the insured, the claimant or other insurers of either.

The above discussion provides only an overview of the most prominent issues in insurance coverage for product recall claims. Individual claims may present additional issues such as the primacy of coverage between specialty and CGL coverage; the effect of vendors' endorsements and additional insured coverage on the "your product" and "impaired property" exclusions; and the analysis of class action suits, to name just a few.