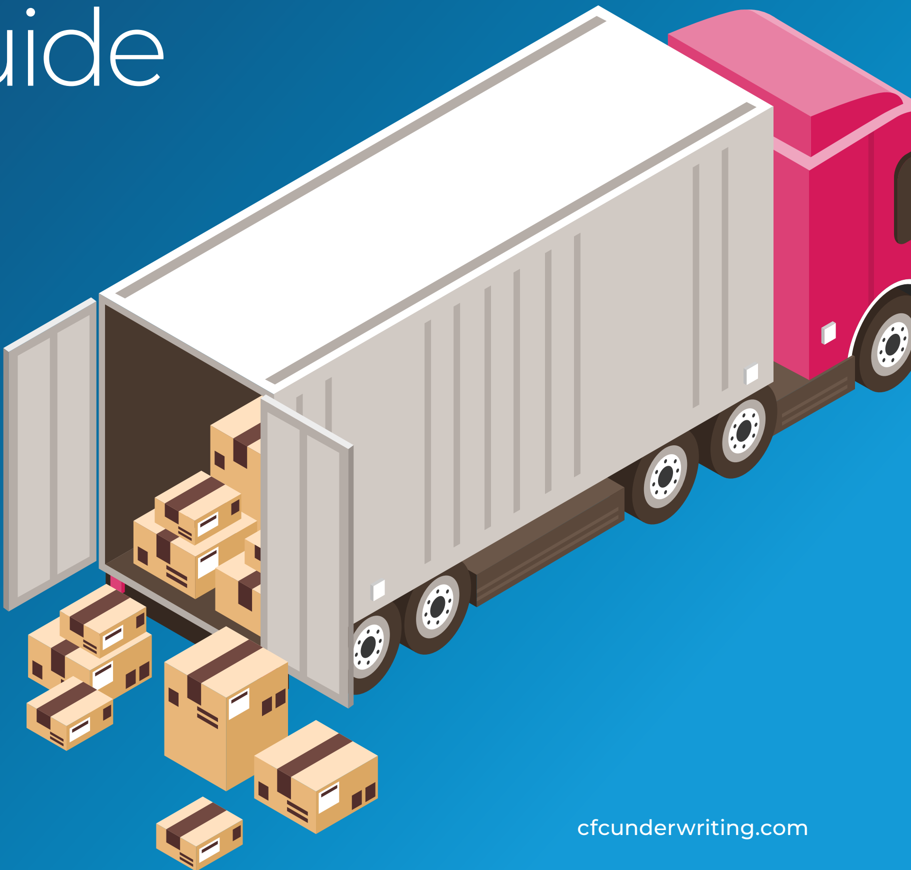
Product recall insurance guide



cfcunderwriting.com

Contents

What happens during a product recall?

A product recall happens when a manufacturer becomes aware of a safety issue in their product and requests it to be returned from the consumer or removed from shelves.

The safety issue could be real – in that it has already, or could likely, cause the consumer bodily harm - or the issue could be threatened or alleged by a member of the public.

When a safety issue is discovered, it kicks off a series of events leading up to and surrounding the recall itself. The manufacturer will have an obligation to notify their regulator immediately, and in most cases they will have to notify the general public, including their customers, their suppliers and other stakeholders.

Often, the most challenging and expensive part of a recall is keeping the business operational while facing intense public and regulatory scrutiny.

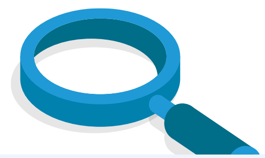
At the same time, the manufacturer will be responsible for identifying and quarantining the affected products, determining the cause of the safety issue and where it came from (was it a faulty component, or a defective or incorrect raw ingredient?), as well as establishing how long the issue has been present. This may require a site inspection or shutdown, and likely some form of independent testing by a regulator or third-party.

Logistically, executing the recall itself can be costly and complex in addition to addressing the underlying issues. In some cases, recalling the defective item may suffice, but in most cases the business will need to invest time and money into replacing ingredients or repairing parts, identifying new suppliers or even bringing in temporary contractors.

Often, the most challenging and expensive part of a recall is keeping the business operational while facing intense public and regulatory scrutiny. For some businesses, a product recall can present a true business crisis. Managing a recall event carefully and quickly is critical to limiting the impact to consumers as well as the manufacturer's own business.

Understanding the cost of a recall

There are many costs involved when a product safety issue is discovered. Along with the costs of withdrawing the product from consumers, there are also costs associated with identifying what went wrong and remediating it, as well as keeping the business afloat. Below are the most common costs associated with a product recall.



Identifying the issue

- Internal or third-party testing
- Employing experts / consultants
- Closing facilities or suspending production
- Cleaning, fixing or replacing equipment

Conducting the recall

- Issuing notices to consumers
- Transporting, storing, destroying or disposing of affected products
- Replacing ingredients, materials or products
- Retailer per store fees
- Overtime for employees
- Crisis communications & PR

Business continuity

- Ongoing loss of sales or customers
- Cancelled contracts
- Replacing suppliers or hiring contract manufacturers
- Prolonged interruption of production
- Stalled R&D, M&A or other investments
- Impact of brand & reputational damage

Want to know more? Get in touch productrecall@cfcunderwriting.com

Industries most often hit by recalls

A recall can hit any manufacturer or distributor regardless of the sector. Recalls of food & beverage products and certain consumer packaged goods (CPG) tend to garner mainstream attention depending on the severity of the issue.

Small to medium-sized enterprise (SME) manufacturers are often less financially able to deal with the increased spending and restricted cash flow during a recall event. These businesses are usually selling products in a highly competitive market, where customers can easily find an alternative supplier. Similarly, those working on highly specialised products can see their fledgling sales destroyed by a product safety issue.

Food and beverage

- Meat
- Fresh fruit and vegetables
- Confectionary
- Pet food
- 'Free-from' products
- Health products (vitamins, protein powder etc)
- Food & beverage products under contract for third-parties

Other consumer products

- Electronic, metal and plastic components
- Medical devices / instruments
- Household goods

Automotive components

- Nuts, bolts and springs
- Fasteners and harnessing
- Electrical components like sensors, lights, wiring and circuit boards

Contamination considerations

Recall insurance is particularly useful for those manufacturing or distributing food & beverage products. There are aspects of this industry which make it a very challenging business environment and companies operating in this area are vulnerable to damaging product and brand issues in various ways.

Shifts in climate, geo-politics, demographics and appetites are driving huge changes in the food and beverage markets, both in terms of what consumers are buying and where the products are sourced.

The largest food & beverage recall of 2019 was for 11.8m lbs of ready-to-eat chicken.

In addition, increasing rates of allergen susceptibility and zero regulatory tolerance for contamination issues significantly ramps up the pressure on food and beverage manufacturers. The sheer rate of recalls, withdrawals, allergen advisories and large-scale outbreaks is making the need for risk transfer in the event of contamination an acute one for all companies operating in the industry.

And, unlike other areas of manufacturing, supply chains are not as stable, reliable nor as contractually watertight in the food and beverage space. Supply chain relationships tend to be shorter and have higher turn-over, making it difficult to pursue and hold accountable the at-fault supplier.

Want to know more? Get in touch productrecall@cfcunderwriting.com

How does a policy work?

> Product recall insurance helps safeguard a business from the financial impact of a recall, specifically the first and third-party costs associated with identifying and addressing the issue, conducting the recall and keeping the business operational.

Recalls of any kind can impact cash flow, squeezing a company's ability to pay staff, purchase raw materials or even continue production. While many companies have adequate protection from third-party lawsuits, they often do not have sufficient protection for their own costs.

A good recall policy should protect a business against a multitude of exposures, both internal and external. Standard covers include:

Rectification cover

The is one of the most significant areas of cost during a product recall. This section of cover should address both premise and product rectification costs, ranging from cleaning and recalibrating buildings or equipment, replacing and redistributing products as well as associated staff costs.

Manufacturing error and cyber product safety

Whether human error or malfunctioning machinery, this section of cover will trigger if there is a production error resulting in the product being hazardous. Cover is provided for safety critical errors arising from the production, programming and coding of software.

Malicious tamper and extortion

This section of cover will address the costs associated with recalling a product that was altered or tampered with by a malicious person giving rise to a product safety issue. This includes threats or extortion demands. Modern recall policies will also cover alteration or tampering carried out by cyber means.

Government actions

Regulatory intervention can occur at any time and their involvement is unavoidable. Regulators often have a 'recall first, ask questions later' policy so it is important to have insurance coverage for any recalls they recommend or enforce. This can mean that you may be forced to withdraw your product even where there is nothing wrong with it. Your policy should ensure these costs are covered, too.

Business interruption

In addition to rectification costs, a product recall policy can offer cover for future loss of sales for a defined indemnity period, while the product remains unavailable for sale or while production is forced to halt.

Negative publicity, brand & reputation protection

Recall events can garner negative attention in the press or on social media. The section of cover will address the costs associated with specialist crisis media management during and after the event, as well as advertising and promotional activity to repair the brand in the immediate aftermath.

Product guarantee

Often a product is not a safety hazard but has accidently been manufactured out of specification. Some product recall insurance policies will trigger even in the event of contractual performance specification not being met.

Extra cover:

- Recall event liability: coverage for claims for damages from customers as well as legal defence costs in the event of a recall
- Claims preparation costs: business interruption claims can be costly, some policies will provide cover
- Retailer costs: retailers are increasingly introducing administrations costs, among other charges, to their contracts that will be charged in the event of a product withdrawal incident

Did you know?

Recall in traditional policies

Some policies such as general liability or products liability may include an element of recall insurance, but this can be misleading. Under these policies, businesses may be protected from third-party claims but first-party costs are generally not covered (or the cover is extremely limited). The recall sub-limits in traditional policies are usually small and often leave companies grossly underinsured. Triggering these sub-limits can also be difficult as the wordings are narrow.

Want to know more? Get in touch productrecall@cfcunderwriting.com

Coverage enhancements

With the world rapidly changing, product recall exposure has developed further than the traditional bodily injury and property damage triggers. As public demand and regulatory response evolve, it's important to look for specific coverage enhancements that address the needs of manufacturing companies in todays world.

Animal by-product

A product is labelled as vegan or vegetarian, but is found to contain traces of animal DNA it can cause major reputational and business issues. An animal by-product endorsement can provide an extension to cover for the ensuing recall event.

Religious specification

A product is found by a certifying body to not meet a religious specification (e.g. Kosher, Halal). A religious specification endorsement provides cover for this type of occurance.

Regulatory advisory

In light of the romaine lettuce events seen in the US, a regulatory advisory endorsement could provide cover for the loss of sales should a regulator issue advice to recall or not consume a product.

Software product safety

Software product safety provides cover should a recall event be triggered by the software element of a product, rather than the physical product itself. This ensures no gaps in coverage for firmware and software products.

Want to know more? Get in touch productrecall@cfcunderwriting.com

The reality of reputational harm

Negative publicity surrounding a product recall can cause significant reputational damage and a long-lasting impact on consumer trust.

Large-scale product recalls, particularly those involving food or beverage products, consumer goods like children's or baby products and automotive related products, tend to capture widespread media attention.

Consider the experience of Toyota when it was hit by back-to-back recalls. As a result, the company's brand score and reputation index dropped significantly, reflecting the increasingly negative commentary heard by consumers[3]. The company's sales were also hit as a result.

In the age of social media, even smaller manufacturers or distributors can experience the impact of negative publicity on their brand. A manufacturer's reputation can also be affected by an industry-wide recall, even when the business itself is not directly at fault.

While a business cannot always avoid the immediate negative coverage generated by a recall, it can control how it responds, both in the press and online. The right kind of crisis response and overall media management by the brand can be a powerful way to turn a negative situation on its head and mitigate the impact to the brand's bottom line.

[3] www.marketingweek.com/toyotas-brand-perception-damaged-by-recall/

Policies in action: Claims examples

F&B manufacturer suffers accidental glass contamination

A pie manufacturer received a complaint from a consumer after they found a small shard of glass in their product. The contaminated pie had been purchased at a nationwide retail chain, and the supermarket quickly removed all the manufacturer's products from their shelves, as well as cancelling all future orders.

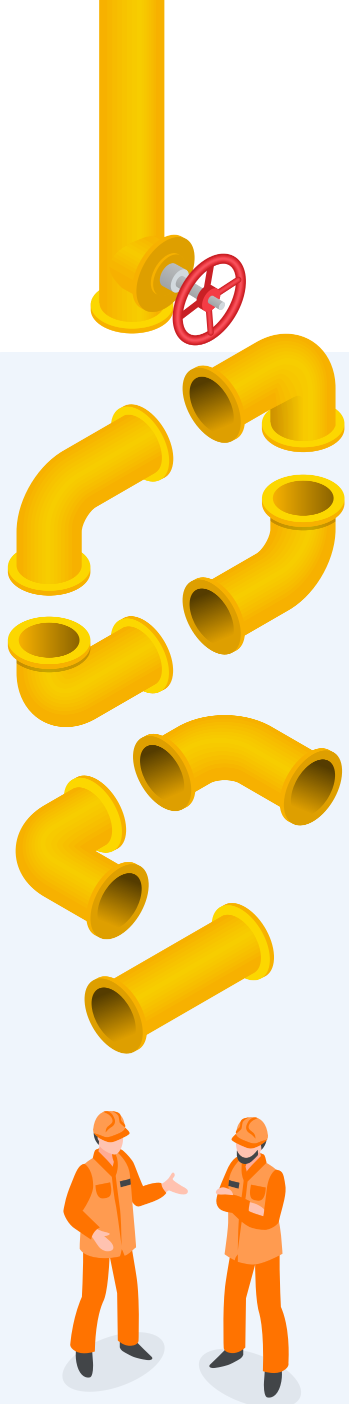
The pie manufacturer recalled the contaminated pies and had to shut down their production line for a factory inspection, and almost wiping out a year's worth of the manufacturer's profit. For a company highly dependent on cash flow, this kind of event can threaten the very survival of the business. The product recall policy covered the cost of the pie manufacturer, and its retailers, recalling the products, the lost business income, the efforts to check and clean the factory, as well as the costs to rehabilitate the company's brand and return sales to pre-incident levels.

Manufacturer left in the lurch by bankrupt supplier

A meat processing business has been producing steaks for wholesalers. Roughly 70 percent of the manufacturer's beef is sourced from a local farm, but it was recently discovered that the supplier had been falsifying the origin documents of stock. The meat processor's products began testing positive for salmonella and the supplier was identified as the cause.

Regulators immediately shut down the local farm with a suspension order and instructed the manufacturer to hold all products - even products which were not sourced from the affected farm.

The meat processor also lost several valued clients and sales took a hit as consumers lost faith in the brand. The manufacturer had a contract in place with the supplier farm which obligated the farm to indemnify the meat processor for any losses, liabilities or expenses incurred due to the supply of unsafe or unfit beef. Unfortunately, the farm declared bankruptcy shortly after the suspension order, so the contract became worthless. The product recall cover reimbursed the costs of the recall event, giving the meat processor much needed immediate financial relief and ensuring their liquidity.



Steel casting manufacturer recalls automotive parts

A privately-owned steel casting manufacturer produces flanges for automobiles, fridges and HVAC units. One of the manufacturer's customers ran routine quality control tests and identified a weakness in the supplied steel, indicating that it would become brittle at very low temperatures.

The manufacturer traced the faulty steel back to a purchase of raw material from the spot market, after their usual supplier was unable to fulfil requests. The faulty steel was in breach of the specifications agreed with the manufacturer's customers. As a result, they notified all customers who may have purchased parts made with the substandard steel and recalled the product. The recall caused a significant financial and reputational loss for the manufacturer, and the viability of the business was under threat due to the impact on cash flow. However, the manufacturer's product recall policy included an extension for recall event liability, which covered their legal costs in defending themselves from lawsuits, as well as any sums which they were legally obligated to pay as compensation. The purchase of the policy ensured the survival of the business by safeguarding their cash flows, enabling them to continue purchasing supplies and conducting business as usual.

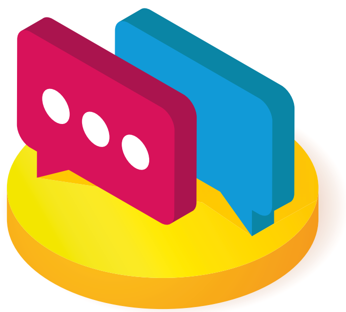
Want to know more? Get in touch productrecall@cfcunderwriting.com

Common misconceptions

Manufacturers may not be aware of the value of product recall insurance or its role in risk transfer. Here are some of the most common objections to product recall insurance that we've seen, and how to address them.

We've never had a recall

It is understandable that companies who have never experienced the huge stress and financial impact of a product recall are reluctant to buy standalone recall insurance. The important thing to bear in mind is that recalls happen all the time. Many first-time buyers are seeking recall insurance because they have recently experienced an uninsured product recall for the first time – the fact that they are now buying the insurance suggests they needed it all along and they appreciate the value of it.



Our quality assurance processes are top-notch, we are unlikely to have a recall

Put simply, it could be human error or unfortunate luck that results in your product being defective. No critical control point in manufacturing or testing is fool proof.

All manufacturers have suppliers, perhaps hundreds, and each of their suppliers will also have its own supply chain. Exposures in a supply chain are vast – each company must rely on its suppliers' quality assurance and the end product will only be as good as its worst supplied component. It is very common to see the supply chain causing product issues, even where the company's controls and processes are best practice.

Our suppliers will pick up the costs of any recalls

This is not a credible argument for any company, even distribution companies or those who rely on a contract manufacturer. No company should put faith in a third-party's ability to fund a recall.

Common scenarios where it is difficult to recover costs from a supplier:

- The supplier may refuse to pay some or all of the costs incurred (for example, they may refuse to pay for loss of sales, brand rehabilitation and third-party costs)
- The supplier may not have enough money to pay these costs
- In some locations, a supplier contaminating your product is thought of as a purely economic loss, and recovery of these costs against the supplier is barred by the economic loss doctrine
- Often the supplier will dispute that they are responsible for the recall
- Liability may have been waived or limited in the supply contract.

My liability insurance will cover these costs

This is not usually the case – and this is a mistake which could cost clients heavily. Liability policies tend to either exclude product recall entirely or provide very narrow coverage for a small limit. Generally, the coverage provided under any other policy for recall or contamination events is negligible. A standalone policy will offer comprehensive first-and-third-party costs.

Want to know more? Get in touch productrecall@cfcunderwriting.com

All information in this booklet is correct as of 01 June 2020. We take great pride in our professional expertise on product recall insurance and as such would like to state that certain content within this guide is liable to become outdated due to the fast-paced nature of the insurance market.

CFC is a specialist insurance provider and a pioneer in emerging risk. With a track record of disrupting inefficient insurance markets, CFC uses proprietary technology to deliver high-quality products to market faster than the competition while making it easier for brokers to do business. Our broad range of commercial insurance products are purpose-built for today's risks, and we aim to give our customers everything they need in one, easy-to-understand policy.

Headquartered in London, CFC serves more than 70,000 businesses in over 80 countries. Learn more at cfcunderwriting.com and LinkedIn.

To contact us, please email enquiries@cfcunderwriting.com or dial +44 (0) 207 220 8500. Our product recall team can be reached via email on productrecall@cfcunderwriting.com.

cfcunderwriting.com

CFC Underwriting Limited is Authorised and Regulated by the Financial Conduct Authority FRN: 312848
Registered in England and Wales RN: 3302887 Registered Office: 85 Gracechurch Street, London EC3V 0AA
VAT Number: 135541330

cfc

Want to know more? Get in touch productrecall@cfcunderwriting.com