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Coverage for product recall is available, but you have to know your insurer — and you have to read the fine print.

Product-Recall Losses and Liabilities: First- and Third-Party Coverage

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The stakes involved in a product-recall situation are enormous. Most product recalls present a double-edged sword for policyholders:

1. the not-insignificant expenses incurred in recalling a product from the marketplace; and
2. the potential liability exposure to third parties claiming injury or damage as a consequence of using or handling the offending product.

Policyholders in almost all industries require reliable insurance protection sold by a dependable insurer to respond to the risks posed by product-recall situations. In order to manage and protect against these perils, it is helpful to examine some of the important coverage issues relating to some of the insurance policies that often provide coverage for product-recall claims. This article discusses issues that arise under the newer insurance products sold to provide insurance protection against product-recall claims. Also provided is an overview of some of the coverage pitfalls and pressure points that affect liability insurance coverage for claims arising from the repair, removal, or recall of a defective or harmful product.

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Product-Recall Insurance

One of the newer products being sold by the insurance industry is product-recall insurance. Several insurers now market and sell product-recall insurance policies that promise insurance coverage for, among other things, the costs associated with product-contamination claims, product-tampering claims, and product-extortion claims.

Inquiring about an insurer's claims-handling history is particularly important with product-recall policies.

Fairly New and Largely Untested

Specifically, certain product-recall policies promise to cover the policyholder's costs incurred in recalling a product that has been contaminated, with which someone has tampered, or that has been the target of extortionists. Product-recall policies may also provide insurance coverage for business interruption losses and for costs to restore the product to its intended levels of quality or to reestablish the product's market share to the level existing before the contamination, tampering, or extortion took place.

Product-recall policies have obvious appeal to policyholders — especially those that have already endured the significant costs associated with removing a product from the market either on a mandatory basis, pursuant to a government-ordered recall, or on a voluntary basis, due to potential product contamination. Indeed, the recent misfortunes of many product makers and their customers underscore the serious consequences of a product recall.

Because the product-recall policy is a relatively new insurance product, policyholders should be mindful of certain issues that may arise when a claim is made and be careful to avoid the pitfalls built into certain of these new insurance policies. While some claims under product-recall policies have already been battled by insurers in litigation, the provisions and promises contained within the newer product-recall policies have largely gone untested thus far.[1]

Purchasing the Right Policy

Both for product-recall policies and as a general matter, it is important to be familiar with the claims-handling philosophy of a given insurer before purchasing any of its insurance products. Policyholders should refrain from purchasing insurance from insurers notorious for poor or unfair claims-handling practices. One of the best sources of information on insurer claims-handling practices is the insurance-brokerage community. Unfortunately, policyholders usually must specifically initiate the dialogue about claims-handling issues with their brokers, as many insurance brokers are unwilling to volunteer this information. Inquiring about an insurer's claims-handling history is particularly important with product-recall policies, as few disputes have actually been made public through the court system. Accordingly, there is currently little openly available information regarding what kinds of claims disputes are ensuing from product-recall losses. Insurance brokers' insights, therefore, are extremely useful.

It is also important for policyholders that their insurers and their insurance brokers sell the appropriate insurance policy to them for the risks they face in their particular business areas. While insurers are presumed to know the business and the associated risks for the policyholders to which they sell insurance, some insurers seek to limit greatly the scope of coverage under their insurance policies. They do this by defining terms within the policy in a fashion that erodes the coverage the policyholder expects and requires. Insurers also attempt to include broadly written exclusions in their insurance policies.

Accordingly, prior to actual purchase of a product-recall insurance policy, it is often helpful to obtain a specimen insurance policy and review the basic terms, conditions, and exclusions to understand whether the insurance policy is suitable for the policyholder's business and corresponding risks. It is also recommended that policyholders obtain and keep any marketing material that the insurer or insurance broker maintains regarding the insurance product being purchased.

Time-Sensitive Policy Provisions

Almost all property insurance policies contain time-sensitive provisions, essentially calling for the policyholder to provide notice, submit a proof of loss, and provide other forms of information within a certain time frame. Moreover, in the context of property insurance, it is common for the insurance policy to impose a shortened statute of limitations for filing a lawsuit against the insurer, should a dispute arise over insurance coverage. Many insurers seek to impose a statute of limitations under their insurance policies as short as one year. While such a short statute of limitations is unenforceable under the laws of many states, some states will nevertheless find such a provision enforceable against a policyholder. This can lead to devastating consequences for such a policyholder.

Policyholders should be mindful that product-recall insurance policies contain time-sensitive provisions similar to those contained in a commercial property insurance policy, including:

1. a notice provision;
2. a "statement of loss" provision; and
3. a suit-limitation provision.

Policyholders are well-advised to address these time-sensitive provisions very carefully, as even a slight delay by a policyholder in responding to these terms is frequently used by insurers to argue for a complete forfeiture of the policyholder's insurance coverage.

Notice Provision

Notice provisions in a product-recall policy typically call for the policyholder to provide notice of an actual or potential claim within a certain period of time. The notice provision of one product-recall policy provides that the policyholder:

> ... will make every reasonable effort to ... give immediate oral notice and written notice to the Company with periodic and timely updates concurrent with activity occurring during the incident[.]

Policyholders should be aware of the specifics of their insurance policies' notice provisions, as insurers routinely argue that they are entitled to deny insurance coverage for a covered claim where the policyholder has furnished "late" notice. It is also important to know that the law in a few states permits insurers to escape their coverage obligations where the policyholder's notice is deemed "late," even when the insurer has suffered absolutely no prejudice or other harm as a result of the "late" notice.

Statement-of-Loss Provision

Another time-sensitive provision contained within certain product-recall insurance policies is a statement-of-loss clause. Specifically, under one product-recall policy form, the policyholder is to:

> ... submit to the Company with reasonable promptness an initial statement of loss, stating the full particulars of the Loss and its initial calculations and/or projections of the elements and composition of the Loss.

Moreover, some product-recall policies call for a:

> ... final statement of loss ... in writing no earlier than twelve (12) months and no later than twenty-four (24) months after an Insured Event first becomes known to the Insured.

The law clearly favors coverage for the costs of preventing or minimizing losses.

Insurers may take the position that "statements of loss" are akin to a proof-of-loss requirement under a property insurance policy, calling for the policyholder to furnish information under oath regarding the extent of the loss suffered and associated costs incurred. As with the "late" notice discussion above, insurers often argue that all insurance coverage is forfeited, should the policyholder fail to file a proof of loss within the time prescribed by the insurance policy. Insurers may argue for the same forfeiture of insurance coverage, should the policyholder fail to provide the "statement of loss" within the time demanded by the insurer. Policyholders should proceed carefully and be mindful of such provisions, so as not to fuel insurer defenses regarding the time-sensitive provisions of an insurance policy.

Suit-Limitation Provision

Product-recall insurance policies also routinely contain suit-limitation provisions that insurers employ to shorten the time by which a policyholder can commence an action under the insurance policy where the insurer disputes a claim. Specifically, under the terms of one product-recall insurance policy, the insurer states:

> No suit, action, or proceedings for recovery of any claim under this policy will be sustainable in any court of law, equity or other tribunal unless all the requirements of this policy are complied with and the same be commenced within twenty-four (24) months after a final statement of loss has been submitted to the company by the insured.

If an insurer unduly delays its coverage determination with regard to a product-recall claim, policyholders must be extremely careful that they address the shortened statute-of-limitations provision in the product-recall insurance policy. Many courts have found such provisions enforceable against policyholders where the shortened statute of limitations does not violate any state statute or insurance-code provision regulating actions under insurance policies.

If policyholders find themselves either in the position of being unsure about when the statute of limitations under the insurance policy begins to run or in the position of rapidly approaching the expiration date of the shortened limitation period, they should seek a written tolling agreement with the insurer. Such an agreement would toll the clock from ticking during the term of the agreement and preserve the policyholder's rights to commence an action under the policy. If an insurer refuses to enter into such an agreement or attempts to place unacceptable conditions on doing so, then the policyholder may have no other choice but to commence an action in order to safely preserve its rights to insurance coverage.

Law, Forum, and Arbitration Provisions

Time-sensitive provisions are not the only potential pitfalls for policyholders purchasing product-recall insurance. Many of the product-recall policies currently being sold expressly call for the application of New York law to any dispute under the product-recall insurance policy. Moreover, many of these product-recall insurance policies contain provisions selecting New York federal or state court as the forum for any litigation that may ensue between the insurer and its policyholder.

By way of background, New York law is notoriously antipolicyholder. This is especially true when it comes to insurer arguments on late notice and late proofs of loss. Under New York law, pursuant to the strictest cases, notice deemed late by only weeks or even days can result in a complete forfeiture of insurance coverage. One court recently characterized New York law on notice as follows:

> The provisions of New York law allowing insurers to disclaim coverage for reasons that have caused no harm are draconian and in a fading minority.[2]

Also problematic for policyholders under New York law is the recourse — or lack thereof — that policyholders have when insurers employ unfair, deceptive, or misleading claims-handling tactics to the policyholders' detriment. Under New York law, courts rarely award bad-faith damages against insurers for unsavory claims-handling practices. In effect, this means that insurers can engage in such improper conduct with little concern over liability for bad-faith claims handling. Indeed, even lawyers for insurers have remarked that:

> [F]ew courts demonstrate the remarkable reluctance of the New York Court of Appeals to impose extracontractual liability for insurer claims handling practices.[3]

Similarly, insurance policies that include arbitration clauses present a trap for the unwary.[4] Arbitration is a good idea that simply does not work in the insurance context. While insurers benefit by the secrecy involved in arbitration rulings, policyholders cannot say the same. Arbitration can prove to be very policyholder-unfriendly. This is especially true where the arbitration provision requires that the arbitration panel be composed of current or former insurance industry executives.

Loss-Mitigation Insurance Coverage

Almost all insurance policies provide coverage for the costs of mitigating or avoiding losses. Whether by virtue of express provisions in the insurance policy or public-policy reasons, the law clearly favors insurance coverage for the costs of preventing or minimizing losses that would come under the coverage of the insurance policies. As such, insurance policies often protect policyholders for costs incurred in taking steps to minimize or avert claims of property damage or bodily injury — two perils that often abound during a product-recall situation.

General Policy Response

Typically, loss-mitigation coverage is provided expressly in first-party (property) insurance policies and implicitly in third-party (liability) insurance policies.[5] For example, efforts undertaken by a manufacturer, distributor, vendor, or retailer in withdrawing a product that is potentially harmful to individuals or to property should be covered in many instances by liability insurance, as such mitigation efforts almost invariably reduce the number of property damage and bodily injury claims.

With any efforts to mitigate or avert losses or damage, policyholders are well-advised to maintain specific records of their mitigation costs. Insurers will often attempt to battle a claim where the supporting documentation is incomplete or vague. Accordingly, good record keeping is extremely helpful for policyholders seeking loss-mitigation insurance coverage.

It is also important, under the appropriate circumstances, to discuss with an insurer the policyholder's plans for averting or minimizing losses. Holding discussions early on can help stem miscommunications and undermine subsequent insurer efforts to second-guess the policyholder's approach to dealing with a potential or actual product-recall loss or related claim.

Product-Recall Policy Response

Similarly, policyholders that have purchased a product-recall or contamination policy often have loss-mitigation insurance for efforts that they take to avoid or mitigate a loss under the insurance policy. Even if the property policy lacks an express loss-mitigation-type provision, courts have held that implicit in all insurance policies is an affirmative grant of insurance coverage for loss-mitigation and loss prevention costs.[6] Indeed, under the terms of some product-recall insurance policies, the insurer specifically calls for certain loss-mitigation efforts by the policyholder. For example, one product-recall insurance policy provides that:

> [The] Insured will exercise due diligence to do all things reasonable and practical to avoid any happening or circumstances covered by this policy and to make all reasonable efforts to mitigate any Loss arising as a result of an Insured Event.

Fortunately, product recalls, many times, take place before the harmful products actually reach the end-user and cause injury or damage. Often, policyholders adopt proactive measures to withdraw a product before it causes injury or damage. One question, then, that must be asked is:

> How does a product-recall policy respond when there are no clearly documented or reported injuries or damage?

An insurer may adopt a claims position that, where the product has been recalled prior to injury or damage, the product is not "contaminated" pursuant to the terms of the product-recall policy. For example, under the "accidental contamination" section of one product-recall policy, the insurer promises coverage in pertinent part for:

> Any accidental or unintentional contamination, impairment or mislabeling of an Insureds Product(s) or any Adverse Publicity implying such, which occurs during or as a result of its production, preparation, manufacture, packaging or distribution; provided that the use or consumption of such Insureds Product(s):
>
> a. has resulted in or would result in clear, identifiable, internal or external, visible physical symptoms of bodily injury, sickness, disease or death of any person(s), within one hundred and twenty (120) days following such consumption or use, or
>
> b. has caused or would cause physical damage to (or destruction of) tangible property, including animals and/or livestock.

In the context of a pharmaceutical product, for example, the policyholder may have been proactive and removed the product from the marketplace before the onset of injury or damage. An insurer may then seize upon the argument that the policyholder cannot demonstrate that the pharmaceutical product, if ingested or otherwise used, would have led to:

> clear, identifiable, internal or external, visible physical symptoms of bodily injury, sickness, disease or death ... within one hundred and twenty (120) days ....

Subrogation often works to the disadvantage of the policyholder.

This is an area of product-recall coverage where, from the perspective of the policyholder, skilled and equitable claims handling by the insurer is absolutely essential. A policyholder should not ever have to be put in a situation where, in order to secure insurance coverage, it has to argue that its product or a product with which it has involvement is contaminated to the extent that it would cause injury or damage. A policyholder forced to make such assertions would potentially be prejudicing its own case against third-party claimants or other businesses in the supply chain of the product that may seek to sue the policyholder for alleged injuries or damages as a result of the pharmaceutical product.

Subrogation Risks

Subrogation, in the insurance context, permits an insurer to step into the shoes of the policyholder and bring a lawsuit against a party that may be legally responsible for some or all of the costs the insurer has expended on behalf of its policyholder in paying a claim. Policyholders purchasing product-recall insurance should also consider risks associated with insurer subrogation rights and negotiate a waiver of subrogation where appropriate. Subrogation may offer policyholders the up-front benefit of lower insurance premiums, but unfortunately, it may greatly complicate life for a policyholder by leading to additional litigation, making claims more difficult to resolve on a "global" basis and jeopardizing key business relationships between the policyholder and other parties.

The insurer that pays a claim under a product-recall insurance policy may then commence litigation against some of the policyholder's business partners, including joint venturers, distributors, licensors, licensees, and others that may have some liability in connection with the loss. These parties may, in turn, file actions against the policyholder seeking contribution or indemnification, leading to even further claims and requiring the policyholder to dedicate often precious resources to helping its insurer with defense of these further claims. Thus, all too frequently, the target of the subrogation lawsuit is ultimately the policyholder or a party with which the policyholder does business. Subrogation, in effect, often works to the disadvantage of the policyholder by engaging it in additional litigation or undermining important business relationships the policyholder has with other parties. Tellingly, many savvy risk managers seek waivers of subrogation when purchasing insurance.

Coverage Under General Liability

In many product-recall situations, the policyholder will be exposed to claims made by third parties for bodily injury, property damage, or nuisance as a result of the policyholder's manufacturing, selling, or handling of the offending product or one of its component parts. In many instances, general liability insurance, excess liability insurance, and umbrella liability insurance policies (collectively, "general liability policies") provide extremely valuable protection against third-party claims that arise from defective or harmful products.

Coverage Found

For example, courts that favor loss-mitigation coverage under general liability policies may find substantial insurance coverage for costs incurred by the policyholder to take proactive measures and mitigate third-party claims of injury or damage. In *Eljer Manufacturing, Inc. v. Liberty Mutual Insurance Co.*, for instance, the policyholder brought an action over defective plumbing systems to establish that coverage existed for property damage which occurred the moment structures incorporated the defective plumbing systems. The insurers argued instead that the structures incurred property damage only when the plumbing systems leaked and that remediation of nonleaking systems was not covered under the policies. The court sided with the policyholder, holding that the involved structures suffered property damage when the plumbing systems were incorporated. Thus, efforts undertaken to mitigate damages from faulty products, by replacing them before they actually cause injury or harm, are covered by general liability policies:

> A homeowner who replaces a plumbing system that is likely to fail could be thought to be trying to mitigate the consequences of the supplier's having supplied a defective product, and thus to be curtailing rather than expanding liability. If so, however, denial of insurance coverage would be arbitrary: it would exploit the adventitious circumstance that a "physical injury" in the purely conventional sense of the word had not yet occurred.
>
> ... The expected failure rate must be sufficiently high to mark the product as defective — sufficiently high, as is alleged to be the case regarding the Qest plumbing system, to induce a rational owner to replace it before it fails, so likely is it to fail. That condition was satisfied. We believe that the coverage provided by Comprehensive General Liability Insurance encompassed (loss of use to one side) the tort claims against U.S. Brass.[8]

Nevertheless, policyholders that seek coverage for claims stemming from product recalls under their general liability policies must keep in mind that insurers raise numerous defenses to coverage, often arguing that a significant amount of any claim is uninsured and must be allocated to the policyholder.[9] Not surprisingly, insurers insert various definitions and exclusions into their policies to either reduce or bar coverage for claims arising from product-recall losses.

Policy Definitions

The definitions contained within general liability insurance are extremely important in the context of coverage for product-recall losses. Definitions of "your product," "impaired property," and "property damage" may all play an integral role in determining the amount of coverage available for a policyholder's claim for coverage in connection with a product recall.

The term "your product" is typically defined as:

a. Any goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by:
   (1) You;
   (2) Others trading under your name; or
   (3) A person or organization whose business or assets you have acquired; and
b. Containers (other than vehicles), materials, parts or equipment furnished in connection with such goods or products.

Many relevant exclusions in general liability policies are tied to whether or not the claims involve "your product." If "your product" is involved in the claim, third-party actions for damages are often argued by insurers to be excluded under the general liability insurance policy at issue. These exclusions are discussed in further detail below.

Policy Exclusions

Two key exclusions are the "Damage to Impaired Property or Property Not Physically Injured" exclusion and the "Recall of Products, Work or Impaired Property" exclusion.

"Property damage" is generally defined as including both physical injury to tangible property and loss of use of tangible property not physically injured. "Impaired property" is generally defined as tangible property, other than "your work" or "your product," that cannot be used or is less useful because it incorporates "your product" or "your work" when it is known or thought to be defective, deficient, inadequate, or dangerous.

The typical "Damage to Impaired Property" exclusion states that the policy does not apply to:

> "Property damage" to "impaired property" or property that has not been physically injured, arising out of:
> (1) A defect, deficiency, inadequacy or dangerous condition in "your product" or "your work"; or
> (2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

The typical "Recall of Products" exclusion states that the policy does not apply to:

> Damages claimed for any loss, cost or expense incurred by you or others for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal of:
> (1) "Your product";
> (2) "Your work"; or
> (3) "Impaired property";
> if such product, work, or property 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.[10]

Unfortunately for policyholders, with many claims involving a product recall, the insurers will deny losses or costs based on the above-noted exclusions (as well as others) — even where such exclusions have no application to the claim. For example, in *Newark Ins. Co v. Acupac Packaging, Inc.*, the court held that the insurer was improperly applying the sistership exclusion, which "by its very terms, is limited to those costs associated with the withdrawing of a product from the market. It does not exclude from coverage damage already caused to the property of a third party."[11] And in *American Home Assur. Co. v. Libbey-Owens-Ford Co.*, the court held that, where an insured's product is recalled due to a "suspected" defect and not an actual failure of the insured's product, the sistership exclusion does not bar coverage.[12]

Policyholders should study these exclusions carefully if the exclusions are raised by their insurers as barring coverage. In the context of third-party claims in connection with product recalls, insurers have on numerous occasions applied these exclusions improperly in an attempt to defeat coverage to which the policyholder is entitled.

Conclusion

Insurance coverage should be a key consideration for those that produce, label, package, handle, and distribute products of all kinds. Equally important to purchasing insurance is avoiding insurers with poor claims-handling track records. Policyholders often must be vigilant in order to secure insurance coverage for the significant costs and claims associated with product-recall losses.

Endnotes

1 *See, e.g., National Union Fire Ins. Co. v. Stroh Cos., Inc.*, No. 98 Civ. 8428(DLC), 1999 WL 1267461 (S.D.N.Y. Dec. 29, 1999).

2 *First Brands Corporation v. American Int'l Specialty Lines Insurance Co., et al.*, No. 95-3587 (Mass. Super. Ct., Middlesex, Sept. 13, 1999).

3 McGuire, James A., and Kristin Dodge McMahon, "Issues For Excess Insurer Counsel In Bad Faith And Excess Liability Cases," 62 *Defense Counsel Journal* (1995): 337, 338.

4 *See* Meier, Barry, "In Fine Print, Customers Lose Ability To Sue," *New York Times* (March 10, 1997): A1; Roland, David Garfield, "Arbitration — A Good Idea That Does Not Work," *Insurance Advocate* (June 8, 1996): 23; Parloff, Roger, "Kaiser Arbitration: Waiting For Judge Godot?," *The American Lawyer* (July 1996): 84; Masters, Lorelie S., "Arbitration Clauses In Liability Policies: A Ticket To Ride?," *The John Liner Review* (Winter 1996): 33; Jacobs, Margaret A., "Policies Requiring Arbitration Challenged," *Wall Street Journal* (October 16, 1995): B5; Anderson, Eugene R., and Paul Liben, "The Perfect Insurance Or The Perfect Crime," *The Metropolitan Corporate Counsel* (January 1995; "Editorials: Surprise Packages," *New Jersey Lawyer* (April 7, 1997): 6; Eppenstein, Madelaine and Theodore G., "An Arbitration Albatross," *New York Times* (June 8, 1997): F12.

5 Loss-mitigation coverage under first-party insurance policies also exists implicitly. *See Witcher Constr. Co. v. St. Paul Fire & Marine Ins. Co.*, 550 N.W.2d 1 (Minn. Ct. App. 1996).

6 *See, e.g., Witcher Construction Co. v. St. Paul Fire and Marine Insurance Co.*, 550 N.W.2d 1, 8 (Minn. App. 1996) (holding that, even absent an express loss-aversion provision in the property policy, an insurer is still liable for its share of reasonable and necessary costs of preventing an imminent covered loss to the insured property).

7 *Eljer Manufacturing, Inc. v. Liberty Mutual Insurance Co.*, 972 F.2d 805 (7th Cir. 1992).

8 *Id.* at 811-12.

9 *See., e.g., Newark Insurance Company v. Acupac Packaging, Inc.*, 746 A.2d 47, 53 (N.J. App. 2000).

9 This exclusion is sometimes called the "sistership exclusion."

11 *Newark Ins. Co v. Acupac Packaging, Inc.*, 746 A.2d 47, 328 (N.J. App. Div. 2000).

12 *American Home Assur. Co. v. Libbey-Owens-Ford Co.*, 786 F.2d 22 (1st Cir. Mass. 1986).