K&L ALERT

Insurance Coverage

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Product Recall? Take a Hard Look at Your Liability Policies

Assume your company's largest customer calls to inform you that a defect in a component your company manufactured has caused a nationwide recall of your customer's product, and that your company is expected to answer for the costs. Time is of the essence, and your company must reach a settlement with the customer – now. Assume further that, thinking quickly, you consult your insurance professionals and learn: 1) your company did not purchase a products recall policy and 2) your liability policies have recall exclusions. End of inquiry? Companies responding "yes" may have turned their backs on substantial insurance assets that could be crucial in responding to the catastrophic liability widespread product recalls may cause.

Companies that produce a wide variety of products – including auto parts, food ingredients, and mechanical or electronic components – may face substantial liabilities when the manufacturer of the product incorporating these items announces a recall, or such a recall is ordered by the government,[1] based on actual or alleged defects in these components or ingredients. In such a "secondary recall" situation, as illustrated by the hypothetical, the manufacturer will likely seek to hold the supplier liable for a variety of costs (some of which the supplier may itself incur to mitigate its potential liability). These costs may include sums for: any injuries sustained by end users of the product, the repair of the end product, production of replacement component parts needed for these repairs (probably on an expedited basis), markups charged by intermediaries in the supply chain, notification of customers, public relations activities, and legal fees. While many of these secondary recall costs may be covered under specialized product recall policies, the supplier should also not overlook the coverage potentially available under its comprehensive general liability ("CGL") or excess liability policies. As detailed below, secondary recall situations often pose intricate coverage issues and require the early development of and execution upon a coverage strategy in order for the policyholder to maximize all available coverage opportunities. This Update will present an overview of the key coverage issues a corporate policyholder may expect to confront in a secondary recall coverage claim.

RECALL COVERAGE AVAILABLE UNDER STANDARD CGL POLICIES

Coverage for secondary recall costs under a CGL policy may depend in large part on the presence and wording of the recall or "sistership" exclusion.[2] Because secondary recalls pose the risk of huge liabilities over which the policyholder may have

[1] Such recalls are often either mandated by or "voluntarily" conducted under the aegis of agencies such as the National Highway Traffic Safety Administration (NHTSA), the Food and Drug Administration (FDA), the Federal Trade Commission (FTC), and the Consumer Product Safety Commission (CPSC).

[2] "Sistership" exclusions take their name from an incident where an aircraft crashed and its "sisterships" were grounded and recalled to correct the common defect. *Arcos Corp. v. American Mut. Liab. Ins. Co.*, 350 F. Supp. 380, 384 n.2 (E.D. Pa. 1972), *aff'd*, 485 F.2d 678 (3d Cir. 1973). There are a number of versions of the "sistership" exclusion. For example, one version of the sistership exclusion purports to exclude from coverage: "damages claimed for the withdrawal, inspection, repair, replacement, or loss of use of the named insured or any property of which such products or work form 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."

little or no control, most courts have construed the sistership exclusion narrowly to bar coverage only for recalls conducted by the policyholder and not secondary recalls conducted by a third party.[3] Having failed to persuade courts to accept their expansive interpretation of the sistership exclusion, many insurers have modified the sistership exclusion in an attempt to exclude coverage for recalls "by any person or organization." The policyholder must therefore check to see which version of the exclusion is contained in its policies.[4]

BERMUDA-FORM COVERAGE

Corporate policyholders with significant limits of liability often place excess liability coverage with a number of Bermuda market insurers. Policy forms developed by XL Insurance Company, Ltd. ("XL") are often used not only by XL, but by other insurers in the Bermuda and European markets. One widely-used form explicitly provides coverage for costs related to secondary recalls.[5] This policy's version of the sistership exclusion reads as follows (emphasis added):

> This Policy does not apply to actual or alleged:
> . . .
> Liability of the Insured:
> . . .
> (3) for the costs incurred for the withdrawal, inspection, repair, recall, return, replacement or disposal of any Insured's Products or work, including, without limitation, architectural or engineering services, or, in connection with any of the foregoing, loss of use thereof; ***provided, however, that this paragraph (3) shall not apply in respect of costs incurred for the withdrawal, inspection, repair, recall, return, replacement or disposal of products or work of a party other than an Insured of which the Insured's Products or work forms a part*** . . . .

The first part of this clause purports to exclude coverage for costs incurred for, *inter alia*, the recall of any of the insured's products. The second half of the exclusion, however, states that it "shall not apply" to costs incurred for the recall of a third-party's product of which the insured's product "forms a part." In order for this so-called "secondary recall" exception to apply, it is therefore crucial to establish what precisely is being recalled (which may, in part, depend on the regulatory regime under which the recall is instituted).[6] Note that it is quite possible that certain costs may plausibly be characterized as falling within both parts of the exclusion, *e.g.*, where costs are incurred to repair the recalled third-party product by replacing a component produced by the policyholder. Such dual character costs falling within the exception to the exclusion should render the entire exclusion inapplicable, but insurers may be expected to argue that such costs predominantly fall within the first half of the clause and should therefore be excluded. The resolution of these disputes will require detailed knowledge of the costs at issue and why they were incurred.

COVERAGE GRANT

Assuming that the CGL policy at issue does not exclude costs for secondary recalls, the insurer may still require the policyholder to prove that the claim falls within the basic grant of coverage. For example, the coverage grant in the Bermuda Form requires a showing that such recall costs fall within the broadly defined category of "Damages" for which the policyholder is liable and were incurred "on account of" covered "Property Damage" or "Personal Injury." In a product recall situation, the recalled products may not have sustained any immediately obvious property damage and in fact may have been recalled in part to prevent such damage from occurring.[7] Nonetheless,

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[3] *See, e.g., Stonewall Ins. Co. v. Asbestos Claims Mgmt. Corp.*, 73 F.3d 1178, 1211 (2d Cir. 1995) (applying New York law); *Forest City Dillon, Inc. v. Aetna Cas. Sur. Co.*, 852 F.2d 168, 173-74 (6th Cir. 1988) (applying Pennsylvania law); *M. Mooney Corp. v. United States Fid. & Guar. Co.*, 618 A.2d 793, 798 (N.H. 1992); *Thomas J. Lipton, Inc. v. Liberty Mut. Ins. Co.*, 314 N.E.2d 37, 38 (N.Y. 1974) (holding that to exclude costs arising from recalls made by third parties would render the coverage "nearly illusory" for a producer of component parts); *Olympic Steamship Co. v. Centennial Ins. Co.*, 811 P.2d 673, 677-78 (Wash. 1991) (citing cases).

[4] In addition to the sistership exclusion, the policyholder will also have to consider the potential applicability of other so-called "business risk" exclusions, including "own product" and "impaired property" exclusions.

[5] This coverage for secondary recalls was in fact marketed as a coverage enhancement when XL introduced revisions to the Bermuda form in 1995.

[6] Bermuda form policies also explicitly adopt New York law, permitting policyholders to rely on the *Lipton* decision cited in note 3 above in support of an argument that the exclusion does not apply to recalls instituted by a party other than the insured. In a secondary recall, of course, it typically is a third party, and not the policyholder, that conducts the recall.

[7] Costs incurred to prevent potential harm posed by a defective product may still be covered, even if these costs were borne by the policyholder itself in order to mitigate its liability to others. *See e.g., Leebov v. United States Fid. & Guar. Co.*, 401 Pa. 477, 479-81 (1960) ("it is folly to argue that if a policy owner does nothing and thereby permits the piling up of mountainous claims at the eventual expense of the insurance carrier, he will be held harmless of all liability, but if he makes a reasonable expenditure and prevents a catastrophe, he must do so at his own cost and expense").

there are three types of property damage that may suffice to secure coverage for secondary recall costs: (1) loss of use of the recalled products; (2) physical damage to all of the recalled products based on the incorporation of the policyholder's defective component; and (3) physical damage to some of the products beyond incorporation of the defective component and/or to other property that may have triggered the recall. Similarly, bodily injury to consumers or bystanders may provide a path to coverage as well.

Secondary recalls likely involve at least some loss of use of the recalled product. It is not necessary to qualify for coverage that the loss of use be total.[8] Even if the product continues to be used, but cannot be used safely, this loss of safe use may be enough to bring the claim within the coverage grant.[9]

Courts have also found property damage based solely on the incorporation of a defective component into a larger whole.[10] The application of the incorporation doctrine may depend on how tightly the component part is integrated into the whole.[11] Some courts also require proof that the component poses a sufficiently high risk of damage.[12] This requirement should be satisfied by a determination reached by a regulator or under some regulatory standard that the risk is sufficiently high to justify the recall for which coverage is sought.

A third type of covered property damage is any actual physical damage beyond incorporation that triggered the recall.[13] Any recall-related expenses could be covered as "Damages on account of" this property damage.[14] Depending on the factual record, however, insurers may be expected to resist such an argument on the grounds that the costs for which recovery is sought are allegedly not "on account of" the property damage at issue.

Once the existence of property damage has been established, the policyholder will have to consider whether such damage is encompassed by a covered "occurrence." Note that the timing of the occurrence, and hence triggering of the policy, may differ substantially depending on whether the policyholder proceeds under a loss of use or incorporation theory. The determination of the number of occurrences may also be crucial to meeting any applicable per occurrence deductible. The existence of a batching clause (as is present in the Bermuda Form) may enable the policyholder to group several related incidents of property damage into a single occurrence if certain causation requirements are met and proper notice is given to the insurer.

STRATEGIC CONSIDERATIONS

The provision of notice to the insurer may raise several other issues that will require careful consideration by the policyholder and coverage counsel. The involvement of the insurer is one additional factor complicating an already complex scenario in which the policyholder will likely be dealing with several other actors, including customers, governmental agencies, and the general public.

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8 See, *e.g.*, *Liberty Mut. Ins. Co. v. Wheelwright Trucking Co., Inc.*, 851 So. 2d 466, 491-95 (Ala. 2002) (citing cases).

9 See *Wagner v. Milwaukee Mut. Ins. Co.*, 427 N.W.2d 854, 856 (Wis. App. 1988) (*overruled on other grounds*) (finding coverage where a gasoline leak rendered a sewer unsafe to use, even though it continued in use).

10 See, *e.g.*, *Hoechst Celanese Corp. v. Certain Underwriters at Lloyd's London*, 673 A.2d 164 (Del. 1996) (applying New York law); *Sturges Mfg. Co. v. Utica Mut. Ins. Co.*, 37 N.Y.2d 69 (N.Y. 1975). Other courts have rejected the incorporation doctrine. *Esicorp, Inc. v. Liberty Mut. Ins. Co.*, 266 F.3d 859, 863 (8th Cir. 2001); *Travelers Ins. Co. v. Eljer Mfg., Inc.*, 197 Ill. 2d 278, 757 N.E.2d 481, 496 (2001). The policyholder will therefore have to analyze what state's law applies in order to determine the viability of an incorporation doctrine argument. Although most insurance policies do not include a choice of law clause, typical Bermuda form policies provide that New York law applies, and New York is a state in which the incorporation doctrine remains viable.

11 This may be less of a problem with food ingredients, which tend to lose their identity in the whole. *See National Union Fire Ins. Co. v. Terra Indus., Inc*., 346 F.3d 1160, 1165 (8th Cir. 2003) (benzene in carbonated beverages) (citing cases). Mechanical or other components, which may be removed and replaced with no great difficulty, may be said by insurers to raise more difficult issues, but even here coverage is available if certain criteria are met. *Aetna Cas. & Sur. Co. v. General Time Corp.*, 77 CIV 5530 (LBS), 1979 U.S. Dist. LEXIS 11533, at *12 - *13 (S.D.N.Y. June 22, 1979) (defective valve motors), *aff'd*, 704 F.2d 80 (2d Cir. 1983). The case for coverage is even more forceful on the degree of integration point if the removal of the defective component is only possible by damaging other parts of the product. *Newark Ins. Co. v. Acupac Packaging, Inc.*, 746 A.2d 47, 55-56 (N.J. App. Div. 2000).

12 A leading decision in this area written by Judge Posner of the Seventh Circuit found that a risk as low as 5% could satisfy this standard. *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.*, 972 F.2d 805, 812 (7th Cir. 1992) (construing Illinois and New York law).

13 Similarly, bodily injury may trigger a recall as well.

14 The "on account of" requirement in liability policies should be interpreted as requiring only simple causation. *Lowenstein Dyes & Cosmetics, Inc. v. Aetna Life & Cas. Co.*, 524 F. Supp. 574, 578 (E.D.N.Y. 1981), *aff'd*, 742 F.2d 1437 (2d Cir. 1983) (table).

Because of the pressure to move rapidly to respond to the emergency, as well as the economic pressure that major customers can exert, the policyholder may have little opportunity to thoroughly investigate the root cause of the problem (which may be the product of many causal factors) or to exhaustively evaluate the actual damage caused by any alleged defect to the property of others before recalls are instituted. These factors are crucial both to settlement with the policyholder's customers (and these claims are generally settled, not litigated) and to the establishment of coverage to the satisfaction of the policyholder's insurers, who may raise defenses on the purported lack of policyholder liability or absence of proven damage to others. Given the policyholder's duty to cooperate under most CGL policies, the policyholder should inform the insurer of any settlement discussions and ask for input as appropriate on potential settlement agreements. Such a procedure not only will blunt an insurer's "voluntary payment" argument down the road, but may also enable the policyholder to use the reasonableness of settlements doctrine to prevent the insurer from challenging the existence of the policyholder's liability to its customers or the existence of damages suffered by users of the defective product.[15]

CONCLUSION

While coverage for secondary recalls may be available under general liability policies, the existence of such coverage depends on a careful and detailed analysis of the facts of the recall under applicable law and complicated policy provisions. When confronted with a secondary recall situation, the policyholder should:

- Identify the key facts in the recall events that could affect the availability of coverage.
- Assemble the policies that could provide coverage for the recall.
- Determine what duties the policyholder owes to its insurers under the potentially affected policies, particularly with regard to the timing and nature of the notice it must provide to the insurer.
- Involve the insurers, to the extent appropriate, in any settlement discussions.
- Assess the types and amounts of costs at issue and how the coverage analysis might play out with respect to each.

The resolution of these and other coverage-related issues is not necessarily as transparent as it may at first appear. It is therefore important for the policyholder to engage in careful review and analysis of policy forms and potentially applicable law early in the recall process. In addition, policyholders must structure carefully their dealings with their insurers, and their communications with customers, agencies and consumers, in order to avoid mischaracterizations of complex underlying events that may harm the case for coverage.

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[15] Note that under the Bermuda Form, the duty to cooperate also extends to the insurer, in that both policyholder and insurer have a duty to reach agreement on covered and uncovered costs.

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