Capturing Recall Costs

Measuring and Recovering the Losses

GMA
The Association of Food, Beverage and Consumer Products Companies

COVINGTON
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Quality In Everything We Do

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Dear Industry Stakeholders:

As complexities with an increasingly global supply chain and advances in technological and scientific expertise evolve, we expect the frequency and impact of recalls will continue to rise in the food, beverage and consumer good industry. In pursuit of continuous improvement, GMA and its member companies remain committed to the ongoing evaluation of the systems used to identify and remove recalled products from the supply chain and to recover the losses that result.

In September 2009, GMA partnered with FMI and GS1 US to release the Rapid Recall Exchange, a service designed to accelerate the recall notification and product removal process between trading partners. In May 2010 we partnered with FMI, GS1 US and Deloitte Consulting to publish Recall Execution Effectiveness: Collaborative Approaches to Improving Consumer Safety and Confidence.

In the third phase of our continuing focus on product recalls, we are pleased to launch Capturing Recall Costs: Measuring and Recovering the Losses. Prepared in collaboration with Ernst & Young LLP and Covington & Burling LLP, this latest report focuses on the financial recovery aspects of a recall. In particular, the report explores the true cost of a recall, how companies manage the recall risks and effective strategies to recover recall losses.

Consumer safety and confidence is always the primary focus in recall situations. Once the decision to recall a product is made, there are steps companies can take to conduct recall and recovery efforts in parallel to ensure it is quickly able to resume meeting consumer demand with safe, high-quality and affordable products while maintaining effective and efficient operations with trading partners. The factors identified in this report, based on a survey and interviews with GMA members, can help to minimize the financial impact of a product recall.

Sincerely,

Denny Belcastro
(GMA Executive Vice President, Industry Affairs and Collaboration)

and

Bert Alfonso (Chair, GMA CFO Committee, and Executive Vice President,
Chief Financial Officer and Chief Administrative Officer at The Hershey Company)

About this Report

This report is the third in a series sponsored by the Grocery Manufacturers Association (GMA). It focuses on the financial aspects of a recall – how companies can quantify recall losses accurately and maximize recovery of those losses from suppliers and insurers.

Previous reports concentrated on the operational aspects, discussing existing product recall practices of US food and consumer products manufacturers and retailers, and identified opportunities to improve recall execution.[1]

Like the other GMA papers concerning recalls, this whitepaper focuses on the experiences of US-based companies and under US law. Its findings are instructive for GMA members with global operations, and many of the concepts related to quantification and source of recovery are going to be quite similar regardless of jurisdiction. However, we would like to note that recall and recovery efforts in countries outside the US will be subject to the laws and practices of the jurisdictions in which the recall and cost recovery efforts occur.

GMA Member Survey Participants

ACH Food Companies, Inc.

B&G Foods, Inc.

Blue Diamond® Growers

Bumble Bee Foods, LLC

Bush Brothers & Company

C. H. Guenther & Son, Inc.

The Coca-Cola Company

ConAgra Foods, Inc.

Del Monte Foods

The Dial Corporation, a Henkel Company

Ferrero U.S.A., Inc.

Flowers Foods, Inc.

Fresh Express, Inc.

Furmano Foods

General Mills, Inc.

Goya Foods of Puerto Rico, Inc.

The Hershey Company

Inventure Foods, Inc.

Kellogg Company

Keystone Foods Corporation

Land O'Lakes, Inc.

McCain Foods® Limited

McCormick & Company, Inc.

Morgan Foods, Inc.

Oregon Cherry Growers, Inc.

Pfizer Nutrition, a business unit of Pfizer Inc.

Pharmavite® LLC

Ralcorp Holdings, Inc.

Ray Bros. & Noble Canning Col, Inc.

Rich Products Corporation

The J.M. Smucker Company

Solae LLC

Sunny Delight Beverages Co.

Vanee Foods Company

[1] For more information related to recall execution, refer to: Grocery Manufacturers Association & Deloitte, *Recall Execution Effectiveness: Collaborative Approaches to Improving Consumer Safety and Confidence* (2010), *available at* http://www.gmaonline.org/downloads/research-and-reports/WP_RecallExecution.pdf.

Survey Method and Demographics

Thirty-six GMA members took part in an electronic survey to assess the impact of product recalls in the food, beverage and consumer product sectors. Eight GMA companies participated in deeper discussions about their individual experiences with product recall quantification and measurement. Participating CFOs, VPs of Finance, risk managers, health and safety/regulatory compliance officers, legal counsel, and supply chain officers represented a broad range of small-, mid- and large-cap companies. These surveys and interviews, augmented by independent research and discussions with industry professionals, as well as subject matter resources from Ernst & Young and Covington & Burling, form the foundation of this report.

The online survey asked approximately 20 to 25 questions that varied based on the responses to previous questions (for example, whether the responding company had previously conducted a recall). Nearly 91% of respondents came from the food and beverage industry. Approximately 58% of all respondents reported that their company had been affected by a product recall in the last five years.

Online survey respondents and in-person interview participants represented companies of varying sizes. This diversity enabled the report to reflect leading practices relevant to the entire GMA membership.

Figure 1 – Industry Segments Represented

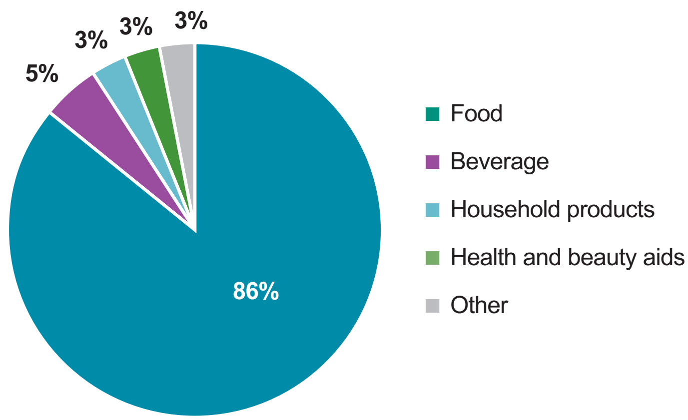
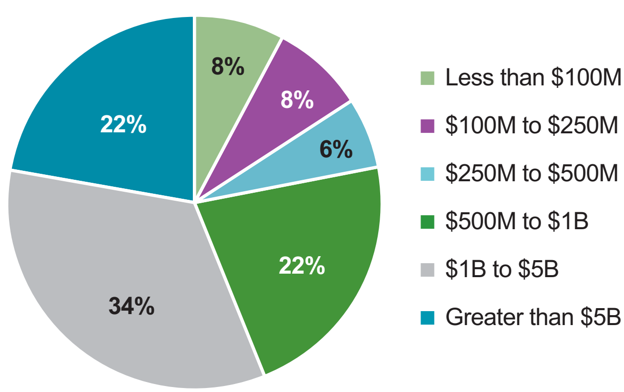


Figure 2 - Company Sizes Represented



About GMA

www.gmaonline.org

Based in Washington, D.C., the Grocery Manufacturers Association is the voice of more than 300 leading food, beverage and consumer product companies that sustain and enhance the quality of life for hundreds of millions of people in the United States and around the globe.

Founded in 1908, GMA is an active, vocal advocate for its member companies and a trusted source of information about the industry and the products consumers rely on and enjoy every day. The association and its member companies are committed to meeting the needs of consumers through product innovation, responsible business practices and effective public policy solutions developed through a genuine partnership with policymakers and other stakeholders.

In keeping with its founding principles, GMA helps its members produce safe products through a strong and ongoing commitment to scientific research, testing and evaluation and to providing consumers with the products, tools and information they need to achieve a healthy diet and an active lifestyle. The food, beverage and consumer packaged goods industry in the United States generates sales of $2.1 trillion annually, employs 14 million workers and contributes $1 trillion in added value to the economy every year.

About Covington & Burling

www.cov.com

Covington & Burling LLP is a trusted business and stategic advisor to its clients. Founded nearly 100 years ago, its 800 lawyers practice as one firm, holding closely to core values that start with a deep commitment to clients and to the quality of work on their behalf. From its founding, Covington & Burling has had a particular strength in substantive areas that profoundly impact business success, including insurance coverage and food and drug regulation.

Covingon’s Food and Drug practice, which boasts the senior government experience of two former FDA Chief Counsels, represents clients in federal court litigation and in proceedings before the FDA, Federal Trade Commission (FTC), and United States Department of Agriculture (USDA), and before regulatory authorities in the UK, EU and Asia. Covington’s Food and Drug practice is routinely recognized by USNews/Best Lawyers, Chambers, Law360 and PLC as one of the leading practices in the world.

In 2010, Chambers USA, Legal 500, PLC and Law360 all rated Covington as the best policyholder coverage practice in the nation for its record of success in maximizing insurance recoveries.
In 2011, Chambers again ranked Covington as the sole “Band 1” insurance coverage law firm, nationwide and in California and Washington, DC, describing Covington as “the undisputed leader of the national policyholder bar.” For more than 30 years Covington has represented only policyholders, a focus that has enabled its 100-member practice to recover more than $15 billion for its policyholder clients.

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

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Our Global Consumer Products Center enables our worldwide network of over 13,000 industry-focused professionals to share powerful insights and deep sector knowledge. We have extensive experience helping consumer products companies improve key aspects of business performance to position themselves to grow profitably. We also support consumer products companies on a wide range of initiatives to sharpen execution across the business. These include: effective brand management, risk management and compliance, enterprise performance management customer relationship management, finance transformation and efficiency of controls.

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Executive Summary

Protecting consumers and customers from products that may cause them harm is at the forefront of every decision and action a recalling company takes. As a result, companies give the operational aspects of a recall top priority. As many participants acknowledged, financial aspects are a secondary concern. But experience shows that the more expertise, collaboration and speed companies employ in recovering their recall costs, the more they tend to recover and the less time it takes.

This report focuses on the financial recovery aspects of a recall by addressing the following topics:

- **What is the true cost of a recall?** Companies want to know which costs they will incur, how they can measure those financial losses quickly and accurately, and how they can document the losses to support recovery efforts.
- **How do companies manage recall risks?** This report explains what factors inform a company's decision to pursue recovery from a supplier, the company's own insurance, or a supplier's insurance, and which insurance policies can provide potential coverage for recall-related losses.
- **What are effective strategies for financial recovery?** Often, a company puts a great deal of money and effort into planning for the execution of a recall, but considerably less effort into planning for the recovery of expenses related to the recall. However, there are several opportunities a company can seize to recapture recall costs.

Five Obstacles to Recovery

Survey and interview participants identified five common obstacles to a successful recovery of recall costs. These are:

1. **Time, effort and expense of recovery.** On average, companies without a recall believed that the cost recovery process was a quick one and that they could recover most of their losses. Even companies with recall experience underestimated the time, effort and expense associated with the recovery efforts.
2. **Brand protection.** Participants were concerned about brand following a recall. The importance of brand protection is only outweighed by the health and safety concerns of the consumer. Cost recovery is a secondary concern.
3. **Supplier relationships.** Supplier issues that may make cost recovery difficult include difficulties in tracking supplier contracts or supplier insurance documentation and preservation of supplier business relationships.
4. **Multiple insurance policies may apply.** Many companies are unfamiliar with how their insurance coverage applies to recall-related costs. Multiple lines of insurance – including property, liability and specialty policies – might be implicated by losses stemming from a single recall. If companies don't know where to look, they might miss out on significant recovery opportunities.
5. **Limited recall claims experience and resources.** As survey participants suggested, many companies simply lack the experience to navigate cost recovery efforts effectively. Companies tend to spend significant amounts of time and money preparing for a recall event—and almost no time preparing to recover the costs of that recall event.

Key Survey Results

- 81% respondents deem financial risk from recalls as significant to catastrophic
- 58% have been affected by a product recall event in the last five years
- 78% manage the risk by procuring insurance
- 77% experienced recalls that had a financial impact of less than $30 million
- The largest recall costs came from business interruption and product disposal
- The highest recoveries came from insurance proceeds

Key Observations

Based on the survey results and consultation with industry participants, there are 10 factors that companies may consider as a means of maximizing their financial recovery in the wake of a product recall.

1. **Have a financial recovery plan.** Although most companies are prepared for a recall, few have put the same effort into planning for financial recovery. Integrate cost recovery procedures into the larger recall strategy, including mock recall drills to simulate the amount of coordination required in the documentation process.
2. **Select a broad recovery team.** Involve representatives from functions across the business, as well as a representative from the facility involved in the recall to identify all potential financial impacts. This team can work in parallel with the recall team to recover losses.
3. **Appoint a cost recovery leader.** Nominate someone from legal, risk management or finance to serve as recovery leader. Ideally, this individual would have enough experience, knowledge and authority across the company to influence others and deliver results.
4. **Clarify recovery goals.** Know the company's risk tolerance, capital structure and the amounts involved to make a decision that is best for the company.
5. **Communicate with insurers.** When seeking recovery through one or more insurers, have a well-planned strategy for communicating promptly and consistently with the insurer to secure a favorable outcome.
6. **Prepare an initial estimate.** Prepare a detailed initial estimate of the losses within the first 30 to 45 days of the recall to identify areas and sizes of losses. This helps to set reasonable expectations regarding losses and recovery, which may eliminate surprises down the road.
7. **Maintain detailed and timely documentation for losses.** Don't underestimate the need for documentation. Insurers require an extensive account of the circumstances and the costs of the recall before a claim may be paid.
8. **Engage outside service providers.** In addition to in-house personnel, consider involving a broker, forensic accountants and lawyers with experience in cost recovery at the beginning of the recall process.
9. **Don't delay.** File a claim promptly and be persistent in following up with the insurer to keep the process moving forward. The timeliness of financial recovery will depend on how consistently the policyholder pursues action from the insurer.
10. **Share lessons learned.** Consider formalizing a process of sharing leading practices and lessons learned internally among business units. Externally, think about reaching out to peers at trade shows and conferences to learn about their experiences and processes for improvement.

The Price of a Recall

In August 2010, more than 500 million shell eggs distributed by an egg producer had to be recalled. According to the Center for Disease Control (CDC), from May 1 to October 15, 2010, approximately 2,500 illnesses associated with the eggs were reported,[2] making it the largest recorded *Salmonella Enteritis* outbreak reported since the FDA's outbreak surveillance began in the early 1970s.[3] Total costs to American shell-egg producers have yet to be calculated. However, the negative media attention produced a drop in prices that cost the shell-egg industry over $100 million in September 2010 alone.[4]

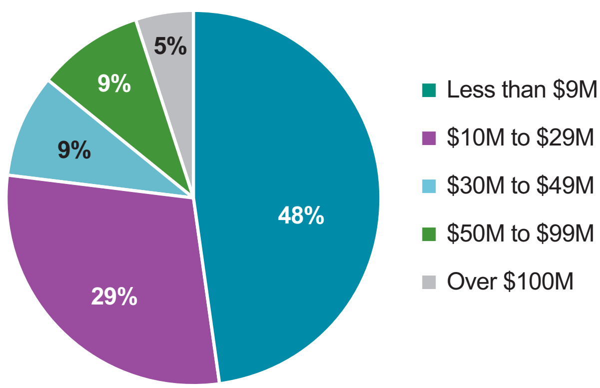
In 2007, the estimated cost of the peanut butter recall to one company due to *Salmonella* contamination was $78 million.[5] The estimated cost to American peanut-containing product producers from the 2009 incident contamination of peanut butter by *Salmonella* was $1 billion.[6]

Typically, there are three issues that drive recall costs:

1. Health and safety
2. Severity and scope
3. Frequency

A recall, particularly a "Class I," or health and safety recall, is usually a significant event for a food, beverage or consumer products company. For companies that have faced a recall in the past five years, 77% of respondents estimated the financial impact to be up to $30 million dollars; 23% reported even higher costs.

Figure 3: What do you estimate the financial impact (sales losses, direct recall costs, etc.) to your company was as a result of the recall?



2 Dr. Simon Shane, *The US egg industry and the salmonella recall*, WATTAgNet, (Dec 15, 2010), http://www.wattagnet.com/The_US_egg_industry_and_the_salmonella_recall.html..

3 Joshua M. Sharfstein, M.D., Statement to the House, Subcommittee on Oversight and Investigations, *The Outbreak of Salmonella in Eggs*, (Sept. 22 2010), http://www.fda.gov/NewsEvents/Testimony/ucm226554.htm.

4 Shane, *supra* note 2.

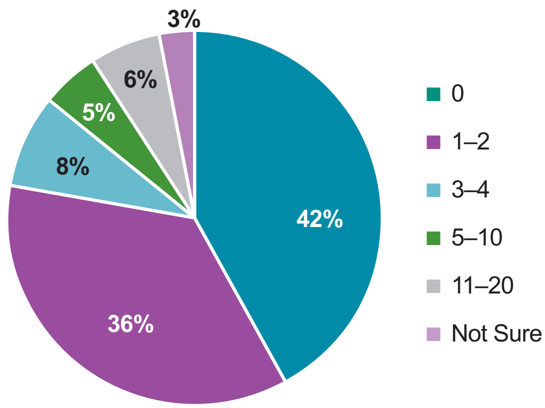
5 Kim S. Nash, *Beyond Peter Pan: How ConAgra's Pot Pie Recall Bakes In Hard Lessons for Supply Chain Management*, CIO (Oct. 22, 2007), http://www.cio.com/article/148054/Beyond_Peter_Pan_How_ConAgra_s_Pot_Pie_Recall_Bakes_In_Hard_Lessons_for_ Supply_Chain_Management.

6 Associated Press, *Peanut industry: Recall price tag $1 billion*, (Mar. 11, 2009), http://www.msnbc.msn.com/id/29634279/.

Expected Increase in Recall Frequency and Severity

Survey respondents generally share the view that recalls have become more common and are likely to increase in frequency and severity going forward.

Figure 4: To the best of your knowledge, how many health/safety recalls has your company been impacted by in the last five years?



Factors that point to more frequent and more comprehensive recalls in the future include:

1. **Just-in-time global manufacturing.** This type of manufacturing is not new, but it has taken on new meaning in the past several years as manufacturing operations shift to BRIC countries (Brazil, Russia, India, China). A contaminated product can be shipped worldwide within a matter of hours or days, spreading the contamination much more quickly than in the past and making investigation of a suspected contaminated product much more difficult.

2. **Fewer suppliers and complex supply chains.** The economic downturn has pushed many raw material suppliers out of business. The remaining suppliers are more concentrated, meaning that a recall by a single supplier can affect a very large number of downstream customers and consumers.

3. **Improved product traceability and detection of food-borne illness.** Technology has allowed experts and regulatory bodies to improve the process for identifying and reporting potential product contamination issues. In 2007, Taco Bell removed and destroyed green onions from 5,800 restaurants across the country, only to find later that the source of the contamination was lettuce.[7]

4. **Increasing regulatory authority and enforcement.** The FDA is expected to increase inspections and enforcement in response to criticism of its inspection practices. Three key regulatory changes, in particular, may have significant effects on product recalls. These include:

    a. **Reportable Food Registry.** In 2007, Congress mandated that the FDA establish the Reportable Food Registry to enable the FDA to track contamination in the food supply. Reports through the registry prompted the November 2009 recall of two nationally distributed sulfite-containing products (lacking proper warning labels) and the February 2010 recall of 177 products containing hydrolyzed vegetable protein tainted with *Salmonella*.

    b. **FDA's new Food Recall Authority.** On 4 January 2011, President Obama signed into law the new FDA Food Safety Modernization Act that gave the FDA additional regulatory authority over the food and beverage industry, including the authority to order recalls.

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7 Dale E. Hausman, *Contaminated Food Scares Raise Myriad Insurance Issues*, Ins. Coverage L. Bull., April 2007.

c. **Current Good Manufacturing Practices (cGMPs) regulations.** The FDA expects to issue newly proposed cGMP rules in 2011. Food consumption has changed dramatically since the regulations were last revised in 1986. For instance, ready-to-eat foods, which pose a higher risk of *Listeria* contamination from a lack of consumer preparation, are more popular. The FDA has already issued guidance documents regarding the control of *Listeria* in ready-to-eat foods, and the microbial food safety hazards of fresh-cut fruits and vegetables.

For a more in depth discussion of the regulatory changes likely to affect future recalls see Appendix 1.

FDA Steps Up Inspections and Enforcement

In April 2010, a US Health and Human Services (HHS) Inspector General's Office report indicated that the number of FDA inspections of food facilities between 2004 and 2008 had steadily declined, despite an increase in the overall number of food facilities.[8] The report "found significant weaknesses" in the FDA's domestic inspection practices and recommended an increase in inspections, with an emphasis on "high-risk" facilities.

Financial Exposures

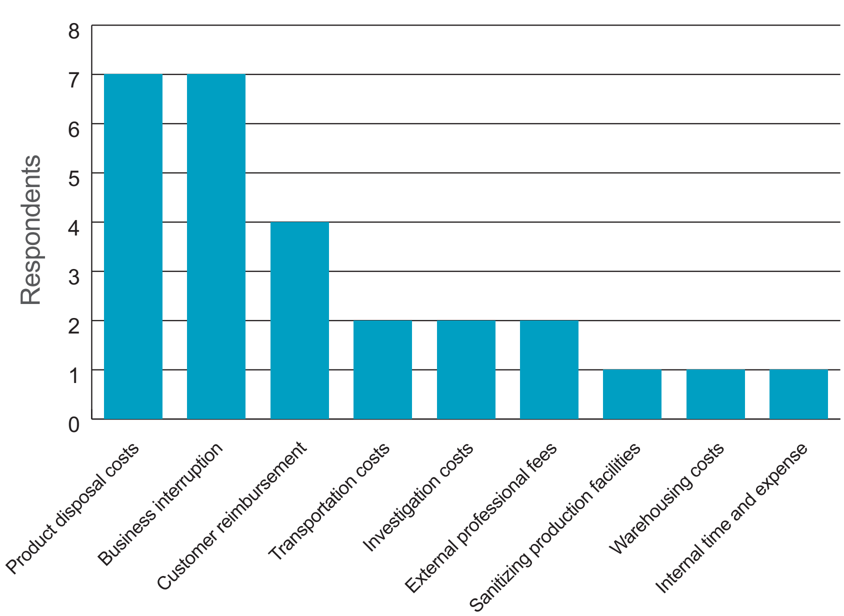
Over 81% of survey respondents described the financial consequences of a recall as either "significant" or "catastrophic." Based on the results of the survey, the four largest financial exposures companies of all sizes face as a result of a recall are:

"Business interruption is not only time to get production back up and running, but also time to get the customer to buy the product again."

– survey respondent

1. **Business interruption or lost profits.** Survey respondents suggested that the highest recall costs came from business interruption. Companies (or their suppliers) may have to close plants for short or long periods of time, while the FDA conducts its investigation, or for sanitization or other plant modifications, depending on the nature of the contamination.

Figure 5: Which of the following costs did your company capture when dealing with the product recall (check the three largest costs)?



8 Dep't of Health & Human Servs., Office of Inspector Gen., *FDA Inspections of Domestic Food Facilities*, April 2010, *available at* http://oig.hhs.gov/oei/reports/oei-02-08-00080.pdf.

2. **Recall execution costs.** Other cost drivers may include storing, transporting or destroying products, supplying replacement products, or public relations to manage reputation or brand damage.

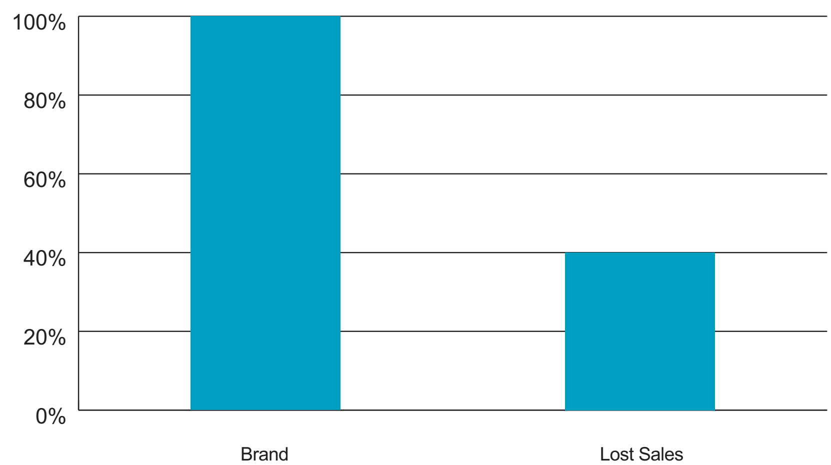
3. **Liability risk.** Recalling companies may face potential liability for bodily injury to consumers or property damage to customers. The costs of litigating those claims can equal or even exceed the ultimate liability. These claims also may include claims for customers' lost profits or business interruption, which can be very costly to litigate.

4. **Reputation damage or loss of brand equity.** Throughout the study, one aspect of financial loss that participants consistently identified as a top-of-mind concern was the protection of the brand. The need to protect the brand is heightened when the product and the name of the company are the same. However, damage to the brand or company reputation is difficult to quantify and challenging to recover financially.

"Brand and market issues are far larger than recall costs themselves."

– *survey respondent*

Figure 6: What are your largest concerns or areas of greatest uncertainty, after consumer safety, if your company is faced with a health/safety product recall event in the next year [after consumer safety]?



Sources of Recovery for Recall Losses

The task for a recalling company is to find a way to minimize the overall financial impact of a recall — that is, to recoup losses while simultaneously protecting the brand. If, as industry watchers expect, recalls increase in both frequency and severity, it will be even more important for recalling companies to minimize the financial impacts of recalls.

The way in which a company manages its recall risk dictates whether and from whom it will seek to recover recall losses when they occur.

Three Strategies for Managing Risk

There are three principal strategies companies use to manage their recall risk: reduce it, assume it or transfer it.

1. **Reducing or Avoiding Risk**

   In the context of product recalls, **reducing risk** means having rigorous quality control procedures to prevent a recall and well-established crisis-management procedures to handle a recall if one occurs. Respondents to the survey reported having both. Some companies further suggested that the best way to protect a company's brand is to create a "culture of quality" that spans the entire business, from manufacturing and supplier relations to sales and customer relations.

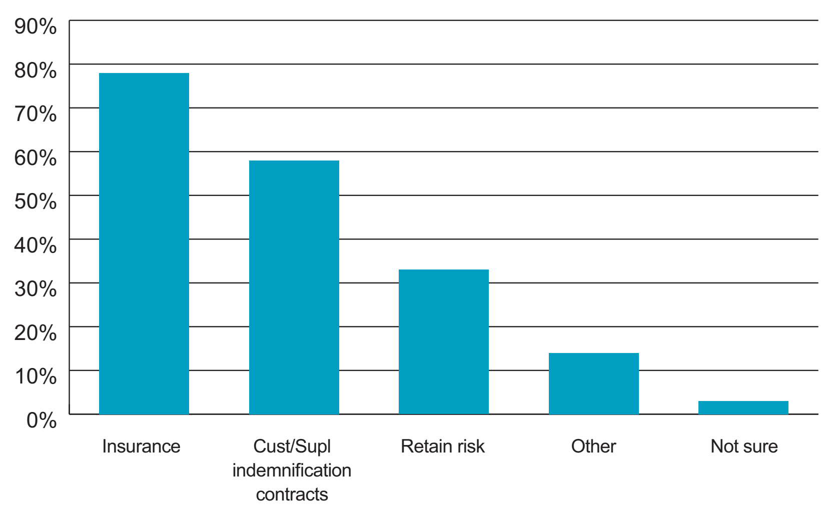
2. **Assuming Risk**

   Assuming risk means paying for your own losses or carrying high insurance deductibles and self-insuring up to a certain amount for product recalls. Large, well-capitalized companies are more likely than mid-cap or small companies to use this approach.

3. **Transferring Risk**

   Transferring risk means having a third party — typically a supplier or insurer, or both — share risk and potentially pay for the costs of a product recall. Most survey respondents anticipated some cost recovery from their suppliers or insurers. These recovery sources are discussed below.

Figure 7: How does your company manage the risk associated with health/safety product recalls?



Evaluating Supplier Responsibility

Much of the recall risk to a company comes from its suppliers. Companies have mechanisms to reduce that risk. These may include qualifying and auditing their suppliers.

> Companies that depend on suppliers located around the globe are particularly susceptible to disruption. For example, the March 2011 earthquake, tsunami and nuclear crisis in Japan directly affected automobile manufacturing in the US. In fact, General Motors suspended manufacturing at a Louisiana plant due to a shortage of necessary parts from Japanese suppliers.

When entering into supply arrangements, companies also may want to address risk assumption and risk transfer in the event of a recall or other losses. In practice, customers or consumers injured by a product commonly assert claims against all parties in the supply chain for a finished product, who then allocate responsibility and cost of that loss among themselves. The transactional costs involved in litigating against both the original claimant and others in the supply chain can be significant.

Companies document their supplier relationships in various, often informal, ways. These may include telephone calls and emails, purchase orders and invoices or formal contracts. Larger companies typically have standard-form contracts. Smaller companies may rely on purchase orders or invoices, sometimes with preprinted contract terms on the reverse. It is challenging to maintain consistency of supply agreements across numerous suppliers — variations might be dictated by the type and amount of product supplied and by the laws of different jurisdictions around the globe.

58% of survey participants said they manage risk of recall through supplier indemnification. However, recovery under supplier indemnification contracts can be challenging.

The documents, if any, may have a wide range of detail. For example, they may specifically address or be completely silent on the following issues:

- Rights to be indemnified for or “held harmless” against a certain amount or type of loss
- Whether each party must maintain certain types and amounts of insurance
- Whether each party has any rights against the other party’s insurance
- Which jurisdiction’s law applies to any dispute
- How any dispute will be resolved (e.g., in court or by arbitration) and where that dispute resolution will take place

These company or manufacturer/supplier transactions take place against a backdrop of existing common and statutory law, such as the Uniform Commercial Code, which different states have incorporated into their own statutes. That existing law may provide the “rules” governing the relationship between parties in the supply chain where those parties haven’t entered into specific agreements.

For the purposes of financial recovery, the survey focused on two decision points for the manufacturing company: whether and how to transfer risk to the supplier before a recall or loss, and whether and how to enforce that risk transfer after a recall or loss.

Transferring Risk Before a Recall

Many survey respondents reported that they focus more on provisions of supply arrangements dealing with the safety and quality of the product to be supplied and less on the responsibilities of the parties in the event of a recall or other loss. The allocation of financial risk can take two forms:

1. **Indemnification/hold harmless.** An indemnification clause requires one party to pay or reimburse the loss of the other party. It may also include the obligation to provide a defense

against third-party claims. Nearly 60 percent of survey respondents reported that they impose written indemnification requirements on their suppliers.

2. **Additional insured status.** An indemnification clause has value only if the indemnifying party is able to pay the indemnification costs. For this reason, the manufacturer seeking indemnification may ask that the indemnifying party carry insurance and name it as an "additional insured" on the indemnifying party's insurance policy to backstop the supplier's indemnity obligations. This is a standard requirement in some manufacturers' supply contracts. Additional insured status gives the manufacturer the right to claim directly against the supplier's insurer, which can include the right to immediate defense by the supplier's insurer. Issues associated with additional insured status can include:

   - **Complexity and cost.** It complicates the relationship with the supplier, which may pass increased insurance costs back to the manufacturer in its product pricing.
   - **Availability and practicality.** It might also become more difficult for the supplier to purchase insurance, particularly if the insurance company views the risk as being fundamentally changed by the addition of a large customer to a small company's supplier's policy.
   - **Record keeping.** It may be difficult for a manufacturer to keep complete records of the certificates of insurance and, ideally, the underlying policies, particularly if many suppliers are involved over many years.
   - **Consistency.** The coverage afforded the additional insured may be broader or narrower than the supplier's indemnification obligation. The manufacturer cannot assume that the indemnity and the additional insured coverage are coextensive without reviewing the policy under which it is an additional insured.

Certificates of Insurance are Not Insurance

It is important to remember that the insurer has to change (or "endorse") the insurance policy to confer "additional insured" status. If an insurance broker supplies a "certificate of insurance" confirming that the indemnified party is an additional insured but the insurer has not changed its insurance policy to include the additional insured, the indemnified party probably does *not* have additional insured status.

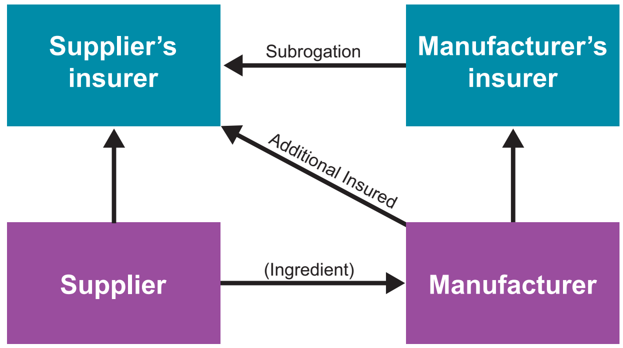
Enforcing the Risk Transfer after a Recall

Some survey participants reported that they sometimes, but not always, pursue recovery directly from their suppliers after a recall. Others indicated that they preferred to pursue a supplier's insurer, typically a liability insurer.

- **Recovering from the supplier.** Survey participants attempting to recover losses directly from their suppliers tended to do so when the supplier was clearly at fault. Many companies said that they may refrain from pursuing recovery from a supplier when they value the ongoing business relationship — particularly if a sole-source supplier is involved, or when there is a risk the supplier will refuse to do business with the manufacturer or simply go out of business. Much of the manufacturing and sourcing of raw materials has been moved to the newly advanced economic development BRIC countries. Respondents and interviewees consistently discussed the increased, but economically necessary, risk associated with doing business in the BRIC.
- **Recovering from the supplier's insurer.** This approach has resulted in success for some, often without litigation. Some manufacturers prefer to pursue the supplier's insurer rather than

the supplier alone. Other manufacturing companies are of the view that a supplier's insurance policy is little more than an invitation to sue, and they prefer not to litigate with the supplier's insurer as well as their own insurers. Instead, these manufacturers prefer to rely on the financial stability of the supplier and on strong indemnity language to recoup their losses.

Figure 8



If there is a dispute between the manufacturer and the supplier's insurer, two additional problems may arise:

1. The supplier's coverage limits might not be adequate to cover the manufacturer and the supplier and any others claiming to be insured under the same policy.
2. The manufacturing company's insurer and the supplier's insurer may disagree as to which of them has an obligation to defend or pay claims against the manufacturer; these inter-insurer disputes can slow recovery, particularly if they end up in litigation.

Evaluating Insurer Responsibility

Recall losses may trigger multiple insurance policies of different types, including: first-party property/business interruption; third-party liability; and specialty policies. Applicable policies may have different insurers, different policy periods and different limits, layers and deductibles, all of which complicate the insurance recovery effort.

The following represents an overview of coverage for recall losses under liability, property and specialty policies.

Although policies vary, most contain a set of standard sections. These include:

- **Insuring agreement.** This section describes the types of coverage provided under the policy.
- **Exclusions.** The exclusions reduce or eliminate coverage that otherwise would be provided under the insuring agreement. Exclusions may contain exceptions that "give back" some of the coverage removed by the exclusion.
- **Conditions.** This section states the insured's obligations to the insurer, including the obligation to give timely notice of a loss and to cooperate with the insurer in claims processing.
- **Definitions.** This section defines key recurring terms in the policy.
- **Endorsements.** An endorsement is a written document attached to an insurance policy that modifies the policy. It may add, limit, clarify, or subtract coverage, add or remove exclusions or conditions, or add additional insureds. Endorsements commonly appear on standard forms.

For a discussion of key insurance coverage battlegrounds for policyholders and their insurers, please refer to Appendix 2.

Interpreting an Insurance Policy

Some specific rules of construction apply to insurance policies. Broadly speaking, these tend to favor the policyholder. These rules include:

- **Coverages.** In most states, the insured has the initial burden of proof to show that its claims come within the coverage grant of the policy. The grant of coverage is construed broadly so as to afford the greatest possible protection to the insured.
- **Exclusions.** Once a claim is shown to be within the coverage grant, the burden shifts to the insurer to show that the claim falls within an exclusion. Exclusions are narrowly construed, but exceptions to exclusions are broadly construed.
- **Ambiguities are construed in favor of coverage.** A policy provision is considered ambiguous when it is susceptible to two or more reasonable interpretations. In general, ambiguities in an insurance policy are construed against the drafter (in this case, the insurer) and in favor of the insured. A court may use extrinsic evidence to show the parties' intentions. This evidence may include the parties' bargaining history, their conduct, or information regarding industry custom and practice.
- **Reasonable expectations doctrine.** Most courts will construe an insurance policy consistently with the reasonable expectations of the insured. Representations made by the insurer to the policyholder are considered evidence of the policyholder's reasonable expectations regarding coverage. An insurer's marketing materials and copies of correspondence between the policyholder's broker and the insurer can be helpful in demonstrating what coverage the policyholder expected to receive when it purchased the policy.

Commercial General Liability (CGL) Insurance

CGL policies generally provide coverage for damages because of bodily injury and property damage caused by an occurrence. The policyholder may be subject to claims asserted by consumers for bodily injury allegedly caused by the recalled product or asserted by customers for property damage allegedly caused by the contaminated product.

There are frequent disputes between policyholders and insurers over whether the customer suffered "property damage" at all. If the contaminated component or ingredient is completely incorporated and cannot be removed from the third party's product, courts are likely to find that there is property damage to the third party's product. There may be property damage even if the finished product is not unsafe to consume, but cannot be sold due to FDA regulations or other laws.

A summary of key CGL coverage issues is below. For a more detailed discussion of CGL coverage for recall-related losses, please refer to Appendix 3.

The Insurer's Broad Duty to Defend

CGL coverage typically requires the insurer to defend or pay the costs of defending claims by third parties against the policyholder. The duty to defend may be very broad. It applies as long as the claims arguably fall within the scope of coverage, even if the allegations are false or fraudulent. This coverage is sometimes referred to as "litigation insurance."

Key Exclusions

Insurers often rely upon one or more of several exclusions that typically appear in CGL policies to deny coverage for recall-related claims. These may include:

- **"Business risk" exclusions.** Four exclusions found in the standard CGL policy are often referred to by insurers as "business risk" exclusions on the theory that liability policies don't insure poor performance.
  - **The recall exclusion.** Also known as the "sistership" exclusion, this exclusion applies to damages and losses incurred for the withdrawal or recall of the contaminated product. The wording of this exclusion is particularly important, and some costs that arise following a recall do not fall within its scope. For example, if the recalled product is not the insured's product, but rather a third party's product that incorporates the insured's product, the exclusion might not apply. Additionally, many courts hold that the exclusion applies only to market-wide recalls of all products as a preventive measure and does not apply to recalls limited to products known to be defective.
  - **The "your work" and "your product" exclusions.** These exclusions apply to coverage for property damage to the insured's own product or own work as opposed to damage to a third party's product or property. Although insurers argue that these exclusions foreclose coverage for the cost of repairing and replacing the insured's contaminated product or ingredient, they clearly do not exclude coverage for other kinds of property damage caused by the insured's product, such as when it is incorporated into a third party's product.
  - **The "impaired property" exclusion.** This exclusion applies to coverage for costs and losses that arise because the policyholder's contaminated product has made a third party's product less useful or unusable. It applies only if the third party's product can be restored to use by simply removing the contaminated component. If not, this exclusion does not apply.
- **The "expected or intended" exclusion.** General liability policies typically exclude "'bodily injury' or 'property damage' expected or intended from the standpoint of the insured." This is a high threshold for an insurer to satisfy. It usually applies only when the insured knew or was substantially certain that the injury or damage would result.
- **The pollution exclusion.** This exclusion applies to coverage for bodily injury or property damage arising out of the discharge of "pollutants." At least one court interpreting a liability insurance policy observed that the pollution exclusion uses "terms of art in environmental law" and does not apply in the context of food contamination. But not all courts agree.

Commercial Property Insurance

Certain recall-related costs may be covered by commercial property insurance. For example, property insurance may cover product contaminated as the result of a flood or fire, product mistakenly treated with an unapproved pesticide or product that must be recalled and disposed of because of a chemical exposure.

Commercial property insurance generally provides coverage for damage to the insured's own property, such as buildings, equipment, goods and stock. Several insurers offer products that specifically cover goods in process, food inventory and products in transit.

In addition to the property loss itself, commercial property insurance also covers losses arising from the interruption of the insured's business due to the property damage. This may include lost profits, extra expenses incurred to restart operations and even payroll. If "contingent business interruption" has been purchased, coverage also may be expanded to losses stemming from suppliers that cannot produce needed goods or customers that cannot receive the company's products.

A summary of key commercial property coverage issues is below. For a more detailed discussion of commercial property coverage for recall-related losses, please refer to Appendix 4.

"Named Perils" or "All Risks"

There are two basic forms of property insurance:

1. **Named peril.** This policy only covers losses resulting from causes (or "perils") specifically listed on the insurance policy (e.g., wind, fire, theft). If a peril is not listed, it is not covered.
2. **All risks.** This policy covers all losses regardless of cause, except for perils that are specifically excluded. All risks policies are usually more comprehensive than named peril policies, and, according to one court, were developed "to protect the insured in cases where loss or damage to property is difficult or impossible to explain."

Direct Physical Loss Requirement

Property insurance policies typically require "direct physical loss of or damage to" property to trigger coverage. "Physical loss" and "damage" are not defined terms and many courts have interpreted them broadly, not limiting them to structural damage or unfitness for human consumption.

Business Interruption

Business interruption insurance does not stand alone: business interruption losses must be tied to property damage for the policy to provide coverage. Many policies further require that the damage occur to property "at the premises described in the Declarations." Thus, the availability of coverage for business interruption losses may depend on which — or whose — property is damaged.

> "Consumer claims are specific and measurable. Recall costs are pretty well defined. Business interruption is a big black box."
> *– survey respondent*

Which Property? Business Interruption Claims after 9/11

After the 2001 destruction of the World Trade Center (WTC), numerous businesses in the "Ground Zero" area of New York made business interruption claims even though their businesses suffered no physical damage.

Coverage depended on a number of factors, including which damaged property had to be linked to the business interruption. For example, in *Royal Indem. Co. v. Retail Brand Alliance, Inc.* a retail store across the street from the WTC recovered business interruption losses, but only until the store reopened in 2002, not until the WTC was rebuilt.

However, in *Zurich American Ins. Co. v. ABM Industries, Inc.,* a company that provided janitorial and engineering services to the WTC recovered business interruption losses until the WTC was rebuilt, even though the WTC was not owned by policyholder.

The availability of business interruption coverage also may depend on whether the business suffered a complete shutdown or simply a slowdown. First, if the policy covers but doesn't define "the necessary suspension of your 'operations,' " it may be construed in many states to require a total suspension or cessation of the business, rather than a partial shutdown. In recent years, however, the insurance industry has added a definition of "suspension" to clarify that partial interruptions and slowdowns are covered as well.

Once triggered, business interruption coverage can be limited. Most policies limit the duration of the interruption they will cover to the "period of restoration." This period usually begins 72 hours after the physical loss and ends when the property "should be" repaired or when business is resumed at a new location (the “period of restoration”). This limitation is not a problem when the suspension of operations is shorter than the period of restoration, for example, if a business can shift operations to a different plant while the damaged one is being restored. But when the suspension of operations extends beyond the period of restoration, the insurer is likely to resist coverage.

Key Exclusions

Insurers may invoke numerous exclusions to deny coverage under a commercial property insurance policy, including the following:

- **Pollution or contamination.** Property insurance usually excludes losses caused by pollution. Many pollution exclusions state that “pollutants” include “contaminants,” but then don’t define “contaminants.” Courts have split as to whether the pollution exclusion applies only to environmental pollutants or is broad enough to exclude virtually any foreign substance contaminating a product.
- **Fungus, wet rot, dry rot and bacteria.** Commercial property policies frequently exclude the “presence, growth, proliferation, spread or any activity of fungus, wet or dry rot or bacteria.” Policy definitions of “fungus” include mold and mildew. Mold damage may nevertheless be covered under policies if the mold was caused by an insured peril.
- **Governmental action.** Property insurance also usually excludes losses resulting from a governmental seizure or destruction on an insured’s property. This exclusion requires a government order or ban, not a government “recommendation,” warning or other non-compulsory action. A voluntary recall does not trigger this exclusion. A government embargo also is usually not enough to trigger this exclusion, because an embargo only prohibits the movement or sale of product, but is not a “seizure or destruction” order.

Supply Chain Coverage

Traditional property policies might not cover business interruption as a result of disruption to the supply chain. In cases where there is no physical damage to the company’s or supplier’s facility but other events disrupt the supply chain, specialty “supply chain” policies might fill the gap. Supply chain insurance may cover a total or partial reduction in supply, which leads to a reduction in output to the business carried on by the insured or additional expenses incurred to mitigate or diminish the insured’s reduction in output, such as procurement of replacement supplies at a higher price.

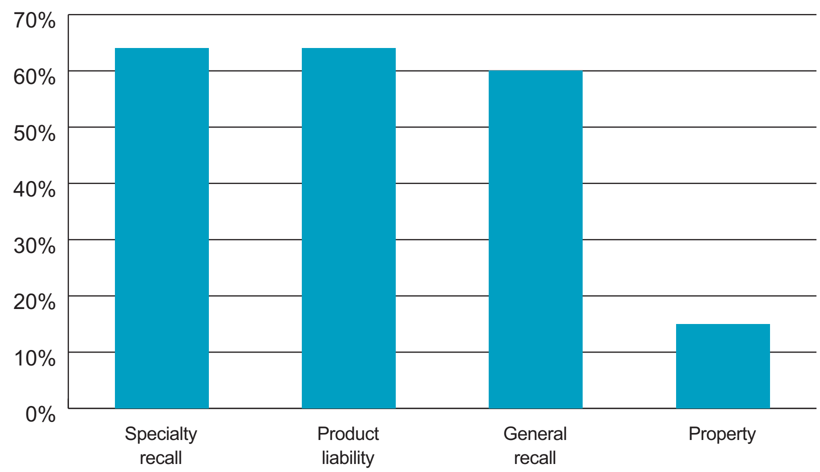
Many supply chain insurance policies are written on an “all risks” basis, and afforded coverage up to a specified amount per specified supplier for losses arising from a non-excluded cause. Some supply chain policies provide coverage for specified disruptions to all of a company’s suppliers. Examples of covered causes of loss under supply chain insurance include political unrest, trade embargoes, natural disasters, terrorism, electrical outages, crime and piracy.

Like all insurance, supply chain insurance comes with its own set of exclusions, which may include “product recall.”

Specialty Policies

Following the Tylenol tampering event in 1982, Lloyd's of London and Chartis (formerly known as AIG) began offering specialty policies to provide coverage for product recall losses. Today, the market for specialty coverage accounts for approximately $350-550 million in premiums. Approximately 64% of survey participants who rely on insurance have purchased specialty coverage at some point. Interest in such policies has increased as a result of the new food safety legislation passed in January 2011.

Figure 9: What types of insurance does your company rely on to manage risk associated with product recalls?



Brokers describe specialty coverage as challenging to underwrite because of multiple uncertainties. The most pressing concern is the aggregation effect that can result from a single contaminated component. Because a contaminated component product can be incorporated into multiple end products, a single product contamination incident or recall can affect many companies.

For this and other reasons, it is difficult for insurers to predict the frequency and severity of recalls. In the food and beverage, and consumer packaged goods industry, this predictability problem has been exacerbated by changes to FDA's authority, which now includes the power to order recalls.

Specialty policies may be issued as stand-alone policies or as endorsements to other policies, typically a policyholder's commercial general liability coverage. They can have multimillion dollar coverage limits or limits as low as $10,000. Although the language of specialty policies varies considerably, there are some frequently used key terms, which are described below. For a detailed discussion of specialty policies, please see Appendix 5.

Specialty Policy Triggers

Perhaps the greatest source of confusion about specialty policies is the nature of the "insured events" to which they respond. Specialty policies may provide coverage for losses — including recall losses — resulting from specific events, including:

- **Product contamination.** Product contamination can be limited to actual product contamination or may include a reasonable suspicion of product contamination.

- **Malicious product tampering/extortion.** Malicious tampering is defined as any actual or threatened malicious alteration or contamination of a product by any person, including an employee. This coverage usually also extends to product extortion, which covers any threat of product tampering made in conjunction with a demand for money.
- **Adverse publicity.** Generally, the definition of “publicity” is limited to instances in which the policyholder’s product name or brand name has been specifically identified in media reports or government publications in connection with actual or alleged product contamination or tampering, such as the mention of the insured and its product in an FDA enforcement report or an FDA 483 (inspection) report posted on the FDA website. An FDA advisory warning consumers to refrain from consuming a specific food item regardless of the brand or producer, such as the advisory following the 2006 *Escherichia coli (E. coli)* outbreak linked to bagged spinach or adverse publicity about a competitor’s product may not trigger this coverage, even if the insured suffers losses as a result.
- **Government recalls.** Some insurers also include government recalls under their specialty coverage. This coverage typically applied to countries outside the US, but now may be relevant to the US because food safety reform has given the FDA food recall authority.

Covered Losses

If the specialty policy has been triggered, the recall-related expenses the policy will pay are listed in the definition of “loss,” which can be narrow or expansive. Covered losses may include:

- **Recall costs.** These costs include the cost of transporting, storing and disposing of the recalled product, hiring and paying temporary staff to manage the recall, paying overtime to regular employees and the increased cost of working (meaning cleaning or repairing machinery and paying employees overtime to do so).
- **Third-party expenses.** These are costs the policyholder is legally obligated to reimburse its customers. They may include the costs incurred by the insured’s customers to carry out the recall, customer loss of gross profits and customer brand rehabilitation expenses.
- **Loss of gross profits.** This is usually the reduction in the policyholder’s sales revenue caused directly by the insured event. The most common area of dispute in a lost profits claim is whether the loss of revenue was directly attributable to the insured event or to some other factor, such as changes in consumer or customer demand.
- **Product rehabilitation.** Product rehabilitation expenses are the cost of re-establishing the pre-recall sales level of the recalled product, including expenditures for sales, marketing, shelf space and slotting.
- **Crisis management.** Several insurers also offer policyholders the option to purchase coverage for crisis management expenses. Insurers view the inclusion of crisis response in a specialty policy as a way to mitigate loss if an insured event occurs. The insurer may designate a crisis management consultant to handle crisis response for the policyholder.

Insurers may limit coverage by imposing low caps on certain events or losses. The “sublimits” normally are included in a declaration or endorsement.

Key Exclusions

Specialty policies contain a number of exclusions that limit coverage. These include:

- **Regulatory violations.** This can be a concern for policyholders, like food and beverage companies, in highly regulated industries. One such exclusion states that no loss will be covered that is attributable to an “intentional” violation related to:
    - Testing, manufacturing, storage, distribution or sale of an insured product
    - Ingredients, components and/or packaging used in the manufacturing process that have been previously banned or declared unsafe by any governmental or regulatory body
    - Maintenance of adequate documentation of the manufacturing process in compliance with any existing governmental or regulatory standards
- **Third-party liabilities for bodily injury or property damage.** These liabilities are typically covered by third-party liability insurance policies.
- **Criminal or fraudulent acts.** These exclusions may apply to fraudulent, illegal or criminal acts by a director or officer of the policyholder.
- **Prior knowledge.** This exclusion applies to circumstances giving rise to the insured event if they were known by or should reasonably have been known by the policyholder before the inception of the policy period.

Other Considerations

There are several other key considerations for a company applying for a specialty policy:

- **Demonstrate stringent quality controls.** A company applying for specialty coverage is a more attractive risk if it can show that it has stringent quality control practices, such as crisis management preparation, product traceability, batch coding and hazard analysis and critical control points (HACCP) plans, all of which reduce the risk of a contamination incident.
- **Be specific in the application.** Applications for specialty coverage tend to be extensive and ask the prospective policyholder to provide detailed information about its operations, locations, products, suppliers, contracts, quality control practices and recall history. Some insurers limit coverage only to those products listed by the policyholder on its application form, so it is important for a company to be specific and thorough on its applications to ensure that the products for which coverage is sought are listed.
- **Understand confidentiality restrictions.** Specialty policies sometimes contain confidentiality provisions requiring that the policyholder refrain from disclosing the existence of the policy to any person, except in limited circumstances.
- **Be aware of dispute resolution limitations.** Specialty policies frequently contain dispute resolution and choice of law clauses that require the policyholder to litigate or submit to arbitration in an offshore venue and/or under foreign law — arbitration in London under UK law is an example. Such clauses can make it logistically impracticable or cost-prohibitive for the policyholder to enforce its insurance contract in the event of a dispute with the insurer.

Comparison of Insurance Policies Covering Product Recalls

	Commercial General Liability	Commercial Property	Recall/ Contamination
What triggers the policy?	‣ An "occurrence" that causes bodily injury or property damage during the policy period	‣ "Loss" during the policy period	‣ Accidental contamination or malicious tampering that has resulted or would result in bodily injury or property damage
What is covered?	‣ Liability for bodily injury and damage to third-party property ‣ Costs of defense against third-party suits	‣ Damage to your property ‣ Related business interruption losses	‣ Costs incurred to recall your products
For example…?	‣ Costs to replace customer products damaged or rendered useless by your ingredients ‣ Hospital bills of consumers sickened by your product ‣ Attorney fees spent to defend lawsuits	‣ Your stock damaged by a contractor's negligence ‣ Lost income during shutdown of operations while repairing damaged equipment	‣ Costs to transport, store, dispose of recalled product ‣ Overtime and temporary staff expenses ‣ Lost profits (sometimes)
What's the catch?	‣ Damage must be caused by "occurrence" ‣ Products liability coverage may have lower limit than policy as a whole	‣ Damage must be physical and caused by a "covered cause of loss" ‣ Business interruption must be connected to such property damage.	‣ Insurance may require more to trigger coverage than FDA requires to trigger recall
Coverage for "your product"	‣ Excluded	‣ Covered	‣ Covered
Coverage for "your work"	‣ Excluded (e.g., if you provide a service, like bottling, rather than a product, like soda)	N/A	N/A
Coverage for "impaired property"	‣ Excluded if the damage can be undone by replacing your product	N/A	N/A
Coverage for replacing, storing, shipping and/ or disposing of recalled products	‣ Excluded, unless recall is of third party's property from which your product cannot be unincorporated	‣ Replacement cost of covered property ‣ Excluded if government ordered seizure/ destruction (not excluded if voluntarily recalled)	‣ Covered ‣ Type and amount depends what costs are listed and excluded
Coverage for contamination	‣ Excluded if caused by a "pollutant"	‣ Typically excluded if caused by a "pollutant" except if contamination was the result of a covered peril.	‣ Included

Financial Recovery

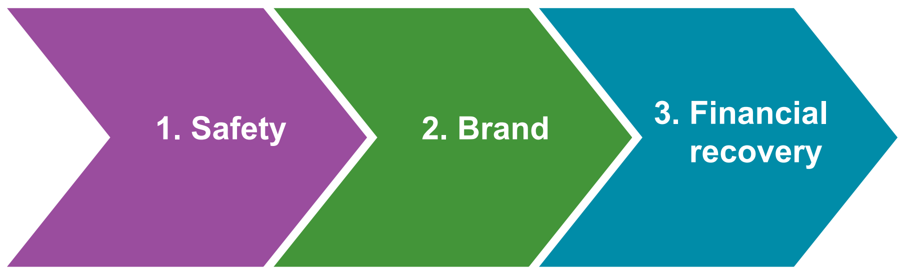
Cost recovery is typically not the first priority in a recall. Companies typically respond to recalls by:

1. **Putting safety first.** This is non-negotiable.
2. **Protecting the brand.** This means communicating openly and often to maintain a level of trust with customers and consumers — to let them know that safety is the company's number one priority.
3. **Seeking financial recovery.** A company tends to discuss the high-level financial impact shortly after a recall. It is critically important to follow up by preparing detailed estimates and compiling and maintaining supporting documentation that will aid in cost recovery.

"Our priorities in a recall situation are (1) the consumer; and (2) defining the disruption of our business — the impact on the top line — and getting back in business."

– survey respondent

Figure 10



One interview participant summed up the entire cost recovery process as "a lot of proof and aggravation."However, the survey results show that the longer a company waits to document costs and make claims to suppliers and insurers, the more difficult it is to recover those costs. Time is a critical element.

Figure 11. How long did it take your company to prepare the final estimate of the product recall losses?

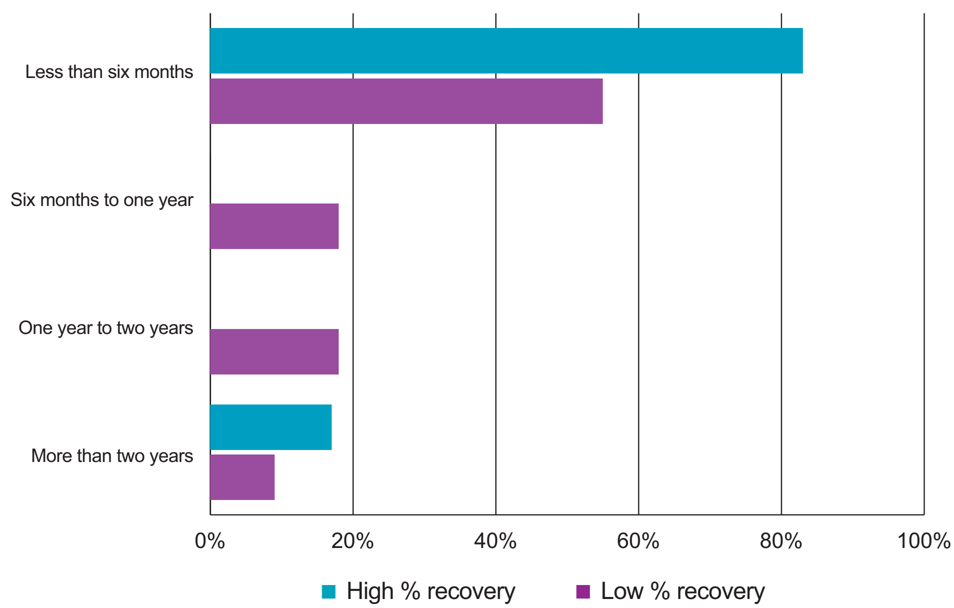
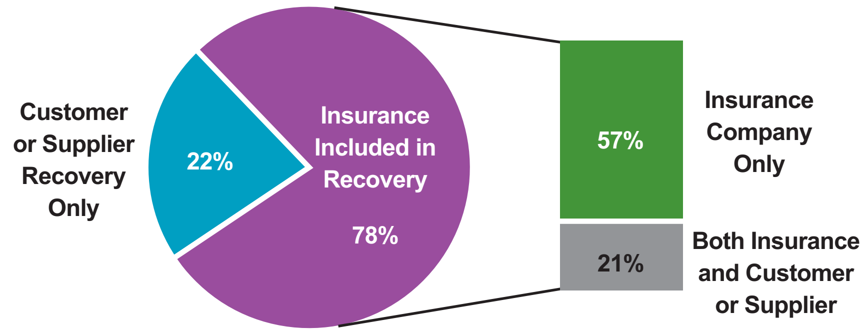


Figure 12: Insurance in Recovery

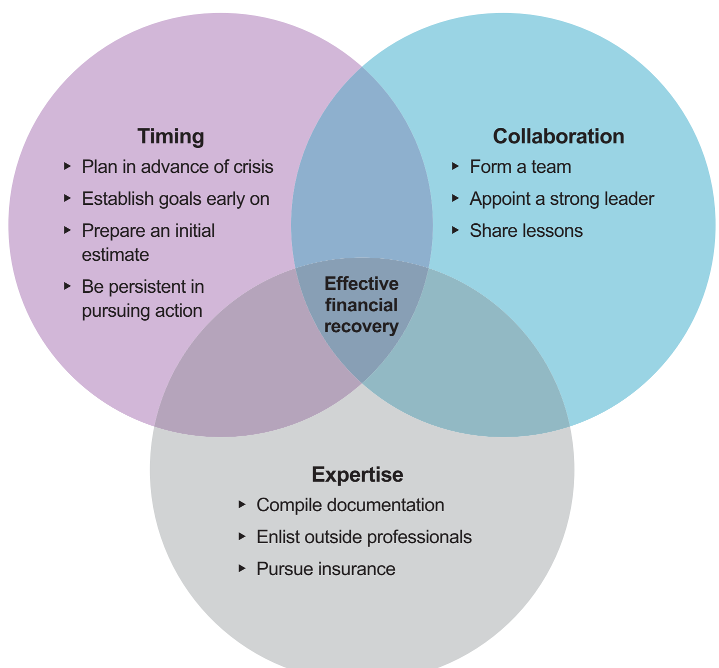


The challenge is to devise a way to recoup losses from a product recall event in a way that does not harm the company's reputation and good will with its customers. To do this effectively, companies need leadership and collaboration in crisis management, with risk management and finance experts shadowing each step of the process. Although the recall team handles the recall itself, the company's financial recovery team tracks the data needed to analyze costs, evaluates supplier responsibility and submits claims to insurers. Thus, the company can maintain its focus on consumer health and safety, which also protects the brand, while ensuring that financial loss information is preserved to protect the bottom line.

Ten Factors for Recovering Losses

Study participants shared their leading practices for financial recovery of recall losses. Some of these leading practices stem from operational procedures that many companies already have in place — having a plan for cost recovery, building a core financial recovery team, appointing a leader, and creating a culture of collaboration. Others specifically relate to the financial aspects of a recall. Identified below are 10 observations, spanning the entire recovery effort, that can help to increase recovery rates, shorten recoveries and ease frustration.

Figure 13



1. Have a Plan for Cost Recovery

Study participants large and small consistently reported that they spent time and money planning for the execution of a recall. However, companies were consistently less prepared to recover losses related to recalls.

Companies with industry-leading recall preparedness and training did not necessarily achieve a full and speedy financial recovery when they were affected by recalls. Financial recoveries require their own planning, time and attention. As part of any recovery plan, companies may want to consider:

- **Developing recovery procedures.** As a counterpart to a mock recall drill, a company can map in advance its financial recovery procedures and identify the responsible parties for each functional area affected. It can also engage external service providers before a recall crisis and work through engagement terms with these external providers so that they are able to start working immediately upon receiving notice of a recall.
- **Educating business units.** Although insurance procurement is still a central corporate function, many organizations are more decentralized. Increasingly, responsibilities for financial results (and recovery) reside at the business unit level. An annual meeting between the risk manager and the controller, treasurer or lead finance person for each business unit can help to ensure that risk managers are aware of any new products, joint ventures or new risks that have surfaced over the past year for purposes of insurance procurement. It also can serve as an opportunity to educate the business units as to any changes to the company's insurance policies. Any delays in communication between the business unit involved in a recall and the central risk management department responsible for communicating with insurers could result in the company's failure to secure full coverage for the business unit's losses.

Involve Risk Management from Start to Finish

In most organizations, risk management serves as a key liaison with insurers (and their adjusters and consultants). Risk managers have likely managed a number of claim recoveries under various policies, but the survey results indicated they are least likely to be included in the cost recovery effort from the outset.

Involve risk management throughout the entire financial recovery process to maximize recovery opportunities and rights under existing policies.

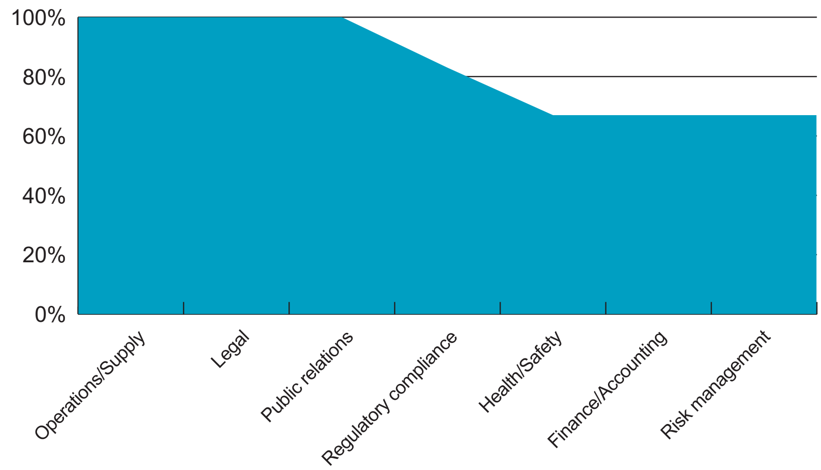
2. Select a Broad Recovery Team

While the recall team, operations and supply chain, and public relations focus on the operational and brand aspects of a recall, finance, accounting and risk management can begin their cost recovery work sooner and with more urgency.

Some of the leading practices respondents cited in building a core recovery team for the operational aspects of the recall are also relevant to financial recovery, and included creating a culture of collaboration, with team-building and training exercises to enable team members to work together on financial recovery.

The loss recovery process — particularly the creation of the initial estimate — often involves an "all-hands" meeting where representatives from many functions brainstorm about potential impacts. Representatives from finance and accounting, risk management, marketing and sales, logistics, production, manufacturing facilities, operations and legal can all take part to identify potential recall-related losses and potential avenues of recovery for each type of loss. This initial brainstorming session often uncovers additional loss areas.

Figure 14: High Recovery % Team



In addition, it is critical that the investor relations team collaborate with the recall and cost recovery teams. If a press release understates the recall impact and misjudges the end date of the recall, insurers may rely on it to help guide their determination of the amount or duration of the loss.

Insurers and their adjusters will appreciate the company's effort to identify all the losses. It enables them to create loss area placeholders within their required reports and minimizes unpleasant surprises for all parties in the claims handling process.

3. Appoint a Recovery Leader

Companies that experienced successful claim results reported that a strong leader took the reins of the claim process. Depending on the avenue of recovery, the company may wish to nominate someone from legal, risk management or the finance/accounting function to serve as a claim leader. Ideally, this individual would have enough experience, knowledge and "gravity" across the company to get things done. In many cases the claim leader can face internal and external pressures.

In an insurance recovery, the cost recovery leader can serve as or designate the single point of contact with the insurer. Having all information flow through this individual can avoid any breakdowns in communication. During certain stages of the recovery, a broker or other individual may take the lead on certain portions of the communication. When a claim involves a coverage dispute that might proceed to mediation, arbitration or litigation, in-house counsel or outside counsel may be the best leadership choice.

Coordination among all members of the loss recovery team is essential to make sure all parties involved are following the same plan and working toward the recovery goals a company sets.

4. Clarify Recovery Goals

Where there is still an ongoing business relationship between a company and its supplier or a company and its insurer, it is often in their mutual best interest to settle the claim and to avoid litigation between them. However, particularly in the early stages, the policyholder should anticipate the possibility of a dispute and should prepare its claims materials with that possibility in mind. Preparations may also include taking appropriate steps to preserve the confidentiality of privileged discussions with in-house or outside counsel.

The key players may benefit from a frank discussion of the company's goals at the beginning of the recovery process. For some companies, maintaining supplier relationships may be more important than extracting money from a supplier, which might put the supplier out of business. Certain suppliers are critical to the long-term growth plans of certain businesses.

5. Communicate with Insurers

Consistent, well-planned communication with insurers is critical to secure a favorable outcome. Coordination of all communications with insurers helps to maintain consistent messaging to the insurers in question. Meticulously documenting communications, particularly if there is a potential coverage dispute with the insurer, can help to prevent any allegations that the policyholder failed to cooperate with the insurer.

"The earlier you sit down with and involve the insurer, the better."

– survey respondents

A first step in communicating with the insurer is to provide timely notice to the insurer of the loss. "Late notice" is one of the most frequent defenses by insurers to deny the payment of claims.

Notice requirements under an insurance policy may specify the following:

- Who needs to communicate the information to the insurer (insurance broker, company officer, risk manager or other representative)
- Who should receive the notice; sometimes the designated recipient is the insurer, but it may also be a US or foreign broker or a claims agent
- What form the notice should take (phone, electronic, written)
- When the policyholder needs to inform the insurer of occurrences and claims; many policies require the policyholder to provide notice to the insurer "as soon as practicable" after an insured event. Some specialty policies require the policyholder to notify the insurer of a suspected or actual insured event within 48 hours of its discovery and to notify the insurer of any third-party claims arising from that event within five days from the event
- What information to include in the notice

The systematic approach to insurer communications can continue at each stage of the claims process, including:

- Providing an initial estimate
- Gathering and sharing appropriate supporting documentation
- Making demands for defense and/or indemnity coverage or advances on property losses
- Responding to an insurer's factual questions and/or coverage positions

When possible, a prompt and thorough response to insurer questions and other communications can ensure the claims process moves forward. In-person meetings with insurers, preferably at an early stage of the claim, can serve to establish rapport as well as to communicate information. Such meetings can help to ensure that constructive dialogue is not overtaken by a barrage of hostile letters and emails.

6. Prepare an Initial Estimate

Preparing a detailed initial estimate of the losses within the first 30 to 45 days of the recall allows the company to identify the various components of the loss and begin to estimate their magnitude. Providing information internally regarding the potential financial impact of a product recall helps give everyone involved information that can help them make good decisions. It also helps to set appropriate and reasonable expectations regarding losses and recovery, which may eliminate surprises down the road.

It is essential to define the purpose of the loss estimates and to test them:

- Is it to set aside an appropriately conservative amount for financial statement reserves? Or is it to identify the largest possible loss?
- How does the estimate compare to supporting evidence or alternative calculations? How does the company's loss estimate compare to prior years' performance, budget or production forecasts?

All these things help to give the estimate context and ensure it is not used improperly.

Internal expectations are sometimes more challenging then external pressures.

Once the initial estimate is complete, the company may want to consider sharing aspects of it, along with any supporting documentation available, with the insurer. Just as companies need to understand potential liabilities and recoveries for reporting purposes, insurers clearly need to set appropriate initial reserves. Final claim payouts that are less than initial reserves set up by the adjusters are not a concern. However, when an adjuster communicates to the insurer that a significant increase in the reserves is necessary on a claim, this causes consternation on the part of the insurer, especially when the increase in reserves is requested many months into the claims process. In this process a policyholder should be careful not to understate its estimate and should consider carefully the arguments for and against coverage of the losses.

Loss estimates in the early stages can be in the form of ranges, based on the best supporting documentation and information available at the time. All potential losses can be included even if they cannot be quantified or estimated easily at the outset. These can either be estimated by those who are closest to the data or they can simply be included as items that will be calculated once more information is known.

A company should be careful not to share estimates prematurely — without consulting necessary members of the recovery team, for example. This can result in underestimating the amount of the loss, omitting categories of loss, or misjudging the extent of insurance coverage for a loss — all of which can be difficult to undo once communicated, particularly in writing.

7. Maintain Detailed and Timely Documentation for Losses

When asked about their experience with the insurance recovery process, one study participant commented, "You can't underestimate the need for documentation." Companies who had been through a recall said they did not fully anticipate the level of documentation that would be needed and scrutiny of that documentation that would take place before a claim is paid.

Sometimes the documentation the insurer is requesting never existed or was not retained. The documentation may not be financial in nature, but may involve the timing and reasons for a specific recall-related decision. Forensic accountants, who specialize in quantifying losses, can often be helpful in determining what to capture and how to retain it.

Although insurers and their consultants often request volumes of supporting documentation to complete their evaluation of the insured's loss, the policyholder can help the insurer understand precisely how the policyholder's business was affected and the loss the insurer is being asked to pay. For example, it is often not helpful for the policyholder to provide the insurer reams of raw data without any context. Data supplied with appropriate analysis and explanation of its purpose and significance can help expedite a settlement. Conversely, burying the insurer in undigested or unnecessary data can slow progress and prompt numerous additional questions that might not have merit.

For example, imagine a company impacted by the recent peanut recalls when allegedly tainted peanuts were introduced to its line of ready-to-eat meals. The adjusting team requested three years of sales history by product SKU for all of the company's product lines. Although a subset of this data was necessary and informative to the process, it would not have been helpful to examine trends in the insured's other businesses to assess the ready-to-eat meal claim. In discussing this request with the insurer's representatives, the company walked through an analysis of the affected product lines (both those with lower sales and those that enjoyed sales increases because they were substituted for the recalled product) and provided the source data behind the analysis. This approach allowed the insured to explain specifically how it was impacted, and also to provide additional commentary on changes to the business or other relevant historical facts.

Types of financial documents that may be required by insurers include:

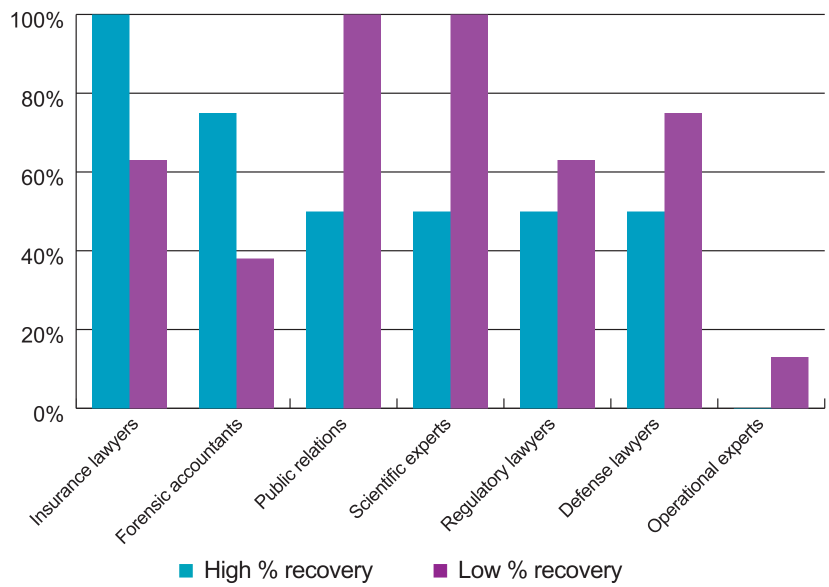
- Invoices and purchase orders for costs incurred related to the recall (trucking/storing/destroying recalled product)
- Documentation related to the reimbursement of customers for returning tainted product
- Historical profit and loss statements
- Historical budgets and forecasts
- Inventory listings and valuations
- Historical production costing data
- Documentation for costs incurred related to public relations and customer communications about the recall
- Costs incurred for discounting or couponing to reinvigorate interest in the product once the recall issue has been addressed
- Internal time and expenses for individuals who were assigned to deal with the recall

Examples of non-financial information that will assist in the recovery may include:

- The rationale for the recall
- Documentation regarding how it was determined what specific product was potentially affected and needed to be recalled
- Destruction certificates
- Documentation regarding the choice of vendors to undertake work associated with the recall
- Documentation regarding the decision to discount or coupon product to reinvigorate sales
- Explanations for increases/decreases in the company's business as a whole or in specific product lines
- Rationale behind changes to operations that were intended to mitigate losses or respond in some other way to the recall

8. Engage Outside Service Providers

Figure 15: Percent of Respondents That Use Outside Experts



Companies that have never had a recall may underestimate significantly how much time and effort goes into achieving a successful financial recovery. Adding dedicated resources to the company's cost recovery team can help level the playing field. Study participants relied on several external parties to facilitate the recovery process. These included:

- **A broker:** This is frequently the person who knows the insurance product the company purchased and the application process. Survey respondents who worked with brokers with specific expertise in product recalls indicated that they not only were instrumental in purchasing the right kind of coverage, but were just as important in a successful recovery.
- **Forensic accountants:** Forensic accountants who specialize in assisting policyholders to document, organize and present insurance claims can help sift through the available documentation to identify and support costs that can be included as a part of the insurance claim. Insurers usually hire adjusters and their own forensic accountants to evaluate claims. It is interesting to note that, of those respondents who had never experienced a recall, none had plans to use a forensic accountant. Conversely, of the survey respondents who had experienced a recall, 55% used forensic accountants in their recall recovery efforts. Of those who recovered a high percentage of their estimated losses, 75% hired forensic accountants. Certain policies provide coverage (typically subject to a sublimit) for professional fees to prepare the claim and gather financial documentation.
- **Lawyers:** Similarly, companies that had experienced a recall were more likely to anticipate using coverage counsel than companies that had not experienced a recall. Lawyers well versed in the legal interpretation of the insurance contracts can understand the opportunities and weaknesses in the company's recovery plan. Respondents also cited the value of having lawyers who are experts in insurance review their policies before purchasing to make sure the companies were achieving their risk transfer objectives. Of those respondents who recovered a high percentage of their estimated losses, 100% hired insurance lawyers.

Whether individually or as part of a team, these external providers can augment resources working to recover costs and can provide specialized expertise that may not exist in-house.

9. Don’t Delay

When it comes to recovering costs from insurers, timing is everything. It is important to note that a policyholder’s responsibility doesn’t end with the submission of a claims estimate, or detailed, timely and relevant documentation to the insurer. In fact, it is only the beginning. The policyholder that follows up consistently is more likely to keep the process moving forward. The timeliness of a recovery is more likely will depend on how persistent the policyholder is in pursuing action from the insurer.

Communicate frequently with the insurer to obtain status updates. Be aware of any additional information the insurer may need to process the claim and be prompt about providing it. As one survey participant noted, “Staying on top of the insurance companies, being tenacious and aggressive,” were key to its cost recovery efforts.

10. Share Lessons Learned

Crisis response teams often perform post-mortems to determine leading practices and lessons learned to improve the efficiency and effectiveness of the recall process, particularly after health and safety recalls. Many study participants thought a similar effort to share the lessons learned from prior recovery efforts would improve future recovery efforts.

Consider formalizing a process of sharing what the company learns among business unit controllers. This may include improving document retention, crisis management and recovery efforts.

In addition to internal knowledge transfer, it may also be useful to reach out to other companies at trade shows to learn more about their experiences and processes around financial recovery. The ability to learn from others, or from studies such as the study, is a valuable means to prepare to recover recall costs.

Conclusion

Faced with an increase in the frequency and severity of recalls, leading companies are finding ways to simultaneously protect their brand and recoup their losses.

By investing the same effort in planning for recovery as the execution of a recall, documenting every step of the recall and every recall cost, and communicating openly and frequently with insurers, companies can maximize recovery costs while minimizing additional risks to the brand and the bottom line.

Appendix 1: The Changing Regulatory Environment

The regulatory environment in which food manufacturers operate is changing rapidly, due in part to regulatory and legislative responses to recent high-profile food illness outbreaks, including the 2009 recall of peanut products due to *Salmonella* contamination. These changes will likely have three significant impacts on product recalls: (1) to establish new regulatory standards for the food industry, (2) to increase inspection and enforcement action by the Food and Drug Administration (FDA), and (3) to increase the frequency of recalls. Key changes to the regulatory environment are described below.[9]

Reportable Food Registry

The Food and Drug Administration Amendments Act of 2007[10] required the FDA to establish the Reportable Food Registry. Congress intended the Registry to enable the FDA to track adulteration in the food supply more reliably, so that the FDA can act more quickly and effectively to protect the public health.[11] Under new section 417 of the Federal Food, Drug and Cosmetic Act (FDCA), "reportable food" is defined as "an article of food (other than infant formula) 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."[12]

A recent draft FDA guidance document indicates that FDA interprets "reportable food" to be at least coextensive with the definition of a Class I recall, which is defined by FDA regulations as "a situation in which there is a reasonable probability that the use of, or exposure to, a violative product will cause serious adverse health consequences or death."[13]

As soon as practicable after discovering "reportable food" — but in no case more than 24 hours later — a responsible party must submit a report to the FDA through the electronic Reportable Food Registry.[14] A "responsible party" is a person who submits to the FDA the registration for the facility where the article of food at issue is manufactured, processed, packed or held.

The report to the Food Registry must include: a description of the food, the quantity, the extent and nature of the adulteration, whether the adulteration might have originated with the responsible

9 For a summary of the regulatory considerations relevant to recalls of FDA-regulated products, see Covington & Burling, LLP, *E-Alert: Recalls of FDA-Regulated Products — What You Need to Know*, (Feb. 9, 2009), available at http://tiny.cc/pwdjd.

10 Pub. L. 110-085, 121 Stat. 823 (codified in scattered sections of 21 and 42 U.S.C.) (2007).

11 Covington & Burling LLP, E-Alert: FDA Releases Updated Guidance on the Reportable Food Registry (May 25, 2010), *available at* http://tiny.cc/l92my; see also Covington & Burling, LLP, *E-Alert: FDA Launches Reportable Food Registry* (Sept. 15, 2009), *available at* http://tiny.cc/ta56w.

12 21 U.S.C. § 350f(a)(2).

13 21 C.F.R. § 7.3(m)(1). FDA, CFSAN, *Draft Guidance for Industry: Questions and Answers Regarding the Reportable Food Registry as Established by the Food and Drug Administration Amendments Act of 2007* (Edition 2) 7 (2007), *available at* http://www.fda.gov/downloads/Food/GuidanceComplianceRegulatoryInformation/GuidanceDocuments/FoodSafety/UCM213214.pdf. In this guidance, FDA explained that an intra-company transfer in a vertically integrated company is not considered a "transfer to another person" that triggers the reporting requirements, but transfer to a third-party warehouse would trigger obligations even if the responsible party maintains ownership over the food. *Id.* at 13. Moreover, the delivery of food to a responsible person, which FDA considers to occur when the food is no longer in transit, can trigger reporting obligations even if the responsible person later rejects the delivery because it fails a food safety test. *Id.* at 15-16.

14 21 U.S.C. § 350f(a)(1). The party need not submit a report, however, if the adulteration originated with the party, the party detected the adulteration before transferring the food to another person, and the party corrected the adulteration or destroyed the contaminated food. *Id.* § 350f(d)(2).

party, and the results of the required investigation, if known.[15] The law states that submission of this information is not an admission that the food is adulterated or caused an injury.[16]

During the first seven months of the Reportable Food Registry's operation, the FDA received 125 primary (initial) reports of reportable food and 1,638 subsequent reports from suppliers or recipients of a food that was the subject of a primary report. The November 2009 recall of two nationally distributed sulfite-containing products (lacking proper warning labels) and the February 2010 recall of 177 products containing hydrolyzed vegetable protein tainted with *Salmonella* were prompted by reports through the registry.[17]

The failure to comply with the reportable food requirements can expose a responsible party to criminal penalties, including fines and imprisonment, imposed by the FDCA.[18]

FDA Food Safety Modernization Act

A recently enacted food safety bill may impose additional regulatory requirements on the food and beverage industry and give the FDA substantially more authority — including the ability to order recalls of food, which the FDA currently lacks.[19]

The FDA Food Safety Modernization Act was signed into law on January 4, 2011. In addition to giving the FDA mandatory recall authority, it requires most food manufacturers to utilize hazard analysis and critical control point (HACCP) systems,[20] permits the FDA to set food performance standards, requires the FDA to engage in risk-based inspections (mandating that high-risk facilities be inspected every three years), and requires the FDA to design a traceability program.

The effect of vesting the FDA with mandatory recall authority remains somewhat unclear. Recalls under the current scheme are considered "voluntary," but manufacturers that do not recall contaminated food risk criminal charges for adulteration and civil liability to consumers. Vesting the FDA with the power to trigger a recall, however, will likely lead to disputes over timing and scope of such recalls. In addition, political pressure on the FDA could cause the agency to become more aggressive and willing to act on less evidence than is current practice in the industry.

Pending revision of Current Good Manufacturing Practices (cGMPs) Regulations

The FDA's food cGMP regulations have not been revised since 1986. Since that time, food consumption has changed, introducing new risks. Scientific understanding of risk factors and proper steps to reduce them has also evolved.

15 *Id*. § 350f(e)

16 *Id*. § 350f(j). Despite section 417's disclaimer, it is not clear whether a report to the Reportable Food Registry could be introduced as a party admission under federal and state rules of evidence.

17 Press Release, FDA, *New Early Detection System Helps FDA Identify More than 100 Food Safety Problems in First 7 Months* (July 28, 2010), *available at* http://www.fda.gov/NewsEvents/Newsroom/PressAnnouncements/ucm220419.htm.

18 Failure to comply with the registry requirements is a "prohibited act" under section 301 of the FDCA. 21 U.S.C. § 331(mm).

19 For a summary of the bill's requirements, see Covington & Burling LLP, *E-Alert: Congress Passes the FDA Food Safety Modernization Act* (Dec. 22, 2010), *available at* http://tinyurl.com/4z9w7qw. For summaries of the bill's prior versions, see Covington & Burling LLP, *E-Alert: Senate Leaders Release Amended Version of Food Safety Bill* (Aug. 18, 2010), *available at* http://tiny.cc/u3exu; Covington & Burling LLP, *E-Alert: Food Safety Bill Clears Senate Committee* (Nov. 20, 2009), *available at* http://tiny.cc/vu9et; Covington & Burling LLP, *E-Alert: House Passes New Food Safety Bill* (Dec. 22, 2010), *available at* http://tiny.cc/qfcoi.

20 Under FDA's current regulations, HACCP plans are required of juice manufacturers, 21 C.F.R. §§ 121.7-.8, and seafood producers, 21 C.F.R. § 123.6.

To address the need for revisions, in 2002, FDA's Center for Food Safety and Applied Nutrition (CFSAN) formed the Food cGMP Modernization Working Group. The Group's report, which was issued in 2005, recommended:

- Required training for supervisors and workers regarding food hygiene, food protection and personal hygiene
- A food allergy control plan
- Written pathogen control program for ready-to-eat foods
- Sanitation standard operating procedures (SOPs)
- Application of cGMPs to fresh produce.[21]

The FDA issued proposed rules in the spring of 2011. FDA has already issued guidance documents regarding (1) the control of *Listeria* in ready-to-eat foods and (2) the microbial food safety hazards of fresh-cut fruits and vegetables.[22] Although FDA guidance documents are technically non-binding, the agency often expects compliance with them.

Increased FDA Inspections and Enforcement

The increased regulatory authority under the new food safety legislation is expected to be backed up by increased FDA inspections and enforcement activity.

The FDA is expected to increase its inspection activities in response to criticisms of its inspection practices. In April 2010, an HHS Inspector General's Office report said that the number of FDA inspections of food facilities between 2004 and 2008 steadily declined, despite an increase in the overall number of food facilities.[23] The report "found significant weaknesses" in FDA's domestic inspection practices and recommended an increase in inspections, with an emphasis on high-risk facilities. Additionally, in August 2010, the FDA was criticized for failing to detect the *Salmonella* contamination that caused the July 2010 shell-egg recall, sickening more than 1,600 people.[24] FDA officials have indicated that they will inspect all 600 major egg producers over the next 15 months.[25]

The results of FDA inspections can be used as evidence of a manufacturer's failure to take adequate precautions to prevent food contamination. Regarding the egg producer involved in the recent shell-egg recall, for instance, FDA issued an inspection report (called a Form 483 report) that identifies a number of deficiencies found at the producer's facilities.[26] The FDA currently

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21 FDA, Food cGMP Modernization Working Group, CFSAN, *Food* cGMP *Modernization — A Focus on Food Safety* (2005), *available at* http://www.fda.gov/Food/GuidanceComplianceRegulatoryInformation/CurrentGoodManufacturingPracticesCGMPs/ucm207458.htm.

22 FDA, Food cGMP Modernization Working Group, CFSAN, *Draft Guidance for Industry: Control of Listeria monocytogenes in Refrigerated or Frozen Ready-To-Eat Foods* (2008), *available at* http://www.fda.gov/Food/GuidanceComplianceRegulatoryInformation/GuidanceDocuments/FoodProcessingHACCP/ucm073110.htm; CFSAN, *Guidance for Industry: Guide to Minimize Microbial Food Safety Hazards of Fresh-cut Fruits and Vegetables* (2008) (asserting that cGMPs in fact apply to these products because, although raw, they are processed through cutting), *available at* http://www.fda.gov/Food/. GuidanceComplianceRegulatoryInformation/GuidanceDocuments/ProduceandPlanProducts/UCM064458.

23 Dep't of Health & Human Servs., Office of Inspector Gen., *FDA Inspections of Domestic Food Facilities* (2010), *available at* http://oig.hhs.gov/oei/reports/oei-02-08-00080.pdf.

24 Mary Clare Jalonick, *Egg Company Heads Give Congress Few Answers*, MSNBC.com, Sept. 22, 2010, http://www.msnbc.msn.com/id/39304636/ns/health-food_safety/.

25 William Nuemen, *Egg Farms Violated Safety Rules*, N.Y. Times, Aug. 30, 2010, *available at* http://www.nytimes.com/2010/08/31/business/31eggs.html.

26 See FDA, *Recall of Shell Eggs* (Sept. 3, 2010), http://www.fda.gov/Safety/Recalls/MajorProductRecalls/ucm223522.htm.

makes FDA 483 reports publicly available in cases of notable public interest, and a pending FDA working group proposal has recommended publication of all FDA 483 reports.[27]

The FDA also increased the number of warning letters sent to food manufacturers in 2010. These letters generally cite observed violations of the FDCA or FDA regulations and indicate the FDA's intention to take enforcement action if the recipient fails to correct the violations.

In addition, the Obama administration has become very active with regard to food safety issues. In 2009, for example, the President convened the Food Safety Working Group, which announced findings regarding the prevention of *E. coli* and *Salmonella* and made recommendations regarding traceback and response systems.[28]

Impact of Changing Regulations

These regulatory and enforcement changes are expected to have several significant effects on the food and beverage industry. First, they might increase the frequency of recalls. This could be beneficial to consumers and manufacturers in removing potentially adulterated products from the chain of commerce before they result in a food-borne illness outbreak or damage other facilities or products. Increased traceability may help restaurants and manufacturers of finished products identify the source of contamination, an issue highlighted by a 2007 outbreak following which Taco Bell removed and destroyed green onions from 5,800 restaurants across the country, only to find later that the source of the contamination was lettuce.[29]

Second, new regulations will impose a greater compliance burden on the industry and subject the industry to increased enforcement risk. Last, regulatory compliance will likely be used as a yardstick by third parties — for example, by plaintiffs' lawyers — in evaluating whether a supplier or manufacturer satisfied a standard of care, or by insurers in deciding whether to insure, or pay an insurance coverage claim asserted by, a supplier of ingredients or a manufacturer of finished products. For example, at least one insurance broker includes on its application for contaminated products liability and response insurance questions regarding quality management systems, HACCP plans, inspections, product testing and product tampering prevention measures.[30]

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27 FDA Transparency Task Force, *FDA Transparency Initiative: Draft Proposals for Public Comment Regarding Disclosure Policies of the US Food and Drug Administration* (2010), *available at* http://www.fda.gov/downloads/AboutFDA/Transparency/PublicDisclosure/GlossaryofAcronymsandAbbreviations/UCM212110.

28 Food Safety Working Group: *Key Findings* (2009), *available at* http://www.foodsafetyworkinggroup.gov/FSWG_Key_Findings.pdf.

29 Dale E. Hausman, *Contaminated Food Scares Raise Myriad Insurance Issues*, Ins. Coverage L. Bull., April 2007.

30 Eydent Int'l Ins. Brokers, *Application for Contaminated Products Insurance, Contaminated Products Response*, http://www.eydent.com/downloads/CPI_Application_01.pdf (last visited Sept. 24, 2010).

Appendix 2: Insurance Coverage Battlegrounds

We list below some of the key coverage disputes between policyholders and their insurers. Some are specific to certain policies.

In this appendix, we do not address business interruption losses or disputes over the documentation of losses, both of which are issues that might present significant battles in which the charge is often led by forensic accountants retained by the policyholder and the insurer.

Rescission

It has become increasingly common for an insurer to attempt to "rescind" a policy after the policyholder makes a claim – i.e., cancel a policy as if it were never issued.[31] The most commonly asserted basis to rescind an insurance policy is that the prospective policyholder, during the application and policy purchase process, made material misrepresentations or omissions concerning the risks to be insured.

In specialty policies, an insurer might include language stating that a policy is void in the event of:

> concealment, misrepresentation or non-disclosure by any Policyholder, whether or not fraudulent, of a material fact concerning:
>
> (i) this insurance or the procurement thereof or
>
> (ii) the Policyholder Product(s) of the Policyholder's interest in the Policyholder Product(s) or
>
> (iii) any Policyholder Event or any Loss or claim under this policy[32]

In most jurisdictions, materiality is judged from the standpoint of the insurer and is determined at the time the insurance contract was issued, not at the time of the loss. The test for justifying rescission is whether a reasonable insurer would regard the fact that was not disclosed or which was misrepresented as one that substantially increases the chance that the risk that the policyholder is insured against will happen and therefore would reject the application or charge a higher premium.[33]

A policyholder is at the greatest risk of a future rescission when it affirmatively misrepresents information in response to questions on the insurance application.

Insurers have also sought rescission even when the application did not ask for the information in question. However, in such cases, it is likely to be more difficult for an insurer to argue persuasively that such information is "material."

Known Loss Defense

Insurers may attempt to assert the so-called "known loss" defense to deny coverage of a claim or loss. The known loss doctrine precludes coverage for an actual loss (not a potential risk) that was known to the policyholder and not disclosed to the insurer at the time of the application.

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31 *See generally* Jamie R. Carsey, Gregory J. Schwartz, & Scott N. Baldassano, *Rescission is the New DJ, ABA Section of Litigation Insurance Coverage Litigation Committee CLE Seminar* (March 4-6, 2010).

32 Catlin, Product Contamination Insurance, Form SJC2010PCI-01 (USA) 11(2010), available at http://www.catlin.com/cgl/storage/Prod_Cont_Docs/PCI_Policy_USA.pdf [hereinafter Catlin Product Contamination Insurance].

33 *Pinette v. Assurance Co. of Am.*, 52 F.3d 407 (2d Cir. 1995); *Burkert v. Equitable Life Assurance Soc'y of Am.*, 287 F.3d 293 (3d Cir. 2002).

Absent contrary policy language, the policyholder must have had actual notice of the specific loss at the time of the application in order for the doctrine to apply. It is not sufficient that a loss was likely or that the policyholder was aware of a problem that might potentially result in liability.[34] Courts have usually rejected insurers' attempts to expand the doctrine. For example, in one case, a claim for coverage arose from a product recall initiated by a beer producer in response to glass contamination discovered in its bottled beverages at a recently acquired plant. The insurer attempted to deny coverage under the known loss doctrine by arguing that the producer knew of the contamination problem and the need for a recall at the time it added the plant to its insurance policy. The court rejected the insurer's argument, noting that even if the producer "knew of a broken glass problem that made a recall likely, it does not follow that the recall, and therefore the expenses in connection with the recall, were known [on the relevant date]."[35]

Recoupment of Defense Costs

It has become more common in recent years for liability insurers to claim they are entitled to reimbursement of amounts they pay to defend their policyholders against third-party claims under CGL policies. A liability policy typically does not contain any provisions that expressly permit the insurer to do so; an insurer may simply assert a right to recoup the cost of defending "uncovered" claims in a "reservation of rights" letter to its policyholder stating many potential reasons it might deny coverage for the claim in question.

Courts permitting reimbursement sometimes take the view that the insurer did not bargain for the obligation to defend uncovered claims.[36] Recently, the Pennsylvania Supreme Court rejected this rationale and held that an insurer has no right to reimbursement unless that right is specified in the insurance contract.[37] The Court reasoned that an insurance company could not use a unilateral reservation of rights letter to create rights that did not exist under the insurance contract and determined that allowing recoupment after the fact would undermine the rights of the insured.[38]

According to one commentary, the Pennsylvania decision reflects a trend against permitting recoupment.[39]

Late Notice

Another common coverage defense is that a policyholder has failed to provide timely notice. To determine whether notice of an occurrence or claim is timely, courts first look at whether the policy imposes specific notice requirements. Many policies require the policyholder to provide notice to the insurer "as soon as practicable" after an insured event. In such cases, a court will make a factual determination of whether notice was given within a reasonable time under the circumstances.[40] Some specialty policies require the policyholder to notify the insurer of a

34 *Employers Reinsurance Corp. v. Globe Newspaper Co.*, 560 F.3d 93, 97 (1st Cir. 2009) (Refusing to apply the known loss doctrine where "[t]he loss [] may have been likely, but [] was not substantially certain or known by the [policyholder] to be so when the policy was obtained.").

35 *Nat'l Union Fire Ins. Co. v. Stroh Co.*, 265 F.3d 97, 107-08 (2d Cir. 2001).

36 *Buss v. Superior Court*, 939 P.2d 766, 770 (Cal. 1997). *See also Valley Forge Ins. Co. v. Health Care Mgmt. Partners, LTD.*, 616 F.3d 1086 (10th Cir. 2010). ("[Colorado Supreme Court cases], even if dicta,unmistakably indicate that Colorado law would allow an insurer to recover defense costs from its policyholder where it reserved the right to do so by letter, regardless whether the insurer also reserved that right in the underlying insurance policy itself.").

37 *Am. & Foreign Ins. Co. v. Jerry's Sport Center Inc.*, 2 A.3d 526 (Pa., 2010).

38 *Id*.

39 *See* Sherilyn Pastor and Alissa Pyrich, *The Continuing Debate Over an Insurer's "Right" to Reimbursement: The Pennsylvania Supreme Court Weighs in Against Reimbursement in a Newly-Decided Case*, 2010 EMERGING ISSUES (LexisNexis Sept. 15, 2010).

40 *See* Lee R. Russ, Thomas F. Segalla, Steven Plitt, *Couch on Insurance §* 186:7 (3d ed.) [hereinafter Couch].

suspected or actual insured event within 48 hours of its discovery and to give notice of any third-party claim arising from that event within five days from the event.[41]

If there is no contrary contract language, many courts hold that failure to give timely notice bars coverage only if the late notice prejudiced the insurer.[42] However, policyholders should be aware that in a few states, late notice may lead to forfeiture of coverage regardless of prejudice.[43]

No Property Damage

Both property policies and CGL properties provide coverage for physical damage to property. In the context of food recalls, there may be a dispute over whether a contaminated ingredient has caused property damage to a finished product. Insurers may argue that there is no property damage if the finished product has not been structurally damaged or rendered unfit for human consumption. However, courts have construed the term "property damage" in property and CGL policies broadly finding property damage even where a contaminated ingredient does not pose a health hazard. For specific examples, refer to Appendices 3 and 4.

The Recall Exclusion

CGL policies typically contain a recall exclusion, which insurers invoke to deny coverage for all costs of conducting a food recall. Policyholders should examine the exclusionary language carefully to determine (a) which recall execution costs are excluded and (b) whose recall costs (the policyholder's or a third party's) are excluded. The recall exclusion typically applies to losses incurred for the recall of "your product," "your work" or "impaired property." Most courts hold that the exclusion applies only to market-wide recalls of all products rather than the recall of just those products known to be defective. For examples, refer to Appendix 3.

The Pollution Exclusion

Property and liability policies typically exclude losses caused by pollution. Whether the pollution exclusion applies usually depends on whether the substance is characterized as a "pollutant." Typical pollution exclusions define "pollutant" as an "irritant or contaminant, terms that are generally not defined. Courts have split as to whether the pollution exclusion is broad enough to exclude virtually any foreign substance, or whether it is meant to exclude only industrial or environmental pollutants. Refer to Appendices 3 and 4 for examples.

Insurers frequently rely on the pollution exclusion when they reserve their rights to deny coverage for a recall or for product contamination losses.

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41 Catlin Product Contamination Insurance, *supra* note 32 at 12.

42 *See* Couch, *supra* note 40, at §186:6.

43 *See id*. at § 186:6.

Appendix 3: Commercial General Liability Insurance

Key Terms in a CGL Policy

Current CGL policies typically provide that the insurer will "pay those sums that the policyholder becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies."[44] The bodily injury or property damage must be caused by an "occurrence." Most of these key terms are defined by the policy. Although the language of the standard form CGL has evolved over time, the language discussed here is found in more recently issued policies.

CGL policies typically contain an aggregate limit on the amount the insurer will pay for "damages because of 'bodily injury' and 'property damage' included in the 'products-completed operations hazard.'" The products-completed operations hazard is defined in the definitions section and applies to food products.

Occurrence

A typical CGL policy defines an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." As the policy language indicates, an accident need not be a rapid or instantaneous event. The focus should be on whether the policyholder expected the injury or damages.[45] Thus, the question of whether there is an accident is closely tied to the somewhat redundant exclusion for "bodily injury" or "property damage" that is "expected or intended" from the standpoint of the policyholder.

Related to the "occurrence" issue is the important question of the "number" of occurrences. Many liability policies contain a limit of liability that applies to each occurrence and a deductible that applies "per occurrence." For this reason, the number of occurrences can significantly affect the amount of available coverage.

Bodily Injury

CGL policies typically define bodily injury as "bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any time." Some policies include language that expressly encompasses emotional distress and mental anguish in the definition of bodily injury.

Property Damage

Property damage is defined in a typical CGL policy as:

> (a) Physical injury to tangible property, including all resulting loss of use of that property …
>
> (b) Loss of use of tangible property that is not physically injured …

Where the policyholder produces an ingredient or component of a finished product, there may be a dispute with the insurer as to whether that ingredient or component has caused damage to a third party's property. If the policyholder's ingredient or component can be separated from the finished product, insurers will likely argue that it has not caused damage to third-party property. For example:

- The policyholder (Sokol) manufactured individually sealed packets of peanut butter that were found to be rancid after they were sold to the customer, who manufactured boxes of cookie

44 ISO Form CG 00 01 12 07, *available at* http://www.sloanmason.com/files/pdf/ISO%20PDF%2 0CG%2000%2001%2012 %2007.pdf.

45 *Columbia Mut. Ins. Co. v. Epstein*, 239 S.W.3d 667 (Mo. Ct. App. 2007).

mix containing the peanut butter packets. The customer retrieved the affected boxes of cookie mix, removed the spoiled packets, and substituted new ones purchased from another vendor. Sokol's insurer denied coverage. The court rejected Sokol's argument that the opening of the boxes to remove the rancid packets constituted either physical injury or loss of use of property, noting that "[t]he paste was sealed in individual packets and those packets were simply removed from the boxes of cookie mix."[46]

In contrast, when the policyholder's product is completely incorporated into the third party's product and cannot be removed, courts are likely to find that there has been physical damage to the finished product. For example:

- In one case, the policyholder (a nut processor) supplied almonds to Shade Foods that were incorporated into nut clusters, which Shade Foods sold to General Mills for use by General Mills in its breakfast cereals. After General Mills discovered wood splinters in the nut clusters, it stopped production and recalled its cereal products. The nut processor's insurer denied coverage arguing, among other things, that the presence of the wood splinters merely caused a diminution in value to the nut clusters and the cereal, which was not covered by the policy. The court, however, saw no difficulty "in finding property damage where a potentially injurious material in a product causes loss to other products with which it is incorporated."[47]

Where an adulterated ingredient is commingled in the finished product, there can be a finding of covered "property damage" even if the finished product is not unsafe to consume:

- The policyholder, Cutrale Citrus Juices, sold orange juice that had been adulterated with trace amounts of food grade propylene glycol to Tropicana, who subsequently mixed the adulterated juice into its own product. Although the juice was not rendered unfit for human consumption, it had to be marketed under a different, less valuable label. The court rejected the insurer's argument that there was no physical damage to Tropicana's products because the products were still fit for human consumption. Comparing the adulterated juice to a damaged car, the court noted that, "A battered automobile may still be usable — and thus marketable — but at a lower value or price, the difference being the measure of damages chargeable to the party who caused the loss."[48]
- In another case, the policyholder, a sugar producer, sold sugar to customers for use in cookie dough. The court held that it was not necessary for the policyholder to prove that the contaminants in its sugar — bee parts and cigarette butts — had actually gotten into its customers' cookie dough to show property damage to the dough. The fact that the cookie dough was produced using the adulterated sugar and thus could not be sold under FDA regulations was sufficient to support a finding of property damage.[49]

Moreover, sometimes the policyholder will be liable for costs arising from the customer's loss of use of physical space, such as storage space to store a contaminated product or loss of use of a facility during cleanup. These types of losses are clearly property damage under the "loss of use" provision.

Key Exclusions

Even if the policyholder demonstrates that the loss comes within the policy's insuring agreement, it may face any of several exclusions raised by insurers as defenses to coverage. Some key exclusions are discussed below.

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46 *Sokol v. Atlantic Mutual Ins. Co.*, 430 F.3d 417, 422 (7th Cir. 2005).

47 *Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*, 78 Cal. App. 4th 847, 865 (2000).

48 *Zurich Am. Ins. Co. v. Cutrale Citrus Juices USA, Inc.*, No. 00-CV-149, 2002 U.S. Dist. LEXIS 26829, at *11 (M.D. Fla. Feb. 8, 2002).

49 *United Sugars Corp. v. St. Paul Fire and Marine Ins. Co.*, 2007 Minn. App. Unpub. LEXIS 660 (Minn. Ct. App. June 26, 2007).

Business Risk Exclusions

Four exclusions found in the standard CGL policy are collectively termed the "business risk" exclusions.

"Your Work"/"Your Product" Exclusions

The "your work" and "your product" exclusions apply to coverage for "'property damage' to 'your product' arising out of it or any part of it," and "'property damage' to 'your work' arising out of it or any part of it and included in the 'products-completed operations hazard.'" In the product recall or contamination context, courts have applied these exclusions to bar coverage for the cost of the policyholder's ingredient or the cost of repairing the policyholder's product, but not for the cost of other property damage caused by the policyholder's product. For example:

- In one case, the policyholder was a supplier of milk to the customer and a dead mouse was found in the hose leading from the milk truck to a storage silo. The court held that the "your product" exclusion barred coverage for the loss of the policyholder's milk, but did not apply to the cost of cleaning the customer's silo.[50]

There may be a threshold question as to what the policyholder's product is. For instance, in Holsum Foods Division, the policyholder, Holsum, manufactured and packaged barbecue sauce using ingredients supplied by its customer.[51] After glass chips were discovered in some of the bottles, the bottles had to be destroyed and Holsum paid its customer for the costs of the destroyed product. Because Holsum provided multiple ingredients to the finished product and performed work that resulted in the production of the final product, the court held that the barbecue sauce was Holsum's product, which was entirely excluded by the "your product" exclusion.[52]

Impaired Property Exclusion

The impaired property exclusion applies 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.

"Impaired property" is defined as:

> [T]angible property other than 'your product' or 'your work,' that cannot be used or is less useful because:
>
> (a) It incorporates 'your product' or 'your work' that is known or thought to be defective, deficient, inadequate or dangerous; or
>
> (b) You have failed to fulfill the terms of a contract or agreement;
>
> *if* such 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.[53]

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50 *Lowville Producer's Dairy Co-Operative, Inc. v. Am. Motorists Ins. Co*., 604 N.Y.S.2d 421 (N.Y. App. Div. 1993).

51 The policy in *Holsum* denied contained an exclusion for "property damage to the named policyholder's products arising out of such products or any part of such products." *Holsum Foods Div. v. Home Ins. Co*., 162 Wis. 2d 563, 567 (Wis. Ct. App. 1991).

52 *Id*. at 569.

53 ISO Form CG 00 01 12 07, *supra* note 44, definition V.8 (emphasis added).

The first step in determining whether this exclusion applies is deciding whether the injured property is “impaired.” The exclusion does not apply if the third party’s property has suffered “physical injury.” It also does not apply where the third party’s property cannot be restored to use by removing an adulterating or contaminating ingredient. In Shade Foods, for instance, the nut clusters were not “impaired property” because it was not possible to remove the contaminated almonds. As the court noted:

> [The insurer] has presented no evidence that the contaminated products manufactured from the diced almonds could be ‘restored to use’ by removal of the wood splinters. Indeed, it is fanciful to suppose that the nut clusters composed of congealed syrups and diced nuts or the boxed cereal product containing the nut clusters could be somehow deconstructed to remove the injurious splinters and then recombined for their original use.[54]

Sistership/Recall Exclusion

The “sistership,” or recall exclusion[55], is often relied upon by insurers to deny coverage for all food recall losses, but should be read carefully in light of the policyholder’s specific situation. The most recent iteration of this exclusion applies 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;”
>
> (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.

If the recalled product is not the policyholder’s product or work and is not impaired property because it cannot be restored to use, a policyholder can argue that the exclusion does not apply. For example:

- In Hall Steel, the policyholder sold an incorrect grade of steel to a manufacturer to be incorporated into windshield wiper brackets. The wiper brackets failed and were recalled. The court held that the recall exclusion did not apply because the brackets were not the policyholder’s product, nor were they impaired property. The brackets were the manufacturer’s product and could not be restored to use by removal of the steel.[56]

Although the above case did not involve food products, the same principles apply where a policyholder supplies an ingredient to be incorporated into a product and the completed product subsequently recalled.

Additionally, most courts hold that the exclusion applies only to market-wide recalls of all products rather than the recall of just those products known to be defective.[57]

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54 *Shade Foods*, 78 Cal. App. 4th at 866.

55 The name arises from the “sistership” doctrine, which historically required that a manufacturer discovering damage to one part of an airplane recall all other similarly equipped planes as a precaution for public safety. *Atlantic Mut. Ins. Co. v. Hillside Bottling Co., Inc.*, 903 A.2d 513, 518 (N.J. Super. Ct. App. Div. 2006).

56 *Amerisure Mut. Ins. Co. v. Hall Steel Co.*, No. 286677, 2009 Mich. App. LEXIS 2545, at *16-17 (Mich. Ct. App. Aug. 27, 2008).

57 *Atlantic Mut. Ins. Co. v. Hillside Bottling Co., Inc.*, 903 A.2d at 518. *Travelers Indem. Co. v. Dammann,* 2008 U.S. Dist. LEXIS 9759, at *21 (D.N.J. Feb. 11, 2008).

The "Expected or Intended" Exclusion

General liability policies typically contain an exclusion for "expected or intended injury" that excludes "'bodily injury' or 'property damage' expected or intended from the standpoint of the policyholder."[58] When applying the "expected or intended" language, courts inquire whether the policyholder subjectively intended the resulting "bodily injury" or "property damage" not the causative act.[59] Recovery will be barred only if the policyholder knew that the damages would flow directly and immediately from its intentional act.[60]

The Pollution Exclusion

Insurers regularly invoke the "pollution" exclusion found in CGL policies to deny coverage for claims arising from alleged contamination of food products. The standard-form pollution exclusion bars coverage for bodily injury or property damage arising out of the discharge, dispersal, seepage, migration, release or escape of "pollutants," which are defined as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste." One court noted that the terms used in the pollution exclusion are "terms of art in environmental law which generally are used with reference to damage or injury caused by improper disposal or containment of hazardous waste."[61] There have been no cases holding that the pollution exclusion in a liability policy bars coverage for liabilities based on food product recalls. For a discussion of cases that have addressed this issue in the first-party context, with mixed results, please see Appendix 4.

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58 ISO Form CG 00 01 12 07, *supra* note 44, exclusion 2.a.

59 *See id.*

60 *Johnstown v. Bankers Standard Ins. Co.*, 877 F.2d 1146, 1150 (2d Cir. 1989).

61 *Keggi v. Northbrook Prop. & Cas. Ins. Co.*, 13 P.3d 785 (Ariz. Ct. App. 2000) (the pollution exclusion did not bar coverage for injury caused by drinking water contaminated with total and fecal coliform bacteria because bacteria was not a "pollutant" under the policy definition).

Appendix 4:
Commercial Property Insurance

Commercial property insurance generally provides coverage for the company's own property, such as buildings, equipment, goods and stock.[62] Coverage extends to property the company owns and also may include property leased to it or property that the company has in its care, custody and control. Several insurers offer products that specifically cover goods in process, food inventory and products in transit.[63] In addition to the property loss itself, commercial property insurance also covers related losses arising from the interruption of business operations, which often exceed the property loss itself. Certain property policies also cover "contingent business interruption losses," meaning they provide coverage when a supplier or customer suffers property damage that results in an interruption of its operations, which in turn disrupts the insured's operation. The scope of covered property will depend not only on what is covered and excluded, but also on how much is covered.

As previously discussed, certain recall-related costs may be covered by ordinary commercial property insurance, which is provided on either a "named perils" or an "all risks" form. The following discussion addresses key property policy terms in greater detail.

Key Property Insurance Terms

Physical damage

Property insurance policies typically cover "direct physical loss of or damage to"[64] property. Courts have found that "physical damage" exists in the following circumstances:

- In a case involving nut clusters to be used in a General Mills breakfast cereal, it was "obvious" to the court that the "contamination of the almonds with wood splinters, requiring their destruction, constituted physical loss of the stock."[65]
- Pillsbury's cream-style corn product was deemed physically damaged where spoilage could occur from potentially unsafe processing, even though there was no showing that the food actually was spoiled.[66]
- A Virginia ham wholesaler's destruction of its entire lot of ham that had been exposed to ammonia was covered as a total loss, even though only some of the ham posed a potential health hazard.[67]
- Beans imported from Europe and treated with a pesticide not approved in the US were "damaged" because they were not marketable under US regulations even though they were not unfit for consumption.[68]
- A contractor's use of a harmless but unapproved pesticide on oats to be used in Cheerios® was "property damage" even though the pesticide did not render the oats unfit for human consumption.[69]

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62 Land is usually excluded from commercial property insurance.

63 *See*, *e.g.,* Travelers, *Commercial insurance for food manufacturers, available at* http://www.travelers.com/business-insurance/mid-sized-business/food-products.aspx.

64 ISO Form CP 00 10 04 02 (2002), *available at* http://www.endlar.com/Documents/Policy_Forms/Arbella%20CP0010%20Bldg%20and%20Personal%20Property%20Covg%20Form.pdf.

65 *Shade Foods*, 78 Cal. App. 4th at 874.

66 *The Pillsbury Co. v. Underwriters of Lloyd's London*, 705 F. Supp. 1396, 1399 (D. Minn. 1989).

67 *S. Wallace Edwards & Sons, Inc. v. Cincinnati Ins. Co.*, 353 F.3d 367 (4th Cir. 2003) (noting that had all of the ham not been discarded, USDA would have recommended a recall).

68 *Blaine Richards & Co. v. Marine Indem. Ins. Co.*, 635 F.2d 1051 (2d Cir. 1980).

69 *General Mills, Inc. v. Gold Medal Ins. Co.*, 622 N.W.2d 147, 152 (Minn. 2001).

All that was required in these cases was that the property be "injured in some way."[70] As the court in the General Mills case (involving Cheerios) reasoned, "The business of manufacturing food products requires conforming to the appropriate FDA regulations. Whether or not the oats could be safely consumed, they legally could not be used in General Mills' business."[71] The loss was covered as property damage.

In contrast, a government embargo was held not to constitute "property damage." This is what happened with the US "mad cow" ban on Canadian beef in 2003. A Canadian beef producer whose cattle were not diseased was nevertheless subject to the embargo. A customer in the US who made oils and shortening from beef tallow argued that he suffered a direct physical loss because his supply of Canadian beef was treated as though it were physically contaminated. The court held that this producer's loss was caused solely by the ban order, not by contaminated beef, and so was not covered.[72]

Business Interruption

Business interruption insurance provides coverage for lost "business income" during the period of time needed to restore damaged property, as long as the business interruption losses are caused by property damage. Typical policy wording states: "the suspension [of the business] must be caused by direct physical loss of or damage to property." Many policies also require that the damage occur to property "at the premises described in the Declarations."[73] It is important to examine the policy to determine exactly which — or whose — property must be damaged in order to trigger the business interruption coverage.[74]

For example, when a well serving a Tahoe City restaurant was found to contain *E. coli* bacteria, the county temporarily shut down the restaurant. The restaurant had an "all risks" policy that covered business interruptions resulting from damage to property "at the described premises," but the on-premises well was contaminated due to an off-premises leak of a sewer manhole. The insurer argued that the sewer leak that caused the well contamination was not "damage to covered property," but the court held that the closure of the restaurant "resulted from direct physical damage to the property at the insured premises" and that "[d]amage to 'covered property' is not required by the terms of the policy to trigger coverage of loss of business income.'"[75]

Most policies also limit business interruption coverage in two additional ways. First, some insurers have argued that the policy's coverage of "the necessary suspension of your 'operations'"[76]

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70 *Id.*

71 *Id.*

72 *Source Food Technology Inc. v. U.S. Fidelity & Guaranty Co.,* No. 06-1166, 2006 WL 2920651 (8th Cir. Oct. 13, 2006).

73 ISO Form CP 00 30 04 02, *available at* www.mwsecurity.com/images/CP0030.doc. Many policies do not expressly require the damage to occur to "covered property." The differences among "property," "property at the described premises" and "covered property" are important, because policyholders may claim business interruption losses as a result of damage to or destruction of someone else's property.

74 Examples of the "which property" problem arose after the 2001 destruction of the World Trade Center ("WTC"), when numerous businesses in the "Ground Zero" area of New York made business interruption claims even though their businesses suffered no physical damage. Coverage depended on a number of factors, including which damaged property had to be linked to the business interruption. *Compare, e.g., Royal Indem. Co. v. Retail Brand Alliance*, Inc., 822 N.Y.S.2d 268 (N.Y. App. Div. 2006) (allowing business interruption coverage to retail store across the street from WTC but only until store reopened in 2002 and not until WTC is rebuilt) *with Zurich Am. Ins. Co. v. ABM Industries, Inc.*, No. 01 Civ. 11200 (JSR), 2006 WL1293360 (S.D.N.Y. May 11, 2006) (allowing business interruption coverage until WTC is rebuilt for company that provided janitorial and engineering services to WTC, even though towers were not owned by policyholder).

75 *Cooper v. Travelers Indem. Co.*, No. C-01-2400, 2002 WL 32775680 (N.D. Cal. Nov. 4 2002).

76 ISO Form CP 00 30 06 95, (1995 business interruption form), *available at* http://www.propertyinsurancecoveragelaw.com/uploads/file/CP%2000%2030%2006%2095.pdf.

requires a total suspension or cessation of the business, as opposed to a partial shutdown.[77] Beginning in 2001, ISO added a definition of "suspension" to clarify that partial interruptions and slowdowns are covered as well as total cessations of business.[78]

Second, most policies limit the duration of the interruption they will cover to the "period of restoration," which is usually defined to begin 72 hours after the physical loss and to end "on the earlier of: (1) the date when the property at the described premises should be repaired, rebuilt or replaced with reasonable speed and similar quality; or (2) the date when business is resumed at a new permanent location."[79] This demarcation is not a problem where the suspension of business operations is shorter than the period of restoration, such as, when a business can shift operations to a different plant while the damaged one is being restored. But when the suspension of operations extends beyond the restoration of the damaged property, the insurer is likely to resist coverage. For example, in *Brand Management, Inc. v. Maryland Casualty Co.,* involving *Listeria* contamination at a sushi plant, the plant closed for 15 days to disinfect the premises, but its largest customer refused to purchase from the company unless it moved from the premises. The insurance company denied coverage for any losses after the plant was disinfected, and a court agreed.[80]

Valuation

The valuation provisions of standard commercial property policies often provide that the value of covered property will be determined "at actual cash value as of the time of loss or damage." The value of stock (i.e., merchandise, raw materials, in-process and finished goods, packing materials and shipping supplies) is often set at "the selling price less discounts and expenses you otherwise would have had."[81] Unlike replacement value ("new for old") coverage, coverage for the actual cash value of property refers to the item's current value. Current value is not always easy to establish and may depend upon numerous case-specific factors. For example, to determine the actual cash value of coffee that had to be destroyed after contamination of processing equipment, the court took into account four factors: "(1) the coffee was not ready for sale, but for packaging, at the point it was contaminated; (2) there was evidence that Interstate's average selling price for the custom-blended coffee in October 1997, was $5.56 per pound; (3) no evidence was presented as to the wholesale cost of the raw coffee beans at the date of the loss, only evidence as to the amount Interstate originally paid for the coffee; and (4) Interstate had added value to the coffee over the course of production."[82]

In addition, commercial property insurance policies often contain detailed appraisal provisions, which often require arbitration-like proceedings to establish the value of the loss where insurer and policyholder do not agree. Appraisals may be formal or informal, and the results are usually binding under typical commercial policies. That said, only the amount of the appraisal is binding; the insurance company may still reserve its right to deny coverage on other grounds.[83]

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77 *Compare Am. Medical Imaging Corp. v. St. Paul Fire & Marine Ins. Co.*, 949 F.2d 690 (3d Cir. 1991) (awarding BI coverage for six weeks of disrupted operations even though accounting and other clerical functions resumed within one day) *with Home Indem. Co. v Hyplains Beef*, 893 F Supp 987, 991-2 (D. Kan 1995), aff'd, 89 F.3d 850 (10th Cir. 1996) (no BI coverage where operations continued throughout the period that computer difficulties existed, "albeit at a reduced level of efficiency").

78 ISO Form CP 00 30 04 02, *supra* note 73.

79 ISO Form CP 00 30 04 02, *supra* note 73.; see *Pennbarr Corp. v. Ins. Co. of N. Am.*, 976 F.2d 153 (3d. Cir. 1992).

80 *Brand Management, Inc. v. Maryland Cas. Co.*, No. 05-CV-02293, 2007 WL 1772063 at *3 (D. Colo. 2007).

81 ISO Form CP 00 10 04 02, *supra* note 64.

82 *Interstate Gourmet Coffee Roasters, Inc. v. Seaco Ins. Co.*, 794 N.E.2d 607 (Mass. App. Ct. 2003).

83 *See generally* Jay Levin, *Demystifying Appraisal: The Scope and Nature of Insurance Appraisals* (International Risk Management Institute, Inc. October 2007), *available at* http://www.irmi.com/expert/articles/2007/levin10.aspx?cmd=print.

Property Insurance Exclusions: Pollution/Contamination

A large body of case law has developed around the interpretation of the pollution exclusion in the context of food contamination or product recalls, with courts split as to whether the exclusion applies only to industrial or environmental pollutants or excludes virtually any foreign substance.

- The pollution exclusion has been held to apply to preclude coverage for dressed poultry contaminated by heptachlor, a banned insecticide.[84]
- In a case involving *Listeria* contamination of a sandwich processor's products, the bacteria was found to constitute a "pollutant" under the policy's pollution exclusion, notwithstanding the policyholder's argument that the exclusion was meant to only exclude industrial pollutants and other inorganic substances.[85]
- Another court held that plastic screening that ended up in a pre-mix for Pillsbury biscuits was not a contaminant, disagreeing with the insurer's theory that "almost any substance or foreign object qualifies as a contaminant."[86]
- Similarly, where contaminated ingredients caused an off taste in certain soft drinks, an exclusion for "pollution and/or contamination" was held to be "directed to environmental pollution, and not product contamination."[87]

Notwithstanding the pollution exclusion, some losses — potentially including product recall expenses — may be covered if the contamination was itself caused by an insured peril. For example:

- In *Allianz Insurance Co. v. RJR Nabisco Holdings Corp.,* Nabisco's food products were insured under "all risk" policies that excluded, among other things, "Loss or damage caused by or resulting from contamination unless such loss or damage results from a peril not otherwise excluded…"[88] After receiving complaints about a strong chemical odor and flavor in various food products, Nabisco discovered contamination by chemicals present at a new warehouse where the food products were stored. Nabisco recalled more than one million cases of food, and was awarded coverage for the recall despite the contamination exclusion. The court based its decision on the exclusion's exception for perils "not otherwise excluded." Under Nabisco's all risks policy, "the actions of a third party," which included the construction company's failure to seal and clean up chemicals it used, were "classic 'perils' covered by an 'all risks' policy."[89] Even though contamination was present, the fact that it was caused by the construction company's negligence brought the resulting damage back within the policy's coverage.
- In another case involving the contamination of food products in storage, a cheese maker claimed coverage for the loss of its product due to odors traced to a chemical found in fruit-based products stored and damaged in the same warehouse.[90] The court affirmed a jury verdict finding that the policy's contamination exclusion did not apply, because the loss was caused by "some event or condition other than mere storage of other food products with its damaged cheese,"[91] i.e., the warehouse operator's negligent spillage and damage of the fruit products, which in turn damaged the cheese.[92]

As shown by these cases, whether food contamination is excluded often will depend upon how the applicable court interprets the definition of "pollutant" or "contaminant" and on whether the policy language contains an exception for other causes of loss.

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84 *Townsends of Arkansas, Inc. v. Millers Mutual Ins. Co.*, 823 F. Supp. 233 (D. Del. 1993).
85 *Landshire Fast Foods of Milwaukee, Inc. v. Employers Mut. Cas. Co.*, 676 N.W.2d 528 (Wis. Ct. App. 2004).
86 *The Pillsbury Co. v. Zurich Am. Ins. Co.*, No. Civ. 03-6560 (DSD) (JJG), 2005 WL 2778752 (D. Minn. Oct. 25, 2005).
87 *PepsiCo, Inc. v. Winterthur Int'l Am. Ins. Co.*, 788 N.Y.S.2d 142, 144-45 (N.Y. App. Div. 2004).
88 *Allianz Ins. Co. v. RJR Nabisco Holdings Corp.*, 96 F. Supp. 2d 253, 254 (S.D.N.Y. 2000).
89 *Id.* at 255.
90 *Leprino Foods Co. v. Factory Mut. Ins. Co.,* Nos. 09-1262, 09-1287, 2011 WL 3134625 (10th Cir. July 27, 2011).
91 *Id.* at *5-6.
92 *Id.* at *5.

Appendix 5: Specialty Insurance

The Specialty Market: Insurers and Policyholders

Specialty policies have been developed by the insurance industry to provide coverage for recall-related losses. Although these policies are frequently referred to as "product recall" insurance, they provide coverage for recall-related losses only when those losses are caused by specified types of events, typically accidental contamination and malicious product tampering. We refer to this group of policies as "specialty" policies.

When Lloyd's of London and Chartis (formerly known as AIG) began offering specialty coverage in the late 1980s, as a result of the much publicized Tylenol tampering incident, they had little competition or loss experience.[93] Today, the market for specialty coverage accounts for approximately $350-550 million in premiums.[94] Although XL Insurance and Catlin dominate the field, several other underwriters now offer this type of coverage, including Liberty Mutual, Crum & Forster, Professional Insurance Agents, Canopius, Zurich, Sagicor, and C.V. Starr.[95]

Most of the purchasers of specialty product recall coverage are companies with revenues ranging from $500 million to $5 billion, particularly private-label contractors supplying large retailers.[96] One leading broker estimates that between 50% and 70% of companies in this revenue bracket purchase specialty coverage.[97] Multibillion dollar companies are less likely to purchase specialty coverage, as are companies with less than $250 million in revenue.[98] In general, a relatively high percentage of companies in the food and beverage sector purchase specialty coverage.[99] Approximately 64% of the GMA member companies who rely on insurance to manage the risk of a recall stated that they had purchased this coverage.

The language of specialty policies, whether stand-alone policies or endorsements, varies considerably and there are very few cases to provide guidance about how such policies will be interpreted. Below we describe some of the key terms of these policies.

What Triggers a Specialty Policy to Respond?

Perhaps the greatest source of confusion about specialty policies is the nature of the "insured events" to which they respond. In general, these policies respond when there has been (a) "accidental contamination," (b) "malicious product tampering" or a related extortion attempt, (c) "adverse publicity" concerning such contamination or tampering, or (d) a "government recall." Specialty policies may provide all or a subset of these coverages and some of these coverages may be provided by endorsement.

Accidental Contamination

Under a policy providing coverage for accidental contamination, a policyholder must be careful to determine whether the policy will respond only when there is proof of actual contamination or also

93 Telephone Interview with Ian Harrison, Executive Director, Lockton Companies - London (June 11, 2010) [hereinafter Harrison Interview].

94 *Id.*

95 Telephone Interview with Geoff Mills, Product Recall Practice Leader, Marsh, Inc. (June 29, 2010) [hereinafter Mills Interview]; Harrison Interview, *supra* note 93.

96 Mills Interview, *supra* note 95.

97 *Id.*

98 *Id.*

99 Harrison Interview, *supra* note 93.

when the policyholder reasonably suspects its product to be contaminated. One specialty policy defines accidental contamination as:

> Any accidental or unintentional contamination, impairment or mislabeling of an Insured Product(s), which occurs during or as a result of its production, preparation, manufacture, packaging or distribution; provided that the use or consumption of such Insured Product(s):
>
> (i) has resulted in or would result in clearly identifiable internal or external physical symptoms of bodily injury, sickness, disease or death of any person(s) within three hundred and sixty five days (365) days following such consumption or use or
>
> (ii) has caused or would cause Property Damage to or destruction of tangible property other than damage to or destruction of Insured Product(s) or any other tangible property or product in which the Insured Product(s) is incorporated as an ingredient or component.[100]

Some policies require the policyholder to retain samples of any contaminated products to establish that an "insured event" has occurred.

If the insurer requires the policyholder to show actual contamination of the policyholder's product, the requirement can present several problems. First, because policyholders must act quickly to protect public health, often while under considerable pressure from governmental authorities, customers and consumers, they might not have the opportunity to confirm that actual contamination of the product has occurred before making a reasonable decision to recall the product.

Second, the language does not track the FDA's recall classifications. The FDA's definition of a Class I recall, which is its most serious recall category, is a situation in which there is "a reasonable probability that the use of or exposure to a violative product will cause serious adverse health consequences or death."[101] This discrepancy could place a policyholder in the position of recalling on its own initiative or being asked by the FDA to recall based on this "reasonable probability" standard, but not being able to satisfy the definition of "accidental contamination" under its specialty policy because it cannot prove its product was actually contaminated.

A recent case interpreted a policy triggered when the policyholder had committed "errors" that gave it "reasonable cause to believe" that its products would cause bodily injury.[102] Fresh Express sold bagged fresh spinach purchased from various growers. In 2006, there was a nationwide outbreak of food-borne illnesses that were traced to *E. coli* bacteria in bagged spinach. The FDA issued multiple advisories warning the public to avoid all brands of bagged spinach, but later determined that spinach packed by another company was the source of the outbreak, not Fresh Express.

Fresh Express was insured under a "Total Recall + Brand Protection Food/Beverage Policy" issued by Beazley. That policy provided coverage for "accidental contamination," which it defined as an "error…which causes the Assured to have reasonable cause to believe that the use or consumption of such Insured Products has led to or would lead to" bodily injury.[103] The insurer denied coverage for Fresh Express's recall-related losses on the grounds that Fresh Express did not commit any "errors" that gave it "reasonable cause to believe" its products had led to or would lead to bodily injury.[104]

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100 Catlin Product Contamination Insurance, *supra* note 32, at 3.

101 FDA, *Recalls, Market Withdrawals, & Safety Alerts: Background and Definitions, available at* http://www.fda.gov/Safety/Recalls/ucm165546.htm (last visited Sept. 28, 2010).

102 *Fresh Express Inc. v. Beazley Syndicate 2623/623 AT Lloyd's et al.,* No. H035246, 2011 WL 3949805 (Cal. Ct. App. Sep. 8, 2011).

103 *Id.* slip op. at 2.

104 *Id.* at 13.

In 2008, Fresh Express sued its insurer for $12 million in losses, the maximum limit of the policy, and prevailed at trial.[105] On appeal, however, the California appellate court reversed, holding that while the *E. coli* outbreak itself may have given Fresh Express reasonable cause to believe that its spinach products were contaminated, the *E. coli* outbreak was not an "error" by Fresh Express.[106] Similarly, Fresh Express' losses were the result of the *E. coli* outbreak, not of any errors by Fresh Express, which were not discovered until after the FDA had already issued its warnings and the products had already been withdrawn.[107]

From a policyholder's perspective, the "reasonable cause to believe" definition of accidental contamination is preferable to the actual contamination requirement, because it affords broader coverage for contamination events and is more consistent with FDA regulations and the realities of administering a recall. However, even the broad "reasonable cause" definition is tied to specific terms, like "error," that make the facts associated with the loss critically important.

Malicious Product Tampering/Extortion

The second type of "insured event," malicious tampering, is defined by one insurer as any actual or threatened, "intentional, malicious, and wrongful alteration or contamination of the Insured Product(s), by any person (including an employee of the Insured), so as to render the Insured Product(s) unfit or dangerous for its intended use or to create such impression to the public."[108] Such coverage usually includes product extortion, which is defined as any threat that the policyholder's product will be subject to malicious tampering made in conjunction with a demand for money.[109] If product extortion occurs, specialty policies may provide coverage for the amount paid under duress, and may also cover rewards paid to informants, costs of travel while attempting to negotiate, and costs of increased security.[110]

Adverse Publicity

Generally, the definition of "publicity" is limited to those instances in which the policyholder's product name or brand name has been specifically identified in media reports or government publications.[111] Under this language, the mention of the policyholder and its product in an FDA enforcement report or an FDA 483 (inspection) report, which is posted on the FDA website, should be sufficient to trigger the "adverse publicity" coverage. However, coverage might not be triggered by an FDA advisory warning consumers to refrain from consuming a specific food item, regardless of the brand or producer, as it did during the 2006 *E. coli* outbreak linked to bagged spinach.[112] Similarly, coverage might not be triggered by adverse publicity about a competitor's product, even though that publicity may adversely affect the policyholder's sales of the same type of product.

Government Recalls

Some insurers also include "government recalls" as "insured events" under their specialty coverage. In the past, such recall provisions have had limited utility in the United States, because the FDA did not have mandatory recall authority over food items other than infant formula.[113] However, on January 4, 2011, President Obama signed the Food Safety Modernization Act, granting the FDA mandatory recall authority. In the future, mandatory FDA recalls may trigger

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105 *Id.* at 14-17.

106 *Id.* at 20-21.

107 *Id.* at 21-24.

108 *See, e.g.*, Chartis, *Sample Product Recall Insurance 6, available at* http://www.chartisinsurance.com/chartisint/internet/GB/en/files/ChartisCMDPRDEF%20140607v1_tcm911-266198.pdf (last visited Oct. 4. 2010) [hereinafter Chartis Sample Product Recall Insurance].

109 *Id.* at 6.

110 *Id.* at 6-7.

111 *Id.* at 2, 6.

112 *See* Fresh Express, No. M88545, *supra* note 102, at 2-3.

113 21 C.F.R. § 7.40 (2010); 21 C.F.R. § 107.20 (2010). FDA does have the power to initiate court action to seize adulterated or misbranded products.

coverage under policies which list “government recalls” as “insured events.”

One product recall insurance program adds certain voluntary recalls requested by the FDA, the U.S. Department of Agriculture, or the Canadian Food Inspection Agency (CFIA) to the list of “insured events.” Developed by Lockton and the American Frozen Food Institute, this specialty insurance provides coverage for suggested as well as mandatory recalls classified by the FDA, USDA, or CFIA as either Class I or Class II, but only if the recall is caused by the introduction into the policyholder’s product of an adulterated ingredient or component.[114]

If the Policy Is Triggered, which Recall-Related Losses Are Covered?

Once the specialty policy has been triggered by a covered insured event, the policyholder must determine which recall-related expenses the policy will pay. Those expenses are listed in the definition of “loss,” which may include some or all of the following:

- Transporting, storing, and disposing of the recalled product
- Hiring and paying temporary staff to manage the recall
- Paying overtime to regular employees
- Pre-recall testing
- Third party recall expenses
- Product rehabilitation costs
- Loss of gross profits
- The increased cost of working (meaning cleaning or repairing machinery and maintaining the policyholder’s workforce for a period of time after the insured event in order to do so)

Some specialty policies also provide coverage for “third party recall expenses,” meaning the recall-related costs for which the policyholder is legally obligated to reimburse its customers, “in the event that the Insured Product(s) becomes a part of a product manufactured, distributed or handled by such customer.”[115] These expenses may include the costs incurred by the customer to carry out the product recall, customer loss of gross profits, and customer rehabilitation expenses. This coverage differs from the policyholder’s liability to its customer for damage to the customer’s product, which is more likely covered by a third-party general liability policy; instead, this coverage captures the customer’s costs of recalling the customer’s product. Insurers generally take the position that recall costs are excluded from general liability policies by the standard-form recall exclusion, discussed above.

Covered recall-related losses might also include the policyholder’s loss of gross profits, which are usually defined as the difference between the reduction in sales revenue caused directly by the insured event and the costs saved by not making those sales, such as raw materials and packaging. The most common area of dispute in a lost profits claim is whether the loss of revenue was “directly” attributable to the insured event.

Finally, covered recall-related expenses might also include limited coverage for product or brand rehabilitation. Product rehabilitation expenses are typically restricted to the cost of re-establishing the pre-recall sales level of the recalled product, including expenditures for sales, marketing, shelf space and slotting.[116] In this respect, product rehabilitation coverage under a specialty policy differs from the coverage afforded by a trade name restoration (TNR) policy, which is designed to deal

114 Lockton Companies LLC, *New AFFI Product Contamination and Recall Insurance* (2010).

115 Chartis Sample Product Recall Insurance, *supra* note 108, at 7.

116 *See Id.*

with the risk of brand name damage faced by restaurants and others in the food service industry.[117] Generally, TNR policies cover a reduction in revenue resulting from business interruption and expenses due to adverse publicity about the brand.[118] Only a few underwriters offer this coverage; they include Professional Liability Insurance Services, Catlin, and Crum & Forster.[119]

Several insurers also offer policyholders the option to purchase coverage for crisis management expenses. Insurers view the inclusion of crisis response in a specialty policy as a way to mitigate loss if an insured event occurs.[120] With this type of coverage, if the policyholder wants to engage the services of a crisis management consultant other than the one designated by the insurer, the policyholder may need to obtain the insurer's consent. Specialty policies with crisis response coverage may specify that, as a condition precedent to recovery, the policyholder must immediately notify the insurer's designated crisis management consultants at the first sign of accidental contamination, malicious tampering, or an extortion demand, in addition to providing notice to the insurer.

Key Exclusions and Limitations

Specialty policies contain a number of exclusions that limit coverage. We discuss some key exclusions below.

Typically, there is an exclusion for regulatory violations, which can be problematic for policyholders, like food and beverage companies, in highly regulated industries. One such exclusion excludes loss attributable to an:

> Intentional violation by the Insured of any governmental or regulatory requirements in connection with the:
>
> (i) testing, manufacturing, storage, distribution, or sale of any Insured Product(s);
>
> (ii) use of any ingredients, components and/or packaging in the manufacturing process which have been previously banned or declared Unsafe by any governmental or regulatory body;
>
> (iii) maintenance of adequate documentation of the manufacturing process in compliance with any existing governmental or regulatory standards…[121]

The policy does not define the term "intentional," which is critical to the scope of this exclusion. A policyholder might argue that this exclusion bars coverage only if the policyholder foresaw the legal violation and acted with the expectation of bringing it about. However, if interpreted broadly to include acts more akin to negligence or carelessness (where the policyholder intended its act, but did not realize that the act would violate governmental or regulatory requirements), policyholders who commit inadvertent regulatory violations could be barred from recovery. To avoid a dispute over the implications of this exclusion, a company should seek removal or clarification of the provision when purchasing a specialty policy.

Other important exclusions exclude the policyholder's liabilities to third parties for bodily injury or property damage (typically covered by third party liability insurance policies); fraudulent, illegal, or criminal acts by a director or officer of the policyholder;[122] circumstances that were known or should

117 *See Panel explores supplier sublimits and other dangers of food safety insurance,* Food Chemical News, Nov. 30, 2009, at 12.

118 *Id.; Business Interruption/Trade Name Restoration (TNR) Program Marks 12 Year Anniversary*, Insurance Journal's Newswire, *available at* http://www.insurancejournal.com/services/newswire/2010/05/19/109968.htm.

119 *Id.*

120 Harrison Interview, *supra* note 93.

121 Chartis Sample Product Recall Insurance, *supra* note 108 at 8.

122 Chartis Sample Product Recall Insurance, *supra* note 108, at 9.

reasonably have been known by the policyholder before the inception of the policy period.[123]

Insurers might also limit coverage by imposing low sublimits on certain events or losses. For example, in *Quick Service Management, Inc. v. Underwriters of Lloyds,* the insurer denied coverage for expenses incurred by the policyholder, Taco Bell, when it unknowingly incorporated contaminated lettuce into its products.[124] The insurer argued that recovery was barred because contamination incidents that resulted from "the operations of any product supplier of the insured" were subject to a sublimit of $0.[125] The insurer asserted that the word "product" in this sublimit provision actually meant "ingredients and components" used to prepare Taco Bell's finished food products.

Applying basic principles of insurance policy interpretation, the court concluded that the policy language was ambiguous and that Taco Bell's interpretation was reasonable. The court went on to explain that, practically speaking, the incident was not the result of the operations of a supplier, but rather the operations of Taco Bell restaurants, which prepared and sold the food to its customers. This case illustrates the importance of sublimits, which are usually specified in a declaration or endorsement rather than the policy itself.

123 *Id.*
124 No. MID-L-4861-07, 2009 N.J. Super. Unpub. LEXIS 3234 (N.J. Super. Ct. Jun. 12, 2009).
125 *Id.* at 9.

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