

Product Liability Risks for Wholesaler-Distributors

Product recalls can be devastating not only for a manufacturer, but also for its wholesaler-distributors. Wholesaler-distributors are subject to scores of laws and regulations related to product liability, which can vary from state to state and over time. Risks include bodily injury and property damage losses arising from the product, its packaging, its instructions for use, labels, warnings and any other on-product messages. While the manufacturer is usually held liable for injury resulting from a defective product, any seller of the product can also be held responsible in the United States under tort liability. Certain circumstances heighten a wholesaler-distributor's risk:

- When it provides installation, service or repair work for the product
- When it modifies, repackages or re-labels products, instructions or warranties
- When it uses its own private label
- When it imports products from a foreign manufacturer that does not carry U.S. product liability coverage
- When it works with thinly capitalized or poorly insured manufacturers
- When it had knowledge of the defective condition prior to the sale and did not take action
- When it recommends a product that is unsuitable for

a given purpose

In addition, an injured consumer can file a suit against a wholesaler-distributor instead of a product manufacturer even if the wholesaler-distributor did not create the defect, participate in the design or production of the product, or author the product instructions or warnings. While the wholesaler-distributor can bring the manufacturer of the defective product into the case as a defendant, claiming indemnity, this is not always successful, especially if a foreign manufacturer produced the product.

Despite considerable risks, many wholesaler-distributors fail to properly protect themselves against product liability.

Consider that the federal government mandates more than 1,000 recalls each year. Not including voluntary recalls, which are unrecorded, that's an average of almost four recalls a day. Costs arising from product liability can easily cascade into the millions, and the negative publicity resulting from a lawsuit can severely damage sales and brand health, and can even lead to shareholder lawsuits. Despite the considerable risks it presents, many wholesaler-distributors neglect to purchase insurance against product liability. Protecting a company against this sizeable risk should be a priority for

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every risk manager.

What can be done, then, to protect against the risks of product liability? In addition to maintaining proper insurance coverage, careful planning is essential in managing the risk of a recall.

First- and Third-party Exposure

There are two categories of exposure to loss for a company faced with a product recall incident: first-party operational losses to the company and third-party liability losses to injured persons.

Unlike third-party losses, first-party loss is often overlooked. In addition to the initial recall expenses, the potential long-term losses from the damage to a company's reputation and loss of sales may continue for months or even years. Because these losses can be catastrophic, this article focuses on ways to manage first-party incident exposures.

Risk Management Considerations

It is a common misconception that product recalls are covered under a general or product liability policy. Those coverages do a good job of covering bodily injury and property damage, but they generally exclude contamination and recall events. The addition of a product contamination or product recall policy protects a company's bottom line by covering the direct costs of recall, but transferring the risk is only one part of closing the recall exposure gap. Having solid risk management policies for recall and contamination events can protect a company against serious damage.

Contamination Perils

It's helpful to understand the three basic contamination perils when designing a risk management program that provides the best protection for the least cost:

- Malicious tampering (intentional contamination) is prone to publicity, so it may seem common. In reality, malicious tampering is rare, but when it strikes, it tends to result in severe loss. Managing

this risk exposure can be difficult, as motives vary widely.

- Accidental contamination is an unintentional error in the manufacturing, packaging or storage of a product. This includes mislabeling as well as contamination.
- Product extortion is the most difficult peril to characterize, and its severity is difficult to quantify. Most extortions are amateurish hoaxes, but they may evolve into outright tampering cases, which can be very costly.

Pyramid Defense

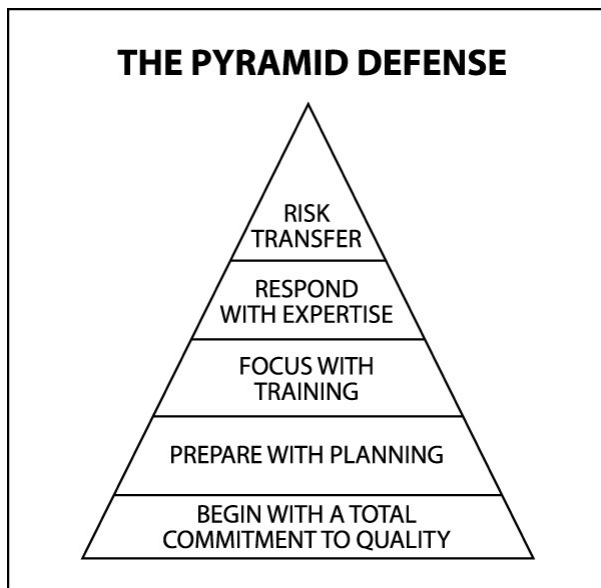
Think of your risk management plan as a pyramid that outlines a series of defenses to counter the threat of a product incident.

The first line of defense is the base of the pyramid. Actions that can be taken to eliminate the majority of threats, such as unwanted bacteria, disgruntled employees, malfunctioning equipment, sloppy suppliers and lax testing, go in the bottom of the pyramid. Any threats not eliminated by the first tier should be addressed by the second, and so on. As the pyramid rises, the plan becomes more specific and more effective at isolating and eliminating product incident threats.

- Tier 1 – Total commitment to quality. Most of what can be done to protect against a product incident falls under product quality assurance and control. If working with foreign suppliers, it is crucial to select a supplier who will produce defect-free products that meet specifications and applicable U.S. legal and regulatory requirements. Field monitoring of the products helps assure continued compliance and detect product irregularities or unauthorized changes to the product's design or raw materials used in production. Also consider independent testing in the U.S. of product samples.

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A wholesaler-distributor may also ask a manufacturer to supply a certificate of insurance, which describes the extent of coverage and the policy term. The wholesaler-distributor can ask to be added as an insured party on this policy, although this is no substitute for having your own coverage. Finally, a wholesaler-distributor can include a term in its contract with a supplier in which the supplier consents to the jurisdiction of U.S. courts in the event a claim involving one of its products is filed. However, contractual indemnity is only as valuable as the manufacturer's ability to pay.



- Tier 2 – Prepare with a contingency plan. It is essential to have a plan in place before a crisis arises. Research indicates that the first 48 hours of a product incident are more crucial than the next 48 days.
- Tier 3 – Focus on training. Contingency plans aren't of much use if they haven't been tested and honed under simulated conditions. Any involved personnel must be adequately informed about and trained in the product recall response plan.
- Tier 4 – Respond with expertise and decisiveness. Even with a good team and a good plan, there is a place in a recall crisis for professional consultants.
- Tier 5 – Transfer risk where possible. Even when prepared for a recall, companies can suffer substantial financial losses. In spite of precautions, a large-scale public recall may cost millions of dollars in lost profits, lost inventory and lost market share. A solid product recall insurance program – one that indemnifies for the host of extra expenses and losses in revenue that come with product withdrawals – is the last line of defense.

Transferring the Risk

Insurance policies for first-party losses caused by product tampering and contamination incidents are broadly labeled as product recall insurance. Product recall policies help to cover the additional costs of a recall, including product loss, costs to withdraw the product from market, product disposal, product testing, overtime wages and crisis management—costs that can be devastating because they arise at a time when a company's revenues are already suffering.

There are several coverage forms designed to isolate distinct components of first-party product exposure. At Bankers Insurance, LLC, we can work with you to ensure your product recall policy provides indemnity for:

- Recall expense. This out-of-pocket expense is associated with executing a large-scale product withdrawal. It includes costs like extra temporary employees; overtime; public safety messages; special testing and handling; destruction and disposal costs; and crisis management and/or public relations consulting fees.
- Replacement cost. As the name implies, this is the cost of replacing any product that had to be destroyed. This includes the cost of materials, labor and overhead directly associated with producing the product.
- Lost profits. This indemnifies the insured for profits which would have been earned on the withdrawn products and also for profits which would have been

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earned on future product sales, but which were not earned because of resultant future sales declines. This is usually limited to a specified time period.

- Brand rehabilitation expense. Most underwriters will also indemnify the insured for necessary rehabilitation of the recalled product's consumer image. This includes costs like extra advertising, extra expense to rush a new product to market and special promotions to rebuild public trust in your business.

In addition to transferring risk, thorough risk management practices are essential to minimize the exposure and the cost of a recall event. The product recall insurance marketplace is highly specialized. Our team of commercial insurance experts can help secure the coverage you need. Contact us today at (800) 541-1419.