

## A Recall Wake-Up Call

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Although Toyota's ongoing vehicle recall has dominated American and international headlines on a scale unseen for nearly a decade, there has been surprisingly little discussion about whether Toyota has insurance to cover its estimated \$2 to 4 billion exposure<sup>1</sup> stemming from the worldwide recall.<sup>2</sup> A Toyota spokesperson said in an e-mail that information on whether the company has recall insurance is not "readily available," and pundits disagree on whether Toyota has recall coverage as part of its insurance program.<sup>3</sup>

As Toyota's experience demonstrates, product recall insurance may be an important type of coverage for product manufacturers to consider purchasing. Every year, product recalls in the United States number in the hundreds, and they are not limited to the automotive industry. Recalls are also commonplace in the consumer product, pharmaceutical, cosmetics, and food and beverage industries. In March 2010 alone, product recalls included a popular potato chip possibly contaminated by salmonella, a children's hooded sweatshirt with drawstrings that posed a risk of strangulation and a device used to power cell phones with a lithium-ion cell problem.

Product recalls can be expensive, easily costing tens of millions of dollars or more.<sup>4</sup> Product recall insurance may cover some or all of the following: (1) the costs of inspecting, withdrawing, warehousing, destroying and replacing the recalled product, as well as the costs of publicizing the recall; (2) lost profits; (3) the costs of reestablishing a brand's reputation and market share; and (4) crisis communications and response expenses.<sup>5</sup>

Some manufacturers may be under the mistaken impression that their comprehensive general liability insurance (CGL) policies cover the costs associated with a product recall but, generally, that is not the case. While most CGL policies cover property damage and bodily injury resulting from a product's failure, product recalls are typically excluded from coverage absent an endorsement to the contrary.

### **I. Application of the 'Sistership' Exclusion to the Classic Recall Fact Pattern**

Commencing in 1966, most CGL policies began including an exclusionary provision relating to claims for costs associated with product recalls. Until 1985, this standard provision excluded from coverage:

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Damages claimed for the withdrawal, inspection, repair, replacement, or loss of use of the named insured or of any property of which such products or work form a part, if such products, work or property are withdrawn from the market or from use because of any known or suspected defect or deficiency therein.<sup>6</sup>

This language, dubbed the 'sistership' exclusion, was added to CGL policies in the wake of insurance claims for losses arising from the grounding of 'sister' aircraft when one plane was found to have a defect.<sup>7</sup> The sistership exclusion excludes coverage "in cases where, because of the actual failure of the insured's product, similar products are withdrawn from use to prevent the failure of these other products, which have not yet failed but are suspected of containing the same defect."<sup>8</sup> It does not apply, however, to the product that has failed and already caused damage to the property of a third party.<sup>9</sup>

In describing the "most usual situation" in which a sistership exclusion would apply to preclude coverage, several courts have used as an example "the recall by automobile manufacturers of vehicles for corrective measures."<sup>10</sup> It follows that, if Toyota did not purchase recall insurance, it likely would not be entitled to coverage for its ongoing recall under any standard CGL policy.

The standard language of sistership exclusions was amended in 1985 to clarify the scope of coverage available for "third-party recalls"—recalls initiated by entities other than the insured manufacturer. Prior to this revision, court rulings were split as to whether the exclusion precluded coverage for recall costs when the recall was not initiated by the insured. Some cases held that the pre-1985 language did not exclude such claims. See *Elco Industries, Inc. v. Liberty Mutual Insurance Co.*, 414 N.E.2d 41, 45 (Ill. App. Ct. 1980) (holding sistership exclusion "operable only where the withdrawal of the product was by the insured rather than a third party"); *Int'l Hormones, Inc. v. Safeco Insurance Co.*, 394 N.Y.S.2d 260, 261 (App. Div. 1977) (sistership exclusion inapplicable following FDA recall because such exclusions are "operative only where the withdrawal is by the insured party itself, and not . . . where the product is recalled by a third party"); *Thomas J. Lipton, Inc. v. Liberty Mutual Insurance Co.*, 314 N.E.2d 37, 38 (N.Y. 1974) (sistership exclusion "extends only to claims . . . arising from withdrawal and recall by the named insured").

The majority and better reasoned view, however, was that the pre-1985 language of the sistership exclusion applied even to situations where a third party withdrew the product. See *Commercial Union Assurance Co. v. Glass Lined Pipe Co.*, 372 So. 2d 1305, 1308 (Ala. 1979) ("The language is clear and unambiguous. There are no words of limitation concerning the identity of the party who might withdraw the products or work completed from the market."); *Menasha Corp. v. Lumbermens Mutual Casualty Co.*, 361 F. Supp. 2d 887, 895 n.17 (E.D. Wis. 2005).

Following the 1985 amendment, the language of the sistership exclusion in most CGL policies specified that the exclusion applied regardless of whether the recall was initiated by the insured or a third party. The post-1985 exclusion excludes coverage for:

Damages claimed for any loss, cost or expense incurred by you or others for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal of:

- (1) "Your product";
- (2) "Your work"; or
- (3) "Impaired property"

if such product, work or property is withdrawn or recalled from the market or from use **by any person or organization** because of a known or suspected defect, deficiency, inadequacy or dangerous condition in it.<sup>11</sup>

Recent cases have uniformly construed the post-1985 exclusion against insureds seeking coverage for losses stemming from a product recall. For example, in *Sokol & Co. v. Atlantic Mutual Insurance Co.*, 430 F.3d 417 (7th Cir. 2006), an Illinois food products manufacturer sought coverage for costs and losses associated with the recall of sealed packets of peanut butter paste. In 2001, prior to the retail sale of the peanut butter paste to the public, a third party discovered that the paste was "rancid," which resulted in the product's recall. *Sokol*, 430 F.3d at 419. In turn, the manufacturer sought coverage for the costs of recalling its product from the market. In affirming the decision of the trial court, the Seventh Circuit examined the insurance policy's sistership exclusion, and found that the losses incurred by the manufacturer all resulted from the peanut butter paste's withdrawal from the market, replacement and disposal.<sup>12</sup> Accordingly, the Seventh Circuit held that the sistership exclusion applied "straightforwardly," precluding any coverage for the costs of recalling the peanut butter paste.<sup>13</sup>

## II. Coverage Issues In Complex Recall Cases

Coverage issues are sometimes more complicated when a recall stems from the incorporation of one company's defective products into another company's product. For example, assume that a third party supplied Toyota with defective accelerator pedals and the incorporation of these pedals into Toyota vehicles is prompting a recall. If Toyota sued the supplier for damages stemming from Toyota's on-going recall, would the supplier be entitled to defense and indemnity under a standard CGL policy? Probably not.

### **1. Damage to Another Product Incorporating the Recalled Product**

In determining whether there is coverage for recall costs when a product has been recalled because a defective component has been incorporated into another product, courts look to the definitions of 'property damage' found in standard CGL policies. Based on this language, courts generally agree that incorporating a defective component or product into a larger structure or system does not constitute insured physical injury to tangible property, unless and until the defective component physically injures some other tangible part of the larger system or the system as a whole.<sup>14</sup> In *Hamilton Die Cast, Inc. v. United States Fidelity & Guaranty Co.*, 508

F.2d 417 (7th Cir. 1975), the Seventh Circuit illustrated this point using an automobile recall due to potentially defective tires as an example:

[I]f an automobile crash results from the failure of its defective tire, the defective component can be said to have caused 'property damage' to the finished product. If, however, some of the tires purchased by the automobile manufacturer are found to be defective and the manufacturer therefore withdraws its car from the market, there has not been 'injury to or destruction of tangible property.'<sup>15</sup>

The reasoning of *Hamilton Die Cast* was followed in *Seagate Technology, Inc. v. St. Paul Fire & Marine Insurance Co.*, 11 F. Supp. 2d 1150 (N.D. Cal. 1998). Amstrad sold personal computers into which Seagate disk drive storage devices had been incorporated. Amstrad subsequently sued Seagate, alleging that the disk drives were defective and failed "to perform as promised or warranted."<sup>16</sup> With respect to whether Seagate was entitled to insurance coverage, a federal court in California found that the installation of Seagate's defective disk drives into Amstrad's computers did *not* impose a duty to defend on Seagate's insurers because there was no allegation of "property damage."<sup>17</sup> The court stated: "A defective disk drive does not injure a host computer upon incorporation. Instead, the drive only inflicts physical injury on the computer if it actually damages other parts of the computer."<sup>18</sup> The court applied the rule that "the risk of replacing or repairing a defective product is considered a commercial risk which is not passed on to a liability insurer," explaining that this principle "is designed to prevent liability insurance from serving as a warranty or guarantee of an insured's product."<sup>19</sup>

On the other hand, in *Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*, 78 Cal. App. 4th 847 (Cal. Ct. App. 2000), a food manufacturer that supplied contaminated nut clusters to General Mills to be added to breakfast cereals was entitled to coverage under its insurance policy. In *Shade Foods*, wood splinters were discovered in the diced almonds supplied by the food manufacturer, which caused General Mills to shut down production, destroy the boxes of cereal in its possession, and ship the unused clusters back to the food manufacturer. General Mills demanded over \$1 million from the food manufacturer, most of which represented the value of cereal it was compelled to destroy. The *Shade* court had "no difficulty" finding property damage in this situation, holding that "the presence of wood splinters in the diced roasted almonds caused property damage to the nut clusters and cereal products in which the almonds were incorporated."<sup>20</sup> The court distinguished *Seagate* by pointing out that there was "no evidence that the contaminated products manufactured from the diced almonds could be 'restored to use' by removal of the lead splinters."<sup>21</sup>

The takeaway from these cases appears to be that coverage for the costs associated with a product recall may hinge on the removability of the defective products and the restorability of the larger final product. Accordingly, if the defective accelerator pedals in our hypothetical can be removed and replaced in the Toyota vehicles that are the subject of the recall, the supplier of those pedals will not be able to establish physical injury to tangible property and therefore may not be able to access insurance coverage to fund the costs of a recall campaign.

## 2. Loss of Use

Even if accelerator pedals in Toyota automobiles can be repaired, the party purchasing a defective automobile may seek economic damages for the loss of use of tangible property, which is a form of property damage. However, both the sistership exclusion and other common exclusions in CGL policies generally exclude coverage for such economic losses. As set forth above, the sistership exclusion excludes coverage for damages claimed for any loss, cost or expense incurred for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal, or disposal of the insured's product. In addition, the business risk exclusion precludes coverage when the insured's "defective, deficient, inadequate, or dangerous product is incorporated into a third-party's product thus impairing or destroying the usefulness of the overall product."<sup>22</sup> And the warranty exclusion precludes coverage for the loss of use of unharmed tangible property when the insured's products fail to meet the level of performance, quality, fitness, or durability warranted or represented by the insured.<sup>23</sup> Working in concert, these three exclusions preclude coverage for virtually any loss of use resulting from the recall of defective products.

## III. Recall Insurance

For companies looking to shield themselves from liability associated with the recall of their products, recall insurance is generally available in the marketplace. There is a wide variety of recall-specific insurance products from which to choose, and companies should evaluate their options carefully to make certain the insurance they select adequately suits their needs. Given the potentially staggering costs of a product recall, it is important that companies obtain recall insurance that matches their unique risk profiles. *Atlantic Mutual Insurance Co. v. Hillside Bottling Co.*, 903 A.2d 513 (N.J. Super. Ct. 2006), provides a cautionary tale.

In *Atlantic Mutual*, a bottling company produced and bottled soft drinks for various beverage companies. The bottler received certain of the necessary ingredients from the beverage companies, and supplied other ingredients on its own. During the process of introducing carbonation into the beverages, which was the bottler's responsibility, certain bottles were contaminated with ammonia. As a result, the beverage companies were forced to recall all products that bore the bottler's plant code without regard to whether they were actually contaminated. The beverage companies sued the bottler for the costs and losses incurred as a result of the recall and the bottler, in turn, sought defense and indemnity from its insurer. The insurer responded by notifying the bottler that the insurer's obligation was limited to the \$25,000 in coverage afforded pursuant to a product recall endorsement, which sum it paid. The insurer then filed a complaint against the bottler seeking a declaratory judgment that it was not obligated to defend the bottler or to cover any of the bottler's costs or losses in excess of that sum.

The trial court entered summary judgment in favor of the bottler, holding that the bottler was entitled to additional coverage under its standard CGL policy.<sup>24</sup> However, the appellate court reversed. First, the appellate court held that the bottler's claim for losses did not fall within the policy's definition of "property damage."<sup>25</sup> The court reasoned that the bottler was not providing the beverage companies with a service that harmed the *beverage companies'* property.<sup>26</sup> Rather, the bottler created its *own* product (as a result of the introduction of carbonation into the beverages) that was

defective.<sup>27</sup> The appellate court also concluded that, regardless, the bottler's claims were barred by several policy exclusions, including the business risk and the sistership exclusions.<sup>28</sup> Accordingly, the appellate court held that the bottler's product recall endorsement, alone, provided all of the coverage to which the bottler was entitled.<sup>29</sup> The issuer had no obligation to provide coverage under the remaining parts of the insurance policy at issue.

Had the bottler in *Hillside* negotiated a more generous product recall endorsement with its insurer, it would not have been left footing the bill when coverage was denied under its CGL policy.

## **V. Conclusion**

Standard CGL policies cannot be relied upon to protect manufacturers against the potentially crushing costs that can accompany product recalls. The exclusions contained in typical CGL policies, in particular the sistership exclusion, effectively limit most forms of insurance recovery for recall of defective products. It is in the interest of any company with potential recall exposure to investigate and secure some measure of carefully-tailored recall coverage. Companies depending solely on their CGL policies for protection do so at their own peril.

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<sup>1</sup> Mariko Sachanta and Yoshio Takahashi, *Toyota's Recall Costs Could Top \$5 Billion*, Wall St. J. (March 9, 2010) available at <http://online.wsj.com/article/SB10001424052748704145904575111341893725992.html> (J.P. Morgan estimating Toyota's total, one-time recall related costs could total 400 billion yen (\$4.2 billion); Chris Isidore, *Toyota Recall Costs: \$2 Billion* (Feb. 4, 2010), [http://money.cnn.com/2010/02/04/news/companies/toyota\\_earnings.cnnw/?postversion=2010020410](http://money.cnn.com/2010/02/04/news/companies/toyota_earnings.cnnw/?postversion=2010020410).

<sup>2</sup> Toyota will likely face third-party claims relating to the injuries and deaths resulting from accidents allegedly caused by its defective automobiles. But the costs of those claims will likely be dwarfed by the costs assumed by Toyota to recall its products. This article focuses solely on coverages potentially available to fund expenses relating to product recalls.

<sup>3</sup> Michael Bradford, *Toyota's Vehicle Recall Puts Reputation at Risk*, Business Insurance (Feb. 1, 2010), <http://www.businessinsurance.com/article/20100131/ISSUE01/301319971>.

<sup>4</sup> See Duane D. Stanford, *General Mills, Kraft Seek Safety Rules in 'Philosophical Shift'* (March 4, 2009), <http://www.bloomberg.com/apps/news?sid=aRnLL61d9xmc&pid=20601087> (peanut recall to cost Kellogg \$70 million); Ian Austen, *Despite Recall, Pet Food Maker is Still a Large Supplier*, N.Y. Times (March 22, 2007), available at <http://www.nytimes.com/2007/03/22/business/worldbusiness/22iht-pets.4991353.html> (pet food recall to cost Menu Foods \$35 million); Gabriel Madway, *Sony Estimates Recall Will Cost It 20 bln to 30 bln Yen* (Aug. 24, 2006), <http://www.marketwatch.com/story/sony-estimates-recall-will-cost-it-20-bln-to-30-bln-yen?siteid=yhoo&dist=yhoo> (laptop battery recall to cost Sony up to \$258.1 million).

<sup>5</sup> Marialuisa Gallozzi and Seth A. Tucker, *Insurance Against Disaster: Coverage for Product Recalls*, The Insurance Coverage Law Bulletin (Oct. 2007).

<sup>6</sup> 4 Law and Prac. of Ins. Coverage Litig. § 45:18 (2009); 2 Madden & Owen on Products Liability § 32:14 (3d ed. 2009).

<sup>7</sup> *Arcos Corp. v. American Mutual Liability Insurance Co.*, 350 F. Supp. 380, 384 n.2 (E.D. Pa. 1972), *aff'd* 485 F.2d 678 (3d Cir. 1973).

<sup>8</sup> *Honeycomb Systems, Inc. v. Admiral Insurance Co.*, 567 F. Supp. 1400, 1406 (D. Me. 1983).

<sup>9</sup> Barry R. Ostrager & Thomas R. Newman, Insurance Coverage Disputes (15th ed. 2010) § 7.02[c][5].

<sup>10</sup> See *Wyoming Sawmills, Inc. v. Transportation Insurance Co.*, 578 P.2d 1253, 1257 (Or. 1978); *Paper Machinery Corp. v. Nelson Foundry Co., Inc.*, 323 N.W.2d 160, 164 (Wis. Ct. App. 1982) (same); *California Insurance Co. v. Stimson Lumber Co.*, No. Civ. 01-514-HA (D. Or. May 26, 2004) (same).

<sup>11</sup> See Ostrager & Newman, *supra* note 7 at § 7.03[b][1] (emphasis added).

<sup>12</sup> *Id.* at 424.

<sup>13</sup> *Id.*

<sup>14</sup> See Ostrager & Newman, *supra* note 7 at § 7.03[b][2][A].

<sup>15</sup> *Hamilton Die*, 508 F.2d at 419–20.

<sup>16</sup> *Seagate*, 11 F. Supp. 2d at 1155.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Shade Foods*, 78 Cal. App. 4th at 865.

<sup>21</sup> *Id.* at 866.

<sup>22</sup> 4 Law and Prac. of Ins. Coverage Litig. § 46:14 (2007) (internal quotations omitted).

<sup>23</sup> See, e.g., *Vons Companies Inc. v. Aetna Casualty & Surety Co.*, 58 Fed. App'x 689, 692 (9th Cir. 2003); *Jacobs v. Russo Builders*, 592 N.W.2d 271, 277 (Wis. Ct. App. 1999).

<sup>24</sup> *Atlantic Mutual*, 903 A.2d at 516.

<sup>25</sup> *Id.* at 519–20.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 523–24.

<sup>29</sup> *Id.*