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PRODUCT RECALLS IMPACT ON BUSINESS FINANCIAL HEALTH

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ALLIED WORLD

In the United States, greater awareness of consumer safety obligations and new legislation — such as the Food Safety Modernization Act (FSMA) and the Consumer Product Safety Improvement Act (CPSIA) — have increased the already significant product recall exposures of both food and non-food product manufacturers. Increasingly global and complex supply chains have also created challenges in maintaining the highest level of food and product safety. As a result, product recall and product contamination insurance for food and beverage as well as non-food products is in high demand.

“This demand may be attributable in part to heightened awareness regarding product safety globally, to greater oversight by and communication between regulators, more frequent and more thorough product testing procedures, and the use of social media where consumers can quickly point out and share problems with other people,” said Tom Mangan, Vice President, Global Crisis Management Division at Allied World.

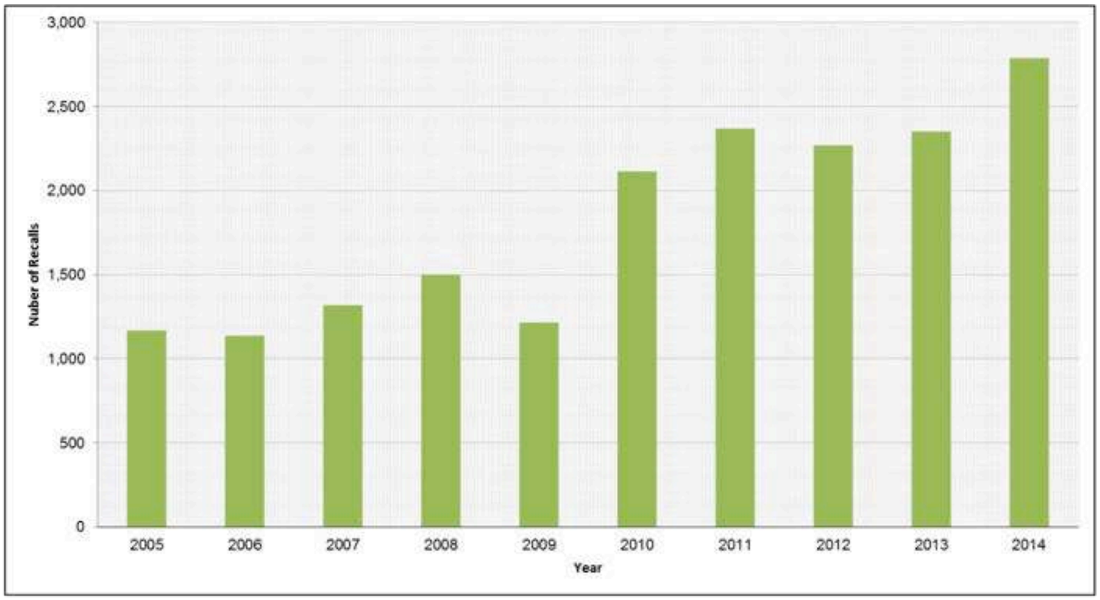
The economic consequences of a product recall can be severe. Although intended to correct a serious problem by pulling unsafe products from the stream of commerce, product recalls also can have a long-term impact on the financial health of an organization.

“Unfortunately, bad things can happen to good people,” said Mangan. “Even the best, well-run businesses that are informed, proactive, and take appropriate steps to mitigate loss due to manufacturing defects, design flaws, human error and supply chain issues can still have a financially devastating product recall and/or a product contamination event.”

A 2011 survey of 36 members of the Grocery Manufacturers Association revealed 58 percent had been impacted by a product recall during the previous five years. Fifty-two percent of those estimated the financial impact to be in excess of $10 million. Five percent said it cost $100 million or more.[1]

The frequency of product recalls is also rising. Advisen Loss Insight data shows the number of product recalls more than doubling over a period of 10 years. (Exhibit 1)

EXHIBIT 1: PRODUCT RECALL COUNTS OVER TIME



[1] *Grocery Manufacturers Association, “Capturing Recall Costs: Measuring and Recovering the Losses” (October 2011), http://www.gmaonline.org/file-manager/images/gmapublications/Capturing_Recall_Costs_GMA_Whitepaper_FINAL.pdf*

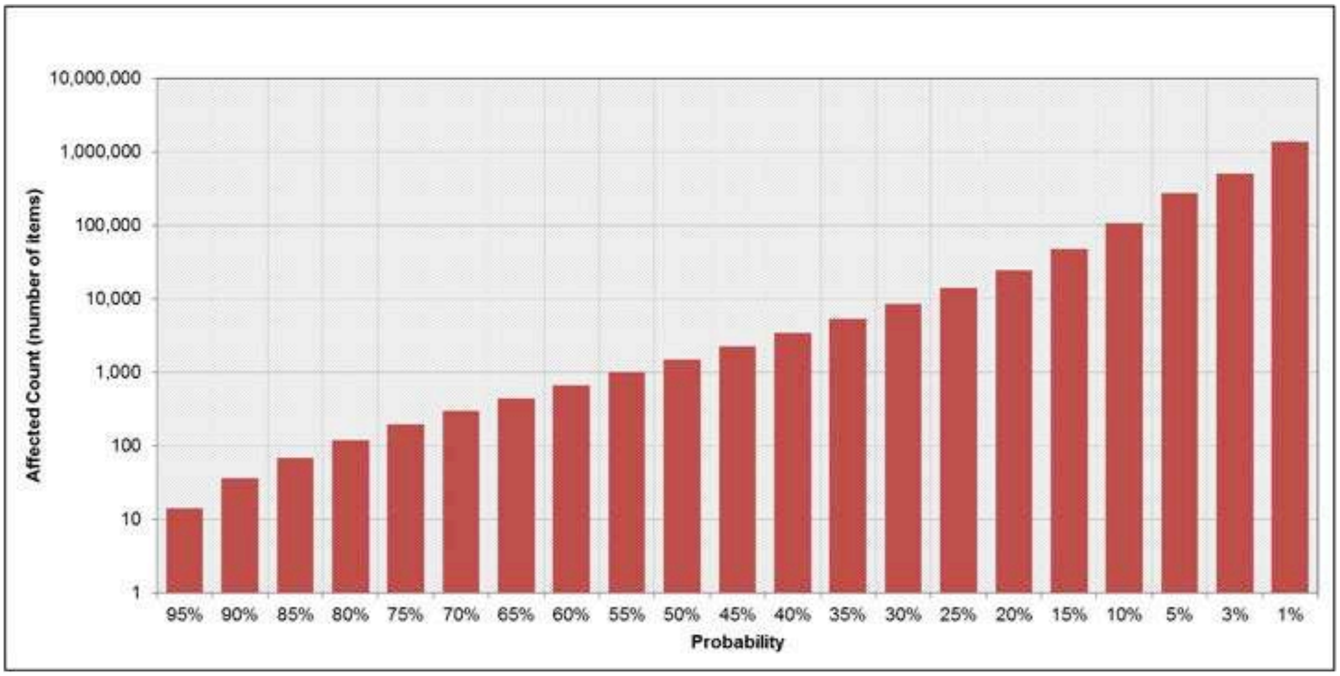
Direct product recall costs include items such as notification, product retrieval and storage, product destruction, unsaleable product, and additional labor costs associated with recall-related activities.

Product recalls can also impact consumers' quality perceptions, which can result in reputational harm. They can cause a loss of investor confidence and a drop in share price of publicly traded companies, or a loss of funding from current and future investors of privately held companies. They also can cause a loss of customers and key business relationships.

The total cost of a product recall can vary based on a number of factors, including the length of time of a recall, the location of products in the supply chain, whether there is a need to expand the recall and/or make additional announcements, and the size of the recall.

The chart below shows the probability of having a recall of a certain size. The chart shows, for example, that one percent of cases will result in a recall of more than 1 million items. Similarly, 50 percent of cases will result in a recall of around 2,000 items. (Exhibit 2)

EXHIBIT 2: LOSS PROBABILITY – TOTAL PRODUCTS RECALLED



The consequences can also vary. For example, the financial impact of a recall of a single product to a manufacturer with multiple product lines may be very different from a manufacturer whose business relies on a single product for the bulk of its revenue. Also, organizations who have built substantial brand equity may fare better than those who have not.

A product recall can be an ordeal. No organization should underestimate the potential consequences of a recall. The three examples below – all with different circumstances and results – illustrate that a product recall can impact the financial health of a business.

APPLESAUCE MANUFACTURER

Washington-based Snokist Growers provides a case study in just how devastating a product recall can be to a company. The century-old fruit processing cooperative filed for Chapter 11 bankruptcy following a 2011 applesauce recall.

According to news reports and information gleaned from its bankruptcy filing, Snokist recalled 3,300 cases, each with six cans of gallon-size applesauce, after a number of school children became sick from school lunches that included the cooperative's applesauce. The direct cost associated with the recall and the interruption to its business resulted in a loss of $21 million from 2010 to 2011.

Consequently, the organization was unable to service the debt it owed to approximately 2,000 creditors. In order to repay creditors, the company liquidated in bankruptcy. At bankruptcy, the company had $69.6 million in assets vs. $73.4 million in debt. The bankruptcy caused 610 employees to lose their jobs and 140 members of the fruit co-op to lose customers.

CLOTHING RETAILER

In March of 2015, a Wisconsin-based clothing retailer announced a voluntary recall of approximately 173,000 units of children's sleepwear purchased between January 2014 and February 2015. Following the recall announcement, the company reported that fourth quarter 2014 earnings fell 28 percent, which it partially attributed to the recall. It further reported net income of $33.1 million, or $1.03 per share compared with $45.9 million, or $1.44 per share, for the same period the previous year.

According to the company, the recall trimmed $3.4 million from quarterly revenue, and approximately $2.8 million from the company's bottom line. The company reported its other operating expense (net) increased to $3.2 million in fiscal year 2014 due to $3 million in expenses related to the product recall. The 2014 operating income was negatively impacted by $4.7 million.

PEANUT AND PEANUT BUTTER PROCESSOR

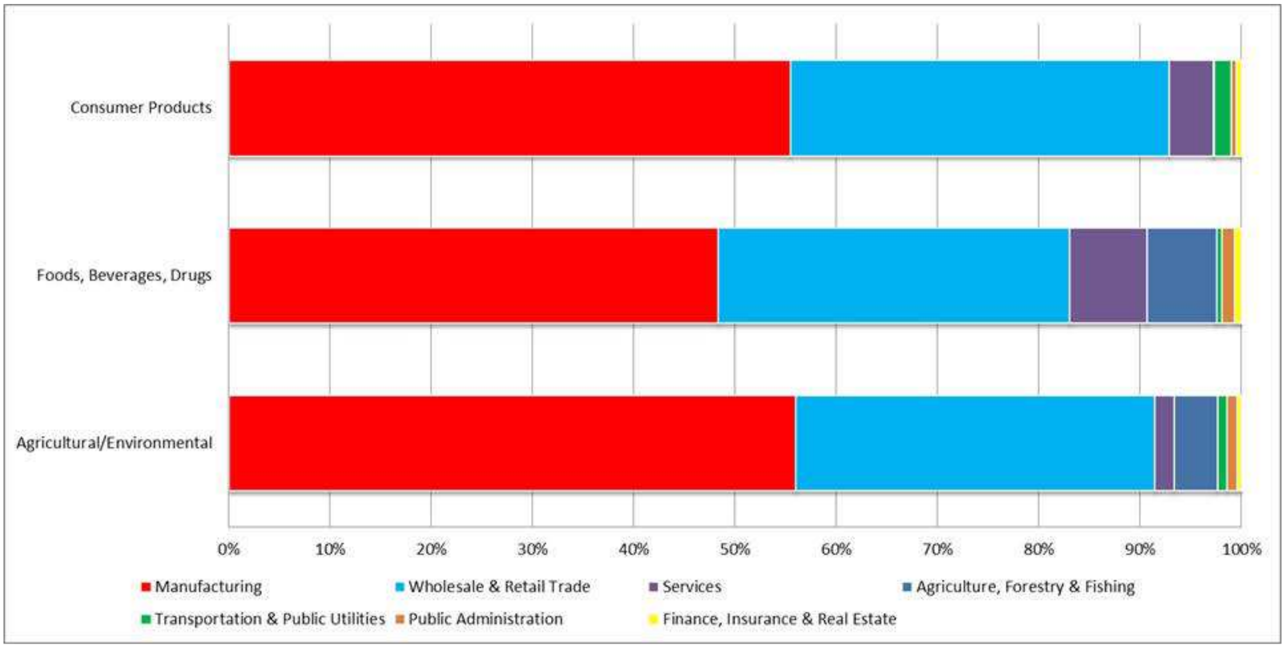
Sunland Foods, a New Mexico producer of organic peanut butter, is another example of a company unable to recover from a product recall. The organization closed its doors and filed for Chapter 7 bankruptcy after it was linked to a Salmonella outbreak in 2012. The recall that began with Trader Joe's Co.'s Creamy Salted Valencia Peanut Butter quickly expanded to more than 100 other nut and peanut products.

This was the first time that the US Food and Drug Administration (FDA) used its authority under the FSMA to suspend the registration of a facility. The subsequent bankruptcy may be attributed to this mandated shutdown. According to the October 2013 bankruptcy filings, the company had between $10 and $50 million in assets and between $50 and $100 million in liabilities.

MINIMIZING THE IMPACT

These examples illustrate how a recall can impact the financial health of an organization. They provide real life examples of lost revenue, reduction in employees, third-party liability, loss of brand equity, and tarnished reputations. They also illustrate the susceptibility of different industries. The chart below shows the industry composition by type of recall over the previous 10 years: consumer products, foods/beverages/drugs, and agricultural/environmental. (Exhibit 3)

EXHIBIT 3: INDUSTRY COMPOSITION BY TYPE OF RECALL – PREVIOUS 10 YEARS



A proactive response is the only way to minimize the impact. To be effective, this response requires substantial foresight and preparation, such as how to quickly and efficiently remove products from store shelves, how to promptly identify and rectify the source of the problem, and how to have open and honest communication with customers, investors, and business partners.

Fortunately, there are resources to help companies protect their financial health. A comprehensive insurance program from a top-rated carrier who specializes in product recall can help reduce the burden.

"First- and third-party product recall and product contamination insurance coverage should be considered as part of a company's risk management solution," said Mangan. "An uninsured recall or contamination loss can erode shareholder's equity. Recall insurance placed on the company's behalf or carried by suppliers to indemnify a company is meant to protect the balance sheet."

In addition to indemnification for specified losses from the recall event, a product recall policy also can provide pre- and post-loss support, such as assistance with quality control, vendor management, auditing, and traceability procedures, as well as access to crisis management firms.