

2008 Liability Trends

Emergent Liabilities: Catastrophe Hidden in the Everyday Risk

By:

Robert Hartwig, PhD., CPCU, Insurance Information Institute

Steven E. Lessick, Vice President, Issue Management, AIG Domestic Claims, Inc.

Bruce D. Margolin, Vice President, Issue Management, AIG Domestic Claims, Inc.

Alan M. Maxwell, Esq., Weinberg, Wheeler, Hudgins, Gunn & Dial, LLC

Timothy J. McAuliffe, President, AIG Excess Casualty

Richard Woollams, Senior Vice President and Chief Claims Officer, AIG Commercial Insurance

Introduction

It is no surprise that the world is a dangerous place and that businesses are routinely faced with various dangers and perils. It is surprising, however, how frequently wholly unanticipated liability risks continue to crop up, despite the scientific and technological sophistication of our modern world.

This paper explores three areas where risk has unexpectedly snowballed, creating substantial liabilities where once there were none. These examples underscore the significant financial exposure that can erupt in unforeseen places, putting consumers and the public at risk and wreaking financial havoc on businesses and industries around the globe. It also spotlights the growing complexity of liability exposures. Today, it is not uncommon for risks to involve political and social considerations as well as an international cast of potentially responsible parties.

I. Foreign Imports Under Siege

In the past year, consumer confidence in foreign-exported products, particularly those from China, plummeted as abruptly as the potential liability of U.S. enterprises selling them grew.

In 2007, the U.S. Consumer Product Safety Commission reported that it had obtained the largest number of voluntary recalls (472) in the past decade. About two-thirds of all U.S. consumer product recalls involve imported products.¹ Many of the incidents of defective or tainted imports recalled in 2007 have already spurred litigation.

A Focus on China

Considered exporter to the world, China's annual exports exceed \$1 trillion, with America its largest customer for consumer goods. Over 70 percent of toys, 95 percent of fireworks, and 59 percent of electrical products used in the U.S. are manufactured in other countries, the lion's share in China.²

In 2007, media coverage of major recalls made consumers abundantly aware of the potential health risks that common products recently imported from China (and potentially other countries as well) could pose to family, friends and animals.

China, however, is far from the only source of tainted products. After examining the U.S. Food and Drug Administration (FDA) records, the New York Times reported in July 2007 that more food shipments from Mexico had been stopped than from China. Indeed, in recent years Mexican food imports have led to several serious outbreaks of salmonella and hepatitis A. India, too, presents a potentially troubling source of tainted products. In January 2008, the U.S. Health Secretary traveled to India for a series of meetings with Indian officials and business leaders about safety issues relating to the export to the United States of generic drugs from Indian manufacturers.

Compounding the worries of both those who consume foreign-exported goods and those who sell them, the FDA admitted efforts to ensure the safety of imported products are impeded by understaffing, outdated computer systems, and a seemingly insurmountable backlog of imported goods to inspect. Imported food and pharmaceutical products, especially those from China, are of particular concern due to their health implications.

While efforts are underway at the federal level to increase program funding and enact remedial legislation to resolve the problem, these efforts may prove to be unsuccessful.

Record Recalls

The following is a partial list of defective or tainted products that were recalled in 2007. Where known, a brief description of ensuing litigation and settlement terms is provided.

- An Illinois toy firm voluntarily recalled 1.5 million wooden trains discovered to have been coated with lead paint in a Chinese factory. In January 2008, the toy company agreed to a \$30 million settlement in a nationwide class action arising from the recall. Most of the money is allocated to refunds, replacement toys, and class counsel fees.

¹ U.S. Consumer Product Safety Commission, 2007 PERFORMANCE & ACCOUNTABILITY REPORT, November 2007.

² IBID.

- A Canadian pet food manufacturer recalled 60 million cans and packages of pet food after veterinary organizations reported the deaths of hundreds, perhaps thousands, of animals. Several U.S. pet food makers subsequently recalled thousands of products containing wheat gluten produced in China contaminated with melamine, an organic compound used in plastics and flame-resistant materials.
- A California company recalled nearly 300 boxes of frozen fish for human consumption mislabeled as containing monkfish. The 22-pound boxes, which originated in China and were distributed in three states, actually contained puffer fish, a species known to contain a deadly toxin.
- A small tire importer was ordered to recall up to 450,000 light truck tires made in China since 2002 because of a defect that could cause tread separation. At least two serious personal injury claims have arisen from accidents allegedly caused by the defective tires. The importer is in litigation with the Chinese tire manufacturer over the costs of the recall and other economic damages.
- A major toy company recalled nearly one million items made in China because they were finished with lead paint. Less than two weeks later, the same company recalled an additional 9.5 million Chinese-made toys in the United States and 11 million distributed in foreign countries due to lead paint concerns and the inclusion of small magnets which could be harmful if swallowed. Less than three weeks later, 800,000 doll accessories and toys were recalled after tests showed they too contained lead paint. Already, 11 putative class action lawsuits arising from the initial recall alone have been filed against the U.S.-based company.
- Four million Chinese-manufactured toys were voluntarily recalled after reports surfaced that they contained beads with a toxic chemical that, if ingested, mimics the effects of the so-called date-rape drug. At least seven putative class actions have been filed against the Chinese manufacturer and the U.S. importer involved.
- As many as 62 people have died and as yet an unknown number of others have been sickened as a result of using the drug heparin, a blood thinner, which contained a contaminant that may have been added as an ingredient during the manufacturing process in China.

II. Liability in the Food Supply

After an alarming number of food contamination outbreaks in the past two years, the safety of America's food supply has come under intense scrutiny. According to the Centers for Disease Control and Prevention (CDC), an estimated 76 million cases of food-borne illness occur each year, requiring 325,000 hospitalizations and resulting in 5,000 deaths. One in four Americans can expect to suffer some form of food-borne illness every year.³ As the U.S. food supply becomes tainted with harmful bacteria or other contaminants more frequently, the liability risks to the food industry mount.

The growth in food contamination claims can be traced to the evolution of the food supply chain itself. Beginning in the late 1960s, an increasing number of Americans began consuming meals prepared at fast food and franchised restaurant chains. As these restaurants grew in popularity and menus broadened to accommodate America's increasingly diverse appetite, food illness claims increased proportionally.

At the same time, food production has shifted from small businesses and family farms to large regional, national and multinational centralized with supply chain roles. Single enterprises often handle growing, production and distribution. America's food supply chain has globalized; offshoring and outsourcing of such functions have become commonplace.

The consequences are far-reaching. A single instance of contamination originating from one grower's crop or one manufacturer's facility can produce an outbreak of national or even international proportion.

Unlikely Sources

The accelerating pace of food contamination incidents and the notable number of first-ever sources of outbreaks is worrisome. A few recent examples:

- A Salmonella outbreak attributable to peanut butter is suspected of producing 628 cases in 47 states.⁴ According to the CDC, this is the first known Salmonella outbreak associated with peanut butter in U.S. history. The true breadth of the outbreak remains unknown, but data suggest it may encompass up to 24,000 cases.⁵ More than 200 lawsuits have been filed, including class actions.

³ http://www.cdc.gov/ncidod/dbmd/diseaseinfo/foodborneinfections_g.htm.

⁴ <http://www.cdc.gov/mmwr/P/preview/mmwrhtml/mm5621a1.htm>.

⁵ Andrew C. Voetsch, et al., *FoodNet Estimate of the Burden of Illness Caused by Nontyphoidal Salmonella Infections in the United States*, Clinical Infectious Diseases 2004;38 (Supp 3), S127, S131 (Estimating there are 38.6 unreported cases involved in *Salmonella* outbreaks for each culture confirmed case).

- Suspected E. coli contamination forced the recall of 21.7 million pounds of ground beef produced by a meat processing company. The CDC confirmed 40 illnesses tied to the outbreak in eight states.⁶ Authorities identified meat trim provided to the manufacturer by a Canadian supplier as the source of the outbreak. A class action and several personal injury lawsuits were filed against the manufacturer, which was forced to cease operations after nearly 70 years and plunged into bankruptcy.
- After 60 people, most of them toddlers, were victims of a Salmonella outbreak, a food distributor recalled snack food in 19 states. When the Salmonella was traced to a spice supplier in China, the recall expanded to other snack foods. Several personal injury actions have been filed against the U.S. companies involved in the manufacture and distribution of the tainted product.
- In 2006, an E. coli outbreak involving baby spinach sickened more than 200 people across 26 states. Three people died, 104 were hospitalized and 31 people, many of them young children, suffered kidney failure. The spinach was traced to a 50-acre farm in California. This was the first E. coli outbreak involving pre-packaged spinach, according to the FDA.

While settlements are often confidential, publicly available information indicates that claims arising from significant personal injury or death in food contamination cases are often resolved in the seven or even eight million dollar range. Ordinary hospitalizations without permanent injury typically result in settlements in the five to high six figure range, particularly when the victims are children. It is easy to see how quickly such incidents can exhaust a primary liability policy and penetrate into and beyond modest excess liability insurance. For example:

- In 2003, \$12 million was paid to more than 100 residents of a Pennsylvania nursing home who became ill after eating from a salad bar containing E. coli infected lettuce.
- In New York in 2005, an \$11 million settlement was reached with the parents of a young child who developed Hemolytic Uremic Syndrome, a potentially fatal complication associated with E. coli infection, after consuming tainted hamburger meat.
- In 2003, a \$6.25 million settlement was arrived at with a man who was forced to receive a liver transplant after becoming ill with Hepatitis A during an outbreak traced to green onions at a Pittsburg-area fast food restaurant.
- Over \$5 million was paid to individuals who became ill after eating contaminated ground beef sold by a Wisconsin beef producer.
- A jury awarded \$4.6 million to 11 children who became ill with E. coli food poisoning after eating school lunch at an elementary school in suburban Washington.

Who is responsible for paying consumers poisoned by adulterated products? The law is generally clear: everyone in the chain of distribution.

The risks that businesses face from contaminated food are amplified by potential reputation and economic losses. If a product is even suspected of being associated with an outbreak, its manufacturer or processor can be shut down until the appropriate health agencies complete investigations. Loss of revenue is immediate. Shareholder value can be quickly eroded. A brand image can be damaged beyond repair.

Additionally, upstream growers, distributors and processors frequently have litigation brought against them by entities further down the distribution channel seeking to recover their own business interruption losses. The grower, processor or manufacturer of the adulterated product can be left to bear the entire business interruption exposure, including all lost sales, diminution of brand values and recall expenses. The costs can become so great, some companies cannot survive.

As food production and manufacture continue to centralize and the food supply chain stretches around the globe, the severity of food contamination claims will continue to grow.

⁶ <http://www.cdc.gov/ecoli/2007/october/100207.html>.

III. New Twists on Premises Liability

As the liability of private and commercial landowners has evolved, the common law rules that an owner is not liable for the conduct of third parties outside his control has been modified in cases alleging inadequate security. Specifically, liability has been imposed on a property owner for the criminal acts a third party perpetrates against the owner's patrons, tenants or guests. More recently, this exposure has been complicated by the reality of terrorist activity, both domestic and international.

Despite the greater use of security stations and access cards at office buildings, background checks, on-site security cameras and new identification technologies—the danger is pervasive. For example, the threat of terrorist attacks at shopping centers has increased, with over 60 such attacks occurring worldwide since 1998.⁷ The U.S. Department of Justice cites drug trafficking in private apartment complexes as a growing concern, particularly in low-income areas.⁸ Restaurants, coffee shops and liquor stores are constant targets of robberies which put patrons and bystanders at risk.

Claims against shopping malls, apartment complexes and hotels are not novel, but some new and complex legal issues are materializing. For example, government contractors responsible for facilities in the Middle East have faced premises liability litigation in the U.S. arising from claims of inadequate security.⁹ The insurance coverage and business interruption litigation arising from the September 11th attacks on the World Trade Center has log-jammed New York federal court dockets for years to come.

Because premises liability defendants are perceived to be large, deep-pocketed corporations such as retail chains, hotels, casinos, apartment complexes and property management groups, verdicts for negligent security cases tend to be significant. A few examples:

- The largest negligent security verdict in the nation's history was rendered in 2007 when a Florida jury awarded \$102.7 million to a man who was shot and paralyzed outside a Miami nightclub. The owner of the strip mall where the club was located was found solely liable based on evidence that the property had a history of multiple violent crimes, yet the owners had spent no money on security.
- A New Jersey jury returned a verdict of \$4.8 million against a major casino-hotel after a patron was robbed and beaten on an outdoor walkway. Security was allegedly non-existent in the area, even though three robberies had occurred nearby in the preceding 11 months.
- A Florida jury returned a nearly \$27 million verdict in favor of a 28-year-old bank employee who was paralyzed after being shot during a bank robbery. The defendant was the security contractor who installed the security system at the bank. The plaintiff alleged that the security system was inadequate.
- A jury returned a verdict of \$3.3 million in a lawsuit alleging failure by a property management company to prevent a sexual assault in an Illinois office building. The plaintiff alleged that the property managers failed to post warning signs and allowed suspicious individuals access to the building, despite knowledge of rapes occurring in the area.
- A North Carolina lawsuit settled for \$9.25 million in a case arising from a third-party assault in a shopping center. The plaintiff, who was pregnant at the time of the attack, suffered a coma and permanent injuries. The lawsuit was brought against the owner of the shopping center for inadequate security for failing to account for repeated criminal activity at the shopping center and the surrounding area in the years prior to the attack.

Even when diligent security controls are undertaken in the form of security measures, courts and juries have held companies responsible for third-party criminal acts and imposed a heightened standard of care on owners. For example, a California jury returned a verdict of \$5 million against a bank after it was argued that the bank should have hired two full-time security guards instead of one full-time and one part-time guard. A New York case settled for \$4 million on a claim that a co-op building did not employ enough security guards, required individual guards to cover too much area of the property, and did not update security measures in response to increased criminal activity.

⁷ LaTourrette et al., "Reducing Terrorism at Shopping Centers," The RAND Corporation (2006).

⁸ Sampson, Rana, "Drug Dealing in Privately Owned Apartment Complexes," U.S. Department of Justice (2003).

⁹ See *Smith v. Halliburton Co.*, 2006 U.S. Dist. LEXIS 61980 (S.D. Tex. Aug. 30, 2006).

Courts have also explored the issue of whether certain criminals can ever be deterred. As one California court explains in a case arising from a 1984 shooting massacre at a McDonald's restaurant in San Ysidro, California:

Any reasonable protective measure such as security cameras, alarms and unarmed security guards, might have deterred ordinary criminal conduct because of the potential of identification and capture, but could not reasonably be expected to deter or hinder a maniacal, suicidal assailant unconcerned with his own safety, bent on committing mass murder.¹⁰

The "undeterrable offender" issue must be considered when assessing risk and is of significant concern in the terrorist arena. Terrorists using tactics such as suicide bombers may be able to circumvent even the most stringent security measures. Nevertheless, litigation arising out of criminal and terrorist attacks on private property remains a virtual certainty.

Safety and Loss Prevention

Sound safety and loss prevention practices are a company's first line of defense and must keep pace with emergent threats. Loss prevention practices come into play even before a company transacts business.

For instance, importers of foreign goods must weigh the potential cost savings gained from foreign labor and raw materials, less stringent safety standards and reduced governmental oversight against the corresponding risk of potentially faulty or defective products or product components. Their reputation, recall expenses, revenue and litigation costs are all at stake. In the courtroom, plaintiffs can be expected to assert novel theories of liability and damages, including costly medical monitoring programs and special and/or exemplary damages. Even one adverse verdict or large class action settlement can negate any hard won cost savings associated with purchasing abroad.

Contractual Arrangements

Potential liability must be contemplated in contractual arrangements. For example, U.S. manufacturers, distributors and retailers that deal with foreign suppliers should negotiate detailed contracts which clearly delineate specifications on issues such as responsibility for recall costs. Whether the remedy includes all costs associated with a recall or merely replacement of defective component parts must be assessed.

Specific indemnity and hold-harmless provisions should be included in a contract in case litigation ensues. Even if a defense is offered, manufacturers and retailers must consider whether they are willing to cede control of their defense to a foreign supplier or whether and to what degree they would maintain control of their own defense.

Given the likely involvement of insurance, manufacturers and retailers should require that the supplier's insurer be U.S.-based and financially capable of responding to a potentially large number of severe liability lawsuits and to provide additional insured and vendors' coverage.

Jurisdictional considerations should be carefully evaluated within the contractual framework, wherever possible. U.S.-based individuals and companies often find it impossible to win damages or other legal redress when forced to litigate abroad. In some countries, for example, targets of lawsuits are often companies that are partly owned by the government or aligned with regional governors whose influence may outweigh legal considerations. A foreign company's agreement to jurisdiction in the U.S. can and should be sought.

Contracts must also contemplate safety issues. For example, quality assurance testing and certification should be addressed within suppliers' contracts. Specific remedies and damage provisions should be included. Finally, contracts should reflect the foreign manufacturer's agreement to cooperate with its domestic customer in all aspects of any pending lawsuit or governmental investigation.

Similarly, for those involved in food supply, prudent risk management suggests carefully negotiated contract terms, including indemnity and hold harmless clauses, choice of law and forum selection, quality assurance and specific remedy and damage provisions, among other considerations.

¹⁰ *Lopez v. McDonald's Corp.*, 193 Cal. App. 3d 495, 515, 238 Cal. Rptr. 436 (1987).

“Foreseeability” in Premises Liability

In the area of premises liability arising out of inadequate security, foreseeability is a central question. What notice did an owner have of the potential for criminal activity on the premises or in the surrounding area? Consequently, affirmative steps should be taken through various channels to assess an owner’s “foreseeability risk” and help mitigate exposure.

Employee-driven incident reports are arguably the best channel of information on criminal activity on premises. A detailed and effective system requiring employees to report any potential criminal activity or suspicious occurrences to a supervisor is paramount.

Police statistics can be an important resource, and law enforcement agencies can typically provide crime data for surrounding areas. However, while these statistics can be useful in painting a broad picture of the criminal activity in a given area, statistics alone, without details on the underlying crimes, may be of limited value.

In addition, crime prevention measures are critical, and they are becoming more widespread in a variety of businesses. Steps taken in the leasing industry are perhaps the most visible. Access-control gates have become commonplace at apartment communities and housing complexes in growing metropolitan areas in the Southeast and Southwest. Some larger apartment communities have employed “courtesy officers”—typically a current or former law enforcement officer—to patrol the premises in exchange for reduced rent.

While all practical safeguards should be pursued, no amount of planning can account for every contingency. Liability risk remains, from known and unknown sources. Obtaining appropriate, reliable insurance coverage is essential to protect the financial interests of businesses of all sizes and types.

Excess Casualty Insurance

A carefully crafted and appropriately high tower of excess liability insurance remains the most effective way for companies to shield their assets and their shareholders against the potentially catastrophic financial impact of U.S. civil liability lawsuits.

However, the insurance purchase itself can be risky business: insurers that have the expertise and financial strength to underwrite complex liability exposures consistently, year-to-year, are rare. History has shown how abruptly companies writing this line can fall victim to financial insolvency. Oftentimes, companies step into this line seeing the potential for quick profits, only to retreat after realizing the magnitude and complexity of its losses.

There is also widespread uncertainty over what level of coverage is enough. What constitutes “reasonable” terms and conditions of coverage, is another question. Some of the most pressing issues to consider when buying excess liability insurance are examined here.

How much liability coverage is enough? The decision is more art than science. Requisite limits vary widely depending on a company’s circumstances. However, it is generally safe to say that even the most benign operations should purchase primary liability insurance, plus at least \$50 million in excess limits. Companies that perceive even a low level of liability risk should count upwards from there.

Of course, the most exposed industries should buy at the highest end of the spectrum. Manufacturers that produce products—such as food or toys—with the potential to impact a large number of people and give rise to a class action or mass action lawsuit are the classic example. Along with vulnerability to mass claims, a buyer should consider the size of its company’s operations, its geographic spread, and inherent industry hazards. A buyer should benchmark limits against peers in its industry and keep abreast of recent settlements and verdicts. Many buyers keep a close eye on the annual listing of the year’s *Top 10 Verdicts* as a barometer of worst case scenarios. Ask, could these happen to you?

In addition, buyers should be cognizant that coverage is not only needed to pay potentially catastrophic judgments or large settlements, but will also serve as the collateral required to post an appeal bond, which is typically the full value of a verdict or more. Many large awards are reduced or reversed on appeal. Without the ability to post bond, a company is powerless to mitigate a loss on appeal.

Is the insurer financially strong enough to take on the risk long term? High levels of insurer financial strength are a must at every level of a liability insurance program. Any coverage purchased at the upper and catastrophic levels should not, and most often legally cannot, “drop down” until lower-level carriers pay their share of the claim.

Consequently, a company’s whole tower of insurance could be rendered unable to respond because of a single insolvent carrier. In addition, payouts involving excess liability claims can span many years. In product liability lawsuits, cases can take more than a decade to reach resolution. Mass tort actions can take two decades or more. Each insurer participating in a corporation’s insurance program needs to be strong today and for many years to come. Companies must be ultra-conservative when assessing insurers’ overall financial condition and financial strength ratings.

What claim and litigation resources support the policy? An insurer that has extensive institutional expertise and resources to help insureds respond to liability crisis events and to handle large liability claims can contribute invaluablely to protecting the policyholder’s interests—from the immediate aftermath of an incident through claims and litigation. The importance of assessing these resources before signing on with a carrier cannot be overstated.

Are terms reasonable? If a carrier is overly generous with policy terms and conditions in the current U.S. liability environment, potential buyers should beware. Undisciplined underwriting cannot be sustained. Insurers that lack discipline will likely subject their insureds to an abrupt change in underwriting strategy and pricing and/or non-renewal not far down the road.

Can limits be eroded by third parties? A company’s tower of excess liability insurance is precious, finite and should be defended vigorously, lest it be depleted when it is needed most. Critical to defending the tower is anticipating indemnity agreements or transactions that might necessitate granting additional insured status to third parties. Losses arising from indemnity contracts will erode policy limits. Insureds have even seen unlimited indemnification agreements evaporate limits available to them—paying instead for liability arising out of the conduct of others. Extending coverage in this manner should be done cautiously and should be considered when assessing the limit to buy.

A Final Note

Broad swaths of liability continue to emerge in unprecedented and unforeseen areas. As the challenges confronting those in the business of assessing and managing risk continue to mount, diligent safety and loss control efforts are critical. Equally vital is sound excess liability insurance from a proven insurer...one capable of addressing emerging liability issues today and those that will arise, unexpectedly but inevitably, tomorrow.

