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The Rescission Trap: Don't Let Product Recalls Contaminate Your Coverage

by Syed S.Ahmad and Paul T. Moura

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Product recalls are on the rise in many industries. The year 2016 saw over 8,000 products recalled by the Food and Drug Administration and nearly 15,000 warning letters issued. Regulatory and consumer protection standards are becoming more stringent and notices of violations more frequent. At the same time, product supply chains are getting more widespread and complex. This increases the potential risk of errors, defects and contamination at all levels of those supply chains, and often these problems do not manifest themselves until after a product hits the market. All of this can lead to staggering expenses for food and product manufacturers facing the risks and realities of product recalls.

To protect against the substantial costs that can result from these recalls, many businesses purchase insurance policies that apply specifically for expenses, lost income and claims arising from recalls. This coverage is triggered when a product causes injury to consumers and reimburses for a variety of expenses arising from a recall. The full scope of recall coverage can vary: Some policies cover out-of-pocket expenses of product disposal and costs of notifying consumers, while broader policies can also cover business interruption and reputational losses.

Many product manufacturers have some form of recall insurance in place. However, a recent case illustrates the potential, and sometimes unexpected, risks associated with the purchase of these important policies. In *H.J. Heinz v. Starr Surplus Lines Insurance*, No. 16-1447 (3d Cir. Jan. 11), the U.S. Court of Appeals for the Third Circuit held that Starr Surplus Lines Insurance Co. could rescind $25 million in recall coverage, thereby preventing Heinz from recovering any amounts under the policy. Heinz had sought coverage for expenses resulting from a recall of a baby cereal product after Chinese authorities discovered the presence of lead. During its investigation, Starr discovered that Heinz failed to disclose a prior $10 million recall loss in response to a question in the policy application, and sought to rescind all $25 million of the coverage based on that nondisclosure. The Third Circuit sided with the insurer, holding that the failure to disclose the prior loss—even if unintentional—was a material omission that justified voiding the policy.

Heinz is only one example of insurers' recent attempts to rescind their recall insurance coverage. Earlier this year, Starr adopted a similar strategy in *Starr Surplus Lines Insurance v. CRF Frozen Foods*, No. 1:17-cv-01030 (S.D.N.Y.), alleging that a Washington-based frozen food manufacturer currently handling a listeria contamination recall failed to mention in its policy renewal application that it had received a series of notifications of violations from the Washington State Department of Agriculture. On March 21,

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Houston Casualty Co.—the excess insurer—piggy-backed off of Starr's rescission claim with its own demand for rescission based on alleged undisclosed information about contamination. And in *National Frozen Foods v. Berkley Assurance*, No. 2:17-cv-00339, (W.D. Wash.), Berkley Assurance Co. has levied similar rescission arguments against another frozen food manufacturer facing a listeria recall.

Lessons Learned

This recent line of cases should illustrates several important lessons for consumer product manufacturers and other businesses that are considering recall insurance. First, it is of utmost importance that policyholders are vigilant during the insurance application process in terms of the information that is being asked by the insurer and the responses that are provided. Not only is it critical to obtain the appropriate scope of coverage, it is also crucial that policyholders provide updated information when seeking a policy renewal. For some policyholders, the best strategy may be to simply direct the carrier to base its offer of coverage on information that is publicly available, rather than on responses to an application, so as to avoid the risk of being accused of making a material misrepresentation. Additionally, the passage of regulations such as the U.S. Food and Drug Administration's Food Safety and Modernization Act (FSMA) may affect the number and character of food safety violations, and policyholders and their brokers should be familiar with these developments as they negotiate insurance coverages.

Second, the *Heinz* decision illustrates how the court's choice of governing law could make or break the case. It is clear that the insurer in Heinz and CRF Frozen Foods has sought to exploit New York's favorable law on contract rescission, which permits rescission even based on unintentional misrepresentations. But other states may require evidence of intentional misconduct before courts will order rescission. Policyholders considering recall insurance should be mindful of state-law differences both during the application process and when considering coverage litigation against an insurer. Choice-of-law provisions in an insurance agreement are an important consideration when structuring a recall insurance strategy. Other factors can affect the choice-of-law calculus, too, including the location where the insurance agreement is signed, the place where the recall takes place, and the state where coverage litigation is initiated.

As consumer product standards and regulations continue to increase in complexity, manufacturers are getting ahead of the game to manage their risk profile. Over recent years, more recall insurance options are being made available, but this also means that the scope and language of these policies have become more diverse and can create new vulnerabilities. A strong risk-mitigation strategy should employ a critical analysis of these options from the outset in order to avoid the risk of rescission down the line.

Syed *S. Ahmad is a partner in Hunton & Williams' Washington DC office, where he focuses his practice on insurance coverage matters. He can be reached at sahmad@hunton.com. Paul T. Moura is an associate in the firm's New York and Los Angeles offices and focuses his practice on insurance coverage matters. He can be reached at pmoura@hunton.com.*

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