The Recall Expense Exclusion—When Your Ship Does Not Come In

July 2010

Insurance does not pay for everything that goes wrong. Consider the commercial general liability (CGL) insurance policy, for example. Even if an insured is responsible for damaging someone else's property, *all costs* that are imposed on the insured as a consequence of covered property damage may not be covered.

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Such damages or costs may be eliminated by exclusion n. of the CGL policy, the "Recall of Product, Work or Impaired Property" exclusion.

Sistership Exclusion

To understand the general purpose of the recall exclusion, consider its origin—the aircraft industry. If one aircraft has suffered an accident due to a defect, it is the practice of the aircraft industry to ground and recall all other similar aircraft (all sister ships) until the defect can be inspected and, if necessary, adjusted or repaired. While property damage to the aircraft damaged by the accident is not reached by the recall exclusion, other damages, such as the loss of use of the grounded aircraft as well as the costs associated with inspecting, repairing, or adjusting all of the "sister ships" that have *not failed, are excluded*.

The historical origin of the "sistership" exclusion was recounted by the Supreme Court of Washington in *Olympic Steamship Co., Inc. v. Centennial Ins. Co.*, 811 P.2d 676 (Wash. 1991):

> The term "sistership" derives from a practice observed in the aircraft industry. When a defect is suspected to be responsible for an aircraft accident, all other aircraft of that type are grounded pending investigation. The potential damages arising from the loss of use of the sistership are enormous. The exclusion was originally designed to exclude coverage for damages arising from the defect, other than those arising from the defect in the aircraft that was involved in the accident.

Thus, the widespread reference to the recall exclusion as the "sistership" exclusion provides some insight into how it applies.

An Explanation

Here is an explanation of the recall exclusion offered by the Supreme Court of Illinois in *U.S. Fid. & Guar. Co. v. Wilkin Insulation Co.*, 578 N.E.2d 934 (Ill. 1991):

> 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excludes coverage "in cases where, because of the actual failure of the insured's product, *similar products are withdrawn from use to prevent the failure of these other products, which have not yet failed but are suspected of containing the same defect*." The exclusion applies only to the costs associated with the withdrawal and repair or replacement of "sister" products which have not yet failed. *It does not apply, however, to the product that has already failed while in use and caused damage to the property of a third party*. [Emphasis added.]

An important point is that the recall exclusion applies only to your product, your work or impaired property that has *not yet failed*. If your product has caused property damage to someone else's property, the recall exclusion does not apply to the damaged property of others.

A Tasteful Example

In *Sokol v. Atlantic Mut. Ins. Co.*, 430 F.3d 417 (7th Cir. 2005), a food products manufacturer purchased peanut butter paste from an outside supplier to include in the food manufacturer's cookie mix. The peanut butter paste was included in individually sealed packets and included in the cookie mix, which was subsequently shipped to the manufacturer's customers for sale. Before the cookie mix was actually sold, the food products manufacturer discovered that the peanut butter was rancid (the supplier denied the peanut butter paste was rancid, instead characterizing the peanut butter paste as being "off taste").

Rancid or "off taste" aside, the food manufacturer withdrew all of the cookie mix boxes, removed the spoiled sealed peanut butter paste packets and replaced the peanut butter paste with the product of another vendor. The food manufacturer sought recovery from the original supplier of the peanut butter paste for the food manufacturer's costs of withdrawing the cookie mix from the market, disposing of the spoiled peanut butter, and replacing the peanut butter paste.

The supplier of the spoiled peanut butter looked to its insurer to pay for the costs being demanded by the food manufacturer. Citing the recall exclusion, the costs of the withdrawal, disposal and replacement of the peanut butter paste were excluded by the supplier's CGL policy. Specifically noted was that the paste was defective, deficient, or inadequate, that the paste qualified as "your product" under the supplier's CGL policy, and even if the Insuring Agreement provided coverage, exclusion n. "knocks it out."[1]

Pinning Down the Exclusion

In *Elco Indus. Inc. v. Liberty Mut. Ins. Co.*, 414 N.E.2d 41 (Ill. App. 1980), Elco Industries, Inc., supplied governor regulating pins to be installed in engines made by the Kohler Company. The governor regulating pins were to be properly heat treated and hardened by Elco prior to supplying to Kohler. However, *after installation in the engine* by Kohler (the first part inserted in the engine), it was apparently discovered that the pins were not properly hardened.

The Damages. Kohler sued Elco for damages sustained as result of Elco's failure to properly heat treat the pins, which included Kohler's cost to recall the engines containing the defective governing pins and removal of the governing pins on about 7,500 engines.

The Denial. Liberty Mutual, Elco's insurer, denied coverage to Elco for Kohler's claim, in part relying on the recall exclusion. Liberty asserted that damages claimed arose out of the withdrawal and replacement of pins and that these damages fell within the scope of exclusion n.—product recall.

The Court's View—Property Damage to the Engines. Although the court found that "[t]he mere installation or removal of defective parts which causes no destruction or injury to the third person's products … does not constitute property damage" and "… the installation of the defective pins did not, in itself, cause actual physical damage to the Kohler engine …," the court concluded that "correction necessarily resulted in damage to several components of the finished product [Kohler's engines]."

The court's finding of property damage was based on the fact that in order to replace the governor pin, Kohler had to dissemble the entire engine, and removal of the pins caused destruction and replacement of several paper gaskets in each engine. The fact that the engines did not need to be entirely scrapped (new pins were inserted) did not alter the fact that Kohler's engines suffered actual physical damage.

The Court's View—The Sistership Exclusion. In considering recall exclusion, the court characterized exclusion n. as follows.

> We next consider the applicability of exclusion (n), commonly known as the "sistership exclusion." It is a common provision in comprehensive liability insurance policies, which is intended to exclude from coverage the *cost of preventive or curative action by withdrawal of the product in situations where a danger is to be apprehended*. [Emphasis added.]

The court further observed that even considering the product recall exclusion, the policy still provided coverage for damages to the finished

product resulting from incorporation of the defective component—in this instance, the defective governing pins. As respects exclusion n. the court concluded:

> On remand, the evidence demonstrated that in the course of removing and repairing the pins, parts of Kohler's engines other than the pins, i.e., paper gaskets and welsh plugs, were destroyed and had to be replaced. In view of all these facts, we conclude that exclusion (n) does not preclude coverage in the present case.

Thus, Elco's CGL coverage applied to the demand by Kohler for the labor expenses and costs incurred by Kohler for the disassembly, reassembly, removal, or replacement of parts of Kohler's engines, which was necessary to replace the pins. The value of the defective pins was not covered.

Summary of Elco. Because all of the engines were considered by the Elco court to have suffered property damage, exclusion n. did not apply. If some of the defective governing pins had been shipped to Kohler by Elco, *but had not been installed in the engines*, the costs of recalling the uninstalled defective pins, including costs to inspect, adjust, repair, or replace the defective but uninstalled pins, would have fallen squarely within the recall exclusion—exclusion n.

The distinction lies in that the recall of the *uninstalled* defective pins is solely curative or preventative, whereas repairing the defective pins that were installed in the engines necessitated property damage and therefore was not solely curative or preventative.

Insured Recall versus Third-Party Recalls

Older versions of exclusion n. as found in the 1973 edition of the Insurance Services Office, Inc. (ISO), CGL policy were less than clear on a critical point—did the exclusion apply only to recalls instituted by the named insured or to *any recall*, including recalls made by third parties?

Majority View. The majority of courts interpreting the 1973 CGL held that the exclusion n. *did not apply* if the recall was by a party other than the insured.[2] The Court of Appeals of New York articulated this view in *Thomas J. Lipton, Inc. v. Liberty Mut. Ins. Co.*, 314 N.E.2d 37 (N.Y. 1974):

> The issue contested is whether these clauses relate to withdrawal and recall of defective products by the named insured only (here Gioia) or whether they extend as well to withdrawal and recall by the claimant (here Lipton). *We conclude that the exclusion in each policy extends only to claims in the first category, i.e., those arising from withdrawal and recall by the named insured, Gioia*.

> Accordingly, all elements of damage asserted here by Lipton against Gioia fall within Liberty Mutual's indemnity obligations under these two insurance policies.
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> To say that the categories of damage claimed here by Lipton do not fall within such coverage would appear to exclude what, as a practical matter, would usually be some of the largest foreseeable elements of such damage. Such an interpretation, *in the absence of claims for damages resulting from consumer injury, would render the coverage nearly illusory*. [Emphasis added.]

Added to exclusion n. in the 1986 or later editions of the ISO CGL policy was the phrase "by any person or organization" to the preceding clause "withdrawn or recalled from the market or use…." This appears to be intended to eliminate coverage for excluded recalls regardless of the identity of the party initiating the recall.

Property Damage

Frequently at issue in claims involving the costs of the recall of defective products is whether property damage has taken place at all. Assuming for the moment that no bodily injury has taken place, the absence of property damage (as defined) will leave the insured with no CGL coverage—and will render exclusion n. superfluous in such a situation.

There does, however, appear to be a split on what constitutes property damage. Some courts have followed the "integration" approach. This says that if one product is incorporated as a component part into a larger product, and the component part is defective, the larger product is considered to have suffered property damage *provided* the reduction in value of the larger product is greater than the value of the defective component part.

The Court of Appeals of New York articulates this "diminution in value" view of property damage in *Sturges Mfg. Co. v. Utica Mut. Ins. Co.*, 332 N.E.2d 322 (N.Y. 1975):

> When one product is integrated into a larger entity, and the component product proves defective, the harm is considered harm to the entity to the extent that the market value of the entity is reduced in excess of the value of the defective component.

This concept of property damage by incorporation and diminished value was explained further in the later New York case of *Marine Midland Servs. Corp. v. Samuel Kosoff & Sons, Inc.*, 60 A.D.2d 767 (N.Y. App. Div. 1977):

> When one product is integrated into a larger entity, and the component product proves defective, it is considered harm to the entity to the extent that its market value is reduced in excess of the value of the defective component. *Thus, if as a result of the defective roof, the value of the [building] computer center was reduced beyond the value of the roof, then, that differential is harm not to the roof, but to the building itself*. [Emphasis supplied.]

In other words, if installation of the defective roof reduces the value of the building beyond the value of the roof, then the building is considered to have suffered property damage.

Contrast this to a later case, *Federated Mut. Ins. Co. v. Concrete Units, Inc.*, 363 N.W.2d 751 (Minn. 1985), in which the Supreme Court of Minnesota expressly rejected the property damage by incorporation and diminished value approach, noting the differences in CGL policy versions:

> The policy considered in *Hauenstein* was a pre-1966 revision CGL policy, whereas the policy we now consider is a CGL policy as revised in 1973. The two policies differ significantly in that the former provides coverage for "damages because of injury to or destruction of property, including the loss of use thereof," while the latter provides coverage for "damages because of * * * property damage" and defines "property damage" as either:
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> *physical* injury to or destruction of *tangible* property which occurs during the policy period, including the loss of use thereof at any time resulting there from, and (2) loss of use of *tangible* property which has not been *physically* injured or destroyed provided such loss of use is caused by an **occurrence** during the policy period. (Emphasis supplied).
>
> Although the "diminution in value" of property caused by the incorporation of a defective component product may constitute "injury to * * * property" under the pre-1966 revision CGL policy (a point we need not reconsider on the present facts), *we conclude that "diminution in value" is not "property damage" when defined as either "physical injury to * * * tangible property" or as "loss of use of tangible property*. [Emphasis added.]

As always, the actual policy wording should be taken into account, including changes to the policy wording compared to past editions that may render past case law inapplicable.

Conclusion

Damages or costs for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal of your product, your work, or impaired property are excluded. However, it is only excluded if the product, work, or the impaired property is withdrawn or recalled from the market or from use because of a defect, deficiency, or dangerous condition that is either known or suspected to be in your product, work, or impaired property.

The exclusion is meant to eliminate coverage for costs incurred to *prevent* bodily injury or property damage.

The intent of the sistership exclusion is that while insurance covers damages for bodily injury and property damage caused by the product that was defective or failed, it was never intended that the insurer would be saddled with the cost of preventing such defects or failures any more than it was intended that the insurer would pay the costs of the defect in the first place or preventing the first failure if the product has been discovered to be in a defective or dangerous condition before the occurrence.

Olympic Steamship Co., Inc. v. Centennial Ins. Co., 811 P.2d 676 (Wash. 1991).

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[1]The *Sokol* court also found that "Sokol's peanut butter, whether rancid or merely "off taste," did not cause 'physical injury to tangible property'" and that "Sokol's payment to Continental [the food manufacturer] was not a sum Sokol was legally obligated to pay for 'property damage' as the term is defined in the policy." In short, the insurer did not need to use exclusion n. to avoid coverage.

[2]Peter J. Kalis, Thomas M. Reiter, and James R. Segerdahl, *Policyholder's Guide to Law of Insurance Coverage* (Aspen Law & Business 2002) 2000 Supplement, pg. 10–25.

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