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## Spoiled Brands: Protecting Your Company's Goodwill and Assets from Food Contamination Claims

by Zachary Finn, ARM; Timothy Anderson;  
and Donald Lund, CPCU, CPA, ARM, ARe, ASLI, APA, AIS, RMPE, CRIS

### Introduction

In the early twentieth century, Upton Sinclair published his famous work *The Jungle*. This work, which detailed the hazardous handling of meat products in Chicago, was a landmark publication and awakened the public to the need for safe food handling. As a direct response to Sinclair's work, Congress passed the Pure Food and Drug Act and the Meat Inspection Act in 1906. More than 100 years later, outbreaks of deadly e-coli and other diseases still plague our food industry.

The first fundamental step of risk management is to identify potential hazards facing a company. In this article we will examine two recent instances in the food industry that were widely reported in the media, and resulted in serious human and economic damage. Risk mapping and quantification of risks, proper loss prevention techniques, and specifically contractual risk transfer when using co-packers will then be examined. Finally, how risk financing and risk transfer help provide stability to a business enterprise will be discussed.

One of the more memorable events from *The Jungle* was how a human finger was processed along with other beef products. Fast forward 100 years when in late 2004 a woman claimed to have found a finger in her chili at a Wendy's in California. The media storm that ensued almost created a nationwide panic, and the ensuing investigation revealed the whole incident was a hoax in an attempt to extort money from Wendy's. Even though this was a single case at a nationwide chain, at the height of the incident, Wendy's estimated losses of \$1 million each day. The entire incident had a dramatic effect on first quarter 2005 financial results for Wendy's, which estimated this single incident lowered same-store sales between 2 and 2.5 percent.<sup>1</sup>

An even larger incident occurred in 2005 when contaminated spinach from California sickened over 200 people and killed at least three.<sup>2</sup> Spinach was pulled from supermarkets across the country, and the direct and resulting economic losses have been estimated between \$60 million and \$70 million. To this day there are likely still people, the authors included, who cannot eat Wendy's chili or purchase spinach from the grocery store without the thought of these prior incidents entering into the decision-making process. Subsequent years have only seen media and consumer awareness regarding food contamination incidents grow, particularly after the series of heavily reported recalls resulting from products and ingredients manufactured and imported from China. The need to properly identify these risks and use established risk management techniques to reduce and transfer such risks is becoming more pressing each day. With that said, and

### Abstract

*For most people, going to a restaurant ends with a sense of satisfaction and enjoyment, not sickness and the possibility of death. This is also true when purchasing products at a local grocery store. However, recent events have cast doubt on the safety of America's food supply. The issue facing risk managers is how to reduce these escalating risks and manage any unfortunate outcomes. The cost of food contamination can be devastating to a business financially, and can result in both direct losses related to product recall expenses and indirect losses such as lost reputation and goodwill. By reducing the frequency and severity of such risks and using proper risk transfer techniques, risk managers can help prevent catastrophic losses from contaminated food, and ensure the long-term viability of their company's brands.*

the risk of product contamination identified, let us next examine where the bulk of a company's exposure lies and quantify what exactly is at stake.

## **Spoiled Brands—The True Cost of a Product Contamination Claim**

While product recall expenses from a contamination event can be expensive, they rarely exceed a few hundred thousand or million dollars, given that a typical product contamination event is often limited to a few batches of product and occurs over a finite period of time. In most cases, food manufacturers are able to perform a limited recall by using serial numbers to trace the contamination to a specific production line, date, time, and batch. In the case of malicious product contamination by an employee, the manufacturer may even be able to trace the event back to the responsible party. Even when a full recall is performed, the expenses related to the recall itself will usually be limited to:<sup>3</sup>

- communications and media expenses
- transportation and warehousing costs
- employee overtime costs
- additional staffing expense
- product testing and destruction costs
- clean-up costs
- increased costs to subcontract additional products

Per the aforementioned case studies in the introduction, the true cost of a product contamination event stems from lost consumer confidence and the resulting damage to brand value and goodwill. In 1995, it was determined that 75 percent of the value of the Fortune 500 was derived from intangible assets such as brand value and goodwill.<sup>4</sup> For some companies, up to 80 percent of their value can be tied up in intangible assets.<sup>5</sup> Obviously the definition of intangible assets includes such items as patents, internal talent, source code for software companies, etc.; however, it also includes the value of any brands the company has spent time and money cultivating, and the resulting goodwill. For a brand-name company, these values can be significant. For example, the estimated value of Coke, McDonald's and Budweiser's brands in 2006, as listed in the annual survey conducted by Interbrand and *Business Week*, were \$67 billion, \$27.5 billion, and \$11.7 billion, respectively.<sup>6</sup> The fact that these values are estimated illustrates the problem with brand value and goodwill, particularly as it relates to implementing a risk management strategy, which is that their true value is often unknown. The reason for this is that GAAP, and specifically accounting rules such as the Statement of Financial Accounting Standards (SFAS) No. 142, provides that internally developed goodwill is not to be amortized. Since there is no accounting requirement to determine the value of internal goodwill, and the undertaking of such a valuation can be expensive, its true value often remains unknown. The only time goodwill needs to be determined, and can be amortized, is when a company is acquired at a price over its fair market value, with the additional purchase price being deemed attributable to goodwill.

While the exact value of a company's brand and goodwill may not be known, it is important to keep such considerations in mind when developing a risk management strategy for product contamination claims. For example, policies insuring against the

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loss of goodwill have come in and out of favor, particularly in alternative markets such as Lloyd's of London; however, these policies have never really gained a foothold in the corporate risk manager's toolbox. The reasons for this include both the aforementioned problem in valuing goodwill, as well as the difficulty in determining an appropriate trigger for coverage. From a risk financing perspective we will provide an overview of product contamination insurance, which covers most, and sometimes all, of the expenses outlined above that are attributable to a product recall. These policies also recognize that much of the risk/loss from a product contamination event results from indirect losses, such as lost revenue, damage to brand value, etc. As such, these policies will often provide coverage for:<sup>7</sup>

- loss of profits
- advertising and consumer education campaigns
- brand rehabilitation expenses
- consultant and public relations assistance

However, before we discuss how to pay for any losses, it is important to remember that the best way to protect your company's brands and goodwill is to prevent a loss from occurring in the first place. As such, the next section will outline the Hazard Analysis and Critical Control Point (HACCP) system used by the food manufacturing industry to do just that.

## **The Best Food Contamination Claim Is No Food Contamination Claim**

As it pertains to food contamination claims, there are three primary ways in which a loss can occur:

- 1. Accidental Contamination**—This is usually thought of as the introduction of an unintended substance into the product, i.e. glass, metal, insects, etc. However, accidental contamination more commonly consists of the mislabeling of a product, i.e. a product containing peanuts is mislabeled as not containing peanuts, etc. The risk, of course, being that someone with a severe peanut or other food allergy will eat a product that does in fact contain that allergen.
- 2. Malicious Contamination**—This form of product contamination is intentional and can result from any number of sources, i.e. a disgruntled employee, customer, special interest groups, etc.
- 3. Extortion Threats**—In the case of extortion, product contamination may have occurred or there may simply be a threat by someone to contaminate a product. In any event, the goal of the extortionist is to use the product contamination or threat of product contamination to extort money from the company.

Regardless of how product contamination can occur, and as any risk manager will tell you, the best kind of loss is no loss at all. As it pertains to food contamination claims, there are numerous tools that can be used to prevent a loss, such as X-ray scans, the use of magnets to detect metal, standard operating procedures that ensure prepared foods are cooked for durations and at temperatures that ensure bacteria are killed, etc. However, it is not enough that loss prevention tools are available; there also needs to be a system in place to ensure that these measures are deployed effectively.

For food manufacturers, the most common system for preventing contamination and applying loss prevention tools is the Hazard Analysis and Critical Control Point (HACCP) system. HACCP evolved from the teachings of Walter A. Shewhart and W. Edwards Deming, who were pioneers in the field of statistical quality control.<sup>8</sup> Those teaching ultimately evolved into a formal program, developed by Howard E. Bauman, Ph.D., of the Pillsbury Co., for NASA that was implemented in 1971 as a means to ensure the safety of food eaten by astronauts in the space program.<sup>9</sup> The Food and Drug Administration eventually co-opted the HACCP system, and in 1995 and 2001 mandated that the seafood and juice industries adopt it, respectively.<sup>10</sup> While the FDA has not mandated the use of HACCP by all food manufacturers, it is now the recognized safety standard for the entire food manufacturing industry.

The seven principles/steps of HACCP, and some thoughts around a few of the more critical steps, are:<sup>11</sup>

- 1. Analyze hazards.** This step is nearly identical to the risk identification process and consists of identifying the potential hazards associated with the food being manufactured, i.e. physical contamination, biological contamination, chemical, etc., and best methods/tools to prevent and control these hazards.
- 2. Identify critical control points.** This consists of identifying the points in the manufacturing process for a particular product where the identified prevention and control tools can best be applied, i.e. the cooking process for prepared foods would provide an opportunity to kill biological hazards, the mixing process might provide an opportunity to screen for physical contaminants via magnet, screen, etc.
- 3. Establish preventive measures with critical limits for each control point.** This step consists of setting the thresholds or standards needed to ensure that a given prevention or control tool is effective, i.e. cooking time, magnet strength, and procedures needed to effectively screen for metal, etc.
- 4. Establish procedures to monitor the critical control points.**
- 5. Establish corrective actions to be taken when monitoring shows that a critical limit has not been met.**
- 6. Establish procedures to verify that the system is working properly.**
- 7. Establish effective recordkeeping to document the HACCP system.** This step is critical as it pertains to the government's efforts to monitor food manufacturers. Absent the HACCP system, the government is only able to monitor food safety on any given day, whereas the HACCP system provides detailed records of a manufacturer's compliance over time. Records provided from the HACCP system consist of identified hazards, the chosen loss prevention and control tools and scientific tests demonstrating the company's efforts to monitor product safety, and the implementation of the aforementioned tools.



Table 1 is a list of the hazards typically controlled through the use of HACCP.

**Table 1**  
**Food Safety Hazards Controlled through a HACCP Program<sup>12</sup>**

Physical	Chemical	Microbiological
Glass	Allergens	Cross Contamination
Metal	Animal Drug Residues	- Post-Cooked
Other Foreign Materials	Cleaning Compound Residues	Pathogens
	Illegal Residues/Pesticides	- Raw Ingredients
	- Packing Materials	- Raw Storage
	- Raw Ingredients	
	- Shipping Containers	
	Natural Toxins	

While exact data on the effectiveness of HACCP in reducing food contamination incidents varies and is often hard to quantify, it is intuitively obvious that companies that utilize HACCP and its regimented system of risk identification and mitigation techniques will be less likely to suffer a food contamination loss.

In addition to requiring the use of HACCP, those companies that outsource the manufacturing of their products to others, commonly referred to as co-packers, should also ensure that they are requiring:

1. Certificates of Analysis describing the quality control data for a particular lot/batch of product.
2. Audits of supplier testing through the use of outside lab testing.
3. Proper insurance and indemnification provisions, i.e. contractual risk transfer, in their contracts, in order to ensure that the company is being indemnified and held harmless for any losses resulting from the co-packers' negligence or willful misconduct.

### **Transferring Risk**

Even the best loss prevention efforts are not 100 percent effective. Given the potential severity of losses that can result from contamination cases, impacted companies will undoubtedly seek insurance coverage to protect themselves from these types of events. While certain affected entities may have insurance specifically designed to cover product recalls and contaminated products, many others do not. Mistakenly, many companies believe that they are protected from product recalls under their general or product liability policies, but unfortunately many of them have discovered the hard way that insurance covering general product-liability risk does not usually cover the costs of implementing a recall of an unsafe or contaminated product. In fact, standard ISO policy forms specifically exclude damages claimed for any loss cost or exposure incurred for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal, or disposal of your product, your work, or impaired property. The typical commercial general liability or property insurance policy that most companies maintain pays for all bodily injury or property damage caused by a hazardous or defective product, but these policies do not typically cover the logistical costs of a recall, nor the associated lost profits.<sup>13</sup>

As a result, some companies have contracted for specialized insurance coverage to protect themselves from these particular kinds of losses. One such coverage is product contamination insurance, also referred to as accidental contamination and malicious tampering insurance. This type of insurance tends to offer companies broad first-party coverage including loss of income, as well as some limited third-party coverage. Covered losses under most product contamination policies include product recall expense (first and third party), product replacement, extra expense, loss of profits, and product rehabilitation expense. For many companies, the latter two—loss of profits and product rehabilitation expense—are the most valuable components of this coverage, especially given the impact to brand value and intangible goodwill previously discussed. Some product contamination policies may also include coverage for extortion payments, which are made in conjunction with product tampering. Most of the time, extortion payment coverage is provided under a kidnap and ransom/extortion policy, which more fully addresses this type of exposure. Because product contamination policies provide greater first-party protection, they are of greater importance to “brand” companies or those providing finished products to consumers.

Another insurance product purchased by some companies is called product recall insurance, which is designed to help businesses financially survive a product recall. A product recall policy covers the logistical costs of a recall, such as publicity, transportation, and storage of the item, repairing and returning the items, and other extra expenses necessary to carry out the recall. This type of policy will not cover the costs of lost profits and rehabilitating a product's image. Product recall policies are of particular importance to companies providing ingredients, components, or contract manufacturing for others. This ensures proper coverage for their customers. Product recall insurance is not a new insurance product. This insurance has been offered for at least 20 years. In fact, the Insurance Services Office (ISO) recently issued a form policy for this insurance.<sup>14</sup> But despite the fact this insurance has been available to companies for 20 years, many companies have opted not to purchase these types of plans, either because it was too expensive or as in the case of companies downstream from the large growers or suppliers, the risks from the contaminated or recalled product were perceived as relatively remote. In fact, the lawsuit that arose following the Tylenol-cyanide incident illustrates the consequences of a company either being unaware of its insurance coverage or deciding not to carry this type of coverage. In *McNeil Labs v North River Insurance*, a federal judge held that Johnson & Johnson's excess-liability insurers were not obligated to reimburse the company for expenses resulting from the recall of 31 million bottles of Tylenol. The judge stated that “at no time until counsel became involved following the recall was there any thought, belief or intent on the part of Johnson & Johnson or of any party that recall and expenses related thereto . . . were covered . . . Johnson & Johnson, which at one time carried recall coverage, knew such coverage could be purchased and elected not to purchase it because the cost was prohibitive.” In addition, an alternative to contamination or product-recall insurance is self-insurance. Some companies have found that self-insurance is necessary to supplement product-recall insurance because of the dollar limitations that most product-recall policies contain.<sup>15</sup>

## Conclusion

As intense media attention has been placed on recent food contamination incidents, awareness has grown regarding how frequently severe incidents occur. Risk managers need to ensure the businesses they support first and foremost have adequate preventive measures to ensure the quality and safety of their products. With proper preventive measures, such as HACCP and established procedures to correct any incidents prior to product release, the company may be able to spare itself from a contamination event in the first place. For those events that do occur, it is imperative that the risk manager understand what is at stake prior to a loss and consider the best form of risk financing in advance. For a co-packer this is likely to be product recall insurance, and for a brand-name company product contamination insurance. Regardless of the method of financing selected, it is the risk manager who understands and quickly mitigates the impact of indirect losses to brand name and intangible goodwill who will be in the best position to ensure the company's future. Proper preventive measures and the transference of risk are at the heart of risk management and once established need constant evaluation in order to ensure success.

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