PRODUCT RECALL INSURANCE
CASE STUDY

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SPOT MARKET PURCHASE CAUSES SUPPLY CHAIN PROBLEMS

Manufacturers often have a complicated production process involving multiple materials and components incorporated into a finished product. Further issues can arise where the manufacturer's product is a small component, part of a far more complex product.

Product quality, supply issues, production breakdown and human errors can all cause complications in a supply chain. Not only will this result in delayed production internally, but it will also have a knock on effect with connected suppliers.

In this product recall case study, we explore how a steel casting manufacturer opted to use the spot market to fill a product shortage but suffered severe consequences as the supplier had not been vetted or verified.

The insured, a privately-owned steel casting manufacturer with a portfolio of standard castings and custom-made products, specialises in carbon steel flanges. This sector of its business has an annual revenue of USD 25,000,000 and makes up 40 percent of the overall company revenue. The flanges are used in consumer products such as automobiles, fridges and HVAC units. The manufacturer has been in operation for 30 years.

FAULTY PRODUCTS DISCOVERED

The insured was first notified of a problem by its customer, an automotive component manufacturer in Michigan. The component manufacturer had performed some pressure tests on the supplied steel flange and discovered that the steel snapped at very low temperatures (which mimic conditions in Northern Michigan during winter).

The insured had not retained any samples from that production lot and requested that the customer return any stock available so it could investigate the issue with the flange. Due to a logistical mistake, the customer initially sent back rods from a prior production lot, which added on a three-week delay to the investigation. When the correct steel was returned, the insured ran various physical tests which confirmed that it was far more brittle than expected. Metallurgical analysis then revealed that the carbon composition of the steel was higher than intended, which was the cause of the increased brittleness.

DID YOU KNOW?

THE SPOT MARKET ALLOWS A MANUFACTURER TO PURCHASE MATERIAL QUICKLY AND EFFICIENTLY FROM AN ANONYMOUS SUPPLIER, IN THE EVENT THAT THEIR REGULAR SUPPLIERS ARE UNABLE TO FULFIL THE ORDER. THIS MEANS THE PRODUCTION LINE IS UNINTERRUPTED AND MANUFACTURING OF THE PRODUCT CAN CONTINUE EFFICIENTLY.

The steel casting manufacturer traced the raw material used in that production lot to determine how many days of operation are affected with the faulty produce. This also indicates where the faulty produce would have used been by other companies in the supply chain. The tracing exercise showed that the particular raw material in question was purchased on the spot market after the insured's usual supplier was not able to fulfil requests over a four day period. The insured very rarely uses spot markets, but on some occasions it is necessary and is quite common in the industry.

The complaint from the component manufacturer was the only issue raised directly to the insured, and was addressed by shipping replacement steel and a small payment to cover expenses - an overall cost of USD 35,000. However, because the carbon composition of the affected batches was in breach of what most customers considered an acceptable range agreed, the insured decided to notify all of the customers who may have purchased parts made with the substandard steel.

ESTIMATING THE LOSS

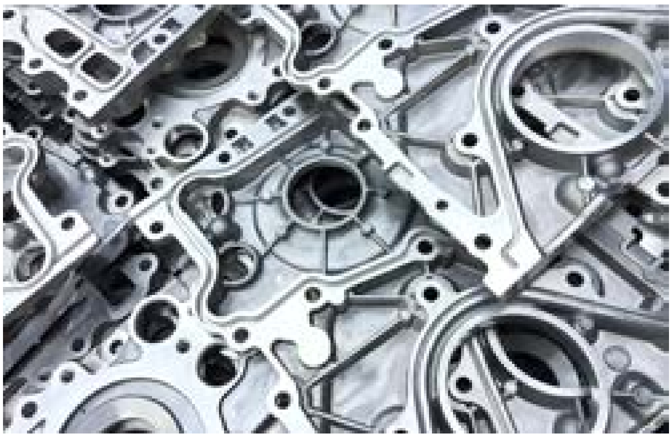
Rather than offer refunds for the faulty steel, which would have topped USD 450,000 and more than depleted the insured's cash reserves, the insured instead offered to replace the steel. However, given the time delay between the sale and the defect notification, many of its customers had already incorporated the flange into their products and instead claimed for financial compensation from the insured citing the following unexpected costs:

- Cost of disposed products due to incorporation of faulty flange
- Costs of removing components which incorporated faulty flanges from in-progress and finished vehicles
- Credits charged for future purchases
- Loss of sales, as one customer lost a contract with a large car manufacturer due to this issue
- Various administration costs

The amount claimed against the insured by its customers totalled USD 3,500,000, and the insured was legally liable for these costs according to their supply contract with the customers, as well as common law (i.e. the insured was negligent).

The insured did not have sufficient cash reserves to satisfy even a third of these claims, especially as they needed to purchase raw materials to continue operating and fulfilling other orders. Additionally, three new customers filed lawsuits and the insured's in-house lawyer required the help of external counsel who charged USD 450 per hour and required a USD 20,000 retainer.

PRODUCT RECALL POLICY AND RECALL EVENT LIABILITY



As a result of the recall, the insured suffered a significant financial and reputational loss, and the viability of the business was under threat due to the impact on cash flow.

Luckily, the insured's product recall policy included an extension for recall event liability, which covered their legal costs for compensation and lawsuits, as well as any sums which they were legally obligated to pay. The purchase of the policy ensured the survival of the business and safeguarded their cash flows, ensuring they could continue purchasing supplies and conducting business as usual.

The companies and circumstances in this case study are fictional, but the scenarios are realistic and reasonable based on our experience.