Baby Steps: Six Steps to Improving Product Liability Risk Management

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In 2012, the U.S. Consumer Product Safety Commission ordered the recall of approximately 312 products, and 52% of them were manufactured in China. Most of the products were aimed at the American consumer market, the largest in the world, and almost half of the products were made for children. Product defects in the children's category ranged from lead paint violations to burn and strangulation hazards, among other problems.

In the *Wall Street Journal*'s China News of December 10, 2012, China's export figures, and particularly those for the U.S., showed weak results.

Among the factors that can influence export trade is brand and customer loyalty or retention. Besides the effects these factors may have on the export market, they will affect an insured's financial performance.

What are the financial and legal implications of this track record of defective children's and consumer products? The overarching impact is reputation damage followed closely by needless legal expenses.

Loss of brand value: The lead story on the Nightly Business News on the U.S. Public Broadcasting Service on December 6, 2012, was Apple CEO Tim Cook's remark that Apple would start manufacturing again in the U.S. While only 1% of Apple's total manufacturing will be done next year in America, this news comes on the heels of the Fair Labor Association report on Apple's contract manufacturer in China. With the highest brand value in the world, Apple's announcement, while small in scale, appears to be a signal supporting their brand. The enormous U.S. consumer market makes the financial implications of even small losses of brand value of critical importance to manufacturers and ultimately, to their insurers.

1) Loss of profitability: Customers will not remain loyal if the products they buy are defective. That is true at all levels of the channel of distribution. As customers churn, those losses are reflected in decreased gross profitability. The beneficial effect of customer retention was studied by Bain & Co. and published in The Loyalty Effect by Frederick F. Reicheld, Harvard Business School Press, 1996, 2001.

2) Legal expenses: The cost of defending a product liability claim in American courts is high. While product liability cases cannot be erased in toto, they certainly can be minimized in their cost and productivity impact.

From Costs, Profits

Over time, the comparative cost of investing in and implementing risk management training with insureds who are manufacturers, is far smaller than litigation defense costs and the correlative financial and reputational damage resulting from product recalls. Why is this principle meaningful to insurers? An investment in risk management programs is a form of corporate social responsibility, which, whether it is called CSR or "better risk management," has been shown to be positively associated with improved corporate financial performance (CFP), (Orlitzky, M., Schmidt, F. L., & Rynes, S. L. (2003). (Corporate social and financial performance: A meta-analysis. Organization Studies, 24(3), 403-441.)

As a result, at the same time that such increased risk management responsibility incurs costs, there is clear evidence from comprehensive economic research studies that socially responsible behavior, here as an insurer's investment in enhanced risk management training with insureds who are manufacturers, is a determinant of positive financial performance. This valuable effect is a distinct competitive advantage spurring secondary financial benefits for all stakeholders (a virtuous circle) in the form of customer and employee retention (directly linked to enhanced profitability by Reicheld, above in #1), increased investor interest and competitive rates of return from socially responsible investment funds1 and benefits to surrounding communities and channel members.

Legal Risk Management Steps

The following section is an abbreviated list of steps a manufacturer should consider to improve product acceptance.

1) Ensure compliance with all applicable code, statute, or product regulations. Before manufacturing and marketing a product, determine all the applicable codes and standards that will apply to your product and ensure that your product will comply with all these standards. It is important that if independent testing is required, that you have a certified laboratory to perform the work.

2) Proper documentation and record retention. Not only is a company expected to monitor the manufacture of its product for quality compliance, such monitoring must be properly documented and the documentation must be stored and easily accessible. The best inspections and laboratory testing will serve no purpose if a company does not have documentation regarding the testing and inspection. It is important that if there is litigation, a company can quickly and easily access the records it needs. Therefore, a company must establish a document retention protocol whereby it stipulates how long quality related documents will be stored, where they will be stored, and how they will be organized. It is also important that a log be meticulously kept of every test, inspection, and modification done to a product with proper information to identify the product, what is being done, when it is being done, who is doing the work, and the results of what is being done. Proper documentation will go a long way in reducing or eliminating a company's liability.

3) Properly manage any and all outsourcing for quality. Although a company can defer some of its liability to a component manufacturer, it still has an obligation to ensure that any components it uses in its product meets the strict quality standards that it has set. Therefore, it is essential that all material that is outsourced be inspected prior to use and installation for compliance with the company's quality guidelines.

4) Contract management. One of the easiest ways a company can protect itself is by drafting a proper contract with the terms necessary to protect it against future liability. Taking the time to ensure that all provisions and agreements are carefully laid out in a contract can save time and energy if a dispute arises. In addition, a contract is a perfect place to allocate risk.

5) Proper training. As the old saying goes, you are only as strong as your weakest link. It is important that a company properly train all its employees on safety, regulatory guidelines, and proper company procedures. An employee not only needs to be able to spot a defect but must know what to do to prevent a defect and whom to alert if a defect is detected.

6) Monitoring product performance. A company's responsibility does not end once a product has been manufactured and sold. It must continue to monitor the performance and safety of its product to ensure that there is not a latent defect and that the product is performing as expected. One of the best ways to reduce or limit liability is to have a system set-up that allows easy monitoring of real life performance of the product. If a company can be alerted immediately when a problem arises in its product, it can quickly and effectively remove or correct the problem before consumers sustain harm. With social media technology, this has become easier and more cost effective. With facebook, twitter, and websites, a company has numerous technologies at its disposal to establish a system for monitoring the performance of its product.

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