CRC Group
Wholesale & Specialty

Food Product Recalls Create Costly Ripple Effects

When a food manufacturer recalls products, the consequences often ripple throughout the product manufacturing, retail grocery, and restaurant industries. The dairy recall of a California-based food manufacturer is one of the most recent in a long line of ingredient recalls that create loss and risk throughout the supply chain.

On January 11, 2024, California-based manufaturer Rizo-Lopez Foods announced the recall of 344 cases of aged cotija Mexican grating cheese after officials in Hawaii found listeria in a sample. On February 6, 2024, the recall was expanded to more than 60 dairy products, including cheese, sour cream, and yogurt. The company's cheese products are used in taco kits, salad, dips, snacks, sandwiches, and even ready-to-eat burritos and other products available in vending machines. To date, the recall has impacted more than 20 grocery chains, including Costco, Walmart, Trader Joe's, and Whole Foods.

Other food manufacturers have also been impacted. Dole Fresh Vegetables recalled salad kits because the kits were assembled on the same line as the recalled cheese and the salad manufacturer was concerned about the risk of listeria cross-contamination.[1]

Product recalls can be costly for food manufacturers, as they must overcome loss of revenue, product, reputation, and brand credibility. However, the losses can quickly compound if the ingredient leaves the facility and is used in other food products, rapidly expanding the recall scope. Fortunately, tools like product recall insurance, along with other management strategies, can help mitigate the risk.

INGREDIENT RECALLS CREATE COSTS DOWN THE CHAIN

Recall ripple effects are common when a food recall involves a commonly used ingredient like cheese, produce, spices, and more. The Peanut Corporation of America (PCA) recall may be the most notorious incident of an ingredient contaminating hundreds of other products. The recall started in January 2009 when the FDA recalled batches of peanut butter due to possible salmonella contamination. The recall gradually expanded to include 3,600 products going back to 2007.[2]

Within a month, more than 600 people had fallen ill with salmonella poisoning. By February 2009, PCA filed for bankruptcy.[2] The two brothers who owned the company were ordered to pay up to $300 million in damages, and each was sentenced to more than 20 years in prison.[3]

Granted, not every recall results in prison sentences for executives. However, the recall risk for a widely used ingredient is still substantial. When a food product is recalled, the manufacturer is likely to experience direct costs related to:

- Communicating with retailers, distributors, and other customers
- The "reverse logistics" of pulling the products from shelves
- Disposal of contamintated products

- Loss of revenue
- Damaged credibility with customers, partners, and the public
- Fines and litigation costs
- Loss of business relationships

It's difficult to put a price tag on the total cost of a recall because there are so many variables involved. A 2016 study found that the average cost of a produce recall was $1.56 million, but that study only considered the market value of the lost product.[4] In many recalls, the other expenses - like lost revenue and reputational damage - could be much greater than the cost of lost product.

Down-channel risk can be significant for manufacturers like Rizo-Lopez, whose dairy ingredients are used by many manufacturers and retailers for a diverse range of products. While it's important for a business to partner with many different customers, it's challenging to implement reverse logistics and minimize recall risk when products have been widely distributed.

Recall costs quickly become inflated when product is sent to distributors, retailers, and other customers. When the manufacturer disposes of contaminated product, it does so at cost. However, if a retailer has to dispose of product, the lost revenue is much higher because the product has been marked up.

For example, assume a cheese manufacturer sells a pound of cheese to a salad manufacturer for $20 per pound. The cheese is used to create 500 individual salads priced at $5 each. If only the cheese is contaminated and caught before it is shipped to the salad company, the cheese manufacturer loses $20 per pound.

However, assume the contaminated cheese is not caught at the facility and is shipped to the salad manufacturer and used in final products. All of the salads must then be disposed of. That $20 loss for a pound of cheese has now become a $2,500 loss for the same amount of original product.

The salad manufacturer could also suffer other costs, like reputational damage and loss of sales in unrelated products. If the salads reach a retailer, that retailer may also suffer losses for which the original cheese manufacturer may be liable. Take this scenario and amplify it across dozens of companies and hundreds of products, and it's easy to see how the costs of a recall can accelerate quickly.

STRATEGIZE TO MINIMIZE FOOD RECALL RISK

The good news for food manufacturers is there are steps they can take to minimize the chances of a recall and the scope of a recall if one should occur. Below are strategies insurance agents should discuss with their food manufacturer clients to fully protect them and their customers from recall risk:

Implement Quality Assurance & Post-Contamination Procedures

While insurance is an effective risk mitigation tool, the best strategy to reduce recall costs is striving to prevent them. A robust test-and-hold policy, which means inventory does not leave until it has cleared testing, can ensure that a contaminated product never reaches a store shelf or another manufacturer's assembly line.

Notable food product recalls that resulted in damages for customers, distributors, and retailers:

Beef recall due to animal abuse with total damages of nearly $500 million.[5]

Salmonella contaminated peanut butter led to nearly $1 billion in loss of sales for peanut butter.[5]

Listeria outbreak led to 10 hospitalizations, resulted in a $60 million settlement, and $19 million in fines.[5]

If contamination does happen, it's essential to have procedures in place to act quickly and reduce the exposure. In 2020, Sauer Brands discovered a possible salmonella contamination in parsley in its Spice Hunter product line. Although no illnesses had been reported, Sauer implemented a recall of the parsley and all other products that were on their line that day.[7] That kind of quick and decisive action can help prevent the recall from extending to retailers and other manufacturers.

Leverage Recall Insurance Covering Third-Party Loss

Product recall insurance effectively protects against a wide range of recall costs, including product loss, revenue loss, fines or judgments, and even reputation rehabilitation costs. Policies may also cover costs for impacted third parties, such as retailers, distributors, and other food manufacturers that use the insured's ingredients in their products.

Many insurance policies also include services to help mitigate the impact of a recall. For example, a policy may offer consultation and audit services to improve a manufacturer's quality assurance policies. Coverage may also assist with quickly notifying customers, retrieving products, and limiting the scope of the recall.

Match Coverage to the Level of Need

One of the challenging aspects of the food product recall insurance market is that there are no benchmarks. For some manufacturers, lower limits may be appropriate, while others require much more robust coverage. In either case, coverage should be based on an insured's unique risk exposure. Questions to help clarify coverage needs include:

- **What is the manufacturer's revenue?**
- **Is revenue seasonal or even through the year?**
- **Does the manufacturer produce many products or have a limited product lineup?**
- **What quality assurance processes are in place to prevent contaminated ingredients from leaving the facility?**

BOTTOM LINE

A food recall can be financially challenging for a manufacturer, but it can be catastrophic if the contaminated product is distributed to retailers and other manufacturers, thus expanding the scope of the recall. Recall insurance that covers third-party costs can be an effective tool to minimize losses. However, coverage is highly specific to each business. Agents should work with an experienced and knowledgeable broker to find the right coverage for their client's products, needs, and unique risk exposure. Protect your food industry clients by speaking with an experienced CRC Group broker about product recall insurance. Reach out today!

CONTRIBUTORS

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END NOTES

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