Product recall claims in the downstream oil and gas sector

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Failure of a manufactured product is a serious concern to any business both in terms of financial loss and reputational damage. Nowhere is the potential impact more severe than in the high value and complex industry of oil refining, processing and distribution.

Whilst it is the overriding expectation from any customer that the products purchased are of good quality and fit for their intended purpose it is a fact of life that things can and do go wrong. It is reasonable to assume that no manufacturer of specialist plant, whether it is machinery, oil pipelines or other high risk equipment, will deliberately set out to cut corners and take unnecessary risks. New oil and gas construction contracts, including start-up projects or more than likely extensions / modifications to existing facilities, have long tail implementation periods. There is little or no opportunity for any manufacturer to redress unexpected negative reputation over the short to medium term, if at all.

So how do suppliers protect themselves by insuring at least some of the risk?

Product Recall Insurance affords the manufacturer a measure of indemnity for the reasonable and necessary cost of recalling the defective product to their own premises. This comes with the proviso that the commissioning or continued use of the product could result in the policyholder incurring a legal liability by causing third party bodily injury or property damage.

It is usual for Product Recall cover to be provided by means of an extension to a Product Liability policy. This provides the manufacturer with indemnity against their supplied product causing third party injury or damage. The recall extension is a means of preventing or containing the risk of a third party claim for damages arising.

Size and complexity of the Product

There is no such thing as a standard Product Recall Policy, albeit the majority of wordings have evolved from manufacturing in the food, automotive, consumer product and pharmaceutical industries. If you have the proverbial "widget" in mind when reading a typical policy it sort of makes sense. However, how does this apply to a major piece of downstream equipment such as a naphtha hydro-treater, a delayed coking unit or even a 400km long carbon steel pipeline - that has just been buried in a 2m deep trench?

These risks bring with them a whole new concept in the interpretation of policy cover for the cost of recalling (removing) the defective product to the Insured's premises. It is doubtful that such risks were really envisaged by Underwriters when first writing Product Recall cover for a "widget".

What actually is "Recall"?

Product Recall essentially provides cover for the expense of recovering products that have been manufactured and supplied by the Insured and whose ownership has passed to third parties. The extent of cover is typically defined to include the cost of:

- Notification
- Transportation
- Return of the repaired or replaced product
- Travel costs for employees or appointed experts where it is possible to repair the product in-situ (*instead of Recalling*)
- Hire of temporary personnel necessary to exercise the Recall
- Product destruction in place of Recovery (*where it is economic to do so*)

The trigger for the engagement of a Product Recall claim is that the product poses an imminent threat of bodily injury or property damage. It would not cover products that are simply defective, are of general poor quality or do not meet the required manufacturing specification, where they do not also constitute a threat to causing injury or damage.

Product Recall would not generally extend to include the cost of remanufacturing a replacement product free from defects. This is something that would ordinarily be picked up by way of Product Guarantee insurance, if such cover has been taken out.

Extensions of cover

It is not unusual for basic Product Recall cover to be extended further, by way of Endorsements or Extensions to a general Product Liability policy. Policy extensions that are of particular interest in the downstream sector include the cost of Dismantling and Assembly, for Testing and Sorting and Impaired Property Endorsements.

Dismantling and Assembly basically concerns legal liability on the part of the Insured for taking apart and removal from the customer's premises those products that do not conform to their intended purpose. It will also generally provide cover for the subsequent installation and assembly of replacement products which are free from defects, but not for the manufacture of the replacement product. The proviso of there being a risk of third party injury or damage still applies.

Considering the "widget" scenario, it is easy to understand the purpose and value of this extension. The cost of removing the offending product and installing a replacement is likely to be somewhat less than a potential third party claim for damages arising. However, in the world of oil and gas processing and distribution the scope for potential expenditure is on a different scale. Consider an underground pipeline for example, where latent defects have been discovered during the post installation pressure testing phase. The term "Dismantling" takes on a new meaning. It is not just a case of technicians visiting the client's premises armed with a bag of tools to remove the offending product. Before the defective section of pipe can be removed (which is itself a major piece of mechanical engineering) it has first to be located, followed by a delicate civil engineering re-excavation exercise just to gain access to the product. The potential costs are not insignificant.

A Testing and Sorting policy extension provides cover for the expense of testing other products that do not currently have identified defects, where there is *"reasonable and justified"* concern that similar defects are feared in products of the same type. In the case of the "widget" this would ordinarily entail an inspection team from the Insured visiting the customer's premises to check and test a sample of supplied products. Extending this procedure to a large item of plant inside an oil refining complex or an underground pipeline (going back to the previous scenario) the potential magnitude of cost can be substantial.

The physical exercise of testing large technical products that have been supplied and incorporated within a customer's operational facility or construction project will often have to be undertaken by the customer or their appointed engineering contractors. The Insured product manufacturer will not have the same level of control over the scope and specification parameters for the tests. Whereas most customers in such situations do invite the product manufacturer to be present and to be actively involved in resolving the problem, this is certainly not always the case from our experience in the world of oil and gas production.

Impaired Property Endorsements are a further option to extend the scope of cover, which might be available to some manufacturers. This endorsement would respond if a third party's product is impaired because it contains the Policyholder's defective component and that it can be rectified by repair or replacement of the offending item. The trigger for activating this endorsement can arise where the defective component has potentially made another product less useful. It may not also have the requirement of imminent injury or property damage. This is delving into the area of bespoke wordings, but it is important to recognise that such an endorsement could find its way into a Product Recall policy.

What is excluded?

As there is no such thing as a standard Product Recall policy, so it is that the exclusions are varied and can be bespoke. Having said that, there are a number of typical exclusions which provide some restriction to what otherwise could have far reaching implications for Underwriters. These could include:

- Breach of legal obligations. The Insured manufacturer is generally required under the policy to have complied with any statutory or other legal requirements when supplying their product. Care should be taken, however, to understand that the legal jurisdiction of the country in question, especially for losses in the varied international territories of oil and gas production.

- Products that are still in the possession of the Insured. If the product has not yet been supplied to a third party customer, it is unlikely that it would pose a threat of third party injury or damage. However, a specific exclusion makes this clear.
- Financial Losses. This can include loss of earnings on the part of the Insured and claims from third party customers for consequential losses to their business. For plant, equipment and infrastructure items that are typically supplied in the downstream energy sector, this will often be within the context of a construction project. In these circumstances, the product may have been supplied to the end user via an Engineering or Procurement Contractor. The contract terms are likely to contain a provision for Liquidated or even Punitive damages in the event that the project completion date is delayed for a variety of reasons, including failure to supply a product free from defects. Product Recall policies will generally exclude all such financial losses, however, this may not always be the case and it is necessary to check the policy extensions and exclusions very carefully.
- Contractual Liability. This is typically an exclusion that will apply across all sections of a Product Recall policy. In essence, the policy will not extend to cover a loss where the Policyholder has assumed liability under a contract, agreement or warranty, but only to the extent that liability would not have attached in the absence of such an agreement. There can also be qualifications as to whether the exclusion would apply if the contract includes a standard wording that is commonly used in the specific manufacturing sector. Potential rejection of a claim on the basis of a contractual liability exclusion is a tricky area and even more so in the oil and gas sector. There are many (so called) standard worded Purchase Orders and Supplier Contracts, even in the same oil producing country, which are actually at odds with each other. The interpretation of what is supposed to be "standard wording" can lead to some interesting legal debates.

Be careful out there!

Manufacturers of products in the downstream oil and gas sector are exposed to a more diverse range of potential risks than in many other industries.

The potential quantum implications can be significant, especially if it proves necessary to recall a specialist piece of plant or equipment from a remote refinery or processing facility. The customer is often located in a different part of the world from the country of origin and they are usually subject to a different legal jurisdiction, which can be hostile to the Policyholder. When remote infrastructure products, including underground distribution pipelines and associated equipment are involved the estimated maximum loss (EML) can have the potential to blow a hole through the Product Recall policy indemnity limit.

Product Recall cover in this specialist sector requires cautious underwriting and perhaps, even more careful claims handling to ensure that the scope of intended indemnity is aligned what is delivered in the event of a claim.