By Aaron Krauss

Reducing the Risk of Failure

It seems like every week there is a front-page story about something that got into some part of the food supply. Pathogens. Allergens. Contaminants. Bits of metal. Everyone is yelling for the government and industry to do something. There should be more tests. There should be more standards. There should be more inspections. There should be more oversight.

But how much would more tests, standards and inspections actually help? Forget the costs (both in terms of increased expenses and the delay and disruption to businesses with already thin margins) for a moment. Also ignore the very real question of whether the U.S. Food and Drug Administration (FDA) has the resources to police the nation's food supply. Even if new tests, standards, oversight and inspections are implemented, and even if they can be implemented in a fair and evenhanded way without bankrupting the industry, they will never be able to eliminate two risks.

The first risk is that a contaminant that no one thought to test for will get into the food supply. Given people's seemingly inexhaustible ability to come up with new and different ways to mess things up, it is only a matter of time before something happens that no one thought of. After all, 20 years ago, who would have thought that the presence of a bag of peanuts in a manufacturing plant would require a labeling change for everything coming out of that plant, even if it did not contain peanuts?

The second risk is that someone will either forget to do the test or the inspection, or that they will do it incorrectly. As every plant manager can tell you, it is easy to write a detailed procedure manual, but it is much harder to get everyone to follow the manual. It is nearly impossible to get everyone to follow the entire manual all of the time.

So what can you do? You have to use your best judgment to decide what to test. You also have to recognize that you cannot test everything. Since you cannot test everything, you should take steps to limit your risk if something happens, despite your best efforts to prevent it.

Transferring Risk

The best way to limit your risk is to shift the risk to others. This can be done through either insurance or an indemnification clause. While insurance is obviously necessary (if for no other reason than it will pay for a defense until someone else steps up to the plate), all insurance policies have both exclusions and limits. Leaving the exclusions aside, the potential costs of a major recall or a major outbreak can easily run into the tens, or even hundreds, of millions of dollars. For example, when genetically modified StarLink corn was mixed with non-modified corn, the costs of recalling all of the products that had been (or might have been) tainted ran into the hundreds of millions of dollars. The costs of recalling peanut butter that was allegedly contaminated with *Salmonella* at a ConAgra plant in Georgia were approximately $60 million. These costs included not only the value of the products, but the costs of physically gathering and removing products from stores and either destroying them or shipping them back to the manufacturer. Even a $10 million insurance policy would be of little comfort in such a situation. Indeed, a major recall, such as Topps Meat Company's recall of frozen hamburger patties that may have been contaminated with *E. coli*, can bankrupt a company.

Contractual clauses can be used to shift all of the risk (not just a certain portion of it) to someone else. Indemnification clauses, in which one company agrees to pay any costs imposed on another, are not as attractive or as helpful as one might think. This is because a party with "deep pockets" will often refuse to indemnify anyone else. Not only does negotiating leverage often go along with deep pockets, a party with deep pockets is unlikely to put their assets on the line for someone else. If you have any doubts as to whether a large company is likely to indemnify a small company, ask a small restaurant owner what happens if he or she asks a national supplier or distribution company to indem-

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nify them against any food-related claims. As a practical matter, a party is only likely to sign an indemnification clause if it has less negotiating power (which usually means less money) than the party demanding indemnification. In addition to being of little comfort, you simply cannot recover much money from a small company.

More importantly, if there is a potentially company-breaking claim, it is quite possible that any party–large, small or in-between–who has signed an indemnification agreement will refuse to honor it. Instead of honoring its agreement, a party faced with a possible company-breaking claim will often refuse to indemnify (or defend), and will instead argue that it was not really their fault, and that the claim does not fall within the scope of the indemnification provision.

If the party who signed an indemnification clause refuses to "step up to the plate," you will have to defend yourself against whoever is suing you, while suing the other party for indemnification. Needless to say, this is both complicated and expensive. Even though you are legally allowed to deny that you did anything wrong, while at the same time arguing that someone else should have to pay any amounts you would have had to pay if you had done something wrong, doing so presents many practical problems. This is especially true if you are trying to explain your case to a jury. Indeed, the whole reason you ask someone to sign an indemnification clause is because you do not want to have to hire lawyers and go to court. Instead, you want the other party to have to deal with the lawyers and the courts. If the party who agreed to indemnify you refuses to step up, you have just doubled your legal fees. Not only does that defeat the purpose of an indemnification clause, you have actually gone backwards, at least in the short term.

"...you should take steps to **limit** *your risk if something* **happens,** *despite your best efforts to* **prevent** *it."*

Limiting Risk

So, if an indemnification clause is going to be difficult (or impossible) to obtain, and if it is unlikely to give you full protection in a major case, what can you do? You can limit, rather than shift, your liability. Contractually, this can be done in three ways. First, you can disclaim warranties. Second, you can limit the types of damages for which you can be liable. Third, you can limit the dollar amount of the claims for which you can be liable.

Disclaimers of warranties are typically effective if they are in large enough print (the days of being able to hide disclaimers of warranties in the small print on the back of a contract have long since passed). If they are not unconscionable, disclaimers of warranties are generally effective in preventing a plaintiff from prevailing on strict liability or negligence claims; however, they usually cannot insulate a party from the consequences of intentional conduct. As a result, disclaimers of warranties are generally effective in reducing claims that a defendant simply "passed on" contaminated food. They are therefore attractive to distribution companies, who simply handle, but do not process, pack or repack food.

Disclaimers of warranties can even limit the claims of parties further "down the chain," as long as those parties knew of the limitations before they purchased the food. They are less effective at reducing claims that a defendant affirmatively contaminated the food. This is because, depending on the type and manner of contamination, a plaintiff may be able to argue that the contamination was the result of reckless or intentional (as opposed to negligent) conduct. Such conduct is typically outside the scope of a disclaimer of warranties. In addition to failing to eliminate a claim that a defendant affirmatively contaminated food, disclaimers of warranties have a practical problem. Often, customers (at least customers paying full price) balk at buying something (especially food) in an "as is" condition. As a result, a company trying to disclaim all warranties may face a great deal of push-back from its customers.

A potential compromise might be to limit the types of damages for which a defendant can be liable, rather than to disclaim warranties. Traditional limitation-of-liability clauses seek to eliminate liability for lost profits and other types of incidental or consequential damages. For example, Topps could have included a clause saying that its customers could not sue it for incidental costs (e.g., the cost of gathering, repacking and returning the allegedly contaminated hamburgers) as well as consequential damages (e.g., lost profits for not being able to sell the allegedly contaminated hamburgers). Such a clause would not, however, have prevented Topps' customers from suing the company for the purchase price of the hamburgers, nor would it have prevented someone who actually got sick from suing whomever they bought the hamburgers from (or the retailer or distributor from passing the cost of the person's illness back to Topps).

Limitations on liability often generate less push-back than disclaimers of warranties. This is because limitations on liability do not attempt to insulate the defendant from all liability flowing from its actions. Instead, limitations on liability simply try to quantify the potential liabilities. Most people (and companies) quickly agree that there have to be some limits to the "lost profits" or the "consequential damages" that flow from a misdeed. Once they recognize the "slippery slope" that begins any time someone starts talking about consequential damages, many customers can be persuaded to agree to this type of limit on liability. While it would be difficult to convince someone that they had no remedy if they bought bad food, it may be possible to convince them that they could only sue if they actually got sick, and could only return the product for a refund if they did not get sick.

The last way to limit liabilities is to place a dollar limit on the liabilities for which a defendant can be held liable.

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These limits range from the very low dollar limit on liability (often $250) that most alarm companies put in their monitoring contracts to the clauses that most architects put in their contracts, limiting their liability to the contract price. While courts will usually strike down a limitation-of-liability clause if they think it is actually an attempt to eliminate all liability, they usually uphold clauses that permit the imposition of meaningful, if limited, liability.

Customer reaction to such clauses is often varied, and is probably in proportion to the liability that remains. Asking a customer purchasing $1,000 worth of products to limit potential liability to the purchase price is obviously more difficult than asking a customer buying $1 million worth of products to do so. For example, it might be possible for a distribution company, which delivers food to a large chain of restaurants, to limit its liability to either its monthly distribution charge or some multiple of that charge. It would be much more difficult for a manufacturer selling a truckload of canned goods to a supermarket to do so. Given the range of both contracts and reactions, savvy businesspeople can either negotiate dollar limits on a case-by-case basis, or make appropriate exceptions (and negotiate appropriate levels of liability) for their best customers.

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While all of these limitations on liability still leave you exposed to a lawsuit (and the expense and disruption that goes along with a lawsuit), they reduce your exposure. This is obviously valuable in and of itself. Beyond reducing your exposure, however, these limitations on liability reduce your risk of being sued. This is because a plaintiff often has a choice of whom to sue. If one potential defendant has limited its liability, a plaintiff will often choose to pursue another defendant who has not. For example, if the distributor who had delivered allegedly contaminated peanut butter to a store had limited its liability, the store might choose to skip the distributor and just sue the manufacturer. Additionally, a plaintiff (especially in a smaller case) might decide that it is not worthwhile to sue someone when their potential recovery is low. For example, if everyone in the "peanut butter food chain" had limited their liability, a store might not bother suing, since it could only recover its purchase price. The end result is the same–a limitation on liability can, in some cases, wind up being as effective as a prohibition on liability, albeit at a lower cost to your customer's goodwill. ■

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