

# Defective Goods: Legal Risks And Protective Measures

*Portfolio Media, New York (July 26, 2007)*

Over the past several weeks, there has been a steady gathering of news articles concerning the importation of defective or unsafe products from China into the United States and other western nations.

From toothpaste poisoned with antifreeze to pet food laced with plastic chemicals to Thomas & Friends wooden railway toys decorated with toxic lead paint, the beat of these stories has been the same: Chinese products are potentially dangerous, if not life threatening, and consumers should be on guard. The fallout from this negative press has not been limited to the United States.

In an effort to quell international fears over defective or unsafe products, Chinese officials recently announced that inspectors have closed 180 food factories in China and have seized tons of tainted food products.

On July 11, 2007, the Chinese Government announced that it had even executed the former chief of its State Food and Drug Administration for allegedly taking bribes from domestic pharmaceutical companies to approve untested medicine. Beijing is in apparent overdrive to curb the damage to the “Made in China” brand image.

Chinese officials are not the only ones who have taken notice of the news reports, however. Plaintiffs’ lawyers have also been eyeing the hysteria with considerable interest, and class action attorneys are already in the process of launching a number of lawsuits against U.S. importers of Chinese products.

Menu Foods, the Ontario pet food maker whose Chinese-sourced product poisoned dozens of brands of U.S. pet food, reportedly already faces more than 100 class action lawsuits. And a Seattle law firm recently filed a proposed class action against the

distributor of various Thomas & Friends wooden railway toys. More class actions are almost certain to follow.

In light of the current legal climate, it is prudent for companies that regularly import goods from China to assess whether they have meaningful exposure to future lawsuits and, if they do, to take proactive measures now to protect themselves against, or at least limit, any future liability. Preparing for the potential rush of legal actions is a complex task that will require careful planning on several fronts.

#### \* Preparation for the Defense of Class Action Lawsuits \*

As an initial matter, it is recommended that importers of Chinese goods with potential legal exposure consult with knowledgeable class action defense attorneys—even before any class action suit is filed—in order to discuss and devise possibly preemptive defensive strategies.

For example, if the importer fears being named as a defendant in one or more personal injury class action lawsuits, it may be possible to implement a strategy early on to defeat class certification. This is because plaintiffs' lawyers often face an uphill battle convincing a court to certify a class of physically injured consumers due to individualized issues of causation.

It should be noted, however, that class action lawsuits seeking the recovery of economic loss only, e.g., the purchase price of a defective product, are considerably easier to certify.

For class action lawsuits subject to filing in state court, knowledgeable defense counsel can also advise whether the cases would be removable to federal court under the Class Action Fairness Act of 2005, and whether the importer is better off fighting class certification in state or federal court.

In addition, defense counsel can advise whether cases in federal court should be transferred and consolidated for multi-district litigation. Early discussion of these and other issues will allow for efficient administration of the often daunting prospect of responding to a wave of class action lawsuits.

#### \* Analyzing Potential Claims Against Responsible Chinese Exporters \*

In the event that an importer of Chinese goods is sued in the United States, the reasonable first step would be to seek indemnification from the culpable Chinese exporter/manufacturer of the goods. Finding a suitable forum to assert claims against a Chinese entity, however, is not always easy.

To start, bringing a third-party claim for indemnification or contribution against the Chinese entity in the U.S. courts is an uncertain proposition. In the event that the Chinese entity does not ignore the lawsuit altogether, the Chinese entity will likely challenge the

jurisdiction of the U.S. court, and may raise complicated defenses such as forum non conveniens or, in the case of a Chinese state-owned entity, foreign sovereign immunity.

Even if an importer is successful in obtaining personal jurisdiction over a Chinese entity, and then in prevailing on the merits of its indemnification/contribution claim, a U.S. court judgment will be essentially worthless if the Chinese entity does not have fixed, recoverable assets located within the United States to satisfy the judgment.

Chinese courts have no obligation to enforce judgments rendered in the U.S. courts and, thus, going to China to collect on a U.S. judgment will likely mean litigating the same claim over again in the Chinese courts.

Thus, it is essential that importers subject to potential exposure analyze their Chinese suppliers now, and ask a number of questions, including: (1) Can the supplier be subject to personal jurisdiction of the U.S. courts?; and, if so, (2) Does the supplier have fixed assets in the United States that can be attached to satisfy a U.S. court judgment?

If the answer to either of these questions is “no,” then it will be necessary to contact a law firm with the capability to bring a lawsuit against the Chinese supplier in the Chinese courts.

Many contracts between Chinese exporters and foreign importers (U.S. or otherwise) contain provisions for the arbitration of any disputes arising “under or in connection with” the contract.

In case of such a provision, the judicial resolution of any indemnification/contribution claim—whether in the U.S. or the Chinese courts—will be foreclosed, and the importer will be required to resolve its dispute exclusively through international arbitration. Most arbitration clauses with Chinese entities call for arbitration under the rules of the China International Economic and Trade Arbitration Commission (CIETAC), the Hong Kong International Arbitration Centre (HKIAC) or other such arbitration rules.

As with litigation in China, it is advisable to retain a law firm with presence in China to prosecute any such arbitration against a Chinese entity, inasmuch as the arbitration will often be conducted in the Chinese language (or dual languages), and inasmuch as Chinese law may both govern the substantive law of the contract and affect the procedural law of the arbitration situs.

A firm with an office in China will also be able to conduct a thorough investigation of the Chinese exporter—including an investigation into the financial ability of the exporter to pay any future arbitration award—and, if necessary, apply to the Chinese courts for attachments or other interim relief in aid of the arbitration.

Whether it is necessary to commence litigation or arbitration against a Chinese exporter, importers should seek advice from international dispute resolution (IDR) lawyers. IDR lawyers are specially trained to help companies navigate the complexities of transnational

legal disputes and maximize the chances of recovery on claims against foreign entities.

#### \* Congressional Investigations \*

It is now clear that the Democratic Congress is going to respond to the Chinese defective goods scandal by conducting aggressive oversight hearings with various federal agencies, including the U.S. Food and Drug Administration, the Consumer Products Safety Council, the U.S. Department of Agriculture and other agencies that regulate the importation of drugs, toys, foodstuffs and other items from China.

It is also likely that U.S. trade associations and U.S. and/or Chinese companies that are involved in particular cases of interest will be “invited”—or eventually subpoenaed—to appear as congressional witnesses at adverse hearings on product importation and safety issues.

Responding to such congressional inquiries is a demanding and potentially dangerous exercise because it requires a coordination of legal, business, media and congressional activity. Most U.S. businesses have a difficult time deciding how to respond to such inquiries.

It is even more difficult for a foreign company, without a cultural understanding of the role played by the U.S. Congress, to understand the degree of damage that such hearings can cause to a brand name, and how subsequent civil or criminal investigations can be impelled or influenced by such hearings. As political commentator Walter Lippman observed in 1922, congressional investigations can be described as a “legalized atrocity...in which congressman, starved of their legitimate food...go on a wild and feverish manhunt and do not stop at cannibalism.”

U.S. importers, therefore, should expect tough congressional oversight, legislation and, most importantly, regulation by agencies to change the business climate for imports from China in the affected business sectors.

As a result, concerned importers need to devise the right mix of legal and lobbying strategies in response to this anticipated governmental oversight. Responding wisely to congressional investigations requires the advice of lawyers and professionals who routinely engage in this arena.

#### \* Product Recalls \*

A potential concern to a U.S. importer of Chinese products is the prospect of having to remove, “recall,” a defective product from the U.S. market. Under the Consumer Product Safety Act (CPSA), a U.S. company that sells and/or distributes products in the United States has an obligation to report and to recall potentially hazardous products.

Under the CPSA, a “substantial product hazard” can be found from either (1) a failure to comply with an applicable consumer product safety rule, which failure creates a

substantial risk of injury to the public, or (2) a product defect which (because of the pattern of defect, the number of defective products distributed in commerce or the severity of risk) creates a substantial risk of injury to the public.

The Consumer Product Safety Commission (CPSC) has been established to monitor, implement and enforce the recall of potentially dangerous products that have been put into the stream of commerce in the United States.

An importer of Chinese products under CPSA is required to reasonably report any information that supports the conclusion that the product is defective and has the potential to cause personal injury. Thus, a U.S. importer of potentially defective or unsafe Chinese products has a statutory obligation to report such products to the CPSC and to implement an appropriate recall of all such defective products that have been sold throughout the United States.

Such a report should be filed immediately upon notice of a substantial product hazard, but in no event should it exceed 10 business days from the time the company obtains knowledge of such defective products and perceives a risk that serious injury could occur to consumers. The CPSC has determined that even a small number of defective products, if they present a substantial risk of injury to consumers, provide a sufficient basis for reporting and possible recall.

A U.S. importer that fails to notify the CPSC of a defective imported product can be subject to fines and penalties in excess of \$1 million.

Moreover, once the CPSC has taken jurisdiction and determined that the imported product must be recalled, the U.S. importer is required to (1) contact all of its stores, resellers or distributors and make all reasonable efforts to stop any sales and to get the product back, (2) provide adequate notice to the public and (3) set up a toll free number, call centers and/or distribution points where the products can be returned. Typically, the U.S. importer must also refund the full retail purchase price of the product to consumers.

Given the huge financial costs of recalling a product from the marketplace—or, alternatively, the huge penalties for failing to recall a hazardous product—it is critical that importers subject to potential exposure contact a product recall attorney to determine the best and least risky course of action. Even if an exporter is uncertain whether its products would be subject to recall, consultation with such an attorney is recommended to minimize potential liability.

\* FDA Issues \*

The Chinese export scandal has, needless to say, caught the attention of the FDA. As the lead federal agency responsible for protecting U.S. consumers from adulterated and misbranded foods, drugs and cosmetics, FDA officials have recently had to deal with a daily barrage of problems associated with Chinese products sought to be imported into the United States.

The FDA has, in turn, significantly increased its surveillance of Chinese food and drug imports, thereby increasing the risk that such imports may be denied entry into the United States.

The FDA only needs to have a suspicion that foodstuffs or drugs imported from abroad may not meet U.S. safety or labeling standards in order to take regulatory action against them. The penalties for such a suspicion can be enormous. The FDA may, for example, reject importation of the products altogether, or require them to be “reconditioned.”

The FDA can also establish mandatory testing requirements before such products can even be considered eligible for entry into the United States, as recently took place with certain fish imported from China.

Furthermore, if the importation of a product is denied, the FDA can be expected to exercise increased vigilance to make certain that the importer does not simply attempt to re-import the rejected products at another port of entry. If the FDA were to identify such behavior, the consequences for the offending importer would be severe, including the possible initiation of criminal proceedings.

The passage of the Public Health Security and Bioterrorism Preparedness and Response Act in 2002 gave the FDA significant additional authority to protect the public from a threatened or actual terrorist attack on the U.S. food supply.

This authority includes requiring foreign facilities that manufacture, process, pack or hold food for human or animal consumption in the United States to register with the FDA. It also establishes recordkeeping provisions for firms involved in the manufacture and importation of foods. In addition, notice must be provided to the FDA before importing foods into the United States.

In light of the above, importers of foodstuffs or drugs from China need to determine both the likelihood of FDA regulatory action against their imports and the possible legal measures that can be taken to limit the consequences and expense of such regulation.

**\* Proactive Review/Revision of Chinese Import Contracts \***

In addition to taking steps to address liability arising out of past Chinese exporter relationships, importers of Chinese goods should constructively review their current import contracts with an eye to minimizing liability on future contracts. Indeed, importers of Chinese goods should insist upon a number of changes to their current import contracts now, including the following:

First, contracts with Chinese exporters should be revised to provide for detailed quality control procedures, including the appointment of a third-party laboratory or other such inspector to review and approve the safety and quality of Chinese goods before they are exported from China.

Many contracts with Chinese exporters do not even address the subject of quality control, much less provide for the mandatory third-party inspection of goods. Failure to include quality control procedures in an import contract may open the U.S. importer of Chinese goods to claims of negligence, or worse.

Second, contracts with Chinese exporters should be amended to include specific indemnities in favor of the importer on product safety and quality issues. That is, the Chinese exporter should agree to fully indemnify and defend the importer against all claims, liabilities and other expenses arising out of allegations that the imported products are defective or unsafe, including, but not limited to, litigation costs and product recall costs.

If the exporter has sufficient bargaining leverage, these indemnities may even be secured by a “hold-back” of part of the purchase price, with the explicit provision that such hold-back is only a security fund and is not intended to constitute a limit of the amount of damages that may be collected through the indemnity.

Third, contracts with Chinese exporters should be amended to include a specific provision requiring the Chinese seller to obtain and maintain sufficient product and general liability insurance, with a reputable U.S. or international insurance carrier, in order to provide sufficient protection to the U.S. importer in the event of a defective or unsafe product. If at all possible, the U.S. importer should be named as an “Additional Name Insured” on such insurance policies.

Fourth, contracts with Chinese exporters should be amended to include a provision mandating the arbitration of any disputes arising under or in connection with the contract. As noted above, Chinese courts have no obligation to enforce judgments rendered in the U.S. courts and, thus, a contractual provision calling for U.S. litigation is a mistake if the Chinese party does not have sufficient fixed assets within the United States to satisfy the judgment.

On the other hand, Chinese courts are generally obligated to enforce foreign arbitral awards, and to attach assets in satisfaction of such awards, pursuant to China’s treaty obligations under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. As a result, it is far easier to collect on an arbitral award in China than it is to collect on a foreign court judgment in China.

That said, care should be taken in drafting such an international arbitration clause with a Chinese entity. China has special rules that must be followed in order to ensure the enforcement of an arbitral provision or arbitral award in China; in this regard, importers of Chinese goods should consult with an IDR specialists for specific advice on the drafting of a Chinese arbitration clause.

McDermott has formed a Chinese Products Practice Group specifically dedicated to assisting clients in evaluating potential risks related to the defective Chinese goods

scandal, and in defending against any litigations, arbitrations, product recall orders or governmental investigations arising from same.

The group consists of lawyers from the United States and Europe, as well as colleagues from MWE China Law Offices who focus on class action defense, Chinese litigation, international arbitration, FDA regulations, product recall compliance and Congressional investigations.

--By B. Ted Howes, John R. Doyle, Christopher M. Murphy, Edward M. Ruckert and Stephen M. Ryan, **McDermott Will & Emery**

B. Ted Howes is a partner in the law firm of McDermott Will & Emery LLP, based in the firm's New York office. Ted is a member of the trial department. His practice is in complex commercial litigation and arbitration, with a special focus on international dispute resolution.

John R. Doyle is a partner in the law firm of McDermott Will & Emery LLP based in the firm's Chicago office. As partner in the trial department, John focuses his practice in the areas of product liability, personal injury defense, Consumer Product Safety Commission investigations and recalls, architecture and engineering malpractice, construction claims, insurance defense and coverage issues, restrictive covenants and commercial disputes.

Christopher M. Murphy is a partner in the trial department, resident in McDermott Will & Emery LLP's Chicago office. He focuses his practice in the areas of class actions and complex commercial litigation. He heads the Firm's international class action practice group.

Edward M. Ruckert is a partner in the law firm of McDermott Will & Emery LLP based in the Washington, D.C. office. He is head of the firm's food and agriculture group, where he focuses his practice on representing a variety of companies in the food, fiber and nursery production and processing industries, including the agricultural chemical industry.

Stephen M. Ryan is partner and head of the government strategies practice group in the law firm of McDermott Will & Emery LLP based in the Washington, D.C. office. He provides lobbying, litigation and counseling services, often for the high-technology community, and companies in highly regulated industries. He has broad experience in addressing the combined legal, political and press related challenges stemming from congressional oversight and investigation.

---