

CORPORATE DEALMAKER

Defending against defections
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Over the past few months, there has been an alarming outpouring of news stories concerning the importation of defective or unsafe products from China into the United States. From toothpaste poisoned with antifreeze to pet food laced with dangerous chemicals to 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.

Plaintiffs' lawyers have been eyeing this hysteria with considerable interest and are already in the process of launching a number of class actions against importers of Chinese products. Menu Foods Ltd., the Streetsville, Ontario, pet food maker whose Chinese-sourced product poisoned dozens of brands of American pet food, reportedly faces more than 100 class actions. A law firm in Seattle has filed a proposed class action against the distributor of various Thomas & Friends wooden railway toys. And on Aug. 20, a class action was filed against Mattel, demanding the toy manufacturer pay for blood-lead content tests for the thousands of children exposed to the toys that it recently recalled. More class actions are 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 lawsuits and, if they do, to take measures now to protect themselves against, or at least limit, any liability.

In addition to the prospect of class actions and personal injury lawsuits, importers of defective goods face a variety of other threats, including:

- **Product recalls.** Under the Consumer Product Safety Act, a company that distributes products in this country has an obligation to report and to recall potentially hazardous products. Product recalls can be enormously expensive and damaging to a brand image. On the other hand, failure to notify the Consumer Product Safety Commission of a potentially defective imported

product will subject an importer to huge fines and penalties and even worse publicity.

- Congressional investigations. It is now clear that Congress is going to respond to the Chinese defective goods scandal by conducting aggressive oversight hearings. It is likely that U.S. companies that are involved in particular imports of interest will be "invited" — or eventually subpoenaed — to appear as congressional witnesses at adverse hearings on product importation and safety issues. Needless to say, such public hearings can cause significant damage to a corporate brand as well as spur civil or criminal investigations into an importer's conduct.

- FDA investigations. The U.S. Food and Drug Administration need only 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, bar importation of the products altogether. The FDA can also establish mandatory testing requirements before such products can even be considered eligible for entry into the United States, as recently happened with certain fish imports from China.

The unfortunate case of Foreign Tire Sales Inc. is a case in point. FTS, a family-owned tire import business, was forced to recall 450,000 Chinese-made tires at a projected cost of \$90 million. This product recall, coming on top of a lawsuit brought by victims of a deadly car accident, is threatening to bankrupt the company. Adding insult to injury, the Chinese tire manufacturer, which apparently has no recoverable assets in the U.S., has simply refused to respond to FTS' lawsuit for compensation.

Clearly, the potential liabilities for importers of Chinese goods are huge. So what can importers do to minimize them?

The best approach is to constructively review and revise their import contracts. Importers should insist upon a number of revisions, including the following:

First, contracts with Chinese exporters should be revised to provide for quality-control procedures, including the appointment of a third-party inspector to review and approve the quality and safety of Chinese goods before they are exported. Many contracts with Chinese exporters do not even address the subject of quality control, much less provide for the mandatory third-party inspections. Failure to include such 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 costs 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 importer has sufficient bargaining leverage, these indemnities may even be secured by a "hold-back" of part of the purchase price.

Third, contracts with Chinese exporters should be amended to include a provision requiring the Chinese seller to obtain and maintain product and general liability insurance, with a reputable insurance carrier, 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. Because Chinese courts have no obligation to enforce judgments rendered in the U.S. courts, a contractual provision calling for U.S. litigation is a mistake if the Chinese party does not have sufficient fixed assets within the U.S. to satisfy a court judgment. On the other hand, Chinese courts are generally obligated to enforce foreign arbitral awards, and to attach domestic 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. CD

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