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United States Government Accountability Office  
Washington, DC 20548

April 22, 2009

The Honorable John D. Rockefeller, IV  
Chairman  
The Honorable Kay Bailey Hutchison  
Ranking Member  
Committee on Commerce, Science, and Transportation  
United States Senate

The Honorable Henry A. Waxman  
Chairman  
The Honorable Joe Barton  
Ranking Member  
Committee on Energy and Commerce  
House of Representatives

Subject: *Feasibility of Requiring Financial Assurances for the Recall or Destruction of Unsafe Consumer Products*

In 2008, the Consumer Product Safety Commission (CPSC) announced that it had obtained the voluntary recall of 563 unsafe or potentially unsafe products by the companies that manufactured, imported, distributed, or sold the products—the largest number for the agency in the past 10 years. In the prior year, CPSC announced 472 recalls—which was also an increase from the previous year and included some high-profile recalls of lead-tainted toys—leading some consumer groups to call 2007 the “year of the recall.” Consumer products can be recalled for a variety of reasons, including violations of safety standards, incidents of injuries that can occur from the design or manufacture of a product, or other conditions that present an imminent or substantial hazard to consumers. Since 1979 there have been few instances in which CPSC could not obtain cooperation from manufacturers or importers to conduct recalls, either because these companies did not have the financial resources to conduct a recall or because the companies refused to assume responsibility for a recall. This included troubled recalls involving more than 1.5 million imported cribs associated with multiple deaths of children. Another recall of imported tires, conducted under the National Highway Traffic Safety Administration, was the responsibility of a small importer that did not have the resources to conduct an effective recall.

These, and similar events, have raised concerns from consumer groups and others about the ability of businesses to conduct effective recalls and of the federal

government to ensure consumer safety. In addition to these concerns, CPSC reports that more than two-thirds of recalled products in 2008 were imported. The proportion of consumer goods sold in the United States that are manufactured abroad has shifted significantly since CPSC was created in the 1970s. From 1997 to 2007, for example, the amount of imported consumer goods sold in the U.S. has more than tripled—an increase of 217 percent—according to CPSC.

In response to these issues, Congress in 2008 passed the Consumer Product Safety Improvement Act (CPSIA), which greatly expanded CPSC's authorities over recalls and its ability to ensure the safety of products under its jurisdiction, including imported goods.<sup>1</sup> Neither CPSIA nor other existing laws require companies to demonstrate that they have the financial resources to recall or destroy unsafe or potentially unsafe products.<sup>2</sup> Instead, section 224 of CPSIA mandated that GAO study the feasibility of requiring companies to demonstrate their financial ability to recall or destroy unsafe products by posting funds in escrow, insurance, or security, such as a bond. This law required GAO to submit, no later than February 14, 2009, a report to the Senate Committee on Commerce, Science, and Transportation and the House Committee on Energy and Commerce. As agreed with your offices, we briefed your staffs on February 13, 2009, on the results of our work. This product documents our compliance and provides supplementary information based on our written and oral briefing; enclosure I contains a copy of our briefing slides. Our objectives were to describe (1) the potential policy options for assuring CPSC that companies have adequate resources for the recall or destruction of consumer products, (2) the factors affecting implementation of these options, and (3) the potential consequences of implementing a financial assurance requirement, as one policy option, including potential benefits and disadvantages.

To identify policy options that could ensure that companies have adequate financial resources for the recall or destruction of unsafe products, we reviewed relevant laws and interviewed representatives of 44 organizations from a variety of stakeholder groups, including trade associations representing consumer product companies, consumer interests, and financial services firms; international trade experts; and consultants that assist companies with product recalls. To identify the factors affecting implementation of these options, we relied on the interviews described above, and on interviews with officials from CPSC, Customs and Border Protection, the Office of the U.S. Trade Representative, and the U.S. Small Business Administration Office of Advocacy. We also convened a roundtable of 20 participants representing consumer product companies, financial services firms, product recall consultants, and federal government agencies on January 30, 2009, at GAO headquarters in Washington, D.C., to foster a dynamic discussion of the key options and challenges affecting their implementation.<sup>3</sup> We selected roundtable participants primarily based on their ability to provide a broad range of perspectives, level of expertise, geographic proximity, and availability. To identify potential consequences

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<sup>1</sup>Pub. L. No. 110-314, 122 Stat. 3016 (2008) (*amending* 15 U.S.C. §§ 2051 - 2089).

<sup>2</sup>Section 224 of the CPSIA requires the CPSC to identify the consumer products for which the cost of destruction would normally exceed the custom bond and to recommend to the U.S. Customs and Border Protection a bond amount that would be sufficient to cover the costs.

<sup>3</sup>Please see enclosure I, slide 11, for a list of participating organizations.

of implementing a financial assurance requirement, we relied on our interviews and the roundtable discussion. Finally, we analyzed CPSC recall announcements dating back to 1979 for incidences in which companies went bankrupt or did not have the financial resources to conduct a recall. We found this information on CPSC's Web site by using the search terms, "bankruptcy," "bankrupt," and "liquidation." As a data reliability measure, GAO provided a draft of this analysis to CPSC and received technical comments, which we addressed as appropriate. These data are limited in that they do not speak to the effectiveness of the thousands of recalls that have been conducted under CPSC's jurisdiction or the financial condition of the companies that conducted them.

We conducted our work from September 2008 to April 2009 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. This framework requires that we plan and perform our work to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our objectives.

### **Results in Brief**

We identified a variety of approaches to assure the federal government that companies have the financial resources to recall or destroy unsafe products. Many of these approaches took the form of financial instruments that companies could be required to obtain in amounts established by statute or regulation to cover, for example, the projected costs of a recall. These financial instruments included an escrow account, insurance policy, or surety bond to guarantee a company's financial stability or ability to perform a recall, as well as line of credit guaranties, guaranties of personal or corporate assets, or liens on personal or corporate assets. Alternatively, many roundtable participants supported providing CPSC with funds to assist companies in conducting a recall, citing the approach as a potentially more efficient and suitable approach for industry and the federal government given the low incidence of troubled recalls in CPSC's history. Nonfinancial options suggested by several sources we interviewed include requiring companies to document their strategies for ensuring product safety or conducting product recalls. Another option is to make no change, according to some roundtable participants and others we interviewed, citing the low number of inadequately funded recalls under CPSC and the ability of companies to generally fund recalls. They said CPSC should use its existing authorities to compel companies to conduct effective product recalls. For example, some participants said CPSC should strengthen efforts to obtain cooperation from companies throughout the supply chain, as well as act more quickly on its mandatory recall authority by filing an administrative complaint when a consumer product company says it has no resources to conduct a recall.<sup>4</sup>

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<sup>4</sup>Under Section 12 of the CPSA, 15 U.S.C. § 2061, the CPSC may file suit in a United States district court seeking the recall, repair, or replacement of, or refund for an imminently hazardous consumer product. This is one of two mechanisms for forcing a mandatory recall. Under section 15(d) of the CPSA, 15 U.S.C. § 2064(d), the CPSC may order a repair, replacement or refund of a consumer product that it finds is a "substantial product hazard." The CPSC must conduct an administrative hearing unless it has filed a court action under section 12. *See* 15 U.S.C. § 2064(f).

Several roundtable participants and those we interviewed identified challenges that could complicate efforts to implement financial assurance options involving the use of financial instruments or a CPSC fund. Although they suggested various strategies for mitigating some of these challenges, significant limitations exist in using the proposed options as financial assurance for the recall and destruction of unsafe products. Representatives of consumer product companies said many companies—especially small businesses—would be unable to afford the cost of posting assurance, especially during difficult economic times and if the required amount of assurance were high. Those representing financial services firms asserted that many of the proposed financial instruments are not currently designed for consumer product recalls and that a firm’s willingness to underwrite consumer product recalls would depend on a variety of factors, including the risk profile of companies seeking coverage and the amount of coverage sought. Enforcement of a financial assurance requirement presents challenges in that CPSC does not have the resources or experience to administer and enforce this type of requirement. Furthermore, there is no program or process that tracks all domestically produced consumer goods or companies, making it difficult to identify companies that may need to comply with a requirement. The proposed financial instruments also present challenges because firms may not make them available to consumer product companies that are financially unstable. In addition, it is unclear whether a requirement to post assurance using any of the financial instruments we studied would fully address cases involving companies that refused to assume responsibility for the recall of products produced by manufacturers it purchased, or recalls companies find to be financially catastrophic. We also note that a requirement targeted to the destruction or recall of goods under CPSC’s jurisdiction would not address some of the troubled recalls that have occurred involving other industries such as food, drugs, and automotive parts.<sup>5</sup>

Although roundtable participants and others we interviewed identified several benefits and disadvantages of implementing policies that ensure resources exist to recall or destroy unsafe products, there was no consensus on whether there is a need to pursue policy changes at this time. Consumer interest groups told us some of the potential benefits of requiring financial assurance, either through the use of financial instruments or a CPSC fund, include ensuring the public’s safety and improving the effectiveness of recalls conducted under CPSC, among other things. However, some roundtable participants and others we interviewed identified several potential negative consequences, including potentially limiting growth and innovation in consumer product companies and distorting incentives for companies to conduct voluntary recalls. Despite these potentially negative consequences, consumer interest groups said some financial backstop is needed to protect consumers when companies fail to effectively recall hazardous products and to address conditions that may increase the incidence of troubled recalls, such as increased U.S. reliance on imported products and new statutory provisions that require, among other things, testing products for lead. However, many others we interviewed and those that

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<sup>5</sup>CPSC has jurisdiction over 15,000 types of consumer products, but some products subject to recall are regulated by other federal agencies. For example, the U.S. Food and Drug Administration regulates foods, drugs, and medical devices; the U.S. Department of Agriculture regulates meat, poultry, and egg products; and the National Highway Traffic Safety Administration regulates motor vehicles and motor vehicle equipment.

participated in the roundtable questioned the need for requiring financial assurances, citing the low incidence of product recalls for which funding is not available and the low cost of most recalls, which companies have funded through operating income or insurance. They also cited incentives that will likely continue to facilitate cooperation from the industry to conduct recalls voluntarily, including the ability of consumers to sue companies to seek remedies for damages from the use of unsafe products, the risk of damaging a firm's reputation from being associated with unsafe products, and CPSC authorities to fine companies for lapses in product safety.

We provided a draft of this report to Customs and Border Protection (CBP), the Consumer Product Safety Commission, and the Office of the U.S. Trade Representative for review and comment. We received technical comments from CPSC staff and USTR that we incorporated where appropriate. CBP did not provide written or technical comments.

## **Background**

CPSC was created in 1972 under the Consumer Product Safety Act to regulate consumer products to protect the public against those products that pose an unreasonable risk of injury and death.<sup>6</sup> In this role, CPSC oversees more than 15,000 types of consumer products, including household appliances and furniture, toys, and children's products. CPSC issues and enforces mandatory safety standards and participates in the setting of voluntary standards; conducts compliance activities, such as obtaining the recall of hazardous products; and alerts the public to and provides information about safety hazards of and safe practices for using consumer products. According to CPSC, its objectives for companies conducting recalls are (1) to locate all defective products as quickly as possible, (2) to remove these products from the distribution chain and from the possession of consumers, and (3) to notify the public about the defect and the actions being taken to correct the hazard (e.g., refund consumers the price of the product, repair the defect, or replace the product). According to CPSC officials, products may be destroyed as part of a product recall or at a port of entry into the United States.<sup>7</sup>

The majority of CPSC's recalls are conducted by companies on a voluntary basis, with CPSC negotiating a corrective action plan with the responsible companies. According to CPSC officials, the agency rarely uses its authority to seek a mandatory recall, citing a high level of cooperation from companies. The officials said some companies pursue recalls voluntarily in acknowledgment of CPSC's authorities to seek mandatory recalls through litigation or to seek civil penalties for engaging in prohibited acts, such as, among other things, failing to report hazardous products.<sup>8</sup>

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<sup>6</sup>Pub. L. No. 92-573, 86 Stat. 1207 (1972), *codified at* 15 U.S.C. §§ 2051 - 2089.

<sup>7</sup>The destruction of goods that occurs at ports of entry is outside the scope of our work. However, GAO has been mandated to report by August 2009 on the effectiveness of CPSC's authorities to ensure the safety of imported goods under its jurisdiction, which includes the destruction of goods at U.S. borders.

<sup>8</sup>For mandatory recalls conducted under section 15 of the CPSA, 15 U.S.C. § 2064, CPSC can obtain certain involuntary corrective actions from consumer product companies. Before the passage of CPSIA, CPSC could order a manufacturer, importer, distributor, or retailer to engage in certain

Moreover, although recalls are typically conducted by manufacturers, CPSC holds all companies along the supply chain responsible for recalls, including those companies that sell, import, or distribute consumer products. As such, according to CPSC, the agency is generally able to obtain recalls from these other entities when a manufacturer is unable to do so.

The Consumer Product Safety Improvement Act (CPSIA) includes provisions that may possibly affect the frequency of recalls and, perhaps consequentially, the number of companies lacking adequate financial resources to carry out recalls. In particular, the CPSIA established, among other things, a stricter lead content standard for children's products, which could increase the number of recalls from companies unable to meet these new requirements.<sup>9</sup> The CPSIA also made it easier for CPSC to require companies to stop distributing unsafe products and strengthened CPSC's bargaining power over corrective action plans when companies pursue voluntary recalls. Also, a possible increase in CPSC's budget and resources may result in a much more active staff that is able to more quickly investigate, test, and demand corrective action by companies. Furthermore, the CPSIA gave authority to each state's attorney general to enforce consumer product safety standards and regulations, which could result in increased enforcement actions by CPSC to avoid multiple different approaches at the state level. CPSIA brought about another change that may counteract potential increases in the number of product recalls. Specifically, CPSIA increased the maximum civil penalty from \$8,000 to \$100,000 for individual violations and from \$1.825 million to \$15 million for a related series of violations, which could motivate companies to cooperate with CPSC on voluntary recalls in order to avoid potentially costly penalties.<sup>10</sup> However, the full extent of the impact of

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involuntary corrective actions if it determined that a consumer product was a substantial product hazard after conducting a trial-type administrative hearing. These actions include (1) to give public notice of the defect or failure to comply; (2) to mail notice to each person who is a manufacturer, distributor, or retailer; and/or (3) to mail notice to each known buyer or recipient. CPSIA gave CPSC authority to require these and three additional actions without a prior hearing, but only after CPSC notified the manufacturer and filed suit. The additional actions include (1) to cease distribution of the product, (2) to notify others to cease distribution, and (3) to notify State and local public health officials. CPSC may also order notice in languages other than English. If, after conducting a hearing, CPSC finds that a substantial product hazard exists, CPSIA gave CPSC greater authority over the actions a company takes to correct the hazard.

<sup>9</sup>Other CPSIA provisions, sections 102 and 103, affecting manufacturers include a new requirement to certify that a children's product had been tested for compliance with various safety standards by a third party entity, as well as a requirement to label children's products with information—such as manufacturer, production date, and production batch—to help consumers identify recalled products and to enhance the ability of manufacturers to track unsafe products to their precise source.

<sup>10</sup>We report inflation-adjusted penalty amounts. The maximum penalty amounts that were specified in statute before passage of CPSIA—\$5,000 and \$1.25 million—was adjusted for inflation in 2004 to \$8,000 and \$1.825 million for individual violations and a related series of violations, respectively. *See Civil Penalties; Notice of Adjusted Maximum Amounts*, 69 Fed. Reg. 68884 (Nov. 26, 2004). Civil penalty amounts are applicable to violations of the Consumer Product Safety Act, the Federal Hazardous Substances Act, and the Flammable Fabrics Act. The maximum civil penalty must be adjusted for inflation every five years, beginning no later than December 1, 2011. The amended civil penalties take effect on August 14, 2009, or the date on which final regulations are issued, whichever is earlier.

these, and other, provisions of the CPSIA is unknown at this time because implementation is ongoing.

Using data from CPSC's Web site, we identified 15 recall events dating back to 1979 involving companies that did not have adequate financial resources to carry out a recall. These recalls involved 12.8 million units, mostly fire sprinklers, cribs, and wall heaters, but also included gas grills, thermostat regulating devices, worm probes, and a pull toy.<sup>11</sup> For many of these events, the responsible company—typically the manufacturer or importer—was bankrupt or in the process of declaring bankruptcy at the time of CPSC's recall announcement. In these cases, the responsible manufacturer or importer may have still provided consumers with a remedy for a limited time. To protect consumer interests, CPSC may have issued public notice advising consumers to either destroy to stop using the recalled product, or retailers may have refunded consumers the purchase price of the product. Some of the more recent events, notably those involving more than 1.5 million cribs in 2007 and 2008, involved issues relating to the entities that purchased or succeeded the bankrupt responsible company. In that case, the acquiring company refused to conduct a recall, claiming that it was not responsible for products that had been manufactured by a company whose assets it had purchased after the products were made. See enclosure II for additional details on these 15 recall events, including the size and scope of each recall.

Out of the three financial instruments specified in the mandate, only insurers offer a product specifically designed to cover costs of consumer product recalls. Consumer product companies that choose to manage risk associated with potential product recalls through insurance generally either obtain an insurance policy from a private insurer or self-insure the risk by underwriting it to a captive insurance entity.<sup>12</sup> According to some financial services representatives, insurers in the United States currently underwrite limited amounts of product recall insurance, with most of the market written for food and beverage products and comparatively little written for consumer goods. Some insurers said that for lower limits of coverage—generally \$2 million or less—they may include coverage for withdrawing recalled products from distribution, among other activities, as part of a commercial general liability policy and, according to an insurer, may or may not charge a premium for this coverage.<sup>13</sup> For higher limits—such as above \$10 million—they said that policyholders typically obtain a customized policy that is written on a stand-alone basis, and not part of a general liability policy. Some insurance brokers also indicated that, as a condition of underwriting, insurers increasingly require policyholders to develop policies and procedures for conducting recalls and maintaining product

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<sup>11</sup>Worm probes are steel shafts connected to an electric current, which when inserted into soil, shock earthworms to the surface to be gathered for fishing. CPSC cited 28 deaths involving worm probes.

<sup>12</sup>For the purpose of insuring product recall risks, a captive insurance entity may generally be a wholly owned insurance company within the corporate structure of a consumer product company or a separate insurance entity used for the specific purpose of insuring risks that share similar characteristics.

<sup>13</sup>Insurers said that this coverage can be written on standardized forms provided by the Insurance Services Office, a provider of insurance forms and other services to aid insurers.

quality. For this reason, and because recalls can result in potentially large claims, product recall coverage is generally viewed by those we interviewed as an expensive form of insurance. The product recall insurance market covering consumer goods shows indications of expanding, with brokers and consultants reporting a noticeable increase in requests for this type of insurance, including from Asian manufacturers. Also, a risk consulting firm that designs computer models to help insurers understand their exposures has said it envisions developing models for recall risks within a few years, which could increase the willingness of some insurers to expand their product recall coverage.

### **Potential Policy Options to Ensure That Companies Have Resources to Recall or Destroy Unsafe Products**

We identified a variety of approaches to assure the federal government that companies have the financial resources to recall or destroy unsafe or potentially unsafe products. Many of these approaches took the form of financial instruments that companies could be required to obtain in amounts established by statute or regulation to cover, for example, the projected costs of a recall. These financial instruments included an escrow account, insurance policy, or bond to guarantee a company's financial stability or ability to perform a recall. Additionally, roundtable participants and others we interviewed suggested that line of credit guaranties, guaranties of personal or corporate assets, or liens on personal or corporate assets could be suitable financial instruments. As discussed in table 1, these instruments function differently, leading some to say that if companies were required to post financial assurance, the federal government should allow them to choose from among a variety of financing options.<sup>14</sup>

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<sup>14</sup>In prior work, we have shown that financial assurances vary in the financial risks they pose to the government, the oversight and enforcement challenges they pose to regulators, and the costs companies may incur to obtain them. See GAO, *Environmental Liabilities: EPA Should Do More to Ensure That Liable Parties Meet Their Cleanup Obligations*, GAO-05-658 (Washington D.C.: Aug. 17, 2005).



**Table I: How Proposed Financial Instruments Might Work as Financial Assurance**

Option	How option might work
<b>Escrow</b>	CPSC develops master escrow agreement and partners with one or more banks that act as escrow agents to establish escrow accounts with consumer product companies. Companies deposit cash or other approved assets in the account; the bank holds the funds until CPSC approves disbursement, and; CPSC, an agent of CPSC, or the consumer product company receives the funds to conduct or complete the recall.
<b>Insurance</b>	CPSC establishes coverage requirements, including minimum limits and covered risks. Consumer product companies purchase required coverage from private insurers and submit claims to cover costs of a troubled recall.
<b>Bond</b>	Sureties assess the financial strength, character, and capability of a consumer product company to perform a recall in accordance with requirements established by statute or regulation. CPSC makes a claim on the bond if a company failed to comply with regulatory requirements. The surety would pay CPSC for its claim, or it could conduct the recall according to regulation.
<b>Line of credit guaranty</b>	A consumer product company pays an annual fee to access a line of credit from a financial institution in an amount established by CPSC to fund potential recalls.
<b>Guaranty of personal or corporate assets</b>	Sole proprietors or the senior officers or principals of consumer product companies provide a written guaranty to CPSC that personal or corporate assets, such as real estate or machinery, would be available to fund potential recalls.
<b>Lien on personal or corporate assets</b>	CPSC receives a security interest in the personal assets of a sole proprietor or the corporate assets of a consumer product company to prioritize its right to collect payment in the event of a troubled recall before other creditors collect payment on unsecured claims.

Source: GAO.

Instead of requiring any of the previously described financial instruments, many roundtable participants supported the idea of providing CPSC with funds to assist companies in conducting a recall, citing it as a potentially more efficient and suitable approach for industry and the federal government given the low incidence of troubled recalls in CPSC’s history, among other things. CPSC could maintain an account to fund troubled recalls by completing them itself or through its agent, or by providing the responsible company with funds to complete a recall. Funding sources could include federal appropriations, assessments on consumer product companies, or civil penalties CPSC obtains from consumer product companies for violations of safety standards. Unlike the other proposed financial instruments, this fund could potentially cover recalls where the responsible company is no longer in business and no other company can be held responsible for the recall.

Several sources we interviewed also suggested nonfinancial options to ensure that companies are better prepared to recall unsafe products, including requiring companies to document their strategies for ensuring product safety or conducting product recalls. A consumer products trade association said that the best way to deal with potential recalls was to prevent problems from happening in the first place and

suggested that companies be required to develop quality assurance plans.<sup>15</sup> Alternatively, some recall consultants we interviewed told us that a requirement to develop product recall plans could help companies mitigate the cost of potential recalls by virtue of increasing their awareness of how to budget for them.<sup>16</sup>

The final option suggested was to make no change to the current system. Some roundtable participants and others we interviewed who suggested this option cited the low number of inadequately funded recalls under CPSC and the ability of companies to generally fund recalls with operating income or insurance, among other things. They said that CPSC should do more to use its existing authorities to compel companies to conduct effective product recalls. For example, some participants said that CPSC should strengthen efforts to obtain cooperation from companies throughout the supply chain, as well as act more quickly on its mandatory recall authority by filing an administrative complaint when a consumer product company said that it had no resources to conduct a recall.<sup>17</sup> One roundtable participant said that CPSC has not pushed companies enough to recall unsafe products. According to CPSC, the agency has rarely acted on its mandatory recall authority, citing a high level of cooperation from the companies it regulates to conduct voluntary recalls. Moreover, a CPSC official said that if using its mandatory recall authority were perceived as penalizing companies that otherwise comply with statutory reporting requirements—the same ones that become the basis for some voluntary recalls—then the agency’s ability to obtain voluntary recalls could be negatively affected. Nonetheless, as recently as 2001, they filed suit against the manufacturers of defective fire sprinklers and obtained cooperation from some in recalling the product. For one company that did not have the resources to conduct a recall, CPSC obtained their cooperation in notifying building owners to replace the sprinklers.

### **Some Challenges Could Make Implementing an Assurance Requirement Difficult**

Several roundtable participants and those we interviewed identified challenges that could complicate efforts to implement alternative financial assurance options. Some of these challenges were specific to stakeholder groups, particularly the financial services industry, and others were specific to the financial instruments themselves. However, strategies that were suggested could mitigate some of these challenges and make a financial assurance requirement more viable.

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<sup>15</sup> A quality assurance plan describes a company’s procedures and controls for monitoring the quality of its products—for example, materials and manufacturing procedures.

<sup>16</sup> Product recall plans describe procedures for conducting a product recall, including the roles and responsibilities of key personnel.

<sup>17</sup> According to CPSC officials, mandatory recalls are most commonly initiated by filing an administrative complaint before an administrative law judge. However, the agency may also initiate a mandatory recall by filing a court action.

## Challenges Specific to Consumer Product Companies, Financial Services Industry, and CPSC

Those we interviewed and roundtable participants identified several major factors and challenges that affect the feasibility of implementing a financial assurance, either through the use of a financial instrument requirement or CPSC fund. First, stakeholder groups representing businesses said that a financial assurance requirement would be cost-prohibitive for many companies—especially for small businesses and during difficult economic times—if the amount of resources needed to conduct a recall were high. A variety of sources have indicated that recalls can cost from a few thousand dollars to tens of millions of dollars depending on the industry, product, and corrective action pursued. For example, items that require specialized repairs, such as fire sprinkler systems, might be more costly to recall than toys and other low-priced items, which consumers tend to discard rather than return for repair or other replacement.

Those representing the financial services industry asserted that another challenge is that financial services firms might not have enough capacity to meet the potential demand for insurance or other coverage because of the limited number of large and specialized firms that could be willing to provide the coverage. They also said that firms—such as those that provide bonds—would be reluctant to provide coverage for recalls if only high-risk consumer product companies were subject to a financial assurance requirement or if potential costs for recalls rose to millions of dollars. Some suggested that financial service providers might be unwilling to pay for relatively costly remedies designated by CPSC, such as the repair and replacement of items. In addition, those we interviewed and roundtable participants, indicated that the willingness and ability of financial service firms to extend coverage for product recalls would depend on the terms and conditions of a financial assurance, including the financial service firm’s obligations, types of recall events or company actions that trigger provision of coverage, and pricing. For example, surety bonds are typically designed to cover short-term obligations of two years or less, but a product can be recalled after several years in commerce. Some suggested that financial service firms might be unwilling to pay for recall costs triggered by a voluntary recall, which constitute the majority of CPSC recalls. Moreover, pricing these new instruments would also be difficult because the financial firms would need to fully understand all the risk challenges of both the companies and their products—an especially daunting task if all companies were required to obtain coverage. Many of these financial instruments—excluding insurance—are not currently designed for consumer product recalls, so financial services firms would have to design financial products to cover product recalls.

CPSC officials and others said, moreover, that any financial assurance requirement would be challenging to enforce. They said CPSC did not have the resources or experience to administer and enforce an assurance requirement. Moreover, consumer products trade associations reported there is no program or process that tracks all domestically-produced consumer goods or companies doing business in the United States, making it difficult to identify companies that may need to comply with this requirement. Any financial assurance requirement that is targeted at imported products could be perceived as a barrier to trade and implicate U.S. obligations under international trade agreements.

## Challenges and Limitations Specific to Implementing Financial Instruments

Those we interviewed and roundtable participants identified specific issues that were associated with using each of the financial instruments or CPSC fund to meet a financial assurance requirement. For example, according to financial services representatives, product recall insurance offered very limited coverage, would be too expensive for many companies needing large amounts of coverage, and was generally not available to the riskiest companies or industries. Because insurance relies on spreading risk among a broad range of companies, it would not be a viable financial tool if applied only to the riskiest companies. Escrows, as another financial instrument, allow companies to accrue interest on funds they set aside. However, escrows are difficult to establish without first determining the specific amount of money to set aside. Escrow accounts could also tie up a company's resources to a greater extent than the other proposed financial instruments and could be particularly burdensome during difficult economic conditions. A bond program might not be an appropriate option for ensuring that company funds were available for recalls but could be used to keep financially unstable companies from engaging in commerce due to surety firms' practice of prescreening companies for financial and operational stability. Companies that are in poor financial condition would have similar problems obtaining line of credit guaranties or providing personal or corporate guaranties, although these options might be comparatively less expensive and could potentially require less capital than other options. A CPSC fund could target resources to troubled recalls, but specific parameters and controls on the use of funds and capitalization would be needed for potentially large or catastrophic recalls. Some roundtable participants raised the concern that the availability of CPSC funds for recalls could create a disincentive for companies throughout the supply chain, such as retailers, to voluntarily cooperate with CPSC in conducting and paying for recalls when a manufacturer was unable to do so.

A financial assurance requirement targeted to products under CPSC jurisdiction and that uses financial instruments we identified or a CPSC fund, faces several major limitations. It is unclear whether a requirement to post assurance using any of the financial instruments we studied would fully address cases involving companies that do not assume responsibility for recalled products produced by entities it purchased. It is also unclear whether highly catastrophic events, such as the incomplete recalls of fire sprinklers, could be adequately covered by any of the financial assurance options we studied, given that the cost of repair, replacement, or refund could be very high. A requirement targeted to the destruction or recall of goods under CPSC's jurisdiction would not address some of the troubled recalls that have occurred involving other industries such as food, drugs, and automotive parts.

## Strategies for Mitigating Challenges

Those we interviewed and roundtable participants suggested various strategies for mitigating some of the challenges that could potentially affect implementation of the proposed financial options. To make a financial assurance more affordable, for example, several interviewees and roundtable participants suggested that companies could be allowed to choose the type of financial coverage that would be most cost-effective, an option that would be particularly beneficial for low-margin or small

businesses. Some suggested that a financial assurance requirement be targeted towards specific types of companies or industries, such as those with a high incidence of troubled recalls. For example, one individual suggested that small businesses be excluded from meeting a financial assurance requirement and some suggested that a CPSC fund be created to target only those companies with troubled recalls. Furthermore, the terms and conditions of any requirement can be used to manage affordability and availability. For example, minimum financial coverage requirements should be set at a level low enough for companies to afford the coverage, yet high enough to meet the policy objective, such as covering the cost of a potential recall. Other terms and conditions that can affect the cost to companies, as well as the willingness of financial services firms to provide coverage, include the specific recall activities that an assurance would be required to address, as well as the point in time when coverage would be required—either once a product had been produced or once the need for a recall had been determined.

In addition, clear policy goals should be established before devising the financial assurance requirement. According to some roundtable participants, for those rare instances in which having some form of financial backstop to protect consumers from unsafe products may be useful, the success of any new policy option depends on how well it matches the specific policy objectives for covering troubled recalls. For example, if the purpose of the requirement is to prevent financially weak companies from selling products, those we contacted said a bond program might be a suitable solution because sureties are unlikely to underwrite bonds for companies that cannot demonstrate the wherewithal to recall goods. This is because surety firms screen companies on their ability to perform either financially or operationally before underwriting a bond on their behalf, whereas other instruments we studied do not directly screen companies. In contrast, if the purpose is to ensure that resources are available to conduct a troubled recall, then some suggested a CPSC fund might be suitable given the infrequency of these events that make other financing options comparatively more onerous for consumer product companies and CPSC. However, care should be taken that such a fund does not inhibit the maturation of an insurance market or other private-sector solution covering product recall risks by crowding out, or competing with, insurers or others willing to assume these risks. To achieve this, some roundtable participants said a fund should be narrow in scope to fund only the most crucial recall activities, such as public notification, and be used in only the most critical circumstances. Also, some roundtable participants said that if civil penalties become the source of the funds, then controls should be designed to anticipate how this might affect the incentives facing CPSC to pursue civil penalties on companies under its jurisdiction.

To improve CPSC's ability to enforce a financial assurance requirement, some sources suggested requiring companies to register with CPSC, thereby creating a means to track companies or products under its jurisdiction and enabling CPSC to identify companies that may need to comply with a requirement. Alternatively, some roundtable participants suggested that CPSC may have existing authority it could use to request more financial information from consumer product companies.

## **A Financial Assurance Requirement Could Provide Benefits but May Have Negative or Unintended Consequences, with No Consensus on the Need for a Financial Assurance Requirement at this Time**

Although roundtable participants and others we interviewed identified several benefits and disadvantages of implementing policies that ensure resources exist to recall or destroy unsafe products, there was no consensus on whether there is a need to pursue policy changes at this time. Consumer interest groups told us that a financial assurance requirement mandating the use of financial instruments or a CPSC fund would help ensure the public's safety. This would be particularly important when economic conditions put pressure on companies to lower costs, potentially compromising product quality and increasing the incidence of troubled recalls. According to one group, a requirement would have been particularly useful in the recent and incomplete recall of a large number of imported cribs that were associated with at least two infant deaths and that caused much confusion among consumers about how to repair the crib. Further, such a requirement could help improve companies' quality controls and standards if companies needed to meet underwriting requirements for financial services firms. For example, as a condition of underwriting, insurers typically require companies to document their quality assurance and product recall plans and a trade association told us surety firms would likely require companies to carry recall insurance as a condition of qualifying for a bond. Finally, these consumer interest groups said a financial assurance requirement could improve the effectiveness of recalls conducted under CPSC, given that the agency has made limited use of its mandatory recall authority.<sup>18</sup>

However, some roundtable participants and others we interviewed identified several potentially negative consequences that could affect companies, consumers, and U.S. exports. For example, the cost associated with providing financial assurance could limit growth and innovation in consumer product companies and cause bankruptcies, especially among small business or businesses in low-margin industries, such as toys. Also, it could distort incentives for companies to conduct voluntary recalls or continue risk management programs that support product safety because coverage would be available for these events. Finally, some international trade experts noted that any financial assurance requirement could cause other countries to establish similar requirements for U.S. exports, particularly if the requirement were viewed as a trade barrier on goods imported to the United States.

Despite these potentially negative consequences, consumer interest groups said some financial backstop was needed to protect consumers when companies fail to effectively recall hazardous products. Increased U.S. reliance on imported products and new statutory provisions that require, among other things, testing products for lead, may also increase the incidence of troubled recalls. Finally, CPSIA also strengthened CPSC's recall authorities, which may create additional troubled recalls depending on the extent to which CPSC exercises its new authorities over product recalls.

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<sup>18</sup>However, CPSC may begin using its mandatory recall authorities more often, because provisions of CPSIA make it easier for the agency to require that companies stop distributing unsafe products and strengthen the agency's bargaining power over corrective action plans when companies pursue voluntary recalls.

However, many others we interviewed and those that participated in the roundtable questioned the need for such a requirement, citing, among other things, the low incidence of product recalls for which funding is not available, recent statutory changes that improved product safety standards, and the low cost of most recalls, which companies have funded through operating income or insurance. They also cited industry's increased attention to product quality after the high profile recalls of 2007. A variety of incentives appear to contribute to a high level of cooperation from industry to conduct voluntary recalls. For example, CPSC has authority to require companies to recall unsafe products involuntarily and to assess civil penalties against companies that fail to meet certain safety standards. CPSIA expanded these authorities by, for example, increasing the maximum civil penalty amount from \$1.825 million to \$15 million for a related series of violations.<sup>19</sup> Other incentives that will likely continue to facilitate cooperation from industry include the risk of damaging a company's reputation by being associated with the manufacture or sale of unsafe products, and U.S. tort law that allows consumers to sue companies for liability associated with unsafe products.

### **Agency Comments**

We provided a draft of this report to Customs and Border Protection (CBP), the Consumer Product Safety Commission, and the Office of the U.S. Trade Representative for review and comment. We received technical comments from CPSC staff and USTR that we incorporated where appropriate. CBP did not provide written or technical comments.

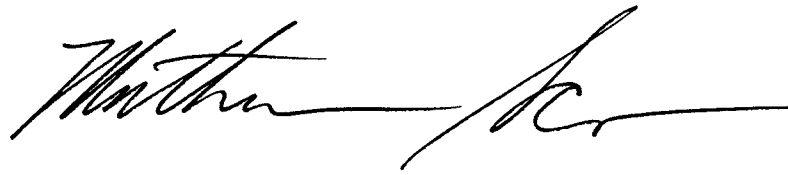
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We are sending copies of this report to the Consumer Product Safety Commission, Customs and Border Protection, the Office of the U.S. Trade Representative, and interested congressional committees. In addition, the report will be available on GAO's Web site at <http://www.gao.gov>.

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<sup>19</sup>In accordance with 15 U.S.C. § 2069(a)(3), the maximum penalty amount for a related series of violations that was specified in statute before passage of CPSIA—\$1.25 million—was adjusted for inflation in 2004 to \$1.825 million. *See* 69 Fed. Reg. 68884.

If you or your staffs have any questions, please contact me at (202) 512-8678 or [sciremj@gao.gov](mailto:sciremj@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Major contributors to this report were Debra Johnson, Assistant Director; Meghana Acharya; Emily Chalmers; Elizabeth Guran; Linda Rego; and Kathryn Supinski.

A handwritten signature in black ink, appearing to read "Mathew Scire". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Mathew Scire  
Director, Financial Markets and Community Investment

Enclosures





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# **Feasibility of Financial Assurances for Consumer Product Recalls**

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**Briefing to the  
House Energy and Commerce Committee  
and  
Senate Commerce, Science, and  
Transportation Committee**

**February 13, 2009**

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## Enclosure I

### Overview

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- Objectives
- Summary of Findings
- Background
- Scope and Methodology
- Discussion of Findings

## Objectives

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In response to a mandate in the Consumer Product Safety Improvement Act of 2008, GAO addressed the following objectives:<sup>1</sup>

- (1) Identify public policy options that the Consumer Product Safety Commission (CPSC) could use to ensure that companies have the resources to conduct product recalls, including destroying recalled products.
- (2) Identify factors that could affect the feasibility of implementing the proposed policy options.
- (3) Identify potential consequences of requiring a financial assurance, as one policy option, including potential benefits and disadvantages.

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<sup>1</sup> Pub. L. No. 110-314, § 224, 122 Stat. 3016, 3069 (Aug. 14, 2008).

## Summary of Findings

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- Public policy options for ensuring that companies can carry out recalls include the use of financial assurances and other options.
    - Financial assurance options such as escrow, insurance, or bond, as well as letter of credit, guarantee of, or lien on personal or corporate assets, and a CPSC fund for recalls.
    - Nonfinancial options, such as requiring quality assurance or recall plans.
    - No change to current laws, but have CPSC make better use of existing recall authorities.
  
  - Factors affecting the feasibility of implementing the financial assurance options include:
    - The cost to businesses,
    - The capacity of the financial services industry to provide coverage,
    - Terms and conditions, and
    - Enforcement mechanisms.
  
  - Potential consequences of a financial assurance requirement include potential improvements to consumer safety, but many stakeholders question the need for such a requirement, citing the low incidence of CPSC recalls for which companies could not pay, among other things.
-

## Background



- CPSC oversees more than 15,000 types of consumer products, including household products, toys, children’s products, and sports products, among other things.
- Recalls conducted under the jurisdiction of CPSC are intended to protect consumers from unsafe or potentially unsafe products.
- CPSC may require companies to conduct recalls, but most recalls have been voluntary.
  - CPSC reported that all recalls it oversaw in fiscal year 2008 were voluntary, totaling 563.
  - According to CPSC officials, the agency rarely uses its authority to seek a mandatory recall, citing a high level of cooperation from companies. They said some companies pursue recalls voluntarily in acknowledgment of CPSC’s authorities to seek mandatory recalls through litigation or to seek civil penalties for failing to report hazardous products.

## Enclosure I

### Background

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- CPSC holds all companies along the supply chain responsible for implementing product recalls, including manufacturers, importers, distributors, and retailers.
  
  - CPSC's objectives for companies conducting recalls are:
    - To locate all defective products as quickly as possible;
    - To remove these products from the distribution chain and from the possession of consumers, and;
    - To notify the public about the defect and the actions being taken to correct the hazard (e.g., refund consumers the price of the product, repair the defect, or replace the product).
    - According to CPSC, products may be destroyed as part of a product recall.
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## Background: Incomplete Recalls under CPSC



GAO identified 15 recalls since 1979 under CPSC jurisdiction that involved companies without adequate resources to conduct a product recall.

- These recalls involved 12.8 million units, mostly fire sprinklers, cribs, and wall heaters. Other products included gas grills, thermostat regulating devices, worm probes, and a pull toy.<sup>2</sup>
- The companies could not carry out these recalls because they had limited financial resources, had filed for bankruptcy protection as a result of a recall, or for reasons unrelated to a recall.
- GAO provided a draft of this analysis to CPSC and received technical comments, which we incorporated where appropriate. Our interviews with product recall consultants and others did not supplement or contradict these data.
- These data do not intend to describe the effectiveness of other recalls conducted under CPSC.

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<sup>2</sup> Worm probes are steel shafts connected to an electric current, which when inserted into soil, shock earthworms to the surface to be gathered for fishing. CPSC cited 28 deaths involving worm probes.

## Enclosure I

### Scope and Methodology



- Our review included:
  - Recalls conducted under the jurisdiction of CPSC to protect consumers from hazardous products,
  - Imported and domestically produced products, and
  - All products under CPSC jurisdiction.
- To do this work, we:
  - Compiled and analyzed data from 1979 to 2008 on product safety recalls that CPSC collected on companies lacking adequate resources to conduct a recall;
  - Interviewed organizations representing consumer product companies, financial services firms, product recall consultants, consumer interest groups, international trade experts, and government agencies; and
  - Convened a roundtable of experts and others to obtain a deeper understanding of the need for and issues involved in implementing a financial assurance requirement.
- We conducted our work from September 2008 to February 2009 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives.



## Enclosure I

### Scope and Methodology: Interviews



- As of January 30, 2009, we had conducted interviews with 48 organizations representing various stakeholder groups, including:
  - Consumer product trade associations (12) representing large and small manufacturers, importers, distributors, and retailers;
  - Individual retailers (5);
  - Financial services trade associations (7) representing banks, insurers, sureties, and brokers of these services;
  - Large insurers, sureties, banks and insurance brokers (8);
  - Product recall consulting firms (8);
  - Consumer interest groups (2);
  - International trade experts (2); and
  - Federal agencies (4), including CPSC, Customs and Border Protection, the Office of the U.S. Trade Representative, and the U.S. Small Business Administration Office of Advocacy.
- We selected organizations to interview based on breadth of membership, size, prior knowledge, and availability.

## Enclosure I

### Scope and Methodology: Roundtable



- We convened a roundtable of 20 participants representing consumer product companies, financial services firms, product recall consultants, consumer interests, and federal government agencies.
- On January 30, 2009 we held an all-day meeting with these participants at our headquarters office in Washington, D.C.
- We selected participants who represented the different stakeholder groups that would likely be involved in developing a financial assurance requirement for product safety recalls, if such a program were initiated. We judgmentally selected participants based on:
  - Ability to provide a broad range of perspectives and speak to as many areas of knowledge as possible,
  - Nationally renowned expertise or national constituency,
  - Our professional judgment on a participant's knowledge of issues, and
  - Geographic proximity and availability for our panel.

**Enclosure I**

Scope and Methodology: Roundtable participants



<b>Consumer Products Industry</b>	<b>Financial Services Industry</b>
American Assoc. of Importers and Exporters	Bank of America
National Assoc. of Home Appliance Manufacturers	Colemont Insurance Brokers
Retail Industry Leaders Assoc.	Insurance Information Institute
Toy Industry Association	International Fidelity Insurance Co. for the National Assoc. of Surety Bond Producers
	SunTrust Banks, Inc.
<b>Consumer Interests</b>	Surety and Fidelity Assoc. of America
Consumer Federation of America	The Bank of New York Mellon
Public Citizen	Zurich North America
<b>Product Recall Consultants</b>	<b>Government</b>
Marsh USA	CPSC
Safe-T-Source Inc.	Customs and Border Protection
	Office of the U.S. Trade Representative
	Small Business Administration

Source: GAO.

## Enclosure I

### Objective 1: Proposed options

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The mandate requires that GAO study escrow, insurance, and a bond as potential options for use as financial assurance.

Roundtable participants and others we interviewed suggested additional financial instruments that could be used as financial assurance, including:

- A letter of credit,
- Guarantee of personal or corporate assets,
- Lien on personal or corporate assets, and
- CPSC fund that would provide funds to cover troubled recalls.

## Enclosure I

### Objective 1: Proposed Options Escrow – How It Might Work



- CPSC partners with one or more banks that act as escrow agents to establish escrow accounts.
- CPSC establishes terms and conditions through a draft model escrow agreement. Under the agreement:
  - Companies deposit cash or other approved assets in an amount that is calculated according to the volume of goods sold or produced or projected recall costs.
  - The bank holds the escrow funds until CPSC approves disbursement in the event of a recall or upon determining that a company has not dedicated adequate resources for conducting a recall.
  - CPSC, an agent of CPSC, or the consumer product company receives the escrow funds to conduct or complete the troubled recall.

## Enclosure I

### Objective 1: Proposed Options Insurance – How it Might Work



- CPSC establishes coverage requirements, such as terms of minimum limits and covered risks (e.g., public notification, product removal, and corrective action), among other things.
- Consumer product companies purchase required coverage from private insurers.
- Companies then submit claim(s) to the insurer on their policy to cover the costs of a troubled recall.
- Variation: If required coverage is not available in the private market, the federal government could establish an insurance pool funded with premiums assessed on consumer product companies (i.e., policyholders).

## Enclosure I

### Objective 1: Proposed Options Bond – How it Might Work



- Consumer product companies obtain a bond from a surety company to assure the CPSC that resources are available to cover legal recall obligations.
  - In exchange for an annual premium, sureties assess the financial strength, character, and capability of a consumer product company to perform a recall in accordance with requirements established by statute or regulation.
- CPSC could make a claim on the bond if a company failed to comply with regulatory requirements.
- The surety company would pay CPSC for its claim, or it could conduct the recall according to regulation.
- Variation: Instead of using a bond to cover all aspects of a recall that can be costly, require companies to obtain a bond to guarantee their compliance with CPSC statutes or regulations related to consumer safety or recalls, such as a requirement to develop a quality assurance plan. This option might carry bond penalties in amounts lower than the potential costs of conducting recalls, making the underwriting more feasible for surety firms.

## Enclosure I

### Objective 1: Proposed Options Other Financial Options



Option	How it Might Work
<b>Letter of credit</b>	A consumer product company pays an annual fee to access a line of credit from a financial institution to fund potential recalls.
<b>Guarantee of personal or corporate assets</b>	Sole proprietors or the senior officers or principals of consumer product companies provide a written guarantee to CPSC that personal or corporate assets, such as real estate or machinery, would be available to fund potential recalls.
<b>Lien on personal or corporate assets</b>	CPSC receives a security interest in the personal assets of a sole proprietor or the corporate assets of a consumer product company to prioritize its right to collect payment in the event of a troubled recall before other creditors collect payment on unsecured claims.
<b>CPSC fund for troubled recalls</b>	CPSC maintains an account to fund troubled recalls by completing them itself or through its agent, or by providing the responsible companies with funds to complete a recall. The account is funded by federal appropriations or civil penalties that CPSC assesses on consumer product companies under its jurisdiction.

Source: GAO.



## Enclosure I

### Objective 1: Proposed Options Nonfinancial Policy Alternatives



In lieu of requiring financial assurance, several sources we interviewed suggested the federal government could do more to promote product safety and effective recalls by requiring consumer product companies to develop:

- Quality assurance plans that describe procedures and controls for monitoring the quality of materials and manufacturing procedures, among other things.
- Product recall plans that describe procedures for conducting a product recall, including the roles and responsibilities of key personnel.
  - According to a risk management firm retained by two large product recall insurers, about 15 percent of consumer product companies have written recall plans, compared with more than 90 percent of food companies.

Some roundtable participants and others we interviewed said no change is needed, citing the low number of troubled recalls, among other things. Some roundtable participants said CPSC should do more to use its existing authorities to compel companies to conduct effective product recalls.

## Enclosure I

### Objective 2: Factors Affecting Feasibility

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Those we interviewed and roundtable participants identified several major factors and challenges that affect the feasibility, including the affordability, availability, and enforceability, of implementing a financial assurance requirement using any of the financial tools considered in the mandate. These include:

- The cost to consumer product companies,
- The capacity of the financial services industry to provide coverage,
- The difficulty of establishing terms and conditions, and
- The lack of an existing enforcement mechanism.

## Enclosure I

### Objective 2: Factors Affecting Feasibility Cost to Consumer Product Companies



- Given difficult economic conditions, companies might not be able to put resources toward obtaining financial coverage, particularly when many are struggling to stay in business.
- Several interviewees, including a consumer group, expressed concern that a financial assurance requirement could negatively impact small businesses in particular and potentially drive them out of the market.
- Determining the amount of financial assurance companies should maintain could be difficult, given that the costs of conducting a recall can vary widely. A variety of sources have indicated that recalls can cost from a few thousand to billions of dollars depending on the industry, product, and corrective action required.

## Enclosure I

### Objective 2: Factors Affecting Feasibility Capacity



- A variety of sources representing the financial services industry reported concerns about whether insurers, sureties, and banks would provide adequate capacity to meet the increased demand for their products that requiring a financial assurance could create, particularly if the assurance is intended to cover all aspects of a recall and to cover recalls that are infrequent, costly, and difficult to predict.
  - For example, according to a corporate escrow agent, there is a finite number of banks large enough to handle the potential demand for escrow agreements.
- Industry representatives said sureties and insurers in particular would be reluctant to underwrite bonds and insurance, respectively, if financial assurance was required only from high-risk companies or companies that had already initiated a recall, potentially resulting in adverse selection. Roundtable participants cited concern about their ability to profit from these arrangements.
- Some of the financial firms indicated that the industry may not have enough capacity to cover large recalls that could cost in the millions or billions of dollars.

Objective 2: Factors Affecting Feasibility  
Establishing Terms and Conditions



Those we interviewed and roundtable participants, including financial services firms, indicated that it would be difficult to extend coverage for product recalls without first determining the terms and conditions of a financial assurance. Some of these terms and conditions include:

- Duration of the financial obligation. Products can be recalled after several years, but financial tools such as surety bonds are typically designed to cover short-term obligations.
- Point in time when coverage would be required. Companies could provide financial assurance once a product had been produced or once a recall was about to occur, for example.
- The recall activities covered. A financial assurance could cover the costs of notification, removal, and remedies. However, some financial service providers might be unwilling to pay for relatively costly remedies, such as the repair and replacement of products.
- Triggering recall event for coverage. Financial assurance requirements could specify whether voluntary and mandatory recalls were covered, for example. One concern has been that some insurance providers might only cover mandatory recalls, even though the majority of CPSC recalls are voluntary.
- Pricing of financial coverage. It would be difficult to price a financial product if not enough is known about the quality controls and other risks presented by a consumer product company and how much a recall might cost. Obtaining this information would be difficult for the wide range of products regulated by CPSC and for imported products.

## Enclosure I

### Objective 2: Factors Affecting Feasibility No Existing Enforcement Mechanism

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- There is no existing mechanism at CPSC, nor the resources or experience to administer and enforce a financial assurance requirement for consumer product companies, according to CPSC officials and sources we contacted.
- Consumer products trade associations reported there is no program or process that tracks all domestically-produced consumer goods or companies doing business in the United States, making it difficult to identify companies that may need to comply with this requirement.
- International trade experts indicated that any financial requirement that is targeted or perceived to be targeted unfairly towards imported products or is restrictive beyond what is needed to meet its regulatory objective could be challenged under international trade agreements.

## Enclosure I

### Objective 2: Factors Affecting Feasibility Challenges to Implementing Financial Assurance Options



Those we interviewed and roundtable participants, including financial services firms, described challenges that were specific to implementing the financial assurance options presented in the mandate.

- Insurance: Insurance functions by spreading risk among a broad pool of individuals. For insurance to be a viable tool, it would have to be applied to all companies rather than the ones that have the greatest number of recalls. Moreover, current product recall insurance is expensive because this type of coverage is considered risky. One advantage of insurance is that it requires less capital from companies than other financial options.
- Escrow: Escrows would be difficult to establish unless a specific amount of assurance is first determined. While escrows are relatively easy to establish, provide contractual flexibility, and allow companies to accrue interest on any funds they set aside, determining the specific amount might be difficult given the range of recall costs. Moreover, it could tie up resources that companies could use for other purposes.
- Bond: Bonds operate with the expectation of zero loss (claims) and require pre screening of companies. Thus, while a bond program could help keep financially unstable companies from engaging in commerce, another financial option might be more appropriate for providing funds for recalls.

## Enclosure I

### Objective 2: Factors Affecting Feasibility Challenges to Implementing Financial Assurance Options



Those we interviewed and roundtable participants, including financial services firms, described challenges that were specific to implementing other financial assurance options.

- **Letters of Credit:** Unlike cash escrows, companies would not have to set aside capital to cover recalls and the annual fees might be less than those for cash escrows. However, companies could find it difficult to obtain letters of credit under difficult economic conditions and companies that are not in good financial standing might not meet pre screening conditions for accessing credit.
- **CPSC Fund:** A fund could ensure that recalls would be covered even if companies could not pay for them. However, possible challenges include:
  - The fund could create a moral hazard in that if CPSC funds were available, companies, such as retailers, might be less inclined to conduct and pay for voluntary recalls.
  - The parameters and controls would have to be established on the use of such a fund, as would a means for initial capitalization and any subsequent capitalization.
  - Roundtable participants debated what the size of such a fund would need to be to account for potentially large or catastrophic recalls, such as the recent ineffective recalls involving 1.6 million cribs.



Objective 2: Factors Affecting Feasibility  
Strategies for Mitigating Major Challenges



Those we interviewed and roundtable participants suggested various strategies for mitigating some of the factors affecting implementation of the proposed financial options:

- Providing flexibility. To make a financial assurance more affordable, several interviewees and roundtable participants suggested that companies should be allowed to choose the type of financial coverage that would be most cost effective, an option that would be particularly beneficial for small businesses.
- Establishing clear goals. The feasibility of using a financial assurance tool to provide coverage depends on the goals of the program. For example, if the purpose is to prevent financially weak companies from selling products, then a bond program might be a suitable solution. In contrast, if the purpose is to ensure that resources are available to conduct a troubled recall, which is an infrequent event, then some suggested the CPSC fund might be suitable.
- Targeting the requirement to specific companies. Some suggested that a financial assurance requirement be targeted towards specific types of companies or industries, such as those with a high incidence of troubled recalls. For example, one individual suggested that small businesses be excluded from meeting a financial assurance requirement and some suggested that the CPSC fund be created to target only those companies with troubled recalls.

## Enclosure I

### Objective 2: Factors Affecting Feasibility Strategies for Mitigating Major Challenges, cont.



- Establishing terms and conditions. To make a financial assurance requirement more affordable and available, terms and conditions would need to be established, such as minimum financial coverage requirements for companies, specific recall activities and obligations for financial service firms, and limits on the use of CPSC funds.
- Establishing an enforcement mechanism. Some sources suggested establishing a voluntary system that allowed companies to register with the CPSC, or for CPSC to use its existing authority to request more financial information from consumer product companies. These strategies could support CPSC's enforcement of recalls.

### Objective 3: Potential Consequences Benefits of Requiring a Financial Assurance



Representatives for consumer interest groups said some financial backstop was needed to protect consumers when companies failed to effectively recall hazardous products, citing of the 15 troubled recalls under CPSC that GAO identified and another under the National Highway Traffic Safety Administration. Also, increased U.S. reliance on imported products and new Consumer Product Safety Improvement Act provisions that curtail the export of recalled products and require testing products for lead may increase the incidence of troubled recalls, justifying the need for a financial assurance requirement. Benefits include:

- **Ensuring public safety:** Because of current economic pressures to keep consumer prices low, potentially leading to declines in product quality, requiring a financial assurance would ensure that companies could pay for a recall in those instances when the consequences of not conducting a recall could result in widespread injury or death.
- **Improving the effectiveness of CPSC's recalls:** A proponent said a financial assurance requirement could give CPSC an important tool to enable product safety recalls in light of challenges it faces in using its mandatory recall authority.
  - Prior to CPSIA, mandatory recalls involved a trial-type administrative hearing that could take a year or longer to complete, according to a CPSC official. With new authorities under CPSIA, CPSC may file a suit and notify the manufacturer that it has determined a product to be imminently hazardous to cease the distribution of the product.
- **Improving quality controls and standards:** Given that insurance providers, for example, require companies to develop recall and quality assurance plans before extending coverage, a financial assurance requirement could encourage companies to improve their quality controls and standards.

## Enclosure I

### Objective 3: Potential Consequences Disadvantages of Requiring a Financial Assurance



Those we interviewed and some roundtable participants also identified several potentially negative consequences of establishing a financial assurance requirement:

- Could limit company growth and product innovation by restricting the cash and credit available to companies,
- Could increase the cost of consumer goods and possibly limit consumer choice,
- May distort incentives for companies to conduct voluntary recalls or continue risk management programs that support product safety by introducing an element of moral hazard,
- May increase the number of bankruptcies among smaller and low-margin businesses, depending on the cost of a financial assurance,
- May increase lawsuits against companies to access the “new” pool of financial assurance funds, knowing there is a financial remedy available, and
- Could cause other countries to impose similar requirements on U.S. exporters if it were viewed as a trade barrier.

## Enclosure I

### Objective 3: Potential Consequences Many Questioned Need for Financial Assurance



Consumer advocates said there was some need for requiring a financial assurance, but many others we interviewed and those that participated in the roundtable questioned the need, citing:

- The low incidence of product recalls for which funding is not available;
- The small proportion of products that are recalled;
- Improved safety standards and attention to product quality and safety;
- The low cost of most recalls, which companies have funded through operating income or insurance, and
- Incentives from the U.S. tort system for private companies to ensure the safety of their products.

However, perhaps acknowledging that some recalls under CPSC are not conducted effectively and put consumers at risk, many roundtable participants from a variety of perspectives supported the idea of providing CPSC with funds to deal with these troubled recalls.

## Enclosure II: Data on Incomplete Recalls

Table 2 describes recalls announced by CPSC in which companies did not have adequate resources to complete a recall program. For many of these events, the responsible company—typically the manufacturer—was bankrupt or in the process of declaring bankruptcy at the time of the recall announcement. More recently, a company that had purchased a manufacturer of recalled products—baby cribs—refused to cooperate with CPSC, claiming it was not responsible for products manufactured before the purchase was completed. We obtained these data from recall announcements published on CPSC’s Web site and incorporated technical comments from CPSC officials who reviewed our analysis. These data do not intend to describe the effectiveness of other recalls conducted under CPSC.

**Table 2: Incomplete Recalls under CPSC, 1979-2008**

Event number	Original date of recall announcement	Product/ estimated number units affected/ estimated unit price	Defect description	Reported injury	Company disposition/ scope of recall
1	September 17, 2008	Crib 600,000 \$150-\$300	Hardware is not appropriate size and can cause structural failure	None	Manufacturer went out of business. Company that purchased the assets of the manufacturer of these cribs refused to conduct recall program. CPSC eventually compelled retailers to refund consumers.
2	September 21, 2007	Crib 1,000,000 \$100-\$300	Error in assembly instructions, if followed, can weaken hardware and pose entrapment hazard; hardware not appropriate size and can cause structural failure	3 deaths, 7 infant entrapments, 55 incidents	Manufacturer provided consumers with repair until company was sold in March 2008. The purchasing company (same as above) refused to conduct recall program, but continued with limited repair program on at least one affected crib model, and published revised assembly instructions for some other affected models.

3	March 4, 2004	Fire engine pull toy 323 \$20	Small parts pose a choking hazard	None	Private label retailer had declared bankruptcy at time of recall announcement. They refunded consumers the purchase price for a period lasting less than a month after the recall announcement. When discontinued, CPSC advised consumers to destroy or discard the product.
4	April 25, 2003	Fire sprinkler 60,000 not reported	Units fail to operate in a fire	None	Company that purchased bankrupted manufacturer dedicated \$1 million towards consumer reimbursement of replacement products for approximately 29 months from the date of the recall announcement.
5	April 25, 2003	Fire sprinkler 400,000 not reported	Units fail to operate in a fire	None	Manufacturer had no assets to conduct a recall, but issued notice to building owners to replace sprinklers.
6	July 19, 2002	Gas grill 155,000 \$160	Design flaw can cause grill to collapse	44 burn incidents to legs, hands, and fingers	Manufacturer declared bankruptcy after CPSC sued to obtain a recall. Some retailers announced a program to provide consumers with refunds. CPSC advised consumers to stop using the grill and seek a remedy from their retailer.
7	September 27, 2000	Gas-fired furnace 190,000 \$2,000	Unit can overheat, deteriorate, and ignite	30 reports of fires and damage to homes; no injuries	Manufacturer had declared bankruptcy by time of recall announcement. In 2001, some distributors provided free inspection, repairs, or replacements covering 30,000 units. In 2002, the settlement of private class action litigation created a fund to compensate owners for some expenses of repairing or replacing units. CPSC advised consumers to inspect units using a licensed heating contractor.
8	February 1, 2000	In-wall heater 1,900,000 not reported	Unit can overheat and ignite, and become energized and create risk of electric shock	4 deaths, 2 serious burn incidents, property damage claims exceeding \$4.3 million	Manufacturer declared bankruptcy after CPSC sued to obtain a recall. As part of the court settlement, manufacturer sold replacement heaters at a discount for about 2 years following original recall notice. After this period, CPSC advised consumers to replace unit at their own expense.

9	October 14, 1998	Fire sprinkler 8,400,000 not reported	Units fail to operate in a fire	At least 4 burn or smoke inhalation incidents; \$4.3 million in reported property damage	The manufacturer's reported financial condition revealed limited ability to pay for sprinkler replacement. Manufacturer provided replacement parts and partial reimbursement for removal and replacement of defective units for 10 months from date of recall announcement.
10	July 12, 1993	Crib 8,000 not reported	Small parts pose a choking hazard	None	Company was in bankruptcy at time of recall announcement and did not proceed with a recall. CPSC advised consumers to contact retailers for replacement part.
11	September 16, 1992	Worm probe 30,000 \$8 - \$27	Energized shaft poses electrocution hazard to users and, when inserted into the ground, to those nearby	At least 28 deaths associated with functionally identical worm probes	Company was bankrupt at time of recall announcement and did not proceed with a recall. CPSC advised consumers to destroy product.
12	February 11, 1987	Crib and playpen unknown not reported	Unit design violates multiple CPSC safety requirements	21 incidents, several involving bruises to children	Company was in bankruptcy at time of recall announcement and did not proceed with a recall. CPSC provided toll-free telephone hotline and advised consumers to call for potential remedies.
13	May 2, 1984	Oil/wood furnace 12,000 not reported	Weld failure can cause carbon monoxide to escape, posing risk of illness or death	None	Company was in process of filing for bankruptcy at time of recall announcement and did not proceed with a recall. CPSC advised consumers to inspect units using professional heating equipment installer.
14	September 22, 1982	Crib 1,000 \$200	Design of crib slats and rail height pose asphyxiation and fall hazard	1 death	Company was in bankruptcy at time of recall announcement and did not proceed with a recall. CPSC advised consumers to discontinue use of the crib.
15	October 15, 1979	Energy- saving thermostat regulator 20,000 \$20-\$25	Unit can overheat and start fire	None	Manufacturer conducted a repair program before filing for bankruptcy about a year after initiating a recall. Upon conclusion of the program, CPSC advised consumers to contact retailers for refund or replacement.

Source: GAO analysis of CPSC information.

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