



Taming the 5-Ton Elephant

The Product Liability Issue

Previously articles in this series have extensively outlined the risks and benefits that electrical distributors face when considering private labeling. A recurrent theme in interviews with distributors, customers and manufacturers is the risk of product liability if the private labeled product is alleged to be defective. In addition to the product liability risk, the interviews also identified concerns related to marketing support, research and development as well as administrative costs currently shouldered by the manufacturer. These costs may be incurred by the distributor that private labels. These concerns can contain, in many ways, legal issues that, like product liability, are better understood through a brief legal analysis.

This article highlights the legal issues related to private labeling so that distributors can make a more thorough decision prior to private labeling. The article is **not** intended to give specific legal advice but is intended to highlight general legal issues that may affect the decision to private label.

Overview

In general, a distributor considering private label has three categories of legal stakeholders to consider:

- The manufacturer of its private labeled products
- The purchaser and end user of the product
- The general public and government

A prudent distributor will take the legal actions necessary to reduce or eliminate its legal risk to each stakeholder category. Legal risks include:

- Product Liability for Injury or Property Damage allegedly caused by a defective product;
- Liability for Patent or Trademark Infringement
- Liability for Counterfeiting

Product Liability for Private Label Products

Product liability is a major business concern. According to insurance consulting firm Tillinghast in a recent Fortune article, 49,743 product liability lawsuits were filed in 2006 and cost businesses (and their insurance companies) \$261 billion.

An the issue is no different in the electrical industry.

Surveys conducted by Allen Ray Associates and Channel Marketing Group consistently show that the risk of product liability lawsuits is one of the main concerns of distributors contemplating private labeling.

Products Liability is a legal action based on an allegedly defective product. Under current law in virtually every state, an injured party can bring a lawsuit against any corporation in the "chain of distribution" of the product, from the original manufacturer to the retailer and every party in between. It does not matter that the distributor may have obtained the product in a sealed box and sold it in a sealed box; the distributor is potentially liable to the injured party (the "Plaintiff") based on the legal doctrines of product liability.

Over the years, the doctrine has been modified and altered by the courts and legislatures. For example, the Texas legislature passed a statute that requires manufacturers to defend distributors sued in product liability actions unless the manufacturer can prove that the distributor altered the product in a way that caused harm to the plaintiff. Other states have



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adopted similar measures, (most less sweeping than the Texas law.)

The key element in a Plaintiff's claims against the distributor, manufacturer, retailer, etc is the concept of "Product Identification". Plaintiff must be able to *allege* that the product that caused harm was manufactured, distributed and sold by the defendants. Keep in mind that the standard for making an allegation in a lawsuit is very low. If there is the slightest possibility that the distributor defendant may have distributed the particular product, that is usually enough to pass muster and allow the filing of a lawsuit. If a distributor is identified based on sales receipts from the distributor to the end-user (contractor or MRO account/installer), it may not matter that the customer was also buying similar or even identical product from other, unnamed distributors.

In a recent contractor survey conducted by Allen Ray Associates and Channel Marketing Group, 11% of respondents have faced product liability issues for products they have installed. Over 70% of the time, these cases included a distributor!. When asked how they determined which distributor sold them the product, customers responded:

- o "Invoices."
- o "Purchase Orders"
- o "Their name was on the product."
- o "I know what I buy and from whom I buy."
- o "Delivery receipts"

In essence, *alleging* distributor involvement can be a low hurdle.

The states with the most survey respondent incidences were California, Florida, New York, Pennsylvania and Texas.

(Note: The Channel Advantage Partnership's forthcoming white paper on counterfeit products is expected to include an appendix of the product liability laws in the 50 states.)

The concept behind this broad based liability is that the Plaintiff should not have to sort out who was at fault in manufacturing, designing, selling or (potentially) altering the product. That should be left to the defendants to determine amongst themselves through agreement or through a legal procedure to shift the costs to the appropriate party. In 90% of the cases, the Plaintiff's main claim is that the design of the product itself is defective and, as a result, the manufacturer (who designed the product) should bear the burden of proving that the product design was not defective.

When most manufacturing was done in the United States, the Plaintiff would typically sue every participant in the chain of distribution and then the U.S. manufacturer would assume the defense for all downstream parties. This arrangement might take place after the suit was filed by agreement of the defendants or it might take place before any claim was made if the manufacturer agreed to include the distributor as an *Additional Insured* on the manufacturer's product liability insurance policy.

When a manufacturer is off-shore or bankrupt, however, things are complicated. If an off-shore manufacturer has no U.S. operations, it may not be subject to suit in the United States. China or India-based manufacturers, in particular, are notoriously hard to serve with suit papers. The same result applies to a bankrupt U.S. manufacturer. A bankrupt company is all but invulnerable to lawsuits.

If the off-shore manufacturer or bankrupt U.S. manufacturer cannot be served with suit papers, then the Plaintiff brings the claims against the viable U.S. parties, typically the distributor. Distributors have a hard time defending against defective design or manufacture claims when

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design and manufacturing were done by the off-shore manufacturer.

Things become more complicated for a private labeler (read *distributor*). Plaintiffs often argue that the private labeler is an “apparent manufacturer” and therefore responsible not only for the product design and manufacture but also the warnings and package instructions. When the Plaintiff makes this type of claim, then the actual manufacturer, whether based in the U.S. or off-shore, may refuse to take over the defense of the private label distributor. The manufacturer will argue that the Plaintiff is making a claim directly at the private label itself, not just the product design.

Ways to Reduce Product Liability Risk

Contract

The best way for a private labeler to reduce the risk of product liability is to include an **enforceable Indemnification and Defense** provision in the Private Label contract. That sounds simple but is, in practicality, fairly complicated.

First, the Indemnification and Defense provision must be **enforceable**. This means that the manufacturer must have ongoing U.S. operations, either as a U.S. based company or an off-shore company with a U.S. subsidiary. If the U.S. subsidiary is expected to provide the product liability defense, then it should be specifically named in the Private Label contract. As previously mentioned, if the private label product manufacturer is bankrupt or off-shore with no U.S. subsidiary able to provide the defense, then the private label distributor becomes the target defendant.

The indemnification and defense provision must provide both **indemnity** (i.e. payment of an adverse jury award) and **defense**, (the costs of attorneys needed to defend the company.) This

latter cost is often higher than the indemnity cost. Most Indemnity and Defense provisions in Private Label contracts are not well drafted. They typically use boilerplate language that makes it too easy for a manufacturer to refuse to indemnify or defend. For example, the standard boilerplate indemnity provision does not mention defense costs. It simply provides for indemnity in the event of an adverse verdict. The distributor is left to cover its own attorneys fees in a case that may drag on for years. Then, if the distributor decides it is cheaper to settle than fight, the indemnity provision does not reimburse the distributor for its settlement payment (because indemnity requires a jury award, not a settlement). Lastly, the standard boilerplate indemnity clause does not require the manufacturer to step in and defend at the start of the case. The manufacturer has the leeway to wait until it is established that the distributor did not alter the product in a way that caused harm to the Plaintiff.

A properly drafted Indemnification and Defense provision allows the distributor to turn over the case to the manufacturer as soon as it is filed. Then, the distributor can let the manufacturer provide the attorneys and indemnity needed to protect the distributor.

Insurance

A second, less effective, way for a private label distributor to limit product liability risk is to require that the manufacturer list the distributor as an Additional Insured on the manufacturer’s product liability insurance policy. This is a less effective method than a well-written contractual indemnity and defense clause because:

- Manufacturers fail to follow through with the commitment to add the distributor as an additional insured, sometimes inadvertently, other times overtly.



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- The manufacturer's policy may limit or exclude the risk of products liability lawsuits.
- The manufacturer may change insurers and not include, or forget to include, the distributor on a later policy.
- The product liability lawsuit may allege a distributor's independent negligence and the insurer may deny coverage based on that allegation.
- The "additional insured" coverage will often be deemed excess or secondary to the distributor's (primary) product liability coverage and, consequently, the manufacturer's insurer will refuse to provide a defense unless the distributor's carrier exhausts its policy or goes into receivership.

For a distributor offering private label products, all of these difficulties are compounded by the possibility that the manufacturer's carrier may expressly exclude private label product liability, especially if the manufacturer is a name-brand manufacturer!

Legal Process

The third and least effective way for a private label distributor to limit product liability risk is to make a claim for indemnity (or contribution) in court. These legal procedures only provide a distributor limited recourse against the manufacturer for some portion of an adverse jury award. They typically do not provide for reimbursement of attorneys fees.

The prudent distributor will protect itself against the risk of product liability at the outset, when it negotiates with the private label manufacturing source. After that point, it may be too late.

Liability for Patent and Trademark Infringement

Distributors offering private label brands typically develop unique labels and trademarks for their

products. In doing so, the distributor will need to insure that its planned trademark and labeling do not infringe on existing marks and needs to register its trademarks and labels with the United States Patent and Trademark Office to insure maximum protection from infringement.

Private labeling distributors should be extremely careful, and thorough, in searching for existing trademarks and packaging. The starting point for trademark search is the United States Patent and Trademark Office's database. This database identifies registered trademarks and labeling using a standard search engine. This is not enough, however.

Just because a trademark is not listed in the United States Patent and Trademark Office database does not mean that it is not being used somewhere in the country. If a business is using a trademark and has been using it for a period of time, that business may have obtained a common law trademark. Like a common law marriage, a common law trademark is recognized in the law if it is in place for a reasonable period of time and if the business treats the trademark as its own.

If a distributor chooses a trademark that is already covered by a common law trademark, then the distributor may be liable for trademark infringement. A distributor should conduct a full trademark search – which generally requires the assistance of a trademark attorney -- to be certain that its proposed trademark does not infringe on an existing registered or unregistered trademark.

The risk of trademark infringement is substantial. If a distributor launches its private label brand and that label is later determined to infringe on an existing trademark, then the distributor will likely have to pay damages and its marked inventory destroyed or re-labeled. Worse yet,

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trademark infringement claims typically are not covered under standard insurance policies.

Once the distributor selects a trademark and begins private labeling, it needs to insure that the private label manufacturer does not misuse the trademark. Standard practice is to allow the private label manufacturer a limited license to print the trademark on the distributor's products and no other products. This insures the integrity of the trademark.

A distributor must also manage the risk of patent infringement. Like product liability claims, patent infringement claims can be brought against any party in the chain of distribution of the product. A distributor can and should insist that the manufacturer bear the risk of patent infringement lawsuits. The best way to handle that risk is through contractual indemnity –the same way product liability risk is handled.

Liability for "Counterfeiting"

Some opponents of private labeling warn that a distributor offering private labeled products could be liable for "counterfeiting". Technically, this is an inaccurate criticism of private labeling. "Counterfeiting" is defined as " the act of producing or selling a product with a sham trademark that is an intentional and calculated reproduction of the genuine trademark". Consequently, private labeling is, by definition, not counterfeiting.

Those who warn of "counterfeiting" are actually warning of patent infringement. The manufacture and sale of a product whose design and operation of which is covered by a patent or patent application held by another company could create the risk of patent infringement. As discussed above, a distributor must vigilant about the patent status of the products it intends to purchase from the private label manufacturer and should place the burden of defending patent

infringement lawsuits on the shoulders of the manufacturer.

Conclusion

The "Five-Ton Elephant" of private labeling is in the room. It won't be going away. The distributor who wants to ride the elephant must take the legal steps to insure that its rights are protected and risks minimized. If it does, it can be a profitable ride.

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