PRODUCT RECALL

International Sales, Franchising and Product Liability Law Perspectives in the United States, Canada, Europe, Singapore and China

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INTRODUCTION[1]

This paper examines the issues which arise if there is the need for a product recall of an article that has been sold and distributed under a worldwide franchise agreement from the perspective of international sales, franchising and product law. The paper will examine issues such as contract terms, warranties, choice of law provisions, the rights and liabilities of the various parties involved in the distribution chain, responsibility for the returned product and managing product disposal, dealing with governmental agencies and statutory notification obligations, managing and addressing consumer rights to compensation, managing customer expectations and dispute resolution. Since this topic was first selected, product safety issues relating to imported products have become a major topic in the United States and some other countries.

SCENARIO

Some of the authors' comments refer to the following hypothetical product recall scenario:

MyBicycle is a U.S. company that sells adult and children bicycles and related accessories through company-owned retail outlets in the U.S. and franchised stores throughout the U.S., Canada, Australia, Singapore, Malaysia, Indonesia and Europe. The bicycles that it sells are labeled with MyBicycle trademarks, but the specifications are set by ABC, an English company that manufactures the bicycles in both the United Kingdom and China. Franchisees are instructed that they must buy bicycles only from ABC or one of the wholesale distributors that MyBicycle has placed on an approved supplier list.

In Canada, Australia, Singapore, Malaysia and Indonesia, MyBicycle has an area developer who operates its own franchised stores. In Europe, MyBicycle has appointed master franchisees for several countries, who in turn sell subfranchises to local third party subfranchisees. All of the bicycles sold to the ultimate purchasers are accompanied by MyBicycle's warranty against defects in material and workmanship.

An independent testing laboratory study in the U.S. has concluded that two models of bicycles (one adult model and one children's model) sold by MyBicycle and its franchisees during a period from February 2000 to present may possibly have defective braking systems. Literally thousands of these bicycles have been sold in the U.S., Canada, Australia, Singapore, Malaysia, Indonesia and Europe. After being notified of the problem by MyBicycle, ABC has been able to correct the problem by working with the component part supplier for the brakes and has available a replacement braking system.

MyBicycle approaches you as counsel for the company and inquires as to a recommended course of action. Some issues they have raised are as follows:

Are there reporting obligations to any government agency in the U.S. or any other country in which these two bicycle models are sold?

- Should all the bicycles of the two models made during the suspect period be recalled?
- Who should pay for the costs of the recall?
- What remedy should be offered to the purchasers of the bicycles?
- What obligation does ABC have to pay for the costs of correction?
- What can MyBicycle do with its inventory of the suspect bicycles?

[1] Sections 1, 2, 3 and 7 by Andrew P. Loewinger, Section 4 by Woon C. Yew, Section 5 by Sönke Lund, Section 6 by Veronica Chen, Section 8 by Daniel Urbas.

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1. THE CONTRACTS IN THE INTERNATIONAL FRANCHISING RELATIONSHIP

Franchising is a unique type of licensing arrangement often, but not always, used at the retail level. It typically involves the licensing of business know-how and trademark rights by the franchisor to franchisees in exchange for fees payable to the franchisor. The earliest franchises were product distribution franchises where the primary purpose of the outlet was to distribute branded products – e.g., petroleum products, automobiles, soft drinks, or bicycles. The emphasis in product franchises was principally on the product supply arrangements. Now, by far the more common form of franchise arrangements are business format franchises used by franchisors to sell a variety of types of products or services using a particularly successful or effective method of operation and/or marketing. Business format franchises typically control the operation of the franchised business more strictly than do product franchises. They are used in over 70 different industries and are very flexible business arrangements.

In this paper, we will use the terms "master franchisee" and "developer" to refer to multiple unit franchisees as described below; "franchisee" to refer to any party that has rights to operate a franchised business (whether master franchisee, developer, single-unit franchisee or subfranchisee); and "affiliate" to refer to any entity that is controlling, controlled by or under common control with another entity.

Although there are a number of countries with franchise sales laws and other laws relating to franchising, franchising is principally a creature of contract law.[2] There are a variety of structures used in international franchising. Broadly speaking, there are two basic approaches: direct franchising and master franchising. In direct franchising, the franchisor enters into one or more agreements to license the party – the franchisee or developer – that will operate the franchised business(es). In master franchising, the franchisor grants rights to a party – the master franchisee – to both operate and sublicense others to operate franchised businesses.

Most international franchising agreements require development of multiple franchised businesses. To assure a given market will be penetrated most franchisors insist that the developer or master franchisee commit to a development schedule, i.e., to develop a specified number of franchised businesses according to a pre-established schedule. In some cases, the parties will enter into

1. a pilot shop arrangement to "test the market" for a particular product or service, or
2. a joint venture agreement, e.g., to share the risk, capital expenditures, and permit the franchisor greater control.

Accordingly, in a direct franchise arrangement, franchisors enter into a development agreement and multiple franchise agreements or a multiple unit franchise agreement (with a development schedule) which together grant the developer the right and obligation to establish and operate multiple franchised businesses within the granted territory. The development agreement, if used, contains principally the obligation to develop franchised businesses. The provisions governing the actual operation of the franchised business are contained in the franchise agreement, as described in the following paragraph.

In a master franchise arrangement, the arrangements are typically more complex. Master franchise agreements will contain:

1. development obligations, and
2. a grant of rights to:
   (a) operate franchised businesses (as described in the following paragraph), and
   (b) sublicense to third parties the right to operate subfranchised businesses. In a master franchise arrangement, a subfranchise agreement also must be used for the master franchisee (also known as the "subfranchisor") to grant subfranchise rights to the subfranchisee to operate the subfranchised business. The operational provisions of a subfranchise agreement are described in the following paragraph; they typically are the same type of operational provisions used in a franchise agreement or a master franchise agreement.

The typical franchise agreement provisions governing the operation of the franchised business are the grant of rights to use the marks and business know-how (often called the "franchise system"), location and construction requirements, operation of the business (many of which are in the operating manual), trademark usage, fees, and exclusivity. Provisions

[2] See, e.g., Loewinger, A. and Lindsey, M., *International Franchise Sales Laws* (eds., ABA Press, 2006); and Asbill, R., and Goldman, S., *International Franchising* (eds., ABA Press, 2001).

relating to products, relevant to this paper, are supply arrangements, approved or designated suppliers, warranty, indemnification provisions, and choice of law provisions.

2. PRODUCT SOURCING REQUIREMENTS

One of the hallmarks of a franchise relationship is establishing and maintaining uniform standards. From a legal point of view, this is explicitly required or implied under the trademark laws of many countries. From a business point of view, quality standards enable franchisors to attract customers who will know that at any location bearing the franchisor's marks, there is a well-known quality standard. Franchisors use several methods to set and maintain system standards; the principal ones are setting and maintaining standards and specifications for various products or services and imposing mandatory sourcing requirements from designated suppliers or approved suppliers.

2.1 Standards and specifications

Most franchisors establish designated standards and product or quality specifications for products or services sold and/or used in franchised businesses under their System. The extent to which such standards and specifications will apply to specific items may depend on a variety of factors, e.g., whether the System is a product franchise or business format franchise, the type of business, and the propensity of the franchisor to control the franchised business.

2.2 Designated suppliers

The most important products in any franchised business are those sold to customers. Accordingly, franchisors control the suppliers of the products or the component parts or ingredients used for such products. Some franchises, e.g., product franchises which are closely identified with the franchisor's products, will require the purchase of products from

1. the franchisor or its affiliate, or
2. designated third parties that may private label such products.

Automobile dealerships, petroleum stations, and branded ice cream stores, cosmetic stores, or bicycle specialty stores – to name but a few – are examples of franchises which require purchases from the franchisor or designated third parties. It is not uncommon for franchisors that do not manufacture their own products, but which have products closely identified with its marks, to have such products manufactured under a private label. In cases where franchisors use designated suppliers other than the franchisor or its affiliates, the franchisor must have manufacturing and/or supply arrangements in place to enable its franchisees to have a continual source of product. The structure of the

supply arrangements and some of the important terms are described below.

2.3 Approved suppliers

A very common alternative to designated (or required) suppliers is the use of "approved suppliers." Franchisors will specify several suppliers for specific products or components that are "approved," from which franchisees may then purchase. Such suppliers may be manufacturers or distributors or both. Franchisees are required to use one of the approved suppliers to maintain the franchisor's quality standards. Oftentimes franchisors will provide franchisees the option to propose alternative suppliers, and will provide a mechanism or process for the franchisee to do so. This may be done both for legal and business reasons. Providing a mechanism to approve suppliers may help the franchisor to avoid claims under anti-trust laws or unfair trade practice laws that the franchisor is forcing the franchisee to use only specific suppliers, e.g., by "tying" the purchase of one product to another. This also makes good business sense as franchisees may know better suppliers. Finally, in some franchise systems, where the franchisor exercises less control the franchisees may be free to choose suppliers of their own choice.

Product supply arrangements are crucial in any franchise relationship. A franchisee's failure to comply with requirements to sell in accordance with the franchisor's standards and specification requirements or other product supply requirements typically constitutes a material default under the franchise agreement and subject the franchisee's agreement to termination.

3. IMPORTANT CONTRACT TERMS

3.1 Terms of purchase

Any franchise arrangement that has crucial product supply arrangements should include terms for product purchase. What terms are specified and where such terms are included will depend on a variety of factors, the most significant of which are the identity of the manufacturer and the structure of the distribution arrangements – i.e., whether the franchisor or an affiliate or a third party is the manufacturer; and whether the franchisor (or an affiliate) or a third party distributes the products to the franchisee.

The manufacturer is likely the most important determinant for the types of product terms between the franchisor and the franchisee. If the products are sourced from the franchisor or an affiliate, then the franchisor will want to specify purchase terms, either in the franchise agreement or in a separate supply or product distribution agreement. In such instances, the franchisor would want to require purchase of the franchisor's products; specify price terms, or a pricing mechanism, terms of sale and shipping, risk of loss, etc., as specified in Section 6 of this paper below.

If the products in question are to be purchased from a third-party, such terms are less likely to be included in the franchisor/franchisee agreement(s), but it is possible. Even if the products are to be sourced from a third party the franchisor may negotiate supply terms with the supplier for the System. This has obvious benefits – e.g., guaranteed source of supply; negotiated terms based on volume purchases; possible price terms; warranty terms; terms related to defective products, notification obligations, and recall procedures; and possible indemnification obligations. Such terms would be included in a separate supply or distribution agreement with the supplier, and then may be incorporated into a supply or distribution agreement with either the franchisor or the third party supplier.

Due to the use of franchise manuals, which permit franchisors to adjust certain operational aspects of the franchised business and relationship over time, franchisors have the flexibility to adjust in the manuals certain product supply terms in their franchise agreement. There is an issue as to whether a franchisor may unilaterally alter material terms of the parties' agreement. If, however, the Operations Manual provisions merely adjust, for operational reasons, previously agreed-upon terms, the adjustments in the Operations Manual are likely enforceable.

3.2 Warranties and warranty remedies

Warranties contained in franchise agreements, supply and distribution agreements, and similar agreements will be governed principally by the law set forth in the choice-of-law provision of the agreement. A U.S. franchisor can therefore likely dictate that U.S. law will apply to goods sold by it in the United States or to its U.S. distributors. Under U.S. law, the Uniform Commercial Code ("UCC") as adopted by most states, governs written and implied warranties and provides remedies to both direct purchasers of goods (e.g., franchisees who purchase goods from the franchisor) as well as "remote purchasers," or end consumers in the normal chain of distribution.[3] Remote purchasers will be protected if they receive any written representation as to the goods they receive (use of the word "warranty" is not required). However, the seller can modify or limit a remote purchaser's remedies under the UCC if the modification or limitation is furnished to the purchaser at the time of purchase in the same writing as the warranty.

Subject to any such written limitations, a seller of goods that breaches its warranty will be liable to a remote purchaser for incidental and consequential damages, but not for lost profits. A remote purchaser may also recover damages for any loss resulting in the ordinary course of events as determined in a reasonable manner.[4]

The UCC also provides that implied in every contract for the sale of goods is a warranty that the goods are merchantable. For goods to be merchantable, they must, among other things, be fit for the ordinary purpose for which such goods are to be used; be adequately contained, packaged, and labeled; and conform to any promise or affirmation on the container or label.[5] A second implied warranty under the UCC is a warranty that the goods are fit for a particular purpose, where the seller has reason to know of the particular purpose and the buyer is relying on the seller's skill or judgment.[6] A written contract between a buyer and seller can negate or limit either of these implied warranties if specific language is set forth in the written warranty and is conspicuous.[7]

When the buyer and seller of goods are located in different countries, the United Nations Convention on Contracts for the International Sale of Goods (1980) ("CISG Treaty") may govern the transaction.[8] The CISG Treaty will apply if the buyer's and seller's home countries are both signatories of the CISG Treaty, or if international law dictates that the law of a signatory country applies to the transaction.[9] The parties to an international agreement for the sale of goods may agree to exclude application of the CISG Treaty or modify the effect of its provisions.[10]

The CISG Treaty, like the UCC, implies warranties into all contracts for the sale of goods. Under the CISG Treaty, a seller must deliver goods that are of the quantity, quality, and description required by the parties' contract and are contained or packaged as required by the contract. Unless the parties agree otherwise, goods do not conform with the contract unless they are:

(i) fit for the purpose for which goods of the same description would ordinarily be used;

(ii) fit for any particular purpose expressly or impliedly made known to the seller;

(iii) possess the qualities of goods which the seller has held out to the buyer as a sample or model; and

(iv) contained or packaged in the manner usual for such goods.[11]

If goods do not conform with the contract, the buyer may require the seller to repair the goods. If the lack of conformity constitutes a fundamental breach of the contract, the buyer may require delivery of substitute goods. The buyer has two years from the date it receives the goods to request repair or delivery of substitute goods. The buyer must provide a reasonable length of time for the seller to perform and during that period may not resort to any remedy for breach of contract.[12] A buyer of non-conforming goods also has the option of reducing the price paid for the goods based on the reduced value of the goods delivered.[13]

If the seller breaches the contract, the buyer may seek damages equal to the loss, including loss of profit,

[3] See UCC §§ 2-313 to 2-318.
[4] See UCC § 2-313A(5).
[5] See UCC § 2-314.
[6] See UCC § 2-315.
[7] See UCC § 2-316.

[8] See Baer, J.R.F., "The Sale of Goods in International Franchising — The Impact of the UN Convention on Contracts for the International Sale of Goods", *Journal of International Franchising and Distribution Law* (Vol. 8, No. 4, 1994).
[9] See CISG Treaty, Article 1.
[10] See CISG Treaty, Article 6.
[11] See CISG Treaty, Article 35.
[12] See CISG Treaty, Articles 46 and 47.
[13] See CISG Treaty, Article 52.

suffered by the buyer due to the breach. However, such damages are limited to what was foreseeable to the seller at the time of the conclusion of the contract.[14] If the buyer purchases replacement goods, the seller will also be liable for the difference between its contract price and the price of the substitute goods. [15]

3.3 Defective product responsibility: Magnuson Moss Warranty – Federal Trade Commission Improvement Act

In the United States, if a seller (e.g., a franchisor) wishes to extend its own written warranty to the end consumer, the seller must comply with the Magnuson - Moss Warranty – Federal Trade Commission Improvement Act, 15 U.S.C. §§ 2301 et seq. (the "Warranty Act"). The Federal Trade Commission ("FTC") administers the Warranty Act. Under the Warranty Act, a written warranty must "fully and conspicuously disclose in simple and readily understood language the terms and conditions of such warranty." For example, the warranty must identify, among other things:

- the names and addresses of the warrantors;
- the party or parties to whom the warranty is extended;
- the products or parts covered;
- what actions the warrantor will take in the event of a defect, malfunction, or non-conformity;
- any exceptions or exclusions to the warranty;
- what actions the consumer must take to obtain performance under the warranty;
- any informal dispute settlement procedures;
- legal remedies available to the consumer; and
- timing requirements.[16]

The FTC has adopted an implementing rule on these disclosure requirements.[17]

The Warranty Act requires that each consumer warranty be designed as either a "Full (statement of duration) Warranty" or a "Limited Warranty." A "Full Warranty" must meet the federal minimum standards for warranties set forth in the Warranty Act. To meet these standards, the warrantor must remedy a product within a reasonable time and without charge, and the warrantor may not exclude or limit consequential damages for breach of any written or implied warranty, unless such exclusion or limitation conspicuously appears on the face of the warranty. In addition, if a product is defective or malfunctions, and cannot be remedied by the warrantor after a reasonable number of attempts, the consumer can elect to receive a refund or a replacement without charge.[18] Because most consumer warranties do not meet these requirements, they are a "Limited Warranty."

The Warranty Act also requires that the text of the written warranty be made available to the consumer prior to sale.[19] The FTC has an implementing rule on what the warrantor and its retail sellers must each do in order to make the warranty available prior to sale.[20] A franchisor that wanted to extend its written warranty to the consumer purchaser would have to provide its franchisees as the retail seller with the materials needed to fulfil this obligation.

A warrantor can designate a representative to perform duties under a written or implied warranty.[21] For example, a franchisor could designate its franchisee to perform warranty services but must make "reasonable arrangements for the compensation" of the representative. A franchisor that wants its franchisees to perform warranty services should write language into its franchise agreement obligating the franchisee to perform such services. A warrantor can only limit the duration of implied warranties that arise under the UCC to the same duration as its written warranties, so long as the duration is reasonable and set forth conspicuously in the written warranty.[22]

Under the Warranty Act, a warrantor may establish an informal dispute settlement procedure, so long as it meets the requirements of the FTC Rules under the Act.[23] A consumer must resort to such procedures, if established, prior to pursuing a legal remedy under the Act. When permitted, consumers may bring a civil action against a warrantor for damages, including attorneys' fees. The automobile industry uses this procedure more than any other industry group. The Warranty Act also permits the Attorney General and the

[14] See CISG Treaty, Article 74.
[15] See CISG Treaty, Article 75.
[16] See Warranty Act, § 2302(a).
[17] *See* FTC Rule on Disclosure of Written Product Warranty Terms and Conditions, 16 C.F.R. § 701.
[18] See Warranty Act, § 2304.
[19] See Warranty Act, § 2302(b)(1)(A).
[20] *See* FTC Rule on the Pre-Sale Availability of Written Warranty Terms, 16 C.F.R. § 702.
[21] See Warranty Act, § 2307.
[22] See Warranty Act, § 2308.
[23] See 16 C.F.R. Part 703.

FTC to seek injunctions against warrantors who violate the Act.[24]

A franchise arrangement or product distribution agreement clearly should address warranty issues. If the franchisor is the manufacturer or supplier, then it would have more control over the warranty terms which can be detailed in the operations manual. If, however, there is a third party manufacturer and distribution, the warranty terms should be addressed in the supply or distribution agreement. That said, the franchisor may nonetheless may – at a minimum – want to reference warranty and recall issues in the relevant franchise agreements and address them in greater detail in the Operations Manual.

3.4 Notification and recall procedure under the Consumer Product Safety Act

The Consumer Product Safety Commission ("CPSC") regulates most consumer products sold in the United States under the United States Consumer Product Safety Act ("CPSA") and four so-called transferred acts.[25] The CPSC can promulgate regulations, called consumer product safety standards, pursuant to which the CPSC can establish safety requirements for certain products. The very first regulation adopted by the CPSC after it came into existence in 1974 was the Federal Bicycle Safety Regulation, adopted under one of the transferred acts, that sets forth requirements for a bicycle.[26]

Over the years, the CPSC has adopted fewer product safety standards and has used as its primary enforcement tool the so-called Section 15(b) obligations of parties in the distribution chain to self-report products that violate a consumer product safety standard or otherwise are a substantial product hazard. Section 15(b) of the CPSA requires a manufacturer, importer, distributor and retailer of a consumer product to immediately inform the CPSC if any of its products fails to comply with an applicable consumer product safety rule or voluntary consumer product safety standard, contains a defect that could create a substantial product hazard, or creates unreasonable risk of serious injury or death. The CPSC may order the manufacturer, importer, distributor, or retailer of a defective product to give notice to the public and/or notice to each individual consumer who purchased the defective product. The CPSC may also seek an injunction to restrain the distribution of a defective product until the problem is resolved in accordance with the CPSA.[27] In addition to the above reporting requirement, a manufacturer of a consumer product that has been the subject of at least three civil actions in a 24-month period that have been filed for death or grievous bodily injury, and are resolved in favor of the plaintiff, must report such actions to the CPSC.[28]

The CPSC's reporting procedures are set forth in its regulations.[29] There is a very short time within which to report, and failure to report in a timely fashion can result in substantial fines. The CPSC has also issued a "Recall Handbook" to assist manufacturers, importers, distributors, and retailers in complying with the reporting requirements under 15 U.S.C. §§ 2064 and 2084.[30] The Recall Handbook describes the CPSC's "Fast Track Product Recall Program," which is designed for companies willing and able to move quickly with the voluntary recall of a product. The fast track program eliminates some of the procedural steps in the recall process. Under this program, if a company reports a potential product defect and, within 20 business days, implements a voluntary recall, the CPSC will not make a preliminary determination that the product has a defect that presents a substantial product hazard.

The Recall Handbook outlines steps for putting together a corrective action plan which is quite useful. Companies should have a recall plan in place and be prepared to address some of the following issues: what is the defect that causes the product hazard; what caused the product defect; where are the unsafe products; have the government and/or appropriate regulatory bodies been advised; has the company discontinued production and shipment of the products and notified retailers to stop selling the products; has the company started to review databases re potential product owners; has a press release been prepared; and is there a plan to ship replacement parts. See also Section 8.9 of this paper.

A company's recall program should be comprehensive and have three objectives: (1) to locate defective products as soon as possible; (2) to remove defective products from the distribution chain; and (3) to communicate reliable information in a timely fashion to the public about the product defect, risk, and

[24] See Warranty Act, § 2308.

[25] See 15 U.S.C. §2051.

[26] See 16 C.F.R. Part 1512 (adopted under the Federal Hazardous Substances Act).

[27] See 15 U.S.C. § 2064.

[28] See 15 U.S.C. § 2084.

[29] See 16 C.F.R. Part 1115.

[30] The Recall Handbook, dated May 1999, is available at www.cpsc.gov/businfo/ 8002.html.

corrective action. Communication is very important; a company involved in a recall should be creative and cast a wide net to communicate recall information, including use of press releases, information on the website, videos, new releases, posters, and use of toll-free phone numbers. Finally, a recall coordinator should be put in place with a clearly defined role. Recalls are more effective in situations where the retailer maintains a record of each purchaser of a consumer product, which happens in certain segments of the independent bicycle dealer segment of the bicycle market in the U.S.

3.5 Independent contractor

It is axiomatic in franchising that the franchisor/franchisee relationship is an independent contractor relationship, not an agency, employer/employee, partnership, or joint venture relationship. Accordingly, in theory, a franchisor is able to shield itself from liability to third parties for the acts or failure to act of its franchisees. That said, not all courts have agreed and there have been some extreme cases in the United States where franchisees are alleged or deemed to be employees or agents of the franchisor. Furthermore, vicarious liability claims are very frequently raised in franchise disputes where there is injury to a third party, as third parties seek to ascribe liability to franchisors for franchisee actions; these are typically based on various agency theories.

3.6 Insurance requirements

As the franchisor-franchisee relationship is one of independent contractors, franchise agreements typically require franchisees to obtain their own liability insurance for claims related to their operation of a franchised business. The franchise agreement will specify the types of insurance coverage, minimum required liability coverage, and that the franchisor must be named as an additional insured. That said, franchisors may not specifically require that a franchisee maintain product liability coverage, and general comprehensive insurance policies may not include such coverage, without an additional policy, amendment, or rider. A franchisor that sells products would be well advised to carry its own products liability and recall insurance.

3.7 Indemnification

Indemnification provisions are typically provided in franchise agreements whereby the franchisee will indemnify the franchisor for third party claims, legal actions, damages and expenses for matters arising out of the franchised businesses. The extent of the franchisee's indemnity obligation will depend on the scope of the indemnity provision. There are occasionally exceptions for matters arising directly out a franchisor's obligations, the franchisor's negligence or reckless misconduct, or products supplied by the franchisor. Seldom do franchise agreements provide that the franchisor will indemnify the franchisee for the failure of the franchisor's products.

3.8 Governing law and dispute resolution

It is common for franchise agreements to specify governing law and how disputes will be resolved. The parties' agreement on governing law will likely be enforceable for most matters, with the exception of those areas where national law would govern as a matter of public policy[31], such as trademarks, anti-trust, or bankruptcy. Other areas also likely to be governed by national law as well, e.g., matters arising under product safety law, confidentiality and non-competition. Most franchisors in international arrangements will provide for dispute resolution by international arbitration, as many counties are party to the 1958 United Nations Convention for the Recognition and Enforcement of Foreign Arbitral Awards ("New York Convention"). The New York Convention provides a framework for international disputes to be recognized and enforced in over 100 countries, subject to a relative handful of exceptions (e.g., fraud and decisions that are contrary to public policy in the enforcing country).

[31] Civil law lawyers would call this "mandatory law".

4. SOURCING OF PRODUCTS

Franchisors usually offer their franchisees a unique branding, and, where the focus of the franchise program is to distribute, a business model which includes a range of products for sale to end-consumers. Franchisors may not be the manufacturers of these products, and it is not uncommon for the franchisors to source these products from third parties.

4.1 Methods of sourcing a product

In sourcing for the supply of the products from third party manufacturers, and in the subsequent re-sale to franchisees, franchisors will have to bear in mind product liability issues. These issues include the infringement of third party rights as well as damages arising from defective design/manufacturing.

Sometimes, as discussed in Section 2.2 of this paper, franchisees are directed by the franchisors to purchase products from approved suppliers. The contract for the sale and purchase of these products will then be entered into directly between the franchisee and the supplier, and the franchisor may not be part of the supply chain.

Where the Products Are Designed / Manufactured to the Franchisor's Specifications
Where the products are designed or manufactured to the franchisor's specifications, the franchisor will bear the responsibility of infringement of third party rights. To minimize the franchisor's liability to franchisees, the franchisor will have to ensure that the manufacturer manufactures the products in accordance with the franchisor's specifications, and provides a warranty and an indemnity to the franchisor in the event that there is any manufacturing defect or non-compliance with specifications. Where the manufacturer supplies the products directly to the franchisee, the franchisor should also ensure that the manufacturer provides a similar warranty and indemnity to the franchisee.

Where the Franchisor Simply Sources Products Produced by Third Party Manufacturers without Specifying Any Particular Requirements
Where the franchisor simply sources products produced by third party manufacturers without specifying any particular requirements, the franchisor runs the risk that the products may infringe upon third party intellectual property rights and may have defects in design or workmanship. As the franchisor does not dictate the specifications, it is very important for the franchisor to obtain warranties and indemnities from the manufacturer for damages, costs and expenses arising in such situations, including recalls. Similarly, a franchisee who obtains the products directly from the manufacturer should ensure that it gets the benefit of such warranties and indemnities.

Limitations on Manufacturer's Liability
Any limitation on the liability of the manufacturer will have to take into account:

(a) the franchisor's liability in the event of any claim by the franchisees or the end-consumers; and

(b) the franchisee's liability to consumers.

Limitations on the manufacturer's liability may result in the franchisor/franchisee being exposed to liability, so it is important for the franchisor and franchisee each to obtain insurance to minimize its exposure. It would also be prudent for the franchisor to insist that the manufacturer carry appropriate insurance naming the franchisor and its franchisees as additional insureds.

4.2 Supply of products

A franchisor will have to ensure that its franchisees have sufficient supply of products to enable the franchisees to meet market demand. The franchisor will therefore have to:

- keep an inventory of products for supply to its franchisees;
- ensure that the franchisees' orders for products can be met promptly by back to back orders with the manufacturer; or
- ensure that the approved suppliers are able to meet the franchisee's demands.

The fulfilment of back to back orders will be of critical importance as the franchisor wants to avoid payment of liquidated damages (if any) and claims for breach of contract for failure to supply product in a timely fashion to its franchisees.

If the franchisor has an inventory of products on hand, and supplies the products directly to the franchisee upon receiving an order from the franchisee, the franchisor is in a position to ascertain whether the products supplied are in good condition or whether they are defective.

If the franchisor does not have products on hand, and requires a third party manufacturer to deliver the products to the franchisee directly, it will not be easy for the franchisor to determine whether the products delivered by the manufacturer to the franchisee arrive in good condition. In such situations, the franchisor has to ensure that:

(i) its contract with the third party manufacturer specifies the consequences if the products are found to be defective by the franchisee upon receipt. Such consequences may include the rejection of the products, the franchisor being relieved of the liability to pay for the products, the obligation of the manufacturer to make another delivery of the products ordered as soon as possible, the manufacturer's responsibility for all damages, costs and expenses in connection with the defective products; and

(ii) its contract with the franchisees require the franchisees to inform the franchisor as soon as possible of any defect in the products specifying full details of the defect.

If the franchisees purchase the products directly from the approved suppliers, the franchisor is relieved to a large extent on the issues relating to defective products as such issues will be dealt with directly by the franchisee and the supplier. However, in the event that the products supplied by any supplier are found to be constantly defective, the franchisor will have to take steps to remove the supplier from the list of approved suppliers, otherwise the reputation of the franchised business may be adversely affected.

Use of Subcontractors

One of the biggest concerns a franchisor may face is the foreign manufacturer outsourcing the manufacture of certain components or the entire product to third party subcontractors without the franchisor's knowledge. This apparently has happened in several well-publicized recent defective imported product cases in the U.S. The franchisor should insert a provision in its supply contract that prohibits the manufacturer from using the services of a subcontractor without the franchisor's prior written consent.

4.3 Terms of supply

The terms of supply of the products will affect the ability of the purchaser to inspect the products delivered.

If the supply is Ex-Works (Incoterms 2000) from the manufacturer's factory or FOB (Incoterms 2000) the manufacturer's port of export, the purchaser (regardless of whether it is the franchisor or the franchisee) will usually have to rely on its appointed freight forwarder to inspect the products to ascertain whether there is any defect.

If the supply is CIP (Incoterms 2000) to the purchaser's premises, then it is possible for the purchaser to inspect whether the products are defective.

The parties may agree on other terms of supply. This article is not intended to deal exhaustively with the consequences of the different supply terms, but merely highlights the fact that the ability of the purchaser to inspect the goods personally depends on the terms of supply, in particular, the location for the delivery of the products.

In many foreign supply arrangements, the franchisor might employ the services of an inspection organization near the site of manufacture or at the point of shipment which can inspect the products prior to their being shipped.

4.4 Rejection of products

The vendor (whether the franchisor or the manufacturer) will usually set out the circumstances under which the purchaser (whether the franchisor or the franchisee) may reject products. Does the purchaser have to reject the products within a certain period upon delivery, failing which the products shall be deemed to have been delivered in good condition? If the products are not rejected upon delivery, does the purchaser have the right to reject the products subsequently?

The following are examples of circumstances under which the purchaser may reject products:

- where a significant portion (for example 15%) of the products delivered do not meet the specifications in a purchase order;
- where a significant portion (for example 15%) of the products delivered are defective; or
- where the products delivered do not meet or are in excess of the quantity ordered by the purchaser.

4.5 Ability to reject products after delivery

It is important for a franchisor to ensure that its contract with the manufacturer allows the franchisor to reject the products even after the franchisor has accepted the delivery of the products because defects

may not be apparent at the time of delivery. As a matter of fact, the defect may not become apparent until the product is delivered to the franchisee for resale.

If the franchisor in turn also allows the franchisee to reject the products subsequent to delivery, the franchisor must put in place a system to ensure that the franchisee stores the products appropriately, and that any damage/non-conformity of the products discovered subsequently is not due to the franchisee's default.

It is useful for the franchisor to specify the circumstances under which the franchisee may reject products subsequent to delivery. It is suggested that any rejection of products subsequent to delivery should not be for causes which are apparent upon delivery.

In order to minimize disputes and time required to look into whether the subsequent rejection of products are for justifiable reasons, the franchisor may wish to adopt other measures, such as:

- placing a limit on the products which may be rejected subsequent to delivery; or
- imposing a deadline by which all products will be deemed accepted.

In order for the franchisor to minimize its own exposure, it will have to make back to back arrangements with the manufacturer of the products. The franchisor should have a written understanding with the manufacturer as to who will take responsibility for, and bear the costs associated with, a defective product, whether involving breach of warranty, injury to person or property, or recall.

4.6 Warranty

Where the franchisor is not the manufacturer of the products, it will have to ensure that the manufacturer provides a sufficiently long warranty period such that any defective products may be returned to the manufacturer for repairs, replacement or refund at no additional charge, and with the remedy at the franchisor's option.

In certain cases, it may be impractical to return products to the manufacturer for repairs, and it may be preferable for repairs to be done locally in the country in which the defective product is located. In such cases, instead of requiring the manufacturer to repair the products during the warranty period, the purchaser (whether franchisor or franchisee) may try to negotiate for the manufacturer to bear the costs of repair incurred by the purchaser instead.

This would usually not be acceptable to the manufacturer for the following reasons:

- the manufacturer would not be able to ascertain whether the product is defective, and falls within the terms of the warranty;
- the manufacturer would not want to incur the costs of repair being done by a third party; and
- repair undertaken by third parties may cause further damage to the products.

4.7 Repair facilities

If it is impractical to return the product to the manufacturer for repairs, the franchisor may have to set up a facility for repairing defective products. Franchisees may be required to undertake repair work, or the franchisor may appoint a third party to undertake such work for all products sold within its franchised system. The system for the franchisee to undertake repair work on behalf of the franchisor, and the remuneration of the franchisee for such work will have to be set out clearly, as the franchisee is somewhat in a situation of conflict. Since the franchisor is likely to pay the franchisee for repair work during the period of warranty, the franchisee is able to increase its own turnover by carrying out repair work (whether or not any work is required).

Repair work carried out after the warranty expires is less problematic as the end-consumer will be paying the franchisee for such work.

Often times repair is impossible or not practical. It is for that reason that the franchisor will want to have available the alternative remedies of replacement or refund.

4.8 Product recall

If there is a manufacturing defect resulting in the need to recall the products from the market, there will be implications for all parties involved in the supply chain. A party's liability will depend very much on:

(a) whether it is subject to the regulations in the country in which the recall is taking place;

(b) its contractual arrangement with the other parties in the supply chain; and

(c) whether it has any contractual obligation to the end-consumer.

A manufacturer or supplier of the product may not be within the jurisdiction of the country in which the recall takes place, so its liability is limited to its

contractual liability to the other parties in the supply chain. The local franchisee will definitely be within the jurisdiction, and will have the greatest exposure in the case of a product recall. In addition to its liability to the end-consumers, it will also be answerable to the regulatory authorities in the country of recall. The franchisor would normally also be out of jurisdiction, but a responsible franchisor which values the continuity and viability of its franchise system should assist its franchisees in the case of a product recall, regardless of whether or not the franchisor is able to claim against the manufacturer.

To minimize its exposure in the case of a product recall, a franchisor will have to ensure that the manufacturer indemnifies the franchisor for all damages, costs and expenses in the event of any defect in the products. As mentioned in Section 4.1 above, any limitation on the manufacturer's liability will have to be considered very carefully.

Where the franchisor provides the franchisee with a list of approved suppliers with whom the franchisee contracts for the sale and purchase of the products directly, it is in the interest of the franchisor to ensure that the supplier provides the franchisee with an indemnity against damages, costs and expenses in the event of any defect in the products. Although it may be expensive, it may be prudent for the manufacturer and/or franchisor to carry recall insurance.[32]

5 DEALING WITH A DEFECTIVE PRODUCT: REGULATORY ISSUES

5.1 General regulations concerning product safety in Europe and the United States: legal aspects and experience, and consequences for the industry

European and U.S. regulators face identical challenges in this field. Many products are sold on both the U.S. and the European Union markets, so often a product identified as defective on one market can still be circulating on the other. Consumer product safety is one of the specific fields mentioned in the EU-U.S. guidelines for regulatory cooperation and transparency negotiated under the Transatlantic Economic Partnership (TEP), launched May 1998.

Europe

In the European Union this matter has been dealt with by means of Directives, especially the Directive 85/374/ECC on the approximation of the laws, regulations and administrative provisions of the Member States concerning liability for defective products, and the more recent Directive 2001/95/CE on General Product Safety (GPSD). These two Directives cover each an important aspect of the Product Liability field in Europe. The first one aims at establishing a common liability system, in order to harmonize the different pre-existing national regulations, with a view to protect consumers' interests and remove some of the barriers inside the Single Market. The purpose of the second Directive is to ensure that products placed on the market are safe. It also defines clear obligations both for the member States (and the competent authorities appointed thereby) and for the economic operators involved.

Member States have diversely implemented those Directives; this entails that some significant differences between Member States are still visible, with the subsequent economic impact. Nevertheless, the European regulation in this field is only meant to supplement, approximate and set series of minimum obligations for national regulations but do not aim at excluding such domestic regulations.

United States

The product liability system in the United States varies from state to state and has been developed through the case-law jurisprudence. Product liability law can also be found in Article 2 of the Uniform Commercial Code which with the sales of goods and it has been adopted by most states. The most important product liability sections are the implied and express warranties of

[32] See Section 5.10.

merchantability in the sales of goods.[33] Product liability is also derived from the common law tort concepts of negligence and strict liability.

The European Union ("EU") regulator has decided to adopt a liability system based on the producer's strict liability (liability is determined by the objective fact of the defectiveness of the product rather than by the producer's fault). On the contrary, in the U.S., doubts about strict liability regulations have led the courts to initiate a "return to negligence" approach by curtailing the use of the consumer-expectation test in favor of the risk-utility approach, especially in cases of defects in design. There, the idea gaining ground is that the interests of producers and consumers are not served by a system relying so heavily on civil litigation. At the same time, manufacturers are finding it increasingly difficult to obtain adequate third-party insurance cover whilst it is feared that excessive damage awards are discouraging innovation.

5.2 Market watch by national authorities

In order to secure the safety of products in the global market, it has become necessary to establish an efficient system of market surveillance between the Member States in the EU. Each of the Member States has appointed authorities competent to monitor the compliance of products with the general safety requirements. Producers and distributors must promptly inform these National Authorities every time they know or ought to know about a risk posed by a product.

The Directive 2001/95/EC on General Product Safety establishes a series of measures to fulfill effective market watch. According to art 8.1 a), the competent authorities of the Member States are entitled to organize for every kind of product appropriate checks on its safety properties even after it has been placed on the market as being safe. Further on they ought to require all necessary information from the parties concerned and finally take samples of products and subject them to safety checks.

To ensure effective market surveillance aimed at guaranteeing a high level of consumer health and safety protection, which implies cooperation between their competent authorities, Member States shall make sure that approaches employing appropriate means and procedures are put in place, which include in particular:

- establishment, periodical updating and implementation of sectoral surveillance programmes by categories of products of risks and the monitoring of surveillance activities, findings and results;
- follow-up and updating of scientific and technical knowledge concerning the safety of products; and
- periodical review and assessment on the functioning of the control activities and their effectiveness and, if necessary, revision of the surveillance approach and organization put in place.

In order to increase the quality of the market surveillance throughout the European Union, National Authorities have formed a network of rapid exchange information for dangerous non-food products called RAPEX. The system ensures information about dangerous products identify in the Member States is quickly circulated between the Member States and the Commission (i.e., some of the national authorities are the Instituto Nacional de Consumo in Spain, the Direction Générale de la Concurrence, de la Consommation et de la Répression des Fraudes in France, the General Product and Services Safety / Rapex Unit of the Consumer and Competition Policy Directorate in the UK, the Bundesanstalt für Arbeitsschutz und Arbeitsmedizin in Germany and the EFTA Surveillance Authority)

Art. 10 of the Directive 2001/95/EC manifests that, one of RAPEX's main objectives is the establishment and execution of joint surveillance and testing projects. Note: RAPEX is not only composed by Member States Authorities, but also by other European countries within EFTA.

In the U.S., products sold there may be subject to the jurisdiction of and possible reporting requirements of a variety of federal agencies, each with its own interpretive regulations. The Consumer Product Safety Commission ("CPSC"), for example, has jurisdiction over most consumer products including toys, bicycles, appliances, furniture and playground equipment.[34]

[33] See Section 3.2.

[34] See Section 3.4.

Automobiles, trucks, motorcycles and their component parts are within the jurisdiction of the Department of Transportation, as regulated by the National Highway Traffic and Safety Administration ("NHTSA"). The Bureau of Alcohol, Tobacco and Firearms enforces federal laws and regulations relating to alcohol, tobacco products, firearms and explosives. Food, drugs, cosmetics, radiation related products, medical devices and veterinary medicines are within the jurisdiction of the Food and Drug Administration. The Environmental Protection Agency has jurisdiction over pesticides, rodenticides, and fungicides. The United States Coast Guard has jurisdiction over boats and other watercraft, including personal watercraft. Each of these agencies has its own regulations and guidelines that affect safety issues.

As far as food surveillance is concerned, see Section 5.11 below.

5.3 Manufacturer's recall or crisis management, compliance and distribution structuring

The Directive relies on a general safety requirement principle according to which producers shall be obliged to place only safe products on the market.

The norm sets additional obligations for producers mainly regulated in Art. 5. Within the limits of their respective activities, producers shall indeed adopt measures commensurate with the characteristics of the products which they supply, enabling them to:

- be informed of risks which these products might pose; and
- chose to take appropriate action including, if necessary to avoid these risks, withdrawal from the market, adequately and effectively warning consumers or recall from consumers.

It is likewise further determined that recall shall take place as a last resort, where other measures would not suffice to prevent the risks involved, in instances where the producers consider it necessary or where they are obliged to do so as a consequence of a measure taken by the competent authority. It may be carried out within the framework of codes of good practice on the matter in the Member State concerned, where such codes exist.

5.4 Risk assessment methodology and notification guidelines for dangerous products

Franchisors selling products should have a written procedure for how they would carry out a risk assessment and take corrective action for a potentially unsafe product. To determine whether a corrective action is needed it is necessary to assess the risk. The franchisor should establish a small team with experience of the product and hazards involved.

Risk assessment usually has several phases incorporating following principles: identify the hazard, estimate the level of risk, assess the acceptability of risk and evaluate the overall risk.

When identifying the hazard, the economic operators in charge of it should in particular analyze the information they have collected and try to determine what the nature of the hazard is, its cause, what is the rage of products affected, who is affected by the hazard and what factors could affect the severity and probability of the injury.

After having collected this information, it is important to estimate the level of risk, in order to better decide which is the most suitable action to take. Estimating the risk depends on the following two factors: the severity of the possible injury to a person using or otherwise coming into contact with the product; and the probability of the possible injury. The severity and the probability estimates are combined to give an overall risk estimation.

Having estimated the level of risk, economic operators also have to decide whether they need to take action. They must therefore assess whether or not the level of risk is acceptable to consumers. Certain types of products (such as tools or machines with sharp blades) have obvious hazards that are accepted by consumers if they consider that the manufacturer has taken appropriate safety measures. For products likely to be used by more vulnerable people, consumers would not accept anything more than a very low level of risk.

Having evaluated all these factors, an overall risk assessment has to be made. It may be expressed as one of the following levels:

- serious risk – requiring rapid action;
- moderate risk – requiring some action; and
- low risk – not generally requiring action for products on the market.

The General Product Safety Directive includes the obligation for producers and distributors to provide information on findings and measures concerning dangerous products to the competent authority, as soon as they are aware of it. To ensure the compliance with this obligation, the Commission established Guidelines to help economic operators such as producers and

distributors to carry out these kind notifications to the competent authorities.

If the overall risk is judged to be serious enough, economic operators should make the competent authorities aware of:

- information enabling a precise identification of the product or batch of products affected;
- a full description of the risk presented by the product;
- all available information relevant to the tracing of the product; and
- a description of the actions taken (and planned) to protect consumers.

With this information the authorities may be able to help producers and distributors to carry out the corrective actions more effectively.

5.5 Operational aspects – process and results of product recalls

Both when withdrawing a product from the market as when recalling it from consumers, there are mainly two phases that must be carried out by the producer: collecting the products and correcting them.

If products are to be returned to the producer, it will need to:

- arrange to collect them from distributors;
- ask consumers to take the product to their nearest distributor or retailer if they are portable; and
- arrange for them to be collected from the consumer if they are not portable.

Unsafe products should be clearly identified and the stock movements properly recorded. The distributor should check the identity of the product and compensate the consumer with a repair, replacement or a refund. See Section 4.7 of this paper.

If the liable party offered to repair or rectify the consumer's product, it may:

- have this carried out by an agent of a dealer at their premises; or
- send and engineer to the consumer's home to carry out the modification.

Modified products should be marked accordingly.

Further, it is also important to decide what to do with the products which have been recalled. It may be acceptable to:

- carry out work that will bring the product up to an acceptable standard for resale. Products that have been rectified need to be clearly marked and the documents accompanying them may need to be updated; or
- rework some of the materials or components to enable them to be reused in other products.

It is not acceptable to sell or pass on uncorrected products to consumers, either to consumers in that country, or in the country of manufacture, or in a third country (by export). If they cannot be corrected or reworked, it will be necessary to ensure that the products are disposed of safely.

5.6 Identification of manufacturer and traceability

The Directive 85/374/ECC established a product liability system based on the producer's liability (may he have incurred in fault or not). As supply chains are often really complex, including numerous suppliers, distributors, importers, wholesalers, retailers, etc., it is important to establish a tidy traceability system.

Traceability is not only of utmost importance in order to determine who the liable person is. It is indeed indispensable to make a withdrawal or a product recall effective.

The "Product Safety in Europe Guide to Corrective Action Including Recalls" issued by PROSAFE (among others) recommends that the work needed to trace products and their owners be started as soon as actions to be taken are decided. These activities need to be coordinated, if possible, by the company's corrective action team, but if the corrective actions are taking place in different countries, it may be important to delegate them to a local agent.

But it is also highly recommendable to foresee a product traceability plan, before any incident has taken place. Such plan should include an identification system in order to be able to identify the affected products, to keep a customer database, and also a supplier database.

Although attaching identifying numbers or marks to some products is difficult or even impossible, producers need to recognize that this may make it more difficult to trace products later. The Directive

establishes that producers need to mark products with a serial number so that the individual products affected can be identified. Otherwise the consequence might be that they may have to carry out corrective action on more products than necessary. For some types of products it may be enough to be able to identify a batch number. Bar codes are widely used for identifying and tracing different types of product.

5.7 Self-denunciation: consumer products and the obligations of the supplier

In order to prevent risks for consumer, the Directive establishes an obligation for producers and distributors. When they know or ought to know on basis of the information in their possession and as professionals, that a product that they have placed on the market poses risks to the consumer that are incompatible with the general safety requirement, they should inform immediately the competent authority. This Self-Denunciation of the consumer product as a product that could pose risk, should be announced in the Member State where the product has already been marketed or otherwise supplied to consumers.

Therefore the notification guidelines mentioned above set by the Commission should help the producers and distributors to realize an immediate and rapid information exchange. This notification shall include in event of a serious risk at least:

- information enabling a precise identification of the product or batch of products in question;
- a full description of the risk that the products present;
- all available information relevant for tracing the product; and
- a description of the action undertaken to prevent risks to consumers.

If the requirements of a RAPEX notification are fulfilled (serious risk, product marketed in several Member States), the competent authority must send a RAPEX notification to the Commission, which will then transmit it to all the Member States. Every Friday the Commission publishes a list of dangerous products reported by any national authority (RAPEX notifications). It contains all necessary information of a product, its risk and the measures, that have been taken.

5.8 Consumer protection vs. correction measures in distribution structures

It is clear that the main challenge when regulating product liability is to find the adequate balance between the protection of consumers' interests and spreading the cost of risk equitably throughout society.

Whilst consumer protection regimes are often compulsory, allocation of liability between the parties in distribution structures by means of liability clauses in the relevant agreements (privity) is possible.

The EU 80's Directive establishes as a general rule that liability will lie on producers' shoulders, though the burden of proof relies on the claimant. Nevertheless, this does not preclude the possibility to include many contractual clauses and remedies which can be used in order to share, mitigate or avoid the costs of such liability. The EU regulation sets clearly that liability will never be avoidable (unless any of the listed defenses concur), but its economic impact is freely disposable by economic operators.

Risk allocation is indeed one of the main functions of any contract, may it deal with sale of goods or not. As supply chains are often very complex and their different links may be each bonded by diverse contracts (including insurance ones), it might be very difficult to determine who is finally going to bear losses of a correct consumer protection policy.

5.9 Product liabilities: when is the product safe – type approval vs. general product safety

The 85/374/CEE Directive established a liability system based on the defectiveness of a product rather than on fault. This implies that the arising of liability will depend on the determination of whether a product is safe or not. This is one of the main contributions of the recent Directive 2001/95/EC, who sets a definition of what shall be understood under the concept of "safe product". According to article 2 b) of the above-mentioned Directive:

" 'Safe product' shall mean any product which, under normal or reasonably foreseeable conditions of use including duration and, where applicable, putting into service, installation and maintenance requirements, does not present any risk or only the minimum risks compatible with the product's use, considered to be acceptable and consistent with a high level of protection for the safety and health of persons, taking into account the following points in particular:

- the characteristics of the product, including its composition, packaging, instructions for assembly and, where applicable, for installation and maintenance;
- the effect on other products , there it is reasonably foreseeable that it will be used with other products;
- the presentation of the product, the labeling, any warning and instructions for its use and disposal and any other indication or information regarding the product;
- the categories of consumers at risk when using the product, in particular children and the elderly.

The feasibility of obtaining higher levels of safety or the availability of other products presenting a lesser degree of risk shall not constitute grounds for considering a product to be 'dangerous'."

The directive establishes nevertheless that if specific community legislation sets out safety requirements covering only certain risks or categories of risks, with regard to the products concerned, the obligations of economic operators in respect of these risks will be those determined by the provisions of the specific legislation. The general safety requirement of this Directive will therefore apply to the other remaining risks.

Note: for certain products, type approval procedures and specific safety rules are laid down, such as for toys, electrical equipment (low voltage equipment), cosmetics and pharmaceuticals.

5.10 Insurance aspects

Most of the risks may be avoided by contractual means within the supplier chain. But some of them will need third party insurance. It is important to bear in mind that insurance should never be resorted to as a substitute for risk prevention measures.

When negotiating insurance, there are some main points which should be taken into account:

- it is important to be aware of the risk and type of damage the product could cause, and also consider in which countries it will be sold, in order to establish which is the appropriate level of cover;
- insurers generally do not pay for the repair, replacement or recall of products that may cause, or have caused harm;
- it is possible that insurance arrangements contain elements of financial cover and claims handling. The later can entail a potential source of conflict of interests between the insurer and the insured company, since litigation decisions are to be taken;
- regarding personal liability for failure to ensure the safety of a company's products, companies may wish to take out personal insurance for some individuals; and
- companies should ensure that contractual and insurance arrangements complement each other and are fully consistent, as insurance cover can be invalidated by contractual terms.

When arranging insurance, it is most likely that it includes a requirement to notify insurers of any potential product liability claim or product crisis. If the insured company fails to comply with this duty, this could enable the insurer to void the policy. When fulfilling this obligation, it is important to know how much information is susceptible to be made available to the insurer (company information can indeed be very sensitive).

Insurance cannot be expected to cover all of the financial consequences for business of an issue of product liability.

5.11 The difference between food and non-food – product liability and recalls

One of the main features of food/feed in relation with the other products is that the EU has a much wider competence on this field. This characteristic implies a much more intense EU regulation of food/feed matters.

Both the 85/374/CEE as the 2001/95/CE Directives are not applicable to food matters. Instead, the EU Parliament and the Council issued a Regulation, namely, Regulation (EC) No 178/2002 laying down the general principles and requirements of food law, establishing the European Food Safety authority and laying down procedures in matters of food safety.

This regulation also contains a general safety requirement in article 14: "Food shall not be placed on the market if it is unsafe".

Food and feed business operators are the main responsible parties at all stages of production, processing and distribution. They shall ensure that food or feed satisfy the food regulations' requirements. Therefore, Member States ought to enforce food law, monitor and verify that the relevant requirements of

food law are fulfilled by food/feed business operators at all stages. This maintains a system of official controls and other activities appropriate to the circumstances including public communication and food/feed safety surveillance .

If a food business operator considers or has reasons to believe that a food which it has imported, produced, processed, manufactured or distributed is not in compliance with the food safety requirements, it shall immediately initiate procedures to withdraw the food in question from the market. If the food is already in the hands of consumers, the operator may inform the consumer about the reasons of the recall.

A European Food Safety Authority (EFTA) has been established. It moved its seat in 1995 to Parma, Italy. This Authority provides scientific advice and scientific and technical support and independent information on all matters within these fields.

This body is entitled to receive any messages forwarded via the Rapid Alert System created by this regulation, and concerning only food/feed matters. Apart from this, this Rapid Alert System is focused on transmitting the information immediately throughout this network.

6. THE MANUFACTURER'S PERSPECTIVE

In China, generally, the manufacturer or the distributor (seller) can be sued directly in cases relating to product liability claims. In relation to the issue of enforcement of court judgment, the court where the manufacturer or the distributor is located has jurisdiction and can be selected as the court for determining claims on product liability.

In our hypothetical case, ABC company manufactures bicycles in both the United Kingdom and China. Suppose a purchaser of bicycles initiates litigation in a PRC court for suing the PRC manufacturer, several issues are to be noted.

The first issue to consider is the governing law. Whether Chinese law or a foreign law is to apply? Generally, compared with some common law countries, consumers' interests are less protected in China.

6.1 Product liability legislation in China

China has issued certain laws and rules in respect of product liability, to include, Product Quality Law, Law on Protection of Consumer's Rights, Contract Law. For certain industries, there are specific regulatory laws and rules. For example, for food products, the Food Sanitation Law applies; for drugs, there are a series of regulatory laws and rules governing the same. In addition, for different products, there may be applicable national standards or industrial standards. For example, for bicycles, there are a series of national standards for different parts of bicycles. For some products, even if there is no national standard, there may be industrial standards for compliance. In some cases, if there are no compulsory applicable standards for certain products, there may be voluntarily applicable standards.

The Product Quality Law ("Law") generally applies to all products in China. Under the Law, any activity of producing or selling products within the territory of the PRC is to be governed by the provisions of this law. Manufacturers and sellers bear the responsibilities for product quality. Further, the Chinese government encourages that the product quality of enterprises exceeds that of the industrial standards, national standards and international standards. China implements a system of enterprise quality system certification in accordance with the quality control standards widely accepted internationally. An enterprise may, according to the principle of willingness, apply to an authorized certification entity for enterprise quality system certification. The

certification entity will issue a certification letter under the enterprise quality system if the enterprise is qualified upon such certification. In addition, China implements a system of product quality certification according to the internationally advanced product standard and technical requirement. An enterprise may apply to a certification entity for product quality certification. The certification entity will issue a certification letter for product quality if the enterprise is qualified upon such certification. The enterprise can label the product quality certification mark on its product or the package of its products.

6.2 Authority in charge of product quality and its functions in China

For any acts suspected to be in violation of the Law, the authority in charge, namely, Administration of Quality Supervision, Inspection and Quarantine ("AQSIQ") or its local branches can exercise the powers below[35]:

- To conduct spot inspection of the places suspected of being implicated in the activities of producing and selling in violation of the Law in relation to the parties;
- To obtain information through investigation from the legal representative of the party, main principal and other persons concerned in connection with the activities of producing and selling in violation of the Law;
- To check or copy relevant contracts, invoices and account books as well as other related data on the part of the parties; and
- To seal up or seize the products that are deemed to fall short of the national standards or industrial standards.

Another government body called Administration of Industry and Commerce ("AIC") or its local branches, the market watchdog in China, may also exercise the functions and powers as listed above to supervise on the product quality. Consumers can lodge complaints with the AQSIQ or AIC for any product liability case.

6.3 General requirement on product quality

Generally speaking, the quality of a product shall at least meet the following requirements[36]:

- Being free of unreasonable risks, which endanger the personal, or property safety; if there exists any national standard or industrial standard for safeguarding bodily health, personal, or property safety, such standards shall be complied with;
- Having the due functions of the products. However, in case that the defects in the function of the product are described, such products shall be excluded; and
- Meeting the product standards described on the products or their packaging, and meeting the quality conditions specified in product instruction and product samples.

Further, the mark on the product or its packaging shall be authentic and meet the following requirements:

- Having qualification certification of product quality;
- Having the product name, name of its production factory and the address of the factory in Chinese;
- If it is necessary to mark expressly the specifications, grades, names of the major ingredients and content according to the characteristics and operating requirements, such particulars shall be indicated clearly in Chinese; if it is necessary to make them known to the consumers in advance, the particulars shall be marked clearly on the exterior packaging or the relevant information shall be provided to the consumers in advance;
- For products which are to be used within a specified period, the production date and safe period for use or expiry date shall be marked clearly in a conspicuous place of the products; and
- In the event that the product is apt to damage in itself or to endanger the personal or property safety if used improperly, a warning mark or warning specification in Chinese is required.

Basically, in case of defective products, if damages are caused to person and property other than the defective products (hereinafter referred to as the "others'

[35] Product Liability Law of PRC, issued by the Standing Committee of People's Congress, effective as of 1 September, 2000.

[36] Product Liability Law of PRC, issued by the Standing Committee of People's Congress, effective as of 1 September, 2000.

property") as a result of the defect in the product, the manufacturer shall be liable for compensation.

The manufacturer who can testify any of the following circumstances can be released from liability for damage:

- Not having brought the product into distribution;
- Where the defect causing damages does not exist when the product is put into distribution; or
- Where the defect cannot be discovered under the state of the art when the product is put into distribution.

6.4 The governing law for a foreign related product liability case

For domestic product liability claims, or if a foreigner encounters product liability problem when he is in China, the above standards and law requirements can be adopted as basis for the claims. However, if the products manufactured in China are exported outside China, and the product defect occurs outside China, there will be complications involved. In our example, the bicycles are manufactured in China, but the defects are found outside China and causing damages. The case can be brought to a PRC court. However, the first issue to note is the governing law. The Civil Procedure Law of PRC has not clarified the issue of governing law in case of a foreign-related product liability case[37]. Neither does the Product Quality Law or the Law on Protection of Consumers' Interest make such clarifications. In practice, a provision in the General Principles of Civil Code is referred to when choosing the governing law for a foreign-related product liability case, which stipulates that the law of the place where an infringing act is committed shall apply in handling claims for compensation for any damage caused by the act.[38] An act committed outside PRC shall not be treated as an infringing act if it is not considered an infringing act under the law of the PRC. Such provision on choice of law is somehow vague, and it ignores the complication and speciality of a product liability case compared to other civil liability. The implementation rules on the General Principles of Civil Code further provide that the law of the place where an infringing act is committed refers to the law of the place where an infringing act is conducted or the law of the place where the result of an infringing act occurs, and if the above two laws are different, the court can make decision. The implementation rules fail to clarify what standards the court will adopt in making such decisions. Thus, it is still unclear as to how the concept of "the place where an infringing act is committed" is implemented.

In practice, it is difficult for PRC court to ascertain which place is the "place where an infringing act is committed". A defective product may be manufactured in country A, designed in country B, sold in country C and used by consumers in Country D. The parts of the defective product may also be provided by suppliers from different countries. The damage caused by the defective product may be due to various reasons, e.g., in relation to manufacture or sale of the product, the defective parts or the product design. Thus, the court is unable to determine which place is the place where the infringing act is conducted, if its decision is based solely on the provision of the Civil Code and its implementation rules.

In most cases, PRC court adopts PRC law as the governing law in a case involving product liability if the manufacturer is located in China. PRC court interprets that the place where the manufacturer is located is the place where the infringing act is conducted. However, if PRC law is chosen as the governing law, the most difficult issue is the compensation standard. According to PRC law, where any personal injury is caused to the victim as a result of the defect of a product, the infringer shall compensate the victim for the medical expenses during the treatment, nursing expenses and the loss or reduction in income arising from loss of working time. In case disabilities are caused, the infringer shall pay for the self-support instruments, living subsidies, disability compensation and the living expenses required for the persons who are supported by the disabled person. In case the victim is dead, the infringer shall pay for the funeral expenses, compensation for death as well as the necessary living expenses for the persons supported by the deceased before his/her death. However, in China, the calculation standard for above compensation is much lower than that in other countries, such as the U.S. or Australia.

According to PRC law, for any damage to the person or others' property arising from the defect of the product, the victim may claim against either the manufacturer of the product or the seller of the product for compensation. If the manufacturer of the product is held responsible and the seller of the product has made

[37] Civil Procedure Law of PRC, issued by the People's Congress, effective as of 9 April, 1991.

[38] General Principles of Civil Code of PRC, issued by the People's Congress, effective as of 1 January, 1987.

the compensation, the seller will be entitled to recover against the manufacturer of the product. If the seller of the product is held responsible, the manufacturer of the product has made the compensation, the manufacturer of the product shall have the right to recover against the seller.

6.5 Recall system

There is no comprehensive recall system established in China. Generally, save and except for defective car products (Regulations on Recall of Defective Car Products), there is no legal provisions governing the recall of products.

The Law on Protection of Consumers' Interest provides that in case a business operator finds that the products or service provided by itself are seriously defective and which may cause personal harm or damages to consumers, the business operator should immediately report to the relevant authority and inform consumers, and take further measures to prevent any damage. However, it is not clear what "further measures" are to be taken, as stipulated in the law. Thus, it is not safe to rely on the provision to enforce defective product recall requirement. In 2002, the AQSIQ issued an announcement requiring all defective plugs and sockets be recalled. In the same year, the AQSIQ required the defective milk powder of a famous U.S brand be recalled. The above announcements were made by AQSIQ upon random product inspections on the market. However, such announcements for product recall are few, and a system on recall of defective products has not been set up. It is necessary to have a law regulating such recall system, which shall form the basis for the authorities to enforce the recall system.

There has been hot discussion in the profession on setting up a comprehensive recall system in China. It is suggested that there shall be a law on defective product recall in the first place, which shall provide for the general principles of recall system, the authority for enforcement, recall criteria, recall procedures and legal liability. The authorities enforcing the recall system shall make corresponding rules to implement the law.

Currently, it is the AQSIQ which undertakes the quality inspection and quarantine work, which has made recall announcements previously. Since it is difficult for AQSIQ to conduct quality inspection on various products, it is suggested that apart from the AQSIQ, other authorities are to be authorised to handle the recall work, for example, the State Administration of Food and Drug Supervision (for recall of defective food and drug products), the Ministry of Transportation (for recall of defective car products), etc.

It is also suggested to clarify the meaning of defective product. For example, if there is unreasonable danger in the manufacture of the product, or if there is unreasonable danger in the design of the product, or if there is the lack of necessary and appropriate warning or instruction on the label or packaging of the product, or if the product fails to meet up to the express guarantee made by the seller, it can deemed that the product is defective.

For the recall procedure, it is suggested to adopt the following procedures:

- *Defective Report* - The report is to be made by the manufacturer itself, or the distributor, importer, repairer, or consumer;
- *Verification by authorities* - the authority is to examine and verify whether the products are defective pursuant to the report;
- *Making recall plan* - The plan is to include measures to cease further manufacture of the defective products, notice to the distributor and seller, notice to consumer or buyer of the defects involved and details for dealing with the defective products, and estimate on the effect of the recall;
- *Conducting the Recall* - The manufacturer is to carry out the recall. The first step is to publish the recall notice, informing through the news media the distributors, and consumers of the defective products the possible damage and preventive measures. The manufacturer is to notify the distributors to cease the sale of the defective products. Hotlines are to be set up by the manufacturer answering enquiries from the public. In addition, the information on the defective products shall be published on online websites designated by the authority in charge. Further, the manufacturer should recall all the defective products for further maintenance or repair (if this can be done) or for destruction, under the supervision of authority in charge; and
- *Submission of recall report* - After the recall work has been completed by the manufacturer, the manufacturer should submit a recall report to authority in charge.

In addition, it is also suggested by the profession that legal liability should be imposed on the manufacturer. Apart from compensation, the manufacturer should also be liable to pay punitive damages.

7. CRISIS MANAGEMENT FOR THE FRANCHISOR

A crisis management plan is crucial for a franchisor, as a franchisor's brand equity is one of a franchisor's most prized assets. A crisis and the accompanying negative publicity can quickly erode the franchisor's name and reputation. Therefore, it is key for a franchisor to properly manage a crisis by being proactive and responding quickly and appropriately to a crisis.[39]

7.1 Public relations and speaking with the press

Although it may at first appear contrary to a lawyer's training to speak to the press, be candid, acknowledge mistakes and fault, and express contrition, this has proven to be a more effective approach in crisis management than secrecy, defensiveness, and arrogance. This approach can also pay dividends when later dealing with legal claims, as the franchisor can present itself as being pro-active and behaving responsibly in dealing with problems. This approach helps to take the press out of the equation, as companies that behave properly are "neither newsworthy or sue-able."

7.2 Identifying the problem and addressing operational issues

One of the first tasks in a crisis is to identify the problem and address the operational issues. This is done through a series of steps, all of which are important. The franchisor:

(i) must be candid with the public that a problem exists; that people have been negatively impacted and the public trust is affected and something will be done to remediate the situation;

(ii) must explain why the problem occurred and the known reasons that caused it; explain what the franchisor learned and how it will affect how it operates in the future and unconditionally commit to regularly report additional information until it is all out;

(iii) should publicly commit to specific steps to resolve the situation and address the issues;

(iv) should verbalize its regret and take responsibility for allowing the situation to occur;

(v) should ask for help and counsel from the community (e.g., victims, government and others);

(vi) should promise publicly that similar situations will never occur again; and

(vii) should determine how to quickly provide restitution to the victims.

7.3 Dealing with the victims

It is crucial for the franchisor to recognize victims' expectations and respond appropriately. To do so, the franchisor must first recognize the impact of the crisis on the victims by assisting with grief, expressing regret, provide information, and recognizing the error. Second, the franchisor must recognize and deal with the fact that the victims will wish to seek retribution; in doing so they need closure, a forum, someone to blame, compassion and empathy. Third, victims will have a distorted recollection, and therefore need rebuilding assistance, counsel, outcome-focused action and understanding.

7.4 Re-creating trust and credibility

A final challenge in a crisis is that a franchisor must re-build trust and credibility. The company can re-build trust by providing advance information; asking for input; listening carefully; speaking clearly and bringing the victims into the decision-making process. The franchisor can illustrate credibility by revealing what the public should know, answering all questions, cooperating with the media and seeking to work with victims and opponents.

In short, a franchisor's good crisis management plan should avoid negative behaviors such as arrogance; lack of concern; shifting the blame; use of inappropriate language; inflammatory statements; being unprepared; missing opportunities to communicate; and not admitting responsibility.

[39] See Lukaszewski, J. and Pressman, A., *Crisis Communication Management: Fostering Public Relations and Lawyer Cooperation* (ABA Forum on Franchising, October 1999).

8 DISPUTE RESOLUTION ISSUES RAISED BY THE PRODUCT RECALL

Previous sections of this paper have dealt with contracts in the international franchising relationship, product sourcing requirements, important contract terms, sourcing of products, dealing with a defective product, the manufacturer's perspective and crisis management.

The present section deals with dispute resolution issues encountered by the manufacturer, importer, distributor and/or retailer in a typical product recall. In a recall, the manufacturer, importer, distributor and retailer must each determine (a) what they need to do and say, (b) for whom they must do it and to whom they must say it, and (c) how to prove to the other parties that they have done and said as was necessary

8.1 Variety of dispute resolutions

A recall in most jurisdictions is in addition to any other legal remedies. A single product recall may generate multiple disputes, either in sequence or, more likely, in parallel. A product recall may result in one or more of the following disputes:

- a regulatory investigation;
- a private or inter partes civil litigation instituted against the manufacturer, importer, distributor and/or retailer before one or more domestic courts by a consumer;
- a private or inter partes civil litigation instituted against the manufacturer, importer, distributor and/or retailer by one of the parties in the distribution chain;
- arbitration pursuant to a contractual undertaking to arbitrate included in a contract between one or more of the parties in the distribution chain; and/or
- a class action instituted by a representative of members of class of injured consumers.

Each dispute will be governed by the substantive law and the rules of procedure either selected consensually by prior contract or imposed after the fact by the applicable rules of private international law.

Parties will want to identify consumers of the product included in their recall, develop remedies, communicate with the others to determine how to repair or replace the defect and contact consumers with the relevant information on the recall campaign and how to participate. Each step creates a list of relevant documents. Parties must be prepared to identify those documents and to preserve them both in anticipation of any recall and parallel to a recall. This is true especially if the parties in the distribution chain have no existing policy to preserve the documents or no prior experience in handling them, such as consumer confirmations that they wish to participate in the recall campaign.

8.2 Relevance, proportionality and reasonableness

Relevance determines which documents will be required to make a party's case as either plaintiff or defendant. For example, a design defect is distinct from a manufacturing defect; the records relevant to one issue are distinct from those relevant to the other. Relevance is also determined not just by the issues in dispute but also by the law and traditions of the jurisdiction in which the dispute will be adjudicated. Differences in culture will impose markedly different approaches to what is relevant and what needs to be communicated to another party in the dispute resolution process.

For example, key differences exist between the rules of evidence and procedure adopted in civil law and common law systems. Faced with identical disputes, each system creates separate expectations for the parties in a dispute resolution. These expectations vary: the extent and content of written pleadings which initiate the dispute resolution; the availability and scope of oral and documentary discovery; the need to authenticate documents by oral testimony or rely on witness statements; the choice of party-named experts vs. those named by the adjudicator; and, the extent and style of any oral argument on the merits. Once a venue is identified to resolve a dispute, each party must grasp both the rules and the reasoning behind any document discovery and address, if not reconcile, competing expectations stemming from each party's respective procedural systems.

Each remedy will also require each of the parties in the distribution chain to identify its rights and obligations vis-à-vis the end consumer and also each other. Each relationship will require the parties to identify, collect and prepare to communicate relevant evidence. To discuss the relevant evidence, it is helpful to use an example from one of the world's largest consumer markets.

The obligation to preserve and disclose "relevant" documents in the common law stems from the tests set out in *Compagnie financière et commerciale du Pacific*

v. Peruvian Guano Co.[40] The traditional test is that any document that could possibly shed light on an element of the proceedings, or could lead to a train of an inquiry that might shed light on the proceedings, must be disclosed. Similar rules apply in Québec civil procedure.[41] In Federal Court of Canada, however, relevance also includes a train of inquiry that may directly or indirectly advance a party's case or damage the other party's case.[42]

Even in jurisdictions inspired by common law document disclosure, the parties and the adjudicators are increasingly guided as much by relevance as they are by proportionality and reasonableness. Manufacturers, importers, distributors and retailers must anticipate how the jurisdiction in which their dispute resolution will be heard will decide relevance. Will relevance include only those documents a party intends to use or does it also extend to documents which may harm a party's case or assist the other party. The approach to relevance has an impact on whether a party will be accused of spoliation or destroying or failing to retain relevant documents.

8.3 Express or de facto document retention and destruction policy

Manufacturers, importers, distributors and retailers must anticipate how to handle these document expectations, with an express or a de facto document retention and destruction policy ("document policy"). Documents are no longer just paper or hard copies. Documents are increasingly created, communicated and copied in electronic format.

Given their nature, electronic documents present new challenges in dispute resolution. These challenges include adopting ways to retain, locate, image and communicate relevant electronic documents before and during dispute resolution. In addition, the parties must tailor those processes to the rules and expectations of the jurisdiction in which the dispute will be adjudicated. Few parties concern themselves with the creation of the copies or reflect on the various paths through which electronic documents pass. Faced with a possible or current recall, manufacturers, importers, distributors and retailers should consult not only their IT personnel but also consider engaging an external electronic discovery service provider.[43]

8.4 Spoliation and "litigation hold"

A premature or hasty destruction of relevant documents or a failure to retain those documents might raise the issue of "spoliation".[44]

"Spoliation is the destruction or material alteration of evidence, or potentially the failure to preserve property for another's use as evidence in litigation that is pending or reasonably foreseeable".[45]

Manufacturers, importers, distributors and retailers must be careful because even a good faith destruction of documents in the ordinary course of business may be considered spoliation. Though the non-retention of documents prior to a recall might have had its justification at an earlier period, a recall might change earlier decisions not to collect documents. The non-production of the relevant documents as evidence in a dispute resolution may create a presumption which justifies the adjudicator to accept other admissible evidence, including the oral testimony of the party responsible for the loss.

Since *St. Louis v. The Queen*[46], only a handful of Canadian cases have dealt with the issue of spoliation in detail and the results are mixed. Dispute remains as to whether spoliation is an independent tort or an evidentiary rule.[47] Some courts consider spoliation as an independent tort while others consider it as an evidentiary rule. Spoliation is of renewed interest in current dispute resolution because of how electronic documents are created, exchanged and stored and how current business processes fail or refuse to capture all

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[40] *Compagnie financière et commerciale du Pacific v. Peruvian Guano Co.* (1882) 11 QBD 55 (C.A.).

[41] *Kruger Inc. v. Kruger* (1987) R.D.J. 11 (C.A.).

[42] *Apotex Inc. v. R.*, 2005 FCA 217. See also *Crestbrook Forest Industries Ltd. v. Canada (M.N.R.)* (1993) 3 F.C. 251 (F.C.A.).

[43] For a useful guide to selecting an electronic discovery service provider, see Peg Duncan and Martin Felsky, "Steps to Working Successfully with E-Discovery and Forensic Service Companies", paper presented to the Ontario Bar Association conference Electronic Discovery and the New ED Guidelines A Roadmap for Dealing with Electronic Information, (November 28, 2005).

[44] *Black's Law Dictionary* 8th ed. (St.Paul: Thomson West, 2004) defines "spoliation" as "The intentional destruction, mutilation, alteration, or concealment of evidence, usu. a document. If proved, spoliation may be used to establish that the evidence was unfavorable to the party responsible." Spoliation is related to the Latin maxim *omnia praesumuntur contra spoliatorem*.

[45] *North American Road Ltd.* v. *Hitachi Construction Machinery Company, Ltd.*, 2005 ABQB 847 (November 14, 2005) (0003 08116) (Alb. Q.B.) Clarke J. at para. 17.

[46] *St. Louis* v. *The Queen*, [1896] 25 S.C.R. 649.

[47] *Spasic Estate* v. *Imperial Tobacco Ltd.*, (2000), 49 O.R. (3d) 699 (Ont. C.A.) leave to appeal to S.C.C. refused, (2001) (S.C.C.).

"relevant" documents. As a result, many disputes now trigger the issuance of a "litigation hold" letter. This letter is sent by one party to another and requires the latter to preserve documents, listed or described as relevant in the letter, for the purpose of communication and use in the dispute resolution process at a later date.

An effective document policy should serve to organize an organization's handling of paper and electronic documents: if and how they are retained after being created by someone or thing in the organization; when and how they will be archived or destroyed if retained at some point; and, what formats will the electronic documents be saved in for future access. Prior to any recall, and parallel with any recall, manufacturers, importers, distributors and retailers must consult with internal or external IT who could identify relevant documents and their location. Those inquiries should address:

- what types of electronic documents are created and stored by the organization in the manufacture, import, distribution and retail of the product;
- what types of hardware and software are used to create electronic documents and to store or archive them;
- the use, number, nature and location of any network servers, on site and off site;
- what types of back up systems does the party have, how is the content of those systems classified and how can that content be accessed; and
- what types of encryption software for active and archived electronic documents does the organization use.

Depending on the circumstances, "relevant" may vary and evolve over time. The responsibility of a manufacturer, importer, distributor and retailer to disclose relevant documents will evolve over time given how recalls can progress.

Discovery has two principal components: information communicated orally by a witness (or confirmed by way of letter, agreed statement of facts or list of admissions) and information contained in documents disclosed between the parties during the course of the litigation.

8.5 Reasons to adopt a policy

A valid document policy is more than just trying to save computer space or reduce storage costs. Other reasons justify adopting and applying a document policy before a product recall. A document policy may, inter alia, enable manufacturers, importers, distributors and retailers during a recall to:

- comply with their statutory and regulatory obligations;
- comply with contractual obligations;
- enable them to defend against tort/extra-contractual claims;
- support their claims or to defend against when litigating or being investigated;
- avoid any improper destruction of documents when a dispute resolution is reasonably foreseeable or anticipated; and
- reduce the expenses and the time when obliged or willing to locate documents.

When establishing a document policy, the concept of what is relevant ought to stem from a manufacturer's, importer's, distributor's and retailer's pre-existing, valid business reason and not in anticipation of avoiding actual or threatened dispute resolution.

8.6 Blocking statutes

Pre-trial discovery is vital in common law systems to how the courts work and how parties come to negotiated settlements. The pre-trial exchange of information in the common law systems through testimony and documents helps inform the parties and either lead to informed settlement discussions or focus the dispute for adjudication. Legislation exists in some jurisdictions, however, which limits the exchange of such information. Called "blocking statutes," such legislation prohibits the removal or transmission of documents out of that jurisdiction. Two Canadian provinces, Ontario and Québec, each have blocking statutes.[48]

For example, Québec's Business Concerns Records Act expressly prohibits the removal, from the province of Québec, of documents relating to any business concern in Québec pursuant to any requirement of a judicial authority outside the province.

"Subject to section 3, no person shall, pursuant to or under any requirement issued by any legislative, judicial or administrative authority outside Québec, remove or cause to be removed, or send or cause to be sent, from any place in Québec to a place outside Québec, any document or résumé or digest of any document relating to any concern."[49]

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[48] Ontario *Business Records Protection Act*, R.S.O. 1990, c. B.19 and Québec *Business Concerns Records Act*, R.S.Q. c. D-12.

[49] Section 1(a), *Business Concerns Records Act*.

The term "document" is defined in the Business Concerns Records Act:

> "any account, balance sheet, statement of receipts and expenditure, profit and loss statement, statement of assets and liabilities, inventory, report and any other writing or material forming part of the records or archives of a business concern."[50]

The legislation means a litigant cannot be ordered to remove electronic documents across the border into another jurisdiction. In *Hunt v. T&N plc*[51], the Supreme Court of Canada refused to enforce Québec's Business Concerns Records Act within Canada between provinces, favoring the litigation process over the protection of documents. The decision thereby limits the legislation's interference with the discovery of documents at least within Canada. Note that the legislation in *Hunt v. T&N plc* has yet to be deemed by a Canadian court not to apply to requests from outside of Canada. Manufacturers, importers, distributors and retailers should consult with counsel in the jurisdiction in which the dispute resolution will take place in order to consider whether such limitations exist and are enforced.

8.7 Accessibility

To gather electronic documents, they must be accessible. U.S. District judge Schindlin in *Zubulake v. UBS Warburg*[52] identified five (5) categories of data:

> "1. Active, online data. This data is in an active stage in its life and is available for access as it is created and processed. Storage examples include hard drives or active network servers.
> 2. Near-line data. This data is typically housed on removable media, with multiple read/write devices used to store and retrieve records. Storage examples include optical disks or magnetic tape.
> 3. Offline storage/archives. This category represents data that is offline on tape or other removable computer storage media. Offline storage of electronic records is traditionally used for disaster recovery or for records considered archivable in that their likelihood of retrieval is minimal.
> 4. Backup tapes. Data stored on backup tapes is not organized for retrievable of individual documents or files, because the organization of the data mirrors the computer's structure, not the human records management structure. Data stored on backup tapes is also typically compressed, allowing storage of greater volumes of data, but also making restoration more time consuming and expensive.
> 5. Erased, fragmented or damaged data. This data was tagged for deletion by a computer user, but may still exist somewhere on the free space of the computer until it is overwritten by new data. Significant efforts are required to access this data."

For more detailed discussion on the disclosure and discovery of electronic documents, readers should consult the February 2007 draft Canadian Edition of "The Sedona Principles: Addressing Electronic Document Production".[53] The Canadian Edition is a project of The Sedona Conference® Working Group 7 ("WG7"). WG7's Canadian Edition builds from The Sedona Conference's Working Group 1's ("WG1") March 2003 "The Sedona Principles: Best Practices Recommendations & Principles for Addressing Electronic Document Production". The WG1 March 2003 draft drew on U.S. legislation, case law and input and has been updated since then.[54]

8.8 Implied undertaking of confidentiality

Some jurisdictions favor generous common law style discovery of documents but still impose limitations on the use of such documents obtained during discovery. For example, Canada has the implied undertaking of confidentiality. This undertaking serves to prohibit a litigant from using information obtained during discovery for purposes other than preparing for the trial and defending its interests at trial, or from disclosing it to third parties, without specific leave from the court. The rule limits the invasion of the privacy interest which the examined party has in its information to what is necessary for the conduct of the proceeding. The rule does acknowledge that, if the information is relevant, and is not protected by some privilege, it must be communicated to the other litigant.

The Ontario Court of Appeal in *Goodman v. Rossi*[55] held that the implied undertaking rule was part of the law in Ontario. The Supreme Court of Canada in *Lac d'Amiante du Québec Ltée v. 2858-0702 Québec Inc.* [56]

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[50] Section 1(a), *Business Concerns Records Act*.

[51] *Hunt* v. *T&N plc*, [1993] 4 S.C.R. 289 ("*Hunt*"). See also *2632-7602 Québec Inc. v. Pizza Pizza Canada Inc.*, [1991] R.J.Q. 2951 for an adjudication of Ontario *Business Records Protection Act*, R.S.O. 1990, c. B.19; *Frischke* v. *Royal Bank of Canada*, (1978) 80 D.L.R. 393 (Ont. C.A.) at 403.

[52] *Zubulake* v. *UBS Warburg*, (2003) 217 F.R.D. 309, 318-320 (May 13, 2003).

[53] The full text of "The Sedona Principles: Addressing Electronic Document Production Canadian Edition is available at http://www.thesedonaconference.org ("Canadian Edition").

[54] See the evolution of the Best Practices Recommendations & Principles for Addressing Electronic Document Production and the related "The Sedona Guidelines: Best Practice Guidelines & Commentary for Managing Information & Records in the Electronic Age" at http://thesedonaconference.org/content/miscFiles/publications_html?grp=wgs110.

[55] *Goodman v. Rossi* (1995), 24 O.R. (3d) 359.

[56] *Lac d'Amiante du Québec Ltée v. 2858-0702 Québec Inc.*, [2001] 2 S.C.R. 743.

on an appeal from Québec ruled that an implied duty of confidentiality at an examination on discovery exists in Québec too.

The implied undertaking of confidentiality applies only to information obtained solely from the examination on discoveries and not to information that is otherwise accessible to the public. The undertaking continues to apply, during and after the trial, to information obtained at pre-trial examinations which is not used for the purposes of the trial. The court retains the jurisdiction to authorize use of the information in other venues and to relieve the parties subject to the obligation of confidentiality of their obligations, in whole or in part, according to the facts, in cases where it is necessary to do so, in the interests of justice. Manufacturers, importers, distributors and retailers should consult with counsel in the jurisdiction in which the dispute resolution will take place in order to consider whether such limitations exist and are enforced.

8.9 Best practices - handbooks, checklists and guidelines

The U.S. Consumer Product Safety Commission's Office of Compliance publishes a "Recall Handbook" as a guide for manufacturers, importers, distributors and retailers.[57] The Recall Handbook serves as a guide on how to report under Consumer Product Safety Act[58] and the Child Safety Protection Act[59] and how to prepare for, initiate and implement a product safety recall. See also Section 3.4 of this paper.

The Recall Handbook includes a section on handling records which helps illustrate the importance of collecting relevant records.

> "VIII. Records Maintenance
> The goal of any product recall is to retrieve, repair, or replace those products already in consumers' hands as well as those in the distribution chain. Maintaining accurate records about the design, production, distribution, and marketing of each product for the duration of its expected life is essential for a company to conduct an effective, economical product recall. Generally, the following records are key both to identifying product defects and conducting recalls:
> A. Records of complaints, warranty returns, insurance claims, and lawsuits. These types of information often highlight or provide early notice of safety problems that may become widespread in the future.
> B. Production records. Accurate data should be kept on all production runs -- the lot numbers and product codes associated with each run, the volume of units manufactured, component parts or substitutes use, and other pertinent information which will help the company identify defective products or components quickly.
> C. Distribution records. Data should be maintained as to the location of each product by product line, production run, quantity shipped or sold, dates of delivery, and destinations.
> D. Quality control records. Documenting the results of quality control testing and evaluation associated with each production run often helps companies identify possible flaws in the design or production of the product. It also aids the firm in charting and sometimes limiting the scope of a corrective action plan.
> E. Product registration cards. Product registration cards for purchasers of products to fill out and return are an effective tool to identify owners of recalled products. The easier it is for consumers to fill out and return these cards, the greater the likelihood the cards will be returned to the manufacturer. For example, some firms provide pre-addressed, postage-paid registration cards that already have product identification information, e.g., model number, style number, special features, printed on the card. Providing an incentive can also increase the return rate. Incentives can be coupons towards the purchase of other products sold by the firm, free accessory products, or entry in a periodic drawing for a product give away. The information from the cards then needs to be maintained in a readily retrievable database for use in the event a recall becomes necessary."

The U.S. CPSC Office of Compliance also publishes a recall checklist[60] as well as web site notification guidelines[61] to help manufacturers, importers, distributors and retailers implement product safety recalls. The recall checklist provides useful reminders and insights into conducting an effective recall. In so doing, however, the checklist creates categories of relevant records. Each step, once taken, might, at a later date, have to be proven to have been taken and taken effectively. For example, any 'stop production' command, any test for replacement and repair, each communication with retailers to inform of recall and any list of consumer responses to repair or replacement options should be preserved. Such records will assist the entity in demonstrating prompt and meaningful response to a product recall and answer critiques of such recall in terms of timeliness and effectiveness. A review of the checklist should stimulate enquiries with each entity's IT department to ensure that such relevant records are not only created but preserved.

[57] Available on-line at http://www.cpsc.gov/businfo/8002.html.
[58] 15 U.S.C. 2051-2084, Public Law 92-573; 86 Stat. 1207, Oct. 27, 1972.
[59] 15 U.S.C. 1261-1278, Public Law 86-613; 74 Stat. 372, July 1960, as amended.
[60] Available on-line at http://www.cpsc.gov/businfo/recallcheck.pdf.
[61] Available on-line at http://www.cpsc.gov/businfo/webnote.html.

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The U.S. CPSC Office of Compliance's Recall Handbook, checklist and guideline each suggest best practices. Each suggests a series of related steps which, if taken together, can reduce the risk or extent of harm to consumers. Each also creates expectations that the steps can be documented or proven, in the event of an investigation or litigation.

The above is only a summary outline of issues raised in dispute resolutions involving product recall. One of the current challenges in product recalls is to find a manageable way to locate, image and communicate relevant paper and electronic documents before and during any related dispute resolution process. Manufacturers, importers, distributors and retailers have to develop practical, bona fide document policies prior to any recall and to update those policies parallel to a recall in order to anticipate prosecuting and defending litigation.

9. CONCLUSION

As this paper has discussed, a franchisor that sources products in a foreign country for resale by its franchisees faces a formidable challenge in handling a defective product, particularly when a recall may be necessary. The franchisor most of all needs to be concerned about the safety of the consumer purchasers of its products in order not to jeopardize its reputation and the safety reputation of its products. The franchisees have to be integrated into the remedy procedure and sensitive to the needs of their customers.

But the greatest challenge for the franchisor may relate to obtaining effective assistance from the foreign manufacturer. Dispute resolution is the last resort and should be avoided in most situations. But the franchisor and its foreign supplier must have a good working relationship that will allow them to work in tandem to effectuate a remedy or recall with the least disruption to the franchisor's franchise system, the least adverse publicity and at the lowest effective cost. Insurance in those situations can help alleviate the financial strains but only if the defective product causes injury to a person or property. Cooperation rather than confrontation will most likely lead to a satisfactory result for all parties in the distribution chain.

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