

# **Product Liability Insurance Update: Why Rates Are Falling So Fast**

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Rates for product liability insurance for dietary supplement companies increased dramatically beginning in 2001 and continued their upward trend for several years, until recently. Now they are falling quickly, even though the products being made have gone largely unchanged (except for the elimination of ephedra in 2004). Why is this? Why would an underwriter who charged a \$50,000 premium in 2003 charge \$20,000 for the same account today?

A first guess answer by many in the dietary supplement industry might sound something like, “well, just like we have been telling insurance companies all along, this is an industry that makes safe, effective products. The insurance companies have just not paid out the losses that they thought they would, so the rates are adjusting to that reality.”

This analysis is certainly part of the answer. While there have been claims, the handful of insurers that underwrite this insurance have made profits the past few years. Simple economics dictate that when that happens, others will recognize it and jump in for their share of the “perfume of the premium.” And that is exactly what has happened. In the past four months alone, four new carriers have begun underwriting liability insurance for supplement companies.

## **Ingredient Exclusions**

Another change brought about by the newly competitive environment has been in the ingredient exclusions that each insurer attaches to their policy. For years, these exclusions denied coverage for ingredients such as bitter orange yohimbe, lobelia, magnolia, l-tryptophan and skullcap. Now, all of these and many other ingredient exclusions can be routinely removed (and the ingredients thus covered), merely by asking.

However, it is important to have an insurance broker representing you who knows that these exclusions can be removed, and further, knows which of your products contain ingredients that may be excluded by your current or prospective insurance company. The ingredient exclusion varies greatly from insurer to insurer, and care must be taken to get the broadest coverage possible before you write out a check for the policy.

## **Insurers Lightly Regulated**

Most people don't realize that the Property/Casualty (P/C) insurance is a highly regulated industry. Unlike many industries, the Federal government has stayed out of regulating insurance, and states were allowed to establish their own insurance regulatory agencies. For the majority of “mainstream” businesses (restaurants, dry cleaners, widget manufacturers, etc.), insurance companies are required to disclose and file their rates with state regulators. In some cases, states have the power to approve or deny rates. To

change rates, insurance companies have to go through another filing process, a time-consuming effort that tends to slow down rate fluctuations.

Conversely, insurers for dietary supplements, known as “surplus line insurers,” face less regulation than their “mainstream” counterparts, even though surplus lines insurers underwrite industries perceived to have higher risk. Today, surplus lines insurers are the only companies offering liability insurance to the supplement industry. Rates are completely unregulated. Insurers can charge whatever they want on any given day, without having to file with any regulatory agency. This is another reason why premiums and rates for the supplement industry rose so fast and are now falling at a precipitous rate—because they can.

### **Price Cycles in Insurance**

There is a bigger force at work that is driving liability rates down for supplement companies, and that is the Property/Casualty (P/C) insurance cycle. Most industries are cyclical to some extent. The P/C industry has historically been characterized by lengthy stretches of declining premiums and intense competition, called a “soft” market. A soft market is followed by a “hard” market, where rates rise, coverage is difficult to obtain and insurance company profits rise.

The P/C industry in the United States had a hard market in the early seventies, followed by a soft market that lasted until about 1984, which was followed by a two year hard market. The following soft market lasted *fifteen years*, until about 2000. Most people do not realize that a new hard market had already begun prior to the 9/11 attack, with that event creating an extreme hard market virtually overnight. This and the escalating controversy and litigation over ephedra were the two most important factors behind high rates in the supplement industry between 2001 and 2006.

### **The Effect of the Investment Environment**

A major contributor to the length and severity of the P/C insurance cycle is investment income. P/C companies hold a large percentage of their investments in the form of bonds to protect their assets against precipitous stock market declines. Typically, about two-thirds of total investments are in bonds and one-fifth in common stock. After the tech bubble burst and the subsequent bull stock market, insurers did very well on their investments, which increased their ability to compete for new premium dollars and encouraged the onset of the new soft market of the last couple of years.

### **The Katrina Effect**

The final major cause of a market going from hard to soft (or vice versa) is a catastrophic insured event that upsets the balance of supply and demand in the entire insurance industry on a massive scale. Insurers must think not only of today’s catastrophe, but must price their products while guessing when and how the *next* catastrophe will affect them. Certainly 9-11 was such an event. When combined with the losses from Hurricane Katrina and the expectation of similar weather catastrophes from global warming, one begins to see the reasons behind the hard market in the first half of this decade.

Conversely, since severe hurricanes that were anticipated after Katrina have *not* occurred, the pressure is off the insurance companies to price their current products in line with that prior expectation.

### **What You Can Do**

We have seen that much of the reason for the rate fluctuations for supplement liability insurance have little to do with the specifics of the supplement industry, and much more to do with the dynamics of the P/C insurance industry. Keeping in mind that the supplement industry has historically had an image problem, what can you do to make sure that the next hard market has the *least* affect on your company? Furthermore, what can you do to take maximum advantage of a soft insurance market?

Simply stated, be the best that you can be in your sector of the industry. Be GMP compliant (FDA, NPA, USP, etc.). Improve your quality control program. Have a good attorney advising you when necessary. Get evidence of insurance from your suppliers, and if they don't have it, think twice about using them. Finally, engage an insurance broker who understands these and other industry issues. Find a broker who can put together a package for insurers that will make you stand out as an insurance risk they will want to have -- and give you a lower premium than your competitors.

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