INDEMNIFICATION PROVISIONS IN FRANCHISE AGREEMENTS: HOW TO DRAFT THEM AND HOW TO ENFORCE THEM

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October 10-12, 2018
Nashville, TN

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INDEMNIFICATION PROVISIONS IN FRANCHISE AGREEMENTS: HOW TO DRAFT THEM AND HOW TO ENFORCE THEM

I. INTRODUCTION

Franchisors and franchisees are presented with a variety of risks each business day – from business loss and theft to personal injury and property damage. Faced with these risks, franchisors and franchisees traditionally allocate and manage risk using a variety of techniques. In a franchise system, risk can be allocated and managed through retention of the risk, transfer of the risk by contract and through the procurement of insurance. Often, risk is allocated and managed through a combination of these methods. The most prominent method to allocate and manage risk within a franchise system is the use of indemnification obligations to transfer risk, typically coupled with commercial insurance products to make sure the transferred risk is practically covered against loss. In a franchise context, an indemnity obligation is typically not a stand-alone contract, but rather part of a larger agreement between two or more parties. In particular, many franchise agreements contain indemnity, hold harmless and defend provisions in combination, whereby the franchisee agrees to indemnify, hold harmless and defend the franchisor against claims or loss arising out of the franchisee’s operations. The focus of this paper is indemnity and the indemnification provisions routinely found in modern form franchise agreements.

II. PURPOSE

A. Definitions and Distinctions

Black’s Law Dictionary defines “indemnify” as “to save harmless; to secure against loss or damage; to give security for the reimbursement of a person in case of an anticipated loss falling upon him; to make good; to compensate; to make reimbursement to one of a loss already incurred by him.”¹ In contrast, many state statutes and common laws are less inclusive, relying on concepts such as legal consequence and causation to limit the indemnification under a particular indemnity contract.² Accordingly, a duty to indemnify alone embedded within a standard form franchise agreement may not yield all of the benefit desired.

To protect against any such gaps, franchisors often couple a duty to indemnify with a duty to hold harmless and a duty to defend. Technically, the obligation to indemnify is different from the obligation to hold harmless. An indemnification is an affirmative right in favor of the indemnitee to be protected against some particular event. An obligation to hold harmless is a release of the indemnitee from a particular liability and an assumption of the same by the indemnitor. In other words, an indemnification protects against the actual occurrence of a particular event while a hold harmless is in effect a replacement of one party for another as to a particular liability.

Indemnity agreements may also permit or more often require the indemnifying party to defend the indemnified party against claims for loss and damage sustained by a third party. Coverage under an indemnity provision for the costs and expenses of defending a claim should not be assumed. As with a general liability policy, an indemnitor’s obligation to defend an

¹ BLACK’S LAW DICTIONARY 886-887 (10th ed. 2014).
² For example, California Civil Code Section 2772 defines an indemnity as “a contract by which one party (the indemnitor) agrees to protect another party (the indemnitee) from the legal consequences of the conduct of one of the parties, or of some other person.” CAL. CIV. CODE § 2772 (2018).
Indemnitee is determined on the basis of the express scope of the duty to defend and the allegations asserted against the indemnitee. State laws and results vary on this issue. In New York, for example, a duty to defend is broader than a duty to indemnify. Accordingly, a New York court may not allow a claim for defense costs unless the indemnitee has expressly agreed to defend. Under California law a duty to defend is implied if the document does not expressly exclude it. Because of this conflict amongst the states, the best practice is to expressly state that the indemnity obligation includes “to indemnify, defend and hold harmless.”

Indemnitees do not typically control the defense of a claim. Under California law, for example, the indemnitee controls the defense of a claim absent an agreement by the parties to the contrary. If an indemnitee does not defend an indemnitee when obligated and given notice to do so, then the result in the underlying litigation will be binding on the indemnitee. In contrast, if the indemnitee is not notified or allowed to defend the claim, then the indemnitee likely will be afforded an opportunity to rebut the determination. If an indemnitee settles a claim without involving the indemnitee, the settlement may not be binding on the indemnitee.

B. Risk Allocation

Indemnity is a form of risk allocation and management that involves a transfer of risk, not an analysis or allocation of fault. In a franchise context, the risk is transferred typically by a contract provision contained in a franchise agreement. The indemnity provision in the franchise agreement serves to protect the franchisor from liability arising out of or relating to the franchisee’s acts and omissions and, often more broadly, business operation and commercial dealings. The provision serves to allocate and transfer any risk associated with the franchisee’s operation under the franchisor’s mark to the franchisee. The duty to indemnify protects the franchisor from third party claims, including vicarious liability claims. As stated above, an indemnification clause often is coupled with a related hold harmless obligation, as well as a franchisee duty to defend such claims at the franchisee’s cost and expense, subject to the franchisor’s approval of counsel and key defense decisions.

The franchisor’s purpose in including an indemnification obligation is to ensure the transfer of the risk of the franchisee’s operation to the franchisee as contemplated by the franchise agreement. The franchisor is motivated in large part by a desire to avoid potential liability to third parties who possess claims against the franchisee or arising out of the franchisee’s operation. Faced with reflexive attempts by those same third parties to include the franchisor as well as the franchisee in such suits, franchisors have come to rely on broad form indemnification provisions to allocate and transfer the risk associated with the franchisee’s operation firmly to the franchisee.

1. Third Party Claims

An indemnity is generally construed to protect the indemnitee against losses from third-party claims. It is not generally considered the appropriate mechanism for allocation of responsibilities between the indemnitee and the indemnitee (so-called “first-party claims”). Breach of contract claims are better suited for first-party matters, as the limitations attendant to an indemnity do not apply. An indemnitee should guard against and resist indemnity provisions being

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3 See, e.g., Van Slambruck v. Econ. Baler Co., 105 Ill.2d 462, 475 N.E.2d 867 (Ill. 1985) (indemnification agreements and actions attempt to shift full liability and loss from one party to another, and the parties’ relative percentage of fault is irrelevant).

4 See Rose Marie Fiore, Vicarious Liability Cases: Duty to Defend and Conflicts of Interest, 25 Franchise L.J. 199 (Spring 2006).
used for first-party claims.

The burden of proof is typically on the indemnitee to prove the scope of the indemnitor's indemnity obligation. An indemnitee's recovery is limited to the matters expressly covered by the indemnity obligation. The terms of the indemnity obligation strictly define the liability of the indemnitor. Accordingly, courts look to the words of the clause and, when the wording is clear and unambiguous, not any extrinsic evidence to understand its scope. Thus, the wording of the indemnity obligation is critically important. For example, an indemnity against "liabilities" protects against a legal finding of liability. An indemnity against claims is triggered upon the filing of a claim against the indemnitee. The filing of a claim occurs at the outset of a case and without liability being determined. An indemnity against "damages" is similarly narrow. It effectively is an agreement to reimburse against actual damages sustained. Accordingly, the indemnitee must sustain and pay the damages first before it gets reimbursed. An indemnity arising out of or relating to operations or possession is broader than the options reviewed above.

2. **Breach of Franchise Agreement / Covenants**

Franchise agreements often contain broad indemnification provisions that attempt to cover breaches of the franchise agreement by franchisees. On a certain level, the inclusion of direct claims possessed by the franchisor under the franchise agreement is redundant and unnecessary. The franchisor will have a direct claim and can enforce the franchise agreement against the franchisee irrespective of any duty to indemnify. On that level, the indemnification provision does not provide additional protection for the franchisor and is a somewhat circuitous route to the same potential result.

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5 See, e.g., Sayles v. G & G Hotels, Inc., 57 A.3d 1129, 1131 (N.J. Super. 2013) (“[i]ndemnity contracts are interpreted in accordance with the rules governing the construction of contracts generally and [w]hen the meaning of the clause is ambiguous ... the clause should be strictly constructed against the indemnitee.”).

6 See, e.g., DaimlerChrysler Corp. v. G-Tech Prof'l Staffing, Inc., 260 Mich. App. 183, 185-187, 678 N.W.2d 647, 649 (Mich. Ct. App. 2003) (because an indemnity contract is to be construed in the same manner as other contracts, an unambiguous written indemnity contract must be enforced according to the plain and ordinary meaning of the words used in the writing, and “the principle of construing an indemnity contract against the drafter, like any other contract, only applies where (1) an ambiguity exists and (2) all other means of construing the ambiguity have been exhausted.”). See also Shea v. Bay State Gas Co., 383 Mass. 218, 222, 418 N.E.2d 597, 600 (Mass. 1981) (citations omitted) (under Massachusetts law, “[c]ontracts of indemnity are to be fairly and reasonably construed in order to ascertain the intention of the parties and to effectuate the purpose sought to be accomplished.”).

7 See, e.g., Pritchard v. Suburban Carting Corp., 90 A.D.3d 729, 934 N.Y.S.2d 460 (N.Y. App. Div. 2011) (where patron was injured when she was struck by a garbage truck in the parking lot of a McDonald's restaurant, and filed suit against the landlord, the tenant McDonald's Corp., and the franchisee subtenant alleging, among other things, negligence, landlord granted summary judgment on its cross-claim against McDonald's Corp. for indemnification where lease agreement provided that McDonald's Corp. would indemnify landlord for any accident or injury “arising, directly or indirectly, out of the business conducted in the Premises or occurring in, on or about the Premises or any part thereof”). See also L.A. Ins. Agency Franchising, LLC. v. Montes, Civil Action No. 14-14432, 2016 WL 4415238 (E.D. Mich. Aug. 19, 2016) (where the franchisee defendant sought to void the entire franchise agreement on the grounds that the indemnification was so overbroad that there was a lack of mutuality in the agreement, the court held that the language of the provision (which indemnified for claims arising out of the possession, ownership or operation of the franchised business) appropriately limited the scope of the indemnification to the only party which possessed, owned and operated the franchised business and therefore the agreement was not overbroad or void). But see Commercial Movie Rental, Inc. v. Larry Eagle, Inc., 738 F. Supp. 227, 231 (W.D. Mich. 1989) (holding contract void for lack of consideration as the indemnitee “Commercial Movie Rental, Inc. was never bound because it was ‘exempt ... for all liability for a breach of its obligations’ because the indemnification provision at issue in that case provided that Commercial Movie Rental “shall not be liable for ... damages of any kind ... on account of any ... event or cause whatsoever.”).
3. Breach of Representations and Warranties

Franchise agreements often also contain indemnification provisions that attempt to cover breaches of franchisee representations and warranties made in connection with the parties' entry into the franchise agreement. Indemnification provisions that attempt to cover breaches of representations and warranties made in connection with a purchase and sale of franchise related businesses and assets are also common place.

M&A practitioners know that, once the consideration has passed and the deal has closed, unexpected liabilities can and often do occur. The question then becomes who should bear the risk. Sellers want to walk away from the closing table with their sale proceeds free and clear. Buyers, on the other hand, want to minimize their liability for issues that arose prior to the transaction and for damages and losses arising from inaccuracies in how the business or its assets were described prior to the closing.

Franchise transactions – whether initial entry into a system or the purchase and sale of a batch of franchised business assets – are no different. Absent a contractual provision that specifies the process for addressing post-transaction liabilities, buyers and sellers would be left with claims for fraud and breach of contract as their only mechanism for recourse. To pre-allocate the risks and give the parties more certainty as to who will bear the post-closing liabilities and how they will be funded, the parties to a franchise transaction can and routinely do include indemnification provisions addressing damages arising from breaches of representations, warranties and covenants. For example, franchise opportunity sellers may make a representation that the company has the right to license and use, and to sublicense others to use, its proprietary marks. If after the franchise sale a claim for infringement is brought against the franchisee-buyer by a third party, the franchisee-buyer would have recourse against the franchisor-seller for a breach of the franchisor-seller’s representation. Similarly, franchisors may rely upon and seek indemnification from the franchisee for any misrepresentations or omissions made by the franchisee in the franchise sales process regarding who the franchisee and its principal owners are, their respective experiences and assets and whether they have any personal, professional or business criminal convictions, bankruptcies or civil judgments.

C. Recoverability

1. Lack of Privity

The most typical privity issue encountered by franchisors in an indemnity context is a lack of privity with a corporate franchisee’s controlling principals. One way or another, it is imperative that the controlling principals either be primarily obligated to fulfill the indemnity obligation by being either a limited or full party under the franchise agreement or a guarantor of the corporate franchisee’s full and faithful performance. Listing the controlling principals as primary obligors under the indemnity in a franchise agreement is not enough if the controlling principals are not signatories to the franchise agreement itself.

Another privity issue encountered in a franchise indemnity context is a lack of privity with downstream beneficiaries seeking to enforce and benefit. The intended beneficiaries of an indemnity should be expressly provided for and stated. The use of wording such as “and its successors and assigns” or the naming of specific third-party beneficiaries should suffice. Unspecified third parties are generally not permitted to enforce indemnities.
2. Assets of Contractual Counter-Party / Indemnitor

A significant consideration for indemnitees should be the assets of the indemnitor. Like any bilateral contract, indemnity provisions involve counter-party risk – the indemnitor’s assets and ability to pay. It is one thing to have the benefit of an indemnity provision. It is quite another to have the promised performance secured and fully funded through an efficient and collectible mechanism. In an effort to ensure that the indemnitee will be able to collect on its indemnity damages in an efficient manner, it should negotiate and secure the source from where the indemnity funds will come.

3. Funding the Indemnity / Additional Sources to Pay

Given the counter-party risk of insufficient indemnitor assets to fund an indemnity obligation, ensuring that the indemnity will be adequately funded is another important aspect of indemnification provisions that warrants significant consideration and resolution. If an agreement does not adequately address the issue, the indemnitee may be forced to proceed directly against the indemnitor to recover its damages. Indemnitees, including franchisors, generally do not favor this approach because there is no guarantee that the indemnitor will have the money to satisfy its indemnification obligation. Moreover, proceeding directly against an indemnitor is time consuming, expensive, drawn out and creates relational friction.

To make sure that the indemnity is adequately funded and the indemnitor will be able to collect on its damages in an efficient manner, the parties will often pre-negotiate from where the funds to pay for identifiable claims will come. The most common approaches to funding an indemnity in a franchise M&A context are: (1) an indemnification escrow account; (2) set-offs against future payments; (3) a holdback of the purchase price; and (4) increasingly, representation and warranty insurance. In a franchise agreement context, not all of those options are available or practical. Accordingly, agreements to indemnify within franchise agreements are often combined with obligations to insure and other related insurance specifications and requirements. The combination of mandates to obtain and maintain levels of insurance with a duty to indemnify is designed to ensure that the indemnifying party has the means to fulfill its duty to indemnify. The relationship between indemnity and insurance is further discussed in Section III.E below.

III. CONTRACTUAL INDEMNITY

A. Avoid Templates or Boilerplate

Legal drafting often draws from the lawyer's own past work or from that of others, whether using templates, practice guides or simply borrowing language from another agreement. But when drafting indemnity provisions, it’s important to resist the urge to simply cut-and-paste from prior agreements or templates. This urge is easily fueled, because indemnity provisions address a future situation that may or may not occur, and are often lumped in with the more perfunctory language towards the end of the contract. But indemnity can have a profound impact on the parties’ ultimate relationship, so it’s important to treat these provisions with the same scrutiny as other primary terms of the agreement. While franchising as a model produces many similarities, each client still has its own unique needs and motivations that can instruct when indemnity might be needed or desired. Failing to tailor the provision to the client’s specific needs, only invites problems down the road.

The best practice when drafting an indemnity provision is to maintain a checklist, and review it with the client. Not only does this help to ensure that the provision will be tailored to the
client’s needs, but it also helps protect the attorney from an unhappy client if indemnity ever needs to be invoked. More than likely, a well-tailored provision will suit the client’s needs, but if it later turns out to be deficient, a trail demonstrating that it was reviewed by the client may well avoid further problems.

B. Anatomy of an Indemnity Provision

Contractual indemnity is of course a contractual obligation. Thus the extent of a party’s duty to indemnify, is determined from the terms of the contract itself. The following sections identify and explain the various elements of a typical indemnity clause. Where examples are given, it’s important to remember that they are provided for illustrative purposes only. Some address specific situations and offer guidance to avoid unexpected or unintended results. But as a general rule, indemnity provisions are by and large discretionary, and should be tailored to the client’s specific needs.

1. Scope – Third Party Claims; Direct Claims; or Both

One of the initial terms to consider is what type of claims will be covered: third party claims, direct claims or both. Third party indemnity is most common, and what generally comes to mind when one hears the term indemnify. But it is not unusual to see direct indemnity in modern franchise agreements. As noted above, it is usually redundant and unnecessary, because a party can almost always sue directly under either a breach of contract theory or in tort. But it can be used to clarify risk or to provide greater or additional remedies beyond those normally available in a direct claim. For example, direct indemnity provisions often add a provision for recovery of attorneys’ fees or other expenses, provide limits on the amount of damages or available remedies, or clarify the risk with regard to representations or warranties. Of course, these terms can also be included independently. But when including them in an indemnity provision, it is important to make sure they are clearly drafted to express the parties’ intent, and they do not conflict with other terms of the contract. If direct or first party indemnity is intended, make sure the language clearly indicates that. Where the language is not sufficiently clear, there may be vastly different results depending on the jurisdiction.

In Zalkind v. Ceradyne, Inc. a California court read the terms “indemnify” and “indemnity” broadly, and found that the parties’ agreement applied to both direct and third party claims.8 The court relied on the statutory9 and legal10 definitions of indemnity to find that an indemnity provision that did not specifically limit itself to third party claims could be read broadly to also include first party claims. On the other hand, in Mead Corp. v. ABB Power Generation, Inc., the indemnity provision did not limit its application to third-party claims, but the court found that it was so limited.11 Specifically, the court determined the contract was susceptible to multiple interpretations, and that it could be read as both including and excluding first party claims. Based

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8 194 Cal. App. 4th 1010, 1025, 124 Cal. Rptr. 3d 105, 114 (Cal. Ct. App. 2011); See also Yang Ming Marine Transp. Corp. v. Okamoto Freighters Ltd., 259 F.3d 1086, 1092 (9th Cir. 2001) (overturning a lower court decision that held the general term indemnify applied only to third party claims, noting that the 9th Circuit traditionally defined the word indemnify liberally).

9 “Indemnity is a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or of some other person.” CAL. CIV. CODE § 2772 (2018).

10 “The first definition in Black’s Law Dictionary for indemnify is [t]o reimburse (another) for a loss suffered because of a third party’s or one’s own act or default.” 194 Cal. App. 4th at 1026, 124 Cal. Rptr. 3d at 115 (internal quotes omitted).

11 319 F.3d 790, 798 (6th Cir. 2003).
on the ambiguity, the court construed the contract against the drafter, held that the provision was limited to third party claims, and therefore dismissed the indemnity claim. In *Hooper Associates, Ltd. v. AGS Computers, Inc.*, New York’s highest court found that general indemnity language did not include direct claims, and therefore limited its application to only third party claims. The court held that particularly with indemnity provisions, the contract “must be strictly construed to avoid reading into it a duty which the parties did not intend to be assumed.”12

Whether the intent is to limit indemnity to third-party claims, or to also include direct claims, what is important is clarity. To withstand attack, and to avoid unintended consequences, the language should plainly indicate which claims are covered, and there should be no contradictory language elsewhere in the contract.

If the intent is to limit the clause to third party claims, make sure the agreement explicitly says that. For example: “INDEMNIFICATION FOR THIRD-PARTY CLAIMS: The parties agree to the following regarding indemnification for third-party claims…” And again, be sure there are no contradictory terms elsewhere in the agreement that might otherwise suggest the parties’ intended to include direct claims in the obligation to indemnify.

If the intent is to include direct claims, make sure the agreement explicitly says that. For example: “INDEMNIFICATION FOR DIRECT AND THIRD-PARTY CLAIMS: Indemnitor hereby agrees to indemnify, hold harmless, and defend indemnitee from and against all claims, demands, damages, etc…., whether direct or third-party…”

2. **Triggers**

Determining what triggers indemnity is another important element. These are typically occurrences such as damages, losses, claims, the filing of a lawsuit, expenses (including attorney’s fees) or liabilities. These elements identify what will be reimbursed and also what will trigger application of the indemnity provision allowing the indemnitee to initiate the indemnification process.

Although every contract is subject to interpretation, for the most part the terms are rather self-explanatory. “Damages” or “losses” typically means some sort of harm; “claims” broadly refers to another party alleging liability against the indemnitee; “filing of a lawsuit” more narrowly refers to when an action seeking relief is initiated; “expenses” may be costs incurred or obligated to be paid – but be mindful that in some jurisdictions, costs do not include attorneys’ fees.13

It’s important to also understand the timing of the various triggers, and when a trigger allows an indemnitee to invoke the indemnity provision. A mere claim that may or may not result in liability, may not be sufficient. For example, in *Dining Dev., Inc. v. QFA Royalties, LLC*, discussed below, the plaintiff, a Quiznos area developer, was being sued by two third parties. It sought a declaratory judgment against the franchisor, Quiznos, that it was entitled to indemnification for the third party lawsuits. The court held that the case was not ripe for

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13 Many jurisdictions do not interpret language that merely provides for recovery of “expenses” or “costs” to include attorney’s fees. See *Woodhaven Homes & Realty, Inc. v. Hotz*, 396 F.3d 822, 825 (7th Cir. 2005) (“Wisconsin courts will not construe an obligation to pay attorney fees unless contract language ‘clearly and unambiguously so provides.’”); *Allison v. Bank One-Denver*, 289 F.3d 1223, 1244 (10th Cir. 2002) (“expenses reasonably incurred did not encompass attorney’s fees.”).
adjudication, because the underlying liability was not yet determined.14

Trigger language in franchise agreements is typically broad to protect the indemnitee to the fullest extent possible. For example:

from and against all claims, damages, losses, demands, liens, payments, suits, actions, recoveries, judgments, fees and expenses (including reasonable attorney’s fees), interest, sanctions and court costs which are made, brought, or recovered against Franchisor, by reason of or resulting from, the operation of the Franchise.

3. **Exclusions**

Exclusions are provisions that limit the circumstances or occurrences for which the indemnitor is required to indemnify the indemnitee. In the franchise context, this is often language stating that the franchisee is not required to indemnify the franchisor for damages, losses or claims which occurred solely as a result of the franchisor’s fraudulent, negligent, intentional or criminal conduct. As discussed in more detail below, franchisors give up little by including these types of exclusions and eliminate a potential red flag in the sales process. For example:

…except to the extent that that such loss or expense arises from the indemnitee’s own willful misconduct or gross negligence.

4. **Who’s Covered / Liable**

   a. **Mutual or One-Sided**

   Most indemnity provisions in a franchise agreement are one-sided in favor of the franchisor. If mutual, the indemnity to the franchisee is often limited to the franchisor’s negligence, omissions or intentional acts, or to challenges against the system’s marks.

   b. **Joint and Several**

   In general, only the indemnifying party is going to be liable under the provision unless the parties provide otherwise. Where the franchisee is an entity, franchisors generally require personal guarantees from the equity owners of the franchisee to create joint and several liability.

5. **Control / Participate / Duty to Defend (Third Party Claims)**

Many indemnity provisions simply include a brief statement at the beginning obligating the indemnitor with a duty to defend – e.g., “Indemnitor hereby agrees to indemnify, hold harmless, and defend indemnitee, from and against...” But if the indemnity provision includes defense obligations, it is good practice to clearly explain the process and expressly state who has what specific responsibilities.

   a. **Optional versus mandatory**

   The indemnitee typically wants its ability to control or participate in a dispute to be optional,

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rather than mandatory. This provides the most flexibility and allows the indemnitee to assess each dispute on a case-by-case basis, and determine what suits it best in a particular situation.

b. **Litigation or Negotiations**

Consideration should also be given to who will control the various stages of the dispute. Defining who will control or be responsible for litigation and who will control or be responsible for negotiations in the indemnity provision can avoid conflict over these issues once a claim arises. For example:

Indemnitee shall have the right, but is not obligated, to control the defense of any claim covered by this indemnity provision, using counsel of its choice. The right to control the defense includes all stages of the claim, including but not limited to, negotiations and litigation. If Indemnitee exercises this option, Indemnitor agrees to indemnify Indemnitee for all costs and expenses associated with its defense of the claim (including reasonable attorneys' fees).

c. **Approve settlements**

Identifying who has the authority to settle disputes is one of the more important considerations. It's not unusual for the indemnitee and the indemnitor to have conflicting interests or entirely different motivations for settling a claim. Thus it is worth considering and identifying which party has the authority to settle claims, or whether one or both parties must consent to a settlement. And especially if the indemnitor has the authority to settle, the indemnitee should insist on a provision requiring any settlement to include a release of claims in favor of the indemnitee. For example:

Indemnitor shall not settle any claim without the prior written consent of Indemnitee.

or

Indemnitor may settle claims in its reasonable discretion, but only if the settlement includes a full release of all claims against Indemnitee.

6. **Notice of Claim**

Typically, the indemnifying party insists on a provision requiring prompt notice of a claim or other trigger giving rise to indemnity. This allows the indemnitor to more quickly react and potentially limit its liability. This is somewhat problematic in the franchise context, however, because the franchisor tends to have exclusive control over what language gets included in the indemnity provision. Nonetheless, franchisors should not overlook including a notice provision, especially where the franchisor has offered some sort of mutual indemnity. By defining the terms of a notice it can avoid potential conflict. Otherwise the chances that the parties end up in court litigating the matter are greatly increased, as is the uncertainty of the outcome. To avoid potential conflict, the provision should specify whether untimely or defective notice excuses or limits the indemnitee’s obligations. Indemnites often seek language that a delay or failure in giving notice to the indemnitor will not impact the indemnitor’s obligations unless, and only to the extent, the indemnitor shows it was materially prejudiced by the lack of timely notice. Additional terms may specify whether indemnity is conditioned on notice, and whether litigation costs incurred prior to the notice are covered. For example:
Indemnitee shall notify Indemnitor as soon as practicable after it has notice of any claim, demand, suit or proceeding brought against it which may give rise to Indemnitor’s obligations under this provision, and shall provide to Indemnitor a detailed description of such claim, demand, suit or proceeding. Any delay or failure by Indemnitee to give notice to Indemnitor shall not relieve Indemnitor of its obligations except to the extent, if any, that the Indemnitor shall have been materially prejudiced by the failure or delay.

C. Construction with Other Terms in Agreement

1. Termination / Survival Clause

The period that an indemnity obligation is alive or, as it is alternatively stated, survives is critically important. The so-called survival period sets forth the time during which the indemnified party may bring an indemnification claim. Generally, buyers and franchisors prefer longer survival periods to provide recourse regardless of when a claim arises. Conversely, sellers and franchisees prefer shorter survival periods so that at some point the deal or, as the case may be, the franchise relationship is over and they can move forward without further tail liability or consideration of possible indemnification obligations.

In a franchise M&A context, survival periods are typically customized and can vary based on the type of claim. Survival periods for breaches of representations and warranties can range in length from six months to three years after the closing. The survival periods for certain core or fundamental representations and warranties can often be longer and in some instances are indefinite. A core or fundamental representation is a representation that is so basic, integral and important to the deal that the counter-party or recipient would not have agreed to the deal if the representation was not made or such party knew that the representation was false.

Survival periods for franchisee indemnification obligations contained within franchise agreements are often indefinite. This type of indemnity obligation is a post-closing covenant. In other words, it imposes an obligation on the franchisee to take certain actions after the franchise sale closes. Generally, longer periods of survival are more appropriate for post-closing covenants because the indemnitor has control over the prospective performance of the covenant. For example:

The indemnification provided herein is a continuing right, and shall survive the expiration or termination of this Agreement.

2. Limitation of Damages / Liability

In addition to limiting the duration of an indemnification obligation or the time period within which indemnification claims must be brought, indemnitors should want to try to narrow the scope of indemnified claims and cap their damages for such claims. In an M&A context, caps are quite common for breaches of non-fundamental representations and warranties. They can be expressed as a percentage of the deal price or as block amounts. Buyers will often seek to have fundamental representations treated differently and will try for little or no cap for such claims. Sellers, on the other hand, will often agree to higher caps for fundamental representations, but may seek to cap other indemnification claims at lower amounts or percentages of the total purchase price. Although beyond the scope of this paper, the negotiation of the scope, duration and liability of indemnification obligations in an M&A transaction can be extensive, with the parties invoking such concepts as “baskets”, “tipping-baskets” and “mini-baskets.” A seller may also seek
to limit its indemnification obligations by including provisions requiring the buyer to mitigate its damages and to first pursue payments from third parties.

The scope of and liability under the indemnification obligations contained within franchise agreements are far less frequently negotiated. Like the survival periods discussed above, this type of indemnity obligation is a post-closing covenant. As with survival periods, a broader scope for indemnified matters is more appropriate for post-closing covenants because the indemnitor has control over the prospective performance of the covenant. Accordingly, the indemnification obligations contained within franchise agreements are often of a broader scope or nature.

3. **Severability**

Indemnification provisions are narrowly construed generally. Thus, the need for a clear and unambiguous duty to indemnify is manifest. Franchisors need to resist the temptation to draft too narrowly and must avoid, where possible, overly broad limitations based on their own negligence or omissions as such carve-outs can be used to attempt to avoid the obligation to indemnify the franchisor. At the same time, overly broad duties to indemnify seeking to protect the franchisor from any and all risks irrespective of fault and causation are also subject to challenge. As a result, striking the right balance in an indemnification provision is difficult.

For these reasons, the attempted creation and inclusion of a one-size fits all, valid everywhere indemnity provision within a form contract is not without risk that the provision may not be deemed valid and enforceable. Accordingly, the inclusion of a severability or savings clause within a form contract containing an indemnity provision, such as a franchise agreement, is critically important. A severability clause is a provision in a contract which states that if any part of the contract is held to be illegal or otherwise unenforceable, the remainder of the contract should still apply. In order to further bolster the indemnification obligation through the severability provision, franchisors should consider including a statement in the indemnity obligation regarding its interpretation to the following effect:

It is understood that the parties intend this indemnity provision to be interpreted and enforced so as to provide indemnification to the indemnitee to the fullest extent now or hereafter permitted by law.

4. **Waiver**

A franchise agreement should provide that the franchisee’s duty to acquire and maintain the specified insurance coverage does not discharge or limit the franchisee’s obligation to indemnify, hold harmless and defend the franchisor under an indemnification provision. For example, the franchise agreement could include the following non-waiver language:

Franchisee’s obligation to obtain and maintain the foregoing policy or policies in the amounts specified shall not be limited in any way by

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15 See *L.A. Ins. Agency Franchising, LLC. v. Montes*, 2016 WL 4415238 at *4 (where salient language in franchise agreements was clear and unambiguous in providing for indemnification of the franchisor against claims arising out of or in connection with the franchisee’s possession, ownership or operation of the franchised business, and the franchisee sought to declare the franchise agreements unenforceable for lack of mutuality, held that the indemnification provisions at issue did not exempt the franchisor from all liability for any breach committed by the franchisor as contended and therefore could not be a basis for finding the franchise agreements to be unenforceable due to a lack of mutuality); *see also* *Commander Oil Corp. v. Advance Food Serv. Equip.*, 991 F.2d 49 (2d Cir. 1993).
reason of any insurance that may be maintained by Franchisor, nor shall Franchisee’s procurement of required insurance relieve it of liability under the indemnity provisions set forth herein. Franchisee’s insurance procurement obligations under this Section are separate and independent of Franchisee’s indemnity obligations.\(^{16}\)

5. **Choice of Law / Venue / Arbitration**

Asserting indemnity claims in a franchise context often involves complex analyses of choice of law/venue and, as applicable, arbitration provisions. Personal injury plaintiffs often prefer a state forum where a franchisee is located and an injury is alleged to have occurred. In contrast, out-of-state franchisors often prefer federal court, especially in a defense context, because among other things federal judges are more likely to be familiar with franchising and related liability concepts.

Forum selection/venue and arbitration clauses embedded in franchise agreements containing an indemnity obligation add yet more complexity to the decision-making process as to whether and when to file a cross-claim or other responsive claim for indemnity. Certain federal and state procedural rules and statutes may trump forum selection/venue clauses, as may federal and state law principles of required compulsory assertion, claim or issue preclusion, conserving judicial resources and avoiding inconsistent results. For example, federal or state rules or public policy may trump a forum selection clause where it operates to defeat a substantial public policy or interest in having a dispute heard and decided all at once by one court.

An indemnitor bound by an arbitration clause may attempt to argue that an indemnitee seeking indemnification by cross-claim or other responsive claim within a broader third-party claim violated a forum selection or arbitration clause or even waived a right to arbitrate. A narrow cross-claim for indemnification within a broader third-party claim should not be deemed a waiver of the indemnitee’s right to arbitrate any other claims, let alone its right to arbitrate claims arising under separate contracts or involving different facts or events. Waiver occurs only “when the parties have engaged in a lengthy course of litigation, when extensive discovery has occurred, and when prejudice to the party resisting arbitration can be shown.”\(^{17}\) Proof of prejudice is “key” to the analysis; without that proof the right to arbitrate is not waived.\(^{18}\) Courts have repeatedly held that the mere filing of a complaint, counterclaim, or cross-claim, especially near the beginning of a case, does not cause prejudice or waive the right to arbitrate.\(^{19}\) Moreover, even if a waiver is found as to the indemnity claim itself, a narrow cross-claim for indemnification within a broader third-party claim should not in the normal course be deemed a waiver of the indemnitee’s right to arbitrate other claims.\(^{20}\)

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\(^{17}\) Great W. Mortg. Corp. v. Peacock, 110 F.3d 222, 233 (3d Cir. 1997).


\(^{19}\) See, e.g., Gavlik Constr. Co. v. H.F. Campbell Co., 526 F.2d 777, 783 (3d Cir.1975) (“[m]erely answering on the merits, asserting a counterclaim (or cross-claim) or participating in discovery, without more, will not necessarily constitute a waiver.”); Developers Sur. & Indem. Co. v. Resurrection Baptist Church, 759 F. Supp. 2d 665, 673 (D. Md. 2010) (finding no waiver occurred where defendants filed answer, asserted counterclaims, and participated in limited discovery because defendants moved to arbitrate at the time or shortly thereafter they filed their answer and moved to arbitrate within six months of case being filed).

\(^{20}\) See, e.g., Doctor's Associates Inc. v. Distajo, 107 F.3d 126, 132-34 (2d Cir. 1997) (waiver by franchisor of the right to arbitrate with respect to some claims did not waive its right to arbitrate claims that were based on a different set of
6. **Personal Guarantees by Franchisee Principals**

As explained above, it is imperative that the controlling principals of an entity franchise either be primarily obligated to fulfill the indemnity obligation by being either a limited or full party under the franchise agreement or a guarantor of the entity franchisee’s full and faithful performance. Listing the controlling principals as primary obligors under the indemnity in a franchise agreement is not enough if the controlling principals are not signatories to the franchise agreement itself.

**D. Common Mistakes**

1. **Omitting or Inadequately Defining Indemnification Procedures**

   Perhaps the most common mistake in drafting indemnity language is either leaving out a desired term or failing to draft the provision with sufficient clarity. Either of these scenarios can have dire consequences if the client is unable to seek indemnity and shift its risk as intended, or if it leads to unwanted litigation. Thus it is critical that all of the intended events giving rise to indemnity, and all of the intended persons, are covered and adequately defined.

2. **Conflicting Language in Other Parts of the Agreement**

   Another common mistake is including conflicting or inconsistent terms elsewhere in the agreement. This opens the door for courts to alter the drafter’s intent, or even invalidate an entire term. Given the size and sometimes evolving nature of modern franchise agreements, it can be somewhat daunting to compare each provision to ensure there are no conflicting terms. Nevertheless, it obviously needs to be done.

3. **Overly Broad**
   a. **Indemnity Against Fraud, Willful Misconduct and Gross Negligence is Generally Not Enforceable**

   An indemnity that protects an indemnitee from the consequences of his or her own negligence is enforceable, but many courts are reluctant to imply coverage for a party’s own negligence absent language expressly providing for it in the contract.\(^{21}\) Other courts require that an indemnity covering a party’s own negligence be “clear and unequivocal” in order for this provision in the indemnity to be enforceable.\(^{22}\) Still other jurisdictions require that an indemnity

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\(^{21}\) See, e.g., *Westfalia-Surge, Inc. v. Dairy Tex, Inc.*, No. 03-C-4304, Bus. Franchise Guide (CCH) ¶ 12,706 (N.D. Ill. Nov. 3, 2003) (dealer of milking equipment was not obligated to indemnify a manufacturer pursuant to their dealership agreement for the manufacturer’s own negligence because, under Illinois law, contractual provisions that indemnified a party against its own negligence were against public policy unless there was clear and explicit language in the contract to the contrary).

agreement conspicuously identify the indemnity provision in a contract—by large bold-faced type, contrasting colors, all caps or some other means of distinction—if the provision provides for indemnification against injuries from a party’s own negligence.\(^{23}\)

In contrast, an indemnity against the indemnitee’s own affirmative and intentional actions such as fraud, willful misconduct and gross negligence is generally not enforceable. Most jurisdictions preclude parties from providing indemnification for intentional or willful conduct as a matter of public policy.\(^{24}\) Indemnitees generally do not resist a request to expressly exclude losses caused by their own gross negligence, fraud or willful misconduct. In effect, by doing so, they are giving up very little in a negotiation. Similarly, and quite understandably, an indemnity that protects the indemnitee from the consequences of his or her own illegal acts is not enforceable as a matter of law.

These types of overly broad provisions excusing the franchisor’s own behavior also create a significant red flag for potential franchisees. Even to a lay person they can stand out as inherently unfair. And if the potential franchisee hires an attorney to review the agreement, it is very likely he or she will advise the client of the substantial risk or even to avoid the system altogether. Thus, it can create difficulties in the sales process which will often outweigh any perceived benefit from including such language.

b. Direct Indemnity - Attorneys’ Fees Provision

Franchise agreements often provide that the prevailing party in a lawsuit between the franchisor and franchisee is entitled to recover its attorneys’ fees. Still, it is not uncommon nowadays for franchisors to forgo those provisions. If, however, the indemnity provision provides for the recovery of attorneys’ fees and is broad enough to include direct claims, the franchisor may inadvertently subject itself to a claim for attorneys’ fees by a prevailing franchisee.

In *International Billing Services, Inc. v. Emigh*, the provision at issue stated that a former employee was required “to reimburse Company for any legal fees, liability, or loss which Company incurs as a result of any unauthorized disclosure or use of Confidential Information.” The

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\(^{23}\) See, e.g., *Boyle v. Christina School Dist. Bd. of Educ.*, C.A. No. 07C-07-248 JAP, 2009 WL 4653832, at *1 (Del. Super. Ct. Nov. 30, 2009) (quoting *State v. Interstate Amiesite Corp.*, 297 A.2d 41, 44 (Del. 1972)) (stating that agreements to indemnify a party from its own negligence are enforceable when they are "crystal clear or sufficiently unequivocal to show that the contracting party intended to indemnify the indemnitee for the indemnitee's own negligence"); *Calloway v. City of Reno*, 113 Nev. 564, 577, 939 P.2d 1020, 1028 (Nev. 1997), withdrawn and superseded on other grounds, 116 Nev. 250, 993 P.2d 1259 (Nev. 2000) ("[W]hen an indemnitee seeks indemnity for its own negligent acts based on an express indemnity clause, the indemnity clause must clearly and unequivocally express the indemnitor’s assumption of liability for the negligent acts of the indemnitee."); *but see Aetna Cas. and Sur. Co. v. L. K. Comstock & Co., Inc.*, 488 F. Supp. 752, 742 (D. Nev. 1980), rev’d on other grounds, 684 F.2d 1267 (9th Cir. 1982) (making an Erie guess that Nevada would follow the "minority rule" whereby indemnity provisions are not strictly construed such that explicit reference to the indemnitee’s own negligence is required, but nonetheless finding that the subject indemnity provision clearly expressed an intent to apply even when the indemnitee is “concurrently” negligent).

\(^{24}\) See *James v. Getty Oil Co. (Eastern Operations), Inc.*, 472 A.2d 33, 38 (Del. Super. Ct. 1983) (“A contract to relieve a party from its intentional or willful acts is invariably held to be unenforceable as being against clear public policy.”); *Gross v. Sweet*, 49 N.Y.2d 102, 106, 424 N.Y.S.2d 365, 367, 400 N.E.2d 306, 308 (N.Y.1979) (“To the extent that agreements purport to grant exemption for liability for willful or grossly negligent acts they have been viewed as wholly void.”).
employees prevailed and were awarded attorneys' fees pursuant to California Civil Code Section 1717, which provides “if a contract gives one party the right to recover attorney fees in an action arising out of the contract, the other party, upon prevailing, is entitled to fees.” The Company, International Billing Services, argued that Section 1717 did not apply since the attorneys' fees provision was contained in an indemnity clause. The appellate court upheld the lower court's award of fees, reasoning that the language in the provision was sufficiently broad to include both third party and direct claims, and because it included direct claims, the reciprocity of Section 1717 applied.25

E. Indemnity and Insurance

It is often said that the essence of insurance is indemnity. Careful consideration of both concepts – indemnity and insurance – reveals why. As stated above, indemnity is compensation for damages or loss, and is often based on a contractual agreement made between two parties, in which one party agrees to pay for potential losses or damages caused or suffered by another party. Insurance, especially indemnity type insurance as opposed to life type insurance, is in essence a subset of indemnity in which one party (the insurer) guarantees to pay another party (the insured) for actual or potential losses or damages sustained by the second party (the insured).

Accordingly, agreements to indemnify are often combined with obligations to insure and other related insurance specifications and requirements. The combination of mandates to obtain and maintain levels of insurance with a duty to indemnify is designed to ensure that the indemnifying party has the means to fulfill its duty to indemnify. Like all parties who are relying on insurance to cover indemnified risk, franchisors and franchisees need to be familiar with the liability exclusions and definitions in the applicable liability policies to make sure that the insurance being maintained by the franchisee to cover the indemnity risk will in fact provide coverage for the franchisees’ usual indemnity obligations under a franchise agreement. For example, general liability policies typically provide an exclusion to coverage for liability assumed under a contract or agreement. However, there typically is an exception from the contractual liability exclusion where the contract is an “insured contract.” An “insured contract” in turn is a broader contract that has a portion or part under which an insured assumes the tort liability of another party to pay for “bodily injury” or “property damage” to a third party. Under the terms of most general liability policies, a franchise agreement qualifies as an insured contract that offers coverage to the insured for the contractual liability assumed by the franchisee under the franchise agreement notwithstanding any contractual liability exclusion.

1. Policy Requirements / Exclusions

Although most franchise agreements require the franchisee to obtain commercial general liability insurance, this alone may not be sufficient to enable the franchisee to fulfill its separate duty to indemnify the franchisor. As discussed above, the majority of general liability policies exclude coverage for liability assumed under an agreement unless the contract is an “insured contract.” In order to be able to fulfill the duty of indemnification, the franchise agreement should specify that the franchisee is required to include the franchisor as an “additional-insured” on the franchisee’s insurance policy.26


26 See Murray v. Wilbur Curtis Co., 189 A.D.2d 980, 592 N.Y.S.2d 837 (N.Y. App. Div. 1993) (holding franchisee had the duty to defend and indemnify the franchisor for vicarious liability claim because provision in franchise agreement
Courts have found that these types of indemnification provisions are enforceable even where the agreement contains a separate provision dealing with insurance coverage. This result is grounded in the idea that the provisions can and should work together to make sure that the franchisee's coverage is sufficient to fulfill the indemnity obligation.

2. Additional Insureds

Almost all franchise agreements include an indemnification and hold harmless provision requiring that franchisees indemnify and hold harmless the franchisor for the acts, errors and omissions and negligence arising out of the franchisee's franchised business. Most franchise agreements also contain a requirement that the franchisee include the franchisor as an additional-insured on its commercial general liability insurance. This additional-insured coverage typically can be obtained at little to no additional cost. It also satisfies the franchisor concern that the indemnity obligation may not be funded vis-à-vis the franchisor, blunts any contractual liability exclusion defenses and provides liquidity and asset protection to the franchisee in the event that the indemnification obligation is triggered. As discussed above, absent adequate insurance coverage or other funding, a franchisee is liable and could be held responsible to indemnify the franchisor directly out of its own assets, or lack thereof.

3. Which Applies? – Indemnity or Insurance

The franchisee’s obligation to procure and maintain insurance is independent and separate from the franchisee’s indemnity obligations. Accordingly, the indemnity clause in a franchise agreement is often set forth separately from the provisions requiring the franchisee to maintain certain minimum levels of insurance. In addition, franchisors should provide that the franchisee’s obligation to obtain and maintain certain insurance coverages does not in any way limit or relieve the franchisee of liability under the indemnity provision. The indemnity and insurance obligation provisions work together to ensure that the indemnifying party, typically the franchisee, has sufficient insurance coverage to perform its obligations to defend and indemnify the indemnified party, typically the franchisor.

IV. COMMON LAW AND STATUTORY INDEMNITY

In addition to contractual indemnity in the franchise agreement, common law and statutory

27 See, e.g., Bassett v. Burger King Corp., Case No. 292433, 2010 WL 4259682 (Mich. Ct. App. Oct. 28, 2010) (holding franchisor breached the franchise agreement when, despite obtaining the insurance required under the agreement, it failed to defend and indemnify the franchisor as required by the “unambiguous contractual provisions” of the agreement).

28 See, e.g., Mace v. Atlantic Refining Marketing Corp., 567 Pa. 71, 79-80, 785 A.2d 491, 496 (2001) (upholding the “clear and unambiguous language” of the franchise agreement providing that the franchisee must defend and indemnify the franchisor “in all claims for personal injuries arising out of [the franchisee’s] use, occupancy, custody or operation of [the franchise],”); see also City and Borough of Juneau v. Alaska Elec. Light & Power Co., 622 P.2d 954, 959-60 (Alaska 1981) (enforcing the indemnity provision in a franchise agreement that was “executed in good faith.”).

29 See Braucher ex rel. Braucher v. Swagat Group, LLC, 702 F. Supp. 2d 1032 (C.D. Ill. 2010) (holding that franchisee was obligated to indemnify under the terms of the indemnification clause in the franchise agreement, which required that the franchisee indemnify Choice Hotels for all costs, including attorney fees and the costs of suit if (1) the franchisor was subject to a claim for damages allegedly arising from the operation of the franchised hotel, (2) the franchisor is not at fault for the alleged damages, and (3) the franchisee is found to be at fault for the alleged injuries).
indemnity may also play a role in the franchise relationship. These generally apply to tort claims and are most likely to arise where the franchisor is a manufacturer and subject to claims of product liability. Historically, a retailer, distributor and manufacturer could all be held liable in product liability actions as part of the chain of distribution. While still true in many states, the majority of states have since enacted consumer statutes that either immunize the downstream participants or provide them with contribution from or statutory indemnity against the manufacturer.

For example, California imposes an implied warranty of merchantability on a manufacturer’s product, and provides that “the retail seller shall have a right of indemnity against the manufacturer in the amount of any liability under” the statute. Under Arizona’s Product Liability Statute, if the manufacturer fails to accept a tender of defense from a distributor or retail seller, the manufacturer is required to indemnify the downstream merchant for any judgment rendered against the merchant and also obligated to reimburse reasonable attorneys’ fees and costs incurred by the downstream merchant in defending the action. In general, these statutes allow franchisees to seek indemnity from their franchisor for product liability claims, if the franchisor is also the manufacturer and the franchisee is blameless as to the product defect. They can also be utilized by franchisors who do not manufacture products, but instead enter the supply chain as a distributor to their franchisees. But the obligations, remedies and exceptions to these rules vary by state. Some allow for a straight indemnity claim, while others require a tender of defense. The available remedies, such as recovery of the underlying liability or recovery of litigation expenses, can vary as well. It’s therefore essential to understand how these claims might be brought under the specific state’s law.

Similar rules can be found in state franchise laws applying to automotive dealers. The Massachusetts Dealers Act requires auto manufacturers and distributors to indemnify and hold harmless dealers from any damages including their attorneys’ fees and litigation costs. Like many of the consumer statutes relating to defective products, it only applies if the dealer is free from any negligence, and further requires the dealer to give prompt notice to the manufacturer or distributor once it becomes aware of a claim. Once notified of the claim, the manufacturer or distributor is then required to assume the defense and resolve any lawsuit at its own expense.

Where statutory indemnity is not available, it may still be possible to invoke equitable or common law indemnity. In general, equitable indemnity is available where a person is liable as a matter of law (e.g., strict or vicarious liability), but another person is entirely responsible for the injured party’s damage. The person seeking indemnity generally cannot have been involved in the manufacturing or design of the defective product, nor have altered or modified the product after receiving it from the manufacturer. While similar to the doctrine of contribution among joint tortfeasors, instead of allocating a percentage of the claim equitable indemnity typically allows an indemnitee to recover from a joint tortfeasor the entire amount the indemnitee was obligated to pay.

31 ARIZ. REV. STAT. §12-681(9) (2018); see also TEX. CIV. PRAC. & REM. CODE §82.002(a) (2018); MISS. CODE ANN. §11-1-63 (2018); IDAHO CODE ANN. §6-1407(2) (2018); N.D. CENT. CODE, §28-01.3-05 (2018).
32 MASS. GEN. LAWS ch. 93B, § 8 (2018); See also, DEL. CODE ANN. tit. 6, § 4905 (2018); N.H. REV. STAT. ANN. § 357-C:5(IV) (2018).
33 Palmer G. Lewis Co. v. Arco Chem. Co., 904 P.2d 1221, 1224 (Alaska 1995). Typically, for equitable indemnity to be viable, there must be actual liability. In Alaska, however, an indemnitee seeking equitable indemnity can recover its litigation costs, even if it prevails on the claim and no liability is found. See Id.
V. ENFORCING INDEMNITY PROVISIONS

A. Franchisor Concerns / Cases

A principal concern of franchisors reflected in the indemnity case law is the allocation and protection of the franchisor against risk presented by third-party consumer claims. This concern was presented in a mass tort context in Estate of Kriefall v. Sizzler USA Franchise, Inc.34 In that case, a three-year-old died and others had allegedly become ill after ingesting E. coli contaminated meat at two Sizzler restaurants in Wisconsin. The victims and their families sued the franchisor Sizzler USA, the Sizzler franchisee and the meat supplier, Excel. Sizzler USA reached a settlement with the victims’ families. Sizzler USA asserted cross-claims against Excel for, among other things, breach of the implied covenant of merchantability and equitable indemnity. The Wisconsin Supreme Court held that Sizzler USA was entitled to equitable indemnity from Excel in the amount of $1.5 million to compensate for settlement payments made to the family of the deceased child.35 The court found that Sizzler USA had been exposed to liability as a result of Excel’s delivery of contaminated meat, and that the settlement payment to the victims’ families was not a “voluntary” payment, and therefore Sizzler USA was entitled to equitable indemnification from Excel. Sizzler USA, however, was not entitled to recover its attorneys’ fees from Excel.36 The court held that because the underlying claims sounded in negligence, they did not justify an exception from the standard “American Rule,” which requires that a party pay its own attorney’s fees.37

Hanover Ins. Co. v. Retrofitness, LLC38 presents third-party consumer claim risk in a different context – a coverage dispute between a franchisor and its insurer. After the franchisor Retrofitness was sued along with others by several plaintiffs on a class action basis alleging a variety of consumer protection related claims, Retrofitness submitted the claims to its insurer, Hanover Insurance, and demanded coverage under two previously issued policies. On March 30, 2016, Hanover Insurance commenced a declaratory judgment action seeking declaratory relief contending generally Hanover Insurance had no duty to defend or indemnify Retrofitness and other defendants in connection with the underlying lawsuit. Hanover Insurance then moved for partial judgment on the pleadings alleging the insurance contracts contained clear and unambiguous consumer protection claim exclusions. In opposition, Retrofitness alleged that the underlying litigation was covered, not excluded, because it had procured the Hanover policies to shield itself from the liability arising out of the “special risk” inherent in a franchisor/franchisee relationship. In ruling upon the motion, the court first noted that coverage is determined by what Retrofitness actually purchased and the coverage is what is written in the policy, not what Retrofitness hoped to purchase. In then granting the motion for partial judgment on the pleadings in favor of Hanover, the court ruled that, even though there are countless causes of action that may flow from the franchisor/franchisee relationship which may be covered, consumer protection claims were explicitly excluded from coverage and, therefore, it was not objectively reasonable for Retrofitness to expect the Hanover policies to cover the underlying lawsuit.39

34 342 Wis.2d 29, 816 N.W.2d 853 (Wis. 2012).
35 342 Wis. 2d at 58; 816 N.W.2d at 866.
36 343 Wis. 2d at 73, 816 N.W.2d. at 873.
37 Id.
39 Id.
Another principal concern of franchisors reflected in the indemnity case law is the recovery of defense costs associated with third-party claims. This concern was presented in a somewhat atypical fashion in *Bergstresser v. Cooke*. The action arose from an action brought by a Mobil gas station customer against the gasoline dealer-retailer and the landlord for personal injuries arising out of an automobile tire exploding during inflation using an air hose provided to customers at the franchised business. Faced with the claim, the gasoline dealer-retailer and the landlord asserted third-party claims for indemnification and contribution against Mobil Oil (“Mobil”). Mobil counterclaimed against them for contractual indemnification, failure to insure, and contribution. Having incurred the expense of defending against the third-party claims, Mobil then sought to recover its fees and costs incurred on two contract-based theories: (1) pursuant to an indemnification provision in the franchise agreement; and (2) as damages for breach of the dealer’s duty to provide insurance coverage for Mobil under the franchise agreement. In defense, the gasoline dealer-retailer relied heavily upon a state statutory provision preventing an owner of real property from shielding itself from the consequences of its own negligence with respect to the condition of the property. In holding that Mobil was entitled to judgment as a matter of law on liability on its claim for contract-based indemnification for its costs in defending the third-party claim, the court held that the loss for which Mobil sought indemnification arose not from any negligence of Mobil with respect to the condition of the real property, but solely from the dealer-retailer’s and landlord’s conduct in bringing their third-party claim against Mobil, thereby imposing on it the expense of litigation.

Enforceability remains a major theme of the franchise indemnity case law, with franchisors and franchisees often facing off over the legal import of various indemnification provisions vis-à-vis enforceability. One such case is *Cohen v. Steve’s Franchise Co.* In *Cohen* the First Circuit held that, even though contract clauses indemnifying a party from its own negligence were looked upon with a jaundiced eye, a franchisor could require indemnification for losses from a franchisee, even for losses resulting from the franchisor’s own negligence. Applying Massachusetts contract law, the court found that Steve’s was entitled to indemnification under the franchise agreement for a pay-out made by the franchisor to a franchisee employee injured during the course of his employment in the franchisee’s business. In particular, the employee was injured when a flammable orange extract was placed on a shelf above a burner and leaked onto the employee who was melting chocolate on the hot burner below. According to the franchisee, the franchisor was not entitled to summary judgment on its claim for indemnification and the franchisee was entitled to summary judgment on its own cross-claim for summary judgment because, in large part, the employee was injured while performing job responsibilities and using authorized products in the normal course of business and in accordance with the franchisor’s own standards. The lower court agreed with the franchisee. In reversing the lower court, the First Circuit held that, even supposing all acts or omissions at the franchised location were non-negligent as to the franchisee and were undertaken in compliance with the franchisor’s specifications, the fact remained that the accident at issue indisputably occurred “by reason of acts or omissions occurring on the premises,” which were within the scope of the franchisee’s indemnity obligation and the franchise agreement should be construed to provide that the franchisee would indemnify the franchisor even for the franchisor’s sole negligence.

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41 Id.
42 927 F.2d 26 (1st Cir. 1991).
43 Id. at 29-30.
Another frequent theme of franchise indemnity cases is when an indemnity claim accrues and can be brought. *Casual Dining Development, Inc. v. QFA Royalties, LLC* is representative of this type of case. In the case, Casual Dining was a party to an Area Director Marketing Agreement with the franchisor of the Quiznos system, QFA Royalties. When widespread litigation ensued in the system between various system development related parties like Casual Dining and franchisees, Casual Dining filed suit against QFA Royalties and requested, among other things, a declaratory order of indemnification. QFA Royalties countered and the court ultimately found that the case should be dismissed because no case or controversy existed that was ripe for adjudication as there had been no finding of liability against Casual Dining. As a starting point, the court noted that, as a general rule, an indemnity claim is not ripe for adjudication until after the underlying liability is established. The court then held that because Casual Dining’s claim for indemnity was not yet ripe, the claim did not present a justiciable case or controversy under the Declaratory Judgment Act and the court granted QFA Royalties’ motion to dismiss.

B. Franchisee Concerns / Cases

Franchise agreements typically contain indemnity provisions that are either one-sided in favor of the franchisor, or if mutual, provide only limited indemnity for the franchisee. For example, when franchisors agree to indemnify the franchisee this indemnity is often limited to their own negligence, omissions or intentional acts, or to challenges against the system’s marks. It is also rare that a franchisor will agree to modify its form franchise agreement to change the indemnity provisions. Thus, franchisees tend to be the indemnitor when it relates to the franchise agreement. On the other hand, when it relates to settlement or sales agreements, these indemnity provisions are usually more mutual in nature. For example, the selling franchisee typically agrees to indemnify the buyer for all pre-sale claims, while the buyer will indemnify the seller for all post-sale claims. When settling a lawsuit, franchisees may have significantly more leverage, which often results in mutual releases and indemnity provisions. So while franchisees are more often than not the indemnitor, it is not necessarily unusual that they may find themselves in the role of indemnitee. Accordingly, the concerns and cases relating to franchisors above, are in many cases instructive to franchisees as well.

Starting with the premise that franchisees are often subject to a one-sided indemnity provision, it’s important not to overreach. Trying to invoke indemnity where none exists can expose the client to substantial costs and attorneys’ fees. As noted in the *Bergstresser v. Cooke* case above, the franchisee tried to seek indemnity from the franchisor, but the indemnity provision in that case was one-sided in favor of the franchisor. The court held that the franchisor was therefore entitled to recover its costs for defending the third-party claim. These types of judgements can be devastating to a franchisee client. The risk of bringing such claims should be carefully reviewed before committing to an action and exposing the client.

Of course, franchisees do not always find themselves in the position of indemnitor. When they are the indemnitee, it’s important to be aware of the franchisor’s obligations. Many indemnity provisions include a contractual limitation, barring claims after a certain time has passed. Therefore it is critical to understand when the claim arises, and how much time the client has to bring a claim. As discussed above, in *Dining Dev., Inc. v. QFA Royalties, LLC*, it was a Quiznos Area Developer seeking a declaratory judgement as to the indemnity provision between it and the franchisor. The court dismissed the action, holding it was not yet ripe for adjudication until the

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45 Id. at 4.
underlying third party claims were decided and liability established. The area developer, however, argued that it was compelled to file the indemnity action, because the indemnity provision contained a one year contractual limitation on claims, which began to run “from the occurrence of the facts giving rise to such claim...” Quiznos, on the other hand, argued that the claim did not arise until the underlying lawsuits established liability. The court agreed with Quiznos, and noted that if Quiznos argued in future litigation that the contractual limitation began to run earlier, the area developer could “justly argue that QFA is equitably estopped from making the argument.”46 This illustrates the rock and a hard place a franchisee may find itself in if confronted with a similar situation. One could reasonably expect that had the area developer not filed the lawsuit, Quiznos would undoubtedly have argued the limitation began to run when the third-party lawsuits were filed, or perhaps even earlier.

VI. ALTERNATIVES TO INDEMNITY

As discussed above, modern day franchise agreements contain indemnification provisions in the normal course. Such indemnification agreements, especially when combined with franchisee procured insurance coverages, provide an effective method of transferring risk from franchisors to franchisees. Alternatively, when a company decides to take responsibility for a particular risk it faces, as opposed to transferring the risk over to another party involved in the transaction or an insurance company, the risk is being retained. Risk is often retained when a company believes that the exposure/cost of retention is less than the exposure/cost of fully or partially transferring or insuring against it. Risk retention is, in essence, a decision to self-insure, subject to the procurement of further insurance coverages. Risk retention typically includes efforts to reduce or mitigate potential loss and exposure through the use of best practices and other risk reduction tools. When risk is retained, business owners have an extra incentive to seek to avoid and reduce risks and their related exposure to those risks. Owners who retain risk can and should proactively adopt procedures and practices designed to minimize and mitigate the likelihood of a significant claim. Finally, commercial insurance is the other typical tool used by businesses to manage certain types of risk. Acting alone or more likely in combination, these methods – risk transfer, risk retention and insurance – allow a franchise system to successfully allocate and manage risk.

VII. CONCLUSION

Having faced a wide variety of risks and claims each business day for years on end, the risk allocation methods of franchise business systems and related case law have become significantly developed and, to a degree, predictable. The most prominent method to allocate and manage risk within a franchise system is the use of indemnification obligations to transfer risk, typically coupled with commercial insurance products to make sure the transferred risk is practically covered against loss. This indemnity obligation is typically not contained in a stand-alone contract. Rather, it is a mere part of a larger agreement between the franchisor and its franchisee – the modern franchise agreement. While these agreements vary, they are typically robust, containing indemnity, hold harmless and defend provisions in combination, whereby the franchisee agrees to indemnify, hold harmless and defend the franchisor against claims or loss arising out of the franchisee’s operations.

46 Id.
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Bryan is one of a small number of attorneys in California to be certified as a Specialist in Franchise and Distribution Law, by The California Board of Legal Specialization. He has represented franchisees exclusively for nearly 20 years, from some of the largest franchisee associations in the country to single unit franchisees. Much of his practice involves franchise litigation, but he also represents clients in transactional matters and all aspects of general business law. He is currently the Chair of the California State Bar's Franchise and Distribution Law Advisory Commission, which oversees specialization certification in California. He is also a past Chair of the State Bar's Franchise Law Committee, which works with legislators, regulators, and the legal community in California on franchise related issues. In addition to presentations at the ABA Forum on Franchising, Bryan has also frequently been a speaker at the Franchise Expo West, and CLE programs for the California State Bar, along with repeatedly being named a Legal Eagle by the Franchise Times.

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Dean T. Fournaris is a franchise and distribution lawyer who has represented public and private franchisors, licensors, manufacturers, pharmaceutical companies, distributors and developers in matters across the country. As Chair of Wiggin and Dana LLP’s Franchise and Distribution Practice Group, Mr. Fournaris focuses his practice on developing, structuring and maintaining franchise and distribution networks, transactions and contracts involving franchise and distribution systems, and other related regulatory and transactional matters. In his practice, Mr. Fournaris regularly advises franchise and distribution system clients in connection with all aspects of their franchisee-distributor, customer, supplier and competitor relationships. Mr. Fournaris also prosecutes and defends franchise relationship and other cases based in a franchise system context, including injunction actions, before state and federal courts and arbitration panels on behalf of franchisors, manufacturers and distributors. Mr. Fournaris is recognized by Chambers USA, Best Lawyers in America and International Who’s Who for Franchise Law, by Franchise Times as a member of its Franchise Lawyer Hall of Fame and on its current list of the top U.S. franchise lawyers, and by Philadelphia Magazine as a franchise "Super Lawyer." Mr. Fournaris is a graduate of Franklin and Marshall College (B.A., 1988) and Cornell Law School (J.D., 1991).