W20-Insurance Dilemma – Challenges in Identifying Adequate Coverage for the Franchisor and Franchisee

Doug Imholte
Marsh & McLennan Agency
Minneapolis, MN  55428

and

Eleanor Vaida Gerhards
Fox Rothschild LLP
Warrington, PA  18976

and

Elizabeth M. Weldon
Snell & Wilmer L.L.P
Costa Mesa, CA

November 2-4, 2016
Miami, FL
TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. INTRODUCTION ............................................................................................................ 1</td>
</tr>
<tr>
<td>II. TYPES OF COVERAGE. .................................................................................................. 1</td>
</tr>
<tr>
<td>A. General Guidelines for Determining Proper Coverage and Limits for both the System and Franchisees .................................................................................................. 1</td>
</tr>
<tr>
<td>1. Conducting a Thorough Risk Analysis of the Industry .................................. 1</td>
</tr>
<tr>
<td>2. Tailoring Coverage Requirements for the Franchisor and Franchisee ......... 2</td>
</tr>
<tr>
<td>B. Commercial General Liability ............................................................................... 3</td>
</tr>
<tr>
<td>1. Coverage Description ...................................................................................... 3</td>
</tr>
<tr>
<td>2. Standard Exclusions ...................................................................................... 4</td>
</tr>
<tr>
<td>C. Property ................................................................................................................ 5</td>
</tr>
<tr>
<td>1. Coverage Description ...................................................................................... 5</td>
</tr>
<tr>
<td>2. Valuation in a Property Policy ........................................................................ 6</td>
</tr>
<tr>
<td>3. Coinsurance ....................................................................................................... 6</td>
</tr>
<tr>
<td>4. Standard Exclusions ...................................................................................... 7</td>
</tr>
<tr>
<td>D. Excess/Umbrella Coverage .................................................................................. 7</td>
</tr>
<tr>
<td>E. E&amp;O/Professional Liability .................................................................................. 8</td>
</tr>
<tr>
<td>1. Franchisee Coverage Description .................................................................... 8</td>
</tr>
<tr>
<td>2. Franchisor Coverage Description .................................................................. 9</td>
</tr>
<tr>
<td>3. Exclusions ......................................................................................................... 10</td>
</tr>
<tr>
<td>4. Additional Considerations: Retroactive Dates; Claims Made Coverage; and Adding Additional Insureds ............................................................... 11</td>
</tr>
<tr>
<td>F. Employment Practices Liability Insurance ......................................................... 12</td>
</tr>
<tr>
<td>1. Coverage Description ...................................................................................... 12</td>
</tr>
<tr>
<td>2. Exclusions ......................................................................................................... 13</td>
</tr>
<tr>
<td>G. Cyber Liability ..................................................................................................... 14</td>
</tr>
<tr>
<td>1. Obligations of a Franchisor and Franchisee to Protect Confidential Information .............................................................. 14</td>
</tr>
<tr>
<td>2. Determining Who Needs Cyber Coverage .................................................... 16</td>
</tr>
<tr>
<td>3. Cyber Coverage Description ......................................................................... 17</td>
</tr>
<tr>
<td>a. Information Security &amp; Privacy Liability ..................................................... 17</td>
</tr>
<tr>
<td>b. Data Breach or Loss Response Costs ............................................................ 17</td>
</tr>
<tr>
<td>c. Regulatory Defense and Penalties ................................................................. 18</td>
</tr>
<tr>
<td>d. PCI Fines and Costs ....................................................................................... 18</td>
</tr>
<tr>
<td>e. Data Restoration/Data Recovery or Loss of Digital Assets .................. 19</td>
</tr>
</tbody>
</table>
I. INTRODUCTION

Insurance coverage issues arise every day in a franchise system at both the franchisee level and the franchisor level. There are multiple risks that are unique and inherent to franchisors, franchisees and the franchise brand as a result of the business model. The complexity of insurance issues facing franchise systems is only growing. Some of the risks that now keep a franchise system’s management team up at night were barely acknowledged a decade ago as even potential threats. Franchise systems are increasingly concerned about risk exposure to vicarious liability claims and employer liability claims by third parties as a result of a franchisee’s alleged misconduct and particularly in light of recent National Labor Relations Board (NLRB) joint employment decisions. What are the keys to structuring the proper insurance requirements for joint employer risks? With vicarious liability claims on the rise, what are the best insurance practices a franchisor should put in place? How are these increased risks addressed through a well-written errors and omissions policy for the franchisor? Does the increase in high profile security and data breaches make purchasing cyber coverage an unavoidable necessity? If so, how can franchisors and franchisees navigate the myriad of options now available that purport to insure against these potential losses?

Franchise systems are often unsure how to develop and launch system wide insurance programs and requirements in a way that equitably allocates risk between the franchisor and its franchisees. As this paper discusses, joint employer and vicarious liability risks are just two of the increased exposures facing franchisors today. This is another reason why it is so important for a franchisor to review and monitor the insurance requirements in place for the franchising entity and the franchisees and update the requirements regularly to reflect the changing times. Done correctly, this will better protect a franchisor, its franchisees and the brand.

II. TYPES OF COVERAGE

A. General Guidelines for Determining Proper Coverage and Limits for both the System and Franchisees

Before a system begins to evaluate coverage requirements for its franchisees, it is important for a franchisor to focus on obtaining its own sufficient coverage for the protection of the franchise system. Step two is determining proper coverage and limits for the franchise system’s franchisees.


A franchise system must first analyze the industry in which it and its franchisees do business to thoroughly understand those exposures for which they are most at risk. Take time to identify and understand the unique risks of the franchise system. For example, does the system work with children like tutoring centers, daycares or schools? Is delivery involved? Does the business consist of food preparation or hiring many employees? Do franchisees handle personal data from clients? Do franchisees go into customer’s homes or provide personal services such as hair removal, massage or facials? Insurance coverage is not a one-size fits all product. These are all diverse risks and can expose franchisees and, potentially the

---

1 This paper represents the collective work of the authors. However, given the nature of the topic and its treatment, as well as the desire to analyze the topic in a unified paper, any particular views expressed herein do not necessarily represent the view of an individual author.
franchisor, if not insured properly. Taking this step will help to reduce the franchisor’s vicarious liability exposure. Moreover, identifying where franchisees have the greatest risk of claims (both in frequency and severity) is an important starting point to determining appropriate coverage for all.

2. Tailoring Coverage Requirements for the Franchisor and Franchisee.

The next step is to tailor coverage for the franchise system by improving insurance requirements to address those risks. As mentioned above, different types of policies are needed based upon the services and products provided by the franchisees. At the same point, over-insuring against any and all potential types of claims is ill-advised. Franchisees should understand and accept that the coverage required by the franchisor is necessary for the protection of their businesses and the system. Unnecessary or excessive coverage requirements can create distrust between a franchisor and its franchisees and give the appearance that the franchisor is trying to protect the system against unlikely or remote risks at the expense of the franchisee. Franchisors should attempt to find a middle ground, and they should work with an insurance advisor to determine appropriate coverages and limits for the franchise system and required coverage for the franchisees.

There is no set formula for determining the coverage limits a business should carry. However, there are a variety of different criteria that a business should consider, such as risk grades, revenues, number of employees, contractual agreements, fleet size, strength of the balance sheet, and others. Reviewing these risk criteria, combined with the franchise risk tolerance, can help to ensure a franchise system and its franchisees are adequately protected.

From the franchisee perspective, a franchisee must analyze what coverage may be needed for the franchise relationship and to comply with the franchise agreement, as well as determine generally the proper coverage necessary for the underlying business.

There are a number of general guidelines an insured should follow when evaluating an insurance policy:

1. Remember that it is unlikely that one insurance carrier will offer the same exact coverage to insure against the same risk for significantly less than a competitor. If you notice a large difference in premium quotes, then compare the coverage, policy language, deductibles and sub-limits very closely. Be an informed consumer. You do not want to find out the franchise system or a franchisee lacks coverage after litigation or some other claim commences.

2. Read the full policy from start to finish. The policy will detail the definition of the named insured, key coverage provisions and exclusions. For example, sometimes coverage that an insured assumes is part of the policy is actually excluded by the insurance carrier in an endorsement. Make sure that required or necessary coverage is not carved-out and excluded under the policy in a later endorsement attached to the front or back of the policy.
3. Do not be afraid to ask the insurance agent or broker questions about the policy and if you are not comfortable with the answer, then ask counsel versed in insurance matters to provide a coverage analysis.

4. Examine the definitions of “Named Insured” and/or “Covered Party” in each policy. Confirm that it includes all the necessary parties, such as independent contractors, part-time employees, temporary workers and volunteers? For example, if your franchisees operate pre-school, does a covered party include substitute teachers, student interns and teachers aids?²

5. Always examine any described “business description” in the declarations page of each policy to be sure it adequately reflects the insured’s operations. Often, and particularly in the case of franchise systems, it is not as comprehensive as necessary.³

B. Commercial General Liability

1. Coverage Description.

General liability is the most common purchased liability policy for business owners and often their first line of defense. A commercial general liability (CGL) policy provides insurance coverage for claims arising from bodily injury, property damage, personal and advertising injury, and can include coverage for products and completed operations. Virtually all franchisors and franchisees will maintain some form of CGL policy as it is the standard business coverage needed for both franchise systems and its franchisees. Within CGL coverage, there is a wide range of additional covered perils that can be added to the policy including:

Non-owned Auto: Basic business automobile insurance typically only covers employees when the employee is driving or operating a company-owned vehicle to conduct company business. “Non Owned Auto Liability” insurance protects a business if it is sued as a result of an auto accident involving a vehicle not owned by the business (for example, an automobile registered to an owner of the business personally, or owned by an employee) if the driver was using the vehicle for company business. These situations occur where employees use their own vehicles to go to the post office or bank or pick up supplies or lunch on the employer’s behalf. It also could occur when an employer provides a car allowance to sales or other employees who use their personal vehicles to meet with customers or clients. Under these circumstances, the business could be held liable for damages.

² See, e.g., Gantman v. United Pacific Ins. Co., 232 Cal. App. 3d 1560 (1991) (holding that individual members of a homeowners association in a planned residential development lacked standing to maintain an action against the insurance company because the policy was purchased by and issued to the homeowners association and the individual members were not insureds under the policy).

³ See, e.g. Westfield Ins. Co. v. Vanderberg, 796 F. 3d 773 (7th Cir. 2015) (holding that the insurance policy only afforded coverage for construction-related business because the business designation and the general liability schedule contained in the insurance policy expressly and uniformly limited the scope of the insurance policies to construction related business, and, thus, the insurance company was not liable for damages arising from a yacht accident).
If an employee is involved in an auto accident while on the job and severely injures him or herself or another party, then a claim resulting from such an accident would trigger a business’s non-owned auto coverage. Initially, the employee’s personal automobile liability coverage would likely respond to such a claim. However, an injured party looking for deeper pockets (particularly in the case where the employee’s automobile coverage has low limits), may sue the business under the theory that the employee was “on duty” at the time of the accident.

**Liquor Liability Coverage:** Liquor liability insurance protects a business against claims that occur because a patron of the business has become intoxicated and injured himself or someone else. A business will need this coverage if it manufactures, sells, serves, or furnishes alcohol to others. Liquor liability coverage may be purchased separately or combined with a CGL policy.

**Business Income & Extra Expense (also known as Business Interruption):** “BI” covers the loss of income, and other expenses, to a business should that business be forced to close, or relocate, for a period of time due to a covered loss. The intent of this coverage is to put the business back on the same financial footing as if no loss had occurred. The following are some of the expenses typically covered under a business interruption insurance policy: (i) loss of income/profits typically based upon prior year financial statements of the same time period; (ii) operating expenses such as rent, utilities and salaries; (iii) the cost to relocate to a temporary location; and (iv) “extra expenses” or those other reasonable expenses incurred by the business while the insured’s property is being repaired, such as increased training costs if employees have to be trained on new equipment.

Again, it is important to tailor insurance coverage to the products delivered and services performed by the franchisees. Not all insurance policies are the same and significant gaps could lead to a franchisee claim not being covered and potential exposure for the franchisor.

2. **Standard Exclusions**

Contrary to the name, though, “general” liability policies have many limitations of coverage. For example, CGL policies do not provide coverage for “employment practices” claims such as harassment, discrimination, or wrongful termination claims; data privacy issues; workers’ compensation claims; professional liability for services performed; and many others. Almost all standard CGL policies also exclude coverage for (i) pollution; (ii) liquor liability; (iii) fraudulent and criminal acts; and (iv) intellectual property infringement.

In addition, franchisors must carefully review and assess all CGL policies for any exclusion which may impact coverage for vicarious liability claims. Often CGL policies limit coverage to the classification for which the insured does business so the underwriter does not become responsible for exposure which was not rated for on the policy. For example, a franchisor that offers and sells frozen yogurt shops may be rated as an “office” business – not as a business that operates a frozen yogurt unit location. This could lead to a denial by the
carrier and a gap in coverage for the franchise system in the event that the franchisor is brought into a vicarious liability claim by a customer of a frozen yogurt shop franchisee.4

Too many franchise owners wrongly believe a CGL policy will cover any and all potential claims against their business and do not understand, until they have filed a claim, that they are not adequately covered under a standard CGL policy. A CGL policy is just the first policy in what should be a comprehensive insurance binder of coverage.

Always review the exclusions to ensure coverage is not illusory. Standard exclusions may be acceptable for most businesses but not the franchise system or a particular franchisee. Most state courts interpret coverage under an insurance policy broadly to afford the greatest possible protection to the insured and interpret exclusions narrowly against the insurer.5 However, insurance policy language is typically construed, like any other contract, according to its plain meaning, and a clear exclusion will preclude coverage in most cases.6 Further, coverage disputes with carriers can quickly become time consuming and expensive for business owners.

C. Property

1. Coverage Description

Property insurance is first-party insurance that indemnifies the insured for the loss of physical property or the loss of its income-producing ability, when the damage or loss is caused by a covered peril such as a fire or explosion.7 Commercial property insurance is designed to protect businesses from unanticipated disasters. Covered events typically include fire, windstorms, theft, or vandalism and the policies are structured to provide coverage for owned/leased buildings, appurtenances, fixtures, furniture, contents and stock including computers, furniture, inventory, equipment, signs and property in the insured’s care custody and control. The declarations page will contain a “Schedule of Locations” where the insured will provide the addresses of each location insured under the policy. Many policies also include Business Interruption insurance discussed above.

Commercial Property Insurance programs are a critical coverage for any business owner, especially if the business has a lot of costly equipment. There are many different coverage options available and the structure of a program is critical in keeping costs manageable while ensuring businesses can recover from a disaster. There are two standard coverage forms that are used by most insurance companies:

---


6 See Century Surety Co. v. Casino West, 329 P. 3d 613, 616 (Sup. NV 2014); Fisher v. State Farm Mutual Auto. Ins. Co., 371 Mont. 147, 150-51 (2013) (“When interpreting an insurance contract, we accord the usual meaning to the terms and the words used, and we construe them using common sense.”); Guam Indus. Services, Inc. v. Zurich American Ins. Co., 787 F.3d 1001 (9th Cir. 2015) (stating that unambiguous insurance policy terms must be given their ordinary meaning).

i. **Basic (Named Perils).** These policies cover only the incidents listed in the policy. This coverage form may be desirable where a business is in a high-risk area for a specific peril, such as a flood or an earthquake. Named perils coverage is usually less expensive because it covers only the specific events listed in the policy.

ii. **Special (All Risk).** These policies provide coverage for any incident unless it is specifically excluded in the policy. Typically, perils like fire, wind, smoke, theft, and vandalism are covered. This coverage protects businesses from the majority of risks they are most likely to face.

2. **Valuation in a Property Policy**

   Insurance companies have several possible methods of establishing the value of insured property to determine the amount the insurer will pay in the event of loss.

   i. **Replacement Cost (RC).** With replacement cost coverage, in the event of a loss, property would be based on the cost of buying the same piece of property, of similar kind or quality new. There is no deduction for depreciation.

   ii. **Actual Cash Value (ACV).** With actual cash value coverage, in the event of the loss, property would be based on the cost of buying another aged piece of property of like, kind and quality. Depreciation is factored into the valuation.

   iii. **Functional Replacement Cost (FRC).** Functional replacement cost can be used if the business owns property that can no longer be replicated, such as historical buildings. This is used to provide coverage for another item of property that will perform the same function with equal efficiency, even if it is not identical to the property being replaced.

   From the franchisor’s perspective using “replacement cost” is the best valuation method for assuring that the franchisee will have sufficient insurance proceeds to get the business back up and running, but it may also impose a higher premium.

3. **Coinsurance**

   Coinsurance is a condition on insurance policies that protects insurance companies from having policyholders undervalue their property since the likelihood of a total loss is much less than that of a partial loss. Coinsurance provides a percentage of value that the policyholder is required to insure compared to its ACV or RC. If a business insures its property for less than that value, the insurance company imposes a “coinsurance penalty” once a claim is filed. The value is determined at the time of the loss. If the amount of insurance is found to be under the stated coinsurance percentage, then a penalty is applied reducing the claim payment.

4. **Standard Exclusions**
Be sure to read your policy and understand if you have a basic or special form. Basic form limits coverage to perils listed, while the broader special forms provides coverage for all causes of loss unless specifically excluded. Here are some examples of commonly excluded perils:

i. Flood;

ii. Earthquake;

iii. Mold;

iv. Faulty Design/workmanship;

v. Wear and tear; and

vi. Pollution.

A franchisor should consider whether requiring “All Risk” property coverage is appropriate for its franchisee. Often franchisees are spread among various states and geographic regions. The last decade has shown an increase in devastating weather related losses due to snow, ice, hail, wind, drought, hurricanes and floods. If the franchise system has an approved supplier, then it should ensure that the coverage package negotiated and offered to franchisees does not erode coverage for certain weather conditions that may be prevalent in the area where a particular franchisee is located. Ideally, a commercial policy will be “all risk” and cover against the majority of all potential weather related losses at the full value of the policy. Many policies, however, have limits for certain weather related claims or exclude coverage altogether. For example, insurance carriers usually require a wind and hail deductible for locations along the coasts.

D. Excess/Umbrella Coverage

The terms “excess policy” and “umbrella policy” are often used interchangeably but there are differences. An “excess policy” is a policy “issued to provide limits in excess of an underlying liability policy which can be, and often is, an umbrella policy."8 It is no broader than the underlying policy and its sole purpose is to provide additional limits of insurance.9 Excess policies are “follow form” policies which means that they follow the underlying policy as to how the provision applies, including conditions and exclusions.10 In other words, it will include and exclude the same perils as underlying policies. It will contain a standard “follow form” clause such as: “it is agreed that this policy, except as herein stated, is subject to all conditions, agreements, and limitations of and shall follow the underlying policy.”

An umbrella policy is a type of excess policy and also provides additional coverages beyond the limits and scope of the underlying liability policy(ies).11 However, an umbrella policy can be written over various primary liability policies, such as a general liability policy business automobile policy, watercraft and aircraft liability policies and employers’ liability coverage

---


9Id.

10For further information on the use and interpretation of “follow form” clauses see Coleman Co. v. California Union Ins. Co., 960 F.2d 1529 (10th Cir. 1992); Commercial Union Ins. Co. v. Swiss Re Ins. Corp., 413 F.3d 121 (1st Cir. 2005); Rockwell Automation, Inc. v. Nat’l Union Fire Ins. Co. of Pittsburgh, 544 F.3d 752 (7th Cir. 2008).

11Id. at 286.
where an excess policy can only be applied to one underlying policy. An umbrella policy serves three purposes:

i. “it provides excess limits when the limits of underlying liability policies are exhausted by the payment of claims;

ii. it drops down and picks up where the underlying policy leaves off when the aggregate limit of the underlying policy in question is exhausted by the payment of claims; and

iii. it provides protection against some claims not covered by the underlying policies, subject to the assumption by the named insured of a self-insure retention.”

Both excess and umbrella policies are designed to protect against catastrophic losses. For example, multiple sexual molestation charges against a daycare employee or an incident that causes the death or serious injury of numerous customers.

Franchisors should carefully consider what type of coverage would require an excess or umbrella policy. This is another area where the franchise agreement or operations manual may require coverage that is not possible or economical to secure or where the franchisee simply fails to secure it. For example, often franchisors will require an excess or umbrella to cover all franchisee insurance policies, however this may not be possible depending on whether a carrier will underwrite an excess or umbrella policy for cyber coverage, for example. In other cases, an umbrella or excess policy can be obtained to provide coverage for each of the required underlying policies but the franchisee may inadvertently fail to ensure that the umbrella policy does so. It is always critical to closely examine the declarations page of an umbrella policy which contains the “Schedule of Underlying Policies”. If a policy is not listed on this schedule, then the umbrella policy will not provide excess limits. This is a very common area where the franchisee’s coverage does not meet the franchise system’s requirements or expectations, so franchisors should be extra diligent during audits or compliance checks.

E. E&O/Professional Liability

1. Franchisee Coverage Description

A standard errors and omissions or professional liability policy (“E&O”) provides coverage against claims for alleged negligence in the performance of professional services. This form of coverage is particularly important for franchise businesses employing teachers, accountants, consultants, bookkeepers, individuals engaging in drug and alcohol testing, physicians or travel agents and other professionals where the services, advice and work product an employee provides can cause financial harm to another party. Companies that perform professional services for others will at some time make mistakes—overlook a critical piece of information, misstate a fact, be misunderstood, forget to do something or misplace something. They can be sued by their clients or customers over allegations such as:

\[\text{id.}\]

\[\text{id.}\]
i. negligence in providing a service;
ii. failure to provide a service;
iii. fraud;
iv. improper documentation;
v. malpractice;
vi. mismanagement;
vii. misrepresentation of facts;
viii. nondisclosure; and
ix. violations of state and federal law (e.g., securities violations, violation of right to privacy, etc.).

2. Franchisor Coverage Description

A franchisor’s E&O coverage provides defense and indemnification coverage for alleged mistakes, exclusions or negligence in their professional services to their franchisees. The definition of “professional services” should state “in performance of franchisor services”. Without clear “Franchise Services” coverage, claims by franchisees may be excluded on many different grounds. Coverage should be made as broad as possible through this definition to encompass the broad range of services, activities and areas of guidance franchisors provide to franchisees. Coverage should include:

i. marketing and solicitation activities undertaken or engaged in by the franchisor in connection with the offer of sale of franchises pursuant to any franchise agreement or contract;

ii. the preparation, registration, renewal and/or amendment of a franchise disclosure document (“FDD”);

iii. duties, obligations or other responsibilities of the franchisor to franchisees which render the franchisor liable to the franchisee, including a claim arising out of third party claims against the franchisee, including, but not limited to the development of standards, specifications, and operating procedures for the franchisees prescribed by the franchisor or failure by the franchisor to monitor compliance with such standards, specifications and operating procedures;

iv. failure to comply with any federal or state law or regulation or the terms of a franchise agreement or contract respecting the renewal or termination of the relationship of the parties to such agreement;

v. rendering of services, training, advertising or other support to franchisees pursuant to the terms of a franchise agreement or
contract or as disclosed to franchisees in an offering circular or other disclosure document; and

vi. assistance in: (i) the selection of a franchise site; or (ii) negotiation of a lease for the premises of a franchise.

Note that underwriting standards may be higher for less mature systems that have not perfected a system support structure and proven brand. Typically, underwriters are going to review the FDD, and assess operations support and growth of the system.

Two emerging issues in the area of franchisor E&O coverage include (i) coverage disputes related to increased risks in the areas of cyber liability, vicarious liability, and joint employer claims and (ii) exposure of a franchisor to class actions brought by multiple franchisees.

For example, if one or multiple franchisees is liable for a data breach and suffers a financial hardship, then a franchisor may be exposed for a claim by the franchisee or franchisees alleging that the data breach was due to franchisor’s negligent training, procedures or requirements (for example, franchisees required use of an approved point-of-service system or vendor whose out of date security practices exposed the franchise system to a data breach). The franchisor may attempt to file an E&O claim as part of its “performance of Franchisor services.” In such a case, an underwriter may or may not provide defense and indemnity depending on the scope of the definition of “franchisor services” under the policy, the policy exclusions and the allegations in the underlying complaint. A franchisor should be cognizant of these new bases for claims, stay ahead of potential exposures and analyze in advance how a policy may address these claims.

3. **Exclusions**

E&O policies typically contain a standard list of exclusions including (i) fraudulent and criminal acts, (ii) breach of contract or warranty, (iii) bodily injury or property damage, and (iv) liability assumed under contract.

Carriers have used the “breach of contract” exclusion to deny defending and indemnifying franchisors against franchisee claims that the franchisor breached the franchise agreement. In *Certified Restoration Drycleaning Network v. Federal Ins. Co.*, a federal court in Michigan granted summary judgment to an insurance carrier following its denial of liability coverage and refusal to defend and indemnify a franchisor who was alleged to have breached a franchise agreement. The policy exclusion provided:

No coverage will be available . . . based upon, arising from, or in consequence of any actual or alleged liability of an Insured organization under any written or oral contract or agreement, provided that this Exclusion (c)(2) shall not apply to the extent that an Insured Organization would

---


15 *Id.*
have been liable in the absence of the contract or agreement.\textsuperscript{16}

In this case, the franchisor attempted to show that the underlying suit did not actually claim a breach of contact but rather misrepresentation and fraud that arose prior to entering into the franchise agreement.\textsuperscript{17} The franchisor pointed to the recitals in the settlement entered into with the franchisee stating that “[the franchisor] misrepresented to [the franchisee] that [it] would earn a minimum of $3 million per year in gross revenues” and “that [the franchisor] misrepresented to [the franchisee] that [the franchisee] would be awarded the Philadelphia franchise if it took over the franchise in Northeast Pennsylvania.”\textsuperscript{18} The court did not agree.\textsuperscript{19} It analyzed the four corners of the franchisee’s complaint which alleged only breach of contract claims and concluded that the breach of contract exclusion precluded coverage.\textsuperscript{20}

Finally, sometimes a franchisor will receive a “demand letter” from a franchisee and agree to return the franchise fee to avoid the franchisee from filing a formal complaint in arbitration or court. If the franchisor then attempts to submit the claim to its carrier, the insurer will likely deny a claim made after refund of the franchise fee or other settlement with a franchisee because an insurance policy is not going to cover business decisions. If a franchisor makes a business judgment to return franchisee fees without including the insurance carrier, then the refund or payment to the franchisee will not be a covered claim.

4. Additional Considerations: Retroactive Dates; Claims Made Coverage; and Adding Additional Insureds

Most E&O policies are claims-made policies, not occurrence form. Claims-made policies provide coverage when a claim is made against the insured during the policy period, regardless of when the wrongful act that gave rise to the claim took place.\textsuperscript{21} The exception to this is that a “retroactive date” is applicable to a claims-made policy. In such instances, the wrongful act that gave rise to the claim must have taken place on or after the retroactive date. The retroactive date of a policy is typically the date of the policy. A policyholder should attempt to obtain a retroactive/inception date as far back as possible. This is important as alleged wrongful acts that occur before the retroactive/inception date of the policy are not covered.

\textsuperscript{16} Id. at *3.

\textsuperscript{17} Id.

\textsuperscript{18} Id. at *5.

\textsuperscript{19} Id.

\textsuperscript{20} Id. at *6.

\textsuperscript{21} An occurrence policy, however, does not restrict the period during which the claim may be made. Coverage is triggered if the incident underlying the claim happens during the policy period, regardless of when the claim is actually asserted against the insured. California Practice Guide: Insurance Litigation, supra n. 4, Ch.7A, 7:38. See A.C. Label Co. v. Transamerica Ins. Co., 48 Cal.App.4th 1188, 1192 (1996) (comparing “claims made” policies to “occurrence” policies); Homestead Ins. Co. v. Amer. Empire Surplus Lines Ins. Co., 44 Cal.App.4th 1297, 1303 (1996) (“A ‘claims made’ policy is one whereby the carrier agrees to assume liability for any errors, including those made prior to the inception of the policy . . . [whereas] an ‘occurrence policy’ provides coverage for any acts or omissions that arise during the policy period[,]” (internal alterations and citations omitted)).
Therefore, it is important for a business to get E&O coverage in place as quickly as possible, and/or negotiate a more favorable retroactive date.

Defense costs and expenses are often included – and not in addition to - the policy limit. Since these costs can quickly erode the policy limits, a good practice is to negotiate policy terms to have defense costs outside the policy limits, when possible. E&O policies cover legal defense costs whether the claim is meritless or genuine. The cost to defend an E&O lawsuit (including attorneys’ fees, filing fees, expert costs and related expenses), even a baseless lawsuit, can be extremely expensive. A business does not want to find itself in a situation where it eroded the limits of a policy on defending the lawsuit and has no remaining coverage to pay a settlement or damage award.

Coverage for independent contractors, area developers and master franchisees can be included in a properly written franchisor E&O policy. Independent contractors should usually be included as often these are the external franchise consultants and/or outsourced operations consultants. A franchisor may not want to include area developers and master franchisors as a named insured on the policy, however, due to the fact that these policies have an insured vs insured exclusion. This means simply that one insured on a policy cannot file a claim against another named insured on the policy. It attempts to curb the potential for collusion between insureds.22

F. Employment Practices Liability Insurance

1. Coverage Description

Employment Practices Liability Insurance Coverage (“EPLI”) is protection for claims made by employees, applicants for employment and/or past employees against an employer for employment related matters. EPLI coverage is written to protect a business against damages for events relating to its workforce, including but not limited to; wrongful terminations, harassment, discrimination, defamation and unfair hiring/firing practices and provide defense costs associated with responding to employment related lawsuits. Examples of EPLI claims include:

i. Race and Sex Discrimination
ii. Emotional Distress Harassment / Discrimination
iii. Wrongful termination Discharge in Violation of Public Policy
iv. Invasion of Privacy
v. Retaliation
vi. Breach of Contract
vii. Defamation
viii. Regulatory Violations and Government Investigations

22 The “insured vs. insured” exclusion (sometimes called the “interinsured suit” exclusion) eliminates coverage for suits brought by one insured against another, including the corporation, with the exception of shareholder derivative actions if commenced without the assistance or solicitation of any insured.” California Practice Guide: Insurance Litigation, supra n. 4, Ch. 7F-C, 7:1684. See, e.g., Am. Medical Int’l, Inc. v. Nat’l Union Fire Ins. Co. of Pittsburgh, 244 F.3d 715 (9th Cir. 2001) (finding insured v. insured exclusion precludes coverage for suits initiated by one current or former director against another director regardless of whether the plaintiff was suing in another capacity); Bilimore Associates, LLC v. Twin City Fire Ins. Co., 572 F.3d 663 (9th Cir. 2009) (explaining that insured v. insured exclusions attempt to mitigate collusive and moral hazard risks because a company, acting through its directors and officers, would otherwise be able to collect from the insurance company for its own mistakes).
ix. Equal Pay Act (EPA) Violations
x. Department of Labor (DOL) Title VII Violations
xi. Age Discrimination in Employment Act (ADEA) Violations
xii. Americans with Disabilities Act (ADA) Violations
xiii. Family Medical Leave Act (FMLA) Violations

Coverage is also structured to provide claims made by third parties (non-employees) for claims of harassment or discrimination. Both the franchisor and each franchisee should maintain adequate EPLI coverage if they employ any staff. However, there are limitations to the coverage provided under an EPLI policy as explained below.

2. Exclusions

Often these policies do not provide coverage for failing to comply with various statutes such as:

i. Workers’ Compensation
ii. Social Security
iii. Unemployment Insurance
iv. Disability Benefits
v. National Labor Relations Act
vi. Fair Labor Standards Act (“FLSA”) (except the Equal Pay Act)
vii. Occupational Safety and Health Act (“OSHA”)
viii. Consolidated Omnibus Budget Reconciliation Act (“COBRA”)

Most EPLI policies exclude any coverage for such statutory claims. Typically, neither the franchisee or the franchisor can insure against this risk. Insurance carriers today are not able to adequately cover this exposure. Claims under the FLSA and similar state laws (wage and hour claims) are becoming increasingly more common, especially in the hospitality industry. Some policies may provide a defense sublimit, typically in the range of $100,000, but there is no indemnity protection if the plaintiff prevails. A franchisor should carefully review a franchisee’s EPLI coverage and insist upon wage and hour defense coverage, when possible. Some underwriters are providing defense and indemnity for wage and hour claims but the retention is too large to warrant application in most cases. Other standard exclusions to EPLI policies include (i) punitive or exemplary damages; (ii) intentional conduct; (iii) fines or penalties imposed by law; and (iv) liability assumed under contract, among others.

G. Cyber Liability

A week does not go by now without a data breach by a well-known brand making headlines. Insurance protection against “data breaches” is no longer just an option for a few large risk adverse national franchise systems. It is becoming a necessity for any franchisor and its franchisees. As most franchise systems now know, “Cyber liability” is a form of coverage that has developed over the past decade to protect against identity theft and data breaches. Unfortunately as technology advances, criminals continue to create new ways to steal identities and information. Franchisors are constantly inundated with horror stories about how prevalent and relentless the threat of hacks to a franchise system’s network or its franchisee’s computers has become. Cyber liability coverage can protect both losses suffered by the franchisor and its franchisees, as well as losses suffered by customers or other third parties. Without sufficient coverage to protect against these potential losses, the costs to remedy a serious data breach, including hiring forensic advisors to determine the extent of a breach, notifying all possible affected customers under state law, and possible damage claims could put a franchisee out of business. However, cyber liability insurance products are still relatively new and evolving. The policies are not uniform among those carriers offering the products and knowing what coverage is needed to adequately protect a franchise system can be complex and overwhelming.

1. Obligations of a Franchisor and Franchisee to Protect Confidential Information

As with any coverage analysis, the first step is understanding what a business’ obligations are and what risks the business needs to insure against. A business may have a duty to keep confidential non-public information about its customers and clients. This information includes:

i. personally identifiable information (“PII”) such as social security numbers, driver’s license information and usernames and passwords;
ii. protected healthcare information; and
iii. credit card and other financial data.

PII is not limited to the information described above and it can also include addresses, phone numbers and demographic information (such as gender and age) and photographs. Confidential information is also not limited to PII of consumers. It can also include trade secrets and data of vendors, suppliers and business partners and employee data.

There is not one single federal law that governs the collection, storage, use and disclosure of PII and the remediation obligations of a business in the event of a data breach. Instead, there is a patchwork of federal regulations that mandate certain practices depending on industry and the type of data collected.\(^{31}\) For those companies which do not neatly fall within

\(^{31}\)See the Health Insurance Portability and Accountability Act (HIPAA) requiring businesses to “protect against any reasonably anticipated threats or hazards to the security or integrity” of confidential health information. 45 C.F.R. §164.306(a)(2); the Gramm–Leach–Bliley Act (GLBA), also known as the Financial Services Modernization Act of 1999 requiring financial institutions to “develop, implement, and maintain a comprehensive information security program” and appropriate administrative, technical and physical safeguards. 16 C.F.R. § 314.3(a); and the Children’s Online Privacy Protection Act (COPPA), requiring the operator of any website or online service that collects PII from children to provide notice on the website of what information is collected, how the operator uses the PII, and its disclosure practices for such PII as well as obtain parental consent for the collection, use, or disclosure of the PII, 15 U.S.C. § 6501 et. seq.
any of the specific federal regulations, the Federal Trade Commission (“FTC”) has also started to “police companies for exposing data they collect from consumers to the threat of breach.”32 A handful of states have also passed laws requiring that businesses take measures to protect PII, 33 and almost all have enacted legislation requiring businesses to notify individuals of security breaches of information involving PII.34 A full analysis of the scope of a business’ obligations under state and federal law is beyond the scope of this paper. For purposes of evaluating whether cyber liability insurance is a critical risk management tool, it is important to note that the obligations on a business collecting and storing PII are substantial and continuing to grow.

2. **Determining Who Needs Cyber Coverage**

A franchisor’s first question is typically whether the system needs cyber insurance coverage. The next question is whether cyber coverage should be a requirement for franchisees. The answer to both questions is typically yes. A franchise system’s data collection practices are unique. Often a franchisor will require a common Point-of-Sale system at the franchisee level that collects data at each individual unit location which is then accessible by the franchisor. This structure exposes both the franchisor and each franchisee to potential data breaches. Insurance coverage at both the franchisor and franchisee level is critical in protecting a franchise system.

32FTC v. Wyndham Worldwide Corp., 799 F.3d 236 (3rd Cir. 2015).


The recent class action against Wendy’s highlights the exposure a franchise system faces when multiple locations experience a breach.\(^{35}\) In the *Wendy’s* case, the plaintiffs allege that the franchisor failed to secure customers’ credit card data and PII and did not provide timely notice to affected customers whose data was stolen.\(^{36}\) The plaintiffs assert that Wendy’s could have prevented the breach if it had implemented new technology and adopted stronger measures to protect the data. Wendy’s is not the first franchise system that plaintiffs have tried to hold liable for the data breaches of one or more franchisees. In *Patterson v. Denny’s Corp.*\(^{37}\), a customer sued both a Denny’s franchisee and national franchisor, Denny’s, alleging that the franchisee printed the expiration date of his credit card on his receipt in violation of the Fair and Accurate Credit Transactions Act of 2003 (“FACTA”).\(^{38}\) The court denied Denny’s motion to dismiss, finding that the plaintiff’s allegation that Denny’s exercised actual control over the franchise operations was enough to state a vicarious liability claim under FACTA.\(^{39}\)

Similarly, a franchisee’s potential exposure to data breaches makes cyber liability coverage a necessary requirement. There are very few franchise systems existing where the franchisees do not collect at least some confidential information about customers, clients, business partners or employees. In addition, recent studies indicate that almost half of all hacking attacks are directed at small businesses.\(^{40}\) Finally, cyber coverage is becoming less cost-prohibitive as additional providers enter the market and policies can be tailored to fit the needs of a franchisee’s business.

3. **Cyber Coverage Description**

Once a franchise system determines that cyber liability coverage is necessary, the next step is deciphering the types of costs, expenses and damages insurable under the policies. There are two main components of a cyber-liability policy:

i. **THIRD PARTY LIABILITY:** Third party coverage insures against claims by customers or other parties affected by a data breach. A general description of each type of coverage is described below.

ii. **FIRST PARTY EXPENSES:** First party coverage includes a business’s costs for: forensic investigations, notification requirements under state law, credit monitoring for those affected

---


\(^{36}\) Id.


\(^{39}\) *Patterson v. Denny’s Corp.*, supra n. 37, at *2. *See also Keith v. Backyard Burgers of Nebraska, Inc.*, Case No. 8:11CV135, 2012 WL 1252965 * 2 (D. Ct. Neb. April 13, 2012)(denying the franchisor’s, Backyard Burger’s, motion for judgment on the pleadings, finding that the franchisor could be vicariously liable under FACTA if the franchisor exercised actual control over the business operations of the franchisee “particularly with respect to those involving point of sale processes, policies and procedures.”).

by a data breach, business interruption costs related to a data breach and consulting costs for crisis management and public relations.

a. **Information Security & Privacy Liability**

This type of coverage is the “Cyber/Data Privacy” coverage also referred to as “Network Security Liability.” This coverage insures against third party lawsuits or claims against a business resulting from a data breach or loss or privacy event; in other words, lawsuits or claims against a business by customers or third party victims of a data breach or loss. When customers or clients suffer losses resulting from a franchisee’s or franchisor’s data breach, then the third-party cyber/data privacy liability coverage provider should defend and indemnify the insured for such claims.

The remainder of the types of coverages described below are considered “first-party expenses.” These are all (or nearly all) of the other types of costs and expenses incurred by a franchisor or franchisee when a data breach occurs.

b. **Data Breach or Loss Response Costs**

This protection is also frequently referred to as “Special Expenses” or “Event Management Expenses.” This coverage provides reimbursement to the insured for many of the types of expenses and costs related to responding to a data breach or loss. These include costs to notify affected individuals and credit monitoring. Expending costs to promptly and adequately notify those third parties affected by a breach and provide credit monitoring is not just necessary to maintain the goodwill of the brand and the loyalty of customers and employees. As stated above, forty-seven states have enacted laws requiring compliance with certain notice requirements. The steps a franchisor or franchisee must take to comply with its obligations under these laws can be expensive and cumbersome.

This coverage also provides reimbursement for public relations costs (also called crisis management, consulting or outside specialists’ expenses), call center services, forensic investigations and legal expenses related to determining liability for a data breach or loss. Sometimes policies will include costs to mitigate damages under this category.

What is not typically covered under cyber liability policies is internal labor costs (such as overtime of employees or in-house legal costs). Often a policy will impose “sub-limits” on these types of costs and expenses. A $1 million cyber liability policy may have a sub-limit of $500,000 for notification and credit monitoring expenses. There may also be specific deductibles for these costs. For instance, a policy may not start providing coverage until 100 individuals have been affected. As with any policy analysis, scrutinizing all limits, sub-limits, deductibles and exclusions is critical.

c. **Regulatory Defense and Penalties**

The federal and state governmental agencies (such as the FTC or Federal Communications Commission) may attempt to investigate the franchise or levy fines or penalties for violating privacy laws. This coverage insures against violations of privacy laws and

---

41 Supra n. 34.
regulatory proceedings that result from a data breach loss or privacy event. Sometimes this coverage is subject to a sub-limit and sometimes it is part of the general Information Security & Privacy Liability coverage and there is no sub-limit. The exposure to state and federal agencies can be significant.

One of the most well-known recent cases involves the FTC’s lawsuit against the hotel chain Wyndham Worldwide.\(^\text{42}\) In 2008 and 2009, Wyndham experienced three different hacks to its system resulting in approximately $10.6 million in damages.\(^\text{43}\) The FTC sued Wyndham alleging that the data breaches were the result of unfair and deceptive practices in violation of the Fair Credit Reporting Act (“FCRA”).\(^\text{44}\) Wyndham argued that the FTC did not have authority to regulate data security under Section 45(a) of the FCRA, but the court disagreed.\(^\text{45}\) Wyndham ultimately settled the case with the FTC and the lawsuit shows the attempts by the FTC to hold businesses liable for these breaches. The costs and expenses related to these investigations can far exceed the settlement amount. In the case of Wyndham, the franchisor estimated that its costs to respond to the FTC’s voluntary request for information when it began its investigation exceeded $5 million in legal and vendor fees.\(^\text{46}\)

d. PCI Fines and Costs

Coverage for PCI Fines and Costs is also frequently referred to as “PCI-DSS (Payment Card Industry Data Security Standards) Assessment” coverage. Often clients confuse PCI Fines and Costs with other regulatory fines and penalties imposed by governmental agencies. PCI Fines and Costs are imposed by the credit card brands. This coverage provides reimbursement for direct monetary fines, assessments or charges owed under the terms of any merchant service agreements resulting from a data breach or loss.

In the event of a data breach, the cardholder is typically not responsible for the cost of fraudulent transactions. Instead, the banks that issue the credit card are responsible for these charges. The issuing bank will then try to recoup its costs through the terms of the merchant service agreement which shifts financial responsibility to the merchant (franchisee). In addition to levying “assessments” for reimbursement of fraudulent charges and costs, a bank can impose fines if they can show that the franchisee merchant failed to comply with industry accepted security standards (PCI rules). Some cyber liability policies will require an insured to be “PCI Compliant” as a condition to providing coverage for PCI Fines and Costs. Insurance carriers will require that an insured independently prove it is compliant. These fines can range anywhere from $5,000 to $100,000 every month until all compliance issues are

\(^{42}\)FTC v. Wyndham Worldwide Corp., supra n. 32  
\(^{43}\)Id. at 242.  
\(^{44}\)Id.  
\(^{45}\)Id. at 244.  
\(^{46}\)Declaration of Korin Neff, Esq. January 20, 2011 [sic] available at http://www.ftc.gov/sites/default/files/documents/petitions-quash/wyndham-hotels-resorts-llc/120420wyndhamreview.pdf. This is not to say that all costs related to a regulatory investigation would be covered. Claims for equitable relief (injunctions or declaratory judgments) and costs related to restitution and unjust enrichment are not covered under standard cyber liability policies.
resolved. If the issues are not properly resolved, then a franchisee or franchisor can even have its ability to accept cards revoked.\(^{47}\)

If a franchise system’s units handle large amounts of credit card transactions on a daily basis (like restaurants and retail stores), then the franchisor should strongly consider requiring coverage for this potential loss. It is unlikely that these losses are covered under other sections of a cyber-policy. In the recent case of *P.F. Changs China Bistro, Inc. v. Federal Ins. Co.*, MasterCard issued a $1.9 million assessment against the restaurant chain after a data breach compromised the credit card data of approximately 60,000 customers.\(^{48}\) The assessment included a $50,000 PCI Fine.\(^{49}\) P.F. Changs paid the assessment so it could continue processing credit cards under the services agreement and then sought coverage under the policy.\(^{50}\) The court ruled that there was no coverage based, in part, because the assessment did not meet the definition of “loss” and on a “contractual liability exclusion” in the policy which precludes coverage for claims based on liability assumed by the insured under contract.\(^{51}\) Without PCI Fines and Costs coverage, a business can find itself wholly responsible for these assessments and, in the case of P.F. Changs, not insuring against this risk cost it $1.9 million.

e. **Data Restoration/Data Recovery or Loss of Digital Assets**

This coverage is also frequently referred to as “Hacker Damage Costs” and includes costs to repair, restore, recreate or replace website, intranet, network, computer system, programs or data to the same condition and with the same contents as prior to the damage. Sometimes a policy will only provide this coverage in connection with a data breach or loss. Sometimes a policy provides this coverage even in the event of accident, human error or natural disasters. Often a disproportionate percentage of a cyber liability premium may be dedicated to providing third party data restoration services. Data Restoration coverage is critical for businesses that have to recreate an entire hard-drive. If a franchisee or franchise system makes the determination that its back-up plans are sufficient to restore data in the event of a loss, then extensive coverage for data restoration may not be necessary.

f. **Business Interruption**

Business Interruption coverage is another first party coverage that provides reimbursement to an insured for lost income resulting from a data breach or loss or privacy event similar to the BI coverage under a property policy. Some underwriters combine Business Interruption with Loss of Digital Assets coverage. The deductible or retention is the length of the period you must wait under the policy until claiming lost income. The waiting period can range from 8 hours to 10 days and has a significant impact on the amount you will recover for business interruption losses. Often an insurance carrier will place conditions on

---

\(^{47}\) A detailed description of PCI is available at https://www.pcicomplianceguide.org/pci-faqs-2/.


\(^{49}\) *Id.* 

\(^{50}\) *Id.* 

\(^{51}\) *Id.*
providing business interruption coverage such as requiring the franchisee to take reasonable steps to minimize or avoid the business interruption event at its own expense.

g. **Cyber Extortion**

Cyber extortion coverage is also referred to as “Data Extortion” and is coverage for any threat to attack or an attack on a computer system for the purpose of demanding money or property as a ransom. More and more smaller companies are experiencing cyber extortion events. Typically, these events involve demands for payments ranging from $2,500-$15,000, although the amounts can be higher. These occurrences are often referred to as “crypto-locker” events, where a computer system is encrypted and disabled, and the victim will only be able to receive the decryption key if an amount is paid in a brief period of time (often within 24 hours and paid through Bitcoin).

h. **Website Media Content Liability**

This coverage is sometimes found in data cyber liability insurance policies and covers damages sustained in the course of certain defined “Covered Media Activities” such as (i) defamation, libel, slander, emotional distress, outrage, torts related to disparagement or harm to reputation; (ii) false light and public disclosure of private facts; (iii) invasion of right to privacy and commercial appropriation of name or person; (iv) copyright infringement; (v) plagiarism, piracy; and (vi) infringement of domain name, improper deep linking or framing.

4. **Additional Issues to Consider When Evaluating Cyber Coverage**

Like with all coverages, the first step is always to assess what coverage is critical by evaluating the likely threats. For example, if a franchisor’s franchisees collect a considerable quantity of credit card data, then coverage for PCI Fines and Penalties is critical. If data collected by franchisees is backed up and held by the franchisor, then significant data restoration coverage may not be necessary. Coverage requirements for franchisees should be carefully evaluated. While there is no one-size-fits-all when it comes to cyber minimums and coverage requirements for franchisees, form guidelines to be tailored to a franchise system are included and located in Appendix A.

a. **Conditions to Coverage**

Some cyber policies require an insured to utilize service providers from its own pre-approved list of vendors. This typically includes legal counsel and public relations firms. These approved service providers are often well-equipped in responding to data breaches but it can come as a surprise to some franchise systems who are more comfortable with their trusted advisors.

b. **Common Exclusions**

Like all insurance policies, it is critical to carefully scrutinize all exclusions but there are a number of exclusions that merit particular evaluation. Many policies contain broad and open-ended exclusions for “failing to follow minimum required practices.” This exclusion can eviscerate coverage. Last year, CNA Financial Corp. sought a judicial ruling that it was not obligated to pay a $4.1 million settlement to a health care system because the insured
failed to adhere to the “minimum required practices” it claimed it followed in its insurance application. 52 The complaint was eventually dismissed based on an arbitration clause but it is an indication of an insurance carrier’s defenses to providing coverage to an insured under a cyber policy. 53 An insured should always attempt to get this exclusion removed or narrowly tailored.

A second common exclusion that an insured should attempt to negotiate is the exclusion for “War, Invasion or Insurrection.” A covered party should request the underwriter carve-out “cyber-terrorism” from the typical blanket general exclusion for war, invasion or insurrection.

H. Additional Types of Insurance Coverage

1. Workers’ Compensation

Statutory coverage providing wage replacement and medical benefits to employees injured in the course of employment in exchange for mandatory relinquishment of the employee’s right to sue his or her employer for the tort of negligence.

2. Directors & Officers

Directors and Officers (“D&O”) coverage provides protection against lawsuits, demands, and other claims from competitors, customers, creditors, the state or federal government, shareholders, etc. Individual directors and officers are routinely named in lawsuits and this coverage affords them protection whether the company can or cannot indemnify them. There is also coverage for the company itself along with the individuals. Usually, however, franchisee claims are excluded under the typical D&O form. D&O coverage is written to:

i. Protect the personal assets of a company’s directors and officers;
ii. Protect the company’s balance sheet;
iii. Provide reimbursement to the organization to indemnify D&O’s for their losses; and
iv. Help the company monitor and provide defense costs associated with responding to lawsuits and investigations.

Examples of sources of D&O claims:

i. Shareholders, Investors, Partners and Members;
ii. Merger / Acquisitions;
iii. Conflict of Interest;
iv. Executive Compensation;
v. Financial Reporting;
vi. Debt collection;
vii. Deceptive trade practices;
viii. Contract dispute;
ix. Business interference;


3. **Fiduciary Liability**

Fiduciary liability coverage provides protection for claims made by plan participants (employees), the government, the Department of Labor and other regulatory agencies, for allegations relating to an employee benefit plans subject to ERISA, such as improper advice or counsel, imprudent investment of assets or lack of investment diversity, and imprudent choice of third party administrator. Coverage is also provided for administrative errors relating to the plans. A fiduciary who breaches any of the responsibilities, obligations or duties imposed by ERISA may be personally liable to compensate the plan for any resulting losses. Fiduciary Liability coverage is written to (i) protect the plan fiduciary(ies) in the event they breach (or allegedly breach) their duties under ERISA and (ii) protect insured persons and the organization in the event of an administrative error related to welfare or pension benefits. Examples of sources of fiduciary claims:

i. ERISA violations;
ii. Conflict of interest in investment of plan assets;
iii. Failure to administer the plan according to plan documents;
iv. Imprudent selection and failure to monitor third-party service providers;
v. Imprudent investment decisions;
vi. Lack of investment diversity;
vii. Inappropriate loans using plan assets;
viii. Improperly advising plan participants;
ix. Mishandling of funds;
x. Inaccurate year-end reporting; and
xi. Delinquent employer contributions.

4. **Crime**

Crime coverage protects a business against a broad range of fraud losses, including employee theft (i.e. embezzlement), as well as acts committed by individuals outside the organization, including forgery, funds transfer fraud and credit card fraud. Coverage can also be structured to provide coverage for claims resulting from your organization’s employees stealing from a client or other third party (also known as Third Party Crime). This coverage is necessary if your franchisees are working at client locations and/or handling their valuables. Third Party Crime Coverage can also alleviate the need for a Fidelity Bond as Crime Coverage is less restrictive than a bond.

III. **ADDRESSING JOINT EMPLOYER AND VICARIOUS LIABILITY ISSUES**

A. **The Impact of Vicarious Liability and Joint-Employer Claims**

There is little doubt that as franchising continues to expand and plaintiffs continue to hunt for deeper pockets, there is, and will continue to be, an increasing number of vicarious

---

liability lawsuits against franchisors. Plaintiffs’ attorneys are attempting to hold franchisors jointly responsible for claims arising at franchisee locations. Additionally franchisors are being pulled into claims and lawsuits as a result of a franchisee’s services and from joint-employer issues, through the acts of the franchisee’s employees. Franchisors should be aware of vicarious liability claims, both common law claims, like negligence, and claims based on statutory violations.

B. Vicarious Liability Issues Facing Franchisors Today

1. Claims of Vicarious Liability

Whether a franchisor can be found vicariously liable for the negligence or other wrong of a franchisee or franchisee employee is a fact-specific inquiry that hinges on whether the franchisor exerts sufficient authority and control over the franchisee to create an agency relationship. Paradoxically, this puts franchisors in a challenging position because they must exert enough control to protect the trademark and goodwill of the franchise while simultaneously ensuring they are not overstepping the boundary to subject themselves up to vicarious liability claims based on an agency theory.55

The California Supreme Court recently addressed this issue in Patterson v. Domino’s Pizza LLC.56 In Patterson, plaintiff, a teenage girl and former Domino’s employee, sued the franchisee and franchisor, claiming the franchisor was vicariously liable for her franchisee manager’s alleged sexual abuse. The Court held that the franchisor was not vicariously liable for the wrongful sexual abuse by the franchisee employee because the franchisor did not retain sufficient control over the day-to-day operations of employment at the franchise. The Court stated: a franchisor “becomes potentially liable for actions of the franchisee’s employees, only if it has retained or assumed a general right of control over factors such as hiring, direction, supervision, discipline, discharge, and relevant day-to-day aspects of the workplace behavior of the franchisee’s employees.”57

A franchisor can also potentially be held vicariously liable for the statutory violations of a franchisee. For example, vicarious liability lawsuits can arise where there are violations of the ADA, the FLSA and other statutes prohibiting discrimination. Franchisors should also be aware of potential liability for violations of environmental statutes such as CERCLA and consumer protection statutes such as the Fair and Accurate Credit Transactions Act.58

55See, e.g., Licari v. Best Western Int’l, Inc., Case No. 2:11-cv-603, 2013 WL 3716523 (D. Utah July 12, 2013) (denying summary judgment in favor of franchisor due to question over right to control where franchisor had right to inspect and issued detailed regulations to franchisee); Braucher ex rel. Braucher v. Swagat Group, L.L.C., 702 F. Supp. 2d 1032 (C.D. Ill. 2010) (granting summary judgment in favor of hotel franchisor on apparent agency claim, in part, because the disclaimer on the plaque in the hotel lobby stated that the hotel was independently owned and operated, as did the hotel website).

56Patterson v. Domino’s Pizza, LLC, 60 Cal.4th 474, 563 (2014).

57Id. at 497-98.

Notably, a franchisor may not be vicariously liable for the franchisee’s wrongful acts simply because the franchisor required the franchisee to maintain certain insurance. In *Hayman v. Ramada Inn, Inc.* 59, the court rejected a plaintiff’s claim that the franchisor was liable for her injury that occurred at the franchisee’s location simply by virtue of the fact the franchisor required the franchisee to maintain insurance and name the franchisor as an additional insured on the policy. “We summarize reject plaintiff’s further contention that by requiring Turnpike to maintain liability insurance naming defendant as an additional insured, and to indemnify defendant for this type of claim, defendant implicitly accepted responsibility and acknowledged liability for injuries on the premises. This type of indemnity contract concerns only the two parties thereto, is not germane to plaintiff’s cause of action, and may not be used to establish defendant’s liability.” 60

2. **Methods of Protecting against Vicarious Liability Claims**

There are a variety of methods franchisors may use to protect against vicarious liability claims including:

i. Ensuring there are specific indemnification and contribution provisions in the franchise agreement to protect the franchisor in the event the franchisor is sued based on a vicarious liability theory;

ii. Requiring that franchisees obtain insurance and confirming that coverage is broad enough to cover a possible vicarious liability claim;

iii. Keeping the franchisor out of the day-to-day business operations of the franchisees as much as possible; and

iv. Publicizing to third parties that the franchises are independently owned and operated.

3. **Insurance Advice for Vicarious Liability**

Vicarious liability claims against a franchisor can arise from the acts of the franchisee or franchisee’s employees. Examples could include:

i. a customer is hurt at a franchisee location and sues both the franchisee and franchisor for injuries;

ii. the franchisor is sued as a result of injury due to products sold at the franchisee level; or

---

June 13, 2013) (granting franchisor’s motion to dismiss plaintiffs’ claims that franchisor was liable for franchisee’s alleged Telephone Consumer Protection Act (TCPA) violations by sending out spam advertisements via text messages because plaintiffs had not sufficiently pled an agency relationship).


60*Id.* at 279-80.
iii. an auto accident where the injured party also sues the franchisor claiming bad practices or oversight played a part in the accident.

In the insurance context, these scenarios are each CGL claims and, thus, would be addressed through Additional Insured language in the franchisee’s CGL policy. Additional Insured status will provide defense and indemnification coverage to the franchisor through the limits of the franchisee’s CGL policy.

Vicarious liability claims against a franchisor can also arise from services performed by franchisees. As mentioned above, the services performed by a franchisee can create E&O (professional liability) exposure. If, for example, the franchisee fails to perform those services adequately the client may also sue the franchisor for failing to monitor the franchisee and/or because the franchisee followed the franchisor’s system. In this scenario, Additional Insured status will not provide defense and indemnity for the franchisor because the franchisor cannot be listed as an Additional Insured under a franchisee’s E&O policy. This is a result of the standard “insured vs. insured” exclusion contained in a professional liability (E&O) policy.61 This highlights the need for franchisors to require and monitor that franchisees are carrying adequate E&O insurance when they perform a professional service and to also indemnify the franchisor for these claims. If not, the burden of this exposure could fall on the franchisor.

Franchisor policies can also provide coverage for vicarious liability types claims in the third party coverage policies and franchisors should consider obtaining their own policies for this coverage. Some carriers will provide a small vicarious liability sub-limit under a franchisor E&O policy but subject to a sub-limit that typically will not exceed $250,000.62 “But ‘third party’ claims involve one or more third persons seeking damages from the insured; and coverage analysis usually focuses on the insured’s tort liability to the party seeking damages and whether that liability is covered under the policy in question.”63 Types of third party liability coverages include, among others, directors and officers liability, employment liability, professional liability (E&O) and workers’ compensation liability.64 These various types of third party liability coverage may overlap with CGL insurance, but can help ensure there are no gaps in coverage.

C. How to Address Risk and Insurance Structure in a Potentially Joint Employer World

61“The “insured vs. insured” exclusion (sometimes called the “interinsured suit” exclusion) eliminates coverage for suits brought by one insured against another, including the corporation, with the exception of shareholder derivative actions if commenced without the assistance or solicitation of any insured.” California Practice Guide: Insurance Litigation, supra n. 4, Ch. 7F-C, 7:1684.

62FranchisorSuite,® Franchisor Malpractice Liability & Vicarious Liability Coverage Part (Form 00 MPL0104 00 09 15) providing coverage for losses arising out of any actions of a franchisee subject to a $250,000 sub-limit.


64Id. at ¶ 7:3.
Vicarious liability claims are prevalent in the joint employer context as well.\textsuperscript{65} This issue came to the forefront of franchising in July 2014 when the National Labor Relations Board (NLRB) announced that it would issue complaints for alleged labor violations, naming McDonalds USA, LLC (the franchisor) as a joint employer of the franchisees’ employees.\textsuperscript{66}

The risks that come from the potential joint-employer exposures can affect franchisors across multiple lines of coverage. However, the biggest impact will most likely be felt in the EPLI and franchisor E&O insurance areas of coverage.

1. Franchisee EPLI and Joint Employer Liability

At the outset, it is more important than ever that franchisees carry EPLI insurance. This provides defense and indemnification coverage for employee and third-party claims for those types of allegations mentioned above. Increasingly, we recommend this coverage be listed as a necessary coverage on FDD insurance requirements, especially if the franchisees have a workforce in transition.

Bear in mind that “additional insured” status for the franchisor is not something that insurance carriers are adding to franchisee EPLI insurance policies. Doing so could expose the insurer to claims by franchisor employees under the franchisee’s EPLI policy. As such, there is a potential coverage gap for the franchisor should the franchisor be named as a defendant in a franchisee’s employment practices claim. Many carriers will, however, provide a defense sublimit on their policy for the franchisor should they be brought into a franchisee’s EPLI claim. This is a very good starting point and one thing that should be added to a franchisee’s insurance requirements. Historically, this defense sublimit was sufficient to remove the franchisor from the claim since the employee was not a franchisor employee, but whether this remains the case under the potentially expanded joint employer test remains to be seen.

Going forward, insurance carriers are monitoring the joint employer issue carefully to determine if and how their insurance policies should change to address this exposure. Since these policies are typically designed by evaluating years of established claim data, insurers are slowly and cautiously dipping their toes into the joint-employer pool.

With that said, there are a few carriers today that will provide a sublimit of coverage for the franchisor under the franchisee’s EPLI policy for joint employer issues. These policies will carry certain exceptions (such as wage and hour claims) and/or cover only specified perils. While we do see a few carriers trying to proactively address this, there is trepidation on their part for full joint-employer coverage primarily because these employees are employed by the franchisee. Again, because insurance carriers are not certain where and how this issue will eventually settle, most are entering this arena cautiously because their potential exposure is large and there is no equitable way to price for it today. Those carriers that do provide some coverage for joint employer issues limit their exposure by offering a sub-limit of coverage under the franchisee’s policy.


\textsuperscript{66}McDonald’s USA, LLC, 362 N.L.R.B. 168 (2015).
2. Franchisor EPLI and Joint Employer Liability

In most cases, franchisors should carry their own EPLI coverage as well. While franchisors will be arguing they are not the employer in many joint employer theory cases, it is good standard practice to retain coverage for any employee or third-party discrimination suits the franchisor may face. Additionally, it could provide a fallback if the courts determine the franchisor to be a joint employer. There is a significantly higher exposure for franchisors than for the franchisee.

However, the potential expanded joint employer liability could also have an impact on the ability for a franchisor to secure affordable and adequate EPLI coverage. One of the factors used to calculate EPLI premiums includes the insured’s number of employees. The more employees of a business, the higher the premium will be for that business. It is possible that insurance carriers will increase the premiums for franchisors due to a potential increased risk of joint employer liability faced from employees of the system’s franchisees. It is important for franchisors to discuss with their insurance advisors whether an EPLI policy at the franchisor level is advisable and if one is already in place, then whether the franchisor should secure additional limits. Some carriers may consider not providing coverage to franchisors with increased franchisee exposure altogether. A franchisor should not be surprised to face increased scrutiny from its EPLI underwriter. These additional questions may include:

i. Whether contractual indemnity exists between the franchisor and franchisee?

ii. Whether franchisees are located and conducting business in states where employees are considered solely employees of a franchisee by statute (such as Louisiana, Texas and Tennessee)?

iii. Has the franchise system ever conducted an audit to determine whether the franchisor is likely to be determined a joint employer?

3. E&O and Joint Employer Liability

The NLRB’s joint-employer ruling may bring about issues and changes to the franchisor-franchisee relationship. These might not only affect employment practices liability claims, but could potentially affect the franchisor’s errors and omissions coverage.

As we described in Section I, the professional services definition we recommend for a franchisor’s E&O policy typically says “in performance of franchisor services.” That is the role of a franchisor, and the definition is broad for a reason: to cover as many of the franchisor services as possible.

We see the possibility of a joint-employer liability issue arising out of the performance of franchisor services if a franchisee’s employee suffers harm as a result of the franchisee or the franchisee’s employee following the guidelines set forth by the franchisor. Frankly, joint-

employer claims have not been addressed through E&O in the past, however, the potential exists for them to impact this coverage if the claim is incurred as a result of an employee suffering harm and it is related to services performed, or not performed, by the franchisor.

IV. FRANCHISE SYSTEM PROTECTIONS

A. Using An Approved Supplier

Franchisors can and often do use preferred vendors for various products and services, including insurance providers. One of the most obvious benefits of using an approved insurance supplier is the franchisor’s ability to leverage the purchasing power of the entire franchise network to obtain better rates for each of the franchisees. Making available an approved insurance supplier can also help demonstrate that the franchise network is well organized and managed and supportive of the franchisees. It can further benefit each individual franchisee by eliminating time the franchisee would otherwise have to spend searching for an insurance company educating the insurer and negotiating rates. Additional advantages to using an approved insurance provider include:

i. ease in managing and maintaining compliance with insurance requirements;

ii. consistency of coverage across all franchisees. As mentioned earlier not all policies are created equal and gaps in one that expose the franchisee and franchisor to potential claims;

iii. the ability to get tailored coverage unique to that franchise system. Each franchise model has their own unique risks inherent to their products/services and an approved supplier can negotiate better coverages and terms for the insurance program;

iv. ease in tracking certificates of insurance endorsements and additional insured status;

v. ease in implementing system-wide insurance requirement changes; and

vi. a potential of having dedicated resources and personnel assigned to that franchise system.

There are some potential downsides to using an approved insurance supplier. Franchisors should be cognizant to make sure that offering an approved insurance supplier does not lead to allegations of a tying arrangement in violation of the anti-trust laws.68 A tying arrangement can arise when a party agrees to sell one product “but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier.”69 In the franchise context, these suits can arise when the franchisor provides that the franchisee must agree to use specific products, supplies,


or merchandise in order to ensure quality and standardization throughout the franchise system. While case law has shown that an anti-trust claim does not necessarily follow a requirement for an approved supplier, franchisors can avoid unlawful tying arrangements by specifying in the franchise agreement that the franchisee is free to purchase products or services from another source if those other products and services comply with the franchisor's reasonable standards. In the insurance context, the franchisor could identify a specific approved insurance supplier and provide a standard for other acceptable insurance suppliers, such as calling for a national insurance supplier who is experienced in providing insurance to franchises in a similar system or industry.

Franchisors also need to be careful that the use of an approved insurance supplier does not create additional ties to the franchisee that could be construed as oversight and control. As discussed above, the more control a franchisor exerts over the daily operations of a franchisee, the more exposure the franchisor has to vicarious liability claims for the acts of the franchisee.

Finally, franchisors should communicate with the franchisees about selecting an insurance provider and should get feedback from the franchisees on the various providers they utilize. Both parties have an incentive to find the best insurance providers in order to protect the franchise system and the money they have each invested.

Whether a franchisor requires an approved supplier or whether franchisees are their own insurance provider, franchisors and franchisees should consider the following when evaluating and selecting an insurance agent or producer:

i. The types of coverage and limits offered;
ii. The policy premium and deductible;
iii. The process for paying claims;
iv. The reputation of the insurance provider;
v. Whether the insurer is a specialist or has franchise experience;
vi. How easy it is to get in touch with a “live” person and whether you will work with the same agent or various different agents; and
vii. The ease or difficulty of signing up for insurance coverage.

---

71 See Mumford v. GNC Franchising LLC, 437 F. Supp. 2d 344 (W.D. Pa. 2006)(franchisor’s requirement that franchisees purchase supplies from franchisor or approved suppliers did not violate anti-trust laws); Philip F. Zeidman, Legal Aspects of Selling and Buying § 9:68 (3d ed. 2015)(“The courts have upheld the legality of approved supplier arrangements in the face of anti-trust challenges. It has been noted, however, that ‘franchisors must walk a narrow path when including in their franchise agreements clauses requiring franchisees to buy supplies from approved sources.’”) (citation omitted).
72 See 9 N.J. Forms Legal & Bus § 20:10 (discussing drafting tips to avoid tying arrangements); 2A Ga. Forms Legal & Bus. § 14A:8 (same).
73 See supra, Section II.I.
B. Additional Insured Status

One of the most well-known and common protections a franchise system can have is the requirement that all of the system’s franchisees add the franchisor and its affiliates, subsidiaries and their respective officers, directors, partners, members, employees and other named parties as “additional insureds” under the franchisee’s insurance policies. Nearly all franchise systems mandate this in their form of franchise agreement. However, this is also one of the most confusing and often misunderstood areas of insurance law for practitioners. Even the most sophisticated and mature franchise systems often fail to address this issue adequately in their form franchise agreements.

1. Certificate of Insurance vs. Additional Insured Endorsement

Many franchise agreements only require a “Certificate of Insurance” as evidence of a franchisor’s additional insured status and to verify the franchisee has met all of the agreed upon insurance coverage requirements. Often a franchisor does not realize until after a claim that the insurance policies purporting to cover the claim were never properly endorsed to add the franchisor as an “additional insured”. A Certificate of Insurance is not an insurance policy. No rights of defense or indemnity are conferred upon the certificate holder just because a Certificate of Insurance has been provided naming them on it. Certificates of Insurance are prepared by insurance brokers, producers or agents and are never dispositive for the purpose of confirming that a franchisor is an “additional insured” and a franchisor cannot rely on it in a dispute about coverage.

Worse are those franchise agreements which do not explicitly require that the franchisee name the franchisor as an additional insured on the policy and instead only require the franchisor is an additional insured on a Certificate of Insurance. The distinction is significant as courts have ruled that requiring a party to be named an additional insured on a Certificate of Insurance is not the same. For example, in West Bend Mutual Insurance Company v. Athens Construction Company, the Illinois Appellate Court ruled that a subcontract did not require the subcontractor to name the general contractor as an additional insured on the policy because the plain-meaning of the provision is that the subcontractor was an additional insured on the Certificate of Insurance. The standard form of Certificate used in the insurance industry contains the following disclaimers and limiting language:

THIS CERTIFICATE IS ISSUED AS A MATTER OF INFORMATION ONLY AND CONFERS NO RIGHTS UPON THE CERTIFICATE HOLDER. THIS CERTIFICATE DOES NOT AFFIRMATIVELY OR NEGATIVE AMEND, EXTEND OR ALTER THE COVERAGE AFFORDED BY THE POLICIES BELOW. THIS CERTIFICATE OF INSURANCE DOES NOT CONSTITUTE A CONTRACT BETWEEN THE ISSUING INSURER(S), AUTHORIZED REPRESENTATIVE OR PRODUCER, AND THE CERTIFICATE HOLDER.

A franchisor will also often discover after a claim that an undisclosed exclusion precludes coverage which is why it is critical to conduct regular audits where the full policies are reviewed and approved. See Section IV(G) herein.

IMPORTANT: If the certificate holder is an ADDITIONAL INSURED, the policy(ies) must be endorsed. If SUBROGATION IS WAIVED, subject to the terms and conditions of the policy, certain policies may require an endorsement. A statement on this certificate does not confer rights to the certificate holder in lieu of such endorsement.

Courts uphold these disclaimers and “[w]here the certificate refers to the policy and expressly disclaims any coverage other than that contained in the policy itself, the policy governs the extent and terms of coverage.”76 An additional insured must always receive an endorsement to the policy from the franchisee clearly showing the franchisor as an additional insured. A specific request must be made by the insured franchisee to the insurance underwriter to add the franchisor as an Additional Named Insured to the insurance policy. That is, the existing insurance policy must be amended by the underwriter; whereupon, the additional named insured franchisor will have the same rights and responsibilities as the party named as the insured in the policy declarations. Otherwise, there is no guaranty that the franchisor holds “additional insured” status. Once the endorsement to the policy is issued, the franchisor entity has the same rights and responsibilities as the franchisee named as the Insured in the policy Declarations. Therefore, any form of franchise agreement used by a franchisor must require the franchisee provide both a Certificate of Insurance, as well as a copy of the endorsement to the policies. Our best practice suggestion is to have the insurance company provide blanket Additional Insured status as required by contract (in this case the Franchise Agreement).

2. Choosing the Form of Additional Insured Endorsement

Obtaining “additional insured” status is just the first step in protecting a franchise system. A franchisor should also always make sure it is requesting the broadest “form” of additional insured endorsement from its franchisees. The form should extend to negligence, errors and omissions of the franchisor and should not be limited to vicarious liability.

A franchisor should also verify that the form of franchise agreement does not inadvertently limit coverage. Many forms of additional insured endorsements state that coverage is no broader than what is required in the underlying agreement or contact. Therefore, if a franchise agreement limits a franchisee’s obligation to providing additional insured coverage for only vicarious liability, then the endorsement will not provide broader coverage for negligence, errors or omissions. Remember, when given the opportunity, insurance carriers will frequently try to limit additional insured coverage to only vicarious liability.

Many forms of franchise agreements require a certain dollar amount of insurance coverage. For example, a franchise agreement may say that a franchisee must have $1 million in general commercial liability coverage. Many additional insured endorsements limit coverage to the lesser of (i) the amount required by the franchise agreement or (ii) the policy limits. Make sure your form of franchise agreement speaks to these dollar coverage limits as minimums. The most recent form of endorsements will not provide coverage any broader than that required under the franchise agreement. If a franchisee is required to have a $1 million CGL policy but purchases a policy with a $2 million limit, then the additional insured endorsement may limit the franchisor to coverage up to the $1 million required under the franchise agreement or operations

76 Id. at ¶ 28.
manual. By speaking to “minimum requirements” in a franchise agreement or operations manual, a franchisor can attempt to avoid losing access to the higher policy limit.

There are many forms of endorsement. One form of endorsement (ISO CG 20-29-11-85) will amend the definition of “Who is an Insured” to include the franchisor but only with respect to the franchisor’s liability related to granting the franchise to the franchisee. Interpretations by courts related to this endorsement, called the “Additional Insured – Grantor of Franchise” endorsement are inconsistent. Some jurisdictions have interpreted the endorsement narrowly to provide coverage only for negligence in granting the franchise while other jurisdictions interpret it to provide full independent liability to the franchisor as an additional insured. Because there is no consistent coverage interpretation for this “Grantor of Franchise” form of endorsement, insurance brokers and producers are currently recommending Form “ISO CG 20-26” as the form of additional insured endorsement offering the broadest and most favorable protection for an insured.

3. Coverage Provided Under an Additional Insured Endorsement

Finally, keep in mind that an additional insured endorsement is typically only available for general commercial liability coverage and automobile coverage. It is generally not available for EPLI, E&O and cyber insurance coverage. In almost all cases a franchise system will not be successful in obtaining coverage under its franchisees’ EPLI, E&O and cyber policies. In cases where an underwriter is willing to add a franchisor as an additional insured, the result can be extremely cost-prohibitive for a franchisee. Therefore, it is critical that a franchise system’s operations manual and franchise agreement require its franchisees to implement and have in place fulsome and current risk management policies to decrease the likelihood that a claim will arise requiring coverage in the first place.

4. Options if Additional Insured Status Fails

Despite a franchisor’s best efforts, there are circumstances when it will discover that a franchisee failed to obtain or maintain an additional insured endorsement. In such a case, there are still options for finding coverage under a franchisee’s policy. There may be defense under an “insured contract” provision of the franchisee’s insurance policy. An “insured contract” provision in an insurance policy provides coverage for liability incurred when one promises to indemnify or hold harmless another (i.e. a franchisee’s promise to defend and indemnify the franchisor under the terms of the franchise agreement). If an insured (the franchisee) agrees to indemnify the franchisor for bodily injury or property damage, and the agreement is part of an “insured contract,” then in most situations, the contractual liability insurance of the commercial liability policy will pay what the insured must pay because of the indemnity provision under the franchise agreement. Therefore, it is critical that the franchise agreement contain a separate hold harmless and indemnification provision. There are drawbacks to using the insured contract exception, so it is not a perfect substitute for a franchisor having additional insured status. First, defense costs are often treated as ‘damages’


under the policy and will erode limits. Second, since the franchisor is not an insured under the policy, the carrier is only obligated to provide defense – not indemnity.

5. **Additional Insured Provisions in the Franchise Agreement**

A franchise agreement’s insurance section should always be drafted to include the following:

i. A requirement that the franchisee name the franchisor and all of its affiliates and related parties as an “additional insured” under its general commercial liability and automobile policies, and where commercially reasonable, the franchisee’s other insurance policies.

ii. The franchisor’s right to approve the form of additional insured endorsement which should not be limited to vicarious liability and should extend to all the negligent acts of the additional insured parties.

iii. A requirement that the franchisee maintain such additional insured status for the franchisor throughout the entire term of the franchise agreement.

iv. A separate indemnification and hold harmless provision.

C. **A.M. Best Ratings**

A.M. Best Ratings refer to the financial strength and size, including reserves, of the insurance carrier. If a franchisor allows a franchisee to shop its own policies, then it will almost always require the franchisee’s coverage to be underwritten by an insurance carrier that is financially stable. Requiring that a franchisee’s carrier maintain a high A.M. Best Rating is the easiest way to ensure that the underwriter will be able to pay losses incurred under a policy if and when the time comes.

The rating scale is between A+++ down to E. The letter signifies the financial strength of the company based upon a balance sheet and operational review and the second symbol is numeric and indicates the size of the insurance carrier. A suggested best practice is to primarily work with carriers with A.M. Best rating of A- or higher. A- rated carriers are considered to have an excellent ability to meet their ongoing insurance obligations. Many franchisors will require a A+ or A++ rating concluding that an underwriter has a stronger financial rating, and the additional financial strength of the underwriter is an added advantage. However, keep in mind that higher rated carriers may charge higher premiums. If there is not much more of a risk for an A- rated carrier as there is for an A++ rated carrier but the premium is much higher, then allowing an A- carrier to underwrite a franchisee’s policy should satisfy both the franchisor and franchisee.

D. **No Waiver of Franchisee’s Indemnity Obligations**

Many franchise agreements contain an indemnification provision which requires the franchisee to defend and indemnify the franchisor for any of its wrongful acts including errors, omissions, and negligence in the franchisee's operations. The franchisor may consider seeking a broad indemnity from the franchisee that specifically encompasses items that may not be covered by insurance, such as attempting to address joint employer liability by seeking indemnity for claims arising out of or related to employees hired by the franchisee or claims asserting joint-employer liability.

The indemnity provision is often separate and apart from a provision requiring minimum franchisee insurance requirements. Franchisors should be careful to include a writing to the effect that the franchisee’s obligation to obtain and maintain particular insurance coverage does not in any way limit or relieve the franchisee of liability under the separate indemnity provision. The franchisee’s insurance procurement obligations are independent of, and separate from, any of the franchisee’s indemnity obligations.

These provisions, although separate, work in tandem and ensure that the franchisee, the indemnifying party, has sufficient coverage to fulfill its separate obligation to defend and indemnify the franchisor, if necessary. The franchise agreement should make clear that the franchisee’s duty to acquire and maintain the specified insurance coverage does not relieve or limit the franchisee’s separate obligation to fully defend and indemnify the franchisor under the separate indemnification provision. Below is sample 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 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.81

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. 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.82

Courts have found that these indemnification provisions are enforceable even where the agreement contains a separate provision dealing with insurance coverage.83 This is because


82 See Murray v. Wilbur Curtis Co., 189 A.D.2d 980, 980 (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 required franchisee to name franchisor as an additional insured on the franchisee’s general liability policy).

83 See, e.g., Bassett v. Burger King Corp., Case No. 292433, 2010 WL 4259682 (Mich. Ct. App. Oct. 28, 2010) (holding franchisee breached the franchise agreement when, despite obtaining the insurance required under the
the provisions work together by ensuring that the franchisee’s coverage is sufficient to indemnify the franchisor in the event that the need arises.\textsuperscript{84} In \textit{Mace}, a customer of the franchisee sued the franchisee and the franchisor after a franchisee’s employee severely beat the customer with a baseball bat.\textsuperscript{85} The Supreme Court of Pennsylvania held, under the clear terms of the franchise agreement that contained provisions requiring the franchisee to indemnify the franchisor and to maintain insurance coverage, the franchisor was not liable for the employee’s actions and the franchisee was responsible for paying the costs that the franchisor incurred in defending itself in the personal injury lawsuit.\textsuperscript{86}

\textbf{E. Disclaimers/Non-Waivers of Contract}

A franchise agreement should always contain clauses with standard disclaimers, and these disclaimers can include insurance related items, such as:

\begin{itemize}
  \item[i.] An acknowledgement by the franchisee that it understands that the franchisor is not warranting or representing that the insurance required by the franchise agreement will be sufficient;
  
  \item[ii.] An acknowledgment by the franchisee that the insurance requirements are for the protection of the franchisor; and
  
  \item[iii.] A reminder that the franchisee should consult with its own insurance producer/agent/broker and other advisors to determine the level of insurance protection it needs or desires in addition to that required by the franchisor.
\end{itemize}

A franchise agreement should also contain a provision stating that the franchisor’s review and verification of certain elements of the franchisee’s insurance does not in any way reduce or eliminate the franchisee’s obligations to fully comply with all insurance requirements. It is the franchisee’s sole obligation to fully comply with these requirements and it is the franchisee’s sole obligation to confirm with its insurance providers that its policies are compliant.

General disclaimers may be enforced depending on the case and the jurisdiction, but the likelihood of enforcement greatly increases as the disclaimer is more specific and detailed.\textsuperscript{87}

\textsuperscript{84}See, e.g., \textit{Mace v. Atlantic Refining Marketing Corp.}, 567 Pa. 71, 79-80 (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]”); \textit{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.”).

\textsuperscript{85}\textit{Mace}, supra n. 84, at 75.

\textsuperscript{86}Id. at 77.

F. Franchise Agreement Drafting Tips

The insurance provisions in a franchise agreement should be thoroughly reviewed by counsel well-versed in coverage issues who understands the needs of the franchise system. Franchise systems, especially emerging growth systems, are sometimes inclined to borrow requirements from an established competitor or even cut and paste provisions from other franchise agreements. Insurance provisions are not “boilerplate” and must be sufficiently tailored to a franchise system, however, there are some general drafting tips that work for any franchise system.

Often a franchise agreement form does not provide enough flexibility to change coverage requirements. Franchise agreements should always include a provision that coverage requirements can be increased or decreased upon the franchisor’s prior notice as set forth in the operations manual or other writing. Surprisingly, many franchise agreements outline detailed requirements and coverage limits but do not specifically provide that the franchisor can change these standards as it deems necessary during the franchise term. Remember that risk exposure will change over time and new products will come on the market. Insurance coverage requirements are not static.

Second, designate when the franchisee must purchase the insurance. It is within a certain time period of signing the franchise agreement, obtaining a certificate of occupancy or a certain time period before commencing business.

Third, consider what happens after the franchise term ends. A franchise agreement often requires the franchisee maintain insurance only during the term of the franchise agreement. Professional liability policies and certain other policies are typically “claims made,” not “occurrence” based. To protect against claims brought after the franchise agreement terminates or expires under claims made policies, the franchise agreement should require the franchisee maintain insurance during the term and for such period after as necessary to provide coverage required for events occurring during the term of the franchise agreement.

When the agreement is terminated, are there any options that can be added to existing insurance policies to extend the coverage? Generally, the answer is yes. General liability insurance policies customarily provide provisions which allow for either (a) extended reporting; or (b) tail coverage. Commonly, extended reporting is referred to as an “extended discovery period.” An extended discovery period is a designated period of time after the policy has expired. The purpose is to allow the insured to report claims that are made against the policy after the expiration date. The policy limits, occurrence and aggregate limit caps remain the same. The designation “tail” gets its name because the coverage applies as the end of the policy period. Generally in the professional liability or general liability context, a claims made policy provides for the purchase of a “tail” prior to the expiration or cancellation of the policy and covers occurrences, acts or omissions committed on or after the policy expiration date. The policy itself will set forth a formula as to how a premium is calculated depending upon the length of time for which the tail is purchased.

Also, consider requiring that franchisees not just purchase additional insurance as may be required by the franchisor or landlord from time to time, but also by any other third party agreement if there are any franchisor-required vendors/suppliers or partnerships where contracts have insurance coverage requirements.

G. Proof of Insurance and Conducting Audits
Another major issue is lack of compliance by franchisees to comply with stated insurance requirements in the franchise agreement and the subsequent failure of the franchisors to detect such noncompliance. Often, a franchisee's policy will exclude particular coverage required by the franchise agreement or have much lower limits than those actually required. No matter how comprehensive and specific the insurance requirements are in a franchise agreement, they are useless if not enforced by the franchisor.

Maintaining compliance to system insurance requirements is a vital step in helping to reduce the risk and cost of vicarious liability. It will provide a level of confidence that your franchisees will have the coverage they need at time of a loss. Establishing proper risk prevention procedures to avoid claims is always the first line of defense but ensuring that both the franchise system and its franchisees maintain sufficient insurance to protect against potential losses is a critical component of any risk management plan.

All franchisors should consider conducting insurance audits as part of their other audits such as royalty or service audits, so as not to cause an undue burden, but still allow monitoring of important insurance requirements. Franchisors are in a unique position because although they do (or should) have limited control over the franchisee operations, the franchisor is still exposed to the risks coming from the various franchisee operations. With those risks in mind, the audits should ensure not only that the franchisees have the minimum amount of coverage required by the franchise agreement but also that the terms and conditions of the coverage are sufficient to protect the franchisor. A single review of a certificate of insurance, policy number, policy period, or insurance carrier is likely insufficient because it does not guarantee that the franchisee has the right amount or correct type of coverage.

Because of the high risks associated with a franchisee’s non-compliance with the insurance requirements, franchisors should have the audit conducted by someone who understands insurance policies and can cross check the system’s coverage with each of the franchisee’s coverage for the purpose of confirming the coverage meets the system’s minimum requirements. This review should focus also on the specific terms and conditions of the additional-insured policy as it relates to franchisor protection. If a franchisee is a multi-unit owner, then make sure the per unit insurance minimums are not being shared among the locations. Often, when conducting an audit, a system will discover that a multi-unit owner does maintain a CGL policy with a required $2 million limit but it is shared among multiple franchise locations. Franchisors should also pay special attention to franchisees that are making late royalty payments as this could also indicate a lapse of insurance coverage due to non-payment of the insurance premium. 88

V. UNDERSTANDING ALTERNATIVE INSURANCE OPTIONS

A. Unlicensed Insurers/Surplus Lines Unadmitted Carriers

Surplus lines carriers can be a solution to coverage that is difficult to find and/or unique in nature. These carriers, many of them London based, can provide pricing and coverage flexibility that standard markets sometimes cannot. There are also risks to getting insurance through the surplus lines market. They are not covered by State Property and Casually Insurance Guaranty Association. Most states have “guaranty funds” to help pay the claims of

financially impaired insurance companies. Guaranty funds are administered by a state to protect policy holders in the event that an insurance company defaults on benefit payments or becomes insolvent, however, guaranty funds only protect beneficiaries of insurance companies that are licensed to sell insurance products in that state. State laws specify the lines of insurance covered by these funds and the dollar limits payable. The result of a carrier not being licensed by a state means that if the insurer becomes insolvent then the ability to obtain indemnity and defense under the policy may diminish. The consequence is that if the insurer becomes insolvent and incapable of paying claims, the insured cannot rely on recovering any monies from the state guaranty fund.

B. Risk Purchasing Groups; Risk Retention Groups; and Captives

Franchisors and franchisees, like any business, are always searching for ways to reduce costs and expenses. There are three distinct insurance risk management vehicles that clients will often want to explore with counsel as potential alternative ways to manage and insure against risk at a reduced cost. These are: (1) Risk Retention Groups (or “RRG”); (2) Risk Purchasing Groups (or “RPG”); and (3) captives. From time to time a franchise system will approach its counsel asking whether one of these options is right for its system or its franchisees. Whether the answer is yes depends on a number of different factors.

A Risk Retention Group or “RRG” is a group self-insurance plan and an alternative risk transfer entity formed as a liability insurance company under the laws of at least one state, in which the policyholders of the RRG are also its owners, thus being exposed to the same types of liability. A RRG operates under the auspices of the federal Risk Retention Act of 1986 that authorizes the formation of group self-insurance programs but requires that membership of a RRG be limited to organizations or persons engaged in similar businesses or activities. RRG’s self-funded groups that take on a certain amount of the risk themselves. By retaining a level of the risk themselves often RRG’s can get lower rates, broader coverage and access to reinsurance markets. Benefits of RRG’s include (1) program control; (2) long-term rate stability; (3) customized loss control and risk management practices; (4) dividends for good loss experience; (5) access to reinsurance markets; and (6) generally lower premiums. Some disadvantages of RRGs include (1) that there is no state guaranty fund availability for members; (2) the contract is between the insurance carrier and the RRG instead of individual members; (3) an RRG may not be able to comply with proof of financial responsibility laws; (4) an RRG is not protected from insolvency; and (5) limits are shared and may be depleted based on quantity of claims.


92 Id.
A Risk Purchasing Group or “RPG” is a legal entity that allows a group of unassociated businesses with similar risk profiles to join together to take advantage of a joint insurance purchase. 93 Like an RRG, an RPG is a product of the federal Risk Retention Act of 1986 and formed in compliance with state law. 94 This usually permits the group to gather purchasing strength to buy insurance at a cost savings with broadened coverage. They are just insurance customers who “pool” together to purchase their coverage from an insurance company. Because franchisees operate the same business, they can be good candidates to form an RPG. One circumstance in which an RPG can be very beneficial is in the employee health insurance coverage context. Franchisees can work together to form an RPG and combine risks pools to receive better rates.

The main contrast between an RRG and an RPG is that in an RPG a group of insureds engaged in similar businesses or activities purchase insurance coverage from a commercial insurer, whereas an RRG bears the group’s risks rather than obtaining coverage on behalf of group members. Thus, under an RPG, individual members may have their own liability limits through a common commercial insurance carrier. In contrast, under an RRG, there are shared liability limits and the group as a whole bears the risk of liability.

Captives are similar to RRGs. A captive insurance company is one that is created and owned by one or more businesses. Captive insurers operate like a regular insurance company and are subject to state or domicile regulation, depending on where they are based. Captives are usually one of two classes: homogeneous and heterogeneous. A homogeneous captive is one that insures the risk of common types of business, whereas, a heterogeneous captive might have several different industries represented in the same group.

A franchisor or group of franchisees should contact a broker and counsel with experience in overseeing the formation of these vehicles. The challenge is these options often sound better on paper than they are in practice. A few of the major challenges with these types of risk insurance groups are:

i. Risk management and reduction strategies are very important to keep and maintain profitability;

ii. Getting all franchisees onboard with a structure and to agree is difficult;

iii. Not all franchisees will follow the same risk reduction strategies and therefore could threaten the profitability and pricing for everyone else;

iv. Coverage limits are shared and if they are exhausted by one or two big claims during that policy term then no coverage exists for other franchisees; and

v. Determining the level of pricing to the franchisees can be difficult.

93 Supra note 81, at 250.

To be clear, forming an RPG is a task undertaken by the franchisees themselves. Franchisors may provide guidance and information to franchisees but a franchisor does not form an RPG on behalf of its franchisees or otherwise control or manage franchisee RPGs.

One way this can work is if the franchisor pays for the group program and then charges the franchisees back through some type of “dues” program. Of course, that could bring in additional vicarious and joint-employer issues. Another reason franchisors may look to one of these groups is if they have a specific type of exposure they want to manage further.

VI. NAVIGATING AN INSURANCE CLAIM

A. Submitting a Claim

An insured’s first responsibility when a claim occurs is to notify the insurance company as quickly as possible, within the first 24 hours is best. All insurance policies will provide the address and contact information for where a claim should be submitted. Make sure to submit the notice of claim to the required parties and retain evidence that notice was provided to the carrier.

Under “occurrence” polices (such as CGL policies) an insured is required to put the insurance company on notice of an “occurrence” or an offense which may result in a claim as soon as “practicable.” Policies written on a “claims-made” basis require an insured to report any claims or circumstances that may give rise to a claim in a timely fashion. Although the definition of ‘claim’ varies between insurance companies, in general it is defined as: (a) a demand against you for money or services, or the filing of a suit, or the initiation of an arbitration proceeding naming you and seeking damages for an alleged error, omission, negligent act, or (b) an event or circumstance, an incident or unresolved fee dispute of which you have knowledge that may result in a claim as described in (a). If a claim is turned in so late that it compromises the insurance company’s rights to settle the case or prejudices the carrier in some way, then an insurer may assert defenses based on a breach by the insured of a condition of the policy. States varies on the standard of when a carrier is considered “prejudiced.” For example, in California an insurer may assert defenses based on a breach by the insured of a condition of the policy but the breach cannot be a valid defense unless the insurer is “substantially prejudiced.” In addition, in California the burden of proving that any breach of the policy conditions by the insured resulted in prejudice is on the insurer and there is no presumption of prejudice. However, each state’s standards may be different and a franchisor or franchisee do not want to be disputing whether it provided proper notice.

Claims get more expensive the longer you wait to report the incident. Carriers will not punish you for reporting incidents that close with no, or very little, payout, however, you can face


96 Id. California Practice Guide: Insurance Litigation, supra n. 4, 6:37 (“to show ‘substantial prejudice,’ the insurer would presumably have to show that the delayed notice and proof of loss impaired its ability to investigate and settle the claim.”).

97 Note that California’s “notice prejudice rule” is not absolute and only applies in cases where a late claim would otherwise meet the elements of coverage. Venoco, Inc. v. Gulf Underwriters Ins. Co., 175 Cal.App.4th 750 (2009). In Venoco, the court did not apply the “notice prejudice rule” where the policy provides that special coverage for a particular type of claim is conditioned on express compliance with a reporting requirement.
denial of coverage if you wait too long to report a claim. You should report the claim directly to the insurance company and notify your broker than you have done so. It is then the responsibility of the Insurance Claims Adjuster to start the process, connect with the injured parties and investigate the claim. As the client you should stay in contact with the Adjuster to make sure you are aware of their findings and can provide feedback through the process.

The role of a broker or agent through the claims process is to act as the insureds advocate with the insurance carrier. A business’s insurance broker should always proactively advocate on the insured’s behalf to appropriately get the claim settled favorably.

B. **Insurance Carrier Responses**

Once the carrier receives notice of a claim filing they will assign a claims adjuster to the file. The claims adjuster must investigate the claim and make a determination of coverage based upon the policy terms and details of the loss. This is another reason why reading and adjusting policy terms before coverage is in place is important. The claims adjuster will also reach out to the insured to discuss the loss and the timeframe for covering the claim. The large percentage of time claims are handled quickly, smoothly and are settled so that the business and/or injured party can be made whole. In those cases, however, where more information is needed, the insurance carrier will often send out a Reservation of Rights letter.

Reservations of Rights Letters (ROR) letters are used in many claim situations when the insurer doesn't have enough information to make a coverage determination and/or sees the potential that some allegations may not be covered. Often claims are submitted with little or unsubstantiated facts that need to be investigated in order to determine coverage. A reservation of rights letter is not a denial letter; it merely says the insurer is continuing its investigation and is reserving the right to later deny or accept coverage when additional facts are known. Sometimes an ROR states the carrier is defending the claim however; certain allegations will not be covered. A ROR letter typically outlines the insurance carrier’s rationale for believing that a claim or certain portions of a claim may not be covered. To be effective and valid, a ROR letter must meet a “fairly inform” requirement adequately explaining to the insured the carrier’s position. The safest thing to do after receiving a ROR letter is to provide a copy to counsel to determine whether a response is recommended. Experienced counsel will know the best way to protect the insureds interest when communicating with the insurance carrier. Also keep in mind that an insurance carrier is required to provide an ROR letter to both the named insured under the policy and any Additional Insured parties.

C. **Franchisor and Franchisee Response to Denial or Reservation of Rights Letters**

98 See Advantage Builders & Exteriors, Inc. v. Mid-Continent Cas. Co., 449 S.W.2d 16, 23 (Mo. Ct. App. 2014)(holding that an insurer was estopped from denying coverage because the ROR letter was ineffective); Hoover v. Maxum Indem. Co., 730 S.E.2d 413, 417 (S. Ct. Ga. 2012)(holding that a ROR letter was insufficient because it “did not unambiguously inform [the insured] that [the carrier] intended to pursue a defense based on untimely notice of claim).

99 See Endurance Am. Specialty Ins. Co. v. Utica First Ins. Co., 132 A.D.3d 434 (N.Y. App. Div. 1st Dep't 2015)(holding that an insurer’s disclaimer of liability for coverage for its named insured did not constitute notice to the additional insured); Erie Ins. Exchange v. Lobenthal, 114 A.3d 832 (Pa. Super. Ct. 2015)(holding that the insurer did not satisfy its obligation to provide timely notice to the additional insured when it only sent a ROR letter to the named insured).
Both insurers and insureds have a variety of options in the event there is a disagreement regarding the existence, extent, or amount of coverage on a given insurance policy. One such option is to file a declaratory relief action at the onset to have a court determine the rights and obligations of the insurer. In some states, such as Illinois, a carrier can be statutorily liable for wrongly denying coverage and forcing the insured to file suit instead. For this reason, a carrier may immediately initiate a declaratory relief action seeking a judicial ruling as to its rights and obligations under the insurance policy. For example, in AMCO Insurance Co. v. Carpet Direct Co., an insurer sued its insured-franchisor seeking a declaration that it did not owe a duty to defend the franchisor in the franchisees’ underlying action against the franchisor.

Similarly, if a franchisor or franchisee receives a coverage denial or reservation of rights letter from its carrier, it can file a declaratory relief lawsuit to seek a judicial ruling as to the insurer’s rights and obligations under the policy. For example, in West Coast Pizza Company, Inc. v. United National Insurance Co., a franchisee brought a declaratory judgment action against its insurer to determine the scope and extent of the insurer’s responsibility to defend another pizza franchise that was a separate entity in an underlying personal injury lawsuit. The court held the insurer did not have a duty to defend the separate pizza franchise because the insurance policy language clearly indicated that West Coast Pizza was the only named insured.

To avoid the need for a declaratory relief action to begin with, franchisors and franchisees should be very careful about the selection of an insurance provider and carefully review the terms, conditions and exclusions contained in the insurance policy. The franchisor should ensure the terms of the franchise agreement contain detailed insurance requirements for the franchisee. In addition, the terms and conditions of the actual insurance agreement should be specific and clear. This is another place where a regular insurance audit could benefit the franchisor by catching any problems before it is too late. Prior to filing an action for declaratory relief, the insured should try and obtain as much detail as possible from the insurer regarding the reasons for denial of coverage and contest the denial. Ultimately, if the insurer denies a claim incorrectly and in bad faith, the insurer can be liable for various damages such as economic damages, emotional distress damages, punitive damages, and attorneys’ fees.

VII. CONCLUSION

To determine what insurance is needed by a franchise system, the franchisor, and its franchisees, it is critical to first take a step back to consider what risks are present for the businesses that are specific to the system. Once you determine the particular risks present for the business, the next step is to determine what specific insurance will aid in ameliorating those

---

100215 ILCS 5/155 (allows an insured to recover damages from the insurer if the insurer’s refusal or delay to provide coverage was “unreasonable and vexatious.”); see Buckner v. Causey, 311 Ill. App. 3d 139 (Ill. App. Ct. 1999) (imposing sanctions against the insurer under section 155 for insurer’s “vexatious and unreasonable refusal” to pay a claim under the policy).


103Id. at 37, 39.

risks. Today the risks are greater than can be addressed by stock general liability insurance. Costly risks such as cyber security, vicarious liability, and others should be incorporated into the analysis of determining what insurance is needed. This type of coverage can be necessary, but also is cost prohibitive and unlike to plug all gaps in risk, making indemnity and other risk management important considerations too. It is helpful to work with an insurance business advisor to determine the insurance necessary, available, and realistic and to create standards for the insurance required by a system’s franchisees. It is also critical to monitor the actual insurance that is actually procured by franchisees in order to make sure the coverage desired is acquired and effective.
Appendix A
Franchisee Minimum Data Cyber Liability Insurance Coverage Requirements

Each franchise unit location must maintain a data cyber liability insurance policy to protect its business against costs, expenses and damages incurred as a result of privacy and data breaches and losses.

Section I below sets forth the Franchisor’s requirements for cyber liability coverage effective [__________]. You must meet the minimum requirements for each franchise unit location you operate. These requirements are intended as “minimum” standards and we strongly suggest that you review your coverage and policies with a reputable insurance agent or broker knowledgeable in cyber liability insurance coverage matters to determine if additional coverage is appropriate or necessary for your franchise. In no event should you conclude that purchasing the coverage indicated as “minimum” standards is necessarily appropriate or sufficient for your franchise.

We understand that data cyber liability insurance coverage is still relatively new and there is little uniformity between policies. Our experience indicates that navigating cyber liability coverage matters and comparing coverage under different policies can be very difficult because, among other reasons, the terminology is not consistent between insurance carriers. Therefore, we are including a general description next to each category of coverage to assist you in understanding what is offered under each proposed policy you evaluate. This information is located in the last column on the chart below. We also included a short list of general guidelines and information you may use in assessing your coverage needs.

Please note that the description of coverage and the information in Section II are only intended to be one source to help you evaluate the policies offered by various insurance agents and it does not contain a comprehensive list and explanation of available coverages, exclusions, limits and conditions. Coverage is constantly evolving and insurance carriers are continuously re-packaging what is offered under their policies. These descriptions and guidelines should not be a substitute for conducting your own thorough due diligence and research.

I. Minimum Coverage Requirements

Data cyber liability insurance policies are intended to protect against various categories of losses. You must maintain a cyber liability policy with an overall aggregate limit of no less than [_____________], which is the total amount the insurance carrier will pay under the policy regardless of the number of claims or data breach or loss events.

- Column 1 sets forth the standard name and alternative names for different types of coverage under most standard data cyber liability insurance policies.
- Column 2 sets forth the current minimum limits imposed by us.
- Column 3 sets forth the maximum retention (or deductible) allowed by us under the policy.
- Column 4 provides a brief overview and description of each type of coverage.

<table>
<thead>
<tr>
<th>Column 1 Coverage</th>
<th>Column 2 Minimum Limit</th>
<th>Column 3 Maximum Retention</th>
<th>Column 4 Description of Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Information Security &amp; Privacy Liability</td>
<td>$________ Each Claim</td>
<td>$________ Each Claim</td>
<td>This coverage insures against third party lawsuits or claims against your business resulting from a data breach or loss or privacy event. In other words, lawsuits or claims against your business by students or other third party victims of a data breach or loss.</td>
</tr>
<tr>
<td>Also referred to as: “Network Security Liability”</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Data Breach or Loss Response Costs</td>
<td>Total Minimum Limit for all Categories (A)-(D) below combined</td>
<td>$________ Each Event</td>
<td>This coverage provides reimbursement to you for expenses and costs related to responding to a data breach or loss. These include costs to notify affected individuals, public relations costs (also called crisis management, consulting or outside specialists’ expenses), credit monitoring, call center services, forensic investigations and legal expenses related to determining liability for a data breach or loss. Sometimes policies will include costs to mitigate damages under this category. Often a policy will impose “sub-limits” on these types of costs and</td>
</tr>
<tr>
<td>Also referred to as: “Special Expenses” or “Event Management Expenses”</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

44
<table>
<thead>
<tr>
<th>Coverage</th>
<th>Minimum Limit</th>
<th>Maximum Retention</th>
<th>Description of Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>expenses. You must have a blanket minimum sub-limit of no less than $________ for all of these expenses and costs combined.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>If your policy provides sub-limits for each data breach or loss response sub-category, then the minimum limits for each sub-category are set forth below. Some policies group coverage differently than set forth in this chart. You are responsible for confirming that the breach or loss response (or event management expense) aggregate limit is no less than $________ or confirming that each sub-category limit does not fall below the minimum limit described below.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(A.) Customer Notification and Credit Monitoring</td>
<td>$________ or [number] notified individuals</td>
<td></td>
<td>The federal and state governmental agencies (such as the FTC or FCC) may attempt to investigate your franchise or levy fines or penalties for violating privacy laws. This coverage insures against violations of privacy laws and regulatory proceedings that result from a data breach loss or privacy event. Sometimes this coverage is subject to a sub-limit and sometimes it is part of the general Information Security &amp; Privacy Liability coverage and there is no sub-limit.</td>
</tr>
<tr>
<td>(B.) Public Relations/Crisis Management</td>
<td>$________</td>
<td>$________</td>
<td></td>
</tr>
<tr>
<td>(C.) Forensic</td>
<td>$________</td>
<td>$________</td>
<td></td>
</tr>
<tr>
<td>(D.) Legal</td>
<td>$________</td>
<td>$________</td>
<td></td>
</tr>
<tr>
<td>3. Regulatory Defense and Penalties</td>
<td>$________</td>
<td>$________</td>
<td></td>
</tr>
<tr>
<td>4. PCI Fines and Costs</td>
<td>$________</td>
<td>$________</td>
<td>This coverage provides reimbursement for direct monetary fines owed under the terms of any Merchant Service Agreements resulting from a data breach or loss and your failure to comply with industry accepted security standards (PCI Data Security Standards). Some policies will require you to be “PCI Compliant” as a condition to providing coverage for PCI Fines and Costs and brokers will require that you independently prove you are compliant.</td>
</tr>
<tr>
<td>Also referred to as: &quot;PCI-DSS Assessment&quot;</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Data Restoration/Data Recovery or Loss of Digital Assets</td>
<td>$________</td>
<td>$________</td>
<td>This coverage includes costs to repair, restore, recreate or replace website, intranet, network, computer system, programs or data to the same condition and with the same contents as prior to the damage. Sometimes a policy will only provide this coverage in connection with a data breach or loss. Sometimes a policy provides this coverage even in the event of accident, human error or natural disasters. Ask your legal advisor or broker the circumstances under which data restoration or recovery coverage is provided. We require that you maintain this coverage in connection with a privacy event or data breach or loss only but you may want to consider expanding the coverage to human error, natural disasters or other non-data breach or loss causes depending on your risk exposure and other factors identified by your broker.</td>
</tr>
<tr>
<td>Also referred to as: &quot;Hacker Damage Costs&quot;</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Column 1 Coverage</td>
<td>Column 2 Minimum Limit</td>
<td>Column 3 Maximum Retention</td>
<td>Column 4 Description of Coverage</td>
</tr>
<tr>
<td>------------------</td>
<td>------------------------</td>
<td>---------------------------</td>
<td>--------------------------------</td>
</tr>
<tr>
<td>6. Business Interruption</td>
<td>$_____</td>
<td>$_____</td>
<td>Business Interruption coverage provides reimbursement to you for lost income resulting from a data breach or loss or privacy event. Some underwriters combine Business Interruption with Loss of Digital Assets coverage described in Row 5 above. The deductible or retention is the length of the period you must wait under the policy until claiming lost income. The waiting period can range from 8 hours to 10 days and has a significant impact on the amount you will recover for business interruption losses. Often an insurance carrier will place conditions on providing business interruption coverage such as requiring the franchisee to take reasonable steps to minimize or avoid the business interruption event at its own expense.</td>
</tr>
<tr>
<td>7. Cyber Extortion</td>
<td>$_____</td>
<td>$_____</td>
<td>Cyber extortion is coverage for any threat to attack or an attack on your computer system for the purpose of demanding money or property as a ransom. Typically, these events involve demands for payments ranging from $2,500-$15,000, although the amounts can be higher. These occurrences are often referred to as “crypto-locker” events, where your system is encrypted and disabled, and you will only be able to receive the decryption key if an amount is paid in a brief period of time (often within 24 hours and paid through Bitcoin).</td>
</tr>
<tr>
<td>8. Website Media Content Liability</td>
<td>$_____</td>
<td>$_____</td>
<td>This coverage is sometimes found in data cyber liability insurance policies and covers damages sustained in the course of certain defined “Covered Media Activities” such as (i) defamation, libel, slander, emotional distress, outrage, torts related to disparagement or harm to reputation; (ii) false light and public disclosure of private facts; (iii) invasion of right to privacy and commercial appropriation of name or person; (iv) copyright infringement; (v) plagiarism, piracy; and (vi) infringement of domain name, improper deep linking or framing.</td>
</tr>
</tbody>
</table>

II. General Guidelines and Suggestions when Evaluating Data Cyber Liability Coverage.

Below are some guidelines and suggestions we believe you may find useful in evaluating your coverage needs. Again, these pointers are not an exhaustive list of the issues you should consider and we strongly advise that you utilize competent service providers when choosing any insurance coverage for your franchise.

1. **Review All Endorsements to the Policy.** Sometimes coverage that you believe is part of the policy is actually excluded by the insurance carrier in an endorsement to the policy. We have noticed this practice occurs particularly in the area of PCI Fines and Costs. Make sure that required or necessary coverage is not carved-out and excluded under the policy in a later endorsement attached to the front or back of the policy.

2. **Know Who is Entitled to Notification in the Event of a Breach or Loss.** In the event of a breach or loss, the policy should cover all costs (after the deductible) for notifying affected individuals and providing credit monitoring and identify theft protection, when needed. Sometimes the policy will reserve the right for the insurance carrier, in its discretion, to determine who is an “affected individual” or will only provide these services to affected individuals over 18. Also, there may be exceptions for individuals located outside the United States.
3. **Understand What Actions are Not Covered Risks Under the Policy.** You should review the exclusions to the policy and discuss them with your broker to determine how they may affect coverage. We suggest scrutinizing broad exclusions for “failing to follow minimum required practices.” You should also ask your insurance broker to carve-out “cyber-terrorism” from the typical blanket general exclusion for war, invasion or insurrection.

4. **Compare Coverage Limits, Sub-Limits and Retentions.** It is unlikely that one insurance carrier will offer the same exact coverage to insure against the same risk for significantly less than a competitor. If you notice a large difference in premium quotes, then compare the deductibles and sub-limits very closely. Also remember that defense costs and expenses are included – and are not in addition to – the policy limit. These costs can erode the policy limit very quickly.

5. **Understand all Conditions to Coverage.** Some policies require an insured to utilize service providers from its own pre-approved list of vendors. This typically includes legal counsel and public relations firms.

6. **Choose Knowledgeable Advisors.** We do not represent or warrant that the minimum required coverage that you are required to purchase will provide adequate coverage. You should consult with your own insurance agents, brokers, attorneys and other insurance advisors to determine the level of insurance protection you need or desire, in addition to the coverage required by us. Our review and verification of certain elements of your insurance does not in any way reduce or eliminate your obligation to fully comply with all insurance requirements. It is your sole obligation to confirm with your insurance providers that your policies are in compliance with these and any other standards and requirements we impose.
ELEANOR VAIDA GERHARDS

Eleanor Vaida Gerhards is a partner at the national law firm of Fox Rothschild LLP. As a member of the firm’s Franchising, Licensing and Distribution Practice Group, she concentrates her practice on commercial transactions and compliance matters representing primarily franchisors, area developers and master franchisees. She also represents start-up franchisors in the establishment of franchise systems and, as a member of her firm’s insurance group, she often counsels franchise systems on insurance coverage matters. Eleanor frequently writes and speaks on legal issues in the franchise industry and her articles have appeared in the ABA Forum’s Franchise Lawyer newsletter, the Franchise Law Journal, PAFI Press and Law360. She is a frequent contributor to Fox Rothschild’s Franchise Law Update blog. Eleanor has been recognized as a “Legal Eagle” by Franchise Times and as one of the International Franchise Association’s Certified Franchise Executives.

DOUG IMHOLTE

Doug Imholte leads the Franchise Insurance and Risk Management Practice Group at Marsh & McLennan Agency. MMA is a subsidiary of Marsh, the largest Insurance Broker in the US. He and his team focus solely on the unique needs and risks of the franchise industry. He started his career as an Underwriter with Chubb insurance company in New York. After completing a 12 step Underwriting recovery program he left insurance to go work for a number of startup software companies to ride the entrepreneurial wave. Thinking that business ownership was for him he purchased the master franchise and franchise rights for a retail franchise concept in Minnesota in the early 2000s. After growing his franchise business to seven stores he sold the business in early 2008 and migrated back to insurance with Marsh & McLennan Agency. Doug specializes in insurance risks, coverages and programs for franchise systems.
ELIZABETH M. WELDON

Elizabeth M. Weldon is a partner at Snell & Wilmer L.L.P. in Costa Mesa, California. Elizabeth Weldon concentrates her practice on business litigation, franchise litigation, and intellectual property litigation. She represents franchisors in matters including breach of contract, trademark and trade name infringement, business competition torts and franchise law claims. She also represents both large and small businesses in intellectual property and other litigation matters, including trademark, trade dress, trade secret, breach of contract and tort claims. She frequently writes and speaks about various franchise litigation topics. Ms. Weldon graduated with a J.D. from the William & Mary School of Law in 2001. She is currently the president of the board of directors of Girls Inc. of Orange County, a non-profit organization serving over 5,000 girls each year.