

Professional Liability

Franchise Opportunities

By Peter Taffae

Can you name an industry that contributes \$2 trillion to our country's gross national product (GNP)? How about an industry that is the fastest-growing and represents one in every 12 businesses that exist today? Or how about an industry that has more than 5,000 different companies and more than 1 million affiliates, and whose historical rate of success is much higher than any other business?

The answer to all of these questions is the same — franchise. The franchise industry, although around for more than 40 years, has seen a renaissance in the past five years. This burst of growth can be attributed to two or three factors.

First, with the financial crisis of 2008,

which resulted in corporate downsizing, an entrepreneurial opportunity of owning a business with a proven business plan became very attractive to people who found themselves seeking a new career. This increased demand for franchisee businesses.

Second, with the wars winding down and veterans returning to a high unemployment environment, they were attracted to taking control of their future with a limited investment and a proven business model.

Lastly, these individuals are strongly attracted to being their own boss and not having to risk everything on an unproven concept.

Opportunities

With rare exceptions, the franchise industry has been under the insurance industry's

radar. Although there are miscellaneous programs for certain franchisees available, franchisors have had a difficult time securing a comprehensive insurance product to senior management's personal assets and corporate balance sheet. Franchisors have been the step-child.

The insurance marketplace has been limited in fulfilling this need. The likelihood of success for those capitalizing on the need for insurance expertise for franchisors and their franchisees presents a great opportunity, specifically in the area of franchisors' liability, which we define as directors and officers (D&O) liability, franchisors errors and omissions (E&O), employment practices liability and fiduciary liability.

The general perception is that unless the franchisor is providing medical, accounting, legal, insurance or technology services through their franchisees, all the franchisor needs is a D&O policy. This is a critical error in thinking. Most underwriters exclude suits brought by franchisees, which is the most likely constituent to bring suit (the majority of franchisors are closely held). With the standard breach of contract and professional liability exclusions, liabilities arising out of the Franchise Disclosure Document (FDD), previously known as the Uniform Franchise Offering Circular, would be excluded.

The FDD is similar to SEC documents in that it is filed with the Federal Trade Commission and spells out the services and responsibilities of the franchisor. This is one of two or so documents the potential franchisee will base his investment on. The most common allegations in litigation by franchisees against franchisors involve misrepresentations arising out of the FDD. The senior management of franchisors needs D&O insurance to protect its potential assets.

Vicarious Liability

The other common cause of litigation with the franchisor is vicarious liability

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arising from the actions of the franchisees. Many courts have determined that a franchisor exercises sufficient “control” over franchisee(s), which leads to the finding that franchisor(s) is vicariously liable for the acts of its franchisee(s).

An example of franchisor’s vicarious liability would be based on allegations that the franchisor supplied a defective product to the franchisee(s) or was otherwise sufficiently involved in the design, manufacture, or distribution of defective product(s) sold by the franchisee(s).

Another possible example would be allegations that the franchisor negligently required the franchisees(s) to adopt specific injurious procedure(s) that caused the injury. Very few insurance markets offer this coverage, and rarely under the D&O policy.

Franchisors E&O will protect the senior management of the franchisor, as well as the franchisor (legal entity) from litigation

brought by the franchisee(s) arising from numerous potential allegations. One of the most frequent allegations that franchisee(s) bring against the franchisor is that the service outlined in the FDD, for which the franchisee is paying a royalty and/or franchise fee, is not performed as it was represented.

Franchisor’s E&O is only offered by a small group of insurers. Each company that offers the coverage has its own policy language and target market.

Often the franchisor requires its franchisees to purchase insurance as outlined in the franchise agreement. An insurance



professional who understands the requirements and franchise concepts can provide better risk management at a better cost. **1**

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