

## FranchisePerils' FranchisorSuite® Program Offers Comprehensive Coverage for Franchisors

*By Bob Bregman, CPCU, MLIS, RPLU*

Recent legal developments have been rapidly expanding the scope of liability to which franchisors are exposed. Look no further than the article in this issue of *EPLiC* by John F. Dickinson and Charles Roberts: "The Potential Impact of the NLRB's Efforts To Redefine the 'Joint Employer' Standard," and it is apparent that the courts will be increasingly likely to find franchisors liable for the acts of their franchisees.

And, previously, in "[\*Franchisors Beware: You May Be Liable for Torts Committed by Your Franchises in California\*](#)" (Winter 2013 *EPLiC*), Don Phin described how the California Court of Appeal ruled that a franchisor may be subject to vicarious liability where it assumes substantial control over the franchisee's local operations, management-employee relations, or employee discipline. Trends such as these, which clearly demonstrate that heightened burdens are being placed on franchisors, will only serve to increase their need for the broadest possible scope of liability insurance coverage.

In this article, we provide details on how the FranchisePerils' FranchisorSuite® program affords just such a package of comprehensive coverage for franchisors. The article begins with a brief explanation of how the program is structured. It continues by describing some of the key features, benefits, and unique aspects of the program, as well as its disadvantages. The article concludes with commentary regarding the future of the FranchisorSuite® program.

### How the FranchisorSuite® Is Structured

The policy combines four distinct coverage parts within a single policy, as follows.

- ◆ Franchisors Errors & Omissions Liability
- ◆ Directors & Officers Liability
- ◆ Employment Practices Liability
- ◆ Fiduciary Liability

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Within the Franchisors Errors & Omissions Liability coverage part are two separate insuring agreements. The first, Insuring Agreement A, affords “Franchisor Malpractice” coverage (a synonym for Franchisor E&O Coverage). Under Insuring Agreement B, the policy provides “Franchisor Vicarious Liability” coverage.

All of the four coverage parts contain one aggregate limit of up to \$5 million, per claim. The policy also includes an annual aggregate limit for all claims.

### **What Is Vicarious Liability?**

Vicarious liability is a legal doctrine that assigns liability for an injury to a person or entity because it has a certain relationship with the person or entity whose action directly caused the injury. For example, one of the most well-known cases of vicarious liability involving a franchisor is the February 1992 incident in which a customer, Stella Liebeck, purchased a cup of coffee at a McDonald’s restaurant that spilled and burned her. Although she bought the coffee from one of McDonald’s franchisees, legal liability for Ms. Liebeck’s injury was also assigned to McDonald’s Corporation, the franchisor. This was because as a franchisor, McDonald’s dictated the policies and practices of its franchisees, including the temperature at which the coffee was to be heated, the type of container in which the coffee was sold, and the marketing techniques applicable to the product. Given these factors, McDonald’s was found vicariously liable for the customer’s injury.

### **What Kinds of Claims Are Made Against Franchisors?**

Claims are frequently made in conjunction with the franchise disclosure document (FDD), which specifies the rights and duties of both the franchisor and the franchisee. The FDD is a complex agreement written by attorneys and filed with federal and state regulators. Frequently, the franchisees allege that

the franchisor did not live up to its duties specified in the FDD, such as failing to provide marketing, training, technical, or human resources support. Litigation also sometimes arises from allegations of fraud, misrepresentation, and breach of contract, in which the franchisee claims that the franchisor made false statements regarding anticipated profits or hours of work required to operate the franchise. In addition, competitors occasionally bring claims against franchisors, alleging trademark infringement, antitrust violations, or unfair competition.

### **Key Features and Benefits of the FranchisePerils’ FranchisorSuite® Program**

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The program uses its own, proprietary policy form, written on Arch Insurance Company paper. Arch is rated A+ XV by A.M. Best. Mr. Taffae offered the following details when I spoke with him about FranchisorSuite® in April 2015.

### **Why the Program Is Unique**

What makes the FranchisorSuite® program unique is that it is currently the only source of the three “traditional” management liability components (directors and officers, employment practices, fiduciary liability) that is *also* offered in conjunction with franchisors errors and omissions liability insurance coverage. Typically, franchisor’s E&O policies are provided on a stand-alone basis rather than being written in conjunction with these three other types of insurance. This is because often the

allegations in litigation will overlap in these four coverages.

### Positive Features of the Program

FranchisorSuite® includes a number of advantageous features that afford significantly broader coverage compared to what is normally offered within standard programs written for franchisors.

**Single Insurer/Single Claims Adjuster.** Frequently, management liability-type claims end up falling within the purview of *more than one* policy. A prime example is when claims arise out of the FDD. In most instances, such claims trigger both the franchisor's D&O liability policy and its franchisor's E&O policy. What creates problems is that, ordinarily, these two policies are written by two *different* insurers. At best, even if both insurers accept liability, myriad problems will invariably ensue since two adjusters will be involved. This means that a time-consuming and complex "allocation" of the claim must be made between the two insurers' policies. In a worst-case scenario, the involvement of multiple insurers has the potential to create a coverage gap, in the event that each insurer asserts that the loss falls within the *other's policy*. Yet, under the FranchisorSuite® program, this is not a problem because only a single insurer and a single adjuster will be involved, since all four coverage parts are underwritten by Arch Insurance Company. And to reinforce this intent, all coverage parts contain an "other insurance clause" designating the Arch Insurance Company policy as "primary."

**Affirmative Coverage for Vicarious Liability.** Nearly all franchisor's E&O policies exclude coverage for vicarious liability. And although a few do not explicitly exclude vicarious liability, neither do they provide affirmative coverage. In contrast, the FranchisorSuite® program offers dedicated vicarious liability coverage within its Insuring Agreement B, subject to a \$250,000 sublimit. The insurer will, however, consider providing a higher limit on a case-by-case basis.

**Coverage Flexibility.** Although most insured franchisors do elect to purchase employment practices and fiduciary liability coverages under the program, it should be noted that these two coverage parts are optional. This approach allows the insured franchisor to tailor the program to the organization's unique business needs.

**Lower Premiums.** By virtue of the fact that an insured may be purchasing up to four different coverages, the franchisor will likely realize considerable savings compared to a situation in which it must buy separate policies for the required coverages. Since only a single application is required for multiple types of insurance, the resulting underwriting efficiencies built into FranchisorSuite® will yield a significant premium discount. Not only is there only one application for four different coverages, the real advantage of this approach is that, because FranchisorSuite® has one aggregate limit, the insured avoids paying up to four primary premiums to obtain the same coverage. One \$4 million policy is almost always less expensive than four \$1 million primary policies.

**Franchisor-Specific E&O Coverage Wording.** Instead of using a generic, miscellaneous E&O policy (to provide franchisor's E&O coverage), an approach offered by all other insurers, FranchisorSuite® makes such coverage available under a franchisor-specific policy form, geared exclusively to the needs of franchisors. This has the effect of affording the insured franchisor much broader coverage, compared to what is provided under a miscellaneous E&O policy.

**All-Risks Franchisor E&O Coverage Basis.** Another unusual and beneficial feature of the program is that the franchisor E&O coverage is written on an all-risks rather than a named-perils basis, the standard approach used by insurers that write such policies.

**Modified Bodily Injury Exclusion in Franchisor's E&O Coverage.** Recognizing that a high proportion of the claims involving franchisor's E&O coverage are the result of

financial loss, the majority of franchisor's E&O policy forms contain an exclusion of coverage for claims involving or arising out of bodily injury liability. The problem with such an exclusion, however, is that when franchisors are held liable for a situation comparable to the well-known McDonald's coffee case (discussed above), they find themselves without coverage for bodily injury liability. Considering the difficulties created by such a gap, the bodily injury exclusion in the franchisor's E&O coverage part contains a carve-out—and thus affirmatively covers bodily injury claims brought against the insured franchisor on a vicarious basis.

**Breach of Contract Carve-Back for the FDD and Related Documents.** As already noted, claims are frequently made against franchisors in conjunction with the FDD. Accordingly, the policy's breach of contract exclusion excepts, and thus covers, such claims. On the other hand, most franchisor's E&O policies' breach of contract exclusions do not contain this important exception.

**No Bankruptcy Exclusion.** Unlike the typical franchisor's E&O policy, the FranchisorSuite® form contains no bankruptcy exclusion. This is important because the presence of the bankruptcy exclusion is sometimes used as a basis for denying claims when a franchisee alleges that actions of the franchisor are responsible for causing the franchisee to declare bankruptcy.

**Modified Hammer Settlement Clause in Franchisor E&O Coverage Part.** The franchisor E&O coverage part of the policy contains a modified hammer clause (also known as a "soft hammer") that applies to the policy's settlement provision. A hammer clause comes into play when an insurer recommends settlement of a claim for a certain amount, but the insured does not consent. Under a standard version of the hammer clause, in the event the claim is eventually settled for a sum exceeding the plaintiff's original figure, the insurer will only pay the initially recommended amount. Nor will the insurer pay any defense costs that accrue, *after* the insured's refusal to settle. On the

other hand, under the FranchisorSuite® modified hammer clause, if an insured franchisor does not want to settle a claim per an insurer's recommendation, the franchisor will only be responsible for 20 percent of any additional, final settlement and for only 20 percent of any additional defense costs that accrue following its initial refusal to settle. The benefit of this so-called soft hammer clause is that it gives the franchisor much more control over claim settlements. This is a critical point, because a franchisor's reputation is on the line under such circumstances. Indeed, a settlement, which could be publicly perceived as an admission of wrongdoing, might have serious, negative consequences for a franchisor's brand.

Taking this positive feature a step further is the fact that the directors and officers, employment practices, and fiduciary liability coverage parts do not contain *any* hammer clause. This means that for claims involving these coverages, the insured franchisor has control of settlement offers and amounts.

**No Claim Warranty Question in Renewal Application.** The renewal application used in the program does not contain the so-called claim warranty question, typically found in most insurers' renewal applications. This is extremely beneficial for an insured because renewal applications almost always contain a question as to whether or not the insured knows of any circumstances that have the potential to give rise to a claim in the future. The problem with the claim warranty question is that if an insured answers "no," and a claim is reported during the new policy period, an insurer might be able to deny coverage by asserting that the insured was, in fact, aware of such circumstances but failed to note them in the renewal application. Yet, because FranchisorSuite® does not include a claim warranty in its renewal application, this ordinarily problematic requirement will never be a source of claim denials.

**Dedicated Franchise Claims Counsel.** In the event of a claim, the insurer will assign a law firm that has substantial franchise law experience. Given the complexities of managing

litigation against franchisors, specialized legal expertise is an invaluable benefit for an insured.

## Drawbacks to the Program

The program has three specific features that are disadvantageous for some insureds.

**Program Available Only for Privately Held Franchisors.** The fact that the program is not made available for publicly traded franchisors reduces the number of possible insureds. However, since the FranchisorSuite® program was initiated only last year (2014), there is a good possibility that it could later be expanded to include publicly traded franchisors.

**Sublimit of \$250,000 on Vicarious Liability.** Since coverage for vicarious liability is capped at \$250,000 (and also provided on a sublimited basis that does not create an additional limit of coverage), this represents another disadvantage of FranchisorSuite®. The insurer will, however, consider providing a higher limit (although still on a sublimited basis), depending on the individual account. Nevertheless, \$250,000 can still go a long way toward providing an effective defense if a franchisor is sued and an allegation of vicarious liability is made against it. Moreover, an affirmative grant of coverage for vicarious liability remains a feature offered by few other insurers. Finally, under such circumstances, an insured will have the benefit of Arch's extensive experience in managing claims involving franchisors.

**No Coverage for Cyberperils.** The FranchisorSuite® program does not regularly offer coverage for data breaches and related cyber/electronic losses. This is despite the fact that cyberinsurance and the three traditional management liability coverages "fit" well together (i.e., much of the same underwriting data is needed for both management liability and cyberexposures, and the same personnel within insurers' claims departments often handle both types of claims). Yet, the insurer will consider providing cybercoverage on a case-by-case basis. And, once again, there is a

reasonable possibility that the program may be expanded to include cybercoverage as a standard option at some point.

## The Future of the FranchisorSuite® Program

Given current trends toward increased vicarious franchisor liability, coupled with the many unique features of the program, it is apparent to me that the future of FranchisorSuite® looks bright.

## All-Encompassing Coverage Approach

The fact that FranchisorSuite® covers the three traditional management liability exposures *along with* the all-important franchisor's E&O exposure (including vicarious liability) all within a single policy, makes it a unique, attractive package, far exceeding other options currently available on the market. As a consequence, the number of franchisors who avail themselves of this innovative, comprehensive, and cost-effective approach is likely to grow over time.

## Continuing/Expanding Need for Vicarious Liability Coverage

Given the current legal landscape, it is evident that we are moving in a direction of expanding franchisor vicarious liability. Accordingly, demand for the protection afforded by FranchisorSuite® is almost certain to increase.

## Growing Underwriter Comfort with the Franchisor Risks

As FranchisorSuite® accumulates additional years of loss experience, it will likely begin offering higher limits for vicarious liability, expand its eligibility to publicly traded organizations, and eventually add a coverage option for cyberliability and related electronic loss exposures.

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