

# Franchisor Malpractice: The Cornerstone of Risk Management

BY PETER TAFFAE

*The first line of defense when problems arise, franchisor malpractice insurance is the cornerstone of a prudent risk management program. It's coverage you hope you will never need, yet it is also the best way to ensure the franchisor's long term financial success.*

**F**ranchisors' malpractice, also known as errors and omission insurance, is a critical component of a franchisor's risk management program. There are numerous insurance companies providing this important coverage. However, each one takes a different approach and has its own policy wording. Most insurers use a generic, miscellaneous professional liability policy. It is important that a franchisor understands the differences between all options and seeks a qualified expert to assist them in determining the best approach in acquiring this important protection.

The two compulsory elements of a comprehensive franchisors' malpractice insurance policy must include financial protection for both the franchisor (legal entity) and the personal assets of its directors and officers.

## FREQUENT ALLEGATIONS

To understand the significance of this insurance we will use the typical and most frequent claim/allegations. A failed franchisee(s) alleges that the

franchisor failed to provide the services outlined in the Franchise Disclosure Document as well as the franchise agreement. Services could include lease negotiations, training, marketing, point-of-sale/software, and so on.

The franchisee(s) usually also allege fraud, misrepresentations, mismanagement, non-disclosure, negligence, or breach of contract arising out of the FDD. The franchisee(s) allege they lost their business and all the capital it has invested. The insurance policy provides defense costs (attorney fees) and indemnification/settlement. While costs vary depending upon the size of the initial investment and the number of plaintiffs, our research shows total costs average \$375,000.

Another frequent type of claim is vicarious liability for the acts of a franchisee. The most famous example of vicarious liability being McDonald's hot coffee incident which resulted in a rumored settlement of over \$20 million. No matter what industry the franchisor is in, the inclusion of vicarious liability is a vital part of the insurance program.

Franchisor litigation is expensive and lasts an average of three to five years. It often has a ripple effect on the franchisors' balance sheet and can easily hinder, and in some cases, unfortunately, end a franchisor's business.

Recently, we have seen an uptick in regulatory agencies taking an assertive enforcement stance. We are all familiar with the National Labor Relations Board and "joint employer" issues and less reported but equally powerful is the Federal Trade Commission's behavior in regulatory enforcement. This is not only in enforcing the federal franchise laws but also the privacy violations that the Federal Trade Commission has taken on as the chief federal regulator. It is imperative to ensure any insurance policy acquired adequately protects for both federal and state regulatory violations.

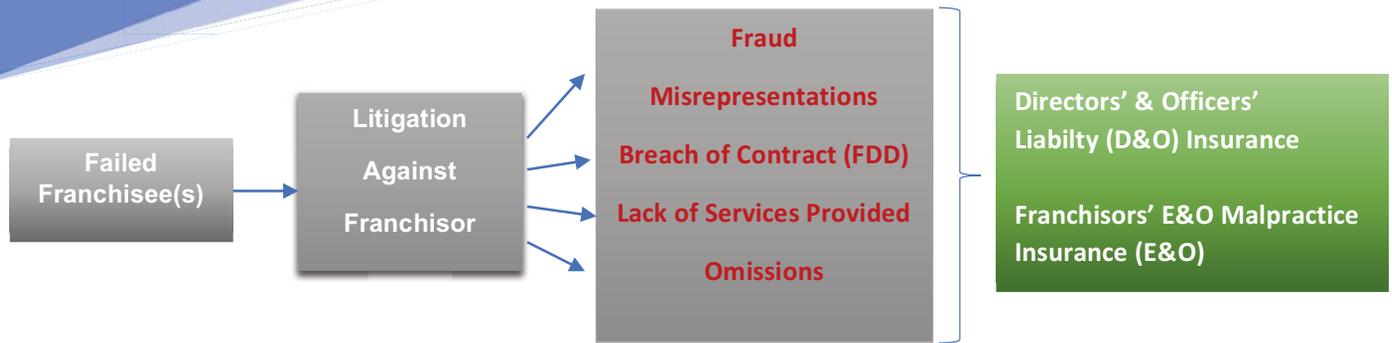
## START ADEQUATE COVERAGE ASAP

Franchisors' malpractice insurance is written on a "Claims Made & Reported" basis. This means that it is important for franchisors to start the coverage as soon as possible because with very rare exceptions the protection only starts for "Wrongful Acts" (allegations of wrongdoing) after the policy inception. Often, we see start-up franchisors postponing the purchase of franchisors' malpractice thinking that at three or five franchisees the exposure is nominal, when in fact it is critical because future allegations are going to arise out of the FDD.

There is also a lag time between when a franchisee(s) signs a franchise

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## MOST FREQUENT FRANCHISOR LITIGATION SCENARIO



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agreement and fails. However, the allegations against the franchisor due to the franchisee(s) failure occurred at the beginning and/or throughout the relationship. It is important to find an insurance company that is dedicated to the franchise industry (understands your challenges) and wants to grow with you.

Unfortunately, the insurance industry with one exception, only uses generic policy language for franchisors and does not offer one policy to cover the franchisor and the directors and officers (for allegations listed above). The common mistake franchisors and their insurance advisor make is to secure only a Directors' & Officers' Liability policy or only an Errors & Omissions policy.

Even if the franchisor purchased both policies, which can be expensive, the coverage would have significant deficiencies, including disputes between the insurers regarding which insurer is responsible for covering the claim. This is the worst imaginable position for a franchisor because while they have paid their insurance premiums they are left with a battle or possibly no coverage at all.

Even if an insurance agent finds one insurance company to write both the D&O and the E&O in addition to being expensive, the franchisor now must deal with the "franchisee(s) exclusion" that the industry places on D&O policies written for franchisors. It is imperative

that franchisors protect their balance sheet and personal assets with one insurance company to avoid insurance companies' denial war.

There are several ways to minimize the conflict between two insurance policies covering the same claim. They include:

- One insurer writing both the D&O and the E&O (best option),
- Having a "tie-in" limits endorsement with a pre-determined allocation percentage.

When choosing Option Two, it is compulsory that the D&O does not have a "franchisee(s) exclusion." Be careful because many underwriters will add this exclusion to their policy.

### FIRST LINE OF DEFENSE

Franchisors' malpractice is the first line of defense when problems arise. Be it franchisee(s), regulatory agencies, investors, competitors and customers. Considered the cornerstone of a prudent risk management program, it is coverage all franchisors need to seriously consider. Not only does it protect the balance sheet, but also the personal assets of the franchisors' directors and officers. This is the type of insurance you hope you will never need, yet it is also the best way to ensure the franchisor's long-term financial success.

It is prudent to transfer the risk to the insurance company for a nominal percentage of the limit (protection).

Franchisors need to retain an insurance advisor who understands their exposures and can work with an insurance underwriter to address their exposures and transfer the risk from the franchisor to the insurance company to ensure financial security.

Other insurance coverages a franchisor needs to consider for a comprehensive risk management program would include:

- **Employment Practices:** Covers litigation arising from discrimination, wrongful termination, sexual harassment, etc. Be sure the coverage extends to third parties, such as customers.
- **Cyber/Privacy:** Although not new coverage, it is probably the least understood and a major vicarious liability exposure.
- **Professional Liability:** Different than franchisors' liability. Professional liability protects against allegations the services provided (i.e.: real estate, travel, legal, tax, etc.) by the franchisor and its franchisees were provided negligently. This coverage is similar to medical malpractice insurance purchased by a doctor. ■



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