DON’T EXPOSE YOURSELF:
Risk Management In Your Franchise System

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INTRODUCTION

It has been said that what distinguishes modern man from our more primitive ancestors is the ability to recognize and control risk.\(^1\) Individuals and businesses, franchisors and franchisees alike, each face a variety of risks every day—from natural disasters and legal liability to theft, poor health, and professional errors and omissions. Fortunately, there are nearly as many tools to manage these risks as there are risks themselves. Business owners seeking to avoid certain types of risks may proactively adopt procedures and practices designed to minimize and mitigate the likelihood of a significant loss. For other types of risks, franchise systems may seek to transfer risk through a variety of methods, including indemnification agreements and traditional commercial insurance products. Still other businesses may employ any number of alternative risk management strategies, such as establishing a “captive” either as a direct insurer or reinsurer.

To help your franchise system navigate the concepts and strategies involved in “risk management,” this paper provides both a broad overview of risk and insurance basics for franchise systems as well as practical insights for franchisors and franchisees, including: (i) best practices for mitigating potential risks in your franchise system; and (ii) important considerations as you choose the right risk management strategy for your business, whether establishing a captive or purchasing traditional commercial insurance products.

INSURANCE BASICS FOR FRANCHISORS

**What is risk?**

Risk, and corresponding losses, occur from what we do not expect to happen. In other words, risk and losses result when the actual outcome deviates from the outcome we expected. All organizations face risks and losses. Losses of property, life and health, as well as liability to others are facts of life that present risk to all business organizations. In fact, CEOs frequently identify these “risks” (i.e., the unknown and unforeseen) as one of their biggest concerns. It is what keeps them up at night. When we talk about corporate risk, we generally categorize risks into two buckets – speculative risks and pure risks.

Speculative risks are those risks that allow for potential gain as well as potential loss. Speculative risks are assumed as conscious choices and are not just a result of uncontrollable circumstances. For example, by definition, almost all investment activities involve speculative risk, as no organization has certainty whether an investment will be a blazing success or an utter failure.

Pure risks, on the other hand, arise where there is only the possibility of loss. In other words, loss is the only possible outcome and there is no potential for a beneficial result. Pure risk is related to events that are beyond the risk-taker’s control and, therefore, a

\(^{1}\) See, e.g., **Peter Bernstein**, *Against the Gods: The Remarkable Story of Risk* (1996).
person cannot consciously assume a pure risk. For example, the possibility that a company’s headquarters will be destroyed due to a natural disaster is a pure risk out of the company’s control. There is no affirmative choice and no potential benefit to this risk. Traditional risk management is concerned primarily with pure risks.

**What is risk management?**

Although subject to interpretation and variation, “risk management” can generally be defined as follows: (i) the procedures used to identify, assess, control and finance accidental loss; (ii) the management of the pure risks to which an organization might be subject; and (iii) the application of resources to reduce and finance identified risk/loss exposures. Keeping this definition in mind, the risk management process requires decisions regarding: (i) ways to reduce/control risk and corresponding losses; (ii) ways to finance risk; and (iii) the negotiation of related legal agreements. In other words, risk management is a combination of risk/loss control, finance and legal disciplines.

Many larger organizations include a stand-alone risk management function. At some organizations, the risk management function is part of the legal or general counsel function. Alternatively, the risk management function may report through the finance or treasury function of an organization.

**What is risk/loss control?**

“Risk/loss control” is a multidisciplinary approach in which human, engineering, and risk management practices are employed to reduce the frequency or severity of losses. Risk/loss control activities are the actions an entity takes, often at the behest of an insurance company or in compliance with regulatory requirements, to ensure that reasonable steps are being taken to avoid a situation in which a claim might be made.

- **EXAMPLE:** If a loss-of-income insurance policy covers a situation in which fire damage to a facility results in a loss of production, the insurance company may require the policyholder to put in place appropriate fire suppression measures to minimize the risk of the reasonably foreseeable event and related claims.

Note that an organization would not conduct risk/loss-control activities for policies that cover loss of income due to acts of nature, such as tornadoes or hurricanes, as loss control activities are implemented to mitigate exclusively foreseeable incidents. However, the business would benefit from pre-loss “business continuity” planning designed to resume operations as quickly as possible as a means to mitigate the business interruption loss and preserve market share.

**How do organizations finance their risks?**

As discussed above, risk management involves making decisions regarding how an organization will finance its risks. There are three primary methods for financing the
risks of an organization: (i) the retention method; (ii) the contractual risk transfer method; and (iii) the commercial insurance method.

*What is the retention method of financing risks?*

As the name implies, retention financing techniques are those that involve paying for accidental losses from the organization’s *own finances*. In other words, the risk of loss is *retained* by the company and *not* transferred to another party. This may involve the organization paying for losses out of operating accounts when losses occur, establishing loss reserves or borrowing funds to finance losses. The retention method is often used to finance high frequency/low severity losses, but rarely used for low frequency/high severity losses. Rather, the risk associated with those types of losses is generally *transferred* through one of the risk transfer methods discussed below, such as the use of a “captive” insurer.

- **Example:** A company may choose to retain the risk of stoppage of certain of its boiler and machinery equipment by repairing such machinery as an operating cost. At the same time, the company may implement a preventative maintenance program to reduce the likelihood of a loss associated with a mechanical breakdown of equipment. In doing so, the risk of loss has been retained by the company and has not been transferred to a third party.

The deductible or self-insured retention required under certain traditional insurance policies is another example of risk retention. A “deductible” or “retention” is the portion of the insured’s loss, expressed in an insurance policy as a specific dollar amount or a percentage of insured loss, which must be paid before insurance coverage will apply. While a *deductible* will ordinarily erode a policy’s limit of liability, the insured’s policy limit is generally in excess of and is not eroded by a *retention*. Depending on the nature of the claim and the policy at issue, multiple deductibles or retentions may be paid before insurance coverage is triggered based on the number of “claims,” “occurrences,” “insureds,” “incidents,” “pollution conditions,” etc., subject to a policy “aggregate.” In some cases, a deductible or retention may itself be financed through the proceeds of other insurance. In other cases, for insurance programs involving large self-insured retentions, the insured may be required to provide collateral to the insurer to secure the insured’s obligation to pay within the retention.

*What is the contractual risk transfer method of financing risks?*

As the name implies, in this finance method, the risk is *transferred* to another party by way of a contractual agreement, such as an indemnity agreement or a hold harmless agreement. An “indemnification agreement” is generally defined as an undertaking to compensate another party upon the happening of a particular set of circumstances. A “hold harmless agreement” is generally defined as an agreement to assume liability on behalf of another party upon the happening of a particular set of circumstances.
• **EXAMPLE:** When a general contractor retains a subcontractor to perform services for a third party, the agreement between the two parties may require the subcontractor to indemnify the general contractor for bodily injury or property damage arising out of the performance of the subcontractor’s services for the general contractor, including loss or damage arising out of either the negligence of the subcontractor or the general contractor’s own negligence.

**What is the commercial insurance method of financing risks?**

Losses that are not retained by an organization, or otherwise transferred to a third party, can also be *financed* by commercial insurance companies. In other words, the organization may buy insurance to cover its losses. The purchase of commercial insurance is, however, not considered a “contractual risk transfer” because the company continues to face the “risk”. Rather, it is a method for the company to protect its balance sheet by transferring the cost of claims to the insurance carrier. It is important to note that the financial transfer to an insurance company is only viable if the insurer is solvent *and* will honor its obligations to pay covered claims. So, even where insurance is purchased, there is still a counter-party risk that the insurer will become unable or unwilling to pay claims. In addition, it is important to note that commercial insurance is generally subject to limits, deductibles, self-insured retentions and exclusions. This is similar to the deductibles individual consumers elect to include on their homeowners or auto liability policies. However, unlike most personal lines products where premium is paid at policy inception, commercial insurance programs may also include premium that is determined on a loss-sensitive or “retro” basis. Where significant deductible or premium obligations exist, commercial insureds are often required to post collateral with their insurers to secure these deductible or premium obligations.

• **EXAMPLE:** A company may purchase worker’s compensation insurance that includes a $100,000 per loss deductible. In doing so, the company has combined the retention (i.e., the first $100,000 of any loss) and commercial insurance (i.e., for the amount of any loss in excess of $100,000) finance methods.

**What is commercial property and casualty (P&C) insurance?**

Generally, commercial property insurance is first-party insurance covering real or personal property exposures of an organization. Casualty insurance is a third-party insurance covering an organization’s liabilities to third parties. More specifically, casualty insurance is liability insurance that provides indemnity or compensation for a harm or wrong to a third party for which the insured is legally obligated to pay. Usually, the injury or damage is caused by the insured's negligent acts or omissions, but in some situations the law imposes strict liability without regard to negligence, and this may also be covered by certain forms of liability insurance.
The term “casualty insurance” traditionally refers to many different coverages (other than life or health), including: (i) automobile and general liability; (ii) employers' liability; professional liability; (iii) E&O insurance; loss of income; and (iv) worker's compensation insurance.

The following is a list of examples of the types of commercial P&C insurance your organization may consider:

- Property
- Business Interruption Insurance
- Loss of Income Insurance
- Boiler and Machinery Insurance
- Crime Insurance
- Commercial General Liability Insurance (CGL)
- Directors’ and Officers’ Liability Insurance (D&O)
- Employment Practices Liability Insurance
- Professional Liability Insurance
- Umbrella Liability Insurance
- Marine Insurance
- Environmental Insurance
- Errors and Omissions Insurance (E&O)
- Worker’s Compensation and Employers’ Liability Insurance

Some of the coverages identified above are “optional” and the organization may instead elect to retain the risks instead of buying insurance. However, some of these coverages may be mandatory as a result of statutory, regulatory or contractual requirements. For example, worker’s compensation insurance is like auto liability insurance in that it is a statutorily mandated coverage. Unless you are a qualified self-insurer, you must purchase a worker’s compensation policy to insure your potential liabilities as an employer. Furthermore, certain of the agreements entered into by an organization with its business partners may require that the organization maintains certain other coverages (such as commercial general liability) in specified amounts.

With the foregoing as context, the following sections will address in more detail risk management practices pertinent to franchise systems, including: (i) best practices in loss mitigation; (ii) alternative risk retention methods, including captive insurance programs; (iii) contractual risk transfer; and (iv) traditional commercial insurance.

**RISK RETENTION: BEST PRACTICES FOR MANAGING RISK IN A FRANCHISE SYSTEM**

Businesses that maintain franchise operations have a risk profile that is unique compared to most other businesses. It is unique in the sense that even though the franchisor has limited control over a franchisee’s operation, the franchisor is exposed to the risks emanating from those operations. Here are some basic techniques that can help franchisors manage the risk associated with their franchise operators:
Establish good communications

First and foremost, maintaining good communications is considered a critical success factor in most risk mitigation strategies. Open communications between franchisors and franchisees promotes parallel interests and a clear sense of purpose. It also creates an environment of respect and collaboration. In the absence of good communication, the risk of brand degradation increases and often results in lawsuits. Technology has provided many means by which communications can be improved. Look to leverage opportunities with the internet, intranet, e-mail, texting and social media.

Form franchisee leadership groups

Forming franchisee leadership groups is another form of enhanced communication. These groups are generally designed to provide franchisees with high level access to company executives. For example, a franchisee leadership council that meets quarterly with company representatives to review strategic initiatives, new products, emerging technology, growth opportunities, business risks, etc. Groups of this nature are often formed to support and maintain the kind of direct relationships necessary for common interests to exist.

Maintain well-written franchise documents and agreements

Franchise Disclosure Documents and Franchise Agreements work to protect both the franchisee and franchisor. When these documents are well-written and kept current, there tend to be fewer conflicts between the two parties. Special attention should be paid to the construction of the disclosures, disclaimers, indemnifications, defaults and termination provisions.

Carefully qualify franchisee candidates

It may seem like a simple concept, but selecting qualified franchisee candidates is always a good idea. When franchisees possess related experience and financial means, they are more likely to succeed to the benefit of all involved. It is considered a best practice to require someone with direct industry experience to be the operating partner within the franchise ownership group.

Require compliance with local, state and federal laws and regulations

One way for a franchisor to manage the risk associated with franchise operations without creating vicarious liability is to include a provision in the franchise documents that requires compliance with local, state and federal laws and regulations. This requirement along with default and cure provisions should be clearly stated in the Franchise Agreement. As an example, a food service franchisor would want to include this requirement to ensure that laws and regulations pertaining to smoking bans, alcohol
service, nutritional information disclosures, etc. are consistently applied in full compliance across the brand.

**Establish detailed insurance requirements**

Requiring specific types and amounts of insurance is a foundational element of all highly effective risk mitigation plans for franchisors. The objective of the franchisor is to ensure that the franchisees maintain insurance that adequately protects them both from claims that present the most significant impact to their respective businesses. When properly designed, the franchisees’ insurance can do just that. From the franchisor’s point of view, it is the first line of defense, or firewall protection, when a problem arises in the franchise operation. It is incumbent upon the franchisor to set the amount of required insurance high enough to cover the working layer (or majority) of claims for the specific type of business. Insurance requirements should be established with the help of a licensed insurance professional and regularly communicated to the franchise system. The franchisor should also maintain an insurance certificate tracking system to verify that the franchisees are in compliance with the established requirements. Examples of the basic types of insurance typically required by franchisors include: Property, Business Interruption/Loss of Income, Comprehensive General Liability, Automobile Liability, Workers Compensation and Umbrella Liability. There is a multitude of other insurance coverages available to businesses that a franchisee may need to properly protect their investment but are not required by the franchisor. As always, a qualified insurance professional should be consulted when evaluating the adequacy of any insurance program.

If it is the intent of the franchisor to hold the franchisee responsible for indemnifying and defending the franchisor for claims that originate out of the franchisee's operation, the franchisor will want to include some additional insurance requirements in the franchise documents. Those requirements would include naming the franchisor as an “additional insured” on the liability policies and requiring the franchisee’s insurance to be “primary” and “non-contributory” with any insurance carried by the franchisor. Doing so will also protect the franchisor as additional insured from claims of subrogation by the insurer, if a waiver of subrogation is not already included in the franchisees’ policies. Each of these provisions is necessary to properly align the insurance coverage with the indemnification and defense requirement.

**Provide “Best Practice” guidance where applicable**

Most franchisors strive to mitigate risk by establishing operational standards for their brand. The trick is how to do that without creating vicarious liability.

In situations where it is not advisable to require certain operating standards, best practice guidance can help support franchisees and maintain brand consistency for the franchisor. For example, if a franchisor in a retail setting believes that there is a need for late-night security personnel but does not want to require it because it could be perceived as controlling the day to day operations of the franchisee, the franchisor could...
provide guidance on when security might be needed and how to arrange for those services.

Another recommended “best practice” would be to have a franchise attorney review all best practice guidelines before dissemination to the franchisees.

**Conduct periodic audits of franchise operations**

Franchisee non-compliance with brand standards is a source of reputational risk. Franchisee non-compliance with local, state or federal laws and regulations is a source of liability risk. Left unchecked, the franchisor is sure to face significant problems and financial impacts.

Conducting periodic audits of franchise operations is one method that can provide some assurance that franchisees are complying with brand standards and regulatory requirements. Compliance audits can take many forms. Audits can be conducted by internal personnel, franchisor personnel and/or third party auditing firms. Regardless of the type, some form of proactive audit process is highly recommended.

Law enforcement and other regulatory authorities will also conduct audits or inspection. The best defense against the unannounced regulatory or law enforcement audit is to assure ongoing compliance though a robust proactive audit process.

There are a plethora of audit resources available in the marketplace. Most accounting firms can provide assistance and direction in this area.

**Provide a crisis management support system**

One of the most important times for a franchisor to provide support to a franchisee is at the time of a crisis. Leaving a franchisee afloat at sea with no lifeline does nothing to control the threat and resulting financial loss. Establishing a crisis management, communication and rapid response system is one way to provide a lifeline to the franchisee. Crisis Management “hotlines” with 24/7 capabilities are an effective method for initiating communication from the franchisee to the franchisor's rapid response teams. Rapid response teams are comprised of individuals who have been trained to response to specific types of events and situations.

It is especially important to have a crisis management process in place for those situations that involve potential brand damage or negative public relations. In this age of hyper-communication, it is more important than ever to be prepared to respond rapidly. The news cycles every 10 minutes. If you are not prepared, you have lost the battle before it has even begun.
RISK RETENTION: CAPTIVES & CUT-THROUGHS

In addition to maintaining “best practices” in your franchise system, another risk retention method involves the establishment of a “captive” insurer, which some organizations use both as a risk management tool and a vehicle to capture additional benefits as discussed below.

**What is a captive?**

A captive is an insurance company formed by a business owner that insures the risks of its owner(s) and/or related parties and returns underwriting profit and investment income. More specifically, using a captive is a risk management technique whereby an organization forms its own insurance company to finance the organization’s retained losses in a formal structure. Accordingly, the use of a captive is an example of the retention method of risk finance. The primary purpose of a captive it to fund the owner(s)’ risks while allowing the owner(s) to actively participate in decisions influencing underwriting, operations and investments.

A “captive” insurance program may be structured either as direct primary insurance or as “reinsurance” as the following diagram demonstrates. As a “direct” insurer, the captive acts as a primary commercial insurer would in responding directly to claims asserted by or against the insured client. Under this structure, the captive may procure reinsurance for the risk assumed in order to capture a savings in premium. Alternatively, depending on the insured’s loss history, the captive may reap profits and retain surplus capital afforded by premium paid from the client. Under a typical captive reinsurance structure, a “fronting” carrier is used to issue insurance policies to the organization. At the same time, the captive enters into a reinsurance agreement with the insurer where by the captive agrees to reinsure the underlying insurer for losses incurred under the underlying insurance policy. As discussed below, the use of the reinsurance structure creates unique counter-party exposure to an insolvency of the underlying fronting insurer.
Unlike traditional insurance companies, most single-parent captives do not adjust claims, underwrite primary risks, issue policies, enter data, or operate risk management information systems. In a captive program, these services are provided by managing general agents, third party administrators, insurance companies or the corporation’s risk management department.

The captive’s board of directors sets policy, selects the insurance mechanism, and directs the captive’s finances. The board consists of company or association appointees and one or more professional directors. Contracted experts advise the board on underwriting policy and insurance company finances.

**Key characteristics of captive insurers**

| As an incorporated insurance company, subject to the regulatory jurisdiction of its domicile, a captive: | ♦ Insures risk, and  
| ♦ Accesses reinsurance and financial markets. |
|---|---|
| It has a set financial structure, including: | ♦ An income statement,  
| ♦ A balance sheet,  
| ♦ A cash flow schedule, and  
| ♦ Liquidity and solvency tests. |
| It employs professional services provided by: | ♦ An insurance broker  
| ♦ A captive manager,  
| ♦ Outside auditors,  
| ♦ A risk manager,  
| ♦ An actuary,  
| ♦ A lawyer,  
| ♦ An investment advisor,  
| ♦ A third party claims administrator, and  
| ♦ Risk control specialists |

**Why do entities form captives?**

Organizations may elect to form a “captive” for a variety of reasons, including the following:

- To provide more structure in a risk management program
- To exert more control over the availability of insurance and the handling of claims
- To reduce/stabilize cost, including by reinsuring losses for less premium than the organization would pay for commercial insurance coverage
- To recapture investment income
- To obtain tax benefits
- To fund retentions (corporate vs. division or subsidiary, etc.)
- To create a cost allocation tool
- To accelerate/manage cash flow
- To fill insurance voids/increase protection for unique risks
- To create access to reinsurers (increase capacity, coverage flexibility)
- To focus operating management attention on loss prevention
- To increase senior management focus on risk
- To support strategic partners
- To warehouse data
- To leverage the commercial market

However, some entities choose not to pursue captive insurance programs if capital and reserve requirements as well as the initial investment in time and resources to establish the captive are prohibitive. Depending on the insured’s loss history, the retained risk, if not adequately assessed, may cause the captive and its client to suffer financial consequences. In some cases, outsourced claims-management functions may not provide any benefit over traditional insurance. Moreover, the use of a captive to insure portions of the policyholder’s risks may result in higher costs to insure risks transferred through traditional insurance for some organizations. Finally, policyholders whose property and casualty programs are reinsured by a captive facility should consider the impact of a potential fronting insurer’s insolvency on such captive reinsurance.

**What impact does an insurer insolvency have on captive insurance programs?**

As an initial matter, policyholders must determine (i) whether their reinsurance structures include cut-through provisions, and (ii) whether such provisions are likely to be enforced under the applicable laws of the direct insurer’s domicile.

If a cut-through provision is not present, or not enforced, the standard insolvency clause included in virtually every reinsurance contract (providing that the reinsurer must pay the reinsurance proceeds to the liquidator based on the liability of the ceding company regardless of whether the liquidator has paid or ever will pay the claim) puts the captive at risk of having to pay the liquidator for reinsured claims. In other words, the proceeds from any reinsurance policies issued by the captive to the insolvent insurer are likely to fall within the general assets of the insolvent insurer’s estate. Where this occurs, the proceeds are unlikely to be used to pay the captive client’s underlying insured claims.

**What is a cut-through provision?**

A valid cut-through provision allows an individual or entity which is not a party to the contract with the reinsurer (i.e., the insured-employer) to have direct rights against the reinsurer in the event the insurer becomes insolvent. Cut-through provisions may take the form of a specific clause, an endorsement attached to the insurance policy, the reinsurance agreement or both, or a separate agreement between the insured and the reinsurer.
The intention behind a reinsurance cut-through is to replicate a direct contractual relationship between the reinsurer and the ultimate insured. If the relevant legal system gives effect to the cut-through, then in the event that the policyholder’s direct insurance company is placed into liquidation, the policyholder is able to “cut-through” the fronting insurance company and receive payment directly from the reinsurer of the insolvent fronting insurance company. As indicated above, without a cut-through or where the cut-through is unenforceable, the proceeds from any captive reinsurance policy fall into the general pool of assets making up the insolvent insurer’s estate, commonly referred to as the general assets of the insurer. In these circumstances the policyholder is likely to receive only a pro rata share of the general assets of the insolvent insurer without any direct access to the reinsurance proceeds.

Note that, in some cases, an insured may be able to obtain reinsurance proceeds absent a “cut-through” clause. See, e.g., Koken v. Reliance Ins. Co., 846 A.2d 167, 172 (Pa. Cmmw. Ct. 2004) (“Direct access to reinsurance proceeds is permissible where the conduct of the insured, the primary insurer, and the reinsurer works a novation of the reinsurance agreement between the primary insurer and the reinsurer.”). However, in other jurisdictions, an express “cut-through” provision must be included in the reinsurance agreement. See, e.g., Jurupa Valley Spectrum, LLC v. Nat'l Indem. Co., 555 F. 3d 87 (2nd Cir. 2009) (refusing to recognize a “cut-through” provision in a reinsurance agreement and dismissing the insured’s claims against reinsurer National Indemnity).

RISK TRANSFER: INDEMNITY/HOLD HARMLESS AGREEMENTS

What is an indemnity/hold harmless agreement?

Generally, an indemnification agreement is an undertaking to compensate another party for certain loss, damage or liability. Similarly, a hold harmless agreement is an agreement to assume liability on behalf of another party upon the happening of a particular set of circumstances. Such agreements may also permit or require the indemnifying party to defend the indemnified party against claims for loss and damage sustained by a third party. In many cases, an indemnity/hold harmless agreement is not a stand-alone contract, but rather part of a larger agreement between two or more parties. In particular, many franchise agreements contain indemnity/hold harmless provisions, whereby the franchisee agrees to indemnify the franchisor against claims or loss arising out of the franchisees’ operations, including intellectual property claims and claims asserted by regulatory authorities.

- EXAMPLE: “Franchisee agrees to hold harmless and indemnify Franchisor and its affiliates and their respective shareholders, officers, directors and employees from and against any action, suit, demand, claim, loss, damages, or liability (including attorneys’ fees and court costs) pertaining to or arising out of or in

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2 As with a general liability policy, an indemnitor’s obligation to defend an indemnitee is determined on the basis of the “allegations” asserted against the indemnitee. See, e.g., English v. BGP Int'l, Inc., 174 S.W.3d 366, 374 (Tex. App.—Houston [14th Dist.] 2005, no pet.).
connection with Franchisee’s or Franchisee’s Principals’, agents’ or employees’ (a) infringement of any Proprietary Mark, patent or copyright or any misuse of Franchisor’s confidential information; (b) violation, breach or asserted violation or breach of any federal, state or local law, regulation or rule; (c) breach of any representation, covenant or provision of this Agreement or any other agreement between Franchisor and Franchisee or any of its affiliates; or (d) acts, errors or omissions incurred in connection with or arising out of the franchised business, including any negligent or intentional acts . . . .”

**What must an indemnification agreement include to be enforceable?**

To be enforceable, some jurisdictions require parties to an indemnity agreement to conspicuously identify the indemnity provision in a contract—whether by large bold-faced type, contrasting colors or other means of identification—if the subject provision is intended to provide indemnification to a party for injuries resulting from the party’s own negligence. See, e.g., *Boyle v. Christina School Dist. Bd. of Educ.*, 2009 WL 4653832, at *1 (Del. Super. Ct. Nov. 30, 2009) (quoting *State v. Interstate Amiesite Corp.*, 297 A.2d 41, 44 (Del. 1972)) (stating that agreements to indemnify a party from its own negligence are enforceable when they are “crystal clear or sufficiently unequivocal to show that the contracting party intended to indemnify the indemnitee for the indemnitee’s own negligence”).

Some jurisdictions also preclude parties from providing indemnification for intentional or willful conduct as a matter of public policy. *James v. Getty Oil Co. (Eastern Operations), Inc.*, 472 A.2d 33, 38 (Del. Super. Ct. 1983) (“A contract to relieve a party from its intentional or willful acts is invariably held to be unenforceable as being against clear public policy.”); *Gross v. Sweet*, 400 N.E.2d 306 (N.Y. 1979) (“To the extent that agreements purport to grant exemption for liability for willful or grossly negligent acts they have been viewed as wholly void.”).

**How are indemnity agreements and insurance related?**

Oftentimes, a contractual indemnification agreement will be coupled with a specification of insurance requirements intended to ensure that the indemnifying party has the means to fulfill its obligation to indemnify and defend, if necessary. Most general liability

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policies exclude coverage for liability assumed under a contract or agreement unless the contract is an “insured contract,” i.e., “[t]hat part of [any] contract or agreement . . . under which you assume the tort liability of another party to pay for “bodily injury” or “property damage” to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.” While under the terms used in most general liability policies, a franchise agreement would qualify as an insured contract excepted from the traditional “contractual liability” exclusion, Franchisors should be familiar with the contractual liability exclusions and “insured contract” definitions in their franchisees’ liability policies to ensure that the insurance required to be maintained by the franchisee will provide an effective means of funding the franchisees’ indemnity obligations under a franchise agreement.

**RISK TRANSFER: COMMERCIAL INSURANCE**

In its simplest form, insurance is spreading the losses of a few across the many who have paid premiums. Insurance is about risk distribution and risk sharing. Insurance requires predictability, and uses the law of large numbers to distribute premiums of the many to pay losses of the few. Insurance looks at historic statistical data, especially losses, to determine how much money may be required to fund losses. Insurers call this “underwriting risk” (insurers also have timing risk, investment risk, and credit risk).

**Why purchase insurance?**

Organizations purchase commercial insurance products for any number of reasons, including the following:

- It is easier to demonstrate required financial responsibilities for exposures such as automobile liability and workers compensation through traditional insurance.
- Commercial insurance coverage may be required by contract or statute.
- Insurance products may be necessary to “transfer” certain types of low-frequency/high severity risks.
- The business operators’ systems and processes required to treat exposures to loss are not well developed or are non-existent.
- Having multiple entities combined in a single insurance program is efficient.
- The exposure is catastrophic and the relative cost of insurance is low.
- As a self insurer or a single parent captive owner you need to establish boundaries (coverage forms or limits).
- You choose to maintain a connection and working relationship with insurers.
- You need to create more certainty (less variability of outcomes) of “cost of risk” for budget purposes.

**What should I consider when buying insurance?**

How much insurance should you purchase? Organizations need to make certain that coverage limits are adequate to meet the reasonably anticipated losses that might affect the organization’s business.
If you review the types of losses (number of claims and frequency/severity costs) your business has had, you can reasonably determine what size your deductibles and policy limits should be or if your program could be written on a cost (losses) plus basis. The key is to understand "expected" losses so that you appropriately assume those that are reasonable for you.

Rarely do insurers and insureds agree on the magnitude of the risk for any specific exposure. Corporations will almost always see less risk than underwriters. Should the converse occur (the underwriter believes there is less risk than the corporation), the available insurance becomes an attractive alternative. Here are some important considerations in negotiation coverage and matching insurance requirements, including policy limits and deductibles, to your franchise system’s risk profile:

- Relying on underwriters and insurers, especially if you are as financially strong as they are, can be fraught with peril due to fluctuating market cycles and the difficulties that often manifest themselves when there is an unusual claim and the insurance policy’s coverage requires interpretation.

- Underwriters want to write a dollar of premium that is 100% profitable. For example, an underwriter would rather write a large deductible program, where the $60 of premium is 100% profitable, than a low deductible program where a $100 premium has to pay $40 of losses. Both programs produce a $60 profit, but the former is more desirable to underwriters.

- Larger risk assumptions can mitigate or eliminate future claim problems.

- Larger risk assumptions (or more restrictive coverage) bring more insurers to the table willing to consider the risk. Brokers can then use a much smaller portion of available capacity, which puts a downward pressure on price.

- While insurance policies are touted as comprehensive or “all risk,” they are full of exclusions, definitions and conditions that limit the risks they cover.

When purchasing insurance, franchise systems should also consider group purchasing, whether among captives, employers, associations, trusts, franchise groups, risk retention groups, risk purchasing groups or affinity groups. Group insurance can take various forms but successful group insurance programs usually have one common feature: a sponsor organization. That sponsor can be a franchisor, a professional association or another type of association. It is important to recognize that the interests of a sponsor and its members will not always be the same. Group insurance programs are often difficult to get off the ground without significant participation by a sponsor who is looking to establish a stable and efficient insurance market for its members.

Common reasons for participating in an insurance purchasing group include lower costs, better or unique coverages and specialized services. When the group is
homogeneous, insurance products and services may be more customized to the particular needs of the group.

Group insurance programs take various forms that include simple sponsored programs with insurers where each individual group member works with the sponsored insurer for individual policies and coverages, or there can be a more sophisticated approach where the sponsor establishes a captive insurance company to provide coverages to its members.

**What is included in my policy?**

Insurance coverages are generally purchased on a comprehensive basis which means that all of one business's activities and operations will fall within the scope of coverages provided by the policies purchased. This does not mean everything is covered as each insurance policy restricts coverage in several ways. It is important, therefore, to understand basic policy construction to ensure that the policy provides maximum coverage for a specific claim.

Every policy has four basic elements: declarations, insuring agreements, conditions and exclusions. These four elements are often modified by endorsements (riders) added to the policy.

- **Declarations.** This section provides basic information about the subject policy, including the identities of insurer and insured, the policy period, policy limits, and any applicable deductibles/retentions.

- **Insuring Agreements.** This section describes the specific hazards, risks, activities or operations covered by the policy. This section, which will be subject to exclusions and conditions, should be phrased as broadly as possible. Although, many policies employ standard forms, which are generally not subject to modification except by endorsement.

- **Conditions.** This section complements the insuring agreement by outlining the terms that must be satisfied for coverage to apply. Common conditions include those relating to the provision of notice of claims, assignment, cancellation, and changes to the policy.

- **Exclusions.** Exclusions provide underwriters with the means to exclude coverage under certain circumstances. Generally, while it is the insured’s burden to demonstrate that a claim fits within the policy’s insuring agreement, it is the insurer’s obligation to prove that an exclusion applies.

**What kind of insurance may benefit my business?**

There are as many different kinds of insurance products as there are risks. For the sake of simplicity, most insurance benefits can broadly be classified as either “first
party” insurance or “third party” insurance. “First party” insurance generally refers to policies or payments that directly benefit the insured. Health insurance or property insurance benefits, for example, are paid to the insured or for services that directly benefit the policyholder. “Third party” insurance refers broadly to policies or payments that benefit third parties, liability insurance being the most common example.

Claims involving litigation may implicate coverage under “first party” or “third party” insurance. A franchise owner, for example, who sustains damages resulting from defective construction, may have the choice of seeking “first party” insurance coverage under a commercial property policy or pursuing litigation against the party responsible for the faulty workmanship. However, more often, clients embroiled in litigation (on both sides) will look to liability insurance to be made whole.

Like insurance generally, there are a variety of liability insurance policies insuring a number of different kinds of risks. Here is a list of common forms of liability insurance coverage that may be available to businesses and individuals:

- **Commercial General Liability Insurance.** Most businesses carry commercial general liability (“CGL”) insurance, which generally provides coverage for amounts the insured becomes legally obligated to pay as damages because of (i) property damage; (ii) bodily injury; and/or (iii) an assortment of “offenses” broadly defined as “personal and advertising injury,” including:
  - False arrest/imprisonment;
  - Malicious prosecution;
  - Wrongful eviction, wrongful entry, or invasion of the right of private occupancy;
  - Libel/slander/business disparagement;
  - Invasion of privacy;
  - Misappropriation of advertising ideas; and
  - Infringement of copyright, title or slogan.  

- **Professional Liability/Errors & Omissions Liability Insurance.** Professional liability or errors and omissions (“E&O”) policies generally insure amounts the insured becomes legally obligated to pay as damages because of a claim for “wrongful acts,” which may include acts, errors, omissions, breaches of duty, misstatements, or misleading statements committed or omitted in the performance of the insured’s professional services.

- **Directors and Officers Liability Insurance.** Directors and officers (“D&O”) liability insurance typically provides three different benefits. First, D&O insurance generally provides direct coverage to past, present and future directors and officers of a company for unindemnified loss that the director(s) or officer(s) become legally obligated to pay because of a claim for “wrongful acts,” including acts, errors, omissions, breaches of duty, misstatements, or misleading statements committed or omitted in the performance of the insured’s professional services.

4 “Advertising” offenses may carry the added requirement that the offense be committed in the course of the insured’s advertising activities.
statements committed or omitted in their capacities as directors and officers of the company. Second, D&O insurance usually provides coverage to the company for amounts paid to indemnify insured directors and officers for loss that such individuals are legally obligated to pay because of a claim for “wrongful acts.” Finally, some D&O policies also provide “entity” coverage for loss that the insured company becomes legally obligated to pay because of a “securities claim,” i.e., claims asserted against the company by shareholders or claims arising out of the purchase or sale of, or the offer to purchase or sell, the company's securities.

- **Fiduciary Liability Insurance.** Fiduciary Liability Insurance customarily insures loss that an insured becomes legally obligated to pay because of a claim for a “fiduciary wrongful act,” including a breach by an insured of duties, responsibilities or obligations imposed upon fiduciaries of an employee pension or welfare benefit plan under ERISA or acts, errors or omissions by an insured in the administration of such plan(s).

- **Employment Practices Liability Insurance.** Employment Practices Liability Insurance (“EPLI”) generally provides coverage for loss that an insured company or its employees become legally obligated to pay because of a claim for an “employment practices wrongful act,” which may include specific employment-related conduct, such as the following:
  - Wrongful dismissal, discharge or termination;
  - Breach of an oral or written employment contract;
  - Employment related misrepresentations;
  - Wrongful failure to promote/deprivation of a career opportunity;
  - Violations of employment discrimination laws;
  - Sexual harassment;
  - Wrongful discipline/employee evaluation;
  - Employment related invasion of privacy;
  - Employment related defamation (libel and slander); and/or
  - Employment related retaliation.

**When does insurance apply?**

Apart from the substantive grants and limitations on “what” an insurance policy covers, insurance policies also contain temporal triggers indicating “when” coverage applies. For example, CGL policies typically require that covered “property damage” and “bodily injury” be caused by an “occurrence” or “accident” that takes place during the policy period. CGL policies are, thus, often referred to as “occurrence” policies because it is the timing of the “occurrence” that determines whether or which policies will respond to a claim. Likewise, coverage for “personal and advertising injury” is generally predicated on an “offense,” i.e., one of the acts described above, taking place during the policy period. As a result, an insured may be able to obtain coverage under a CGL policy issued many years in the past regardless of when claims for liability are asserted against the insured.
By comparison, professional liability, E&O, D&O, fiduciary liability and frequently EPLI coverage is triggered on a “claims-made” or “claims made and reported” basis, as opposed to an “occurrence” basis. Here coverage is triggered, not by damage, injury or conduct occurring during the policy period, but rather by claims made or claims made and reported within the policy period. A covered claim or suit asserted against the insured during the period of a “claims made” policy will trigger the policy’s coverage, in many cases, regardless of when the underlying conduct or injury occurred.\(^5\) Similarly, a “claims made and reported” policy will respond to claims/suits that are both made against the insured and reported to the insurer during the policy period.\(^6\)

**How can liability insurance benefit my franchise?**

CGL insurance generally provides two distinct benefits that franchisors and franchisees need to understand: (i) the “duty to defend”; and (ii) the “duty to indemnify.” CGL insurers commonly have a “right and duty to defend” the insured against “suits” seeking damages because of covered “bodily injury,” “property damage,” or “personal and advertising injury.” Generally, the duty to defend is determined by comparing the allegations against the insured with the terms of the insurance policy. If even a single allegation creates the potential that the insured will be subject to covered damages, the insurer is typically obligated to defend the entire suit. Importantly, under many CGL policies, amounts paid by the insurer to defend an insured do not exhaust the policy’s limit of liability.

While many E&O, D&O, EPLI and Fiduciary policies may not contain an express “duty to defend,” subject to the policies’ terms and conditions, such insurers nonetheless are generally obligated to pay “loss,” including defense costs for covered claims. Moreover, even absent an express duty to defend, the insurer’s obligation to advance or reimburse the insured for defense costs is determined in the same manner—on the basis of the “allegations” pled against the insured and the terms of the policy.

In contrast to the “duty to defend,” the “duty to indemnify” requires the insurer to pay covered “damages,” *i.e.*, settlements, awards and/or judgments against the insured. Unlike the “duty to defend,” the “duty to indemnify” is established by the actual facts establishing the insured’s liability for covered damages. The “duty to defend” and the “duty to indemnify,” therefore, may each exist independently of the other. Sophisticated franchisors and franchisees will make the effort to understand and trigger an insurer’s “duty to indemnify” under a given policy in order to effectively liquidate an adverse party’s claims and maximizing the insurer’s defense obligation in order to shield themselves from financial exposure to either attorneys’ fees or the costs of a settlement or judgment.

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\(^5\) Some “claims-made” policies do exclude coverage for claims made during the policy period, which arise out of conduct or circumstances occurring prior to a defined “retroactive date” set forth in the policy.

\(^6\) In most cases, “claims made and reported” policies provide a window after the close of the policy period for insureds to report claims made within the policy period.
What do franchise systems need to do to access insurance coverage?

Every insurance policy is unique. However, most liability insurance policies contain three basic requirements for insureds to observe: (i) the duty to provide timely notice of claims and suits; (ii) the duty to “cooperate” in the defense and settlement of covered claims or suits; and (iii) the obligation to refrain from assuming liability or making voluntary payments without the insurer’s consent.

Typically, under an “occurrence” policy, the insured must provide the insurer with notice of an “occurrence” or of claims or suits asserted against the insured “as soon as practicable.” Nevertheless, in some jurisdictions, an insured’s failure to timely notify its insurer of a claim or suit does not defeat coverage if the insurer is not prejudiced by the delay.

Under a “claims made and reported” policy, the insured is generally required to give notice of claims made during the policy period “as soon as practicable” but no later than a specific interval after the policy period expires. While a failure to provide notice as soon as practicable may be excused in the absence of prejudice to the insurer, a failure to provide notice before the close of the policy’s reporting/discovery period may result in a loss of coverage.

Similarly, with regard to the insured’s other duties, unless the insurer is prejudiced by the insured’s failure to comply, depending on the jurisdiction, the insurer may not be excused from its coverage obligations. Moreover, if the insurer is itself in breach of its coverage obligations, in some states, the insurer may not enforce the policy’s conditions against the insured.

Although an insured may be excused from strict compliance with a policy’s notice or other conditions, franchisors and franchisees are well advised to provide notice to all potentially applicable insurance and otherwise comply with policy conditions to ensure that the insured’s rights to all available coverage are preserved.

SUMMARY

Risk may be managed or financed through retention, contractual risk transfer or through traditional commercial insurance products—or in some cases through a combination of these methods. Risk retention includes best practices employed to reduce or mitigate potential loss to a franchise system as well as the use of tools such as deductibles/retentions or captive insurance programs to control certain types of risks. Alternatively, as reflected in many franchise agreements, indemnification/hold harmless agreements may, in conjunction with traditional insurance, provide an effective means of transferring risk from franchisors to franchisees. Finally, commercial insurance is another common tool used by businesses to manage certain types of pure risk. Together, these principles and methods, as described above, can make risk management a key component of your successful franchise system.