



# The Franchise Valuations Reporter



## Featured Expert: Adam Cottini



This issue's lead article was provided by Adam Cottini, Area Vice President New York City for Arthur J. Gallagher & Co. He is a National Resource for Executive Risks Liability for Arthur J. Gallagher Risk Management Services, Inc. Adam manages a diverse book of professional liability accounts consisting of Directors & Officers Liability, Employment Practices, Fiduciary Liability, Professional Errors and Omissions, Cyber Risk, and Media Liability. Adam can be reached at 212.994.7048 (direct) or [adam\\_cottini@ajg.com](mailto:adam_cottini@ajg.com).

## To Our Canadian Readers

We want you to know that we intend to comply fully with the **Canadian Anti-Spam law** going into effect this year. If you wish to continue receiving this newsletter, please let us know so we have your consent on record.

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## Cybersecurity: No Coverage for the Cost of Defense Under General Liability Policy

*New Developments May Affect How CGL Responds to Cyber Liability*

*By Adam Cottini*

On April 26, 2011, Sony Corporation (Sony) disclosed that 77 million records were released by virtue of a known vulnerability exploited by hackers around the world. The breach included information that could be used to commit identity theft and included names, addresses, email addresses, birthdates, passwords and logins, online ID, profile data, purchase history and credit card numbers. This breach was the seventh largest on record, and it also attracted a number of lawsuits by plaintiffs claiming injury due to the breach. The lawsuits included one by Sony's comprehensive general liability insurance ("CGL") carrier.

Why would an insurer sue its customer? In brief, Sony's carrier asked the court to rule that it was not obligated to defend or indemnify Sony in the multitude of lawsuits triggered by the breach. The policy in question covered "bodily injury, property damage or personal and advertising injury". Part B of the CGL policy has been interpreted by some courts to provide coverage for privacy breaches under "personal and advertising injury", if there is a finding of consequential "bodily injury", arising out of oral or written publication, in any manner, of material that violates a person's right of privacy.

A reasonable interpretation is that Sony's carrier, recognizing that the law was uncertain and that the stakes were high, chose to have a court decide the issue rather than negotiate with its insured. Its gamble paid off, at least in the short term, as the New York court agreed with the carrier on February 14, 2014.

It is important to note that not every court which has viewed this issue agrees with the New York court, nor is it certain that this opinion would withstand appeal or rehearing. In light of this continuing uncertainty, one should expect CGL carriers to take action in the near future.

Most insurance professionals would agree that CGL carriers do not actuarially price for cyber liability and do not intend to cover data breaches. Pricing models were developed well before cyber liability was a concern. When the "personal and advertising injury" policy language is interpreted to cover cyber liability, CGL carriers believe it an unfair distortion. On the other hand, policyholders find that the coverage is the result of established case law and modern risk needs. As such, litigation has accompanied this disconnect between insured and the insurer.

Insurance carriers are less fond of litigation than their customers. Their reluctance to act in the past can be attributed to the industry's belief that their policy language would ultimately be interpreted "correctly" or that changing it would constitute an admission of error. In any case, it is likely that the standard CGL form will be changed to better reflect the almost universal intent of the carriers who sell comprehensive general liability insurance.

An explicit "Unauthorized Access Exclusion" will likely be added either to the form itself or by endorsement. This will be more specific language intended

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- Damages, Valuations & Expert Testimony
- Finance, Accounting and Tax
- Cyber Security and E-discovery of Electronically Stored Information

We offer a free initial consultation. If any readers have questions, you are welcome to email or phone us and we will provide our best answer as quickly as possible.

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## Franchise Technology Risk Management



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**Franchise Regulation and Damages**, the only treatise that covers valuations of franchises, is updated 3 times a year.

For more details, to see a Table of

to eliminate any idea that coverage exists in the CGL policy for data breach litigation. While language may vary, insureds should expect something such as the following:

"There will be no coverage for Loss arising out of any unauthorized access to or disclosure of any person's or organization's confidential or personal information, including patents, trade secrets, financial information, credit card information, health information or any other type of non-public information"

Of course, all claims are different: Policyholders and courts may yet find this language open to interpretation.

Still, 2014 would seem to be the time to exercise prudent risk management of cyber exposure by accepting that the "C" in CGL does not mean "Cyber".

Cyber liability policies are clearly written to provide robust coverage not only for privacy breach litigation, but also for liability arising from the spread of malicious code and distributed denial of service attacks. In addition, first party coverage has been refined to offer expansive breach response costs (legal advisory, forensics investigations, notification and credit monitoring and public relations), network business interruption including dependent business interruption and cyber extortion.

Moreover, coverage is widely available, negotiable and reasonably priced. Cyber Liability is the right tool for the job and Cyber liability insurance is not your average "C"GL.

### **Editor's Comments: Two Thing Every Franchise Business Can Do Now To Protect the System, the Brand and the Franchisees From Cyber Attacks**

**1. Hire a third-party security consultant that specializes in cyber security.** Most in-house IT departments are not proficient in cyber-security and have to attend to the day-to-day operations of the business. Third-party specialists are probably more aware of the latest malware, more familiar with tracking intrusions through logs and bring more to bear in combating against threats.

**2. Hire the third-party security consultant through outside counsel thereby providing draft reports with attorney-client privilege.** The first security analysis report will undoubtedly be the worst report card the organization gets, and having it protected by attorney-client privilege could become very important, especially if there is discovery in a lawsuit after a cyber-episode.

For more, see this article from a past issue of this newsletter: [For the Best Cyber-Security Hire a Lawyer](#). Or call Bruce Schaeffer (212-689-0400) for a free attorney-client privileged initial Penetration Test.

## Nexus: Rhode Island Demands Certification That State Taxes Are Paid For Franchise Renewal -- Special Thanks to Cheryl Mullin

### **Franchising Creates Income Tax Nexus By Regulation**

Cheryl L. Mullin, J.D., LL.M. (in Taxation), Shareholder in Mullin Russ Kilejian, P.C. of Richardson, Texas, alerted us to the fact that Rhode Island is now demanding affirmative assertions that taxes have been paid for registration renewals [[see screen shot here](#)].

Not having a physical presence in Rhode Island is no protection against

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income tax nexus (although physical presence probably is required for sales tax nexus). Under RI law a corporation is subject to the business corporation tax if it derives any income from sources within the state or engages in any activities or transactions within the state for profit. ( Sec. 44-11-1(2), G.L. ). The Regulations read in pertinent part:

CT95-2.IV.A.

Unprotected Activities:

The following in-state activities (assuming they are not of a *de minimis* level) are not considered as either solicitation of orders or ancillary thereto or otherwise protected under P.L. 86-272 and will cause otherwise protected sales to lose their protection under the Public Law:

CT95-2.IV.A.19.

Entering into franchising or licensing agreements; selling or otherwise disposing of franchises and licenses; or selling or otherwise transferring tangible personal property pursuant to such franchise or license by the franchisor or licensor to its franchisee or licensee within the state.

## Valuations: EBITDA Multiples

### *New Pratt's Stats Reveals Significant Trends*

According to the Business Valuation Resources publication, *BV Wire*, data for 2013 from Pratt's Stats, the leading private M&A transaction database, reveals several notable trends:

- The median selling price-to-EBITDA ratio for all major sectors was 2.96x in 2013, up slightly from 2.88x in 2012 but down from a 10-year high of 6.16x in 2006. In 2013, the major sector with the greatest median selling price-to-EBITDA ratio was manufacturing, at 5.69x, and the sector with the lowest was retail trade, at 2.01x. The tech sector, which Pratt's Stats classifies as a subsector under the major industry sector "services," had a median selling price-to-EBITDA ratio of 12.98x in 2013.
- The median selling price-to-EBITDA ratio in 2013 for public companies acquiring private companies was 9.55x, significantly more than that of individuals buying companies, which was 2.78x.

## Baby Boomer Exit and Succession Planning Seminars

### *Presentations for Franchise Systems and Franchisee Associations Available from Franchise Valuations Ltd.*

With 40 million people in the US aged 65+ (projected to be 55 million by 2020); with 10,000 people a day turning 65; and with 28% of franchisees now over the age of 55, baby boomer exit and succession planning is a demographic imperative. There will be a tremendous turnover in units in the coming years with franchisees and franchisors benefiting from well-planned seamless transfers. But they will be punished for failing to plan with distress sales and transfer disputes.

Bruce Schaeffer and Michael Seid recently spoke about the issue at the International Franchise Association Annual Convention. Franchise Valuations offers half-day seminars to review and discuss what must be done to accomplish franchise exit and succession planning that will serve both the franchisees and the franchisors.

We invite you to contact us to discuss how we can custom design a presentation for your system. This is not an issue that can be avoided. It is a certainty, for it is death and taxes.

## Cybersecurity

### *More Reasons to Harden Your Network*

[Sally Beauty Believes Customer Data May Have Been Stolen](#)

[ZIP Codes Show Extent of Sally Beauty Breach](#)

[Law Firms Are Pressed on Security for Data](#)

[Credit Card Breach at California DMV](#)