Two Key Insurance Considerations For Startups

August 27, 2015

Startups have varying insurance needs, requirements, and questions. Questions include: Is the startup well-financed with directors and officers that have an immediate need for directors and officers (D&O) liability insurance? Or does the startup need errors and omissions (E&O) insurance coverage (or other professional liability insurance)? And if the startup already has employees, will it offer employee benefits, such as health insurance and life and disability insurance? Does the state (or states) in which the startup operates require employers to pay for disability insurance? How does the Affordable Care Act (ACA) impact the startup? Startups can benefit from legal counsel in navigating the issues associated with the ACA, and other employee benefit and insurance needs. Two additional types of insurance needs may not be readily apparent to a startup, but can provide significant benefits for different reasons: commercial general liability insurance and "key person" life insurance.

General Liability Insurance General liability insurance provides a wide range of coverage that can be crucial for a young business. Many of these policies protect companies against liability for bodily injury, property damage (including property the company rents), and personal or advertising injury. Many insurers also offer to cover the costs of investigating and defending companies against legal claims. This is particularly important, because the legal fees necessary to fight a lawsuit can deplete a new company's funds even if the legal claim is meritless.

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Some general liability policies may also cover individuals acting on the startup's behalf. This is also important, because startups' owners often do some, if not significant, work on behalf of the startup in their individual capacity, often before a corporate entity is established. Once a general liability policy is in place, these individuals are protected when they act on behalf of the startup, even if a corporation, limited liability company or similar entity is not yet formed. While a corporate structure should be set up to shield a startup's owner(s) from liability, a general liability policy can act as a second shield for the company's founders. In addition, when a startup is new, errors may be more likely because systems and safeguards are not yet known or established to protect the startup.

Lawsuits and liability claims also have greater potential to impact a new startup that is stretched thin on capital. A general liability policy can protect startups in this vulnerable situation.

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But while there are many potential benefits of a general liability policy for a startup, the policy should be examined carefully, particularly its exclusions from coverage. Most individuals naturally focus on the amount of liability coverage and deductibles associated with a general liability policy before purchasing it, but a careful review of the policy's exclusions is just as important. Some general liability policies might exclude a startup's entire type of work, service provided, or product produced and thereby significantly undercut the policy's value to the startup. In this situation, it is sometimes feasible to purchase separate coverage to insure the excluded area. To select appropriate coverage, startups should consult an experienced insurance broker with knowledge of their industry. **"Key Person" Life Insurance** Startups also might not immediately recognize the benefit of key person insurance. But such coverage may serve a crucial purpose. Many startups, by virtue of their newness, are completely dependent on the vision, knowledge, and expertise of one or two individuals. Other startups might be dependent on one person, because it is only identified with one person's likeness for advertising purposes. While this may not present a problem when the startup solely consists of one or two ambitious founders, risk increases as the startup grows and begins to employ numerous individuals or is backed by investors infusing capital to expand it. Particularly as this risk increases, key person insurance should be considered.

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This type of insurance protects against the death of a key person in the company where it would lead to a sharp decline in earnings or even the company's demise. Accordingly, it is important for startups to honestly evaluate whether the death of a key employee or founder would significantly harm the startup' s financial health. In addition, investors or creditors may want the assurance of a key person insurance policy before investing or loaning money to startups. If it is determined that key person insurance is needed, an amount of coverage must be chosen. This analysis will, of course, vary from startup to startup, but the startup should analyze its current net worth or the present value of its likely future profits. This will help inform the amount of coverage to purchase. And, again, consulting an experienced insurance broker will help a startup determine the appropriate amount of coverage. If key person insurance is obtained, the startup should continue to evaluate whether coverage is necessary as the company grows and becomes less reliant on one or two individuals. Startups have numerous and different insurance needs and will face many challenges as new businesses, but by considering whether general liability and key person insurance are appropriate products they will likely be better positioned for sustainable growth. *This originally appeared as a JD Supra Perspective on August 27, 2015.*

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