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Entrepreneur's Introduction to Insurance

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Introduction

The concept of insurance is in many ways at odds with the ethos of entrepreneurs and their ventures. Among the questions every entrepreneur must ask from the beginning (What? To whom? Why? How?), the question “What about insurance?” rarely appears. This is undoubtedly because purchasing insurance requires fixating on worst-case scenarios and spending time and money—both scarce commodities—on securing protection against those scenarios. Yet, insurance can be an important component to a startup’s continued viability and long-term success.

As will be discussed further in this guide, from an insurance perspective, each early stage venture is different. Only by undertaking a critical review of legal risks can one adequately determine what type of insurance program is appropriate. Whether the goal is to attract sophisticated investors and directors, protect the venture’s balance sheet or protect the founding team’s personal assets, insurance can play a role.

This guide covers the basic types of insurance seen in the startup ecosystem and provides some practical tips for evaluating and securing the insurance product(s) you may need.

Do We Really Need Insurance?

Do you really need insurance? Almost certainly. But the better questions are, what type of insurance do you need, and when do you need it?

Different ventures have different risk profiles. While spending money on insurance may be one of your least favorite things to do, spending money on unnecessary insurance is even worse. The potential legal liability—that is, risk—for a single-person or two-person startup in the discovery phase in the green-product space is materially different than a 20-person healthcare industry company with significant venture funding that is about to scale. While both companies may need certain similar insurance policies, such as errors and omission (E&O) insurance and employment practices liability (EPL) insurance, they do not need it at the same time. One of these startups in operating in a heavily regulated space, while the other is not, meaning one may want to purchase directors' and officers' (D&O) immediately, while the other has a less pressing need for it.

Practical Advice

Partner with someone with extensive experience evaluating entrepreneurial venture's insurance needs from a legal perspective. That person will also have an extensive understanding of the insurance market and be sensitive to the costs associated with providing their expertise. Also think about whether having insurance can provide a marketing advantage over your competitors. In certain spaces, having financial backstopping in the form of insurance can impact customers' choices.

For startups, there are five common insurance products: 1.) general liability (GL) insurance; 2.) D&O insurance; 3.) E&O insurance; 4.) EPL insurance; and 5.) cyber-liability insurance. For these products, when to buy them is generally the issue. If you do not yet have any employees and are not planning on hiring any soon, EPL insurance is probably not appropriate. On the other hand, if you know you will be hiring additional help in the near future, it would be prudent to start talking with your advisor about the process of securing EPL insurance.

Aside from the five insurance policies mentioned above, three other policies may be appropriate, or in some cases, insisted upon by investors or funds: 1.) key person insurance; 2.) intellectual property insurance; and 3.) a tail insurance policy. From the perspective of an individual or fund providing funds to a startup, venture capital risk insurance may be appropriate.

Even beyond the policies listed above, certain entrepreneurial ventures have unique risk that must be addressed early. For example, an on-demand company that uses drivers will need to spend significant time working to secure an insurance policy that addresses their auto risk. Or, if you are in a supply chain with either upstream or downstream vendors (or both), you may want insurance that guards against business interruption.

Now that you have a basic framework, the next section provides key insurance concepts.

Core Insurance Concepts

- **Most insurance policies provide three types of protections**: (1) indemnification for loss or damage to your own property (*think*: stolen laptops, facilities burning down, etc.); (2) indemnification for bodily or financial harm to third parties (*think*: your product injuries a customer or innocent bystander; or you are alleged to have improperly misappropriated someone's copyrighted material; or you are alleged to have misrepresented the value of the company in the process of securing funding or issuing shares); and (3) paying for the cost of defending against claims or regulatory enforcement actions (*think*: defense costs).
- **Purchasing insurance can be quick, or not, depending on the policy.** Understanding how long the underwriting process will take can mean the difference between securing coverage and not. A small operation looking to purchase GL coverage might only need a couple of weeks, but a startup planning to offer a financial services product that requires retaining customers' personally identifiable information (PII) may take many weeks or months to finalize cyber coverage. Have a frank discussion with your insurance advisor about the time it will take to secure coverage—and be responsive to requests for information.
- **Insurance policies can be negotiated.** The language of many types of insurance policies can be negotiated prior to "binding," the term used to describe when an insurance contract has been entered. Negotiated policy terms are said to be "manuscripted," and it is here that many startups fail to maximize their ability to tailor the coverage purchased to their particular risk. Pressing insurers and your insurance broker for critical changes to the policy can make or break the performance of the policy when you need it most.
- **In the event of a potential claim, talk to your insurance legal counsel first.** A company faced with a potential claim on its insurance often makes the mistake of discussing key aspects of the claim with its insurance broker and insurer first. Those conversations may not be privileged (i.e., protected from disclosure to third parties), and care should be taken in the first instance to consult with your insurance legal counsel about the most appropriate response and next steps necessary to secure coverage.

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Common Types of Insurance for Startups

- **General Liability Insurance**: GL insurance protects against damage to property and products, as well as some personal and advertising injuries. A typical GL policy will also provide a legal defense defending against third-party allegations of harm.
- **Employment Practice Liability Insurance:** EPL insurance provides defense and indemnity for allegations of, for example, discriminatory hiring or firing practices, sexual harassment, etc.
- **Cyber-liability Insurance:** This insurance policy is critical for certain types of startups and provides three types of coverage: (1) costs of responding to a privacy event, including notification costs and crisis management costs; (2) defense costs and indemnity for third-parties' allegations of disclosure of PII or other harm; and (3) defense costs for responding to regulators' enforcement actions for violations of privacy and data security laws.
- **Directors' and Officers' Insurance**: D&O insurance protects the personal assets of board members and certain other key employees in the event of allegations related to mismanagement of the company. Sophisticated incoming board members may insist on the company having D&O coverage, and care should be given to integrating D&O insurance into the other protections afforded to directors or officers through the corporate by-laws or contractual arrangements.
- **Errors and Omissions Insurance:** E&O insurance protects the company from allegations that its product or service failed to perform. The protection comes in the form of defense costs and, if necessary, indemnity for any settlements or judgments resulting from customers' financial injury.
- **Intellectual Property Insurance:** If you are a startup entering a space where competitors might use patent infringement claims to put you out of business or scare off customers or investors, intellectual property insurance may be for you. Evaluating whether this product is needed requires a frank risk evaluation with your intellectual property attorney.
- **Key Person Insurance:** Some investors and venture funds will insist on the purchase of key person insurance to provide some financial backstopping in the event of the death or departure of a key employee, often a member of the founding team.
- **Tail Insurance:** This insurance is designed for companies that are about to be sold or integrated into another organization. If you are about to be acquired, this will protect against future allegations of wrongdoing occurring in the run up to the acquisition.

Evaluating and Securing Insurance

With this information in hand, you have decided that insurance might be appropriate. So, what are the next steps?

1. **Talk to an insurance expert.** We hope that you would consult with Michael Best, but whomever it is, that person should work with your team with a tested step-by-step process for evaluating your likely insurance needs based on current and future legal risks or strategic goals. That person will be sensitive to your time and resources and will work with you on an arrangement that makes sense.
2. **Evaluate and decide on an insurance broker.** Yes, choosing an insurance broker is a separate step from talking to your insurance expert. You can only have one insurance broker in the marketplace speaking on your behalf, so it is an important decision. Not all insurance brokers are created equal, and nowhere is this more true than with respect to entrepreneurial ventures. Your friend may know a great agent, but what does that person know about startups in your space? An insurance expert will be able to recommend three or four potential insurance brokers and give frank advice on which one will serve you best. It is also important to interview potential brokers to ensure a good fit.
3. **Begin the underwriting process.** This will required plenty of paperwork and responding to insurers' requests for information. Here, you will work most closely with the insurance broker, but certain questions have legal implications, and answering them inappropriately can undercut your ability to secure insurance coverage in the future. Make sure you discuss your application with your insurance attorney before submitting it to the underwriters.
4. **Evaluate proposed policies, and negotiate terms.** Not all insurance policies are created equal either, and subtle—even imperceptible—differences between two policies can make a huge difference in the type of coverage you end up with. Your insurance broker will highlight some of the key differences, but getting a privileged analysis of certain provisions may be appropriate. Once deficiencies have been identified and prioritized, negotiate hard with the insurance, and press the broker to secure the best possible coverage.
5. **"Bind" your insurance, and move on to the things that matter: getting from idea to business and beyond.** Once you have the best possible policy negotiable, "bind' the coverage, and pay the premium. You will receive a copy of the policy shortly thereafter; keep it and do not discard it. Seriously, keep an electronic copy and a paper copy somewhere safe. Evaluating how to respond to potential liability involves understanding what insurance you may have to offset costs. Surprisingly, not all brokers or insurers make it easy to get copies of the policies when you most need them. Remember, if you even suspect you might have a claim, talk to your attorneys and insurance counsel first.

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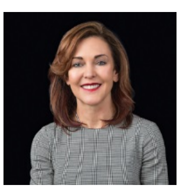

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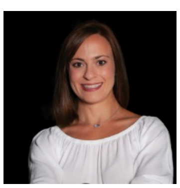

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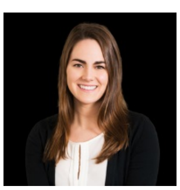

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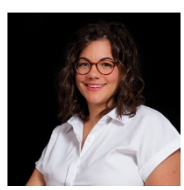

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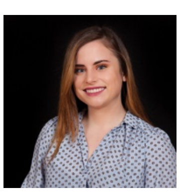

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About Michael Best

Michael Best is a leading law firm, providing a full range of legal services to clients on a global, regional, and local basis. The firm has more than 340 legal professionals, including more than 250 attorneys, serving clients in 13 offices across the U.S. in Colorado; Illinois; North Carolina; Texas; Utah; Washington, D.C.; and Wisconsin.

Michael Best's areas of practice include: intellectual property; labor and employment relations (including employee benefits); litigation; corporate; government relations, political law and public policy; privacy and cybersecurity; real estate; regulatory; and tax.

The firm serves a variety of industries, such as advanced manufacturing, agribusiness, banking and financial services, digital technology, energy, food and beverage, higher education, and life sciences. For more information, visit michaelbest.com.

About Venture Best

Our Venture Best™ group works closely with entrepreneurs, and with their venture capital and angel investors, to help new, high-growth companies find financial backing and grow their businesses.

We help companies and investors make connections, structure and close transactions, and maximize returns. We also counsel early-stage businesses on their financial, organizational, and regulatory needs as they grow.

We represent start-ups and emerging technology companies in many different industries, including biotechnology, information technology and software, clean tech, pharmaceuticals, medical devices, electronics, and other high-technology sectors. Members of our Venture Best team have themselves been venture-backed entrepreneurs, as well as angel and venture capital investors, giving us great depth of insight on both the legal and business sides of the start-up environment.