Insurance Essentials for Entrepreneurs

Entrepreneurs will need to establish two types of insurance programs: the first is Property & Casualty (Liability) insurance (some refer to it as "P&C" or "business insurance"); and the second is employee benefits insurance programs for health, life, and disability, et al. Insurance is the transfer of risk from the business owner to an insurance underwriter and allows business owners and providers of capital to businesses to, in essence, take on additional risk or pursue activities that, uninsured, might prove too uncertain to risk capital. An agent represents the insurance underwriters and must be licensed to sell P&C and/or Life & Health – they are separate licenses. Both types of insurance are regulated state-by-state so the rules and rates vary, e.g. whether or not you will need Workers Compensation insurance and what it will cost.

P&C: There are over 3,000 P&C insurance companies licensed in the U.S, but less than 10 that offer the types of coverage most likely needed by a technology company. They are represented by independent agents. Most likely you will need at least Property insurance (including equipment) to satisfy any lenders; General Liability insurance to satisfy landlords, lenders, investors, and customers; and Workers Compensation if you have 3 or more employees (in Virginia). Next, you will probably want to have Auto insurance, at least for your company's vicarious liability, and an Umbrella policy. Umbrella policies don't give you more coverage per se, but they add an additional layer of available limit on top of the "underlying" policies. Finally, as you grow, you may want Professional Liability insurance (a/k/a "Errors & Omissions"); Crime insurance; Directors & Officers Liability; and Employment Practices Liability insurance. There are over 40 types of coverage in all and most businesses wind up with 8-12 types.

Life & Health: There are also hundreds of insurance companies selling group health, life and disability coverage, but usually 5-10 that are competitive for small businesses in each state. Your P&C insurance is supposed to protect you and your investors against large losses; but your group benefits insurance program will benefit employees and help you in recruiting and retaining them. You are usually not required by law to provide any employee benefits, but will have a difficult if not impossible time keeping good employees if you do not offer them. Each insurer offers variations of their health insurance product that vary the benefits paid - which affects the cost.

Complimenting your insurance coverage should be the steps you take to reduce the possibility of losses. If, over time, your losses paid by the insurer are more than average you will wind up paying more than average. For P&C insurance this is referred to as "loss control" programs; for employee benefit programs is had more to do with the age of your employee group, wellness programs, and work environment (stress).

1 FAQS

1.1 How does the underwriter determine the premium I am charged?

Underwriters use the "exposure basis" for the particular type of coverage requested and then they develop a rate based on their evaluation of the severity of the insured's exposure and the insured's attempts/programs to control losses. The exposure basis for Property insurance, for example, is the replacement cost of the property insured, but the rate is based on the location and construction type of the building to be insured – or the building in which the personal property is stored.

1.2 What is the underwriter evaluating?

An insurance underwriter is trained to assess the likelihood of an insured having more, less, or average claims (the dollar amount paid by the insurance company). Factors such as previous medical history; driving record; construction materials used in the building; fire protection equipment; quality of your standard customer contract; are all factors that affect an underwriters decision about whether to use standard rates or to debit (increase) or credit (decrease) the rate you will be charged. An agent's submission of underwriting information on your behalf is critical to this decision – so you can help your agent obtain lower premiums if you are adhering to good practices for risk management and can document it.

1.3 What is a loss control program?

The insurance company will credit the rates they charge if you have effective loss control programs in place. This can be anything from ergonomically designed work stations to reduce repetitive motion injuries, to safety training for drivers, to education programs for your management on negotiating contracts with customers to avoid taking on legal liability. For Life & Health, there is less emphasis on loss control programs but the effect of wellness and stress reduction programs can usually be seen in lower claims paid which help reduce your premiums.

1.4 Do I have to buy insurance?

Basically, no, you do not have to buy insurance, with the exception of state-mandated Workers Compensation insurance. However, it will be difficult to lease premises, obtain financing, or sell to customers if you cannot assure them that another, larger, company is standing behind you should you be unable to pay for any damages you cause. Insurance is an enabler of the stream of commerce in most civilized countries and the issue is obtaining the lowest rates for the best coverage.

1.5 Where can I find the least expensive insurance?

Start with finding an agent who you trust to be familiar with your type of business and consult with them on the short list of insurance companies likely to be competitive for the products you need. You can use the Web to apply for coverage for a few simple types of coverages (like one vehicle), and otherwise line up meetings with underwriters in person or by phone. Spend more time on putting together information that puts your company's business in the best light and less time obtaining quotes from any random carrier – agents will know best which carriers will be competitive and what you want to achieve is bringing out the best in those underwriters.

1.6 How is insurance regulated?

Each state has a department or bureau of insurance – and Virginia has one of the most stable and even-handed of these. They are regulators, charged with the dual role of protecting consumers while also creating an environment where multiple insurance companies feel they can make a fair profit for each line of coverage they offer. The Bureau of Insurance can be approached if you feel your have been treating unfairly or illegally by an insurance company or agent. For most lines of coverage, the insurer must file their rates and policy language with the Bureau and evidence that those rates are fair and that claims history justifies them. Occasionally, a state and the insurers in that state will disagree on the adequacy of rates and insurers will discontinue writing a line of coverage. This has happened with Workers Compensation insurance in multiple states and is a nightmare for consumers. The more complex, or sophisticated, lines of insurance such as E&O or D&O are frequently written on a "non-admitted" basis which means the insurer does not file the rates or form with the state. The consumer will pay a small tax on these policies but are usually happy to do so as the process allowed the underwriter to be more flexible in what they charged and what coverage they offered. However, non-admitted policies will not enjoy the benefit of the state's fund against insurer insolvency – so the buyer should select a stable, highly rated, carrier.

1.7 I'm not happy with my insurance, can I cancel?

Generally speaking the insured can cancel a policy at any time with written notice to the insurer. But a refund of the premium that is not yet earned, assuming the cancellation is prior to the expiration of the insurance policies as originally set up, may incur a "short-rate" penalty of 10% of the unearned premium. So, check with the agent or underwriter. You can also face serious problems with obtaining coverage in the future for a claim of which you were unaware at the time you requested cancellation – so, again, check with the agent or underwriter about the rules for reporting claims and possibly buying "tail" coverage to allow you to report claims after the effective date of cancellation for things that occurred prior to the cancellation date (of which you were previously unaware). You also need to avoid going "bare" or without insurance as you may run afoul of state regulations or lender/investor covenants and not be able to reinstate coverage.

1.8 What can I expect to pay for P&C?

This is the $64,000 question, hopefully less! Use the following as a guide only, there is tremendous variance based not only on what your company does, but also high much exposure there is (insurance rates decline as the total exposure basis goes up). Property rates are per $100 of value but Liability policy rates are per $1000 of revenue. The property insurance rate for a building is credited, or reduced, as the value increases as actuarially you are less likely to have a complete loss on a large building (although the events of 9/11 brought that theory into question:

Property insurance (buildings) $0.25 - $0.75 (cents) per $100 of value insured

Example: A $1,000,000 building with a 50 cent rate is $5,000 in annual premium

1,000,000 / $100 X .50 = $5,000

Contents (including computer equipment) $0.35 - $0.90 per $100 of value insured

Business Income and Extra Expense $1500 for every $1 million in limit purchased

General Liability $0.20 to $2.00 per $1,000 of revenue; significantly more ($3.00 to $10.00) for tangible products that can cause bodily injury, medical diagnostic equipment or other higher hazard products.

Transit insurance is $.08 to $.25 per $100 of the value of goods shipped 50% if shipment is international ("Ocean Marine")

Workers Compensation is a rate per $100 of payroll. That rate varies for each of over 600 possible classifications of the work an employee performs; and is different in each state. Confusing?! Most technology companies only use 2-3 classifications, mostly for white collar employees and the rates are $0.20 to $1.00 per $100 of payroll. Blue collar, hands-on, jobs have rates usually varying from $1.00 to $7.00 for assembling computers to $12 to $20 for working in a warehouse or driving a delivery truck.

Umbrellas are $1500 to $5000 in premium for each $1 million in limit purchased – based on the size of the underlying policies which, assumedly, are reflective of the overall volume of risk and exposure. Umbrellas only extend over other Liability policies, never Property policies.

2 GLOSSARY OF TERMS

2.1 P&C

Property & Casualty insurance refers to the groups of insurance policies that are sold under the P&C license by agents for the insurance companies. Included in P&C insurance are Property; Auto; General Liability; Professional Liability; Crime; Management Liability (e.g. Directors & Officers and Employment Practices). State insurance departments determine which products are sold under the P&C license and regulate the policy language and rates for most of these products

2.2 Life & Health

Employee benefit program insurance products such as health, life, disability, vision, dental, and prescription drug plans. State insurance departments determine which products are sold under the Life & Health license and regulate the policy language and rates for most of these products.

2.3 Independent Agent

Independent agents or brokers are licensed by each insurance company they represent to sell that insurance company's products. Agents represent the company but are independent contractors.

2.4 Underwriter

The insurance company employee or representative who evaluates the prospective insurance company and decides how to price the different types of coverage requested by the entrepreneur or agent. "Underwriter" can also refer to the insurance company in general. A synonymous term for insurance company is "carrier", a term used more frequently in Life & Health. The term underwriter originated at Lloyd's tavern in a coastal town in England where merchants would offer a percentage of the profits of upcoming shipments to/from the New World in exchange for individuals who wrote their name on a sheet under the name of the ship and description of cargo who agreed to share in the loss if the ship was lost or pirated. This is the origin of *Lloyd's of London* insurance syndicates – 400 years later it is still an important underwriting market.

2.5 Professional Liability Insurance

Commonly known as Errors & Omissions insurance (E&O) this policy covers the insured company's legal liability to a third party (most likely a client or customer) for damages that result from an error, omission, or performance failure of the insured's product(s) or service(s). Some carriers offer options of also covering intellectual property violations (by the insured against a 3rd party's IP) on this policy.

2.6 Employee Benefits

Used generically to refer to the insurance policies that are purchased by a company to offer their employees coverage for medical, death and disability claims incurred by the employee and/or the employee's family (if enrolled). Employee Benefit plans can also include non-insurance programs such as tuition reimbursement, retirement plans such as 401(k), and even vacation time.

2.7 Rates

Whether the insurance product is P&C or Life & Health, each insurance company develops a rate that, when multiplied by the applicable exposure basis, generates the premium. P&C insurance product premiums are expressed usually on an annual basis. Employee benefit product rates are usually expressed as a rate per employee, or employee + family, per month. Insurance regulators approve a range of rates filed by each insurer.

2.8 Exposure Basis

An underwriter will use a quantifiable subject such as property value, vehicle value, amount of revenue in a year, or amount of payroll in year as the exposure basis which, when multiplied times the rate(s) for the applicable coverage, will result in the premium. The exposure basis equivalent for Life & Health insurance products is usually the age, gender, and home address zip code of the insured employee.

2.9 Coverage or policies

An insurance policy is a contract that guarantees to the insured that the underwriter will [ay claims if they result from covered "causes of loss". To maintain actuarial validity, coverages are frequently separate by policy to make it easier to predict losses. P&C insurance coverage, or policies, includes:

Property

Business Personal Property

Business Income and Extra Expense

General Liability

Auto

Umbrella

Workers Compensation

Crime

Directors & Officers Liability

Employment Practices Liability

Professional Liability (E&O)

Inland Marine

Ocean Marine

For Life & Health the list of coverages includes:

Group Health (major medical)

Short term disability

Long term disability

Vision

Dental

Life insurance

Travel Accident

Long-Term Care

2.10 Policy

The insurance policy itself, or coverage form, is usually 1-20 pages and is a legal contract. They can be difficult to understand for the laymen but are usually structured around five basic sections:

1. Declarations – the name of the insured, policy dates, premium.

2. Insuring agreement – the 1-4 sentences that express what the insurer agrees to protect the insured for, e.g. the type of claims or activities.

3. Conditions – a series of requirements that the insured and the insurer are agreeing to meet to maintain the validity of the contract.

4. Exclusions – the section of the policy that reduces or eliminates coverage for certain types of losses, causes of loss, or clarification that the policy doesn't cover a particular type of claim because that type of claim is insured on another policy.

5. Definitions – the description of what key words, or phrases, means within the policy; frequently italicized in throughout the policy.

3 KEY ISSUES

3.1 Selecting a broker

Check with local trade associations as well as the local underwriting offices of major insurance companies and ask for the names of local agents with expertise in insuring technology companies. There are usually 2-5 independent agencies in any major market that have this expertise, but it varies. Ask friendly competitors for references or other professional services providers, e.g. lawyers, accountants, or bankers.

3.2 Determining coverage needs

Start with an understanding of your planned business operations and compare it to a list of all possible insurance policies and consider how "severe" your exposure is for each type of coverage, as well as the likelihood of a claim. Divide that list into mandatory coverages (required by state law or lenders or landlords); desirable policies such as an Umbrella policy or Crime insurance; and then optional coverages that for a reasonable price would transfer significant risks away from your business. What is optional for one company is desirable for the next. Obtain a 1-2 sentence summary of the essence of each line of coverage so you can refer to each as you evaluate (for example: "E&O: Covers the insured's legal liability to third parties for damages that result from the insured's products or services, including failure to perform"). This process will probably prompt some critical thinking by you as to possible business operations that might be better performed by 3rd parties to reduce risk. Or you might decide to change the types of products you will sell/develop or the type of customers to whom you will sell.

For Employee Benefits work with an HR consultant to evaluate the local employment market and determine what package of benefits you must offer. You may check with employers in your marketplace (they'll frequently advertise or mail employment packages to prospective job candidates) and you can purchase reports by the *Society for Human Resource Management* (*SHRM*); *Mercer Consulting*; the *Employee Benefit Research Institute*; and other annual reports on benefit programs.

