

Forming an Entity and Obtaining Adequate Insurance Coverage Go Hand in Hand

by

James M. Jimenez, Esq.

A common question I hear from entrepreneurs is whether they need to incorporate or form a limited liability company (LLC) if they have "adequate" insurance coverage for their new or existing business. Conversely, some clients ask why insurance is necessary if they are protected from liability as a shareholder of a corporation or member of an LLC. Both are excellent questions. And the answer is simple: to minimize your liability in our litigious society, you need to do business as a corporation or LLC AND you need adequate insurance coverage to boot.

In most instances, individual shareholders of corporations and members of LLCs are shielded from personal liability if the business is sued. If a judgment not covered by insurance is entered against a corporation or LLC, the business may be lost, as well as the shareholder or member's investment in the business. But the individual shareholder or member usually will not lose his or her home, assets or personal fortune as a result of a judgement against a corporation or LLC. That's why most savvy and well-informed entrepreneurs engage in business through a corporation or LLC.

Insurance should never be overlooked as a means of protection either. Insurance will cover many claims of a "tortuous" nature (slip & fall, negligence, etc). The fact that you have insurance to cover these types of claims will be of tremendous benefit, especially if your corporation or LLC is undercapitalized. If you do not have insurance and some injured party sues your undercapitalized corporation or LLC a court could conclude that you were not "playing fair" and thus pierce the corporate or LLC veil and assess personal liability against shareholders or members. This potential liability is particularly critical if your business is engaged in activities that are dangerous or hazardous to the public. What is an "adequate" amount of insurance? The answer depends on the type of business you are in and a myriad of other factors. Adequate coverage is always known with the benefit of hindsight. Determining the amount of insurance coverage up front, however, is a complicated question.

Insurance typically will not cover breach of contract claims, but courts are less likely to set aside a corporation for these types of debts. However, claims such as sexual harassment, employment discrimination, wrongful termination and fraud are almost never covered by insurance.

Another benefit of insurance is that the duty of an insurance company to "defend" (pay for your legal defense) is much broader than its duty to "indemnify" (pay for a judgment against you). Legal fees alone can be painful, even if you win in court. Courts rarely award the defending party legal fees and the plaintiff's lawyer is often working on a contingent-fee basis, so that the plaintiff himself has nothing to lose by suing your company.

The following is a brief summary of some available insurance for your protection:

1. **General Business Liability Insurance**. This type of insurance can be reasonable and will cover a wide range of lawsuits from personal injury claims to copyright violations. Obviously, the higher the

deductible, the cheaper the insurance. It may be worthwhile to keep an insurance policy with a large deductible and high limits to substitute for having to keep excess capital in your corporation.

2. **Malpractice Insurance**. Lawyers, doctors, engineers, architects, real estate brokers, contractors and other professional can obtain malpractice or "errors & omissions" insurance. This insurance covers goof ups that you and your employees make in dealing with clients. This insurance can be very expensive, depending upon the kind of business in which you are involved. In addition, the coverage is weak because the policies are often "claims made"; that is, it only covers claims made in the year the policy is in effect. Regular liability insurance will cover you if you are sued years later for events that occurred during the policy period. In many states, the statute of limitations for malpractice is six years, so a lawsuit years later will not be covered if you do not maintain continuous coverage.

3. **Director Liability Insurance**. Director liability can be so precarious that many people refuse to serve on the board of any corporation without director liability insurance. This insurance is expensive and may not be necessary for a small corporation.

4. **Umbrella Liability Insurance**. An umbrella policy is one that kicks in after all other underlying coverage is exhausted. For example, if you have a general liability policy with \$100,000 and a judgment is rendered against your corporation or LLC for \$500,000, the umbrella policy kicks in the extra \$400,000. Umbrella insurance does not cover other claims that are otherwise not insured (e.g., breach of contract claim). Most insurance companies require that you maintain all of your insurance with their company before they will issue an umbrella policy. Umbrella policies are quite reasonable, and can cover your business for up to several million dollars.

5. **Extended Homeowner's Insurance**. A typical homeowner's policy will cover basic liability claims against you regarding the property. It will not cover general liability claims unrelated to your property. For example, if you injure another while riding your jetski on a nearby lake, this claim will not be covered unless your homeowner's policy has a special endorsement.

When you begin a business, it is most often advisable to form a corporation or LLC. Consult an experienced business lawyer who can advise you on the proper choice of entity depending on your particular circumstances. At the same time, you should consult with an experienced and well-regarded insurance agent to determine the types of insurance, coverage issues and policy limits that make the most sense for your particular business. Always buy adequate insurance. If cost is an issue, increase your deductible. But don't "go bare." There are many inherent risks to being in business. Don't increase those risks by being short-sighted and thinking that "it will never happen to me!"

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James M. Jimenez is a business and real estate lawyer and the founder and president of Pacific Business Law Group, a Professional Corporation. Jim has been practicing law for over 22 years and has vast experience in representing entrepreneurs, emerging growth companies and privately-held enterprises in all aspects of business and real estate matters. He may be reached at 310-255-8835. E-mail: JMJ@PacificBusinessLaw.com. The firm's website is at www.PacificBusinessLaw.com.