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Small Business Planning: Insuring Closely- Held Businesses & Their Owners

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*Lifecycle Financial
Planning*

About your instructor



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Insuring Small Business Owners

- Just like larger companies, small businesses need insurance. Underwriting may be simpler though.
- If business is conducted in the name of the entity (rather than the individual), the insurance policy will generally need to be in the entity's name.
- The risk profile of a closely-held business is often tied to the owner's own actions.

Risk Control vs. Risk Financing

- Risks are typically dealt with using Risk Control and/or Risk Financing
 - Risk Control – Avoid/Minimize Losses
 - Risk Financing – Pay for the Loss
- Most situations will require a combination of techniques....

Building an Insurance Program

- Insurance program should start with a package policy – typically:
 - Commercial Package Policy (CPP) for larger companies
 - Business Owners Policy (BOP) for smaller companies
- Specialized policies for unique areas of risk – examples:
 - Internet-based company may need a cyber policy
 - Cash-based business may need a commercial crime policy
- Umbrella policies for excess risk exposures

Common Insurance Terms

- **Insurable Interest**

- P&C → Time of the Claim
- Life → Time of Application

- **Insurance to Value**

- Why is this important?
- Coinsurance

- **Deductibles** - Small Business Losses

- **Valuation Methods:**

- Actual Cash Value
- Agreed Value
- Functional Value
- Replacement Value = ACV less Depreciation

Example - Coinsurance

DEF Company's insurance policy covers its commercial building and contains an 80% coinsurance clause. The building is worth \$500,000 at the time that it incurs \$100,000 of damage in a fire. Assume that there is no deductible on the policy and that the policy pays claims at actual cash value.

If coverage is \$400,000 (80% of the ACV) or more, the claim would be paid in full. However, if the coverage was only \$300,000, the claim would be paid according to the following formula:

$[\$300,000 / (\$500,000 \times 80\%)] \times \$100,000 = \$75,000$ claim payment.

Business Owners Policy (BOP)

- Commercial Package policies tends to be for larger companies, while a BOP tends to be for small & mid-size companies
- Usually include: Building, Personal Property, Business Income, and the equivalent of CGL (with other coverages available)
- Simplified underwriting – typically based on annual revenues, number of employees, or similar items

Simplified Underwriting - An Example



- Has fewer than 100 employees
- One location, office, or premises
- Less than \$1 million in annual revenue – based on last 3 years (or projected)
- Operates in a low-risk industry
- Less than 12 months of business income insurance needed

ISO Policy Conditions

- **Cancellation** – Policy may be cancelled at any time in writing by the named insured delivering notice to the insurance company.
 - Insurer can cancel, but they must give advance notice of 10 days for nonpayment of premium or 30 days, if the reason is for anything else.
- **Policy Changes** – Policy may only be changed by written endorsement
 - Only named insured can request policy changes
 - In practice, companies will often take the change over the phone and then follow-up in writing.

ISO Policy Conditions

- **Inspection and Surveys** – Insurer has the right to inspect the insured’s premises at “any reasonable time” during the policy period.
 - Insurer can (and often does) outsource the inspection to a third party
 - Insurer may share the inspection results and recommend changes – but they have no obligation to do this (nor are they responsible for any violations).
 - In practice, insurance companies will often say they are coming – but they don’t have to
- **Examination of Books & Records** – Insurer can examine and audit the insured’s books and records at any time during the policy period
 - May also audit up to 3 years after policy termination

ISO Policy Conditions

- **Transfer of Rights and Duties Under the Policy** – Insured cannot transfer any rights or duties under the policy (in other words, insured can't assign)
 - Example: An insured sells a building that is covered under the policy. The Insurance company has no obligation to cover the new owner.
 - Insurance company can agree in writing to cover the new insured, but in practice, this is rare.
- **Premium Payments and Returned Premiums** – Named insured is technically responsible for making premium payments. Premiums refunds (and claims checks) are made out only to the first named insured.

Common Commercial Property Conditions



- **Insurance Under Two or More Coverages** – If a claim could be covered under two different coverages within the same package policy, then the insurer will not pay out more than the actual loss amount.
- **Legal Action Against the Insurer** – Before the insurance company can be sued, the insured has to comply with the policy terms (like the conditions applicable to the claim).
 - The action against the insurance company must generally be started within two years (but this can differ by state)

Common Commercial Property Conditions



- **Other Insurance** – In the instance where a different policy would also cover the same claim, the insured will pay out their pro-rata portion of the claim cost.
 - For example, let's assume a \$100,000 claim is covered by two different policies. Further assume, there are no deductibles. The insured has \$200,000 of coverage under Policy A and \$300,000 of coverage under Policy B. In this instance, policy A would cover 40% of the cost (\$40,000) and policy B would cover 60% of the cost (\$60,000).
 - Keep in mind...This is when two different policies cover the same claim. If the claim is covered under two different sections of the same policy, the insured would cover the loss in-full, but would never pay more than the loss amount.

Commercial General Liability (CGL)



- Covers Non-Professional Negligent Acts
- Covers liability caused by your services, operations or employees for:
 - **Bodily Injury & Property Damage (Part A)**
 - Ex: Customer slips & falls in your store

Commercial General Liability (CGL)



- **Personal and Advertising Injury (Part B)**
 - Libel, Slander, False Arrest, Copyright Infringement, Malicious Prosecution
- **Medical Payments (Part C)**
 - Reasonable Costs for Medical Treatment, Hospital, Ambulance, Funeral Expenses of Non-Employees

CGL – Notable Exclusions from Part A



- **Expected or Intended Injury** – No coverage if injury was expected or intended.
- **Contractual Liability** – No coverage if liability was assumed voluntarily under a contract
- **Worker's Compensation** – No coverage if an injury is covered under worker's comp

CGL – More Exclusions from Part A



- **Liquor Liability** – No coverage if liquor was a contributing factor in a claim
- **Pollution** – No coverage for pollution clean-up
- **Aircraft, Auto, or Watercraft** - No coverage for these items
- **Items covered better under other parts**

Professional Liability Insurance

- Professional Liability Insurance will cover negligent acts that you perform in your capacity as a professional. Certain industries may need certain coverage amounts to operate in a given state.
- Policies are highly specialized – but small businesses may have simplified underwriting available.
- Professional associations may offer group rates for their members.

Buildings & Personal Property – What if I just work out of my house?



- Homeowners policies generally provide very limited insurance coverage for business ventures.
- If a business owner is seeing clients regularly or operating specialized machinery from their home, then a separate commercial policy will often be needed.
- *Example: A client has converted a portion of his home into an office. He sees walk-up clients in his home and has signage for the business out front. He would likely need a commercial policy, since the risks are generally the same as if he had a separate office location.*



Buildings & Personal Property (BPP)



- Covers any combo of:
 - Building
 - Insured's Personal Property
 - Personal Property of Others
- Standard Deductible: \$500

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BPP – Notable Exclusions

- Land, Water, Bridges, roadways, walks, patios, and other paved surfaces.
- Retaining walls that are not part of the building
- Bulkheads, pilings, piers, wharves, and docks
- Foundations below the basement floor (or surface of the ground, if no basement)
- Underground pipes and drains.

BPP – Notable Exclusions

- Outdoor grain, hay, straw, and other crops
- Outdoor TV/radio antennas, satellite dishes
- Outdoor fences
- Outdoor trees, shrubs, and plants (unless part of a vegetated roof)

BPP – Other Items

Covered:

- Leased Personal Property that you have a responsibility to insure
- Tenant's Interest in Improvements
- Most Inventory

Not Covered:

- Money & Securities (Usually on Inland Marine)
- Electronic Data & Valuable Papers
- Airborne or Waterborne Personal Property
- Animals

Business Income Insurance

- aka – Business Interruption
- Part of BPP, CPP, or BOP → Not Stand-Alone
- In the event of a disaster, covers:
 - Increased expenses
 - Income that would have been earned

Business Income Insurance

- **Covered (based on prior F/S):**
 - Profits
 - Temporary Location Costs
 - Fixed Costs
 - Extra Expenses
 - Government Mandated Closures

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Commercial Crime Policies

- Criminal acts can be covered to some degree in other policies, but since loss exposures can vary significantly → Need special underwriting
- Covers Money, Securities, and Other Business Property against criminal acts

Commercial Crime Policies

- Criminal Acts Covered:
 - Employee Theft
 - Robbery
 - Forgery
 - Extortion
 - Computer Fraud
- Discovery or Loss Sustained basis

Cyber & Privacy Insurance Policies



- Covers Liability & Property Damage claims of consumers of technology services or products:
 - Internet Selling
 - Collecting Data
- Not Technology E&O Coverage
 - Website Designers, Computer Software Manufacturers, etc.

Cyber & Privacy Insurance Policies



- Policies are **NOT** standardized
- Covered Perils fall into two buckets:
 - 1. Data Privacy:** Improper disclosure or exposure of private information
 - 2. Data Security:** Compromised systems (like hacking or malware)

Cyber & Privacy Insurance Policies



- 4 Types of Insuring Agreements:
 1. Liability to Third Parties for privacy breaches
 2. Liability to Regulators for privacy breaches
 3. Liability to Third Parties for computer system security breaches
 4. Investigation & Monitoring Costs

Cyber Insurance - What Might be Covered?



- Notification Costs
- Credit Monitoring
- Costs to Defend Claims by State Regulators
- Fines and Penalties
- Loss Resulting from Identity Theft
- File Recovery Costs
- Investigation Costs
- Data stored on laptops and other portables
- Information stored on the cloud
- Information stored both offline and online
- Advertising and other content
- Crisis management and PR costs
- Cyber extortion

Cyber Insurance - What is NOT Covered?



- Reputation, Reputation, Reputation
- Content of your Public Relations
- IT morale and additional security measures going forward
- Rogue employees may or may not be covered

Cyber Insurance - Other Key Considerations



- Premium Cost is typically based on the amount and content of data stored
- Policies are usually on a claims-made/reported basis (not occurrence)
- Balancing the value of data vs. the cost of additional coverage

Planning Issues

- Unlike personal insurance, commercial insurance products are generally not available online. Therefore, a small business owner will normally need to work with an insurance broker.
- Commercial insurance brokers often will have those in-charge of risk management fill out a general application - and then shop the policy around to several insurance companies. The goal is to give you choices and find the best premium cost.
- The broker is the one communicating with the underwriters. Therefore, they are often the ones communicating things about your company's risks.

Planning Issues

- For this reason, it is often best to be as upfront as you can about unique aspects of your business. Simply put – if the broker does not have a solid understanding of the business model, he/she is going to have difficulty communicating the appropriate risk factors to the underwriters.
- If an underwriter is not comfortable with a risk, they will often either not write the policy or assign a high premium.
- Growth of operations, new locations, new products, and strategic changes should be talked about with brokers ahead of time to avoid coverage lapses.

Summing It Up

- The underwriting of a small business insurance policy is often tied to the business owner.
- BPP & CGLs are parts of the package policy – but just like other coverages, they have their own unique coverages and exclusions.
- Making sure that insurance brokers understand your business is imperative to getting the right coverage and the best rate.

Thank you!



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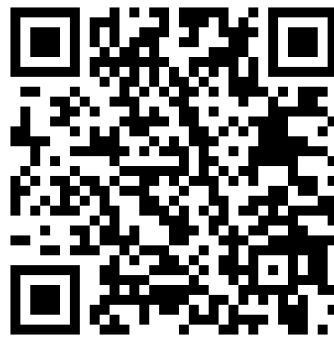
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