



Mary Hanson



About the Business Advisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

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She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

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Addressing Business Risk: Insurance, Incorporation, Indemnification, and Planning.

by Mary Hanson

A business involves many risks - from products, services, employee actions, contractual obligations, employment, customer problems, accidents, problems on the business premises, failure to comply with laws, and more. There are business risks in even the most "risk-free" business.

In addition, business owners are concerned about frivolous lawsuits, brought by customers, employees, or others, which can be expensive to defend, even if unfounded.

Since there are always risks, a person wishing to completely avoid risk should probably not operate a business.

Once a person has a business or plans to go into business, the issues of risk and liability must be considered. Even a business owner willing to accept a high level of risk should not blindly move ahead without analyzing the risks in order to address them in the business plan.

There are business planning objectives that require that risks be addressed. One is purely financial. The risks must be in some manner quantified in order to adjust the projected revenues and return on investment for the effects of risk. The potential business owner may determine that the particular business is not worth pursuing, when

the financial impact of risk is factored in.

Another business planning aspect of risk is that policies and procedures must address the risks associated with a particular business. Large companies have professional risk managers and financial managers who establish policies and procedures to reduce risk, including insurance issues, safety issues, employment policies, payment policies, and credit policies. In a small business, the business owner must address the same issues, whether by using outside professionals or making his or her best effort to perform the tasks involved.

A common concern of the individual business owner is personal liability, which is a separate issue from the risks associated with the business. This is the risk that is addressed by incorporation of a business (and also by the use of other entity forms, such as the limited liability company).

You cannot rely on a corporation to protect you from all personal liability arising from a business. In many types of business-related lawsuits a claimant can and will sue you personally, even if the business is incorporated. If you are a licensed professional, any claim based on your services is primarily against you personally. If you were the driver of a vehicle, the consultant

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providing advice, or the installer of some equipment, you can be named directly as the responsible party. If you are the sole owner and sole employee of a service business, incorporation of the business may offer very little protection from personal liability. You remain personally liable for your actions.

Make a List

As part of preparing a business plan, address risk by starting with as broad a list as possible of all the types of risk that could affect this type of business. List every possible type of person or business that could make a claim against your proposed business. The list should include customers, employees, contractors, vendors, and competitors, and anyone else that would be dealing with the business.

List every type of claim each type of party could possibly have. For examples, vendors could have claims of nonpayment or breach of contract terms, and customers could have claims of defective goods, improper charging, injury related to your product, and injury on your premises.

List every other type of loss, claim, or liability you think this type of business could possibly be exposed to. List natural disasters, strikes (e.g., no delivery of goods), property damage, damage to your inventory as a result of a leaking roof or other cause, having to relocate the business temporarily, damage or loss of business records, etc.

Does your business have trucks driven by employees? The risks associated with this must be included. Is your business a type of

professional practice, so that malpractice claims or failure to supervise claims must be considered?

After trying to list all the possible types of risks, list the ways of addressing the risks. Some will clearly be risks for which insurance should be obtained. For many risks, the only means available to reduce or minimize the exposure are the implementation of policies and procedures requiring business personnel to take certain steps or avoid certain actions.

For risks arising from the actions or negligence of employees, risk reduction may involve hiring standards, employee policies and handbooks, scripts or procedures to be followed, and supervisory policies.

For risks of damage to inventory, loss of business records, and relocation of the business, the plan should identify the likelihood of the type of loss and the steps that can be taken to reduce risk. Insurance policies should be reviewed for coverage.

Insurance

Insurance coverage protects the insured party or parties from the risks specifically identified in an insurance policy. No matter what the policy is or what it is called, it does not cover “everything.” There is no such thing as complete protection from liability.

An insurance policy does not cover anything “excluded” from coverage. Some policies only cover listed risks. An insurance policy may be limited to claims brought within a certain

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period of time. Claims that are less than the deductible will not be covered. The stated policy limit is the MAXIMUM that will be paid, and that maximum may not be entirely available for a particular claim.

One of the overlooked benefits of insurance is that your insurer will provide a legal defense for claims that are covered by your policy. You don't have to hire your own attorney to respond to the claim or lawsuit.

If you do not have insurance coverage for risks that are typical in your business, you need to plan how you will respond to claims. Instead of calling your insurance company for advice and guidance, what will you do?

Incorporation

If you incorporate to obtain protection from liability, and rely on that "protection" without obtaining insurance, you do not have anything like insurance coverage.

First, the only "protection" provided by a corporation is the shield between you and the incorporated business. This protection does nothing to address risks, reduce risks, handle claims, or protect the value of the business itself.

If you receive a claim for \$500 or \$10,000 or \$1,000,000 you need to resolve it yourself or hire an attorney to defend it. If you receive notice of a lawsuit, you must hire an attorney to provide your own defense.

If a successful lawsuit "bankrupts" your corporation, you cannot move the assets of the business out of the bankrupt corporation and begin

business anew elsewhere. Laws regarding conveyance of property to avoid creditors prohibit this.

If you have much of your personal net worth tied up in the corporation, you will not want to walk away from the corporation to avoid dealing with claims or lawsuits.

Even where incorporation provides an effective shield from product liability, employee actions, contractual obligations, and the acts of co-owners, insurance should be obtained to protect the corporation (and secondarily the personal owners) from liabilities that would jeopardize the business.

Indemnification

Business risk can be contractually transferred to others. Your contracts with vendors, customers, and others can clarify that those other parties are responsible for certain losses. Certainly they should be responsible for all losses, claims, expenses, etc. arising from problems they caused.

Do your contracts with other businesses provide that the other business indemnifies (holds harmless) your business from losses, claims, and expenses arising from the acts (or failure to act) of the other business, their employees, or others working on behalf of that business?

If the party you are contracting with is so weak that you do not think an indemnification provision is worthwhile, why are you doing business with this person or entity? Why should you be faced with liability arising from their acts? Does your insurance cover the risks involved?

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Publisher's Note

There are a number of issues that relate to protection from personal liability. Protection can come from a number of angles. Some business owners facing significant business risks make certain their spouses maintain separate property. Unlike community property, such property is not subject to claims arising from the other spouse's business activities.

On the down side, the property belongs to the spouse, not the business owner. In the event of divorce, the spouse keeps his or her separate property. And it can be very difficult to maintain some property as separate property (it gets "tainted" by loans and commingling of funds). Nevertheless, it can be effective in providing some insulation from business risks.

In contrast, the typical grantor trust (living trust) used for estate planning provides no protection from personal liability. Holding business assets or other assets in such a trust does nothing to protect the trustee from personal liability.

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Attorney/Publisher

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To reduce your business risk, avoid indemnification of others. Check your contracts and make note of contracts in which you have indemnified others. Only agree to indemnification if you have insurance that will cover any indemnification claims.

Business owners must attempt to "value" the risks and potential liabilities of a business. Contractual liability can be estimated quite accurately and meaningfully. Catastrophic losses are difficult to anticipate, but easier to quantify, through valuation of fixtures, equipment, inventory, etc.

Liability for personal injury is the most difficult to anticipate and estimate. Business owners should be very conservative on risk issues involving potential personal injury. The dollar amount of liability can be beyond meaningful estimate.

It is difficult enough to estimate and anticipate levels of sales, cost increases, overhead, and other somewhat predictable business expenses. Predicting the types of costs and liabilities that arise from accidents, incidents, problems, and mistakes that were never intended is far more difficult. **BA**

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