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PERSPECTIVE

**VENTURE CAPITAL CORNER**

## What startups need to know about D&O liability insurance

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**D**irector and officer (D&O) liability insurance is not often at the forefront of startup founders' minds when setting out to build a company. Inevitably the topic comes up, and it is something founders should be thinking about sooner rather than later. Common questions that legal counsel receives with respect to D&O insurance policies for startup companies include when a startup company should obtain D&O insurance, what type of policy levels and premiums are appropriate, and how to obtain D&O insurance.

### What is D&O Insurance and When Should a Startup Obtain it?

Director and officer insurance protects a company's directors and officers from liability in the event a company is sued with respect to a business matter, e.g., when the directors and officers make a decision that negatively affects the company, causing the value of the company to decline. Director and officer insurance is ubiquitous among later stage and public companies, but less so with early-stage companies.

Generally, incorporation is too early to obtain D&O insurance, as most startup companies will be months (or even years) from launching a product or raising outside capital. Similarly, hiring advisors or establishing an advisory board is unlikely to occur at this early stage for the same reason. Most startup companies will first consider obtaining D&O insurance policies when an outside investor or other third party joins the board of directors or at the time of hiring employees.

Prior to joining a board of directors and making an investment, venture capital investors expect portfolio companies to

have D&O insurance policies in place. Unlike many startup founders who have limited assets, making them judgment proof, an investor or outside director will have substantial assets and legitimate concerns about protecting those assets. Investors want to protect their assets and those of their investment funds from liability, and D&O insurance is a simple way to achieve this goal.

A sample D&O insurance policy covenant in investment documents may read: "[Startup company] shall obtain, within [X] days, Directors and Officers liability insurance, from financially sound and reputable insurers, in an amount of at least \$[X] million, and shall cause such policy to be maintained until such time as the Board of Directors, including [Investor Director], determine that such policy should be discontinued."

There are instances where the nature of the startup's business or early traction in the marketplace necessitate obtaining D&O insurance prior to receiving outside funding, but these examples are few and far between.

A startup company may also consider obtaining a D&O insurance policy when hiring employees. Employment practices liability insurance can be included under the same policy form as the D&O insurance policy and limits can be shared between the two policies.

### Appropriate Policy Levels and Premiums

The amount of insurance coverage needed by a startup business will vary depending on the nature of the business and stage of its life cycle. An insurance broker can provide more guidance as to precise amounts, but coverage around a couple of million dollars will generally suffice for an early-stage company. However, a startup can plan on approximately \$15,000 in premiums for \$1

million in coverage, depending on market condition and policy wording.

Note that policy underwriting is largely conducted based on the financial condition of the business and inclusion of current financial statements (income statement and the balance sheet) will largely determine the premium. Any prior claims will also have a negative impact on pricing. It's critical to be able to negotiate policy wording to extract the broadest coverage grants for the business. Policy premiums may vary among insurance providers, but a startup can expect to pay higher premiums for greater coverage.

### How Does a Startup Obtain it?

Contact a licensed insurance broker that specializes in working with startup companies to procure a standard D&O insurance policy at the lowest possible rate. Generally insurance companies do not directly write policies to the insured, so a startup will have to go through a broker. Further, a broker will be best suited for identifying the policy levels that are appropriate for your business and addressing any questions. To obtain a referral to a broker, legal and financial advisors are a good place to start.

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