



Ontrack 

Small-business insurance essentials

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Knowledge areas and accreditation

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Overview

Drawing together several pieces of research data suggests that there are as many as 2.7 million small businesses in Australia. But there are nowhere near 2.7 million business insurance policies in the market, which means that a large number of these small businesses have little, if any, insurance protection.

The risks facing very small business are more acute than those facing larger businesses. They have less ability to withstand “shocks” and in most cases the personal assets of the business owner(s) and not just the business assets are at risk.

This article examines why this occurs, and reviews the insurance covers appropriate to small business and its owners.



Learning objectives

After reading this article, you should be able to:

- › provide an overview of the main types of insurance required by businesses, with a specific focus on small business
- › discuss disclosure requirements within business policies
- › analyse the risks for clients around legal liability in the event of non-disclosure.

Small business in Australia

The most commonly quoted statistics on the number of small businesses in Australia come from the Australian Bureau of Statistics (ABS). According to its annual publication, *8165.0 Counts of Australian Businesses*, there were 2,238,299 businesses in Australia at the end of June 2017.

Table 1: Australian businesses by turnover and staff numbers

Annual turnover	Number	%
Zero to less than \$50k	551,224	24.6%
\$50k to less than \$200k	776,196	34.7%
\$200k to less than \$2m	758,309	33.9%
\$2m to less than \$5m	87,473	3.9%
\$5m to less than \$10m	31,012	1.4%
\$10m or more	34,085	1.5%
Total	2,238,299	100.0%
Staff numbers	Number	%
Nil	1,370,051	61.2%
1–4	608,733	27.2%
5–19	203,351	9.1%
20–199	52,249	2.3%
200+	3,915	0.2%
Total	2,238,299	100.0%

Source: ABS 8165.0 — *Counts of Australian Businesses, 2017*.

There are some adjustments that need to be made to the ABS data. Firstly, the ATO has estimated that 577,000 of all 'businesses' are inactive trusts.

If you eliminate the inactive trusts and accept the (narrow) definition of small business as being one that employs fewer than 20 people, then the number of small businesses in Australia is about 1.6 million.

A 2017 Australia Post report, *Under the radar*, calculated that there were an additional 1.1 million micro businesses that were operating informally and without an ABN. Assuming the Australia Post report to be correct, then there are about 2.7 million small businesses in total.

‘Business pack’ policies

Most small businesses now buy their general insurances under a ‘business pack’ policy. These omnibus policies contain many sections, and a small business owner can select the options — property, liability, motor vehicles, goods in transit, machinery breakdown, employee dishonesty and business interruption, etc. — that they wish to purchase, then complete application questions for just those selections.

The key advantages of a business pack policy are that it:

- › will usually provide the best possible balance between appropriate cover and affordable price, by being cheaper than purchasing individual policies for property, motor vehicles, liability, etc.
- › will be written as one continuous policy, so it avoids the overlaps and gaps that occur with multiple different policies.

The generic business pack policies are generally best suited to businesses such as retail shops, cafes or self-employed tradespeople.

Insurance brokers have access to a wide range of small business policy wordings that have been tailored to meet the needs of different trades and professions. This ‘library’ of different wordings means that there is likely to be policy to fit the needs of just about any business.

The need for business insurance

Many small businesses grow out of a non-commercial or semi-commercial activity conducted from home. Small distribution businesses (especially internet-based businesses), after-school tutoring, consulting and service businesses such as party or wedding planning often start out this way.

If people are visiting the premises, as they will for a tutoring business, for instance, then the owner will need public liability insurance. In other home-based businesses, they will also have assets such as computer and office contents or tools. However, while some home policies provide relatively generous coverage for business activities, most home policies provide very limited cover for home-based business activities, as follows:

- › Business equipment is generally covered in a home office. Other types of business activity and stock in trade are usually excluded.
- › No cover is provided for any liability exposures arising out of a business, trade or profession.



Example

Sample wording from a product disclosure statement

The following sample wording taken from a product disclosure statement is quite typical:

We will not cover your legal liability for claims arising out of or connected with your business, trade or profession (unless you are working on a part-time basis as a baby-sitter caring for children).

Source: Allianz Home Insurance.

This is not unreasonable. Household insurance is designed to cover private dwellings, not businesses. There are policies available, such as AAMI Business@home, that do specifically extend Home insurance to cover a home-based business.

The important issue for business owners to recognise is that their normal household policy will not cover them for legal liability claims related to business activities that occur in their home. If a guest in the client's home falls and is injured, the liability exposure is covered by the public liability section of the household policy. However, if the person is there as part of a business dealing (for instance, a student coming to the home for tutoring), the household policy will generally not provide cover.

Main types of business insurance

Given the necessity for business insurance, the key business insurance policies currently available are covered in the following discussion.

Property insurance

Property insurance, or more usually, the property section of a business pack policy will cover the business for loss or damage done to its property by any number of physical causes, including storm, flood, fire, burglary, vandalism, etc. The insurance covers both the building itself as well as any contents such as machinery, stock, office equipment, etc.

Business interruption insurance

Business interruption insurance is designed to cover businesses in the event that their business has to cease operating because of physical damage or loss of business property.

Business interruption will 'make up' the loss in gross profit, meet the payroll expense and pay for any 'extra cost of working' expenses during the period while the physical damage is being repaired (such as the cost of renting temporary premises and equipment) and any loss of profit if the business is forced to operate at reduced capacity.

Traditionally, a valid claim under business interruption had to meet three conditions:

1. There must be a direct physical loss suffered at the insured premises, and
2. The loss must have been caused by an insured peril, and
3. There must be an interruption to the ability to carry on business that occurs directly as a result of that loss, or an increase in the cost of working.

The courts have consistently adopted a fairly narrow view on these questions so that this is an area of insurance law where the definitions and covers available have not been expanded by judicial interpretation over the years.

A 2004 case, *McMahon's Tavern Pty Ltd v Suncorp Metway Insurance Limited* [2004] SASC 237, decided by the South Australian Court of Appeal, reinforced this understanding.

In this case, a group of patrons were ejected from the hotel but returned some time later, throwing rocks at the building. Customers and staff barricaded themselves inside. Windows were broken, cars were smashed and other damage was done. The tavern was closed for a short period of time while the damage was repaired. However the larger problem for the business was a subsequent downturn in business as a result of the media coverage given to the incident.

The tavern owner argued that it should be covered for all the loss in trade because it flowed from the physical damage. The court found, however, that the policy only covered losses directly related to the physical damage and, therefore, only for the period of the repairs. The court drew a distinction between the ability of the insured to carry on business at its premises and the success of the business due to a change in attitude towards the business or damage to its reputation. In short, the business interruption must be due to physical damage in order for there to be coverage.

Many of the newer business pack policies have extended the reach of their business interruption cover to include losses caused by events at other premises.

Imagine the situation where a fire destroys the factory owned by your key component supplier. Your supplier is insured and their business interruption cover protects them during the time it takes them to get back into production. However, your business is also interrupted but, under the traditional wording there has been no damage at your premises and so your business interruption cover is not triggered. In the same way, an incident at your largest customer's premises might see them not place another order for perhaps six months. Your business could lose 25% of its turnover (or more) for that length of time.



Example

In 1998, an explosion occurred at Esso's natural gas plant in Longford, Victoria. The fire started by the explosion was not extinguished for two days. The Longford plant was shut down immediately, and the state of Victoria was left without its primary gas supplier. Within days, VENCORP shut down the state's entire gas supply. Many of the state's businesses were without gas for 20 days.

Those businesses with traditionally worded business interruption insurance were not covered because the physical loss took place nowhere near their premises and their premises suffered absolutely no physical damage.

However, businesses with the extended definitions were covered and were able to lodge claims to cover the loss of business they suffered.

Key person insurance

Key person insurance is designed to protect a business, its operations and profits during the period immediately following the loss of key personnel. In the event of the departure of a key worker through death, disability or illness, having an insurance policy that covers their loss can provide a much-needed financial buffer until that worker's skills and contributions are replaced.

If a client wishes to take out key person insurance, they should first establish who their key personnel are and whether the business could withstand their death, illness or disability. They will also need to work out the insurance amount required to cover potential business losses, should such a situation arise.

When selecting the suitability of a policy, it's important to give consideration to the events covered or excluded by the policy and the speed with which any claim will be settled. Key person insurance will only be useful if a claim is settled rapidly, providing cover during the period immediately following the loss of a business' key worker.

Funding insurance for buy-sell agreements

A buy-sell agreement is a contract usually entered into between business partners or owners, pursuant to which the surviving partner/owner is bound to buy out the other partner/owner's interest in the business should a specific event occur. Specific events which may trigger a buy-sell agreement include death, divorce, long-term disability, retirement or bankruptcy.

Generally, the agreement is structured in such a way that it does not matter what business structure has been used to own the business, that is, family trust, company, partnership. A buy-sell agreement provides certainty for the future of the business by preventing, if necessary, external parties from coming into the business should a specific event such as those mentioned above occur and ensuring that the business moves into the hands of the intended successor as agreed.

An integral part of the buy-sell arrangement is the funding agreement, a separate document outlining where the funds will come from to pay out the family members of the deceased partner, in return for their part of the business. By far the most common funding method for buy-sell arrangements is a self-owned insurance policy on each of the relevant partners' lives. Insurance policies for this purpose may include term life, total and permanent disability, or TPD, and trauma risks.

Income protection

In contrast to business interruption, income protection (IP) is more of a personal risk insurance contract which protects the earnings that are used to establish and maintain the insured's lifestyle. That is, the revenue generated by the insured less the business expenses incurred in generating that revenue. Broadly, up to 75% of earnings can be insured under IP insurance — insuring a higher amount can affect the motivation of the insured to return to work, hence a higher percentage of coverage is rarely available in the marketplace.

IP insurance policies tend to include or make available a wide range of ancillary and optional benefits, such as double benefits for certain conditions and shorter waiting periods for accidents.

Public liability insurance

Public liability insurance will cover your client's potential liabilities to third parties for personal injury or property damage, should they or their business be found to be negligent. Statute laws impose a duty of care upon certain people, including employers, owners of property and suppliers of goods. If they are found to have breached their duty of care, they may be liable for damages.

Professional indemnity

Professional indemnity (PI) insurance protects the insured against claims of professional negligence made against them by a client or customer. This type of insurance is available to professionals across a range of industries and covers the costs and expenses of defending a legal claim, as well as any damages payable.



Consider

Professionals are legally held to a higher degree of skill and care than ordinary people. If others suffer a loss that can be attributed to a failure to uphold professional standards, they risk being sued for a breach of professional duty. A client's loss may be material, financial or physical.

Which type of insurance for which kind of business?

Legal structures of a business

Most small businesses are structured as either sole traders, partnerships, or companies. In round figures, a little under 50% of small businesses are sole traders, about 15% are partnerships and 35% are private companies (ABS Counts of Australian Businesses 2017).

From an insurance perspective, the important distinction is the level of risk inherent in an unincorporated structure. For the sole trader or partner, their exposure is unlimited. A liability claim, be it product liability, public liability or PI, will expose the business owner's personal assets, including their house, to any judgment that goes against the business.

For some sole traders, it may be worthwhile planning a one-way buy/sell agreement, which essentially becomes an exit strategy for the original business owner. A new party, for instance, could enter a business with a view to buying it, or a succession plan could be entered into with a key employee or family member.

The position of a partner can be even worse. Each partner is potentially liable for all the debts of the partnership. So, if the other partner(s) cannot be found or if they are bankrupt then the remaining partner will be liable to cover all the debts of the partnership, irrespective of whether or not they instigated any particular transaction.

Key person insurance can provide vital protection to a small business that is dependent on a particular person for profitability or for its viability in general. It may be used to protect revenue or to protect capital, such as guarantor insurance, and may be appropriate whether the key person is a director, partner or employee.

Table 1: Australian businesses by structure (excluding trusts)

Legal structure	Number	%
Sole proprietor	839,507	49.6%
Company	586,547	34.6%
Government	267,442	15.8%
Total	839,507	100.0%

Source: ABS 8165.0 — Counts of Australian Businesses, 2017.

Public liability insurance is available to individuals, businesses and non-commercial organisations. It provides legal protection to a range of operations, including home-based businesses, shopping centres, swimming pools, carnivals and fetes or event centres.



Consider

For some organisations, public liability insurance is mandatory. Even the smallest retail business may find it needs to have at least public liability insurance. This insurance is normally a condition of obtaining retail space, including even a stall space at the markets.

PI insurance is the most necessary for the increasing group of professionals working from home, either as a choice, while between jobs, or on a part-time basis while also working full-time elsewhere.

There are large numbers of people providing design or consulting services, business planning services and IT services such as web design. In a very large number of cases, these people are operating as sole traders and, therefore, have their personal assets at risk in the event of a claim against them for issues such as negligence, breach of copyright or registered design, defamation or breach of privacy.

Where a business is incorporated as a private company, then a 'corporate veil' will limit a judgment to the assets of the company in many circumstances. However, officers of public companies and directors in general are increasingly being held liable where they act inappropriately or do not uphold their duties as required by law.



Example

Under some circumstances directors may now be held personally liable for the debts incurred by a company which is insolvent or which lead to insolvency. That is, if their actions contributed to that situation. Specialist 'directors and officers' insurance is available to help protect these business people.

Workers compensation insurance

Workers compensation insurance is mandatory for any business that employs staff. So, when a business first grows from a one-person operation to recruiting even one or two staff, it confronts the legal requirement to take out workers compensation insurance. The particular complication with workers compensation is that it is regulated under state law. Consequently, the provisions differ slightly from state to state (or territory).

Among the obligations listed in the New South Wales WorkCover regulations:

- › An employer shall obtain and maintain in force a policy of workers' compensation insurance (Penalty \$55,000 or six months imprisonment).
- › Records relating to wages are to be kept for seven years (Penalty \$55,000).
- › If the Authority is entitled to recover an amount from a corporation and the amount is not recoverable from the corporation, the Authority is entitled to recover that amount from a person who was a culpable director of the corporation at the relevant time.

If an employee is injured and not covered for workers compensation, in most jurisdictions, the relevant authority will pay the appropriate benefits to the injured worker. It will then take action to recover that amount from the employer. The cost to an uninsured business may be crippling. In New South Wales, for instance, as shown above in the regulations, where the business is unable to pay, the Authority is entitled to take action against the business owner(s).

The practical challenge though is to determine who is an employee. If the business is a sole proprietor or a partnership then the owners are **not** employees. They do not need to be covered under workers compensation and, in fact, they are not entitled to be. If the business is structured as a company, then a shareholder or director is not an employee.

However, the position of a working director differs between jurisdictions. In New South Wales, for instance, they are considered to be employees, and should be covered. In Queensland, they are not.

At the time workers compensation was introduced, the concept of an 'employee' was quite clear. The workplace comprised business owners and their employees. All employees were required to be covered under workers compensation.



Consider

In the modern world, the concept of who is an employee is far from obvious. The legislation in each state makes it clear that part-time and casual employees are to be included.

In most states, people filling certain roles are deemed to employees, but these definitions differ from state to state. Many contractors and subcontractors, who would not otherwise be considered to be employees, are very often included in the definition of 'workers' for workers compensation purposes.

Duty of disclosure

When a business owner or entity is completing an insurance application form, they have a duty to disclose to the insurance company everything that either is known or could reasonably be expected to be known. The area that causes the most difficulties across all business insurances is that of non-disclosure. There are quite definite rules about what must be truthfully disclosed to an insurer before a contract of insurance is entered into.

These rules, along with the consequences for breaching the rules are set out in Part IV of the *Insurance Contracts Act 1984*. The duty of disclosure is set out in section 21:

... an insured has a duty to disclose to the insurer, before the relevant contract of insurance is entered into, every matter that is known to the insured, being a matter that:

- a) *the insured knows to be a matter relevant to the decision of the insurer whether to accept the risk and, if so, on what terms; or*
- b) *a reasonable person in the circumstances could be expected to know to be a matter so relevant.*

Section 21 goes on to state that the insured does not need to disclose something that diminishes the risk, something that is common knowledge, or something that the insurer ought to know.

Section 22 imposes on the insurer the duty to “clearly inform the insured in writing of the general nature and effect of the duty of disclosure”, while s 27 establishes that if a person fails to answer a question on the proposal form or gives an “obviously incomplete or irrelevant” answer, then the onus is on the insurer to pursue an answer before it can rely on the failure to answer as non-disclosure.

In the event of non-disclosure, an insurance company can elect to reduce or decline their level of cover. If an insured deliberately withholds information, the entire policy can be voided.

Multiple insureds

The wording throughout Part IV refers to an ‘insured’ in the singular. What is the position if there are multiple insureds, for instance, partners in a business, taking out a policy? What if one of them, innocently or deliberately, is guilty of failing to disclose some fact or other?

The definitive case is a judgment in the High Court, *Advance (NSW) Insurance Agencies Pty Ltd v Matthews* [1989] HCA22. Mr and Mrs Matthews had taken out household insurance in their joint names. They had answered ‘no’ to the question of whether ‘you’ have ever had any claim rejected. In fact, Mr Matthews had had a claim rejected at the business in which he was a partner.

Almost immediately after taking out this household policy, the couple lodged a claim in respect of a burglary. The particular events surrounding the claim were somewhat bizarre and gave rise to the idea that the matter ought to be investigated further. This brought to light the previous claims’ history.

The High Court ruled that the insurer has an interest in the individual claims’ history of each person. It found that ‘known to the insured’ simply means known to at least one of them.

It is now clear that the consequences fall on the policy as a whole. If one of the insureds deliberately withholds information, even without the knowledge of the other parties, the entire policy can be voided. If the non-disclosure or misrepresentation is not fraudulent, then the assessment of damages applies to the whole policy and not just pro rata to the ‘guilty’ party.

Basic risk management

Even at the most fundamental level, there are a few simple things that small business owners can do to increase their chances of survival after an incident. In particular, they should be encouraged to keep copies of all their critical records (including computer records) at an off-site location. This way, they will have the minimum necessary information to continue billing clients and document an insurance claim or a claim for compensation against a third party.

Small business owners should also give consideration as to how they would continue to operate under a number of different scenarios. Just the process of having thought through these issues beforehand will be beneficial in the event that they must operate under difficult circumstances.

It is expected that businesses will keep adequate records for accounting, tax, reporting and other purposes. These records will provide the details regarding the value of the loss to substantiate claims. The following sample wording, taken from an AAMI business insurance policy, is quite typical and should be heeded by clients and advisers alike:

Keep any evidence of value of property and proof of ownership (receipts, valuations, owner’s manuals or warranty books, etc.) as we may ask you to provide them if you make a claim. If you are unable to provide us with the evidence we require, we may reduce or refuse to pay your claim.



Example

In March 2005, a fire destroyed the Brescia Furniture business.

The problem that Brescia faced was that most of the company’s records were destroyed in the fire. No copies or other documentation had been stored off-site and it was very difficult for the company to establish with any degree of convincing evidence the quantity and value of the stock on hand. This became a battle of the experts, with forensic accountants employed by both sides.

The legal position is that the onus is on the party making a claim to substantiate the basis for that claim. Brescia had great difficulty in doing this. In the end, the court found substantially in Brescia’s favour, but it might be considered fortunate to have achieved that outcome.

Disaster plan checklist

Table 2 provides a checklist which can assist your clients to understand essential contingency plans in the event of an unforeseen disaster.

Table 2: Small-business client checklist

1. We have a standing arrangement to rent substitute premises. This is reviewed regularly.	Yes/No
2. All computer records are backed up daily, and copies are stored off site.	Yes/No
3. All hard copy records are duplicated and the copies stored off site.	Yes/No
4. All staff are aware of our disaster plan, and their part in it.	Yes/No
5. Our accountant has up-to-date records of our business.	Yes/No
6. We are able to divert telephones, etc. to alternative numbers seamlessly.	Yes/No

7. Income replacement/life insurance/key person insurance has been arranged for all critical personnel. The amount of cover will be sufficient for all contingencies.	Yes/No
8. Sufficient liability insurance has been arranged to cover all contingencies and all workers are covered by workers compensation.	Yes/No
9. Insurance has been arranged so that if our major client/supplier is unable to operate because of natural disaster, our business will be secure.	Yes/No
10. Alternative sources of supply have been located for stock/raw materials and a reliable source of replacement machinery is also available.	Yes/No
11. Sufficient funds will be available to pay salaries for all/essential staff until normal business is resumed.	Yes/No

Source: Insurance Council of Australia.

Conclusion

Is insurance always the best solution for business risks? The simple answer here is 'no'. Insurance is only one method of managing risk.

Insurance is an example of risk financing where the person or business transfers the risk to an insurance company, which then finances a loss if it occurs. The business may also finance the risk itself by retaining the risk. That is, taking on the risk itself without any other risk management techniques being employed. Unfortunately, this is what a lot of businesses do without considering the consequences.

Risk may also be transferred by using subcontractors for certain elements of the business or 'outsourcing' certain activities and functions.

There are two other options for managing risk: avoidance and control.

Risk avoidance means simply not undertaking the activity because the risks and costs involved are too high.

Risk control means putting measures in place that will reduce the frequency of the event occurring and/or its severity. Some instances of risk control measures in a business are occupational health and safety standards, smoke alarms or security systems.

On a final note, just because a risk cannot be insured does not mean all is lost. Other techniques can be used to manage certain risks and also often help to reduce premiums for risks that are insurable.

References

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Legislation

Insurance Contracts Act 1984.

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