Strategic Use of Referral Agreements

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Insurance agencies rely on referrals as an important method of growing revenues, and many of those referrals happen organically from business-to-business relationships and personal introductions. In those circumstances, there are no written agreements and no expectations of compensation to the referral source. There may be times, however, when the unique relationship between an insurance agency and a particular referral source would benefit substantially from a written referral agreement.

When we refer to a "referral agreement," we mean an agreement pursuant to which a referral source agrees to provide referrals to an insurance agency in exchange for the sharing of commissions from the agency. Referral agreements tend to work best when the referral source is in a position to recommend to its existing or prospective customers that the insurance agency be part of the customer's team of financial and business advisors. For example, banks can be excellent referral sources, because they typically have numerous customers who require insurance services but do not provide those services themselves.

An insurance agency giving thought to entering into a referral arrangement should first consider the pros and cons of formalizing the particular referral relationship. It is also essential to understand and guard against the potential legal risks associated with such an agreement.

Benefits of Referral Agreements

The advantages of a written referral agreement are straightforward. For the insurance agency, the key benefit of a well-drafted referral agreement is that it requires the referral source to use reasonable efforts throughout its organization to direct potential referrals to the agency. An agreement can provide the insurance agency with a new, long-lasting, and consistent source of referrals.

The referral source also benefits because the insurance agency has an opportunity to build familiarity with the referral source's personnel, brand and procedures, thereby allowing the agency to provide a customer service experience that is more tailored to the referral source's culture and customers. At its best, this creates a recipe for boosting revenues for both the insurance agency and the referral source, while simultaneously providing consistently high quality service to customers. This can make the relationship with a customer "stickier" and therefore longer lasting.

Referral Agreement Risks

The major risk of entering into a referral agreement is that doing so could have an adverse effect on the insurance agency's relationship with its other referral sources. For example, if an agency enters into a formal referral agreement with one bank, then other banks may be disinclined to refer customers to the agency for fear that that the agency will in turn refer its customers to the bank with which it has a referral arrangement. Importantly, the agreement may directly limit the agency from working with other entities in the same industry as the referral source. From a customer's perspective, a referral agreement can send the message that the referral is less about which insurance agency is best, and more about which insurance agency will pay the referral source the highest commission.

An additional risk is that the referral source may refer customers who are not a good fit for the insurance agency. The agency should vet the potential referral source to ensure that the quantity and needs of potential customers are consistent with the agency's expectations. Despite both parties' best efforts, it is also possible that the referral agreement may simply not work as intended. Perhaps the referral source will not be willing or able to refer the volume of customers it thought it would, or, less likely, the insurance agency will be unable to adequately fulfill the customers' insurance needs.

A well-drafted referral agreement will help to mitigate these risks while also creating an opportunity for both parties to generate revenue. All referral agreements should be in writing and clearly describe the obligations of the

parties. A “handshake” agreement may save time and money at the outset, but it opens both parties to unnecessary risk and misunderstandings. In the absence of a written agreement, even a minor misunderstanding can destroy a relationship or result in costly and time-consuming litigation.

Key Provisions

There are several key provisions that should be set forth in every referral agreement.

First, it is essential to include a provision requiring the referral source to obtain and maintain all necessary insurance licenses, approvals and permits as may be necessary for it to receive commissions under applicable state law. This obligation should rest with the referral source, and the insurance agency must have the right to withhold payment of any commissions until such time as the referral source has obtained all necessary approvals. In most states, paying a commission to a referral source that does not have the necessary producer license and other applicable approvals could result in the agency losing its insurance license, as well as steep monetary penalties. Laws regarding payment of commissions for referrals differ in each state, and it is therefore crucial to communicate with legal counsel prior to entering into, or paying commissions in relation to, any referral agreement.

Second, the insurance agency should always retain the right to decline to do business with any customer referred by the referral source, and the agreement should carefully describe the parameters for how and when a commission must be paid. The agreement should clearly define what constitutes a “referral,” the commission that will be paid for referrals, and the metrics that will be used to determine when a commission has been earned. As just one example, the agreement could require all referrals to be made in writing and only deem a commission to be earned if a customer actually purchases insurance within a specified timeframe following the referral.

Third, the agreement should also clearly identify the timing of when the commissions will be paid to the referral source. The agreement could call for payment to take place on a monthly, quarterly or yearly basis.

Fourth, the referral agreement should be for a short term, typically one year, with an option to extend the term. There should also be a mechanism for either party to terminate the referral agreement prior to the end of the term if the relationship is not working as intended (or for any reason). This limits the potential harm to both parties if one of the parties is either unable or unwilling to meet its obligations under the agreement.

Fifth, the parties to the agreement should consider whether mutual non-piracy and nonsolicitation covenants should be incorporated into the document to protect employees from being solicited, and to limit exposure to losing business to the other party after the term of the agreement ends.

Finally, every referral agreement should contain a confidentiality provision. These provisions can serve several purposes, but the main benefit of a confidentiality provision is to provide comfort to each party that the other party will not disseminate confidential information, such as commission and premium data or customer lists, to third parties, both during and for a period of time after the term of the agreement has expired. This is particularly valuable if the relationship between the parties ever sours.

This article provides a general overview and general guidance regarding referral agreements, but note that every situation is unique. The key to a successful referral relationship is to ensure that the parties are compatible and that the agreement is drafted in a manner to mitigate risk while providing both parties with an opportunity to thrive.

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