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Tips and Traps on Referral Arrangements

Most planners have arrangements with colleagues, friends, local businesses and the like for referring clients. As we all know, it is hard to find new clients, and even harder to find clients that are worth having, and so the art of referrals is to choose your sources wisely.

Accountants and lawyers are an attractive source of referrals as clients who have a need for their services are likely to have either significant assets or a clear and present need for financial planning services. And so many successful planners actively cultivate referral relationships with accountants and other professionals.

But despite the best will in the world, these relationships can turn sour. So it is important to establish them so that they don't only run smoothly during the honeymoon period, but also in the divorce phase.

Referral arrangements can take a number of forms:

MERE REFERRALS

The simplest is a mere referral, where the referrer simply provides the prospect with the planner's contact details and some information about the services you provide.

These can be wonderful sources of new clients but they are a little uncertain. If the referrer does no more than hand over information, there is no guarantee that the prospect will contact the planner. It's more effective for the referrer to ask the prospect's permission for you, the planner, to contact the prospect. If you're efficient and do so promptly, there is a good chance that you will convert the prospect into a client.

It is then up to you to service and develop a professional relationship of trust with the client. If the referral arrangement comes to an end, there is a high likelihood that the client will stay with you, due to the personal nature of the services that you will have provided.

REFERRER AUTHORISED REPRESENTATIVE

One technique which many find effective in increasing the success of referrals is for the referrer to badge their services with your planning brand.

But this gives rise to compliance issues.

Because the referrer would be holding themselves out as a provider of financial services, the referrer would need to be appointed as your authorised representative. As a licensee, you will be responsible for any financial services that the referrer provides to clients, so you would need to carefully consider what, if any financial services you want them to provide. You also need to be careful that you do not become liable for the referrer's other activities, which in the case of accountants could include accounting, audit, and tax advice.

To protect against this, you need to:

- Carefully define which elements of the referrer's business fall within what you have authorised them to do. In particular, with accountants, ensure that standard accounting services are outside this;
- Ensure that the referrer clearly explains to clients which of the advice and services that they provide are under your AFSL and for which the referrer is personally responsible;

- Ensure that the referrer does not step over the line and provide financial product advice or services. The difficulty is that the referrer might already be providing financial as opposed to financial product advice and the temptation to 'blur' the lines can be high.

JOINT VENTURE

Another common structure for a referral arrangement is a joint venture. The rationale for this is that both the planner and the referrer can share in the benefits brought by the client. These include not only up front and trail commissions, but also, if the referral arrangement is successful, the development of a valuable asset.

Generally a separate company will be incorporated in which the planner and referrer hold shares. The joint venture company can either provide the planning services or, if it is an arms length entity to both you and the referrer, it can be appointed as your corporate authorised representative.

Either way, as shareholders, the referrer and planner will be able to participate in the profits earned by the JV company and in the value of the business they are creating.

COMMON PITFALLS

Let's look at some of the pitfalls of the joint venture and authorised representative arrangements.

- **Compliance risk –** We have already seen that in both arrangements, as licensee, the planner carries the compliance risk for any financial services that the referrer provides, even if they are provided inadvertently. Both the referrer and the JV must be required to comply with your compliance requirements and must accept that non compliance will result in termination of the authorisation.
- **Distribution of revenue –** As the planner, you need to be properly compensated for the risk to your AFSL and the contribution that you make in terms of your systems, processes and procedures.
  The referral partner may not appreciate fully this contribution and may seek a greater share of the revenue as the party providing the client base. Generally the planner would receive any plan fee and an agreed percentage of the commission and the parties would then share in the profits of the joint venture company as dividends paid to share holders.
- **No referrals –** What if the referrer's promise of a ready and willing client base of referrals does not eventuate. It is advisable to tie the referrer's revenue share to client referrals – so the referrer is incentivised to bring profitable clients to the business.
- **Expenses –** If you share offices and resources with the referral source, then agree the basis on which you will pay for those resources up front and link it to market pricing. If you are dealing with accountants or lawyers, then predefine the basis on which they will contribute their services to the joint venture. Should they be entitled to do so at full (or even partially) commercial rates, when you are contributing your time, expertise and systems for a salary plus profit? Or should they be compensated on a cost recovery basis?
  Avoid tying your contribution to expenses to the share of revenue that you generate for the firm. One client with this arrangement, who successfully developed the planning side of the business, ended up subsidising the rest of the referrer's business.
- **Non-exclusivity –** What if the referrer has other JVs with other financial services providers, such as general insurance brokers or life writers? Consider the potential exposure to your AFSL and your competitive position before agreeing to any cross endorsement arrangements.
- **Termination –** Perhaps the biggest issue is: what happens when the relationship irretrievably breaks down or even if it is happily terminated? For example the referrer might decide to obtain their own AFSL or they could reach a potentially more profitable relationship with another planner. Who will have the ongoing right to service the clients of the joint venture? Are you happy for the referrer to directly compete against you?

When going into a joint arrangement, it is easy to overlook the fact that over the life of the venture,

just like a marriage, the relationship will become increasingly complex.

Think about your friends and colleagues who have been divorced? Did they split amicably with no arguments about kids or property? Did they have to go through the Family Court? Were they happy with how much it cost them in legal fees?

How much easier would it have been if they had a pre nuptial agreement?

Business relationships are like marriages. Easy to get into and hard to get out of.

Unless the rules are laid down in advance, when negotiations and discussions are easy because goodwill abounds, significant and sometimes irretrievable problems can occur after the relationship has broken down and communication is poor.

SHAREHOLDERS AGREEMENTS

And that is what a Shareholders Agreement in effect is – a pre nuptial agreement for business.

A Shareholders Agreement sets out the pre-agreed rules which govern the manner in which the Joint Venture operates and the rights and obligations of both of the parties, both during and after the life of the Joint Venture. For less complex arrangements, a Referral or Authorised Representative Agreement can be used in a similar manner.

The sorts of issues that a Shareholder's Agreement can assist to manage include the following:

- **Services –** The scope of the services that each party will provide, for example you as the planner, will provide planning services. What remuneration will you receive for this? Who will be responsible for the financial management of the JV? If you have an arrangement with an accountant, this is within their expertise, but how will they be remunerated? At cost or at their professional rates? If one party is supplying premises, what will the rent be? Is it marked to market and if so, how?
- **Remuneration –** How will the profits of the joint venture company be distributed?
- **Accounts –** What financial accounts will be kept and when they will be prepared and tabled?
- **Intellectual Property –** Financial planning methodologies and systems are valuable intellectual property. Think about the work that was involved in establishing your advice process, your IT reporting system, your compliance system, your Approved Product List and your relationships with fund managers. How effectively you operate these systems will often play a significant role in the profitability of the planning business.
  If it includes appropriate confidentiality obligations and clauses defining who owns this intellectual property, a Shareholders Agreement can protect these assets and prevent your joint venture partner using this IP outside of the agreement.
- **Liabilities and Indemnities –** Who will be liable for negligent acts or omissions, or even breaches of the Corporations Act and other legislation? Sometimes the line between the services provided by the joint venture and those provided by the referrer could be blurred, especially if they are an accountant or lawyer. Was it the investment advice or the accounting advice that caused the client to suffer a loss? Was it the structure proposed by the financial planner that caused the loss or was it the execution of the suggested strategy by the lawyer, for example a discretionary trust with inadequate investment or distribution powers, or a testamentary trust that fails? What if it was a little of both? How should liability be apportioned?
  The Shareholders Agreement can define this, so that neither party assumes liability for the actions of the other and indemnities that will ensure that each party is ultimately responsible for the loss that they caused.
- **Decisions and Deadlocks –** How to make decisions and how to resolve deadlocks if you don't agree?
- **Termination –** What happens if one party wants to exit the joint venture – to whom can they sell their shares? Can one party prevent the other from selling to an unsuitable partner? Most Shareholders Agreements give the existing shareholder a pre-emptive right to purchase the outgoing shareholders' shares. But at what price? And how is market price to be determined? A multiple of EBIT, of profit or a multiple of recurring revenue? Should it be based on market price at all, when you have spent all your time and effort building up the business?
- **Client "Ownership" –** Issues regarding client "ownership" are among the most difficult.
  - Who will have the right to service the clients after termination? What is the process for effecting this in practice? For example, if you will continue to service them, who will tell the clients? What if the referrer appoints another planner and approaches the client. What if the client declines to go with you and wishes to stay with the referrer? Will this be permitted? Should it affect the amount of any money that one party pays the other on termination?

- You may be able to agree with the referring partner how the clients will be serviced post termination, but if you do not 'control' the referrer's personal relationship with the client base, there may be no 'stickiness' in that agreement. A good Shareholders Agreement will contain restraints and documented co-operation obligations from the referring partner to prevent them undermining the client ownership.
- You may wish to limit the referrer's ability to compete against you for a period after termination. These types of restraints are difficult. If they are too onerous, they may not be enforceable. If they are too lenient, they may not protect your asset. They need to be carefully prepared having regard to the law in this area. Because this is an area where the law is laid down by judges, it changes regularly.

CONCLUSION

There will be a cost to obtain a well drafted Shareholder's Agreement that is customised for your circumstances. Many clients initially feel that they cannot justify the cost. But this small upfront outlay will pale in comparison to the potential legal fees, personal time and potential loss that you could incur if you don't have one.

One of our clients had a joint venture with an accountant where the planning business sat in the accountant's premises and paid over the odds rental. The accountants did the bookkeeping for the planning business – at exorbitant accounting rates, far more than the cost of hiring a bookkeeper. This planner found himself building up a client base, only to be paying more out to the accountants for services than he was taking home himself.

Another client's separation from his referral partner was made so difficult that it affected his health for years afterwards, impacting his ability to look after his clients and operate the business for some years after the split.

Neither of these had any documentation in place to govern their rights and responsibilities – a form of corporate Russian Roulette!

As a wise man once said "Bad advice is much more expensive than good advice".

AN INVITATION TO CONTACT

Gold Seal is a leading provider of a compliance, risk management, legal, human resources, training and education services to financial services intermediaries.

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