

What is 'secret profit commission'?



Without the knowledge of most lessees the landlords, managing agents and insurance brokers are profiting from the purchase of buildings insurance. Insurance brokers are paid for their services with a commission, which is inflated and agreed in advance with the insurance company and taken out of the premium paid by the lessees. Since these insurance premiums are normally reserved under the lease as additional rent, most lessees are entirely unaware that the insurance premium that they pay to the landlord includes these inflated commissions, least of all that they are paying for these commissions out of their own pockets.

Lessees are not the only parties losing out. Mortgage providers and other lenders, who are co-insured alongside a lessee with the landlord, are also invariably not informed about the commission received by the insurance brokers for purchasing the insurance, since insurance brokers, landlords and managing agents make no disclosure about these arrangements. Due to the hidden aspect of these commissions paid by the insurance broker to the landlord or managing agent, they are known as 'secret profit commissions'.

How do secret profit commissions operate?

By way of an example, consider the following situation. A landlord decides to purchase a property and secures the necessary finances through a lender. The landlord then arranges insurance through his chosen insurance broker, who receives commission for placing the cover. As part of this transaction the insurance broker and landlord have entered into a commission sharing arrangement.

The managing agent is instructed on behalf of the landlord to re-charge the insurance premium to the lessee as allowed for under the terms of the lease. The insurance premium is reserved under the lease as additional rent. Of course, neither the landlord nor the insurance broker are transparent about the commission arrangement in place.

The insurance broker and the landlord share the commission and neither the lessee nor the lender has any knowledge of the arrangement that exists between the landlord and the insurance broker.

Who is affected?

For many landlords and managing agents, secret insurance commissions have served as an easy and consistently reliable source of income for many years and, unfortunately for lessees and lenders this has been the rule rather than the exception, with secret insurance commissions playing a key role in the property owners' model.

It is very rare for lessees to be consulted by a landlord in relation to their choice of insurance broker and it is just as unusual for them to be fully informed of the commissions built into the arrangement. Within this arrangement landlords, managing agents and insurance brokers have formed an informal alliance by working closely together, keeping prices high and essentially operating a cartel to the detriment of lessees.

Principles of Agency Law

It is a prime tenet of agency law that an insurance broker is always presumed to act on behalf of the insured, who is known as 'the principal'.

To ensure compliance with the law of agency, an insurance broker must (i) act in the best interests of the principal, (ii) not allow themselves to be placed in a position where their interests may conflict with their duty to the principal, (iii) act within the scope of their authority, (iv) not make a personal profit out of their position as an insurance broker without the principal's knowledge and consent, and (v) use reasonable due skill and care at all times.

Transparency - Duty of Disclosure

An insurance broker, under agency law, is therefore obliged to make full disclosure to a principal, i.e. the insured, of all personal interests and must account for all payments received from the other party i.e. the insurance company. As remuneration for their services, an insurance broker may receive payment from the insurance company by way of a fixed fee or a commission, which must be reasonable. Insurance brokers are not allowed to make any additional profit beyond 'reasonable brokerage fees', which must be disclosed. Undisclosed commissions amount to a breach of agency law, since they secure a financial advantage for the insurance broker by virtue of their position.

Unfortunately for lessees and lenders, insurance brokers are taking advantage of a regulatory loophole which enables them to withhold disclosure to commercial insurance clients of commissions received, unless specifically requested to do so. Retail insurance clients are even worse off, since there is no obligation for insurance brokers to respond to a disclosure request.

When do secret profit commissions become bribes?

The English courts have confirmed that a secret profit commission becomes a bribe when a commission, or other type of inducement, is given by an insurance broker to a third party and is not disclosed to the principal, i.e. the insured. The law enforces an irrebuttable presumption that a third party receiving secret commissions is inevitably influenced by them, even if he/she acts honestly and in the best interests of the principal, since a principal is entitled to the services of an insurance broker who is free from all possible influences.

Secret profit commissions are a criminal offence under the Bribery Act 2010 and if an insurance broker is found to be liable, the courts may also charge the Directors and other Officers of the company. Therefore, there is an added incentive for insurance brokerage firms to tighten up their systems and controls and to encourage transparency, which would be a welcome development.

A shifting of the tide

Secret profits commissions have been a lucrative feature of the UK property insurance market for many years, however there are signs that the tide is shifting in favour of a more transparent, client focused approach, where landlords, managing agents and insurance brokers are not allowed to unduly profit from revenue-generating schemes at the expense of the client.

In September 2014, in a landmark case, the Supreme Court held that bribes and other secret commissions received by an insurance broker are the true property of the principal and that the broker shall hold the sums 'on trust' for the principal. This decision simplified what was a very complex and unclear area of law and represents a clear shift towards transparency and client duty of care.

In March 2016, the Competition and Markets Authority (CMA) published its long awaited paper on 'Residential Property Management Services' concluding that a greater emphasis should be placed on transparency and integrity and recommending that property managers "disclose what is included (i) within the core management fee and rates of management charges, (ii) administration and supplementary charges, and (iii) commissions (including commissions earned by the property manager for arranging the buildings insurance)."

This is good news for lessees and reflects the changing tide, which insists on greater integrity from insurance brokers and an increased clarity in their disclosure to clients of all commissions received when placing business.

Recovering secret profit commissions

For those affected, there are options. When a broker lacks integrity and fails to act in the best interests of his principal by accruing secret commissions, the affected parties may have a claim for non-disclosure against the broker and potentially their Directors and Officers. Undisclosed sums may be recoverable going back as far as six years prior to the current claim, so long as secret commission payments were made throughout that period.