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An Overview of External Transition Planning for the Registered Investment Adviser

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For years, we have urged investment advisers to establish succession plans for their firms. While it's always a good practice to be prepared for possible future transitions, we believe the current economic climate makes succession planning imperative. A well-designed succession plan will help protect existing client relationships, ensure business continuity, promote economies of scale, and provide procedures for dealing with the eventual retirement of advisory firm founders, whether via internal succession or an external acquisition or sale.

Whether the succession is internal or external, it is critical for firms to have certain underlying documents in place. An internal succession plan should include a well-crafted compensation plan, a well-drafted shareholders' agreement or operating agreement addressing the terms and conditions for the disposition/succession of ownership interests (e.g., stock, membership interests, etc.) upon the occurrence of various events, including the admittance of new owners, regulatory disqualification, death, disability, retirement and termination of employment. Plans for an external transition (a succession from the outside via merger, acquisition or joint venture) should include a well-drafted purchase agreement (or sale, merger or joint venture agreement) that adequately protects the respective parties' interests before and after the transaction. For both internal and external transitions, restrictive covenant agreements that protect the firm's proprietary interests in its client relationships are crucial. In either case, it is critical for firms to conduct appropriate due diligence and review the corresponding regulatory issues.

This article will provide an overview of each of the important components of effective external transition plans for registered investment advisers. (It is not intended, however, to provide an exhaustive discussion of all succession planning considerations. Firms should consult with their legal counsel and other professional advisers for specific advice.) Last month's issue of *Compliance Review* addressed the components of internal succession planning.

Protecting Client Relationships

Many principals of investment advisory firms think ahead to the day they may sell their largest asset, their firm. Unfortunately, too many firms do not adequately protect their most important asset—

their client relationships. It is imperative for the selling firm to preserve the relationships between its clients and the employees who serve them (generally, the firm's Investment Adviser Representatives). Any firm that fails to do so risks losing client relationships to departing employees at the very time that it seeks to sell the business to a third party. The same issue applies to the acquiring firm. As part of the acquisition process, the acquiring firm will want to ensure that it protects its newly acquired client relationships from interference by the seller and its key employees (including the selling firm's principals and Investment Adviser Representatives).

Both firms can avoid the risk of losing client relationships to departing employees by requiring each employee who is responsible for establishing and/or serving clients to execute a restrictive covenant agreement. The primary purpose of this document is to prohibit or restrict an individual's ability to divert client accounts from the firm upon termination of employment, whether voluntary or otherwise. Although putting a restrictive covenant agreement in place is a relatively simple process, too many firms either neglect to do so or have drafted agreements that do not protect the firm, for a variety of reasons. Last month's issue of *Compliance Review*, on internal succession, addressed restrictive covenant agreements in detail.

The External Transition Process

Often in cases of external transition, the firm ownership either has not established a reliable internal succession plan or has done so, but has received a superior opportunity from outside the firm. Depending upon the type of external transition, firms should consider using the following basic documents when establishing a reliable external transition plan:

1) Confidentiality agreement—If the parties intend to exchange information and/or documentation about each other before entering into a letter of intent (discussed below), a confidentiality agreement should be executed prior to this exchange. The purposes of this document are to protect each party's proprietary interest in, and access to, confidential information and documents and to provide for the immediate return or destruction thereof (including any copies) in the event that a transaction does not proceed within a specified period of time (e.g., 90 days).

2) Letter of intent—The letter of intent, which may precede the preparation of a purchase agreement (or sale, merger or joint venture agreement), should set forth the basic terms and understandings of the parties, including those involving payment, due diligence review, continued employment and restrictive covenants. Although the letter of intent will usually be drafted by legal counsel, the parties should attempt to arrive at its basic terms, as well as a preliminary due diligence schedule, without legal counsel's direct involvement. If a confidentiality agreement has not been executed, the letter of intent should contain a confidentiality provision.

3) Purchase agreement—A comprehensive document to be executed between the seller and buyer, this agreement sets forth the terms and conditions of the purchase of the investment advisory entity (or sale, merger or joint venture), including, but not limited to, representations and warranties, purchase price and payment terms, remedies in the event the agreement's terms are violated, continued employment of key personnel, restrictive covenants, and indemnification. One of the most critical sections of the agreement is an explanation of what happens if the purchase and/or transition does not go as planned due to various events, including, but not limited to, the firm's failure to have certain clients transfer/maintain accounts (e.g., purchase price setoff), any breach of material representations or warranties (e.g., recapture of business, further setoff of purchase price or repayment of monies previously paid, etc.), the loss of key personnel or the inability of the successor adviser to perform as required under the sale agreement.

Stock Sale Versus Asset Sale

Generally, most transactions will be structured as either an "asset" sale or a "stock" sale. Liability

and tax issues will drive the decision, especially with C corporations. In an asset sale, the firm is selling certain assets and specific liabilities to the buyer. The assets and liabilities that are not sold and are retained by the selling firm will be disposed of as desired by the shareholders. Stock sales are structured; the shareholders sell shares of the firm (usually a corporation) to the acquirer. Certain assets may be transferred out of the firm or redeemed by the selling shareholders immediately prior to a sale.

As a rule of thumb, a seller usually prefers a stock sale to an asset sale; likewise, a buyer usually prefers an asset sale to a stock sale. In an asset sale, the buyer has the ability to acquire assets only, without assuming any liabilities of the seller—thus, there are fewer risk-management issues to contend with, such as contingent liabilities of the firm that could potentially be inherited. The buyer can also pick and choose which assets to acquire. The buyer can immediately step up the basis in the assets acquired to their fair market value. The buyer cannot immediately expense the purchase price in the year of the sale, although most buyers can depreciate fixed assets over the assets' useful life and amortize intangible assets over the prescribed amortization period. In a stock sale, the seller is transferring title to stock certificates rather than transferring title to each asset in the firm. C-corporation shareholders prefer stock sales because the taxable gain (the difference between the basis in the shares and the sale price) is taxed only once at the shareholder level, and at capital gains rates. There is no difference in capital gains rates and ordinary income rates for C corporations. Please check with your tax adviser to determine your state's tax treatment for sales—the taxable gain referenced above applies only to federal tax.

Generally, stock sales will create a capital gains tax liability to the shareholders in an amount equal to the amount received less the shareholders' basis in the stock, provided that the holding period of the stock has exceeded 12 months. In an asset sale, tax treatment depends on the allocation of the purchase price, which must be agreed to by both buyer and seller. The seller must make the allocation to determine the amount and character of gains or losses, and the buyer is required to determine future allowable depreciation and amortization. When an investment advisory business structures the sale as an asset sale, a large part of the negotiated purchase price is allocated to goodwill, which includes intangibles of the business such as the client list, client accounts and client relationships. Goodwill is taxed to the seller as a capital gain, and the buyer benefits from a 15-year deduction of the intangible goodwill. The consulting agreement, if one is entered into in connection with the sale, is taxed to the seller as ordinary income when payment is received, and the buyer is able to immediately expense the payments. Accordingly, a seller should try to limit the amount of the sale price being allocated to the consulting agreement, as it will be subject to greater taxation. If there is a restrictive covenant agreement, there are no tax advantages to allocating part of the sale price to it. The seller must treat the payment as ordinary income, and the buyer must amortize the payment over 15 years. Nonetheless, if there is a restrictive covenant, a portion of the purchase price will need to be allocated to the covenant.

In many sales, the purchase price is paid over time (this is sometimes referred to as an "installment sale"). There must be an interest rate assigned to the payments, and the seller incurs a taxable event on each payment received. The interest on the payments is treated as ordinary income for the seller, and the buyer can immediately begin depreciating and/or amortizing the full cost of the assets. In some instances, a forgivable loan is part of the

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purchase price. Each time a portion of the loan is forgiven, the seller must treat that portion as ordinary income.

Regardless of whether the sale is structured as a stock sale or an asset sale, the various tax implications associated with each type of sale should be explored with professional advisers.

Conducting Appropriate Due Diligence

Regardless of the type of succession, it is critical to allocate sufficient time to conduct appropriate due diligence. The type and scope of the due diligence process will depend upon whether the firm is involved in an internal succession or external transition. Generally, unless the prospective employee/owner is a new lateral hire with an established book of business, the due diligence process in an external transition is far more extensive.

The scope of the due diligence that's generally required for an external transition is quite considerable. Too many times, sellers neglect to conduct the appropriate due diligence, believing that due diligence is a buyer's exercise. However, it is just as important for the seller to conduct due diligence, in order to determine whether the buyer has any past, current or anticipated regulatory, legal or financial issues that could adversely impact the buyer's ability to fulfill its payment obligations under the agreement and/or cause the seller's clients to discontinue their relationship with the buyer. As discussed above, one of the most critical considerations of any external transition is to provide appropriate recourse in the event that the purchase and/or transition does not go as planned due to various events.

Depending upon the type and size of the external transition (and whether your firm is the buyer or the seller), the following are some of the tasks that should be completed in a basic due diligence review:

1) Background checks on all of the firm's professional personnel, including Investment Adviser Representatives (IARs), management and board members. As part of this process, IARs should complete the Investment Adviser Representative Questionnaire, to disclose any disciplinary history, past or current regulatory history, client complaints, litigation, potential conflicts of interest or outside business activity that requires review and/or disclosure on prospective regulatory filings.
2) Review of regulatory filings, including ADV filings, IAR filings and state filings to confirm that they are current and in good standing, and meet regulatory requirements.
3) Obtainment of the corresponding good-standing certificates (secretary of state, regulatory, banking commission, etc.).
4) Review of current investment advisory agreements executed by clients.
5) Review of a cross-sample of client files.
6) Review of policies and procedures.
7) Review of past and current financial statements.
8) Review of current and threatened client complaints and litigation matters.
9) Review of current and prospective errors and omissions (E&O) insurance requirements to determine if "prior acts coverage" is necessary and, if so, whether it is available for purchase.
10) Depending upon the size of the transaction, an on-site compliance review of the firm.

Regulatory Considerations

During the external transition process, firms must address various issues related

to the Investment Advisers Act of 1940 (“Advisers Act”) and state regulations, including:

1) Amendment of the firm’s ADV filings, as required, including: (a) for the acquirer/surviving entity—making sure that its written disclosure statement is amended to accurately reflect the scope of the investment advisory operations, procedures and conflicts of interest as a result of the acquisition of the seller and/or the combination of the seller and acquirer; and (b) for the seller—the withdrawal of its registration, and the timing thereof.

2) The filing/maintenance/withdrawal of notice filings with each state requiring the firm to do so, including: (a) for the acquirer/surviving entity—making sure that the acquiring/surviving advisory entity makes notice filings in those states in which it was not previously required to do so but which now require filings as a result of the acquisition or combination, and the obtainment of new client relationships from the seller; and (b) for the seller—the withdrawal of its state notice filings, and the timing thereof.

3) The filing/maintenance/withdrawal of individual IAR registrations with each state requiring the firm to do so, including: (a) for the acquirer/surviving entity—making sure that as a result of the acquisition or combination, and the obtainment of new IARs from the seller, the acquiring/surviving advisory entity makes IAR registration filings for all such new representatives. If, as a result of the transaction, the acquirer now has an office in a new state, filings should be made for both the firm (notice filing) and those representatives (registration filing) who maintain a place of business in that new state; and (b) for the seller—the withdrawal of its former representative filings, and the timing thereof.

4) Coordination and timing of announcement to employees and to clients.

5) Assignment under the Advisers Act (there will most likely be a change in firm management or control due to the external transition, which will result in an assignment under the Advisers Act); and to the extent that there is an assignment under the Advisers Act, the obtainment of corresponding client approvals (note: in some cases, negative consent letters may not be appropriate).

6) Advisory agreements (assignment versus execution of the new agreement). This is referring to whether it is preferable to assign the existing advisory agreements or to execute a new agreement.

7) Books and records retention.

Conclusion

As discussed above, the external transition process involves a number of components. From the outset, it’s important to make sure that the selling and acquiring firms protect their most important assets—their client relationships. Without protecting client relationships from potential threats posed by departing and/or new employees, the seller or acquirer runs the risk of a potentially disastrous result. Prudent planning, comprehensive due diligence and the retention of experienced professional advisers (e.g., CPAs, attorneys, management consultants, etc.) to coordinate the process will help ensure a successful external transition.

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