Succession Agreements for CPA Firms

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It's often the case that, like the barefoot children of the shoemaker, CPAs advise their clients as to the need for succession planning but fail to do it themselves. Although the resulting risk to the CPA's family, clients, and staff is significant, it is easily displaced by the fire of the day that requires extinguishment. Here is some insight into the preparation of a succession agreement and the issues that should be contemplated prior to entering into that process.

Succession Agreements for Sole Practitioners

In its most common form, a succession agreement (the "Agreement") for the sole practitioner will provide for a transfer of the practice to a successor individual CPA or firm upon retirement, death, or disability. An important component of this Agreement is the requirement that the practitioner or his or her legal representatives sell and the successor purchase the practice.

Types of Agreements

A succession agreement for the sole practitioner will likely be either an asset purchase agreement or, in the event a limited liability company or professional corporation is involved, a membership interest or stock purchase agreement. The asset purchase would allow for the successor to pick and choose assets and either accept or avoid liabilities. Notwithstanding the tax implications, the stock or membership interest purchase agreement may facilitate a transfer in cases where real estate or equipment leases or licenses are a significant asset, with restrictions on transfer.

Components of the Agreement

Triggering Events. A first step in the process is identifying the events that will require the successor to assume responsibility for servicing clients and administering the practice of the departing practitioner.

Temporary Disability. Depending upon the type of practice, it may be necessary to address the occurrence of a temporary disability that makes it impossible for the practitioner to meet the short-term needs of clients. It will be necessary for the Agreement to include an objective definition of "temporary disability." If a disability income insurance policy is held, an option may be to incorporate its definition or determination of pay status. A timeframe (six months to one year) for commencing and terminating service should be included. Also, a provision that interfaces with permanent disability and death should be considered.

Permanent Disability. The determination is again important. Consider a number of days, not necessarily successive, within a year to avoid the problem that may result from temporary returns to work. The regular care and treatment of a physician during the timeframe should also be required to substantiate the credibility of the condition.

Retirement. Retirement can be a complete termination of activity at a certain age or a predetermined phase-down over time.

Death. Consider the timing associated with the probate of an estate and, in particular, the appointment of a personal representative. The executor cannot sell the practice until he or she is appointed by the appropriate court where the will is admitted for probate. The designated executor should be familiar in advance with the Agreement and authorized under the will of the deceased practitioner to implement it. Life insurance owned by and payable to the purchaser could provide necessary funding for the purchase.

Purchase Price. The purchase price can be fixed based upon the value of the practice or contingent, based upon retention of the client base and related billings. In either case, the Agreement should allocate value to tangibles, receivables, work in process, and the client list. Intangibles such as telephone numbers, web addresses, and other sources of goodwill should not be forgotten.

Methods of Payment. Depending upon the triggering event, the Agreement may provide varying methods of payment. In the event of a temporary disability, payment may equate to a percentage of the hourly rate that the sole practitioner normally charges. A death payment could include insurance proceeds and a promissory note for the uninsured or underinsured value. Payment as a result of permanent disability or retirement might consist of a down-payment and schedule of payments over a designated period based upon earnings.

Additional Provisions

Assignment of Leases and Contracts. The Agreement should provide for the assumption of any real or personal property leases. In this regard, as part of the due diligence prior to entering into the Agreement, equipment leases and service contracts should be reviewed for assignability. Provisions for allocation of prepaid costs should also be considered.

Representations and Warranties. The Agreement should include conventional purchaser and seller representations and warranties, including one that states that assets transferred are free of encumbrances and all tax obligations have been satisfied. These provisions provide the basis for recourse for the purchaser or seller in the event things are not as originally described.

Notice and Transfer of Files and Records. The Agreement should address the timing and manner in which clients, staff, and the community will be notified of the transfer. The mechanics for delivery of client files and employee records should be summarized. The seller should also have reasonable access to this information for some period of time, if necessary for tax or other administrative reasons. Remember that the client owns his or her data and should acquiesce to its transfer.

Non-Compete and Non-Solicitation. Depending upon the circumstances, the Agreement may include a non-compete provision as well as a provision governing the non-solicitation of clients and employees. The non-compete provision must be reasonable in terms of geography and time to be enforceable in Connecticut. The Agreement should also address the allocation of a portion of the purchase price to the non-compete covenant.

Indemnification and Insurance. The Agreement should include a provision for indemnification of the purchaser by the seller for actions prior to the date of closing and of the seller by the purchaser for actions after the date of closing. In addition, the sole practitioner seller may want to negotiate the costs of a malpractice tail insurance premium.

Succession Agreements for Other than the Sole Practitioner

Succession agreements for a group of CPAs are commonly referred to as "buy-sell" agreements. These agreements will address (a) the circumstances under which stock or other ownership interests in the practice will change hands; (b) who may purchase the stock or interests subject to a right of first refusal or other transfer restriction; (c) the purchase price for such transfer, and (d) how the transferor will be paid.

The Agreement should accomplish the following: (a) the orderly transfer of ownership and uninterrupted continuity of the business operations and client relationships; (b) the avoidance of conflict between continuing owners and departing parties; (c) generating liquidity with respect to an otherwise illiquid asset either during life or at death.

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Types of Agreements

There are varying types of succession agreements for firms, each with advantages and disadvantages.

Redemption Agreements. The business entity purchases the departing owner's interest. The interests of the remaining owners will increase *pro rata* as a result of the "retired" ownership interest. The advantage of this arrangement is its simplicity and the psychological effect of the entity supplying the funds for the purchase. Further, if insurance will be utilized for the purchase, the number of policies necessary for the funding is reduced and the concerns regarding premium payments are mitigated. The disadvantage of this arrangement is that the remaining owners may not get a step-up in basis in their ownership interest as a result of the purchase (depending upon the circumstances).

Cross-Purchase Agreement. The remaining owners purchase the departing owner's interest *pro rata* (or subject to some other agreed-upon percentage). The cross-purchase agreement can also incorporate the use of a trustee. It is the trustee's job to act as the facilitator of the ownership interest and fund transfers. A benefit of this arrangement is the step-up in basis. A disadvantage of this arrangement is the reliance on the remaining owners to follow through with the purchase. This disadvantage can be eliminated by the use of the trusteed agreement. Further, if insurance will be used to provide funding for the purchase, the trusteed arrangement will reduce the number of policies and ensure the premiums are paid and the proceeds delivered to the departing owner.

Hybrid and "Wait-and-See" Agreements. A hybrid agreement is partly a redemption and partly a cross-purchase agreement. This type of agreement may be used in the following situations: (a) part of the funding will be contributed by the entity (perhaps as a result of insurance policy ownership), and part by the owners; or (b) in the case where the entity will purchase under certain circumstances (death or disability), and the remaining owners will purchase under others (voluntary transfer or retirement).

A "wait-and-see" agreement provides the entity with the first option to purchase, the remaining owners with a second option, and the entity with a final obligation if neither option is exercised. This agreement will allow the remaining owners to decide how the purchase should occur after assessing the circumstances then in effect. All things being equal, the selling owner should not be impacted by the decision.

Drafting the Agreement

Recitals. Contracts generally begin with a summary of the circumstances and a statement of purpose. These opening statements are referred to as the "recitals," and they provide a basis for the understanding of the parties.

Ownership Interest and Restrictions on Transfer. This portion of the Agreement will notify the parties that all ownership interests (stock, membership, or partner) are subject to the terms of the Agreement. The actual certificates of ownership may be endorsed with a legend identified in the Agreement.

This endorsement will provide notice to potential third-party transferees of the existence of the Agreement. The Agreement may also include provisions identifying restrictions related to Subchapter S Stock or the requirement of professional licensing for ownership.

Transfer Triggers

Voluntary Transfers. This provision will govern any voluntary transfers by an owner. It will include a right of first refusal and requirements for notice to the remaining owners or the entity and a period during which any option must be exercised. This provision may also allow for transfers to third parties. This free transferability is particularly important where family members are a part of the firm and some portion of the ownership interest may have been gifted by a parent to a child or future gifts are contemplated.

Disability. The key portions of this provision are the definition of "disability" and the period necessary for the "disability determination" to be effective. If disability buyout insurance is purchased in conjunction with this Agreement, it will be necessary to coordinate the definition in the policy and the definition in the Agreement. If the owners have also executed employment agreements with the firm, then the definition of "disability" contained in those agreements should also be coordinated.

Retirement and Termination of Employment. This provision in the Agreement should also be coordinated with any employment agreements of the owners. The owners should decide if an economic penalty for early termination is appropriate. Likewise, if there should be an incentive for owners to retire to allow for "new blood," the Agreement should quantify that incentive. Those generally take the form of purchase price adjustments.

Death. The key to this provision is the timing of required actions by the decedent's personal representatives and the surviving owners. The measuring point should be the receipt by the personal representatives of their appoint-

ment by the Probate Court. In general, actions should be required within 90 days of that date.

Determination of Purchase Price. The determination of the purchase price will be dependent upon the circumstances. However, the methodology should be specifically stated in the Agreement. An option is to include the calculation in a "certificate of value" that's attached and updated annually by the parties. The Agreement should also contain a provision that if the value is not updated or cannot be determined, an appraisal will be performed. The applicability of marketability and minority interest discounts or a majority interest premium should also be addressed to avoid possible disagreements at a later date.

Payment of Purchase Price. This provision should incorporate the application of insurance funding, if any. If the purchase price is overfunded by the insurance then this provision should address whether the excess accrues to the benefit of the surviving owners or the deceased or disabled owners. Any shortfall should be incorporated into a promissory note. The interest rate of the promissory note should, at a minimum, be the Applicable Federal Rate appropriate for the rate's term. The term of the note should balance the cash flow of the firm or owners with the financial position of the decedent's heirs.

The Agreement may include restrictions on the activities of the entity during the period the note is outstanding, such as borrowing or making acquisitions or increasing the salaries of the remaining owners. These restrictions would not be unlike those imposed by a lending institution in conjunction with a financing transaction. The structure of the Agreement should also consider security for the promissory note. The options in this regard would be a stock or membership interest pledge, a security interest in the assets of the entity, and personal guarantees by the remaining owners.

Finally, the Agreement may include an adjustment to the purchase price in the event the entity is sold within 12 to 24 months after the buyout. This provision would allow for the terminating owners to participate in any accrued value that may have existed at the time of the buyout but for some reason was not captured in the original price.

Insurance. In the event the buyout will be financed by insurance, the Agreement should include provisions governing the acquisition of policies. The economics of premium payments and the allocation of costs, especially where age or health differences exist, should be addressed. Also, provisions for acquisition of policies by the insureds upon completion of payments as a result of a buyout or in the event of the termination of the Agreement should be included.

Indemnification. The Agreement may include a provision for indemnification of the seller for liabilities arising after the date of closing as well as a hold-harmless for any obligations that the seller may have personally guaranteed.

Miscellaneous Provisions. The Agreement should include a provision for termination. Consideration should be given to the possibility that a common disaster could occur and there are no surviving owners to complete a purchase. The Agreement should also include a provision addressing what state law will apply to its interpretation. Finally, a provision addressing whether or not any disputes will be subject to arbitration may be included.

Conclusion

Although this discussion is not all-inclusive, it should provide a starting point for the practitioner. Compiling thoughts about how the issues addressed above interplay with the specific circumstances of a practice is the next step. After this analysis is completed, the practitioner should locate an attorney experienced in the drafting of these agreements to finalize the plan. Note, however, that these agreements should be reviewed on a regular basis to be certain that they continue to be relevant to an evolving practice.

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