CONTINUITY PLANNING 2.0

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FP TRANSITIONS®

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CONTINUITY PLANNING 2.0

Independent financial practices are among the most valuable professional service models in the U.S. One of the biggest challenges in realizing that value, however, is that many of these same books and practices are often built around the skill sets and personalities of individual advisors/owners, leaving that significant value proposition vulnerable to accidents and illnesses and whatever else life may throw their way.

Accordingly, the single, biggest threat to an independent practice with one owner or one primary advisor is not the lack of a succession plan, it is the lack of a plan to protect the clients and the owner's cash flow and value in the event of his or her sudden death or disability (temporary or permanent). Ironically, it is also a great opportunity for third-party continuity partners to grow their own practices through acquisition in the long term, in exchange for supporting an advisor's continuity plan in the short term.

The good news is that most independent advisors have a wide range of continuity planning solutions to apply in a relatively uniform and often simple, well-organized manner – there's just no reason not to attend to executing your own continuity agreement. Ultimately, your clients are counting on you to establish a comprehensive continuity plan to protect their interests for years to come; clients have a right to expect that your business plans will be as *buttoned-up* as the financial plans that you prepare for them.

WHAT EXACTLY IS A CONTINUITY PLAN?

A continuity plan takes the form of a written agreement between two or more advisors and is designed to assure a seamless transfer of control and responsibility in the event of a sudden departure from a book, practice, or business of any of its owners, young or old, and whether by choice, death or disability, even a partnership dispute. These triggering events do not always constitute an emergency but are prompted by something relatively sudden - something we hope doesn't happen.

There are many kinds of continuity plans and agreements and the choice as to which is the best approach tends to revolve around the number of owners in the book, practice or business, the type of operational structure (sole proprietorship or entity), and what you are attempting to protect against. It further depends on whether the multiple plan participants who are setting up a continuity plan own individual books in a practice model or are shareholders or partners of a single business or firm. Even the regulatory structure can significantly impact the choice of plan and continuity partner.

Securities regulators also have an interest in this area. As a point of clarification, FINRA Rule 4370 and SEC proposed Rule(206(4)-4 are about the protection of clients in the event of a significant business disruption. These rules, prompted and influenced by hurricanes Katrina and Sandy, also address disruptions that may occur from any natural disaster as well as the loss of a key employee or advisor. This white paper, and the continuity plans and agreements described below, focus on protecting a departing owner and his/her value, as well as the underlying client base, should the business owner be unable to continue their work due to their death, disability or other exit from the business.

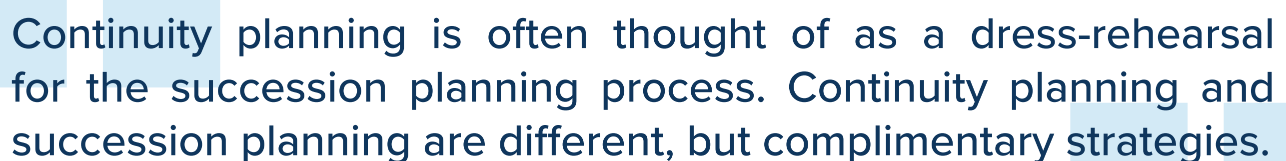
CONTINUITY PLANNING VS. SUCCESSION PLANNING

After decades of development and experience, FP Transitions offers many different, customized continuity solutions depending on whether you are a force of one or one of several shareholders or equity partners in a larger, more sustainable business. To be clear, what you've built and how you've built it determines which solution sets apply.

For some financial professionals, only obvious solution is to purchase a life insurance policy on the life of the owner/advisor. This is a good first step in the continuity planning process but without more, this is a solution that completely ignores the needs and welfare of the client base and any staff members. Another common solution supported by many independent broker-dealers (IBD) is a revenue sharing agreement addressed in more detail below. In this white paper, we'll explain some additional options and, perhaps, better, more sophisticated approaches for you to consider as you try to address all of the stakeholders in your circle.

At the other end of the spectrum, if you've built or are building a multi-owner, multi-generational business, your continuity plan will derive from your formal succession plan and supporting documentation. A succession plan can be defined as a professional, written plan designed to build on top of an existing practice or business and to seamlessly and gradually transition ownership and leadership to the next generation. The foundation for a succession plan is an entity structure, such as an LLC or S-Corporation (appropriate for fee-only and fee-based FINRA models), in which multiple equity partners own a single, valuable business. This structure supports the best continuity plan available as a client's needs are addressed by fellow owners who are invested in the same business – a business designed to outlive any one individual advisor/owner.

For the vast majority of advisors, continuity planning is often thought of as a dress-rehearsal for the succession planning process. Continuity planning and succession planning are different, but complimentary strategies.



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THE MECHANICS OF THE PROCESS: TYPES OF CONTINUITY PLANS

In the late 2000's, even as FP Transitions was figuring out the framework for this process, we met an advisor at a conference who shared his continuity plan with us. He had written a letter to each of his clients letting them know that there had been "an event" and for that reason he could no longer be their advisor. Each signed letter was placed in a pre-addressed envelope. He then put all of these letters in a large manila folder and gave it to his wife and asked her to mail the letters out if he died or became permanently disabled and was unable to handle the task himself. As a sole proprietor, he felt that this was his only and best option at the time and, he said, it gave him great comfort as he looked out for his clients to the very last moment.

This profession has come a long way. Today, there are a variety of continuity solutions available to address and protect clients, cash flow, operations, and value, and to bring you a similiar level of comfort. Choosing the right option depends on the size and sophistication of the book, practice, or business you own. The following list, along with explanations, begins with the most basic solution sets for sole proprietorships or one-owner books and practices and progresses to larger, sustainable businesses with multiple shareholders:

Revenue Sharing Agreements

The most common continuity solution for a single owner practice derives from the most commonly used compensation structure at the book-building level: a revenue sharing arrangement. Independent broker-dealers, custodians, and insurance companies routinely hand out short-form contracts to their advisors at no charge as a continuity solution. These continuity agreements are often called something more formal, along the lines of an "Agreement for Assignment of Accounts" or "Deferred Buy-Out Agreement" and allow a prospective seller and buyer (or continuity partner) to agree ahead of time on the terms of a sale or transfer in the event of an advisor's death, permanent disability, or sudden retirement.

These agreements are simple, inexpensive, and reasonably effective at transferring the client relationships to another advisor within the same network. The downside, which can be significant, is that these agreements usually aren't comprehensive, often result in the seller's proceeds being taxed at ordinary income rates, and typically do not provide for any down payment or bank financing. Because the buyer has no up-front financial commitment or risk and only pays for the clients they want to keep and work with, final "value realized" is almost always less than anticipated, sometimes much less. Still, most advisors enter into these agreements with someone they know or are friends with, someone who is local and with the same IBD, custodian or insurance company. Trust bridges many of the gaps, at least going into the process.

The truth is these agreements mirror the way most books and many practices are assembled and built – so it is only natural to use a similar tool to take them apart and bring them to an end. This is part of the cycle of building a one-generational book or practice. The end result is that the clients have continuity of services and support, and the advisor receives some value for their work.

Practice Emergency Plans

The Practice Emergency Plan (PEP) is a unique option developed and offered by FP Transitions to help book owners and sole proprietorships address the challenges of setting up a practical, reliable continuity plan. Advisors who have not identified a suitable continuity partner can enroll in FP Transitions Equity Management Solutions® program and access all of the tools and support necessary for this solution set.

PEP starts by providing an annual, market-based valuation – a process that allows an advisor to ascertain the value of the book they've built from the perspective of a highly competitive open market of qualified buyers. This valuation process not only helps advisors understand what

they can expect, it also helps the FP Transitions' team understand the advisor and his/her needs. Augmented by an annually updated PEP Profile, this solution set stands ready to implement an immediate search of the marketplace for other like-minded advisors, many of whom are EMS™ members as well and who stand ready to step in on a moment's notice and acquire and pay for what you've built. The PEP also includes personalized guidance and instructions to coordinate the process with your family, personal representative, and your estate plan.

This Practice Emergency Plan is intended to provide all key stakeholders of your practice with a clear understanding of your intent to list and sell your independently owned financial services business in the event of your death or permanent disability in order to find the best qualified successor. With a current buyer to seller ratio of over 50:1, this competitive listing process is designed to also help you maximize the value of a lifetime of work.

Guardian Agreements

A Guardian Agreement is a type of continuity plan that addresses the possibility of a temporary change in operating control or delivery of services. This situation might occur, for example, when an advisor is severely injured in an auto accident or faces a significant medical issue and is unable to work for several months but eventually plans on returning to the business. In such instances, a Guardian Agreement is used to identify a third-party advisor (almost always local and with the same IBD, custodian and/or insurance company) who is willing to step in and take over the client relationships, and then step back out when or if the founding owner returns.

As a result, Guardian Agreements must provide not only for compensation to the incoming advisor for providing such services on a temporary basis when and if needed, the agreement must also address the long-term motivation of the third-party advisor to perform this role – usually the guardian's contracted ability to acquire the book or practice in the years to come and to act as an external successor of sorts.

A Guardian Agreement illustrates another a very important concept – the function of a "tethering agreement." In this manner, a larger, stronger financial services or advisory business can use this approach to grow and acquire smaller books and practices over time, effectively and contractually taking them "off the market" five to ten years before the founding advisor wants to sell and fully retire. A Guardian Agreement may be a standalone document or it may be combined with a Buy-Sell Agreement (explained below).

Another common method of providing for this guardian function and temporary protection is to set up an entity such as an LLC or an S-Corporation and to allow a younger advisor/key employee to buy in to ownership; the role of guardian then is handled by a minority shareholder within the same business – someone known to the clients and staff members. A Shareholders Agreement or Buy-Sell Agreement is used to memorialize the process. If the next generation isn't ready for a complete buy-out or the value is too great, the practice can be sold to an outside third-party buyer, either prearranged and documented or via a search function when the time comes to find the best talent and attract the highest offer from a competitive open marketplace.

Buy-Sell Agreements

For businesses or firms set up as an entity with two or more shareholders, the choice of continuity partner is fairly clear — a fellow owner or owners will be the best choice. If a Shareholders' Agreement or an Operating Agreement has been entered into, the choice is usually a matter of contractual obligation. In that a Shareholders' Agreement typically refers to a corporation, and an Operating Agreement refers to an LLC, this section will use the more generic term of a "Buy-Sell Agreement" to refer to a continuity planning agreement for multiple owners of any entity structure.

A Buy-Sell Agreement is a legal document that specifies how a privately held company and its owners will redistribute ownership in the event that one of the owners dies, becomes disabled, retires, or otherwise leaves the business. The agreement provides for a contractual covenant by each owner (and the company) to acquire or redeem the equity stake of any owner who departs, with the goal of providing payment of value to that individual or to their estate, and to ensure that the business enterprise survives. A Buy-Sell Agreement also helps to reduce or eliminate the complications of having a surviving spouse (or a son or daughter), or Uncle Charley, suddenly appear at the ownership table in the event their loved one dies or becomes permanently or temporarily disabled.

In the case of a privately held, independent financial services business, the primary goal of a Buy-Sell Agreement is to avoid conflict and confusion by keeping ownership and control in the hands of those individuals who will be responsible for managing the operations of the business. In other words, the goal of such an agreement is successful business continuity. It underscores the concept that a business enterprise can outlive its founding owner(s). A Buy-Sell Agreement is an integral part of a well-designed and longer-range succession plan. While Buy-Sell Agreements are common in most businesses across America, the continuation of a valuable, highly regulated business means this document takes on even greater importance.

MOST VARIABLE

Revenue Sharing Agreement

Requires that you identify another advisor to take over your client relationships in the event of your sudden death or disability. This must be signed by all parties and your broker-dealer, custodian, and/or insurance company.

Potential outcome: Typically taxed as earned income

Practice Emergency Plan

A plan designed to get your practice to market as quickly as possible with the knowledge of the key stakeholders.

Potential outcome: Valuation at or near market rates taxed at long-term capital gains rates

Guardian Agreement

Identifies a designee to take over the client relationships immediately, but specifies that this guardianship is temporary until the practice can be sold on the open market or per the terms of your buy-sell agreement.

Potential outcome: Provides a bridge to a sale or return of practice owner

Buy-Sell Agreement

Relies on fellow shareholders or owners as the continuity solution. The agreement is comprehensive and defines, in detail, the terms of the sale to support contining operations. Service is uninterrupted, and the advisor's estate receives market value (usually taxed at long-term capital gains rates).

Potential outcome: Defined sale terms + predictable, reliable, results

MOST SECURE

THE IMPORTANCE OF ACCURATELY DETERMINING VALUE

As financial services and advisory books, practices and businesses have grown more and more valuable over the years, the necessary function of determining value is now a part of every transaction, whether performed by a professional appraiser or by the application of a simple rule-of-thumb. When contemplating the value of a professional services practice, the first questions to ask and answer should focus on *what* is being valued and *why* it is being valued. When a sole proprietor sells a list of loyal clients, AUM and the accompanying cash flows, the clients are the medium being transacted for. Conversely, when one of three shareholders sells his or her equity stake in an LLC, stock is the medium to be valued. Stock, unlike assets, includes all expenses and all debts and liabilities, known or unknown. The valuation approaches and often the results are completely different and for this reason should be addressed in detail in the continuity agreement.

In some instances, especially with smaller books (roughly $150,000 in annual gross recurring revenue or less), the valuation process is addressed through the mechanics of the revenue sharing process. A buyer might agree to pay a seller, for example, 50% of every dollar received from the seller's clients for a period of three, four or five years typically. Simply put, however much money is delivered or paid in that timeframe based on the payment terms is the value and the answer to the question, what is my book worth?.

The benefit of this approach is that, especially under the circumstances of a continuity event, a buyer will only pay for as much revenue as they are able to retain over time.

An alternative rule-of-thumb valuation approach uses a Gross Revenue Multiple, or GRM. Many sole proprietorships or entities with just one owner or one primary owner prefer this method for its simplicity and ease of use and application and because it fixes a price at the outset – something the seller can depend on and the buyer can pay for using a promissory note. A simple GRM, for example, multiplies trailing twelve months (T12) gross revenue, usually fees and/or trails, by a multiple in the current, typical range of 1.00 to 2.50. The benefit to this asset-based approach for a buyer is that if they're able to retain most of the clients and assets, or AUM, and grow the acquired revenue stream in the years to follow, the value doesn't increase with the increasing revenues and AUM as it would using a revenue sharing approach. From a seller's perspective, negotiating and agreeing on a fixed price at the outset eliminates a lot of the risk of the highly variable revenue sharing approach.

As the gross revenue numbers start to climb, however, and as the amount of overall recurring revenue increases, the margin for error starts to greatly eclipse the cost and time commitment to have a formal, professional appraisal performed.

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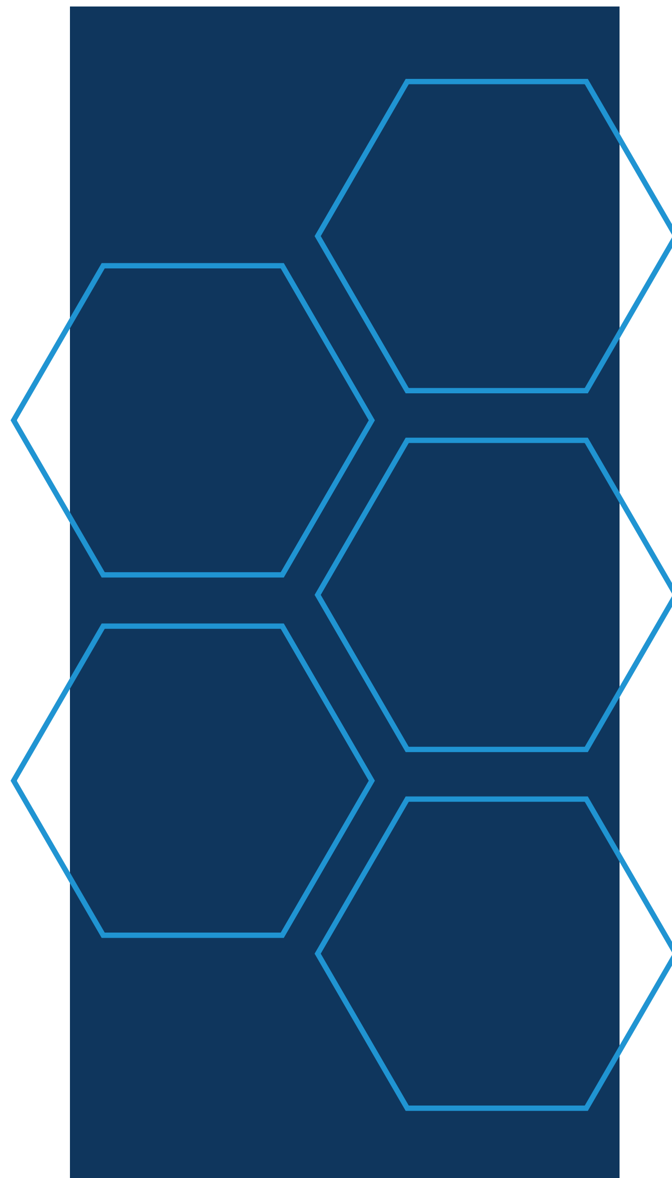
In addition, there is often a shift at some point to a stock-based transaction as larger, more valuable businesses typically utilize some type of entity structure. The benefit of having a third-party, equity-based valuation is that the results are impartial, are based on experience, are earnings focused, and most importantly take into account the underlying intricacies of a professional services business – client demographics, overhead, profitability, balance sheet issues (i.e., retained earnings, debt, and liabilities), regulatory issues, growth rates, geography, taxation, and more - issues largely ignored when using a rule-of-thumb. In addition, conventional or SBA-backed bank financing requires a professional appraisal in every instance.

Finally, it is important to recognize that continuity agreements are much more difficult to value given the inexact timing and circumstances of the transaction that is being documented in advance. What if the transaction occurs in the early months of a severe recession and the multiple is tied to a T12 gross revenue number? What if the continuity triggering event is precipitated by a stressful, serious regulatory event? What if the profitability is unusually low, or the demographics unusually poor? Rules-of-thumb are indeed simpler and easier, but they are not designed to address the myriad issues that often exist in a highly regulated, professional services practice.



FUNDING THE VALUE OF A CONTINUITY PLAN

Whether viewing the transaction as a buyer or as a seller, once a continuity agreement transaction is triggered and the value has been determined or agreed upon, the next major question is, “How will this transaction be financed?” The quick and simple answer is that every transaction will be either seller financed or bank financed, occasionally both – all cash transactions are rare. The more complete answer is more complicated, depending on whether the continuity agreement is between two sole proprietorships, two or more shareholders in a single entity, or two or more entities, just for starters. Add in the unique continuity plan issues of temporary vs. permanent disabilities, life insurance, and lump-sum disability insurance, and the funding options become, well … complicated!

The most important take away is that, whether you are the prospective seller or the buyer, you have many choices depending on what you’ve built and how you’ve built it, how you choose to construct your continuity plan and agreement(s), and who your continuity partner will be (third-party, key employee, current equity partner, family member, etc.). The following is a list of financing methods from simplest to most complex along with a brief description of the mechanics:

a) Cash Payment (In Full). Rarely used except to pay for very small books (less than $100,000 to $150,000 in value) and usually at a very steep discount.

b) Revenue Sharing Arrangement. A written agreement in which the buyer agrees to pay the seller a percentage (usually 30% to 50% in terms of a range) of every dollar received from every acquired client for a period of time, often 3, 4 or 5 years. This is a form of seller financing.

c) Earn-Out Arrangement. Part of a formal, asset-based sale and document set, an earn-out arrangement requires the buyer to pay the seller a set percentage of all revenue received from the acquired clients for a period of time or up to an agreed upon valuation amount, usually at long-term capital gains tax rates, preceded by a down payment. This is a form of seller financing.

d) Adjustable or Performance-Based Promissory Note. The most commonly used contingent seller-financing method, this promissory note is for a fixed amount, usually after a down payment is made, with a single “look-back” adjustment often on the one-year anniversary of closing in which the face amount of the note is adjusted, one time, based on the gross revenue transferred and retained by the buyer. This is a form of financing that can accommodate either seller financing, bank financing, or both.

e) Conventional or SBA Bank Financing. Live Oak Bank, to its credit, pioneered the wide-scale use of SBA-backed bank financing in the independent financial services and advisory space in the early 2010’s, but conventional financing was slower to evolve. Today, conventional financing is a viable option and widely available for unique transactions that may not qualify for an SBA loan. The use of bank financing can also usually accommodate a seller-financed element in the same transaction.

f) Insurance Funded Buy-Sell Agreement. Prospective buyers should always consider a life insurance funded solution if feasible, especially in a continuity plan/agreement. Insurance can be purchased by the individual or entity serving as a continuity partner (a prospective buyer) with specific terms and obligations for any balanced owed, provided in the continuity agreement.

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Most continuity agreements that involve a third-party buyer/continuity partner are paid for on a contingent basis over time. Most continuity agreements that involve multiple shareholders in an entity structure utilize a more complex financing approach, one that might involve life insurance proceeds, seller financing, conventional bank financing, or even SBA-backed financing. These equity-based, internal buy-sell transactions reflect the designed sustainability of the enterprise and the much lower transition risk when an advisor suddenly exits the business.

For buy-outs triggered by death, a life insurance policy held by the buyer (sometimes this is the business itself) on each of the owners can be an effective option for funding either a significant down payment or the entire purchase price. Lump-sum disability insurance is also an option for buy-outs triggered by disability, but in practice is rarely used due to cost and availability issues.

BEST PRACTICES

As you put together your own Continuity Plan and supporting agreement, here are the best practices to consider:

1. **Put your plan in writing.** Create a concise, clearly written continuity agreement so that it works under adverse circumstances and without your ongoing involvement.

2. **Review and update your agreement.** Read through it every year and make adjustments as necessary as your business evolves and grows in value.

3. **Use an industry-specific valuation** for market value in a contemplated transition to a third-party buyer or external continuity partner, or an equity-based valuation for equity ownership interests as is common with internal continuity partners or fellow shareholders. For situations like death or disability, it is important to quickly, and accurately determine value. Be sure the valuation opinion comes from a credible, third-party with the database and accreditation to support the result.

4. **Carefully and clearly define the term "disability"** in your continuity agreement. Many practice and business owners allow boilerplate language to define when an owner is disabled and must be forced to sell. The reality is most disability cases are not caused by something sudden or catastrophic. They are more often caused by things like a health issue that starts and stops unpredictably over time, or by the medical condition of an advisor's spouse or child that significantly alters their involvement and effectiveness on the job. Study the definition in your agreement carefully and make sure it fits the circumstances of your profession, your practice, and your life.

5. If you are a partner in a multi-owner business, **make sure that your continuity agreement addresses what happens in the event of the involuntary departure** of any one of the partners or shareholders – which could cause any one of the partners or shareholders to be a buyer or a seller. An owner who is asked to leave as a result of a difference in goals and objectives may be viewed very differently than a person who leaves because of performance issues or, even worse, significant regulatory violations. Draft these considerations as early as possible, while everyone is getting along and these issues are largely theoretical.

6. If you are a partner in a multi-owner business, be **mindful when two or more senior owners are of similar age.** An internal buy-out arrangement can easily require as many as seven to ten years (or more) in terms of amortization from start to finish. This can make the process impractical for a single remaining owner in their 60's.

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GETTING STARTED

In sum, as you contemplate setting up or amending your existing continuity plan and agreement, you have a lot of choices to make and, for the most part, you don't have to go it alone. FP Transitions commonly works with advisors needing a Continuity Plan on a flat-fee or subscription basis. Under one roof, you can receive coordinated and experienced help from a variety of industry experts including consultants, appraisers, analysts, M&A transaction experts, compensation specialists, and attorneys, all of whom specialize in working with independent financial advisors.

Base your plan on current facts, unbiased information, and expert guidance. Many advisors utilize FP Transitions' Equity Management Solutions® (EMS™) to obtain a formal valuation and set of benchmarks to guide their decision making. This basic but important information is the starting point for developing a practical, focused and successful plan for you and your business – when you and your family need it most.

Regardless of how or when your career and work come to an end, take control of the future and make your business work for you.

EMS™ ESSENTIALS

Fundamental business tracking and protection tools for practice owners who are looking to maximize the value of what they have or in preparation for a sale.

MARKET VALUE ANALYSIS

CONTINUITY PLAN

- Market Value Analysis
- Continuity Plan with Updates
- Acquisition Notifications
- Exclusive Member Tools + Resources

The above is adapted and excerpted from FP Transitions' book, "Succession Planning for Financial Advisors: Building an Enduring Business," published by John Wiley & Sons.

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