Top 10 Legal and Compliance Concerns in Investment Advisor Acquisitions

a complimentary whitepaper for registered investment advisors

Whether you are purchasing an advisory firm to expand your business, or selling your advisory firm to effectuate your succession plan, there are legal and compliance matters that will need to be addressed. Legal issues, tax considerations and federal and state laws and regulations will play significant roles in any transaction. Considering all these components before you commence a transaction is critical in structuring the transaction and obtaining a favorable result.

Legal Issues
The parties must first agree upon a structure for the transaction. The two most common options in unrelated party acquisitions are an asset purchase or a stock (or membership interest) purchase. The buyer and seller should each consult with its attorneys to determine which option should be pursued. Each option comes with its own pros and cons, and the relative positions and interests of the parties will dictate the option chosen. Although parties will typically choose an asset purchase, the purchase of the ownership interests in the seller’s advisory firm may be a better option depending on the parties’ circumstances.

The purchase agreement should fully set out the manner in which the buyer is acquiring the advisory firm, and how and when that acquisition will take place. Other critical components that should be addressed in the purchase agreement are: (i) payment terms and offsets; (ii) security for future payments; (iii) representations and warranties; (iv) indemnification; and (v) restrictive covenants. Client transitioning, including a timeline and the parties’ responsibilities regarding client contact, should also be addressed. (Client transitioning is discussed in “Compliance Concerns” below.) Post-transition items should be addressed as well. The purchase agreement must clearly set forth roles and responsibilities of all parties in order to minimize confusion for clients and employees.

Payment Terms and Offsets: The purchase agreement should clearly define how the payout for the ownership interest will be structured. If outside financing is not involved, a party should typically expect a 20-30% down payment with the remainder paid over time. Of course, there may be situations where this “typical” arrangement is not appropriate, or where outside financing permits a different payment structure. The payment terms must meet the seller’s financial needs, yet still be affordable to the buyer in terms of total price and continuing costs to the business during the payout period. The purchase agreement should set up a specific structure for future payments.

A well-structured purchase agreement would include “offsets” if a certain dollar value of assets is not transferred, certain types of assets do not transfer, certain clients do not transfer and/or a certain level of revenue is not generated over time. How to structure the offsets – for example, by way of reducing future payments – and the legal mechanisms for doing so must be addressed. The purchase agreement must also address how to handle advisory fees that have been earned by the seller prior to the closing, but not yet paid, and those fees that are earned by seller post-closing on clients who have been “sold” to the buyer.

If the total purchase price is tied together with employment and/or consulting agreements with the seller(s), the offsets may be tied to
further payments under those agreements, but the consequent tax effects on both parties must be addressed.

Security: The issue here is how the seller can secure its right to payment. Many buyers do not have the financial wherewithal to buy the business outright without financing. Thus, many buyers will be paying for the business, in part, out of the ongoing revenue generated by the “sold” clients. Because the buyer is acquiring advisory clients and associated goodwill, personal property in which a security interest can be given is generally not available. Depending on the nature of the transaction, the seller may take a security interest in the shares being sold (in a stock purchase scenario) or the buyer’s stock in his/her entity (in an asset purchase scenario). A personal guaranty from the buyer may be appropriate as well. (A personal guaranty to a lender would likely be required in any outside financing.)

The buyer can achieve some degree of security by structuring the payments over time, by including offsets or by applying a “hold-back” on certain payments. In addition, requiring the seller to be involved in servicing the transferred clients after the transaction will support transferred client retention for the buyer.

The structure of the security should be based on the structure of the transaction.

Representations and Warranties: It is important to know and understand the status of the assets, and actual or potential liabilities, of the selling entity. Due diligence should be conducted on these matters. However, the best protection comes in the form of precise representations and warranties from the seller confirming, for example, whether there are any regulatory investigations, customer complaints, tax liens, or liens of any kind against the assets of the selling entity. It is critically important that compliance issues affecting the selling firm, and its employees who will transfer to the buyer, are disclosed in the representations and warranties section of the purchase agreement. The seller should also expect to give representations and warranties on items that may impact the purchase price, such as amount of assets under management (AUM) with the seller, the nature of fees being charged and whether any changes in client relationships have occurred.

The buyer should expect to give standard representations and warranties (e.g., authority to enter into transaction) as well. Depending on the circumstances, additional representations and warranties by the buyer may be appropriate or necessary.

Indemnification: A purchase agreement will typically contain a promise by each party to indemnify the other against certain losses. Indemnification provisions in the purchase agreement must be negotiated and carefully drafted. Mechanisms such as caps, minimum loss requirements and holdbacks can be incorporated into indemnification provisions. These provisions will typically include notification and related procedures.

Buyers and sellers should be aware, however, that an indemnification provision is only useful to the extent that the party providing the indemnification is able to fulfill his/her obligations under that provision. With this in mind, buyers and sellers should consider whether insurance coverage for indemnification obligations may be appropriate.
Restrictive Covenants: Because the underlying client relationships drive the advisory firm’s business, the common wisdom is that the selling party should be bound by restrictive covenants after the transition. Those covenants can range from non-compete agreements that prohibit the seller from being in the advisory business for a number of years, to non-solicitation agreements that provide that the seller cannot solicit clients “sold” to the buyer for a number of years, to a combination of both. If the seller works for the buyer post-transition, these restrictive covenants may be broader in scope or time. The laws of certain states may impact the enforceability of restrictive covenants, so experienced legal counsel should be retained on this matter. The confidentiality of the parties’ information should also be addressed. All parties should document their compliance with their legal obligations to maintain and protect the confidentiality of their clients’ information.

Negotiated and well-drafted restrictive covenants will clearly define what business ventures and/or clients are – and are not – being protected in the future. Negotiated and well-drafted restrictive covenants will clearly define what business ventures and/or clients are – and are not – being protected in the future. Restrictive covenants allow the parties to avoid unpleasant problems that can arise in the future when the parties develop different expectations. The purchase agreement should also detail what happens if a party violates the restrictive covenants agreed to by that party, and who should be responsible for any resulting attorneys’ fees.

Tax Considerations
Tax issues can materially affect the purchase price. The tax treatment of the purchase price payments and tax rate to be assessed on those payments must be factored into the price being negotiated between the parties. Buyers and sellers should understand that all dollars under the purchase agreement are not equal, and tax considerations must be addressed in coming to the final terms of that agreement.

Acquisition Structure: If the acquisition is structured as a sale of stock, the seller receives capital gain treatment and the buyer takes no deduction for payment of the purchase price. The seller may also receive capital gain treatment on the sale of its intangible assets (i.e., book of business) in an asset purchase scenario. If so, the buyer can generally amortize the purchase price. The parties must discuss tax considerations when structuring the transaction. Each party should consult with tax professionals to examine and discuss that party’s particular tax situation and tax consequences of the contemplated transaction.

Restrictive Covenants and Employment: If a restrictive covenant is part of the transaction, the parties can allocate part of the purchase price to the restrictive covenant. Payments allocated to the covenant will be ordinary income to the seller, and deductible by the buyer over a period of years. Payments under an employment or consulting agreement would simply be compensation to the seller and deductible by the buyer in the normal course.

Compliance Concerns
Client Consents and Transition: The successful transition of the client relationships is the key to a profitable acquisition. Since the purchase price and payment stream are often based, in whole or in part, on the revenue stream generated by the “sold” clients, it is critical that clients transition to the buyer in a timely fashion.
In almost all acquisition scenarios, client consent to the transfer must be obtained. The parties can request that the client consent in writing to an assignment of the underlying client management agreement to the buyer. This type of affirmative consent is generally preferred. An alternative method for obtaining consent is through the process of “negative” client consent, whereby the client is notified of the pending transition and given an opportunity to object. In the asset purchase scenario, the clients can be requested to sign a new management agreement with the buyer.

Because the transitioning of the client relationship is critical, the purchase agreement should contain clear provisions as to the transition procedures, should delegate responsibilities for various transition matters, and should establish a timeline for transitioning the clients.

**Privacy:** Both the buyer and seller need to be aware of privacy concerns regarding disclosure of client information during the due diligence process. Generally, identifying information should not be disclosed without client consent. There are also privacy concerns on a post-transition basis depending on how clients are transitioned to the buyer.

The buyer and seller’s privacy policies should be examined and amended as necessary.

**Governing Documents:** The Form ADV, brochure and management agreement should be uniform and consistent on a going forward basis. Compliance concerns arise when these documents contain inconsistent provisions. Such a failure highlights a potentially significant problem: firm ownership is not concerned with compliance and regulatory matters.

At a minimum, a review of the following documents is necessary:

- **Form ADV and Brochure:** A purchase of an advisory firm or a change in control of an existing firm will require the Form ADV and the brochure to be amended. Because such amendments will likely be material, the revised brochure would have to be delivered to clients within a specific time frame. In all transactions, changes in the types of products used, fees charged, investment policies, custodial relationships, and ownership and control must be disclosed. If new conflicts of interest will exist as a result of the transaction, those must be disclosed, as well as any new “soft dollar” arrangement. U-4s and U-5s must be filed where appropriate. Depending on the circumstances, the seller may withdraw its registration after a transition period of time.

- **Management Agreement:** Depending upon the language of the seller’s management agreement, the buyer may wish to have the acquired clients sign a new management agreement, whether at the time of the transition or in the future. The buyer should ensure that the management agreement being used for a particular client is consistent with the arrangement for that client and the buyer’s business.

- **Compliance Manual:** An acquisition of a business often brings new products, new types of fees, new investment advisor representatives with differing backgrounds and new issues that may not be addressed in the buyer’s compliance manual. It is strongly recommended that the buyer have its compliance manual reviewed in light of the business to be acquired to determine if a revised manual is necessary.
Conclusion
The purchase or sale of an investment advisory firm raises numerous complex legal and compliance issues. To ensure a successful transaction, all such issues should be properly and fully addressed in a purchase agreement. Failing to address these issues during negotiations or in the final agreements between the parties can be costly to both the buyer and seller, and can expose both parties to unnecessary risk. Experienced legal counsel should be retained.

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