

The Importance of Practice Continuation Agreements

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Succession planning remains a top concern for partners of CPA firms small and large.

But what's the best course of action when you're a sole practitioner? While any professional should be mindful of the need for life planning and client transitions, those practicing on their own (solos) face distinct concerns and challenges compared to CPAs practicing within firms.

Hoping for the best is not a strategy that anyone advises for their clients, and yet, for many solos in the growth years of their practice, hope is all that is in place. Consider what would happen to your clients, your practice and your family's livelihood if you were to become disabled or unexpectedly die? Would your practice collapse, become worthless and leave your clients, employees and family in the lurch?

Fortunately, there are steps you can take to minimize and safeguard against such a train wreck and to better protect the value of your practice as a retirement asset.

Using a practice continuation agreement

Practice continuation agreements (PCAs) have become a popular planning tool for solos who are concerned about the future of their clients and practice in the event of an untimely death or disability. In a multiple-member entity, this kind of planning is normally covered by the partnership, shareholder or some form of buy/sell arrangement between the owners.

A PCA allows you to negotiate an arrangement with another accountant or accounting firm that closely mirrors the benefits of a typical buy/sell agreement; it also incorporates many of the critical terms that would be negotiated if the business were being sold to the third party. The terms of a PCA are essentially a hybrid of a buy/sell agreement and a contingent stock purchase agreement.

Step No. 1: Identify a potential practice continuation successor

Succession planning close to retirement focuses on receiving top value for the practice and a transition plan.

For the solo considering a PCA, however, the focus turns to, "If something happened to me next week, who do I know and trust to take over my practice on a moment's notice?" The answer to this question may not be the same as the party that might be chosen for a retirement sale of the practice.

PCAs can be structured as reciprocal agreements between two solos, or as agreements between a solo and a firm. The general terms are the same, but reciprocal agreements may look more like buy/sell agreements because each party is essentially agreeing to trust the other party with terms that they find fair regardless of which solo potentially winds up taking on the other's practice. PCAs negotiated between solos and firms may make more sense the closer the PCA is to natural retirement, and tend to look more like contingent purchase agreements.

Among the important qualities to look for in the potential PCA partner are:

- Integrity, character and professional reputation
- Compatible personality
- Appropriate level of experience and technical skills
- Communication and organizational skills
- Staffing capacity
- Geographical proximity

Step No. 2: Get organized

Assuming that the selected practice continuation partner does not work in your physical space or know your clients, imagine what it would require for someone to take on your practice tomorrow. The place to start is with a written office manual, and a plan to maintain and update the manual throughout the term of the PCA. Such a manual will also serve you well when the time comes to prepare your practice for a more traditional sale.

The manual should contain this important information:

1. Names, addresses, telephone numbers and job descriptions of any support personnel
2. Names and contact information for key third-party relationships (landlord, insurance carriers, brokers and attorneys)
3. The name and contact information for the personal representative or trustee of the solo's estate
4. Location, account numbers and signers for business and trust accounts
5. Location and access information for safe deposit box
6. Location and access information for storage facilities
7. Computer and voicemail access codes
8. Location of important business documents (leases, maintenance agreements, credit cards, client records, accounting records of business, employment contracts and insurance policies)
9. Location(s) of client files and records, including client lists and working papers

Step No. 3: Consider valuation method and purchase of insurance

Among the factors that make succession planning a challenge for solos is that client goodwill is 100 percent personal goodwill, by definition. This creates challenges for valuing solo practices, especially in the context of a PCA where a gradual client transition is not possible. When negotiating a value to be paid to you or your estate, especially in a reciprocal PCA, the agreed valuation method may be materially less than what might be negotiated in a strategic sale contract.

To make up the difference, each party is encouraged to purchase life insurance and long-term disability insurance. Because PCAs are only triggered in circumstances that can be partially funded through insurance, the parties can focus more on ensuring that the clients and personnel will be well-served. Perhaps, most importantly, an effective PCA can minimize the risk of a professional liability claim being made against the estate of the solo due to lapses in performance caused by unexpected practice interruption.

While some PCAs can be transformed in later years into traditional sales contracts, the expectation is that the valuation method should be revisited in the event that the transfer is based on a planned retirement.

Step No. 4: Remember client confidentiality

One obvious concern arising from the potential disposition of any accounting practice is the duty of confidentiality. Minnesota law imposes its own duty of confidentiality on client information and incorporates, by reference, the AICPA Code of Professional Responsibility. In addition, client tax returns and related information are fully protected by Section 7216 of the Internal Revenue Code.

Fortunately, both state and federal law allow the disclosure of client information — including highly-sensitive tax information — in connection with the transitioning of an accounting practice. Generally, there is no need to disclose client-specific confidential information at the time a PCA is being negotiated, except if there is a concern about a potential conflict of interest between the parties' clientele. In any case, an appropriate nondisclosure agreement should suffice.

Step No. 5: Sign a mutual nondisclosure agreement

Before negotiating a PCA, be sure to sign a nondisclosure agreement with these key provisions:

- Prohibit either party from disclosing the existence or terms of discussions
- Limit the parties' use of information to considering the prospective agreement
- Prohibit the parties from conducting any communication with employees or clients without prior authorization
- Bar each other from soliciting each other's employees or clients during the term of the PCA
- Prevent the disclosure or other use of client-specific information

Step No. 6: Draft and sign the PCA agreement

Once the right PCA partner has been identified and locked into appropriate confidentiality and non-solicitation restrictions, it is time to negotiate for a letter of intent. The letter of intent should anticipate all of the key provisions of the desired final agreement, including valuation methodology and payment terms. Normally, the parties also provide aggregated data to the other party, supplemented as may be deemed appropriate with client-specific information having all identifying particulars redacted.

The final PCA agreement should take into account the following factors:

- Protections for the heirs and trustees of the solo
- Specify the right to an accounting for the heirs and trustees
- Incorporate noncompete and non-solicitation clauses
- Perpetuate a confidentiality provision
- Protect against liability for pre-transfer legal claims through the purchase of insurance
- Allow for both complete transfer of the practice and transfer on a temporary basis in the event of a nonpermanent disability
- Protect the employees of each party with an agreement to continue their employment for a defined period of time

Step No. 7: Communication regarding the PCA

The final consideration is when and how to communicate with clients and others about the PCA agreement. Practitioners should consider three steps:

1. Include a right to transfer provision in client engagement letters.
2. Pre-sign a transition letter that can be sent out to clients by the PCA partner in the event of the practitioner's death or disability, explaining why the practitioner chose the other party to take over the practice. The letter should also ask that clients consider completing the forms necessary to transition their files to the PCA partner. Advise of their right to move their business elsewhere within a period of no less than 90 days, to be sent only following the practice terminating event.
3. Finally, inform your key employees and heirs of the PCA and the succession plan, so there are no surprises as to your wishes in the event of a sudden death or disability.

Step No. 8: Maintaining and updating the agreement

Because a PCA may be in place for many years (or even decades), it is important that the parties revisit the document periodically to ensure that the agreement still accurately reflects their wishes. Walk back through all of the steps, and remember the agreement can be revoked by either or both parties at any time.

Periodically, the solo will want to reconsider the PCA in view of these factors:

- Is the party you chose still the party that you would most trust with your clients' business?
- Is it time to consider an outright traditional sale of the business so you can retire?
- Is the valuation method chosen still appropriate, and do the levels of life and/or long term care insurance need to be adjusted?
- Has the business manual been properly maintained and updated?
- Has there been a material change to one or more of the party's practices that should be disclosed to the other?
- Have your staff or family relationships changed, and have new office managers and heirs been informed of the agreement?

If properly negotiated and maintained, a PCA agreement can be an ideal vehicle to give a sole proprietor the peace of mind to know that their practice, their clients and their family will be taken care of in the event that death or disability intervene before planned retirement, or traditional brokered sale of the business can be completed.

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Practice Areas

Professional Liability

