Accounting Firm Mergers

By Russell Shapiro

Merger activity among accounting firms has grown significantly of late. Allan D. Koltin, CEO of Koltin Consulting Group, commented that "2012 was another record year for CPA firm M&A. It represents the fifth consecutive year of increasing M&A activity, and the trend looks as though it will continue for some time. The increase in mergers is due to both succession planning issues as well as increased strategic planning opportunities."

This article addresses the legal aspects and process involved in combining two accounting firms and uses the following terms:

- *Partner.* An owner of an accounting firm, regardless of the form of entity.
- *Partnership agreement.* The documents governing the relationship of the owners.
- *Selling firm.* The firm that is being absorbed into a larger firm.
- *Acquiring firm.* The larger firm that is absorbing the selling firm.

General structure

Typically, the structure of combining two accounting firms is very simple. The most common structure is for the partners of the selling firm to join the acquiring firm and for certain assets of the selling firm to be transferred to the acquiring firm. Then, the selling firm is liquidated and wound-up over a period of time. This is not always the case. Sometimes there is a merger, and sometimes there is an acquisition of the selling firm's equity.

Business terms addressed in the agreement

Transfer of assets. Generally, the acquiring firm will acquire the physical assets of the selling firm. There may or may not be a value attached to those assets. Additionally, the acquiring firm may or may not acquire the receivables and the work-in-process of the selling firm. In either case, the benefit of those receivables and work-in-process will go to the selling firm partners and generally be used to fund the capital contribution of the selling firm partners in the acquiring firm.

Obligations to retired partners. All agreements will address how the obligations to the currently retired partners of the selling firm will be handled. Typically, the acquiring firm will assume these obligations. It is important to review the selling firm's deals with its retired partners because—in some cases—amounts or promissory notes payable to retired partners could be accelerated in the event of a change-in-control transaction. The obligations due to retired partners of a selling firm are taken into account by the acquiring firm in evaluating the economics of the transaction.

Retirement of current partners. The selling firm partners will typically get the same retirement benefits as the acquiring firm partners. However, this is not always the case for partners nearing retirement or founding partners of a selling firm who may get other retirement benefits. Additionally, it is not uncommon for partners of the selling firm to receive some type of assurance that they will not be divested of retirement benefits in the event that they leave before normal retirement age. Additionally, selling firm partners will receive vesting credit for their time at the selling firm.

Governance. As the selling firm partners are joining the acquiring firm, it is the acquiring firm's partnership agreement that will govern. However, selling firm partners may be able to negotiate for a seat on the executive committee or compensation committee for a period of time after the transaction, and they may also be able to secure an agreement that the selling firm's office will be the lead office in the metropolitan area in which it is located.

Capital accounts. The incoming selling firm partners will obtain capital accounts in the acquiring firm generally in accordance with the amount of capital contributed. As mentioned above, funds will typically be obtained from the working capital collected from the selling firm's accounts receivable.

Litigation. Each firm will have to understand whether the other firm is subject to material litigation. If a firm has exposure, provisions should be made to allocate this exposure to that firm's partners.

Guaranteed compensation. Compensation of selling firm partners is guaranteed typically for a period time—generally 12 months. This is conditioned on the selling firm offices generating roughly the same revenue as they did in the prior period in order to justify the compensation, and there may be an adjustment mechanism if that revenue is not reached. It is also common for there to be a discretionary bonus component for the selling firm partners.

Leases. Leases must be examined to determine whether landlord consent is required for an assignment of the leases to the acquiring firm. Additionally, if there are personal guarantees on the lease, the acquiring firm typically will agree to attempt to negotiate a removal of those personal guarantees at the earliest opportunity.

Transaction process

The transaction process in accounting firm mergers is very similar to the transaction process that any other company goes through in a sale-type transaction.

Confidentiality agreements. A confidentiality agreement is the first legal document in the transaction. The parties should enter into a confidentiality agreement that will require them to keep each other's information confidential, as well as keep confidential that they are engaging in discussions. Additionally, a confidentiality agreement will often have a "no poaching" provision, such that each firm agrees not to poach the employees of the other for a period of time in the event there is no transaction.

Letter of intent or term sheet. The next step is for the parties to outline the terms of their combination in the form of a nonbinding letter of intent or term sheet. This will encompass the terms of the transactions. There are usually a few binding terms. The first and most important binding term is what is referred to as a "no-shop" provision. That provision prevents the selling firm from trying to find another acquirer for a period of time—typically 60 to 90 days—during which time the firms will conduct due diligence and complete their definitive agreement. Sometimes, the acquiring firm will agree not to talk to any other firm in the same metropolitan area for the same period of time. Each party will also agree to bear its own transaction expenses.

Due diligence. The acquiring firm will want to undertake substantial due diligence of the selling firm and its partners, which will be from both a financial and legal perspective. The acquiring firm's due diligence will include an understanding of the following issues regarding the selling firm:

- finances;
- liabilities;
- insurance coverage;
- peer-review reports;
- potential conflict and independence issues; and
- all things relevant to the analysis of whether the transaction is right for the acquiring firm, and whether there are issues or problems in the business of the selling firm.

Likewise, and sometimes initially overlooked, the selling firm will also want to conduct similar due diligence (although not as extensive) of the acquiring firm. Particularly, the selling firm will want to understand the acquiring firm's financial condition and contingent liabilities. The selling firm may also want to review the peer-review reports of the acquiring firm and understand the conflicts and potential independence issues. Additionally, the selling firm partners may want to understand whether any partners of the acquiring firm have special or unique deals with the acquiring firm.

On-boarding of partners. Probably the most time-consuming aspect of accounting firm deals is getting all, or nearly all, of the selling firm partners on board. One can write an entire article on this subject. I will only write a little and caution managing partners that this will be a very time-consuming part of the work they do. Selling firm partners will be cautious about change, and the managing partner and the executive committee will invariably spend a lot of time at partner meetings explaining the transaction and its benefits. From a legal perspective, it is important for the firm leaders to make sure that the partners get adequate information about the deal in order to enable them to make an informed decision about whether to vote for the transaction. This will often entail a presentation by the acquiring firm's leadership. It should also entail a package of information, including financial information and contingent liabilities of the acquiring firm. The selling firm partners will have to understand the partnership agreement of the acquiring firm. In some cases, the acquiring firm's partners also will be voting on the transaction. Depending on the size of the acquiring firm and the size of the

transaction, authority may be vested in the acquiring firm's executive committee to consummate the transaction without a vote of the acquiring firm partners. However, that is not always the case.

Definitive agreement. While the due diligence is occurring, the attorneys are typically preparing what is referred to as the definitive agreement. The definitive agreement will include the business points and transaction structure as discussed above. It will include representations and warranties about the selling firm (*e.g.,* financial statement accuracy, status of litigation and disputes, matters relating to employees, intellectual property, and insurance). Essentially, the representations and warranties confirm the due diligence and bind the selling firm and its partners to what they have told the acquiring firm about the selling firm. Similarly (although to a somewhat lesser degree), the selling firm partners will want certain representations and warranties from the acquiring firm along the lines mentioned above.

One area of potential contention relates to the indemnification obligations for breaches of representations and warranties and other provisions of the definitive agreement. Generally, the acquiring firm will want to hold the selling firm and each of its partners jointly and severally liable for the full amount of any damages. Selling firm partners will want to have several liability (*i.e.,* responsibility only for their percentage share of the selling firm), and they will also want to have an indemnity limitation so that the maximum exposure is capped. These will be negotiated points. There will be other provisions that are dealt with in the definitive agreement (*e.g.,* the selling firm name may be tacked onto the acquiring firm's name for a one-year period at the office locations of the selling firm). Another provision often deals with the employees of the selling firm and provides that they will be hired by the acquiring firm at the same compensation levels, subject to signing the acquiring firm's employment agreement.

Finally, as mentioned above, the selling firm partners will join in the acquiring firm's partnership agreement. Individual selling firm partners may also enter into supplemental agreements with the acquiring firm to address specific issues.

Internal issues

There are a number of internal issues that have to be dealt with by and between the selling firm partners in connection with a transaction and the winding-up of their old business. They include the following:

- How will units in the acquiring firm be divided among the selling firm partners?
- How will other transaction consideration be divided among the selling firm partners?
- Will there be a true-up of capital accounts or loan balances?
- Should there be a general release among the selling firm partners for anything that occurred prior to the merger?
- If there is life insurance on the selling firm partners, what happens to it?
- Should the managing partner or some group of partners be designated as representatives of the entire selling firm partner group to deal with issues that may later arise under the agreement with the acquiring firm (like an indemnity claim)? Sometimes, the acquiring firm will want this provision.
- Because the definitive agreement may have joint and several liability, and thereby potentially expose partners to liability beyond their percentage share, will there be a contractual contribution obligation among the selling firm partners so that no partner is liable beyond his or her percentage share, except to the extent of his or her own personal misrepresentations or bad act?
- Will tail insurance be obtained by the selling firm to protect it from claims made post-closing based on pre-closing work? Generally, this is insisted on by the acquiring firm so that the acquiring firm is protected against claims of successor liability. Because professional liability insurance almost always covers "claims made and reported during the policy effective period," tail coverage is another way to describe what contractually is an extended reporting period for claims made after termination of the policy. It is prudent to get tail coverage for the longest possible statute of limitations period under which clients can file a malpractice claim post-closing. There are a number of considerations and options involved. For example, if a report will be issued after the closing date by the selling firm, the in-place insurance will have to remain in place for a period of time after closing before the in-place insurance is canceled and the tail policy becomes effective. In some transactions, the acquiring firm insurance carrier will provide prior acts coverage under its own in-place policy, which will be used instead of a tail policy. In that situation, additional premium expense may reduce the acquiring firm's purchase price by the amount of the premium, and any post-closing deductible payment or self-in-

sured retention cost in the event of a post-closing claim may be borne by the selling firm.

About the author: Russell Shapiro is a member of Levenfeld Pearlstein, LLC and serves on the firm's executive committee. He concentrates his practice on mergers and acquisitions, joint ventures, and management buy-outs. He also serves as outside counsel to several businesses. As a Certified Public Accountant, he brings significant tax and financial understanding to business transactions. From time to time, Russell also serves as an expert witness on merger and takeover transaction disputes. As an outgrowth of his corporate, CPA, and tax backgrounds, he acts as counsel to professional service organizations, including accounting firms, law firms, consulting firms, and investment banks and advises them concerning their partnership agreements, mergers and acquisitions, and enforcement of restrictive covenants. ✦

This article is reprinted with the publisher's permission from the CPA Practice Management Forum, a monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the CPA Practice Management Forum or other CCH Journals please call 800-449-8114 or visit www.tax.cchgroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH or any other person.