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Accounting Law Bulletin

A bulletin designed to keep clients and other friends informed on accounting law matters

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February, 1999

BUYING SELLING AND MERGING A CPA PRACTICE

By Dan L. Goldwasser

While it may seem hard to believe, there is a strong possibility that at least 50 of the largest CPA firms as of January 1, 1998 will have been dissolved or merged out of business by December 31, 2000. There are a number of reasons why this seemingly rash prediction is likely to come true. First, there are distinct economies of scale within the accounting profession created by the need to provide high levels of expertise in order to compete. Every aspect of professional practice requires significant expertise, which must be continually updated. Moreover, the demands on the profession to provide zero defect services require quality controls and review procedures which only a practice of a substantial size can support. Thus, the pressure to merge, in large measure, is driven by the economics of the practice.

Second, CPA firms are starting to provide a broader spectrum of services to each of their clients. Like McDonald's, the accounting profession has discovered that increased profitability can most easily be achieved by selling more services to existing clients than by selling the same services to a broader base of clients. This largely explains why so many accounting firms are now seeking to provide investment advisory and financial planning services to their individual clients. In order to provide those services, however, CPA firms must expand their rosters of professionals who possess the additional expertise needed to offer these new services.

Third, most small and mid-size accounting firms are faced with a successorship problem which frequently compels them to merge with other (usually more substantial) firms. Thus, CPAs who have worked hard to build their practices

may feel uneasy about the ability of their younger partners to continue their practices and to purchase and pay for those practices in the form of retirement benefits. Rather than take a chance on their successors' ability to carry on their practices, they opt to merge into a larger firm, thereby hoping to secure their retirement benefits. This problem has grown even more acute in recent years because of the rapidly changing nature of the practice, which adds even more doubt as to whether a firm's younger partners will be able to successfully carry on the practice.

Fourth, being able to compete in the future will also require substantial amounts of capital, both to fund the working capital needs created by expanding practices and to fund investments in new technology that will enable CPA firms to compete in traditional, cost-sensitive markets. Unfortunately, CPA firms do not have the luxury of seeking outside investors; and many banks are wary of extending substantial amounts of credit to professional firms. Thus, many CPA firms may seek to be acquired simply to satisfy their growing need for capital.

Finally, since the acquisition of Goldstein Golub Kessler & Co., P.C. by American Express Tax & Business Services, Inc. ("American Express"), the rate of acquisitions of accounting firms by non-traditional accounting firms (or consolidators) has greatly accelerated. These consolidators hope to provide comparable services with brand name recognition, which is likely to make it more difficult for independent CPA firms to continue to compete successfully. Many partners of small and mid-size accounting firms may therefore fear that they will suffer the fate of "mom & pop" retail stores when Wal-Mart opened a store in their towns.

While not every firm will succumb to the temptation to merge, there will be very few who will not consider that possibility. Indeed, no merger should even be considered without some clear objective to be achieved through the merger. Thus, each firm must adopt its own strategy for competing in a rapidly changing marketplace and must understand that many mergers fail to achieve the goals of both the acquiring and the acquired entity.

Assessing Your Practice

The first issue that any firm contemplating merger must

address is whether the firm's partners can continue to practice as an independent unit. In this connection, a firm must consider who is likely to be its competition and whether it will be able to maintain and attract new clients and staff. To do this, the owners must consider whether or not their firm will be facing lower price competition from large, non-traditional accounting firms, such as American Express, Century Business Services, HRB Business Advisors and Cornerstone Professional Advisors.

Second, the firm must consider the quality of its services and whether quality of service places it at an advantage or disadvantage with regard to its competitors. While every CPA firm likes to believe that it provides the highest quality professional services, more often than not, this is not the case. Therefore, CPAs trying to evaluate the future viability of their practices should exercise professional skepticism in assessing the quality of their services. Two objective guidelines are the peer review process and the extent to which the firm engages in continuing professional education. In addition, by serving on the technical committees of accounting societies, CPAs can obtain valuable insight as to whether they are practicing on a par with the firms with which they are competing.

No assessment of the future viability of an accounting practice would be complete without also considering the ability of the firm to attract qualified professionals. This is particularly true in a growing economy. A firm that finds itself constantly having to reduce its standards in making new hires must realize that it is sowing the seeds of its ultimate failure. While hiring problems might have once been considered a long-term precursor of a firm's decline, the pace at which the accounting profession is now changing has undoubtedly transformed it into a short-term indicator.

If the foregoing analysis raises questions as to a firm's continued viability, the firm's leaders must next assess whether or not the firm can adapt itself to survive in the new environment. Firm survival might be achieved by selling additional services to the firm's existing clients, by increasing productivity or by charging more for the services that the firm currently provides. While raising prices may be possible in some cases, in most cases, there may be few opportunities to increase fees for current services, as competing firms may have found ways in which to reduce their cost of providing traditional

services.

In assessing whether or not it can survive in the future, a firm must also consider whether it can generate the levels of revenue necessary to support the training and supervision costs that will be critical to its ability to compete. In most cases, CPA firms will have to expand their client bases in order to survive. A larger client base will enable them to invest in time-saving systems that will be necessary to provide services at a lower cost. Moreover, an expanded clientele will also support an expanded overhead structure, which will be necessary to provide the quality of services that most clients now demand.

To survive, most accounting firms will also need to recruit and maintain other professionals with expertise not currently available within the firm. In this way, they can provide additional services, as well as provide traditional services in industries that they do not currently service. The days of the general purpose auditor are rapidly coming to an end. When selecting an auditor today, most companies look for experience in their own industries. Conversely, most clients have little patience for professionals who hope to obtain their training at the client's expense.

Finally, in determining whether or not it can adapt to a changing environment, a CPA firm must consider whether it has the financial means to make the necessary changes its practice. Each firm must analyze whether it is sufficiently profitable today to make the appropriate investments in people and systems to enable it to expand its client base and scope of services. If the profitability of the firm has dropped to the point that the partners need all cash revenues simply to maintain their lifestyles, the firm may not be in a position to make the necessary changes, even assuming that its partners will be successful in adapting themselves to the changing environment.

Why Firms Sell or Merge

As noted above, one of the primary reasons why a professional firm explores merger is to be able to compensate its founders or other retiring partners for their interests in the firm. Another common reason for seeking a merger is that the firm cannot support the overhead that is required to sustain its operations. This is frequently the case with a firm that practices in the public company arena

and has lost one or more of its principal audit clients. In order to continue to service its remaining audit clients, the firm must continue to maintain a technical review partner and engage in substantial continuing professional education. The remaining audit clients may not be able to support this overhead, with the result that the firm is faced with the unhappy choice of either discontinuing its audit practice or trying to replace the lost client(s). In some cases, firms with declining practices or which have lost partners with significant books of business may find that their overhead is simply too high for their projected level of business. That overhead might consist of substantial obligations to former partners, large lease obligations or sizable support staffs that cannot be eliminated without incurring additional expenses or sacrificing the quality of client services.

Some firms may seek a merger simply because they do not have a critical mass of professionals within their firm to engage in substantial cross-selling. Thus, they may have a clientele with a substantial potential for revenue generation and no ability to tap that potential because they lack the requisite expertise to offer their clients the additional services their clients need and would gladly pay for. Thus, such a firm must either try to recruit that expertise or seek a merger with another firm that possesses the expertise required by the firm's clients.

Even if a firm has a sufficiently broad spectrum of expertise, it still may face difficulty in attracting and retaining qualified professionals. Firms that have been servicing a clientele that cannot afford to pay top dollar for professional services may find themselves at a competitive disadvantage in attracting qualified professionals. While the obvious answer is to try to service those segments of the market that can afford to pay more for the firm's services, such a transition cannot take place overnight, and the firm's assets simply may not be sufficient to enable it to undertake the necessary transformation in the firm's clientele. Thus, a merger may offer the only way for the firm to buy time to upgrade its clientele. This is particularly true if the future of the firm is highly uncertain, which would further jeopardize the firm's ability to attract qualified professionals, even assuming it had the resources to pay them a competitive rate of compensation.

Why CPA Firms Acquire Other Practices

Clearly, the most common reason for a CPA firm to engage in an acquisition program is to expand its client base. Expansion of a client base facilitates economies of scale, which can enable the firm to become a lower cost provider and more easily support its overhead. Some firms seek to acquire other practices because those practices have clients that are better able to pay for the firm's services. For example, an accounting firm that has traditionally serviced a manufacturing clientele whose fortunes have declined might welcome an opportunity to acquire a firm that services rapidly growing companies in fields that are able to pay top dollar for professional services. In this way, the firm can upgrade its clientele and its profitability.

Frequently, a firm will acquire another professional practice in order to obtain professionals with other areas of expertise that can be cross-sold to the firm's existing client base. In this way, the firm can expand the spectrum of services which it offers to its clientele and thereby achieve greater revenues from its existing client base. Having a broader spectrum of professional capabilities can also open new opportunities for the firm, enabling it to bid on engagements that it might otherwise not be qualified to undertake. While many firms attempt to service clients that require professional skills that they do not possess by joint venturing such engagements, joint venture arrangements are usually complex and not particularly attractive to clients who might prefer to deal with a single entity.

Finally, many accounting firms undertake acquisitions of other professional practices simply to obtain highly qualified professionals who might fill important leadership roles within their own organizations. Thus, a firm with a leadership void might wish to acquire another firm with one or more strong leaders who can help the acquiring firm better realize the potential represented by its professional staff and clientele.

The Seller's Analysis

While it is possible for a firm seeking to be acquired to simply make that fact known within the profession, this is not likely to achieve the best result. Indeed, no firm should engage in merger discussions without undertaking a thorough analysis of its strengths and weaknesses and assessing the qualities of the optimum merger partner.

One of the first points of examination should be an analysis of what the firm has to offer. Here, the firm will want to consider its client base and the scope and quality of the skills which it is able to offer. With respect to its clientele, the firm should look not only at the dollar volume of fees currently being generated by its clients, but also at the extent to which those clients might be able to pay higher fees for higher quality services as well as their need for additional services. If the firm concludes that it is currently charging its clients as much as they can possibly afford and is offering them the full spectrum of services which they require, then the firm must conclude that its client base has little untapped value that might be exploited by an acquiring firm. On the other hand, if the firm has only been able to offer its clients a very limited scope of services and certain of its clients would be willing to pay more for a higher quality services, its clientele might prove extremely attractive to an acquiring firm beyond its ability to absorb the acquiror's excess overhead. Second, the firm should examine the expertise which it possesses and should consider what firms or types of firms might best benefit from that expertise. For example, a firm that possesses a very good tax planning capability might be of considerable value to a firm with a sizeable audit practice that does not possess the same degree of tax expertise.

In addition to determining the assets which it would bring to any merger, the firm must also undertake a serious economic analysis of its practice in order to determine which acquirors would be economically compatible. In this regard, a CPA firm is not likely to be attractive to an acquiror whose per partner and per professional revenues substantially exceed its own. Such disparities normally exist as a result of the nature of services that are provided as well as the nature of the clients that are serviced by the firm. While many would-be acquirors might be interested in a practice that has greater per partner and per professional revenues, few would be interested in those with a lessor ability to generate revenues unless there were significant untapped resources within the firm. Similarly, a firm that lacks the resources to pay obligations owed to retired or retiring partners will also be of little interest to firms that do not have sufficient financial resources to meet those obligations.

In some cases, an acquiring firm may find untapped resources in its ability to cut operating and overhead costs.

For example, if the acquiror has invested in extensive computer tax preparation software, it might be able to service the acquired firm's clientele at a lower cost and thereby generate greater profitability from the acquired firm's clientele. Usually, such greater efficiencies are achieved only through eliminating staff, with a result that unless the acquired firm has other forms of untapped resources, it should face the reality that some, if not several, of its partners and staff members may not survive (or survive long) at the combined firm, even assuming that the acquiror agrees to take all of the acquired firm's professionals at the outset. Therefore, a firm that has relatively low revenues per professional is likely to find that it will be most attractive to those firms that are capable of providing the same type of services at a very low cost.

Firm compatibility should also be assessed in terms of salary structure of the partners and employees. If the acquiring firm pays its employees at a higher rate, the practice of the acquired firm may not be economical under the acquiror's salary structure. This is because it is difficult to have two separate salary structures within a single firm. While split salary structures are occasionally acceptable in different departments within a given firm, it is awkward, at best.

Compatibility of the firms must also be weighed in terms of whether their practices complement each other. For example, one firm may derive a substantial portion of its revenues from servicing the accounting needs of lenders, while the other firm may derive its revenues from the customers or potential customers of those lenders. While this alone would not preclude servicing both classes of clients, it could pose serious conflicts if the combined firm obtained adverse information concerning a borrower which might significantly affect one of its lender clients. Moreover, some clients object to their accountants' working with their competitors. Thus, before pursuing serious merger discussions, it is important to review each firm's roster of clients to determine whether, and to what extent, there may be client incompatibilities.

A final area of inquiry is to determine whether or not the firms might be compounding their problems through a merger. All too often, professional firms in trouble pursue a merger strategy in the hope of curing their problems. Unfortunately, merging one problem firm with another not

only may not cure their respective problems, but may even aggravate them, as big problems are clearly more difficult to solve than small ones. At best, the two merging firms may achieve some economies of scale, but they may only be able to solve their financial problems by significantly reducing their cost structures, which means that they must eliminate duplicative costs. Accordingly, they will likely have to terminate one or more partners and staff members in order to achieve the economies necessary to return the combined firm to financial health.

One of the first questions that most firms seeking a merger ask is what size merger partner they should be looking for. Unfortunately, this question frequently is resolved not on the basis of the economics of the two firms, but more on the basis of personality. For example, if a firm seeking a merger is controlled by a partner who wishes to exercise a leadership role in the combined firm, he or she may wish to only look for a merger of equals, rather than have his or her firm acquired by a much larger firm. While such considerations cannot be wholly discounted, it is more important to focus on what the firm is trying to achieve through the merger and to give primary emphasis to what type of acquirer is most likely to achieve the firm's goals. Thus, examining the economic compatibility of the two firms and the extent to which their practices complement each other should be given the greatest emphasis in determining the best merger candidate. As a practical matter, an individual partner who has real leadership skills is likely to rise to the top of the merged firm, irrespective of its size.

One recent development is the advent of a group of consolidators that are now seeking to acquire accounting firms around the country. These non-traditional firms are currently focusing on mid-size firms that are prominent within one or more of the 25 largest metropolitan markets around the country. In particular, the consolidators are looking for CPA firms with in excess of $10 million in revenues and which service middle market businesses and individual clients with high net worth. It is their intention to make such firms the focal points of their growth strategies; and the CPA firms that they find most attractive are those which view their acquisition as a means of expanding their practices with the resources to be provided by the consolidator. A strong management is a strong selling point for any firm wishing to be acquired by a consolidator.

Because consolidators are generally willing to pay top dollar for their "foundation firms," it is critical to their business strategies that such firms be well positioned to greatly increase their revenues and profits, as this will enable the consolidator to achieve a return on its investment. Most of the necessary expansion will have to be achieved through internal growth (which can be achieved by selling additional services to the firm's existing clientele) and by expanding the firm's clientele through better management and exploitation of the consolidator's brand name. Nevertheless, additional expansion will undoubtedly be achieved through the foundation firm's acquisition of additional (or "tuck in") firms with resources provided by the consolidator.

Perhaps, the main advantage of seeking an affiliation with a consolidator is the cash payments that will be made to the firm's owners, a very important consideration to those partners who are facing retirement. Non-traditional accounting firms, however, are generally looking for CPA firms that wish to build their practices using the resources which the consolidator is able to supply and will be turned off by partners who are simply looking to bail out of their practices.

Non-traditional accounting firms, however, have an ability to provide certain services to tax preparation clients at a reduced cost as well as to provide a wide variety of advisory services. Thus, a firm experiencing difficulty in making money out of a practice which is heavily dependent upon individual tax preparation services would find that its practice may have far greater value to a non-traditional firm. Conversely, an accounting firm with a large audit practice, may find that its practice could be jeopardized through an affiliation with a non-traditional firm, especially one that prevents acquired firms from accepting new public company clients.

The Acquiror's Analysis

Before any firm embarks upon an acquisition program, it must carefully analyze its strategic objectives. That means it must decide what it is trying to accomplish through its acquisition strategy and what parameters will be used in making acquisitions. For example, the firm may decide that it wants to broaden its base of audit clients to take greater advantage of substantial expertise in the audit area. Similarly, a firm might decide that it wants to acquire

other firms with specialized expertise that it can drawn upon to broaden its services to its existing client base or the firm simply may be looking to expand its total client base in an effort to more fully amortize its overhead costs. Whatever the objective or objectives of the acquiring firm, each merger candidate should be considered in terms of those objectives. Thus, the acquiring firm should carefully examine the client base, human resources, cash requirements, complementary skills, work ethic and culture of each potential candidate.

Second, the acquiring firm must consider the timing of any acquisition. For example, if it has recently completed a significant acquisition, it may not have the cash resources to fund the acquisition of yet another firm, no matter how desirable the acquisition of that firm may appear. Moreover, every acquisition involves a certain amount of assimilation; and it is not always easy to assimilate a very large group of new practitioners in a short period of time. There may be a period of growing pains following any acquisition; and an acquiror needs time to address the problems that may arise out of an acquisition before taking on additional problems.

Because many professional firms seek to be acquired to satisfy their cash needs, any firm engaged in acquiring other firms must carefully consider the cash needs of each potential acquisition candidate as well as its own ability to satisfy those cash needs. The acquiring firm must consider that the fortunes of an accounting firm frequently follow the fortunes of its clients and during a period of a weak economy, its clients are likely to forgo many services which the firm might otherwise offer and/or may balk at paying the firm's bills for past services. Thus, the acquiror's analysis should try to contemplate likely economic changes and their impact on the combined firms.

Getting Together

Once a firm has made the decision that it wishes to merge, it must locate the right merger partner. There are many ways of doing this, the most common of which is to let the firm's intentions be known among other accounting firms. Thus, at meetings of state and national accounting societies, firm partners can inform their friends and acquaintances of their firm's desire to engage in merger discussions. The accounting profession is a relatively tight-knit profession, and such statements of interest

generally travel fast. In addition, CPA firms tend to work closely with a number of law firms, which also come in contact with other accounting firms; and these associations are also a good way to make the firm's intentions known. Also, many accounting firms seek their merger candidates through advertisements in professional journals as well as through finders who specialize in putting accounting firms together.

While all of these approaches work, each has its advantages and disadvantages. Obviously, advertisements and business finders entail a certain cost which would not otherwise be incurred through word-of-mouth solicitations. On the other hand, by using a business finder, a firm looking to be acquired or to acquire other accounting firms can spare itself the trouble of dealing with those firms that might not make suitable merger partners and can avoid the image of being "shopped around."

Perhaps the best approach is for the firm to give serious consideration as to the qualities it would like to have in a merger partner and do its own research to determine which potential merger candidates best fit this profile. The firm can then make its own direct contacts to ascertain whether the selected candidates are receptive to merger discussions. While some firms might find this process awkward, in the long run it will be the least costly and the most efficient means of achieving a desired merger.

The Negotiations

Before engaging in any merger negotiations, each firm should have a very clear idea of the objectives it is trying to achieve and the parameters of the transaction it would like to consummate. In this regard, the firm should also consider alternative structures and reach some preliminary conclusions as to which alternative structures would be acceptable to it. In addition, it should determine what issues are not negotiable. By considering these issues in advance, the firm will be in a position to make quick decisions as to whether and to what extent it wishes to pursue further discussions with each potential merger candidate. For example, a firm that wishes to have all of its partners join the merged firm would be in a position to make a fast determination as to whether it wished to continue discussions with a firm that was only willing to take most, but not all, of the firm's partners. Similarly, a

firm which decides that it must receive a substantial cash payment as a part of the transaction should not waste time with a potential acquiror that simply is looking to merge the two firms.

It must be appreciated, however, that merger talks can be extremely destructive to any professional firm. This is because it is difficult to keep such talks secret and once known by the firm's employees, it may be difficult to retain the services of its employees. This is because the employees are likely to feel very insecure about the possibility of working for a new employer and may wish to have some say as to who that employer will be. Thus, if merger negotiations are to be undertaken, they should be undertaken quickly and should be broken off once it appears that a deal is not likely.

Just as employees may bolt a firm engaged in merger discussions, so too may the firm's clients. For example, a client that has had a bad experience with the proposed merger partner may look upon the proposed transaction not merely adversely, but as an affront to its own sensitivities. Thus, the firm could end up losing such a client even if the transaction is never consummated.

Just as a potential merger must be pursued quickly, the firm should take every effort to maintain the confidentiality of the merger discussions. The firm's management, having received approval of the firm's partners to seek a merger, should not publicly discuss its talks with any particular merger candidate until those talks appear to be proceeding toward a possible transaction. More importantly, each member of the firm who is informed of the merger discussions must be warned of the importance of maintaining secrecy and given explicit instructions not to discuss the firm's plans with any other employee of the firm and not to leave documents alluding to those discussions in places where they might be viewed by others. This includes documents stored in the firm's information systems. In this way, the firm can protect the integrity of its operations while merger discussions are proceeding.

When engaging in merger discussions, the negotiators should start with the basic terms of the proposed transaction, and only after agreement is reached on those matters should specific issues be addressed. In this way, time will not be wasted on minutiae if there is no

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fundamental compatibility between the two firms. The firms should first try to reach an understanding regarding the basic structure of the transaction and the compatibility of the two firms' economics, clientele and operating philosophies. If there is no understanding reached on these items, questions of partner compensation and firm governance need never be addressed.

In exploring whether the economics of the two firms are compatible, the parties should examine whether there are conflicts of interest among their respective clients and whether their billing rates and compensation scales are compatible. In regard to compensation scales, compatibility must be viewed at all levels, including with respect to partners, professional staff and non-professional employees. While minor variations are not likely to squelch a deal, any significant variation is not likely to be overcome and will ultimately stand in the way of consummating a proposed transaction.

It is also important for the firm's negotiators to find out whether either party feels that there is a *sine qua non* to its participation in the transaction. For example, the acquiror may only be interested in a merger candidate if it can deliver all of its principal clients. In such a case, before proceeding with further negotiations, some effort should be made to ascertain how the necessary clients would view the proposed transaction. Many firms seeking to be acquired may be reluctant to share with any of their clients (and, particularly, their major clients) their desire to be acquired. This is a subject of enormous sensitivity and the parties must decide at the outset how they wish to address the issue. In some cases, such an issue may only be resolved by agreeing that if one or more of the necessary clients cease to utilize the firm within a specified period of time, the parties will agree to demerge. Indeed, it is not uncommon for merger agreements to provide for a honeymoon period during which either party may rescind the merger on a *status quo ante* basis. It should be understood that most consolidators will not agree to the inclusion of a demerger clause, even though they may be open to discussing demerger if the transaction later proves to be a mistake.

Frequently, among *sine qua non* issues will be which partners of the acquired firm will become partners of the merged firm. While in most cases all partners of the acquired firm will be taken into the merged firm, the

management committee of the merged firm will likely retain the authority to terminate any partner. Thus, if a requirement of a merger is that all partners of the acquired firm must become and remain partners of the acquiror, it is important to review the provisions of the acquiror's partnership agreement (or by-laws or shareholders' agreement in the case of a professional corporation) to ascertain under what circumstances and terms a partner may be expelled.

Another common *sine qua non* of a professional firm merger is the extent to which the partners of the acquired firm will be given "years of service" for purposes of the retirement benefits provided for in the acquiring firm's partnership agreement. While such considerations are rarely among the first issues to be considered in merger negotiations, they are frequently deal breakers, even though in most case such issues can be resolved to the satisfaction of the parties. Nevertheless, they may be very important to the senior members of the acquired firm who may possess a veto power over any merger.

Another important consideration to be analyzed at the outset of negotiations is the compatibility of the personalities involved. It is not uncommon for many small accounting firms to be run on a collegial basis, with all partnership issues being voted upon by all members of firm. In mid-size and large accounting firms, however, managing partners are frequently given the power to manage the firm's practice, and a personality conflict with any such managing partner may be a precursor of a short-lived relationship. Thus, the partners of the acquired firm should carefully consider whether they would feel comfortable practicing in a firm that is managed on a day-to-day basis by the acquiror's managing partner. Unfortunately, personality conflicts are not always present at the outset of negotiations. Nevertheless, reasonably good insight into the personality of a managing partner can usually be obtained simply by speaking with former partners of the prospective acquiror.

In order for merger negotiations to proceed beyond the preliminary stages, it will be necessary for the firms to share certain data. This is particularly important in the case of the firm to be acquired. Such data will normally include several years of financial statements, a list of clients with the revenues derived from each major client over the past few years, aggregate data about the types of

services provided by the firm and the volume of revenues derived from each type of service. The firms should also share payroll and billing rate data so that compensation scales and billing rates of the two firms' professionals can be compared.

Naturally, no professional firm wishes to make such data known to others without confidentiality protections. The parties should, therefore, enter into a confidentiality agreement providing that, unless otherwise waived by the supplying party, all materials supplied in the course of merger discussions will be kept confidential and will be returned to the supplying party if and when merger negotiations are discontinued.

As a practical matter, merger negotiations must be conducted by a limited number of individuals on each side in order to maintain their confidentiality and efficiency. Once the basic terms of the transaction have been determined, it may be possible for the remaining partners of the firm to be acquired to meet with the negotiators (and possibly other partners) of the acquiror. Such meetings, however, should not be held until substantive merger discussions are approaching their conclusion. In this way, not only is confidentiality protected, but also the time of the remaining partners can be concentrated on servicing the firm's clients.

Negotiations with a consolidator generally tend to be far more complex, both because the deals tend to be more complex and because of the additional regulatory considerations. Rather than simply merging practices, a sale to a consolidator is likely to involve cash payments. Thus, the amount, timing and conditions to these payments must be agreed upon. In addition, some acquisitions by consolidators provide for payments in the consolidator's securities. In these transactions, there must be some basis for determining the value of the stock, a series of covenants designed to protect the value of those securities, as well as restrictions on the resale of those securities.

Because consolidators may not provide "attest" services, it will also be necessary to separate the firm's attest and non-attest services. This is usually done through a "separate practice" agreement under which the acquired firm's partners receive a license to continue to perform attest services and a "service" agreement under which the consolidator agrees to lease back facilities, services and

employees to permit the partners of the acquired firm to conduct their "separate practice." Thus, these transactions tend to involve far more issues than mergers of two CPA firms.

Equally significant are the remaining regulatory concerns. There are still a great many states that have not taken a position on whether the "separate practice" format complies with existing state regulations. This means that in such a state, there is a lingering possibility that the state might find that the performance of accounting related services through a non-CPA-owned firm violates its law. Similarly, there is a possibility that the state might conclude that the separate practice is, in fact, owned and controlled by the consolidator, thereby precluding the acquired firm from continuing to offer attest services. While these possibilities are relatively remote, they add further complexity to the negotiations.

The Acquisition Agreements

In addition to a confidentiality agreement, the parties will undoubtedly wish to negotiate a merger/acquisition agreement spelling out the terms by which the firms are to be combined. It is important for the parties to agree upon the terms of the combined firm's partnership agreement as that agreement will govern the future operations of the firm and the terms under which the firm's partners will be compensated and the firm will be managed. The partnership agreement also will include provisions relating to the withdrawal, expulsion and retirement of firm partners, which are clearly critical provisions for the partners for the acquired firm who are yet to prove themselves to the management of the combined firm. Consolidators may also wish to enter into an employment agreement with each individual partner of an acquired firm.

One of the issues that the negotiators must work out is how detailed the agreements need be. CPAs must bear in mind that agreements are only pieces of paper with writing on them, and only evidence legal rights if the parties are willing to go to court to enforce those rights. Therefore, there is little to be gained by negotiating minute details of the transaction. It is usually far more important to develop a sense of trust and goodwill among the parties so that issues may be resolved quickly and smoothly if, and only if, they actually arise.

Acquisition agreements should record the major terms of the transaction, such as which partners and employees of the acquired firm are to become partners and employees of the merged firm, their compensation and the amounts to be credited to the capital accounts of the acquired firm's partners. In many cases, compensation will be defined only in terms of partnership points or units, and a significant portion of a partner's annual compensation may be based upon bonuses awarded for specific contributions. Thus, there is likely to be no fixed amount of compensation attributable to any specific partner.

Many of the more important terms are likely to be found in the acquiring firm's existing partnership agreement. These are likely to include how the firm is to be governed, the terms under which a partner may withdraw or be expelled and the moneys a partner will be entitled to receive in those events. The partnership agreement is also likely to include a list of covenants pertaining to each partner as well as restrictions on servicing firm clients following withdrawal from the firm. Such provisions frequently prompt many firms to negotiate a demerger clause which permits the acquired firm to demerge within a specified period under terms not governed by the acquiring firm's partnership agreement. Demerger clauses thus enable the firms to proceed quickly without ironing out all issues on the understanding that will be addressed during the honeymoon period. If they are not addressed to the satisfaction of the acquired firm, it has the right to rescind the merger.

The parties should reach an understanding on how they will handle claims that arise out of acts taken prior to the merger and what insurance coverage the parties will obtain to cover such claims. This is frequently a sensitive issue, and its resolution may depend upon the state of the insurance market at the time of the transaction.

Similarly, agreement must be reached regarding who will take responsibility for leasehold and bank obligations of the acquired firm as well as continuing obligations to the former partners of the acquired firm. While these would normally become the obligations of the acquiring firm, in some cases they remain the obligations of the partners of the acquired firm. This usually happens when a substantial number of partners of the acquired firm do not participate in the transaction.

To be sure, the firms' lawyers will add numerous other provisions, including representations and warranties and conditions to closing. These provisions, while commonly thought of as being standard or "boilerplate" clauses, are an important part of the due diligence process, helping the parties to focus on important information regarding the practices of each firm. Because a violation of these provisions could give rise to a serious claim for damages or cause the merger to fail, they must be given careful attention.

Conclusion

At some point during the next three years almost every CPA firm is likely to give serious consideration to merging its practice with another firm. The important thing is to focus clearly on the objectives to be achieved through a merger. If those objectives cannot be met, the merger should be aborted.

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