JOURNAL OF ACCOUNTANCY ONLINE

PRACTICE MANAGEMENT

Untying the Knot:

Planning for a De-Merger

A well-drafted agreement eases the pain if a CPA firm merger goes sour.

by Joel Sinkin and Terrence Putney

EXECUTIVE SUMMARY

A merger process should include planning for a de-merger and establishing a sound agreement if a de-merger subsequently becomes necessary.

De-merger agreements define how to treat specific issues if a de-merger has to take place. Items to consider addressing in a de-merger agreement include:

- Protecting the original client relationships of each firm
- Treatment of new clients acquired during and after a merger
- Staff
- Office facilities and infrastructure
- Partial de-mergers in the event that one or more partners wish to leave a combined firm under a predetermined set of conditions
- Merger costs

Most mergers include issuing the equity of one firm or a newly formed firm to the partners of one or both of the merging firms. Affiliations involving the "purchase" of one firm by the other might involve acquiring the value of one firm for consideration other than the issuance of equity.

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Celebrity divorce is often the cause of rampant public speculation, especially if a prenuptial agreement is not in effect. While a prenup agreement is an obvious necessity to some, planning for divorce is rarely at the top of anyone's list when entering into marriage. Similarly, when two accounting firms agree to merge, they focus on the deal's positive aspects and invest significant time in due diligence to ensure the merger will be successful. But having a sound de-merger agreement in place may also be a prudent part of the merger planning process.

WHY MERGE?

In 2001, a $1 million firm and an $8 million firm decided to merge. The merger presented exciting opportunities for growth and cross-selling, overall operational effectiveness, and a better synergy of talent. Each firm gave up its current office space and relocated to a larger space that accommodated both firms.

Six months into the merger, things were not going well. Unforeseen cultural and personality differences were contributing to a crisis, and the firms decided to de-merge and return to their former arrangements. Because they did not have a de-merger agreement in place, they were forced to "undo" the plans that had been created through the merger. At first, the de-merging of the firms went pretty well. They quickly resolved that each firm would take back its original clients (of course, they had to break the news to their clients that they were switching them again to the "old" firm). However, both firms had clients they wanted to trade to better serve their needs. Things became complicated when the larger firm wanted the smaller firm to pay for new clients the smaller firm had developed after the merger had started. Due to its reputation, the larger firm felt the smaller firm would not have been in a position to generate new clients had it not been for the merger and the backup support provided by the larger firm.

Other issues compounded an already contentious situation. The larger firm was now on the lease for the new office space but couldn't afford to pay the overhead. The smaller firm had given up a lot of its hard assets to make the move and now had nowhere to go. Further complicating matters, a few staff members wanted to switch firms; the potential existed for some clients to do so also.

When our firm was called in to help, it was obvious that a de-merger clause would have saved a lot of headaches.

We have consulted on more than 850 transactions over the past 16 years. Of those, approximately 150 were pure mergers (not for the purpose of succession) and 75% of those mergers had a de-merger clause in their agreement. The suggestions in this article are based on those experiences.

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Terms to Address in a De-Merger Agreement

De-merger agreements define how to treat very specific issues if a de-merger has to take place. Each merger is unique and requires special considerations. The time during which a de-merger can be exercised under the terms of the agreement should range from as short as possible (for example, the next tax season) to two years. The longer a de-merger option is available, the harder it is to merge the firms into a cohesive team. While a de-merger clause is still effective, partners and associates of both firms are likely to protect their turf to maintain their viability if something should go wrong.

Protect Client Relationships

A primary objective of a de-merger plan should be to protect the original client relationships of each firm where possible. Identify each firm's clients and create restrictions that prohibit competition for those clients for an agreed-upon time, up to several years. Most client relationships are easy to assign to each party. This is normally handled by attaching lists of existing clients to the merger agreement on the date of the merger.

Sometimes, clients are shifted to partners or staff of the other firm. This may be due to special expertise, pending partner retirement, or capacity or location considerations. Even when it's not intended, a client may prefer to remain with the new firm instead of staying with its original firm (after a de-merger has taken place). Rather than attempting to force the client to accept a solution that is not in its best interest, it is better for all parties if the firm losing the client "sells" the client to the firm retaining the relationship.

Example. Firm A, with a $2 million practice, merged with Firm B that has a $1 million practice. A de-merger is triggered and after sifting out all the clients that shifted allegiance, Firm A retained $1.8 million in clients and Firm B retained $1.2 million. Firm B is required to "buy" the $200,000 in clients it acquired based on an agreed-upon valuation formula. In this case, Firm B would typically agree to pay a premium, between 1.25X and 2X, with little to no retention considerations for taking more than it brought into the merger to ensure the firms have no incentive to steal each other's clients.

New Clients

The treatment of new clients developed after a merger is trickier. If a de-merger is put into effect, it is best to allow clients that are developed and served by a partner of one firm to remain with that firm if they choose. Two basic approaches are used to assign value and determine compensation for new clients:

1. Assume the firm that retains the relationship has earned the value and, therefore, no compensation is required.
2. Assume new clients are shared pro rata and account for any disproportionate allocation (based on relative equity of the two firms) with an agreed-upon valuation formula.

Sometimes a partner or associate in one firm develops a client relationship, but the client is assigned to someone from the other firm who retains the relationship after the de-merger. Or a client may elect to stay with the "other" firm due to size, location or other considerations.

Example. Firm C and Firm D merge. Firm C was assigned 60% of the equity at the merger. During the time the firms remained merged, $500,000 of new business was generated. After the de-merger, Firm D retains $300,000 of the new business. An allocation based on relative equity would require Firm D to compensate Firm C for $100,000 of excess new business it retained. This payment is typically structured based on retention and collection of this new client going forward at a reasonable multiple, for example, 1X their equity share.

Example of a De-Merger Clause

De-merger agreements have unique aspects that can range from one to five pages. The example below is an abbreviated version that covers the critical aspects of de-merger language. It is a compilation of several agreements that were written by attorneys. **Consult an attorney before writing or signing a de-merger agreement.**

DE-MERGER

At any time up to XX/XX/XXXX, upon 90 days written notice, which may not be delivered between Nov. 1 and March 1, or at any other time that the FIRM and FIRM 2 mutually agree to terminate this AGREEMENT,

(A) Either Party may, by notice (the "NOTICE") delivered to the other Party, exercise their DE-MERGER OPTION, terminate the affiliation and not be bound by the terms of this AGREEMENT except the provisions of this section.

(B) In the event the DE-MERGER OPTION is properly exercised

a. The clients listed on Exhibit A (hereinafter "CLIENTS") shall no longer be deemed clients of the FIRM and FIRM 2 may take such CLIENTS with them under no penalties or restrictions.
b. All other FIRM clients shall not be solicited or retained by FIRM 2
c. In the event a CLIENT indicates a preference to remain with the FIRM, the FIRM shall reimburse FIRM 2 based on the terms __________ (list mutually agreeable terms here).
d. The outstanding accounts receivable and work-in-process of the CLIENTS shall remain assets of the FIRM.
e. A list of the outstanding accounts receivable for the CLIENTS as of the date of the de-merger (hereinafter "DE-MERGER A/R") and a list of the work-in-process for the CLIENTS as of the date of the de-merger (hereinafter "DE-

MERGER WIP") will be provided to FIRM 2 by the FIRM within 30 days subsequent to the date of the de-merger. Such lists shall include a statement signed by an authorized representative of the FIRM that the list is true, accurate, and complete.

f. FIRM 2 will complete any DE-MERGER WIP, invoice and divide the collections derived from completion of such DE-MERGER WIP pro rata in accordance with the time each Party devoted to each such case.

g. Any collections received by the FIRM from CLIENTS subsequent to the date of the de-merger shall be considered to be collection of DE-MERGER A/R and collection of DE-MERGER WIP for a specific CLIENT until the DE-MERGER A/R and DE-MERGER WIP for such CLIENT is satisfied in full. Any collections made by FIRM 2 from the CLIENTS subsequent to the date of the de-merger shall be considered to be payment of DE-MERGER A/R and DE-MERGER WIP due to the FIRM for a specific CLIENT as of the date of the de-merger until the DE-MERGER A/R and DE-MERGER WIP for such CLIENT is satisfied in full. FIRM 2 shall remit to the FIRM any such collections within 30 days of such collection.

h. The collection of DE-MERGER A/R and DE-MERGER WIP shall be considered COLLECTIONS and FIRM 2 shall be paid compensation related to such COLLECTIONS. Such compensation shall be paid to FIRM 2 by the FIRM on the 15th day of the month following the month of collection.

i. FIRM 2 shall have the right to take the specific assets contributed by them in Exhibit B of this AGREEMENT.

j. FIRM 2 shall have the right to employ any employees of the FIRM that were employed by FIRM 2 prior to the EFFECTIVE DATE of this AGREEMENT (hereinafter "PRIOR EMPLOYEES").

k. In the event an employee of the FIRM that is not a PRIOR EMPLOYEE indicates a preference to leave the FIRM and become employed by FIRM 2 and FIRM 2 elects to employ such employee (hereinafter "LEAVING EMPLOYEE"), FIRM 2 shall pay FIRM a fee equal to 20% of such LEAVING EMPLOYEE's annual base compensation in 12 equal monthly installments commencing on the 15th of the month following the month of NOTICE.

l. FIRM 2 shall have the right to sublet from the FIRM for up to 6 months, or through April 30 following the date of NOTICE in the event that NOTICE is delivered after June 30 of a calendar year, the office and area used by any FIRM 2 members, PRIOR EMPLOYEES or LEAVING EMPLOYEES at the time of such event and will pay the FIRM rent based on what the FIRM pays the landlord per square foot FIRM 2 utilizes plus an additional 25% for reasonable use of the software, furniture, fixtures, equipment, internet connectivity, telephone systems, and other such infrastructure necessary for the operation of an accounting office in same manner the FIRM operates at the time of NOTICE. FIRM 2 shall also reimburse the FIRM for any direct out-of-pocket expenditures incurred by the FIRM as a result of FIRM 2 continuing to operate in the offices of the FIRM.

STAFF

In today's marketplace, the value of staff is at an all-time premium. Staff members should return to their original firms in the event of a de-merger. However, their wishes should be considered. If one firm retains a disproportionate amount of staff following a de-merger, compensation similar to the fee paid a recruitment firm may be appropriate. The normal range of compensation should be 10% to 30% of annual salary and should be agreed to as part of the de-merger agreement. Compensation creates capital for the affected firm to replace lost staff and is also a disincentive to "recruit" staff to switch firms.

OFFICE FACILITIES AND INFRASTRUCTURE

When the two firms have not moved in together, this issue is rarely difficult to address in a de-merger clause. Each firm remains in its space and goes on as before. If the firms moved in together, the separation has to address infrastructure. This part of the agreement has two objectives:

Allow both firms to continue to operate after the de-merger with as little disruption as possible.
Protect both firms from the commitment for long-term investments in infrastructure.

If the space that will be left unoccupied in the event of a de-merger is not material to one firm, a three-month transition period to find and equip new space for the smaller firm is normally adequate. If a material amount of space will be left unoccupied, the agreement should allow for the space to be subdivided, and each firm then assumes its share of the cost going forward until other arrangements can be made.

Similar issues must be addressed for computer networks, telecommunication systems and other shared infrastructure. Agreements often allow for a transition period where the systems continue to be shared and, in some cases, sharing the cost of a new system for one of the firms may be built into the agreement as well.

When Is a De-Merger Clause Not Appropriate?

Client relationships usually make up the bulk of an accounting firm's intangible value. When one firm is buying the equity of the other, a transfer of client relationships to cement the purchase of the assets usually takes place. Once the client relationships have been transferred, it is difficult to go back. Therefore, when it is anticipated that client relationships will transition soon after the affiliation, it is not advisable to allow one firm to back out of the agreement through a de-merger clause. The only way for the "selling firm" to mitigate the risk that the acquiring firm would exercise its right to de-merge is to delay the client transition process. Delaying client transition would defeat one of the key objectives of this type of merger.

A de-merger clause in a merger that is essentially a near-term acquisition creates the risk that either firm has the option to make a deal today and a better deal tomorrow. The "buyer firm" has made significant investments in new infrastructure, deal costs and marketing. If the "seller firm" finds a better deal and exercises its right to de-merge, the investment will be lost. Conversely, the buyer firm may invoke the threat of a de-merger as a way to negotiate a better deal even though the buyout was set in the merger agreement.

In cases where the risk of irreparable harm from a de-merger is significant for some but not all the partners in one or both firms, a de-merger option that applies to only some partners may be appropriate.

PARTIAL DE-MERGERS

De-merger clauses sometimes allow a partner to leave the combined firm during an agreed-upon window even if the rest of the partners will remain. In such cases, discontented partners are often allowed to leave with clients whose volume is equal to the partner's equity interest in the firm. If the volume of clients the partner leaves with is less than his or her pro rata share, compensation may be provided for the shortfall. If the volume exceeds the pro rata share, compensation should be paid, often at a premium, to what is considered market value. This discourages aggressive recruiting of clients by the partner who is leaving.

Another popular approach is to prohibit partners that leave from taking any clients. In these cases, a buyout of their equity is probably appropriate. The downside risk of this solution might be significant enough to some partners to preclude a merger from being consummated in the first place.

MERGER COSTS

In almost every merger one or both firms incur closing costs. These costs include but are not limited to legal fees, moving expenses, technology investment, consulting/brokerage fees, leasehold improvements, and furniture and equipment. Often, one firm (usually the larger if substantially different in size) bears most or all of these costs. However, a de-merger clause may require a retroactive allocation of the costs to both firms. This creates fairness and can be a disincentive for one firm to trigger a de-merger without good cause.

COMBINATION AFFILIATIONS

Normally, in a merger, equity in one of the firms or in a newly formed firm is issued to the partners of one or both of the firms.

Affiliations involving the "purchase" of one firm by the other might acquire the value of one firm for consideration other than issuing equity. An example of this would be where Firm A merges with Firm B. Firm B has four partners. Part of the merger had Firm A buying out two partners of Firm B and the remaining partners merging into Firm A. In cases involving a combination of some equity and some purchase, a de-merger clause is normally appropriate when the equity being acquired through purchase is not substantial. If the purpose of the merger includes succession within approximately five years or less from the onset of the merger, a de-merger clause would not be appropriate.

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In a combination affiliation where some equity is acquired for cash or deferred compensation in the transaction, the equity may need to be acquired from the party that paid for it if a de-merger option is triggered.

Example. Firm A merges into Firm B. Four of the partners of Firm A, who own 80% of the equity in Firm A, received equity in Firm B as a part of the merger. One Firm A partner was bought out in the transaction and received deferred compensation from Firm B to be paid over five years. After two years, the de-merger clause is triggered and Firm A de-merges. The partners of Firm A should be required by the de-merger clause to reimburse Firm B for the payments made through the date of the de-merger and to assume the liability to the Firm A partner who was bought out.

DISADVANTAGES OF DE-MERGER CLAUSES

Normally, mergers create synergy through cross-selling services, opening new markets, creating stronger brand identity, absorbing excess capacity and eliminating redundant costs. All of these require change and commitment. Discussing the potential for that commitment and investment to end in a de-merger is not conducive to an effective team-building environment. The easier it is to unwind the merger, the less likely the parties will be to work out their differences and keep the firms together.

Firms surviving a de-merger are likely to be, at least for some time, weaker than they were before the merger. In extreme cases, viability of one or both firms may be at stake.

DOCUMENTATION

A de-merger agreement must be included in the merger agreement and be as specific as possible. It is not advisable to negotiate this after the fact. Leave as little as possible to decide later. In addition to the major issues addressed above, the method of handling accounts receivable, work in process, and professional and other liability incurred while merged should be considered. (See section B of the sample de-merger agreement for an example of how to address accounts receivable and work in process.)

AICPA

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September 25, 2007

Joel Sinkin
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Dear Mr. Sinkin,

I am very pleased to write this note of gratitude on seeing your article, "Untying the Knot: Planning for a De-Merger", in the October 2007 issue of the ***Journal of Accountancy***. It's the work of contributing members such as you who make the *Journal* the respected publication that it is.

I also want to congratulate you for writing a piece that successfully passed through the layers of rigorous review that the *Journal* requires. The first step in that process is a review by your peers, the publication's advisory board of CPAs, who agreed that your article would be a valuable selection for the profession—that is an honor of the highest magnitude.

Thank you for sharing your talent and experience with the accounting profession.

Sincerely,

AICPA

B. C. M

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