

CAMICO: War Story No 82 – Firm Merger

Subject: Proposed firm merger, high due diligence

Services: Tax, investments

Clive Little, CPA, was interested in merging his tax practice with the practice of another accountant, Victoria Hugo, CPA, who was interested in retiring in a few years. Hugo also provided tax services as well as investment advisory services. The merger was to be preceded by a trial period of about 12 months, during which Little would work in Hugo's offices.

The trial period went smoothly, and the two CPAs then agreed to form Little & Hugo CPAs, with Hugo a 60 percent shareholder and Little owning 40 percent. (Little brought about 200 clients to the new firm, while Hugo brought about 300.) Little would then buy out Hugo over a period of three years.

Shortly after memorializing the merger in a stock purchase agreement, Little noticed that Hugo was depositing client investment funds in a personal account under her own name. When Little confronted her with the information, Hugo did not think that it was a problem.

Little made an appointment to meet with Hugo, but before the meeting took place, Hugo called him to say that she had a family emergency in Florida and had to fly there immediately. With Hugo out of the office, Little began searching her files for more evidence of malfeasance.

Two days later, Hugo called from Florida to say that she did not know when she would be able to return to the office. She told Little that her assistant, Monica, would be able to answer any questions from clients. With Monica's help, Little found out from Hugo's banker that Hugo had liquidated one of her "personal" accounts of \$475,000, which had held some of the investment funds from her clients.

Soon thereafter Hugo's investment clients began to call the office to find out why they had not received their regular monthly payment from their investments with Hugo. The calls trickled in at first, but after a few days the number of calls increased sharply.

Little learned from Monica that many of the investors were members of Hugo's church, and some of the callers wanted their entire investment returned to them. Others hinted that everything was fine with Hugo's practice until Little joined her, implying that Little was to blame for their payments not being received.

About 40 investors eventually called the firm about their payments. Many of them expressed disbelief that their "good friend" would mishandle their investments, and they demanded that Little do something about resuming the payments or repaying the investments. Two of the investors were retirees, causing Little to worry about "elder financial abuse" charges being leveled against Little & Hugo CPAs.

Little and Monica estimated that the investments totaled about \$4 million, averaging about \$100,000 per investment, but some were four times that amount. By now, Little had become alarmed about the possibility of being held jointly liable for the damages caused by Hugo's misappropriations, especially when he checked his insurance policy and read the exclusion for claims arising out intentional misconduct on the part of an insured person.

He consulted with CAMICO, and a decision was reached to rescind the purchase agreement between him and Hugo, based on a clause in the agreement stipulating that it would be void if illegal activity was discovered. They also filed a complaint with the state board of accountancy regarding Hugo's "investment" activity.

Loss Prevention Tips

There is no substitute for a proper due diligence process prior to merging one's firm with another. The two firms can sign a confidentiality agreement so that files can be exchanged and perused for due diligence purposes. CPAs should develop a familiarity and comfort level with the other firm's culture, quality controls, type of practice, and client mix. Interview personnel at all levels of the firm as well as key clients, attorneys and others familiar with the firm.

If the other firm specializes in a certain area that is unfamiliar to you, speak with others who are familiar with it, take CPE, and attend discussion groups to familiarize yourself with the area.

For more comprehensive guidance see the article on "Successful Mergers and Dissolutions" on the CAMICO Members-only Site under Knowledge Tree/Risk Management/Mergers and Acquisitions/Articles & War Stories.

"War Stories," drawn from CAMICO claims files, illustrate some of the dangers and pitfalls in the accounting profession. All names have been changed.