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# The Counselor

The newsletter of the Illinois State Bar Association's Business Advice & Financial Planning Section



## Expansion of Private Equity Into the Accounting Industry: Some Considerations When Representing the Seller

BY DAVID A. JOHNSON, JR. & DOUGLAS C. MURRAY

Recently, there has been an uptick in private equity firms looking to acquire accounting firms. Acquisitions, mergers, combinations, etc. of tax preparation and accounting firms by other *accounting* firms are not new phenomena. However, because accounting is a regulated industry, acquisition or investment by private equity firms—who are professional investors

*Continued on next page*

## Practitioner Notes: Bank Insulates Itself From Liability in Check Scam

BY PAUL J. RICHARDS

With cyber crime on the rise, old fashioned check forgery schemes tend to get overlooked by many practitioners. However, such schemes can be disastrous for the typical small business client.

Imagine the following scenario—your client contacts you in a panic, stating that one of its employees has stolen the company's blank checks, and has been cashing them. Despite the fact that this client checks its monthly bank statements on a regular basis, the client is "old school" and does not do online banking or check its account activity online. By the time the client contacts you, dozens of fraudulent

*Continued on page 4*

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CONTINUED FROM PAGE 1

without ties to accounting—may create angst and uncertainty among potential targets.

However, private equity has been highly active in other regulated industries for well over a decade. A good example is the medical services space. Indeed, strong parallels can be drawn between the medical services industry and accounting industry—as, among other things, both are regulated industries in which the services are performed by licensed practitioners. Should you have a client presented with the opportunity to sell its accounting firm to a private equity group, it is worthwhile to be aware of some issues and considerations that may impact your client, as well as some parallels from other service industries that can be applied to accounting firm transactions.

Your accounting clients may be familiar with a standard sale of a business. In M&A transactions in many industries—such as “brick and mortar” industries – the revenue stream being acquired is derived from the sale of the seller’s *product*—where the seller’s owners cash out and do not remain with the business after the sale. However, where the seller is in a regulated *service* industry such as accounting—especially where the services are a licensed activity—the seller’s *people* are often the profit center and may be expected to remain with business for a relatively long period of time after the sale. Thus, the relationship between the private equity firm and your client, and the terms of that relationship, are important.

To understand the terms of that relationship, the following should be considered as part of the sale process:

1. *Control*. A common question other service providers have asked, particularly physicians, when selling their practice to an equity firm is: *How much control will the individual service providers maintain over their practice?*

Often the service providers are able to maintain some control and autonomy over their practice. However, major decisions, strategy, growth, and the high-level business and direction of the practice are often shifted to a professional management team (including the private equity firm). That being said, the day-to-day practice of many service providers often remains unaffected after a sale to private equity sponsor. We think this would probably be the case as well in the accounting industry.

A few things to keep in mind when negotiating control:

- Your client’s ability to negotiate management and decision-making can vary greatly depending on the private equity firm and the stage of investment. If the private equity sponsor is acquiring several accounting firms in a “roll-up” of accounting firms, you may have more negotiating ability if you are the first accounting firm being acquired in the “roll-up” than if you are smaller accounting firm acquired as a later “tuck-in” in the roll-up.
- While it is common for the private equity sponsor to require professional management (including the private equity firm) to manage strategy or higher-level issues for the accounting firm, the level of control over the rendering of “professional services” will probably provide for more autonomy.
- An area that sets the accounting profession apart from other service industries, such as the medical profession, is the concern of the individual accountant to control their rates. Physicians are largely compensated through negotiated insurance contracts. However, accountants are not, and the ability of your clients to control rates can be vital to the growth of their individual book of business.
- While this may be a non-issue, it is worthwhile to have the conversation

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with your client and the buyer during the sale process.

- As a matter of helping to set your client's expectations, it is inevitable that after your client's firm is acquired, they will experience increased oversight and bureaucracy.

2. *Growth and Exit*. While every private equity firm is different, the private equity industry often works on a 3-5 year growth and exit window. To meet this growth requirement, a roll-up strategy is commonly used to increase EBITDA for the private equity sponsor's exit. Knowing the equity firm's growth and exit strategy at the outset can help you negotiate necessary protections (or at least set expectations). Things to keep in mind:

- While the inorganic growth will increase EBITDA, your client as a professional services provider may have greater likelihood of conflicts of interest. Growth can be good for the enterprise, but bad for the individual accountant who may lose the client to the conflict.
- This type of growth affects company culture. If certain aspects of your client's culture are vital to them, make sure it is addressed in the sale.
- Inorganic growth will likely lead to the dilution of your client's equity position in the business. This is obvious but often underappreciated at the outset. As inorganic growth occurs, the new additions will be offered a share of equity, diluting your client's equity interest. If the acquisition meets expectations, everyone is better off as the economic pie increases, but not every acquisition meets expectations.
- Your client will have an increased chance for a capital event, if not multiple capital events, as the equity firm looks to exit. These are exciting events often bringing substantial results. However, this could mean new owners, with new controls, and possibly a new company culture.

3. *Payment/Employment Terms*. You should have a strong understanding of how your client will be paid. Looking at other private equity transactions, distributions can be rare – necessitating a capital event to find value for your interest. Care should be taken when considering the compensation structure, which may be starkly different than your client's current compensation structure. You should also discuss with your client their expectations for how they will work (such as hours worked, remotely or in the office, and staff allotment).
4. *Timing of Employment Negotiations*. Often, the employment relationship can take a back seat to the more complex, and often substantially larger equity transaction. However, leaving the employment negotiations until late in the sale process can be a mistake. Many private equity sponsors consider the economic terms of the transaction to be locked in at the letter of intent stage – and failing to seek all of the benefits or economic protections early on can often jeopardize the request. The best practice is to have a full understanding of your client's employment requests when negotiating the letter of intent and to try and incorporate as many of those terms into it as possible.

The involvement of private equity in regulated industries has not been without controversy, and (as with everything else) individual providers have differing opinions on the value of private equity on their practice. This will also be the case in the accounting industry. Preparation and proper negotiation, particularly with an understanding of the private equity industry, can alleviate much of the angst and properly calibrate expectations at the outset of the transaction leading to a smoother, more profitable relationship. ■

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## Practitioner Notes: Bank Insulates Itself From Liability in Check Scam

CONTINUED FROM PAGE 1

checks for tens of thousands of dollars have already been cashed.

As a practitioner, your initial reaction might be that under the Uniform Commercial Code, the client account holder is only liable for an instrument that he actually signed (or which was signed by an agent having authority pursuant to signature cards executed with the bank). In this instance, the bank is not a large institutional lender, but a regional bank, so you anticipate that the bank will not only provide exceptional customer service to its commercial client, but will also aggressively seek to recover the funds from the depositing banks.

All of your expectations are likely to be incorrect based on prevalent banking practices regarding commercial accounts.

The Uniform Commercial Code, as presently adopted by the State of Illinois, provides the bank with tremendous flexibility to shift the entire liability onto its customer, the account holder. Under §3-406(a) of the Illinois Uniform Commercial Code, the bank may avoid liability altogether by proving that its customer account holder "failed to exercise ordinary care", and that such failure "contributed to the making of the forged signature" on the check. Further, under §4-406 of the Illinois Commercial Code, if the bank pays a forged check and later establishes that its customer was negligent in examining its bank statements, detecting forgeries, and notifying the bank of the forgeries, the customer is precluded from asserting the bank's liability. Due to the availability of modern technologies, the bank has many arguments available to it to shift liability to its own customer.

For example, did the small business owner check its online banking activity daily to detect any forgeries? Certainly, many small businesses do not have this capability, and might be "old school" or "not tech savvy" enough to do so. Did the small business client have cameras installed to detect the theft of its business checks? Once again, many small business owners do not have the ability to install cameras in their offices. In the scenario described above, the bank took the position that its own customer failed to exercise ordinary care by not having cameras installed on its premises, not keeping its checkbook in a locked location, and by failing to check its bank statements daily to detect any forgeries.

In addition, the bank further insulated itself from liability in its own Business Account Agreement and Disclosure, in which the bank included—in the fine print—a disclaimer from all liability relating to comparing signatures on checks against the signature cards on file at the bank. Further, when the business client opened the account, thereby agreeing to the terms of the Business Account Agreement and Disclosure, the account holder unknowingly agreed to pay the bank's legal fees in the event of any litigation involving the account, including litigation over whether the bank is responsible for payment of forged checks.

The bank stacked the deck in its favor, not only by including such provisions in the fine print, but by exploiting the provisions of the Uniform Commercial Code by imposing obligations on its customer—such as installation of cameras, checking the bank statement online daily—so that in the event of stolen checks or forged signatures, the bank had already insulated itself from any liability.

The small business client should be advised of the possible need to install additional security measures on its premises, and to be sure to check its account activity at least weekly, not only to prevent such a loss, but to proactively prevent the bank from shifting blame to the customer. Small business clients should also be advised of the possible need to obtain insurance coverage covering employee dishonesty claims and should be advised to check with their insurance broker about the availability and cost of such coverage. Make sure this insurance has coverage for those acts and they are not excluded under the insurance policy.

Clients should be advised that the laws are written for the banks and not the customers. In today's world, it is almost a given that the banks will not admit liability. Without the protections mentioned above, the customer can be out of luck and out the money.■