Accountability

Issue XII

Successor Liability from the Purchase of an Accounting firm Assets: Do you also Acquire the Professional Liability Exposure?

After years of struggle, many accountants choose to sell the assets of their practice, while other, more adventurous souls choose to purchase the accountant's business. Each side of the transaction typically believes that it knows what it has sold and what it has bought: The seller assumes that he may move on to other endeavors, while the buyer frequently believes that he has acquired only assets and not the liabilities of the prior business. Unfortunately, from a legal standpoint neither side of the transaction may have received what they bargained for. Instead, certain legal liabilities could well remain with the seller, while other liabilities may transfer to the purchaser by operation of law

Our focus here is the potential professional liability exposure of an accounting firm arising from the purchase of the assets of another accountant. An illustration of some of the general pitfalls of these transactions may serve to clarify some of the popular misconceptions surrounding such purchases.

The financial aspects of these transactions are easily dealt with in legal documents. As a general rule, the purchasing accountant would not be liable for any of the contractual or financial obligations of the predecessor business, unless those obligations were assumed specifically by the purchaser. For example, the asset purchase could involve the transfer of business personal property, real property, employee obligations, customer lists, leases and contracts pertinent to the ordinary running of the business. The principles of so-called successor liability have no application in this context, because the purchasing accountant would have no liability unless key business obligations are specifically assumed.

It is the so-called tort liability, the classification that would include the professional liability of the selling accountant that could be inherited by the purchaser under certain circumstances. As a general rule, a corporation that acquires the assets of another corporation ordinarily does not assume the tort liability of its predecessor except under the following circumstances:

1. the purchasing corporation expressly or impliedly assumes those liabilities;
2. the selling corporation and the purchasing corporation actually merge;
3. the purchasing corporation is a mere continuation of the selling corporation; or
4. the transaction is motivated by fraudulent intent in an effort to escape such obligations.

These exceptions to the general rule have been fashioned by the courts on essentially a public policy basis, to ensure that parties injured by the misconduct of a defunct corporation have a legal right to reach the responsible party. For example, the courts would probably apply these principles in favor of a client allegedly subject to late filing penalties through the errors committed by an accountant who has sold his business. A professional liability suit would, in all likelihood, be brought against both the purchasing accountant and the selling accountant, just to be sure that a legal remedy was available.

A closer look at the exceptions noted above is therefore necessary. The first and fourth of these exceptions are self-explanatory. Obviously, if the purchasing accountant affirmatively undertakes all liabilities of the seller, or purchaser and seller conspire to

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concoct a transaction to avoid liability to potential claimants, liability will flow according to clear paths defined by law.

The second and third of the exceptions are not as easily understood. They are very closely related and are the primary source of judicial findings imposing successor liability on purchasing corporations.

In imposing the following such liability, the courts have looked at such factors as:

1. Whether there was, in fact a statutory merger of the two corporations, i.e., the filing of a legal document absorbing the selling corporation into the purchaser;
2. Whether there is de facto merger. Here, the courts consider whether there is continuity of shareholder ownership; continuity of management, in whole or in part; assumption of the liabilities ordinarily necessary for the uninterrupted continuation of the selling practice; continuity of employees; continuity of principal location, physical assets and general business operations; and
3. Whether the selling corporation continues doing business as an ongoing entity. If the selling corporation continues to do business, this ends the inquiry and successor liability is not imposed. If the selling corporation, on the other hand, does not continue in business, the courts may look to the successor.

What is important to remember about these legal principles are that they provide a potential cause of action to individuals who are not parties to the asset purchase transaction: the clients of the selling practice. Therefore, even if the asset purchase agreement specifically deals with the issue of assumption of such contingent liabilities either by the seller or purchaser, this contract only allocates the risk of such liabilities between the two parties to the transaction. It has no impact whatsoever on the possibility of the claimant's election of remedies against either the seller or purchaser. In other words, if we assume the court establishes that the purchasing practice is a continuation of the business of the selling practice or that a de facto merger occurred, the purchasing accountant is vulnerable to suit by the selling accountant's clients.

Finally, remember also, that any discussion of so-called successor liability is a separate topic from the potential for direct professional liability of the purchasing corporation. For example, assuming the asset purchase encompasses accounts that are in midterm, the purchasing accountant, while under no obligation to adequately advise a client concerning accounting matters, may be cast in liability if it affirmatively undertakes to do so and makes an error, or fails to abide by standing instructions by a client regarding accounting issues that predate the purchase transaction, and about which the purchasing accountant knew or should have known. In other words, the purchasing accountant is always liable for its own errors arising from the newly acquired business.

Suggestions

We propose the following considerations be addressed when undertaking a merger or asset purchase of another practice:

1. You get what you inspect, not what you expect. When considering the accounts in an asset purchase, your practice has bought the good (the accounts and the revenue) and the bad (hidden time bombs from professional liability claims).

   Prior to the transfer, you should request written confirmation that all files have been reviewed by the seller, and any potential claims or incidents that might give rise to a claim have been advised in writing to the seller's professional liability insurer prior to termination of the seller's coverage.

   As soon as client's files are taken over, the purchaser should all open matters to ensure that all time sensitive items have been followed up, and any grievances with clients have been identified and addressed.

2. Require adequate professional liability insurance. An accountant in an asset purchase transaction often overlooks this.

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While you can transfer the risk of potential professional liability claims to the seller in the purchase agreement, this transfer is useless if the seller has limited assets to pay any claim. Remember that the contractual arrangements between a seller and purchaser only affect the rights to the parties to the asset purchase transaction.

Careful consideration must be given to the purchase of a tail on the selling accountant's professional liability policy, and/or the impact of a prior acts exclusion on the seller's professional liability policy. This is particularly problematic if the partners of the selling practice join the acquiring firm. It makes little business sense for an accounting firm to undertake an asset purchase and then be placed in the uncomfortable position of having to bring a claim against a partner who generated the valuable accounts sought in the first instance.

In addition, when dealing with the issue of prior acts exclusions and tails on insurance coverage, remember that the statute of limitations for actions against accountants in generally six year from the date of the mistake giving rise to the claim. Even New York, which amended its nonmedical malpractice statute of limitations to three years in 1996, may allow suits against accountants to be brought within six years.

Some broader accountants professional liability policies may permit the purchaser to add the merged or acquired firm to the purchaser's coverage as a predecessor in business. This may be a cleaner way of providing protection to the purchaser; however, the are a couple of additional considerations:

i. An agreement should be reached with the seller about clams arising from his practice regarding the impact of the deductible. Who is responsible for this and how is this to be paid?
ii. If there are claims and these have an impact upon the future cost of the purchaser's professional liability insurance, how is this to be charged back to the seller?

An indemnity agreement may be secured from the seller that addresses these issues. This agreement may be supported by a personal guarantee or, where the acquiring firm's deductible significant, an extended reporting period policy equal to the purchaser's deductible.

3. Don't be your own lawyer. This may be self-evident, but acquisition of the assets and business of an accounting firm is not the same as selling a Laundromat. Not only are there potential professional liability exposures as discussed above, but also there are a myriad contractual obligations to outside suppliers and per diems to consider. We suggest retention of a lawyer who not only is a competent commercial attorney, but one who can also understand your business - accounting.

This article was inspired by an article written by David H. Paige and Robert M. Suillivan, Esq. Of the Law firm of Nicoletti, Hornig, Camprise & Sweeny that appeared in the E&O QUARTERLY Newsletter of the PIA.. Jorgensen & Company is not an attorney and does not give legal advice. Any questions about the legal aspects of this article should be referred to an appropriately qualified legal counsel.

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