The buying game

General Features

30 November 2021

Karen Eckstein considers the risks and opportunities you may not have thought of when buying or selling a professional services firm

Key Points

What is the issue?

A business acquisition would allow the purchaser to access the target firm’s client base; access individual employees within the target firm; access practice areas within the target firm; grow within a particular location; and accelerate growth and benefit from economies of scale.

What does it mean for me?

The seller clearly wants to maximise the potential return and minimise the potential claims that would be made under any warranties or indemnities that they may be asked to provide in the transaction.

What can I take away?

A detailed and analytical review of the target practice’s risk management environment can be extremely useful, considering the processes and systems it has in place, its culture and its risk maturity, together with an analysis of its practice areas and their particular risk profile.

The professional indemnity insurance market is currently very hard, and many professionals are struggling to find insurance cover on affordable terms. There is a limited number of insurers who are prepared to insure tax advisors, as there is a perception in the market that the work carried out by tax advisors is inherently risky. Insurers have been extremely wary of anybody who has a history of introducing tax schemes to clients.

There is some hope as a result of the recent success in Knights v Townsend Harrison Ltd [2021] EWHC 2563 (QB), which explored the extent of the duty of care owed by introducers to tax schemes and which dismissed claims by claimants who allegedly suffered losses as a result. However, success in any case is fact specific, and the courts will look at the specific duties adopted by the advisors in each case.

It is likely that insurers will remain wary of anyone with a history of introducing tax schemes to their clients.

Advisers who are struggling to obtain cover at all or on affordable terms therefore need to consider options to enable them to continue in business. One option could be to obtain a detailed review of their claims history and their tax scheme activities so that these can be analysed and the risk assessed and quantified. This can then be reported and explained to insurers and hopefully cover obtained on better terms.

Reasons for sale and acquisition

An alternative option is to find a purchaser for their business, or to purchase other businesses in the hope that the larger entity is more attractive to insurers.

Other reasons for selling a business might be because the owner is coming up for retirement, or because their business has been profitable in recent years and the owner wants to capitalise on that recent profitable period.

Many businesses are currently acquisitive because of the low cost of borrowing. Clearly, purchasing an existing business is a quicker way of expanding into a new area (whether that be a new practice area or geographic location, or both) and can be cheaper and less risky than recruiting specific individuals. Of course, one acquires the client base at the same time. There are also economies of scale to be taken into account and, from an insurance perspective, riskier practice areas may form a lower percentage of the overall business. So there are lots of reasons why growth by acquisition is attractive.

Preparing for sale

So what things does a seller need to think about when preparing for sale? Clearly, the seller will want to maximise the potential pay out and minimise potential liabilities. Advisers can contribute towards preparing a business for sale, through improving overall profitability, margins and cash flow . They can also advise on the commercial terms, including warranties and indemnities.

What is rarely considered is the risk of potential negligence claims and their root cause. Sellers should ask whether the claims and activities analysis referred to above could help to increase the sale price and reduce the warranties and indemnities, as well as reducing any escrow payment required. The report would go to the causes of potential claims, their value and possible defences. It would consider whether processes are in place to prevent any new claims arising from those causes and provide a valuation of risk.

If risk improvements were implemented before sale (and demonstrated in an updated report) the saleability would be enhanced and business value increased. It should also limit the likelihood of claims arising under which any warranties or indemnities or escrow payment should be required.

Splitting up the business

An alternative step that the seller could consider is hiving off an area of the practice known to be unattractive to purchasers, which would drive down the overall sale price. That separate area could be retained by the seller, and enhanced procedures and processes put in place to improve risk management performance. This could mean that insurance can be obtained on better terms than previously before the seller then decides to close that aspect of the business. Run off cover is based on the premiums charged in the latter years of business, so this in turn should impact on those costs. Again, this needs to be considered significantly in advance of sale, securing the advice of expert professional indemnity brokers and commercial advisors, as well as risk management experts.

Before deciding on these steps, a risk management report should be commissioned relating to both aspects of the business. This should consider the risk management processes and systems, the value of potential claims arising, the defences to those claims, and the improvements that could be put in place in those practice areas. This report could then provide insurers with the quantified estimate of potential liability, allowing them to provide an insurance quote for each element of the business, helping the potential seller to make informed decisions as to the way forward.

This report would make the saleable element of the business more valuable, as it should have a lower risk attached to it. It would also enable the seller to determine an exit route for the less saleable element of the business.

Even if the seller did not decide to carve out the less attractive element of the business and wanted to sell the business as a whole, the report should assist in making the business as a whole more attractive. The entirety of the risk management processes and systems will have been reviewed, and the problems within the business identified. Root causes of claims and notifications can identify weaknesses within the business to determine the improvements needed prior to sale, thus increasing the sale value.

The purchaser's perspective

As mentioned above, the purchaser may be motivated to buy a professional services firm for a range of reasons, including acquiring an additional client base with additional employees, adding new locations or practice areas, and potentially benefiting from economies of scale.

Many people think that purchasing an existing business in a new location is less risky than a start-up. However, they overlook the fact that there may well be skeletons lurking in the cupboard. Existing businesses may have historic problems – caused by difficulties in certain practice areas, by certain individuals, by process failures or by the business culture. The unwary purchaser may find that the fantastic bargain it has made turns out to be a very expensive purchase.

Purchasers looking to buy a professional services business will usually only undertake due diligence to work out what the business is worth, looking at the assets and liabilities of the business, its financial management and legal structure. Due diligence usually considers the property, assets, staff and litigation the business is currently embroiled in. An analysis of cash flow might be undertaken and the purchaser might look at the target firm's claims history, but it is rare that any detailed analysis is undertaken.

In summary

A detailed and analytical review of the target practice's risk management environment can be extremely useful, considering its processes and systems, its culture and its risk maturity, together with an analysis of its practice areas and their particular risk profile. Combining this with a legal analysis of files (on a sample basis) to consider any potential claims can help to determine the way forward in negotiations.

It will help the purchaser to negotiate the appropriate warranties and indemnities, and to agree an escrow account into which funds can be placed and released as the risk reduces on an ongoing basis. Just as importantly, the purchaser will be aware of any shortcomings in the risk management processes and can correct those immediately following purchase to avoid new claims arising in that area. This, of course, allows the prevention of claims arising in the new combined business. It also allows for a speedier integration of the two businesses, an additional important benefit not to be overlooked.