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POOLING OF INTERESTS: AN EXPANDED ROLE FOR THE CORPORATE ATTORNEY

PAUL M. FISCHER*

AND

MARTIN J. GREGORCICH**

The corporate attorney now has the ability to determine whether his client will be permitted to use an advantageous hybrid financial reporting technique. The enabling pronouncement is Accounting Principles Board Opinion No. 16, "Business Combinations." This article attempts to provide a basic understanding of the principles involved and their application in a planning context to serve as an important addition to the attorney's repertoire of corporate reorganization planning considerations.

INTRODUCTION

An attorney structuring the substance of a business combination has the task of wending through a maze of technicalities. Myriad state and federal precepts affect the legal formalities of the transaction. Since 1970 a phenomenon termed the "merger fever" has substantially subsided after a wave of legislation and regulation designed to curb abuses and to stabilize business activity. One portion of the wave, Opinion No. 16,¹ has yet to be comprehensively analyzed as to its effect on business activity.

The underlying importance of the topic can be satisfactorily understood only after a brief overview of a basic problem in the regulation of business. Under authority of the Securities Exchange Act of 1934 the legal profession delegated the task of establishing financial reporting principles to the accounting profession.² Since

¹ Accounting Principles Board, American Institute of Certified Public Accountants, BUSINESS COMBINATIONS (1970) (APB Opinion No. 16), 2 CCH AICPA ACCOUNTING PRINCIPLES REP. 6637 [hereinafter referred to as Opinion No. 16, or the Opinion. Other opinions and interpretations are referred to by number.]

² Congress vested the SEC with extensive powers to determine the general accounting methods to be used in preparing financial reports. Securities Exchange Act of 1934 § 13(b),
then the two professions have gone their separate ways developing
different nomenclatures yet working on the same subject matter.
The attorney speaks of statutes and liabilities while the accountant
relies on pronouncements of generally accepted accounting prin-
ciples. Neither is able to understand the other without special back-
ground or training. Gradually the corporate disciplines of law and
accounting have been merging. Boundary lines between each pro-
fession's domain are overlapping. Professor Homer Kripke has
long been instrumental in the area advocating that "accounting
principles are too important to be left to the accountants."³

Opinion No. 16 is viewed by the authors of this article as being
a striking outgrowth of the problem and trend. The Opinion was
written by accountants, ostensibly to serve as a guideline for ac-
countants. However, its practical ramifications appear to be just
as important to the attorney involved in the planning stages of a
corporate reorganization.

Mention of the interplay between the roles of the accountant
and attorney with which this article is concerned should provide
further perspective. A corporation's financial statements are used
for reporting to investors, creditors and governmental agencies.
The function of the certified public accountant is to render his
expert opinion on whether the form and content of the statements
conform to guidelines set forth in pronouncements of the account-
ing profession. The penalty for nonconformity is a qualified opin-
ion, the consequences of which could be extremely detrimental to
the corporation's relationship with the SEC, lending institutions

(1964) (power to determine form and content of financial data contained in registration
statements); and Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a) (1964)
(power to determine form and content of proxies).

The SEC chose to rely upon the accounting profession for assistance in the development
of the specific methods used in preparing financial statements. The decision was announced
in SEC Accounting Series Release No. 4, 11 Fed. Reg. 10,912 (Apr. 25, 1938), and affirmed
Accounting for Business Combinations: A Critique of APB Opinion Number 16, 23 STAN.

exhaustive statement of his views see Kripke, Accounting for Corporate Acquisitions and
the Treatment of Goodwill: An Alert Signal to All Business Lawyers, 24 BUS. LAW. 89
(1968). As a result of a recommendation made in the "Wheat Report," the APB (composed
entirely of accountants) is in the process of being replaced (since July 1972) by the Financial
Accounting Standards Board which provides for the possible membership of persons other
than accountants. Pines, The SEC and Accounting Principles, 30 LAW & CONTEMP. PROB.
727 (1965). I. KELLOGG, THE LAWYER'S USE OF FINANCIAL STATEMENTS (1967) (see pre-
face especially).
and stock exchanges. The significance to an attorney is often minimal except in certain areas, one of which involves a corporation's absorption of another company. Often the sole motive for such a transaction is its effect on the disclosure of the resultant company's annual income. By structuring the combination to satisfy the guidelines of Opinion No. 16 (and thus eliminate an opinion qualification) the attorney could permit the client's use of the more favorable of two treatments available to report accumulated, current and future earnings.

The primary concern, however, is that the verbal expression of the concepts expounded by Opinion No. 16 might seem shallow to an attorney. Gaps exist between the basic principles and the specific rules, such that a legally-trained mind would have difficulty reasoning from the theory and through the rules so as to evaluate the impact upon a contemplated fact situation. Since 1970 the accounting profession has issued interpretations designed to explain the intended meaning and application of the original Opinion. Fundamental premises are gradually becoming more lucid.

This article's contribution to the literature on the subject is intended to be its usefulness both for planning a particular transaction and for understanding the applicable theories. The first major section points out the differences between the two financial reporting techniques dealt with in the Opinion. The presentation emphasizes the accounting benefits which a corporate client may achieve with the aid of a knowledgeable attorney. The second section attempts to set forth the elements of the esoteric theory which justifies the use of the beneficial disclosure technique. The third section interprets and translates the vague rules of the Opinion into a format more useful to a planner. The objective is to analyze practical problems which would likely arise, and to deduce a set of basic "black letter" rules understandable to an attorney attempting to comply with the requirements of the Opinion.

I

A Comparison of Financial Reporting Consequences

A business combination is described as occurring when a corporation and one or more other firms, whether incorporated or not,

4. The purpose of the interpretations is to provide guidance without the formal procedures required for an APB Opinion. Although not regarded as ultimate authority (a status reserved for Opinions), the interpretations constitute "substantial authoritative support." Interpretations are issued sporadically. In the month of issuance they appear in The Journal of Accountancy. They can also be found in CCH AICPA Accounting Principles Rep.
are brought together into a single reporting entity to carry on the previously separate, independent enterprises.\(^5\) The specific types of transactions to which this article is directed are the issuance by an existing or newly formed corporation of its own voting common stock, or that of a parent, in exchange for (a) the voting common shares of another corporation, or (b) all the net assets of another business. A statutory merger or consolidation is included in the latter category and viewed as a transfer of assets by operation of law.

There are two significantly different accounting methods possible to record the above transactions: the purchase and pooling methods. The technique used will have material consequences on financial reports of subsequent periods. Prior to 1970 they were regarded as alternatives, and considerable latitude existed in the application of each. Opinion No. 16 contains definite requirements for the application of each method and puts forth specific criteria which must be met for a given method to be used. The most desirable financial reporting consequence may now be attained only if the attorney carefully plans the substance of the transaction to meet the new criteria.

Business enterprises might combine in either of two ways. The usual method is for the management of one company to purchase and pay for substantial assets from the owners of another company. On the other hand, when the stockholders of one corporation agree with the owners of a different company to unify or pool their separate enterprises, then growth is achieved in an entirely different way. The total assets of the resultant corporation are enlarged theoretically without payment and without a clear cut transfer of ownership.

The issues of concern to an attorney are twofold. First, at what value or amount should newly obtained assets and liabilities be recorded on the books of a combined corporation? Secondly, what should be the amount of retained earnings or earned surplus available for the declaration of dividends?

\(A. \text{ The Traditional Form of Financial Reporting — The Purchase Method}\)

Purchase principles treat the acquisition of an existing business just as any other purchase of property. The assets acquired are

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recorded at the price paid. The purchase method of recording a combination is required in all transactions where cash or other property is used as consideration. Where securities are used as payment the combination must also be recorded as a purchase unless all the subsequently discussed pooling criteria are met.

To simplify the explanation, first examine the case where another firm is acquired for cash. The total price paid for the group of assets which constitute the firm must be allocated to the individual assets acquired. Opinion No. 16 requires that each identifiable asset (except previously recorded goodwill) be recorded at its current market value. Very likely, where a firm is acquired for its expected future profitability, the price paid will exceed the total market value of the identifiable assets. The excess payment is deemed the purchase of goodwill. Goodwill is an intangible asset which must be amortized against future revenue for a period of forty years or less.

To illustrate the foregoing principles, assume that Company A purchased the gross assets of Company B for $1,400,000, including the assumption of $300,000 of liabilities. Figure 1 is a condensed balance sheet for Company B just prior to the combination.

The price paid must be allocated to the identifiable assets acquired on the basis of current market values. $200,000 remains and is assigned to goodwill. The assignment of the price paid to the identifiable assets and goodwill will lead to the changes in acquiring Company A's balance sheet that are shown in Figure 2a.

The same purchase principles are applicable to a combination involving an exchange of securities where the transaction does not comport with the pooling criteria. The only added complication involves the determination of the total price paid for the acquired firm. Opinion No. 16 requires that the cost of the acquired firm "be determined either by the fair value of the consideration given

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7. See Opinion No. 16 ¶ 88 for detailed guides for recording individual assets.

8. In rare cases of "bargain purchases," the sum of the market values of identifiable assets may exceed the price paid. The recording procedure then is to (1) record current assets at market value, (2) allocate the excess (of the total price over the sum of the market values of current assets) to long term assets according to their relative market values, and (3) for any remaining excess, create a deferred income account which is to be amortized to income over a period of forty years or less. Opinion No. 16 ¶ 91.
### FIGURE 1
Balance Sheet of Company B
Immediately Prior to Combination

<table>
<thead>
<tr>
<th>Assets:</th>
<th>Liabilities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Receivable (book &amp; market values)</td>
<td>Current Liabilities . . . $300,000</td>
</tr>
<tr>
<td>Inventory (book &amp; market values)</td>
<td></td>
</tr>
<tr>
<td>Land (current market value of $200,000)</td>
<td></td>
</tr>
<tr>
<td>Building (recorded at book value net of depreciation; current market value of $500,000)</td>
<td></td>
</tr>
</tbody>
</table>

| | |
| TOTAL: | TOTAL: |
| $800,000 | $800,000 |
or by the fair value of the property acquired, whichever is the more clearly evident. Thus, some subjectivity enters into the establishment of the total price paid. The value assigned to debt securities given must be added to the debt of the acquiring firm. The entire value assigned to equity securities must be added to the paid-in capital of the acquiring firm. Under no circumstances may any of the acquired firm's retained earnings be carried to the acquiring firm.

As an example of a combination involving an exchange of equity securities, assume the same facts as the previous example except that 22,000, $50 market value shares of Company A stock are substituted for the $1,100,000 cash. The total consideration of $1,400,000 (which includes the assumption of liabilities) would be assigned as before to the identifiable assets and goodwill. The balance sheet changes as of the date of combination for Company A would differ from Figure 2a. Figure 2b shows that instead of decreasing cash, Company A would increase its paid-in capital by $1,100,000.

B. The Hybrid Form of Financial Reporting—Pooling of Interests

Where a combination involves an issuance of voting common stock, and meets the other pooling criteria, the recording of the combination and subsequent reporting is drastically different from the purchase method. The pooling criteria seek to insure that previously separate stockholder interests are combined to share equally the future business risks. Such combinations are not an exchange, but rather a mere fusion or pooling of previously inde-
## FIGURE 2

Net Changes in Balance Sheet of Company A
Resulting from Combination with Company B

(a) Purchase of B for Cash

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$(1,100,000)</td>
<td>Current Liabilities</td>
<td>$ 300,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ 300,000</td>
<td>Total</td>
<td>$ 300,000</td>
</tr>
</tbody>
</table>

(b) Purchase of B for Securities

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Receivable</td>
<td>200,000</td>
<td>Current Liabilities</td>
<td>$ 300,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land (market value)</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building (market value)</td>
<td>500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,400,000</td>
<td>Total</td>
<td>$ 1,400,000</td>
</tr>
</tbody>
</table>

(c) Pooling with B

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Receivable</td>
<td>200,000</td>
<td>Current Liabilities</td>
<td>$ 300,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land (book value)</td>
<td>100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building (book value)</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ 800,000</td>
<td>Total</td>
<td>$ 800,000</td>
</tr>
</tbody>
</table>
POOLING OF INTERESTS

pendent interests. Since there is no transfer of property ownership, there is no exchange price to acknowledge and no market values are assigned to the underlying assets. Instead, the balance sheet (book) values of the constituent firms are merged.\(^1\) The merging of accounts includes the combining of capital balances. The paid-in capital of the constituent firms is summed to determine that of the combined firm. The retained earnings of the combined firm is the sum of that of the predecessor firms. In some rare cases, combined retained earnings may be reduced to meet a par or stated capital requirement.\(^1\)

Clearly, although market values are not recorded in a pooling of interests, they are of prime importance in negotiating the terms of the combination. The combiners must agree on the market values of both the assets and the issued securities. If the immediately preceding example were to be recorded as a pooling, it would still be necessary to determine the total value of the firm ($1,400,000), and the number of $50 market value shares that were necessary to equal $1,100,000 ($1,400,000 less liabilities assumed). The mechanics of the transaction are unaffected by the accounting treatment. Returning to the previous example, assume now that the combination qualifies and is recorded as a pooling. The balance sheet amounts in Figure 1 for Company B are now added to those of A to produce the balance sheet changes subsequent to combination shown in Figure 2c. A comparison of the pooling changes in Figure

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\(^{12}\) Gormley, *The Pooling of Interests Principle of Accounting—A Lawyer's View*, 23 *Bus. Law.* 407 (1968). V. Brudney & M. Chirelstein, *Cases and Materials on Corporate Finance* 496-516 (1972). One of the first uses of the term "pooling of interests" was a Federal Power Commission ruling, *In re Montana Power Co.*, 4 F.P.C. 213, 234 (1943), which denied two utilities the right to revalue their assets upward (the purchase method) when the interests of the same groups of stockholders were combined into one unit. An enlarged rate base would have justified the passing on of rate increases to customers. The companies were required to retain their original book values.

2c with the purchase changes in Figure 2b reveals that:

1. Market values are not recorded for individual assets under the pooling treatment.
2. Goodwill is not recorded in a pooling.
3. Previously recorded retained earnings is carried forward to the combined firm under the pooling method.  

C. Effects on Future Income

While the purchase versus pooling methods have significantly different effects on the balance sheet of the combined firm, the divergent results on future income statements are even more marked.

Under the purchase method, the future income of combined Company A will be burdened not only with depreciation of the building based on its $500,000 market value, but also with amortization of the goodwill. Prior to the 1970 Opinion, specific methods for determining the fair market value of individual assets were not enumerated, and goodwill, when recorded, was not required to be amortized in future periods. To a large degree the depressing effect of the purchase method on income reported in future financial statements is a product of Opinion No. 16. For tax reporting purposes however, goodwill is not deductible and depreciation of assets must be based on the cost to the combiner which was the original purchaser if the combination qualifies as a tax-free exchange. Depreciation based on market value may be deducted only when the combination is not a tax-free exchange to the seller.

By contrast, the pooling method requires that depreciation in the future be based on the original cost of the long term assets to the combiner. And, since no goodwill is recorded, none is amortized. The tax consequences are minimal.

14. The previous examples assume the dissolution of one of the combiners. As an alternative, one firm may purchase a ninety percent voting control of another firm, which would then remain a separate legal entity with its own accounting records. For external reporting, however, the financial statements of the two firms will likely be consolidated into one set of statements. AICPA ACCOUNTING RESEARCH BULLETIN No. 51 (1959). Except for the possible existence of a minority interest, purchase or pooling principles and their ramifications are equally applicable to parent-subsidiary relationships. Hackney, supra note 10.

15. V. BRUDNEY & M. CHIRELSTEIN, supra note 12 at 496-504.

16. The three types of tax-free reorganizations involved are covered in Int. Rev. Code of 1954, § 368(a) (1) (A), (B) and (C). See also Id. § 362(b) (the basis of assets or securities acquired is the same as it would be in the hands of the transferor); Red Wing Malting Co. v. Willecuts, 15 F.2d 626 (8th Cir. 1926) (goodwill is not depreciable because of its indefinite duration).

17. Herzel, Analysis of the Negotiation of an Acquisition Agreement, 27 Bus. Law.
Figure 3 is a projected annual income comparison of purchase and pooling treatments for combined Company A of the previous examples. Note how the non-deductibility of market based depreciation and goodwill amortization accentuate the income difference between the two methods.

II

CONDITIONS PRECEDENT TO THE USE OF THE POOLING OF INTERESTS METHOD

What in substance theoretically should occur when two companies combine in order to justify the use of the pooling method for reporting the combination?

Until 1970, the pooling method of accounting had developed into a shrewd technique often employed retroactively to mislead readers of financial statements as to the earnings record of a company. The practicing accountant had no grounds upon which to qualify his opinion since both the pooling and purchase methods, although loosely defined, were "generally accepted accounting principles." With the Opinion, pooling has become a severely restricted financial reporting "loophole," the use of which is determined by the circumstances surrounding the substance of the transaction. However, the Opinion's major flaw, for the attorney, is its failure to specify the basic elements of a pooling transaction. The general descriptions given are, for example: "the uniting of the ownership interests of two or more companies by exchange of equity securities," or "the sharing of risks by the constituent stockholder groups." The concepts are sound, but what do they mean? The implied premise of the descriptions must be uncovered.

From the few court opinions which actually delved into the nature of a pooling relationship, the fundamental principle may be gleaned and articulated. The legal criteria will then serve as a guidepost for comparing the development of accounting criteria. A combination may be designated a pooling where the fact situation comes within the ambit of the following proposition:

1223, 1223-27 (1972). In recent years most combination transactions have been designed to qualify for tax-free treatment, which means that for tax purposes the assets of the acquired company are carried over onto the books of the acquiring corporation at the same tax basis that they had been assigned on the books of the acquired company, in a manner akin to the pooling of interests treatment for financial reporting. Stoloff, Corporate Combinations: Mergers, Consolidations, Asset and Stock Purchases, 45 OR. L. REV. 161, 187-200 (1966); Harney and O'Connor, Tax Accounting and Financial Statement Principles Applicable to Business Combinations, 49 TAXES 864 (1971).

18. Opinion No. 16 ¶¶ 12 and 28 respectively.
## FIGURE 3
Comparison of Expected Annual Income for Company A Under Purchase and Pooling Methods

<table>
<thead>
<tr>
<th></th>
<th>Purchase (see Fig. 2b)</th>
<th>Pooling (See Fig. 2c)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>$ 200,000</td>
<td>$ 200,000</td>
</tr>
<tr>
<td><strong>Less:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>All expenses except deprivation of building formerly belonging to Company B and amortization of goodwill</em></td>
<td>(100,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td><em>Depreciation of former Company B building</em></td>
<td>(50,000)</td>
<td></td>
</tr>
<tr>
<td>Purchase (mkt value $500,000) life 10 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pooling (book value $200,000) life 10 years</td>
<td></td>
<td>(20,000)</td>
</tr>
<tr>
<td><em>Goodwill amortization</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(amount allocated $200,000) period of amort. 40 years</td>
<td>(5,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Net Income Before Taxes</strong></td>
<td>$ 45,000</td>
<td>$ 80,000</td>
</tr>
<tr>
<td><strong>Less: Income Tax¹</strong></td>
<td>(32,000)</td>
<td>(32,000)</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>$ 13,000</td>
<td>$ 48,000</td>
</tr>
</tbody>
</table>

¹ The tax computation is based on book value depreciation and no amortization of goodwill. Therefore, the tax computation is identical under the purchase and pooling methods. A straight 40% tax rate is used. It is assumed that the combination qualified as a tax-free exchange.
WHERE an owner of property and a separate owner of different property insure against future business conditions by contracting between themselves to

1) relinquish individual ownership rights in their particular properties,
2) combine the assets and have representatives of the owners operate them as a unit, and
3) become joint owners of the combined assets to be treated equally in all matters,

THEN the transaction is in the nature of a pooling of the respective ownership interests, from which justifiably flows the financial reporting consequence of a carryover of previous earnings and asset values to the combined business enterprise.

In a corporate combination the two separate owners are the two groups of stockholders. The managers of the two business enterprises negotiate the details of the proposed contractual relationship. The resulting combined corporation must be owned jointly. Each group, in exchange for the relinquishment of its former interests, must receive voting common stock which is both proportionate to its contribution to the pool and equal in all respects with that held by the other poolers.

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22. Campbell v. Fields, 229 F.2d 197 (5th Cir. 1956), discussed infra note 55.
23. United States v. Paramount Pictures, Inc., 334 U.S. 131 (1948); Twentieth Century Fox Film Corp. v. Goldwyn, 328 F.2d 190 (9th Cir. 1964); American Biscuit & Mfg. Co. v. Klotz, 44 F. 721 (1891), discussed infra note 24.
24. As an example of the concept, American Biscuit & Mfg. Co. v. Klotz, 44 F. 721 (1891), an early anti-trust case, found that a corporation for the manufacture and sale of biscuit and confectionery had as its real purpose the combining and pooling of large competing bakeries throughout the country into a trust to prevent competition, enhance prices and secure control of the supply and prices of leading articles of breadstuffs. The arrangement provided that each bakery, when secured, was to be carried on by its former managers, subject to control by the central management of funds, territory and prices. All profits were to be pooled and divided on the basis of the stock assigned to each bakery. The court described a pooling as "an aggregation of property or capital belonging to different persons, with a view to common liabilities and profits," Id. at 725, and within the ambit of the Sherman Anti-Trust Act's "combination in the form of trust." This case elevates the level of consideration of a pooling from a contractual relationship among individual persons (supra note 11) to an arrangement among separate business enterprises which are pooled by their owners. The combination of bakeries effected no substantial change on the operational level, and the change in management was only to effect centralization. However, ownership rights in each particular bakery were relinquished in favor of a share in the supposedly enhanced earning power of an efficiently-run aggregate enterprise. It is as if sole ownership of a small company were transformed into joint ownership of a larger
Between 1950 and 1970 the accounting profession had been plagued with problems in its attempt to formulate rules which would effectively restrict the use of the pooling method to transactions which in substance comport with the pooling proposition. The vague guidelines were frequently ignored by firms intent on achieving the advantageous income effect. In practice, pooling and purchase became alternative treatments for a given transaction. Financial statements no longer were reliable indicators of earning potential or comparative standing in a particular industry. The Securities and Exchange Commission, financial analysts and the investing public clamored for curbs to be put on the abuses which were rampant. In response to the crisis, the American Institute of Certified Public Accountants attempted in Opinion No. 16 to redefine the circumstances under which the pooling method would be appropriate. As a result, eligibility for pooling treatment has been severely restricted. Corporate management and the accountants no longer have options for the reporting of a completed combination. Instead, the ability to achieve the advantageous re-

organization. Another way of viewing the pooling of interests with which this article deals is by reference to a business combination which would be an illegal trust but for the minimal effect on competition.

25. In 1950, the Committee on Accounting Principles first officially recognized and approved the use of the pooling method. The condition, as restated in Accounting Research Bulletin (ARB) No. 43 in 1953, was "a continuance of the former ownership . . . to be found in the attendant circumstances." Indicative factors were relative equality of size of the combining companies, continuity of management and similar or complementary business operations. The presence or absence of any one of the factors was cumulative in effect to evince continuity of ownership. In 1957, ARB No. 48 expanded on the circumstances from which continuity of ownership could be found. In 1965, in Opinion No. 6, the Accounting Principles Board unanimously reaffirmed the pooling concept, and once more in 1966, in Opinion No. 10, the Board reviewed ARB No. 48 and made no change in the conditions precedent to the use of the pooling method.


27. Issues to be decided by the Board are first studied by AICPA's Division of Accounting Research. The report of the research is published for comment and discussion among the members of the profession and interested parties. After deliberation, the Board prepares an "exposure" draft of its tentative decision. After considering further comments received, an affirmative vote of two-thirds of the members of the Board is required to authorize formal publication of an opinion. See generally Sprouse & Vagts, *The Accounting Principles Board and Differences and Inconsistencies in Accounting Practice: An Interim Appraisal*, 30 Law & Contemp. Prob. 706, 706-18 (1965).
porting technique appears to have been vested in the persons active at the planning stages—usually the corporate lawyer.

In planning a pooling it is often sufficient to comply with the general guidelines of the accountants’ pronouncements. The unqualified opinion on the CPA’s certificate to the client’s financial statements will probably be obtained. However, the Securities and Exchange Commission and the New York Stock Exchange, mindful of the disregard of previous formulations of rules, now make their own independent judgments on whether a combination qualifies as a pooling. 28 The importance of understanding the theory was recently demonstrated in S.E.C. Accounting Series Release No. 130 which chastised registrants who complied with “the individual requirements . . . set forth in . . . Opinion No. 16 but which [did] not conform with the overriding thrust of that Opinion which requires . . . a sharing of rights and risk.” 29 After functioning as a planner, the attorney should be prepared to argue that the substance of the transaction complies with both pooling theory and the rules of the Opinion. The aforementioned proposition should be the key to understanding the esoteric concept underlying the pooling method. By arguing that all the basic elements are present in a given situation, counsel should be able to justify a particular arrangement or contract provision as being consistent with the nature of a pooling transaction.

The Opinion classifies the twelve conditions precedent to the use of the pooling method according to (1) attributes of the combining companies, (2) manner of effecting the combination of ownership interests and (3) absence of planned transactions. As written, the rules have little practical value to an attorney in his attempt to structure the details of an exchange and to evaluate the Opinion’s impact upon a contemplated fact situation. The different type of analysis provided by this article should be more helpful.

III

PLANNING THE COMBINATION UNDER OPINION NO. 16

The following sections are arranged in a format intended to be of practical value to counsel retained to conduct the legal aspects of a corporate reorganization. Until 1970 the attorney could safely relegate all financial reporting consequences to the accountants.

Not so any longer. A knowledge of Opinion No. 16 will allow its provisions to be incorporated into the total planning which precedes a combination. The headings and subheadings to follow represent the major areas of inquiry. In response to the issues raised, a basic or "black letter" rule is presented as the stepping stone for the legally-trained mind to reason through the concepts of the Opinion so as to evaluate their impact on a contemplated provision of the plan of combination. The discussion which follows is the product of the authors' long struggle to make sense out of the theoretical rules of the Opinion, as construed by AICPA Interpretations. After gaining a basic understanding of the Opinion's impact, experienced counsel will be equipped to provide a client with desired financial reporting consequences, along with the achievement of tax and other legal objectives.

Since an important function of law review articles is to explore the "why's" underpinning the rules analyzed, some explanation is necessary. To a large degree, the rules of Opinion No. 16 are arbitrary, apparently for three reasons. First, the basic purpose of the Opinion was to serve as a strong citadel against the recurrence of financial reporting abuses. Secondly, the accountants were attempting to specify rules to comport with a vague concept, defined only in generalities. Thirdly, the "law of the land" regarding pooling treatment was decreed by eighteen men "in a smoke-filled room," after accounting politics and compromises, by two-thirds majority rule. The rules have now become effective. What can be done to apply them?

A. Would a Proposed Combination Qualify to be Reported as a Pooling?

The initial conference with the client should include a discussion of the benefits of the available financial reporting techniques. If the results of the pooling method are desirable, an investigation of the relationship between the combiners will be the first step in determining eligibility.

In making the investigation, it would be helpful to view the Opinion as establishing two important time zones. The "qualification period" is composed of the two years prior to the initiation date of a combination. The "activity period" is the time between

30. For a practical discussion of the broader aspects of a combination see Herzel, supra note 17.
32. The initiation date is the earliest time at which the stockholders of the combining
the initiation and consummation\textsuperscript{33} dates. One year is the maximum allowable time during which the details of the exchange must be finalized.

1. Circumstances Which Must Exist During the "Qualification Period"

a) A party to a pooling must not have been an entity controlled by a larger business enterprise.

The pooling principle of accounting requires that the assets of two autonomous companies be combined by agreement of the owners. But, when is a company "autonomous"? Opinion No. 16 states that "each of the combining companies . . . has not been a subsidiary or division of another corporation."\textsuperscript{34} An AICPA Interpretation uses a broader definition. It says that entities under common control generally constitute one business enterprise which is not allowed to fragment itself and pool only some pieces.\textsuperscript{33} It is an all-or-nothing concept, in that all the components and risks of an enterprise must be combined without selectivity. The rule is aimed at the discontinuance of the practice of absorbing only profitable activities while leaving the other parts of the enterprise for the original owners.

As applied to corporations, the autonomous entity concept is generally construed to mean that a potential combiner should not be over fifty percent owned by one stockholder who also controlled other companies during the qualification period. There are exceptions however. One of the parties to a pooling may be a subsidiary or division of another if either (a) substantially all of its shares (over 90%) are owned by a parent firm, it distributes only the stock of its parent, and the parent meets the remaining conditions for a

\hspace{1cm} firms are informed of the terms of the combination either through a public announcement or written notification.

33. A plan of combination is consummated when the individual ownership of the two separate companies is transformed into joint ownership of the aggregate net assets. The actual date is that on which shares are exchanged, assets are transferred to the issuing corporation and/or securities are issued. Physical transfer of the stock certificates need not be accomplished so long as the transfer is in progress. The date is significant in that qualification for use of the pooling method is then determinable, and subsequent events have little or no effect. Interpretation No. 4 (Dec. 1970). The situation can best be described by analogy to the contractual nature of a pooling, i.e., there is a one year maximum time limit between the offer and acceptance of the contract which creates the joint ownership arrangement.

34. Opinion No. 16 \S 46a.

pooling. Or, (b) the entity was created as a result of preventive action against, or compliance with, an order of a governmental authority or a judicial body. It may be a subsidiary divested or a new company which acquired assets disposed of under the order. The divestiture or disposal may even be to avoid circumstances which, on the basis of available evidence, would result in the issuance of such an order.\textsuperscript{36}

Not mentioned by the Opinion, but inferred from interpretations,\textsuperscript{37} is the fact that it becomes more difficult to determine the dividing line between business enterprises where a combiner is not a corporation, but instead, is a segment of a partnership or sole proprietorship. In addition to common ownership, one must examine the surrounding circumstances. If similar businesses are commonly controlled, one of them may not be split off and pooled. For example, the acquisition of half of a chain of grocery stores may not be reported as a pooling. On the other hand, if the type of business is unlike that of the other members of the controlled group, it may be pooled. For example, where a grocery store and auto dealership are under common control, a combination with either meets the autonomous entity requirement since there are unlike lines of business.

The relationships among the components of a personal holding company require a different analysis. If the common controller intermingles the affairs of each business, or if each component is intra-functional, a combination with one of the components may not be reported as a pooling. But if the personal holding company is merely a convenience established for federal income tax reasons, and the various "subsidiaries" are in fact operated by the "owners" as if the holding company did not exist, then pooling may be permissible.

For companies which would qualify for pooling treatment except for this autonomy requirement, there might be curative action available. Since the two year period of analysis is determined by the initiation date, it appears permissible to arrange for divestiture of the controlled entity as an initial planning step. Afterwards, it would merely be a matter of delaying the initiation date so as to have it occur more than two years after the divestiture.\textsuperscript{38}

\textsuperscript{36} Interpretation No. 18 (Sept. 1971); Interpretation No. 35 (May 1972).
\textsuperscript{37} Interpretation Nos. 27 and 28 (Dec. 1971).
\textsuperscript{38} \textit{Infra} note 51 and accompanying text.
b) **Ownership interests must not have been manipulated in contemplation of the exchange.**

The Opinion states that "none of the combining companies shall change the equity interest . . . in contemplation of effecting the combination."\(^{39}\)

What changes should be examined as possibly manipulative? Abnormal dividend distributions of cash or property, and security issuances, acquisitions and retirements are mentioned. In the absence of persuasive evidence to the contrary, any such transaction during the "qualification period" by either combiner is presumed manipulative and thus disqualifies the combination from pooling treatment.\(^{40}\) What evidence will rebut the presumption?

Dividends of cash or property would allow a firm to liquidate part of its assets to stockholders and combine only the residual, contrary to the concept of pooling as a complete fusion of existing ownership interests. Dividends must be proven to be "normal." Normality may be established by reference to earnings during the period and to previous dividend policy. A problem may arise in the pooling of a Subchapter S corporation since there is often the wish to make a premerger distribution of previously taxed income contained in the retained earnings account. Most likely it is a change in the equity interest "in contemplation of effecting the combination." However, there is some authority which reasons that it is a customary practice of Subchapter S corporations to make such distributions before abandonment of the election, therefore it is a normal distribution and not fatal to pooling.\(^{41}\)

The reacquisition of a corporation's own shares, whether subsequently retired or held as treasury shares, in essence severs some equity interest. The intentional elimination of original owners destroys the continuity of equity interests which is basic to the pooling concept. Thus, the Opinion presumes that any shares reacquired thwart the continuity requirement. However, evidence of some other valid purpose for acquiring the shares will rebut the presumption. Examples of valid purposes are that the shares were needed to satisfy a compensation plan or a normal recurring stock dividend, or to satisfy the claims of previously issued stock options which have been exercised. A systematic pattern of treasury stock acquisitions also constitutes rebutting evidence. All that is needed

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39. Opinion No. 16 ¶ 47c.
40. Interpretation No. 20 (Sept. 1971).
is a definable program, such as, buying shares from resigned employees or from estates of deceased shareholders, or buying when market price is at a predetermined level.\(^\text{42}\)

The client need not be automatically disqualified from pooling treatment for reacquiring voting stock when the evidence is not sufficient to rebut the presumed manipulation. Curative action is available. If the reacquisition was for equity (other than common stock) or debt securities, the transaction may be reversed by issuing voting stock to the holders so as to make them owners again. If the reacquisition was for cash, and the number of shares involved is not material in relation to the number to be issues in the combination, then the corporation need only restore a like number of shares to the market.\(^\text{43}\)

Other devices mentioned as being manipulative of ownership interests are the spin off of a division or a subsidiary in contemplation of effecting a combination, and the placement of a restriction upon the transfer of stock to prevent anyone other than the issuing corporation or an affiliate from becoming owners of a combiner.\(^\text{44}\)

The Opinion places no absolute limit on the definition of an ownership interest. A broad view would encompass the “common stock equivalents” described in Accounting Principles Board Opinion No. 15, *Earnings Per Share*.\(^\text{45}\) Certain convertible preferred stock and bonds, options and warrants, and contingent share agreements may dilute ownership interests in the near future. The attorney should use caution in this area since it would be easy for the SEC to contend that manipulation of potential ownership also causes the pooling method to be unavailable.

c) The combiners must not have owned over ten percent of each other.

The pooling principle requires that the combiners be independent as between themselves. For purposes of the Opinion, independence is violated when there is an intercorporate investment of over ten percent, by either combiner, at any time during the qualification period.\(^\text{46}\)

\(^{42}\) Id.

\(^{43}\) Opinion No. 16 ¶ 47d; Interpretation Nos. 19 and 20 (Sept. 1971).

\(^{44}\) Interpretation No. 22 (Sept. 1971); Interpretation No. 11 (Apr. 1971).


\(^{46}\) Opinion No. 16 ¶ 46b; Interpretation No. 3 (Dec. 1970), *but see infra* note 54 and accompanying text.
2. Defining the Line Between the "Qualification" and "Activity" Periods—The Initiation Date

The second area for analysis by the attorney ascertaining eligibility for pooling treatment concerns the date on which the two year qualification period ends and the one year activity period begins to run. When is the line crossed? How much negotiating, bargaining and preparation may be accomplished before the plan is considered initiated? A basic rule, gleaned from the pronouncements, may be stated thusly:

A business combination is initiated when the major terms are set and formally announced.

The "major terms" appear to be facts necessary to construct a formula for the determination of the ratio of exchange. The actual ratio (for example, one share to be issued for every two shares received) need not be absolutely determinable by objective means until the consummation date. The facts which usually affect the ratio are earnings records, market prices and appraised valuations of the combiner. The disclosure of the data, by itself should have no effect on the determination of the initiation date, unless or until some indication of the relative weight is assigned to each factor.47

In addition to being defined, the major terms must be "set." There must be a definite obligation on the part of the offeror to perform, such that the contract would be formed, theoretically, as soon as the solicited owners say, "I accept." The subject of an interpretation involved the stockholders of a closely-held corporation desirous of a future combination with another small firm. If the device used were an option to exchange shares, then the plan would have been "initiated." On the other hand, if there were merely an agreement which granted the right of first refusal, then the twelve month restriction would not as yet have been applicable.48

Assuming that the terms are set, "formal announcement" occurs when there is an offer by the stockholders of a corporation, acting through management, seeking a joint ownership arrangement with the owners of another business. The offer may be made in either of two ways. First, by a share-for-share tender offer made by the corporation directly, or by newspaper advertisement, to the stockholders of another company. Second, by the public disclosure

47. Opinion No. 16 ¶ 47a; Interpretation No. 1 (Dec. 1970); Interpretation No. 10 (Apr. 1971).
of an exchange offer negotiated between the representatives of two or more companies. Apparently the announcement would be considered made by any information release reasonably believed to be directed at a specific group of persons—the offerees, or stockholders of the other combiner. However, communication to a corporation's own stockholders does not constitute an announcement which would begin the running of the twelve month time limit. In negotiations with a close corporation, the very first talks would probably satisfy the announcement requirement.

Thus, no statement can be made concerning the specific type of activities which may be accomplished before a combination is considered initiated. The attorney, however, should realize that the amount of allowable planning and preparation depends on the degree of awareness, and the number, of offeree stockholders. It appears that, in many cases, the establishment of a definite initiation date is a matter for subjective analysis. The planner should be able to support the choice he makes.

Once the combiners have crossed the line into the "activity period," the one year time limit may be extended if a delay in consummating the exchange is beyond the control of the combiners. The only delays considered uncontrollable are (1) proceedings and deliberations of a federal or state regulatory agency on whether to approve or disapprove a combination where the combination cannot be effected without such approval; and (2) litigation aimed at prohibiting the combination, such as an anti-trust suit filed by the Justice Department or a suit filed by a dissenting minority stockholder. The test of controllability appears to be strictly construed. An example of a delay held controllable which will not extend the time period is a delay due to the registration of securities with the SEC or a state securities commission.

Rather than having the activity period extended, it may be desirable to close out the old and begin a new period. A termination of negotiations brings an end to any plan of combination. Subsequent announcement of a new plan would initiate another one year activity period. Also, changing previously announced terms after some stock has been exchanged constitutes the initiation of a new plan, unless earlier exchanges are adjusted to the new terms.

49. Opinion No. 16 ¶ 46a; Interpretation No. 2 (Dec. 1970); see also Burley Tobacco Soc'y v. Monroe, 148 Ky. 289, 146 S.W. 725 (1912), discussed supra note 11 for insight into the contractual nature of a pooling.
50. Opinion No. 16 ¶ 47a; Interpretation No. 5 (Dec. 1970).
51. Supra note 47.
B. Requirements Governing the Exchange

Assuming that the circumstances of the combiners during the “qualification period” make the client eligible for the benefits of pooling treatment, what is the basic consideration which must be exchanged during the “activity period” to meet the criteria of Opinion No. 16?

1. "Substantially" All Equity Must be Transferred

Strict pooling theory requires all the owners to bring together the totality of two separate business enterprises. There should be a relinquishment of all individual rights and the creation of joint ownership in the combined assets. Theoretically the issuer should receive one hundred percent of a combiner’s voting stock or net assets. However, the Opinion’s rule may be restated thusly:

Only voting common stock of the new or surviving corporation must be exchanged, either for all net assets, or for at least ninety percent of the voting common stock of the other company.

The Opinion squares with pooling theory for direct acquisitions of assets. For indirect receipt of control over assets—through voting stock—the Opinion permits modification of the concept, but only within a strict ten percent leeway, to accommodate situations where most, but not all, shares are exchanged.

The ninety percent test is applied to the number of common shares outstanding at the date of consummation. But, in making the calculation, shares acquired previous to the consummation date, and shares acquired for cash are not included in the number

52. American Biscuit & Mfg. Co. v. Klotz, 44 F. 721 (1891), discussed supra note 25. McInerney v. Nachman, 286 Ill. App. 477, 3 N.E.2d 105 (1936) involved a company president who had induced a group of people to buy, through him, a large block of his company’s stock while the price was low. It was later discovered that the stock so purchased was being used temporarily, before the delivery date, as collateral for a company loan. In an action to recover the amount paid to the president by one member of the group, the court held that there was no way for the plaintiff to recover. “[H]e contributed his money as a participant in a ‘pool.’ The term ‘pool’ means a surrender of certain individual rights and powers to the common holder for the benefit of all, on the theory that the accruing benefits gained by the joint venture outweigh the individual rights surrendered.” 286 Ill. App. at 484, 3 N.E.2d at 109. The court reasoned that when the plaintiff knowingly entered into the pool he surrendered to the common buyer for all the right to control the details of the manner in which the defendant should purchase, hold and distribute the stock. In this case the poolers were the people induced to buy the stock; as among themselves, each was entitled to equal treatment. Nevertheless, their individual rights were subordinate to the representative of the group who, although not an owner of the property pooled, had management rights.

53. Opinion No. 16 ¶ 47b; Interpretation No. 25 (Nov. 1971).
of shares outstanding. Thus, an intercorporate investment of less than ten percent may prevent the combination from meeting the test.\textsuperscript{54} The problems which could arise in this area are complex and should remain the primary responsibility of the corporate client’s accountant.

2. All Owners of the Pooled Firm Must Have Equal Rights

The Opinion attempts to put the theory of joint ownership of combined assets\textsuperscript{55} into a workable rule by stating that the combining stockholder groups must share their rights in the stock issued. Complying with the rule requires that a comparison be made between the features of the previously outstanding and newly issued shares. To be specific, substantially all classes of voting common of a combiner must receive shares with rights identical to those of the majority class of voting common of the issuer, exactly in proportion to the relative ownership interests which existed before the combination.\textsuperscript{56}

The typical method of differentiating rights among stockholder groups is to classify the stock; for example, a special class of “acquisition stock” is often used. An interpretation states that classification usually serves no useful purpose in a pooling situation, and therefore is not recommended since it gives rise to the

\textsuperscript{54} Interpretation No. 3 (Dec. 1970).

\textsuperscript{55} The theory can be illustrated by what the oil and gas industry considers to be a pooling—the bringing together of two or more small tracts of land to form a drill site. The arrangement is a species of joint venture whereby owners of tracts join to drill a well and share in expected benefits. In a tax case, Campbell v. Fields, 229 F.2d 197 (5th Cir. 1956), the court described “unitization” or “unit operation” as constituting the development and operation of an oil pool as a unit. It involves consolidation or merger of all interests and designation of one or more parties as operator. The element of jointness becomes salient. “Joint” means “united; . . . undivided; . . . coupled together in interest.” \textit{BLACK’S LAW DICTIONARY} 971 (rev. 4th ed. 1968). The individual owners form a joint venture or enterprise, the elements of which are “a community of interests in the objects or purposes of the undertaking, and an equal right to direct and govern the movements and conduct of each other with respect thereto; each must have some voice and right to be heard in its control or management.” \textit{Id.} at 972. The significant consequence of a finding of joint ownership is that each party holds an equal, undivided interest in the same property.

\textsuperscript{56} Opinion No. 16 \textsuperscript{47c}. The right of the stockholders of a combiner to maintain a proportionate ownership in the pooled corporation is a form of the pre-emptive right. Theoretically, a pooling occurs when owners of a firm surrender their interests in return for a smaller interest in a larger business. The ratio of the interest of an individual stockholder to the interests of other common stockholders of the combiners should remain the same as a result of the exchange. The problems which may arise involve the determination of the ratio of exchange and should remain the primary responsibility of the corporate client’s accountant. However, the attorney should be mindful of the right of proportional ownership when drafting other portions of the plan of combination. Interpretation No. 6 (Dec. 1970).
inference of a presently formed intent that, in the future, the rights of one class will be changed relative to another class. For example, voting rights may be restricted, preferences may be granted for liquidation purposes or dividends may be increased, guaranteed or limited. Two of the rights for which the pooling contract must provide equality of treatment are worthy of note.

a) Right to Vote

A basic element of corporate ownership is the right to vote shares as one sees fit. Pooling theory would require that the joint owners of the combined corporation receive the same type of shares—restricted or not—so long as the substantive voting rights remain equal among all the poolers. However, the Opinion appears to go a step further by, in addition, prohibiting all restrictions on the exercise of voting rights. An example given by the Opinion states that the rule is violated if shares issued to effect the combination are transferred to a voting trust. Given that the voting rights are the same, is there some way to control their exercise? It might be argued that the separation of voting rights from share ownership, the salient characteristic of a voting trust, is significantly different from the use of other control devices popular in close corporations. Since not specifically prohibited, the use of irrevocable proxies and stockholder agreements affecting the voting of shares may be justifiable so as not to disqualify a combination from being reported as a pooling.

b) Right to Sell

A stock certificate has an inherent right of transferability by its definition as a negotiable instrument. Although not mentioned in the Opinion, an interpretation implies that any requirement imposed on a stockholder either to sell or not to sell the stock received usually creates a difference in rights. However, where the restriction is in compliance with a governmental regulation, then rights are not held to be different. For example, if certain shares are restricted pending the effective date of registration with the SEC or state securities commission, and at the time the combination is consummated the registration is in process or a contract to register subsequently is in existence, then ownership rights are con-

58. Opinion No. 16 ¶ 47f.
60. Interpretation No. 11 (Apr. 1971); Interpretation No. 33 (Jan. 1972).
sidered shared equally. A problem may be encountered where a publicly held company plans to combine with a closely held company. Management would prefer not to have one or a few stockholders owning a large block of its stock. A requirement that the owners of a close corporation sell to the public various amounts of stock received at various times in the future would violate the rule. The objective could not be achieved by affecting the right of transferability but a third party buy out arrangement, considered subsequently, probably would be successful.

A question not answered by the Opinion concerns the duration for which there must be an equal sharing of rights among all the stockholders. From other time limits it might be inferred that two years after the consummation date is a satisfactory amount of compliance.

3. Permissible Use of Cash or Other Consideration

The "only for voting stock" requirement is probably the thorniest constraint in qualifying for pooling treatment. Theoretically, only common shares should be issued so that the transaction constitutes a continuity of the combiners' equity interests. However, built into the Opinion's requirements governing the exchange are a few limited exceptions where cash or other consideration may, out of necessity, have to be disbursed.

Some stockholders may refuse to exchange their shares although the requisite number approve the transaction. Any such dissenting minority has the appraisal remedy whereby it may obtain current market value for the shares held. The non-common stock distribution could thus jeopardize the pooling treatment where the minority interest is larger than ten percent of the combiner. Also, the Opinion does not require the issuer to buy out or issue shares to a minority which is within the ten percent leeway—the dissident stockholders may be left standing as a minority interest in a subsidiary controlled by the issuer. Beware of a pitfall where a stockholder desires to exchange only part of his interest for voting stock. He is not classified as a dissenter. Although the issuer otherwise acquires ninety percent, an interpretation states that pooling treatment is not allowed where the individual exchanges only some of his shares and either keeps the remainder or receives cash for them.61 The reason most likely revolves around the requirement that stockholders of a combiner must contribute the totality of their ownership interests to the pool.

61. Interpretation No. 25 (Nov. 1971).
The Opinion permits cash or other consideration to be distributed in lieu of fractional shares. Essentially, there is only a slight difference between disbursing cash for some shares held by an individual and for fractional shares attributable to all stockholders. To comply with the pooling concept, an interpretation requires that the payment for fractional shares must be reasonable in amount and should be proportional to each stockholder’s fractional interest.62

Owners of the firm being absorbed often view themselves as “sellers,” indifferent to the financial reporting desires of the larger corporation. How may a “seller’s” demand for cash in hand be at least partially satisfied? Specifically prohibited is a prorata distribution of cash or other consideration, such as warrants, of the issuer to the stockholders. The solution appears to be a simple matter depending upon the capital structure of the combiner. Note that the rule applies only to ownership interests in a combiner, defined as voting common and equity or debt securities issued or exchanged for voting common during the “qualification period.” Therefore, for any other outstanding equity and debt of a combiner, the issuer may (a) assume a debt, or (b) exchange substantially identical securities, for example, warrants for warrants, or (c) distribute cash and retire equity securities which are callable or redeemable.63

C. Achieving the Client’s Objectives—Prohibited and Permissible Arrangements

The preceding two sections treated the basic inquiries for the planner contemplating whether a particular combination may be recorded as a pooling of interests: the qualification of the two companies and the consideration to be exchanged. This section highlights collateral matters which need to be recognized.

Acquisition-minded corporate managers intend to execute the absorption of another company with as few growing pains as possible. In a pooling situation the attorney might be expected to:

(1) Devise a way to lessen the impact of a potentially bothersome, closely-united or one-man minority interest in the resultant corporation.

(2) Contrive a formula of payment for the assets or equity interests. The combined firm most likely will desire to retain control

62. Id.
63. Opinion No. 16 ¶ 47b; Interpretation No. 12 (Apr. 1971).
over the disbursement of some consideration after the consummation (a) to protect itself against overpayment in case the absorbed company does not in fact possess its expected earning capacity, and (b) to serve as an incentive or reward for the prior owner to make his best efforts to help manage his part of the combined corporation during the transitional period.

Opinion No. 16 crimps the planner's choice of alternatives by restricting certain devices and activities. What arrangements are specifically prohibited? What arrangements appear to be permissible to achieve the corporate client's objectives?

Not made clear by the accounting pronouncements, yet of vital importance to the attorney is that the Opinion has no jurisdiction over events subsequent to the consummation date. The decision as to eligibility for pooling treatment apparently is a one-time determination made as of the date of the actual exchange. The criteria for decision are to be found in the negotiations and terms of the agreement or plan or combination. Future events have no weight other than to indicate what management's intent was prior to the consummation date. To be safe, anything that would expressly or impliedly counteract the effect of combining owners' interests should be carefully excluded from the negotiations and contract terms. At the planning stage the attorney has the task of storing sufficient documentation and circumstantial evidence of presently formed intent. After the consummation date the attorney may be called to justify the client's activities. The following four areas will most likely be subject to close scrutiny:

1. The Poolers Are to Share Risks Arising Only After the Combination

The Opinion states as a condition that "the combination is resolved at the date the plan is consummated and no provisions of the plan relating to the issuance of securities or other consideration are pending." It would appear that any transfer of money, shares or other property after the consummation is prohibited. However, the Opinion fails to explain or distinguish risks arising before, from those arising after, the consummation date. The distinction is important considering the weight which the SEC places upon risk sharing. Pooling by its very nature contractually provides for self insurance against future business conditions not reasonably known

64. Opinion No. 16 ¶ 47g.
65. SEC Accounting Series Release No. 130, supra note 29.
at the time the contract becomes effective. The future risks will be reflected in the pooled company's earnings and market prices. A general rule may be restated thusly:

Additional consideration may be given based upon facts reasonably known, to cover situations the outcome of which can be reasonably determined at consummation, which are not earnings or market price contingencies.

Agreements may provide for contingent payout or required return of shares as long as they are not based on "earnouts" or stock valuations. In other words, where the parties gamble on the future they must share in the effect equally.

There is but one allowable situation in which an arrangement may be based on future earnings or market prices. It might be feasible to devise a formula in which a contingency period ends before the consummation date. It may be necessary to juggle the dates on which the combination is considered initiated or consummated to make the deal workable.

The combination agreement may provide for only a substantial sharing of risks beginning with the consummation as long as there will be complete sharing within a reasonable time. Two examples are given which would justify revision of the number of shares issued where a later settlement of a contingency known at consummation is at a different amount than that recorded by a combiner. The first is the later settlement of a contingency pending at consummation, such as the settlement of a lawsuit or an additional income tax liability resulting from the examination of "open" tax

66. In Green v. Higham, 161 Mo. 333, 61 S.W. 798 (1901), two brothers formed a pool of their company's stock under an agreement whereby all royalties received from sales to another company would be shared equally. In a suit for an accounting, the court construed the contract and described a pool as "a joint adventure by several owners . . . subjecting all their holdings to the same control for the purpose of a speculative operation, in which any sacrifice of the shares contributed by one, and any profit on the shares contributed by another, shall be shared by all alike." Id. at 799. Inherent in the court's reasoning is the idea that the pooling concept has elements of an insurance contract in that the parties intend to spread future risks among themselves. Mutual protection is afforded against losses arising after the date of the agreement, while the parties gamble for an equal share of any profits which result from their alliance.

67. Previous articles and synopses of the Opinion's rules state flatly that all contingent consideration is prohibited. A literal reading of the Opinion justifies such a conclusion. The authors of this article contend that the rule is not so broad. The premises and reasoning of the interpretations, and the analysis of the basic nature of a pooling relationship, lend support to the statements in the above text.

returns. The second is a "general management representation or warranty" which provides time for determining that the representations of the other party are accurate. The attorney should demand that an audit be made to ascertain whether the assets of the other company exist and are worth the specified amounts and whether all liabilities and amounts are disclosed so that risks which arose prior to the combination will not be shared equally. For example, the risk of inventory obsolescence and of non-collectibility of receivables are elements which properly should be allocated to only one of the former ownership groups, and not shared equally by all the poolers. Such elements, if known specifically at the time, would have affected the amount of property contributed to the pool, and would have ultimately influenced the establishment of the exchange ratio. In fairness, reasonable time after the consummation date should be allowed to ascertain the true value of the pooled property. To provide for the aforementioned circumstances, the plan or contract of combination might provide for: (a) reservation of a percentage of the shares being issued, (b) subsequent issuance of more shares, (c) return of shares, or (d) issuance of shares to an escrow agent. Whatever device is chosen, the Opinion requires that the agreement also provide that the intended recipients are able to vote all such shares pending the settlement of the contingency or the ascertainment of values.

It would be easier to prove intent of risk sharing if, at the planning stage, every possible claim and inchoate right is determined and provided for in the pooling contract before consummation. The reasoning justifying each such provision should also be sufficiently documented.

2. A Former Ownership Group Must Not Be Specially Benefited by Financial Arrangements

The rule of equality of treatment must prevail as of the time of consummation. The oral or written agreements between the parties must avoid expressly or impliedly favoring one stockholder group over another. However, the owner-managers of an absorbed company would likely insist upon some type of fringe benefit as an inducement to combine. How may a combining stockholder be given some financial benefit consistent with the rules of the Opinion?

An obvious technique by which to favor a group would be the

The use of special compensation agreements with employees, officers and directors who were also former stockholders of a pooled company. Although the Opinion does not touch upon the subject, some grounds for analysis are provided by an AICPA Interpretation.\(^7\)

The basic principle seems to be that the compensation should not represent a premium or reward for contributing assets to the pool. Where the agreement is in the form of payment for past or current services, then there is no effect on the qualification for a pooling as long as the amounts are reasonable on some grounds. A possible inconsistency arises. The words of the interpretation say that stock options may be granted for past or current services. However, the theory underlying stock options is that they are granted as compensation for services to be performed in the future.\(^7\)

Whether the technicality has any impact on compliance with Opinion No. 16 is yet to be seen. Nevertheless, it appears permissible to grant a reasonable bonus to former employees or directors of a combiner.

A more difficult problem arises where compensation agreed upon is in the form of a new employment contract or some form of deferred compensation ostensibly to be paid for future services. In such a case, the interpretation sets forth the standards for determining the effect of the future compensation contract on qualifying for pooling. The issuer may grant such compensation to former stockholders of a combining company if the arrangement is (1) reasonable in substance, and in relation to the person's existing employment contract, (2) entered into for valid business purposes, and (3) restricted to the personnel who were active in the management of a combining company and continue to be so in the resulting pooled corporation. Doubt is expressed whether a "consultant contract," drafted solely to provide the necessary consideration for a promise of future payments granted to former stockholders, meets the tests. Some additional consideration would be needed.

Other financial arrangements with stockholders of a combiner would probably be subject to the same analysis. The Opinion specifically mentions that the pooling contract may not provide for the guarantee of loans secured by stock issued.\(^7\)

\(^7\). Interpretation Nos. 31 and 32 (Dec. 1971).


\(^7\). Opinion No. 16 ¶ 48a.
3. The Stock Issued to Effect the Pooling Must Not be Reacquired

Pooling theory requires that the interests of the formerly separate owners be carried forward to the combined corporation. The specific rules of the Opinion governing the consideration to be exchanged are an attempt to put the "continuity" theory into practice. The rule of this section now attempts to insure that management does not plan to do immediately after consummation that which it was prohibited from doing before (manipulate or extinguish ownership interests). Thus, the restated rule for the planner is that the terms of the pooling agreement should not evince an intent to negate the exchange of equity securities by directly or indirectly providing for the retirement or reacquisition of all or part of the shares issued in the combination. How may the attorney provide for the discontinuance of the interests of certain stockholders?

Owners of a closely held combiner could become an obstructive minority interest in a large corporation as a result of the issuance of solely voting stock. The objective of the issuer's management would be to mitigate the problem in some way. Although continuity of ownership interests is required after consummation, the same individual persons need not continue on as the joint owners. Apparently, all that is required is that proportionate common stockholdings remain outstanding, regardless of who actually owns the stock.

Certain buy out arrangements seem to be permissible. The nature of a pooling is a contractual relationship between the two stockholder groups. Completely free from restriction is a contractual relationship between a pooler and a third party. Immediately after consummation third parties may buy all the voting stock issued. An interpretation states that an explicit or implicit requirement to sell or to enter into such a contract may not be imposed as a condition precedent to consummation of the pooling transaction. The pronouncements most likely would sanction a subsequent sale so long as the "plan" does not evidence the obligation incurred or the coercion employed. The interpretation was endorsed by the SEC which considers adequate risk sharing to have occurred "if no affiliate of either company . . . sells or in any other way reduces his risk relative to any common shares received

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73. Interpretation No. 21 (Sept. 1971); Interpretation No. 36 (Nov. 1972); Opinion No. 16 ¶ 48b; Pivar, supra note 41, at 62; Scriggins, supra note 68 at 1253-55.
... until such time as financial results covering at least 30 days of post merger combined operations have been published."^74 It is left to the ingenuity of counsel to devise a technique whereby it is assured that a third party will buy the shares issued while not actually being required to do so.

The interpretation also suggests that the extent of the prohibition is merely that the companies involved must not use their own financial resources to "bailout" former stockholders of a combiner or to induce others to do so. Either the issuer or one of the combiners may assist the former owners in locating an unrelated buyer for their shares, such as by introductions to underwriters, as long as compensation or other financial inducements from the company are not involved. Also, if unregistered stock is issued, the issuer may agree to pay the costs of initial registration. However, the company may not guarantee the sale or the price.

4. Former Revenue-Generating Functions Must Survive and Not be Intentionally Discontinued

The nature of pooling requires that the joint assets be operated as a unit by the management of the former firms.^^ The "unitization" or "unit operation" connotes the requirement that the former businesses of the combiners must be continued as the mainstay of the resultant corporation. The management of the issuer might be tempted to plan to sell the assets contributed to the pool so as to realize immediately the submerged profits which might exist in the difference between the carried-over book values and the current market values. The practice of pool and resale was one of the abuses which made comparative income statements misleading. With the purpose of limiting the possibility of such abuse, the continuity of business requirement was stated thusly in the Opinion: "The combined corporation does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination."^76 But the rule was interpreted to be broader in its application and more consistent with the concept of unitization. The implication for the planner is that the pooling agreement should not expressly or impliedly provide for immediate substantial changes in operating policies of either combiner.

The prohibition against intentional discontinuance has its ex-

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74. SEC Accounting Series Release No. 130, supra note 29.
75. Campbell v. Fields, 229 F.2d 197, 198 (5th Cir. 1956), discussed supra note 55.
76. Opinion No. 16 ¶ 48c.
ceptions. First, the definition of a disposal of "significant" assets does not include the elimination of duplicate facilities or excess capacity, or disposals in the ordinary course of the business of the formerly separate companies. Secondly, immediate disposal of a significant part of the assets, although planned and included in the terms of the agreement, is permitted if the sale is undertaken (a) to comply with an order of a governmental authority or judicial body, or (b) to avoid circumstances which, on the basis of available evidence, would result in the issuance of such an order.\textsuperscript{77}

In some situations it will take close regulatory scrutiny to achieve the purpose of the rule and thwart a growth-minded company's attempt to achieve "instant earnings." Accordingly, reported income could be boosted where a combination qualifies for pooling treatment and the consequent carryover of book values, and the company then proceeds to avoid the issuance of, or complies with, a divestiture order and sells the assets at their current market value. In substance, such a series of transactions would be a mere purchase and sale of assets rather than a contractual arrangement among separate owners. But it would be difficult to establish a violation. The major obstacle would be proof that the issuer originally should have known at the consummation date that a court or regulatory agency would have decided that the combination violated the law to such an extent that it should not have been allowed to continue.

To be safe, the attorney should ascertain that an intention to sell a significant portion of the pooled assets can not be reasonably inferred from any of the complex provisions of the plan.

CONCLUSION

It behooves the corporate lawyer to understand thoroughly the difference between the purchase and pooling principles of accounting. The two methods cause drastic differences on financial statements. Once aware of the impact, the attorney can achieve for the client the desired reporting technique by integrating the requirements of Opinion No. 16 with the myriad other details which accompany a business combination.

\textsuperscript{77} Interpretation No. 22 (Sept. 1971).