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AN OVERVIEW OF POOLING TRANSACTIONS

In general, there are two accounting methods available to parties to a merger or acquisition: the purchase method or the pooling of interest method ("Pooling"). Though the method of accounting chosen has no impact on a company's underlying performance or health, the earnings of the surviving corporation can differ significantly, depending upon which accounting method is selected.

Under the purchase method of accounting, the cost of the company acquired is reflected on the acquiror's balance sheet. However, goodwill (*i.e.*, the difference between the purchase price and tangible asset value of the target) must also be entered on the acquiror's balance sheet. Goodwill is typical in acquisition transactions because a firm's earning power is generally greater than the value of its tangible assets. Such goodwill must then be amortized over not more than 40 years, potentially having a negative impact on the earnings of the acquiror.

On the other hand, Pooling in stock-for-stock transactions treats the two independent companies as if they had always been one combined enterprise. Because the assets are "pooled," the purchase price is not reflected on the balance sheet of the acquiror. In other words, the goodwill is ignored.

For example, suppose a company having assets with a book value of $100 million acquires a company with assets having a book value of $50 million for a purchase price of $100 million in a stock-for-stock deal. Under purchase accounting, $50 million of goodwill would be present in the merged entity with a book value of $200 million in assets. Alternatively, in a Pooling, the goodwill would be ignored and the total value of the assets on the merged entity's books would be $150 million.

The financial advantages of Pooling versus the purchase method can be significant. However, the availability of Pooling is subject to stringent requirements, which can affect the structure of a transaction and restrict certain rights parties would otherwise bargain for in the absence of Pooling. This article discusses Pooling generally, highlights how certain threshold requirements may alter the structure and documentation of a transaction, and notes some recent trends in Pooling transactions.

The Benefits and Rules for Sellers and Purchasers

The primary accounting benefits of Pooling are as follows:

- **No Goodwill –** The purchaser can record the target's assets at the same book value as the book value listed on the target's financial statements. As a result, unlike the purchase accounting method, where the portion of the purchase price in excess of book value is recorded as goodwill and amortized over a 40-year period, there is no goodwill and, more importantly, no 40-year drag on earnings.

- **Earnings –** The purchaser gets the benefit of the target's earnings from the beginning of the year of the acquisition. In addition, if the purchaser reports its prior year's earnings and balance sheets, the target's historical financial results are also included therein.

The requirements that must be met in order for a transaction to qualify for Pooling ("Pooling Rules") were established by the Financial Accounting Standards Board (FASB) and are enforced by the Securities and Exchange Commission (SEC), which is responsible for oversight of FASB. Though the Pooling Rules are generally considered arbitrary, failure to comply with these Rules could prove disastrous to the combined enterprise if the SEC disallows a Pooling. As discussed in the last section of this article, the result could be that the SEC requires the purchaser to revise its financials to include goodwill.

Though analyzing each specific Pooling Rule is beyond the scope of this article, there are certain Pooling Rules relating to the structure of a transaction that sellers and purchasers should be aware of as they consider Pooling. The following is a summary of these Pooling Rules:

- **Consideration –** The consideration to be paid must be voting stock of the purchaser equivalent to the seller's stock with respect to voting and other rights. One exception to this rule is that a purchaser may pay cash or other consideration in an amount up to 10% of the purchase price where such cash consideration is for fractional shares or the purchase of all the common stock held by one or more shareholders of the target who do not wish to receive the purchaser's stock. Additionally, other ancillary agreements such as post-closing employment agreements or consulting agreements between a purchaser and a selling shareholder will not generally disqualify Pooling. However, if the compensation is inconsistent with the services to be rendered, the SEC may regard payments under such agreements as disguised purchase price, in which case the SEC may disallow the Pooling.

- **Restrictions on Sale of Stock –** Subject to a narrow exception, affiliates of the target and purchaser may not sell common stock of either the target or the purchaser for a period beginning 30 days before consummation of the transaction and lasting until 30 days of combined financials are published by the purchaser (typically 45-60 days after closing). Under the Pooling Rules, affiliates are generally officers, directors, 10% shareholders and members of any control group of the target. The narrow exception allows affiliates of a target to sell up to 10% of the shares received by such affiliate but in no event more than 1% of all shares received. The Pooling Rules also restrict a purchaser from repurchasing its stock post-closing. Consequently, the parties may not contractually provide a selling shareholder with liquidity. Additionally, because the Pooling Rules require the consideration to be in stock, any shareholder of a target who receives an amount of the purchaser's common stock which, under the SEC rules, would result in his being deemed an "affiliate" of the purchaser post-closing, would be subject to certain resale restrictions in addition to the Pooling restrictions. Obviously, in a volatile market, the Pooling and SEC restrictions on liquidity increase the risk of loss for a selling shareholder in the event of a drop in stock price of the purchaser. Certainly, from a selling shareholder's perspective, this increase in risk should be part of any discussion of purchase price.

- **Other Risks –** The Pooling Rules also severely restrict the use of any post-closing adjustment to the purchase price. This restriction is broad enough to prohibit (subject to narrow exceptions) the use of indemnification, escrows, earnouts and holdbacks, and other post-closing payments by selling shareholders. Therefore, the Pooling Rules restrict the methods that purchasers customarily use to reduce their post-closing risk of loss. Under the limited exception to this rule, sellers may agree to indemnify purchasers up to an amount equal to 10% of the purchase price for post-closing liabilities. Moreover, in addition to such 10% exception, the Pooling Rules allow for "reasonable" indemnification payments for losses suffered relating to exceptions to the representations and warranties identified by the target as a source of potential post-closing liabilities (*e.g.*, litigation). The Pooling Rules allow these payments to be made pursuant to an escrow arrangement and either by way of a return of stock or in cash in the event the stock received in the transaction has been sold.

As a result of the restrictions on post-closing remedies, a seller must emphasize a thorough due diligence investigation. A purchaser also has greater incentive to adjust the purchase price to account for potential liabilities.

The Contract

Pooling can also result in changes to customary transaction documentation that relate specifically to the Pooling Rules. The following is a summary of certain relevant items.

- First, significant losses can result if a transaction, structured and priced as a Pooling, is subsequently disqualified as a Pooling due to any pre-closing or post-closing action by either of the parties. Accordingly, purchasers and targets and/or selling shareholders should require reciprocal representations and warranties that no action was taken prior to closing which precluded the use of Pooling. In addition, purchasers and targets and/or selling shareholders should require reciprocal covenants not to take any action post-closing that would result in a loss of Pooling.

- Second, because Pooling provides an immediate economic benefit to purchasers, targets and/or selling shareholders should require that their transactions be structured in such a way as to provide immediate financial benefit for the target and/or selling shareholders (in addition to any premium being paid). For instance, targets and/or selling shareholders may require that their transactions be structured in such a way that the seller receives favorable tax treatment (*e.g.*, a tax-free reorganization). Both sellers and purchasers should recognize, however, that the Pooling Rules and the rules and regulations promulgated under the Internal Revenue Code are not identical and, in some cases, are inconsistent. Therefore, while a transaction may qualify as a tax-free reorganization for Internal Revenue Code purposes, it may nonetheless fail to meet the Pooling requirements.

- Third, due to the technical nature of the Pooling Rules, purchasers and targets and/or selling shareholders should retain Pooling advisors. Generally, a Pooling advisor will review the transaction structure and documents and advise on issues that may arise during negotiations (and solutions the parties may devise with respect to those issues). In addition, depending on the engagement, Pooling advisors may deliver an opinion at closing stating that (subject to certain qualifications and assumptions) the transaction qualifies for Pooling.

Trends and the Future of Pooling***Trends and the Future of Pooling***

There were approximately $25 trillion worth of merger and acquisition transactions announced in 1998, and one investment banker estimated in *Business Week* that a significant percentage would not have been done if Pooling had not been available.[1] In fact, based on estimates from Securities Data Co., there were 11 transactions accounted for using Pooling in 1990, compared with over 350 in 1998.

The SEC, however, is focusing on Pooling as an area of

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concern.[2] In particular, the SEC is taking a closer look at enforcing the Pooling Rules that restrict stock purchases. These restrictions have been of issue in several recent transactions. For instance, Chrysler Corp. reissued about 28 million shares in order for its merger with Daimler-Benz AG to be accounted for as a Pooling.[3] The reissuance was required to offset a stock buyback which would have precluded the use of Pooling. If Pooling had not been available, the estimated earnings of the Daimler-Benz/Chrysler entity could have been reduced by 10% per year for 40 years. Moreover, it has been reported that the SEC forced U.S. Office Products to change the way it accounted for 22 transactions from Pooling to the purchase method because the company violated the buyback restrictions.[4] As a result, U.S. Office Products will have to pay an estimated $10.6 million in goodwill charges over 40 years. Similarly, because of the repurchase of its shares, Corporate Express had to restate its acquisition of Data Documents using the purchase method instead of Pooling. This change will result in an annual $3.3 million goodwill charge for the next 40 years.[5]

FASB is currently reviewing the Pooling Rules and, according to recent published reports, is considering either eliminating Pooling altogether or modifying the existing rules to make its use more difficult.[6] Some industry watchers believe this latter proposal includes a new requirement that only parties who can show they are "equals" may take advantage of Pooling.[7] Another proposal would be to allow goodwill to be recorded as an asset as long as the purchaser could prove that the value of the asset had not declined.[8] Other reports speculate that another proposal being discussed would include a new requirement that the parties separate goodwill among the business components and assign a "useful life" to each component.[9] The parties would then devise a "weighted average" useful life which would then serve as the source of the yearly write-off of goodwill.[10] Neither the SEC nor FASB has published an anticipated release date of any FASB proposal.

Until such time as the SEC or FASB rules on Pooling are changed, parties to transactions where stock is the consideration will likely continue to look to Pooling as a means of maximizing the efficiencies of their transactions. Sophisticated purchasers and sellers will also recognize

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that the Pooling Rules alter more than the accounting landscape, and will protect themselves accordingly.

[1]Nanette Byrnes and Richard A. Melcher, *Earnings Hocus-Pocus*, Bus. Wk., Oct. 5, 1998, at 134.

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[2]Elizabeth MacDonald, *SEC Moves To Tighten Merger Ploy*, Wall St. J., July 14, 1998, at C1.

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[3]Id.

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[4]Id.

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[5]Id.

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[6]*Pooling Rules change to hit M&A Market*, Corporate Finance, Aug. 1998, at 5.

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[7]Joseph McCafferty, *Pooling under fire again*, CFO, The Magazine for Senior Financial Executives, Sept. 1998, at 23.

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[8]Melody Peterson, *Market Place; An accounting method favored in mergers may get a new name,* N.Y. Times, May 13, 1998, at D8.

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[9]Martin Sikora, *Do Acquirors Face a Goodwill Squeeze? Accounting Board Weighs Fast Goodwill Write-Offs and Elimination of Pooling*, Mergers & Acquisitions,

May/June 1998, at 6.

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[10] Id.

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