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Nature of "Acquired" Surplus

By Thomas York

The term "acquired surplus" is applied in some quarters to what is in reality paid-in surplus, created upon the issuance of shares as part or entire consideration for a corporate business acquired by purchase or by statutory merger or consolidation. Such surplus differs from ordinary paid-in surplus only in that it is wholly or partly made available for the payment of dividends, in lieu of the earned surplus previously possessed by the company whose property was acquired, by express statute in jurisdictions which otherwise prohibit dividends from paid-in surplus, at least on common stock. The term appears to be employed chiefly by accountants. It is seldom if ever met with in law cases, and it is not found in the few statutes which authorize payment of dividends from such surplus. It would appear that the expression owes its currency to the notion that the transferee company actually acquires the surplus of the transferor company. Indeed, some of the statutes pertaining to this surplus are expressed in language which imports the conception of surplus being acquired. From its nature, however, earned or any other type of surplus cannot be acquired, any more than its counterpart, stated capital, can be acquired. It is merely an abstract sum of dollars measuring the extent to which assets may be distributed in dividends. What is acquired are the transferor company's assets and business as represented in a general way by the asset side of the balance-sheet, and also, in a technical or statutory merger or consolidation, its charter rights and powers and any special privileges and immunities granted it by the state.[1] The real nature of the transaction is likewise misrepresented in the statement commonly made with reference to it, that the one company is acquired or absorbed by the other, language to that effect being used even in the statutes. It is immaterial whether a corporation is viewed as a separate entity existing apart from its stockholders or, more realistically, as an association of those referred to as stockholders; it cannot in the nature of things be absorbed by another. What is absorbed is merely its business and assets, and it itself ordinarily, after discharging its indebtedness from the consideration received for its business and distributing the rest to its stockholders, passes out of existence, by dissolution, which marks the termination of the agreement among its members and of the state's permission to act as a corporation. The conception that one corporation absorbs another as such is chiefly entertained with reference to technical mergers and consolidations. But it is submitted that even here such conception is not in accord with the facts and results in inconsistencies and confusion of thought.

Creation of Paid-in Surplus in the Acquisition of a Going Business

The transaction by which the going business of one corporation is acquired by another takes any one of three legal forms: (1) ordinary liquidation and dissolution; (2) the purchase and sale of the business and assets; and (3) statutory or technical merger and consolidation. These legal devices for effecting the transaction are fundamentally the same, differing for the most part only in the extent to which they are subject to special statutory regulation. Reduced to

[1] There is in reality no transfer of charter rights, but rather, as the courts hold, a fresh grant to the transferee company, by operation of the merger and consolidation statute, of charter rights similar to those possessed by the transferor company.

its primary elements, the transaction consists merely of transferring the going business of one corporation to another for a consideration, and the three legal methods by which this is done are distinguished essentially, at least as far as concerns the question under present discussion, in respect to the statutory regulation of what shall constitute the subject matter of the transfer, the mode of conveying title to the assets, and the form of the consideration paid by the transferee to the transferor company.

In all cases except where the transfer takes the form of statutory merger or consolidation, the consideration may consist of anything of value. It may be comprised entirely of cash or other property, or of the transferee company's stock, or of its obligations, including the assumption by it of all or any portion of the transferor's liabilities; or it may be made up of any combination of these several forms of payment as agreed upon by the parties. Where the transaction is effected by means of a technical merger or consolidation, the statutes in most cases restrict the form of consideration to an assumption by the transferee company of all the transferor company's liabilities, including all outstanding contracts, and an agreed amount of the transferee company's stock.

The debts of the transferor company assumed by the transferee company should not be confused with the business transferred. The debt assumption is merely a part of the price paid for the business. In the case of the transfer of a business of a failed company, it may constitute the entire payment. It is also a gross misconception to regard a company as acquiring the "net assets" of a concern whose entire liabilities it has assumed. The term "net assets," like the term "surplus," has reference merely to a mathematical difference. It is not a thing capable of being possessed, used, and enjoyed and, therefore, of being transferred to another party, any more than surplus is. The following would be acquired in the transactions under consideration: specific pieces of property, claims against others, contracts and other rights and privileges, goodwill, trade-marks, trade names, records, correspondence files, etc., all of which collectively constitute the operating organization or going business, although in the case of a sale, as opposed to a statutory merger and consolidation, the precise extent of the transfer is a matter determined by the transfer agreement.

It is obvious that regardless of the surplus, earned or derived from any other source, which the transferor company may have had just prior to the transfer of its business, the transferee company will have no occasion to set up a surplus on its books in consequence of the transaction unless it issues shares of stock in part or entire payment for the business. If it does so issue any shares, the part of the value of the total consideration or price paid for the business, which is assignable to the shares, must be entirely allocated to stated capital, or else must be apportioned between stated capital and surplus, depending upon the relation of the aggregate par or stated value of the shares to the amount of consideration received for the shares, or in the case of shares without par or stated value, as the corporate authorities may decide, acting in accordance with the statutory requirements. It is evident that any surplus set up in connection with such issuance of shares is paid-in surplus. It is distinguishable in no respect from that created upon the issuance of stock for cash or single items of property.

Nothing seems plainer, therefore, than that there can be no inherent connection between the amount of any paid-in surplus set up on the transferee company's books and the amount of any earned and/or other surplus which the transferor company may have had at the time of the transfer of its business.

In the first place, the total consideration paid for the business is fixed without giving any thought to the transferor's existing surplus. Secondly, there can be no addition to the net worth of the transferee company as a result of the transaction unless it issues its shares of stock in part or entire payment. Thirdly, if shares are so issued, the portion of the total consideration paid for the business which is attributable to them will be divided between stated capital and surplus on a basis which utterly disregards the surplus of the transferor company. And finally, if a certain amount is allocated to surplus, it constitutes paid-in surplus and under no consideration can be regarded as earned surplus merely because the transferor company had an earned surplus, at least not where the transaction is entered into at arm's length between two mutually independent companies, the separate identity of which can on no account be disregarded.

It may also be noted that where a corporate business is comprised of several departments, each constituting more or less a distinct line of business, and it is broken up into these component parts by selling them as independent going businesses to several other corporations, these transfers may give rise, on the books of the purchasing companies, to "acquired" surplus of the same nature as when the entire business is transferred to a single corporation, that is to say, to paid-in surplus. Moreover, so far as any surplus which a corporation may set up on account of the acquisition of a going business is concerned, it is absolutely immaterial whether the previous proprietor of that business was a corporation, a partnership, or an individual; or, if it was a corporation, whether it had any surplus whatever, earned or paid-in. Nor does it matter as regards any surplus which the transferee company may set up, whether in the case of a transfer of a business by sale, as against technical merger or consolidation, the transferor company winds up its affairs and dissolves at once, or continues its existence indefinitely as holder of any securities it has received as consideration, with its surplus adjusted in consequence of the substitution and change of value of its assets. If the transferor company is continued, the fact that the transferee company has credited to surplus a portion of the value of the consideration it has paid will not affect the surplus of the transferor company.[2] In short, the acquisition of a going business partly or wholly with the acquiring company's stock—whether that acquisition takes the legal form of a purchase, a technical merger, or consolidation—in nowise differs from the acquisition of any other type of asset with stock, so far as its effect on the acquiring company's surplus is concerned. A going business is nothing more than a bundle of assets from the point of view of the company acquiring it.

Reason for Rendering Paid-in Surplus Created in the Acquisition of a Business Available for Dividends

In the great majority of going-concern acquisitions the consideration paid by the acquiring company consists of

[2] There is, to be sure, some legal authority for the view that a corporation cannot remain in existence after selling its business. It is, indeed, a fair question whether a corporation which has abandoned its charter objects by parting with its business, including the goodwill (and which has thereby impliedly agreed, as the courts hold, to refrain from competing with the vendee corporation), can on principle be regarded as doing other than effecting a *de facto* dissolution. Even the statute permitting corporations to hold stocks in other companies is hardly blanket authority for a company organized to manufacture, to flout its constitution, the articles of association, and turn itself into a purely stockholding company, at least over the objection of the state, or a stockholder, or perhaps even a creditor. Of course, where the transfer of the business in its legal aspect assumes the form of a technical merger or consolidation, the transferor company is almost universally considered to be automatically dissolved. The courts generally so hold, regardless of whether or not the merger and consolidation statute has an express provision to that effect.

two component parts—(1) the assumption of the transferor company's liabilities and (2) the acquiring company's stock. This is necessarily the case, under the statutes of most states, where the transfer takes the form of a technical merger or consolidation. The acquiring company may, therefore, have occasion to credit a certain amount of the consideration it pays for the business to paid-in surplus, and will plan to do so where its existing surplus is insufficient to absorb the contemplated dividends on the increased stock, in states where dividends are payable out of paid-in surplus. On the other hand, in states permitting payment of dividends out of earned surplus only, an otherwise desirable acquisition of a corporate business may be prevented by the fact that the acquiring company would be unable to increase the surplus available for dividends in correspondence with the augmentation of its issued stock, except from future earnings, and old stockholders would in the meantime have to be satisfied with a reduced rate of dividends. In the case of the acquisition of two or more businesses by a newly formed corporation the situation in this respect is even more unsatisfactory because the company starts its career without any earned surplus whatever. This statement applies also to a new corporation formed solely for the purpose of taking over the business of an old corporation by way of a reorganization, although here it might be contended that the transfer of the business is purely technical and has no reality because not effected between independent concerns. This possible obstacle to the effectuation of transfers of going businesses between corporations is removed by statute in a few states whose laws prohibit the payment of dividends, at least on common stock, out of any but earned surplus. The statutes, however, are couched in language that suggests the view, here considered mistaken, that the surplus set up by a company acquiring the business of another partly or wholly for its stock is the earned surplus of the company whose business is acquired, continued as such on the books of the acquiring company to the extent that it has not been capitalized.

Statutes Authorizing Dividends From Paid-in or "Acquired" Surplus

These statutes relate mostly to technical mergers and consolidations. Illinois, Pennsylvania, Minnesota, and California, which otherwise forbid by statute dividend disbursements on common stock out of paid-in surplus, permit such dividends to be paid out of surplus created in a merger or consolidation.

Illinois statute (Bus. Corp. Act, sec. 69) and Pennsylvania statute (Bus. Corp. Law, sec. 907) are expressed in identical language as follows:

"The aggregate amount of the net assets of the merging or consolidating corporations which was available for the payment of dividends immediately prior to such merger or consolidation, to the extent that the value thereof is not transferred to stated capital by the issuance of shares or otherwise, shall continue to be available for the payment of dividends by such surviving or new corporation."

The Minnesota provision (Bus. Corp. Act, sec. 20) is as follows:

"Whenever two or more corporations shall hereafter be consolidated or merged, the earned surpluses of the constituent or merged corporation or corporations may to the extent that they are not capitalized upon such consolidation or merger, be treated as earned surplus by the consolidated or surviving corporation."

California statute (Civil Code, sec. 361, as amended by L. 1933, c. 533, sec. 59) takes cognizance of any paid-in as well as earned surplus an "acquired" company may have and is as follows:

"The surplus appearing on the books

of the constituent corporations, to the extent to which it is not capitalized by the issue of shares or otherwise may be entered as earned or paid-in surplus, as the case may be, on the books of the consolidated or surviving corporation, and may thereafter be dealt with as such."

Michigan (Act No. 327, P.A. 1931, sec. 43, as amended by P.A. 1935, No. 194) has the following provision with respect to reorganizations:

"Nothing in this act contained shall prevent any corporation . . . which shall reorganize, from continuing any surplus which such corporation may have at the time of such change."

Ohio, although permitting dividends from any paid-in surplus, nevertheless has a statute (Gen. Code, sec. 8623–67) to the same effect as Illinois, Pennsylvania, and Minnesota, except that it applies to reorganizations as well as mergers and consolidations. The statute is, of course, a mere redundancy.

Minnesota, in addition to the provision pertaining to technical mergers and consolidations, has one pertaining to acquisitions by purchase, which is as follows (Bus. Corp. Act, sec. 20):

"Whenever a corporation acquires all or substantially all of the assets of another corporation in consideration of the allotment of shares of the acquiring corporation, with or without other consideration, the earned surplus of the acquired corporation shall become earned surplus of the acquiring corporation, but only to the extent that the aggregate of the stated capital, paid-in surplus, and earned surplus of the acquired corporation exceeds the aggregate of the following amounts:

(a) The value of the consideration given therefor, other than shares of the acquiring corporation and other than the assumption by the acquiring corporation of liabilities of the acquired corporation.

(b) The par value of all shares of the acquiring corporation having par value, given as consideration, and

(c) The stated capital represented by all shares of the acquiring corporation without par value, given as consideration."

The somewhat complicated nature of the foregoing formula for determining the purchasing corporation's "acquired" surplus is due to the fact that the consideration paid for the business may include whatever forms of payment and in whatever proportions may be agreed upon by the parties, and not merely stock and assumption of all the other company's debts. The formula may be reduced to the following statement: The "acquired" surplus of the purchasing corporation may not be greater than the excess of the "acquired" corporation's net worth (exclusive of any revaluation surplus) over the aggregate of the acquiring corporation's additional stated capital resulting from the issue of shares in making the acquisition and any other consideration (cash or the acquiring company's bonds and other obligations) but not the assumption of the "acquired" company's debts. Presumably, also, under this statute the "acquired" surplus cannot exceed the acquiring company's additional surplus set up in connection with any issue of shares in the transaction, or the earned surplus of the "acquired" company.

Wisconsin, which otherwise restricts payment of dividends to earned surplus, has the following provision (Statutes, sec. 182.14):

"In case, however, of the issuance of such [no-par value] shares in exchange for shares of an existing business then having a surplus, such surplus may be retained as surplus available for the payment of dividends. . . ."

The application of this provision appears to be in doubt—first, as to whether it refers to acquisitions of businesses by purchase, merger, or consolidation, and second, as to whether it actually relates to the acquisition by one corporation of shares of another corporation

merely for purposes of control, the other corporation continuing its existence and being in no way affected by such acquisition. While the acquisition by one corporation of a controlling or complete stock ownership of another corporation is sometimes considered as a "pooling" of the financial interests of the two corporations, and as, therefore, affording sufficient grounds for regarding the parent company as "acquiring" its subsidiary's surplus, it is difficult to reconcile this view with the fact that the two corporations remain separate and distinct entities. If the conception is untenable that a corporation in the process of acquiring the business of another acquires a portion of the latter's surplus, then *a fortiori*, it cannot be maintained that one corporation can acquire the surplus of another by the mere acquisition of a stock interest in the latter.