

ESOP Financial Advisor Insights

FAIRNESS OPINIONS IN ESOP TRANSACTIONS

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INTRODUCTION

At some point, virtually all privately held, middle-market company owners seek opportunities to transition company ownership and to diversify their personal wealth portfolios. An employee stock ownership plan (ESOP) is an attractive vehicle to allow employees to purchase company stock from the current business owner.

During the ESOP structuring and formation process, an independent financial advisor typically works with the current business owner and with the independent ESOP trustees in conjunction with the ESOP transaction. This article will describe the importance of the fairness opinion provided by the independent financial advisor to the ESOP trustee in an ESOP formation and/or stock purchase transaction.

OVERVIEW OF AN ESOP TRANSACTION

Although each ESOP transaction is unique, an ESOP transaction often begins with a very simple concept—a sale of stock between two parties. The current business owner decides to sell a portion of his or her equity ownership in the company to the ESOP. As the seller, the current business owner has various motivations, including the desire to diversify his or her personal wealth portfolio. However, for many business owners, there are additional desires (1) to maintain some involvement (and often operating control) in the company and (2) to maintain the independent status of the company.

An ESOP can be the ideal company buyer in this situation. This is because the ESOP trustee is not a management company. Therefore, the ESOP trustee relies on the company management team (often including the current owner) to continue to manage the company and its investment. Furthermore, because the ESOP is a private buyer, the company can keep its financial information confidential from competitors and from other outside parties.

The independent ESOP trustee is responsible for negotiating the company stock purchase with the selling shareholder(s). Therefore, it is important for the ESOP trustee to follow the proper procedures. These procedures include retaining qualified professional advisors in the form of both (1) legal counsel and (2) an independent financial advisor.

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*“The fairness opinion only relates to the facts and circumstances of the specific transaction, and it is only relevant on the date that it is issued.”*

ROLE OF THE INDEPENDENT FINANCIAL ADVISOR

The responsibilities of the independent financial advisor in an ESOP transaction are:

1. to analyze the company and
2. to estimate the fair market value of the equity being sold.

As part of this process, the independent financial advisor is often asked to provide an opinion on the final transaction structure. The opinion to the independent ESOP trustee typically states that the ESOP is not paying more than adequate consideration for the stock that it is purchasing in the transaction, as required by ERISA.

In addition, the ESOP transaction opinion often includes a fairness opinion. This fairness opinion states that the transaction, in its entirety, is fair to the ESOP from a financial point of view. The fairness opinion is a much broader, more inclusive opinion that covers all financial aspects of the transaction including “adequate consideration.”

FAIRNESS OPINION

As part of the fairness opinion, the financial advisor asserts that it is independent. This means that the financial advisor has (1) no financial interest in the company and (2) no competing relationships with any related parties to the transaction. In other words, the financial advisor is representing only one party in the transaction: the ESOP. In addition, the financial advisor’s compensation cannot be contingent

on (1) the conclusions of the opinion and/or (2) the consummation of the transaction.

The fairness opinion itself generally states that the transaction, in its entirety, is fair to the ESOP from a financial point of view. This opinion goes beyond the price per share or the value of the stock being purchased. The fairness opinion covers:

1. all elements of the transaction,
2. the potential effect of the transaction on the ESOP, and
3. the financial treatment of all other parties to the transaction.

In essence, the fairness opinion is a test of relative fairness. That is, the fairness opinion (1) considers the financial benefits to all parties and (2) determines that the ESOP is being treated fairly relative to those other parties from a financial point of view. The fairness opinion only relates to the facts and circumstances of the specific transaction, and it is only relevant on the date that it is issued.

Business owners or other company advisors often question why the independent ESOP trustee requires a fairness opinion. In general, the fairness opinion is viewed as an important part of the fiduciary process. The ESOP trustee is making an investment decision. Obtaining a fairness opinion provides an element of assurance that the ESOP trustee and its financial advisor:

1. have investigated all elements of the investment and
2. have used reasonable business judgment in making the final purchase decision.

As part of satisfying its obligation to the ESOP trustee, the financial advisor will help negotiate specific elements of the transaction. The outcome of these activities, as described in the fairness opinion, provides a higher level of documentation and support that ultimately will withstand the scrutiny of the U.S. Department of Labor.

Examples of the specific transaction elements that are typically considered by the financial advisor as part of its analysis include:

1. liquidity rights for any/all shareholders;
2. security rights (dividend, voting) that accrue to any non-ESOP shareholders;
3. the terms of the internal ESOP loan terms, compensation, consulting and noncompete agreements with key sellers/shareholders; and
4. any terms with other company stakeholders such as mezzanine or subordinated debt investors.

### WHEN SHOULD AN ESOP TRUSTEE OBTAIN A FAIRNESS OPINION?

In general, an ESOP trustee will confer with legal counsel to determine if it is prudent to obtain a fairness opinion from its financial advisor. Examples of corporate events that generally require the ESOP trustee to obtain a fairness opinion include the following:

1. the ESOP is participating in a purchase or sale of stock (other than annual repurchases due to termination events),
2. any time the corporation engages in a significant transaction with non-ESOP shareholders, particularly the controlling shareholder(s),
3. as part of issuing new equity to outside parties, and
4. when the company terminates the ESOP.

In addition, the ESOP trustee may request a fairness opinion (1) if the company undergoes a recapitalization or (2) if the company requests a restructuring of the ESOP loan. Although each of these corporate control events is unique, each such event can have a significant effect on the value of the ESOP's equity investment.

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### FAIRNESS OPINIONS TO OTHER PARTIES

Since the fairness opinion is directed to the ESOP, it is noteworthy that the opinion does not determine whether the transaction is fair to any other party. In many cases, the board of directors of the selling company may determine that a separate fairness opinion is necessary to satisfy its fiduciary obligation to the current shareholders.

A fairness opinion addressed to the board of directors of a company opines that a transaction is fair to all shareholders (rather than solely to the ESOP as a shareholder). In this case, however, the board of directors will typically retain its own independent financial advisor. This is because the ESOP's financial advisor is not independent with respect to the ESOP.

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### SUMMARY AND CONCLUSION

ESOPs continue to be an attractive vehicle to allow closely held business owners to sell company stock to the company employees. As part of the ESOP transaction, the ESOP trustee often requests a fairness opinion from its independent financial advisor.

The fairness opinion provides a review of (1) all elements of the transaction and (2) the potential impact of the transaction on the ESOP's investment. In the final analysis, the fairness opinion provides additional assurance that the independent ESOP trustee satisfied the trustee's fiduciary obligation.

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