

ESOP Financial Advisory Insights

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## ESOP EMPLOYER STOCK PURCHASE/SALE TRANSACTION FAIRNESS OPINIONS

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*The ESOP trustee has a fiduciary responsibility to the ESOP plan participants. This duty is no more obvious than when the trustee has to vote on (or otherwise approve) transactions involving the employer corporation stock. Examples of such transactions that directly affect the ESOP include: (1) the ESOP purchase (whether leveraged or not) of the employer stock, (2) the ESOP sale of the employer stock—either back to the plan sponsor or to a third party, (3) the ESOP's participation in the sale of the entire employer corporation (e.g., in response to a merger/acquisition tender offer), and (4) the employer corporation issuance of a new class of equity security (either common or preferred stock). In all of these instances, the ESOP trustee typically relies on a fairness opinion issued by an independent financial adviser to obtain information to assist the trustee in his/her decision making. This article summarizes the (1) intent, (2) content, and (3) purposes of the typical ESOP employer stock purchase/sale transaction fairness opinion.*

### INTRODUCTION

The capital structure of the typical ESOP-owned employer corporation has become more complex than ever. Many employer corporations have various layers of debt and equity securities, synthetic equity instruments, and S corporation income tax attributes.

In turn, assessing whether an employer corporation stock purchase/sale transaction is fair to ESOP participants has become more challenging for ESOP trustees. The ESOP independent financial adviser, by analyzing whether a particular stock purchase/sale transaction is fair from a financial point of view, helps the ESOP trustee to fulfill that fiduciary duty.

When the ESOP first buys the employer corporation stock, the ESOP trustee will request a fairness opinion from an independent financial adviser. This request is made to analyze whether or not the ESOP is paying more than “adequate consideration” for the employer corporation stock that it is purchasing.

In addition to the adequate consideration test for the ESOP employer stock purchase, the fairness opinion analysis is also a test of relative fairness. The purpose of the fairness opinion is to consider (1) the financial benefits of the stock purchase/sale to all transaction parties and (2) whether the ESOP is being treated fairly—relative to all other parties to the transaction—from a financial point of view.

And, when a proposed transaction involves the employer corporation capital structure, the financial analysis

underlying a fairness opinion may help the ESOP trustee negotiate on behalf of the ESOP. For example, the analysis of the synthetic equity (i.e., stock options, phantom stock, warrants, or stock appreciation rights) may allow the ESOP trustee to renegotiate so as to not upset what would otherwise be a fair transaction to the ESOP.

ESOP trustees typically obtain a fairness opinion when an important transactional event may affect the relative value of the ESOP stock ownership investment. Examples of such important transactional events include when:

1. the ESOP is participating in a purchase or sale of stock (other than routine events involving ESOP participants),
2. the employer corporation engages in a significant related-party transaction or a recapitalization,
3. the employer corporation is issuing new equity to outside parties, and
4. the ESOP is terminated.

### THE PURPOSE OF THE FAIRNESS OPINION

For the ESOP trustee, the transaction fairness opinion serves a number of useful purposes.

First, the fairness opinion is an important procedural tool. It provides the ESOP trustee with important information regarding various financial and valuation aspects of the proposed transaction so that the ESOP trustee may be

able to negotiate more effectively on behalf of the ESOP partners.

Second, the fairness opinion is an important legal tool. It provides evidence that the ESOP trustee used reasonable business judgment in the evaluation of the proposed transaction. Under the legal concept of business judgment, courts will not second guess the decisions of the ESOP trustee (or find liability for honest mistakes) provided that the ESOP trustee acted:

1. on an informed basis,
2. in good faith,
3. in a manner the trustee reasonably believed to be in the best interest of the ESOP beneficiaries, and
4. without fraud or self dealing.

Third, the fairness opinion is an important practical tool. It provides a level of support for the proposed transaction that other parties to the deal may find comforting. While not an explicit endorsement of the proposed transaction, the fairness opinion may persuade other parties to approve the transaction if the transaction is considered fair to the ESOP.

It is noteworthy that the fairness opinion (1) only relates to the facts and circumstances of the specific transaction, (2) is directed only to the ESOP, and (3) is only relevant on the date that it is issued.

### FAIR FROM A FINANCIAL POINT OF VIEW

There is no generally accepted or statutory definition of the phrase “fair from a financial point of view.” The concept encompasses both legal and financial issues. And, the fairness opinion itself does not address the legal aspects of the proposed transaction. The legal aspects of the transaction are analyzed in a legal opinion that is separate from the fairness opinion. Furthermore, the term “fair” as used in a fairness opinion is subject to interpretation.

The standard of value applicable in most state dissenting shareholder rights proceedings is “fair value.” Some ESOP professionals say analyzing that “fair value” is the appropriate standard of value for fairness opinions.

Other ESOP professionals argue that, for a price to be fair, the price should represent the highest value that shareholders would receive if the company was sold as a stand-alone entity in an auction to the highest bidder. Still other ESOP professionals argue that expected post-deal synergies should be taken into account when evaluating fairness from a financial point of view.

The fairness of the transaction consideration should be evaluated based on the facts and circumstances surrounding the particular proposed transaction. The form and the content of the proposed transaction will influence:

1. the elements of the valuation and
2. the fairness of the transaction.

For example, in certain circumstances a proposed transaction can be “fair” even if it does not include a price premium for expected post-deal merger synergies or for ownership control. In other circumstances, a proposed transaction may not be considered “fair” unless such economic factors are incorporated in the analysis of the transaction price.

*"The responsibility of the independent financial adviser in an ESOP transaction is to estimate the fair market value of the subject employer corporation equity interest."*

### INCREASING RESPONSIBILITIES OF THE ESOP TRUSTEE

Over time, gradual ownership transitions at mature ESOP-owned companies and favorable income tax treatment of the S corporation status have moved many ESOPs into controlling ownership positions. In an ownership control ESOP, managing the inherent conflict of interests has become increasingly difficult.

In these circumstances, even though the individual ESOP participants own a noncontrolling ownership interest, the ESOP trust is the stockholder of a control position in the employer corporation. Therefore, the ESOP trust has more duties than does the owner of a noncontrolling ownership position.

For example, the control owner of an employer corporation can influence (1) the make up of the board of directors (who, in turn, elect corporate officers) and (2) decisions involving the future of the subject business (e.g., mergers and acquisitions, contractual relationships, management compensation).

The trustee of a private company ESOP, using the services of a financial adviser, is required to conduct an independent appraisal of the employer corporation stock that is held by the ESOP trust. And, when the ESOP controls a employer corporation that needs to consider opportunities affecting its capital structure, a heightened level of vigilance regarding adequate consideration and relative fairness is expected of the ESOP trustee.

The responsibility of the independent financial adviser in an ESOP transaction is to estimate the fair market value of the subject employer corporation equity interest. As part of the process, another financial adviser is often asked to provide

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any contingent and limiting conditions regarding the analysis and opinion.

After reviewing the valuation report in its entirety, the ESOP trustee should be in a position to address the following questions:

- Was the report readable and easy to understand or was it filled with undefined valuation terms and jargon?
- Was the report comprehensive and organized in a logical manner?
- Has the concluded value changed over time, and if so, what were the primary drivers of this change in value (i.e., company performance, market performance, or a combination of the two)?
- Has the employer corporation financial performance improved or deteriorated over time, and has the concluded value changed accordingly?
- Have the business valuation approaches and/or methods that were used in the analysis changed over time, and if so, why have they changed?
- Does the employer stock valuation conclusion seem reasonable given (1) the historical and projected financial performance of the employer corporation, (2) the relevant market-based data, and (3) the relevant economic and industry-specific conditions?
- Does the valuation conclusion properly reflect the ESOP-specific factors such as the ESOP debt and its related income tax benefit?

## SUMMARY AND CONCLUSION

When fulfilling its fiduciary duties, an ESOP trustee will typically hire an independent financial adviser to assist in estimating the fair market value of non-publicly-traded employer corporation stock. The ESOP trustee places a great deal of reliance on the valuation opinion of the independent financial adviser. As a result, the ESOP trustee needs to exercise care in selecting a qualified, independent financial adviser.

In reviewing the work of the financial adviser, the ESOP trustee needs to have a basic understanding of the valuation process employed by the financial advisory firm. This understanding will enable the trustee to appropriately conduct a thorough review of the ESOP employer stock valuation report.

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a fairness opinion of the transaction from a financial point of view to a particular party to the proposed transaction.

While one particular party may not perceive a conflict of interest, other parties to the transaction may perceive such a conflict. In an effort to mitigate some of the perceived conflicts of interest, the employer corporation may create special committees of independent board members (1) to evaluate a proposed transaction and (2) to obtain a second transaction fairness opinion.

There are several instances when an employer corporation should obtain a second fairness opinion. For example, additional assurance opinions may be appropriate if the financial adviser providing the transaction opinion:

1. has a financial interest (e.g., equity, debt, option);
2. has an existing relationship (e.g., board member, supplier, customer); or
3. has a stake in the outcome of the transaction (e.g., a contingency or performance-based fee).

The current focus on corporate governance points fiduciaries toward obtaining independent financial advice even when a fairness opinion has already been rendered to one particular party to the proposed transaction.

## SUMMARY AND CONCLUSION

Fairness opinions serve a number of useful purposes for ESOP trustees. From a procedural standpoint, the analysis supporting the fairness opinion may be useful to the ESOP trustee in employer stock purchase/sale transaction negotiations.

From a legal standpoint, a fairness opinion provides evidence that the ESOP trustee exercised reasonable business judgment in the evaluation of the proposed transaction. From a practical standpoint, other parties to the proposed transaction may find comfort in the transaction if it is considered to be fair to the ESOP.

The form and context of the proposed employer corporation transaction will help to identify the appropriate standard of value to use when evaluating fairness. The fairness opinion for the ESOP trustee considers the financial benefits of the proposed transaction to all parties and whether the ESOP is being treated fairly relative to all of the other parties to the proposed transaction. The fairness opinion provides additional assurance that the ESOP trustee has satisfied the trustee's fiduciary obligation.

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