

ESOP Financial Advisory Insights

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A FIDUCIARY'S GUIDE TO SELECTING A FINANCIAL ADVISER AND REVIEWING AN ESOP STOCK VALUATION REPORT

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This discussion summarizes the various factors that an ESOP fiduciary should consider when hiring an independent financial adviser. The article also presents a checklist of items that the ESOP fiduciary should consider when reviewing an employer corporation stock valuation report.

INTRODUCTION

ESOP trustees are expected to act in the best interests of the ESOP participants and the plan beneficiaries. To exercise prudence in this regard, ESOP trustees often rely on independent professional advisers to help them fulfill their fiduciary obligations.

One example of this exercise of prudence is when the trustee hires an independent financial adviser to estimate the fair market value of non-publicly-traded employer corporation stock for (1) an ESOP stock purchase/sale transaction and (2) plan administration purposes.

Given the importance of these employer stock valuations, it is important that the ESOP trustee hire a qualified, independent financial adviser. Moreover, the ESOP trustee should have a reasonable understanding of the valuation process, the valuation analysis, and the written valuation work product. This understanding can assist the ESOP trustee to properly fulfill his or her fiduciary duties.

This article provides a summary of the issues an ESOP trustee should consider when (1) selecting an independent financial adviser and (2) reviewing an ESOP employer stock valuation report.

SELECTING A QUALIFIED FINANCIAL ADVISER

The ESOP trustee should exercise a great deal of discretion in selecting the financial advisory firm to conduct (1) employer corporation stock purchase/sale transaction-related valuation work or (2) the ERISA-required annual employer corporation stock valuations.

The criteria that are often considered during the ESOP trustees selection process include:

1. the qualifications of the financial advisory firm,
2. the qualifications of the principal analyst(s), and
3. independence issues regarding the professional firm.

"The individual qualifications of the principal analyst are just as important as the institutional qualifications of the financial advisory firm."

The qualifications and competence of a financial advisory firm can be demonstrated in many different ways. An ESOP trustee should consider retaining only financial advisory firms that routinely render valuation opinions and fairness opinions related to ESOP engagements. Given the intricacies of ESOP-related valuation work, it is necessary for the financial adviser to be familiar with the various

ERISA, IRS, and DOL guidelines and proposed regulations that impact ESOP-related analyses.

The financial advisory firm should be able to demonstrate its past experience to the ESOP trustee related to: (1) structuring ESOP transactions and (2) conducting valuation analyses for such ESOP assignments. This demonstration should include the financial advisory firm's relevant industry-specific valuation experience.

The individual qualifications of the principal analyst are just as important as the institutional qualifications of the financial advisory firm. Since the principal analyst will be conducting/managing the valuation engagement, it is important for the principal analyst to have a working knowledge of ESOP-related valuation issues. Often, the analyst acquires this knowledge through years of experience of working on a variety of ESOP-related assignments.

While interviewing the individual valuation analyst, it is prudent for the ESOP trustee to inquire about the analyst's personal experience in conducting ESOP-related engagements. This inquiry would typically include questions related to the analyst's experience in providing advice on ESOP feasibility, structuring, and valuation issues. It may also be appropriate for the ESOP trustee to inquire about the analyst's industry experience, education, professional accreditations, and professional memberships.

While it is not required that the analyst be a specialist in a particular industry, the ESOP trustee should expect the analyst to have at least some relevant industry-specific experience that complements the subject assignment. This experience is particularly helpful when the subject employer corporation is affected by various industry-specific risk return factors and valuation metrics.

In terms of education, many ESOP financial advisers have formal education in finance, accounting, and/or economics. In the same respect, many analysts hold one or more professional accreditations that are specific to the business valuation discipline.

Some of the more noteworthy professional accreditations related to the business valuation profession include the following:

1. accredited senior appraiser (ASA) designation of the American Society of Appraisers,
2. certified business appraiser (CBA) designation of the Institute of Business Appraisers (IBA), and
3. accredited business valuation (ABV) designation of the American Institute of Certified Public Accountants (AICPA).

The ESOP trustee may also find it helpful to inquire about the analyst's involvement in professional organizations, specifically organizations dedicated to the business valuation profession. Involvement in these organizations demonstrates the analyst's interest and dedication in advancing his or her profession.

In selecting a financial advisory firm, the ESOP trustee should not hesitate (1) to conduct interviews with various firms and (2) to follow-up with references provided by the firms. Often, these interviews provide ESOP trustees with information that they could not gather by simply reviewing firm brochures.

For example, interviewing an analyst allows the ESOP trustee to learn about the analyst's expertise and experience. Such interviews also allow the trustee to evaluate the analyst's communication and presentation skills. These skills are important, especially in situations where the analyst will be making periodic presentations to the ESOP

trustee, the employer corporation board, and/or the plan participants.

The ESOP trustee should also be concerned with independence issues when hiring a financial adviser. These independence issues tend to arise when the financial advisory firm either has or intends to provide other services to the sponsor corporation.

The ESOP trustee should understand what, if any, prior services have been provided by the financial advisory firm to the sponsor corporation. These prior services may include valuation services that were conducted for:

1. estate and gift tax planning,
2. succession planning,
3. financial reporting,
4. income tax purposes,
5. mergers and acquisitions, and
6. litigation-related purposes.

The ESOP trustee should also understand how those prior services impact the financial advisory firm's independence in providing advisory services to the ESOP trustee.

In the same respect, the financial advisory firm should evaluate the methods, assumptions, and limiting conditions that are part of its past valuation work for the sponsor corporation. The objective of such a review is to determine whether these methods, assumptions, and limiting conditions will be different in the context of an ESOP-related analysis.

This review will help the financial advisory firm foresee any possible conflicts that may arise due to changes in valuation procedures and assumptions.

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REVIEWING THE VALUATION REPORT

The first step in reviewing an ESOP employer stock valuation report is to become familiar with the business valuation process. The ESOP trustee should have a sense of the level of due diligence and analysis that was conducted by the analyst to reach the employer corporation stock valuation conclusion.

For example, the ESOP trustee may be interested in whether the analyst conducted interviews with company management during the course of the valuation. These interviews are normally conducted to:

1. understand the nature and history of the sponsor corporation and
2. discuss the historical and prospective performance of the sponsor corporation.

It is not uncommon for these interviews to take place in-person at the sponsor corporation facilities. This arrangement provides the analyst the opportunity to tour the sponsor corporation facilities and view the physical condition of the sponsor corporation tangible assets.

The interview process will also allow the analyst to gain a better understanding of the employer corporation: (1) products and/or services, (2) strategic plan, (3) competitors, and (4) competitive position in the market.

A thorough valuation analysis will be documented with a comprehensive valuation report. It is prudent for the ESOP trustee to review each periodic stock valuation report in order to understand its content.

The following sections of this article provide an overview of the typical employer stock valuation report content that should be of interest to an ESOP trustee.

Description of the Subject Ownership Interest

The valuation report should adequately describe the ownership interest subject to valuation. Often, this description includes:

1. the number of shares subject to valuation,
2. the name of the employer corporation, and
3. the form of ownership.

For example, a description of the valuation subject may read as follows:

We estimated the fair market value of 20,000 voting common shares of ABC, Inc. ("ABC"). ABC is a corporation organized in the State of Delaware.

The above description provides the ESOP trustee with (1) the exact number of shares that are subject to valuation and (2) the name of the employer corporation that is subject to analysis.

Standard of Value and Premise of Value

Fair market value is the standard of value for ESOP-related valuations conducted for plan administration purposes. The valuation report should specifically state that fair market value is the appropriate standard of value for the subject engagement, and the valuation report should also define the term fair market value.

There are several definitions of fair market value, but many of these definitions contain similar language. Fair market value is commonly defined to be the price at which the property would change hands between a willing buyer

and a willing seller, when neither is under any compulsion to buy or to sell, and with both parties having reasonable knowledge of the relevant facts.

Some analysts expand the definition to add that the buyers and sellers are hypothetical buyers and sellers—opposed to a specific buyer and/or seller. Nevertheless, the important elements of the definition remain the same. That is, an unrelated buyer and seller are coming together to conduct a transaction when neither is being forced to buy or sell and both parties are aware of all relevant information concerning the subject ownership interest.

The employer stock valuation report should describe the premise of value—that is whether the company was valued (1) as a going-concern business enterprise or (2) based on a liquidation premise of value. If the analyst did not value the employer corporation as a going concern, the valuation report should discuss the rationale for conducting the valuation in that manner.

Purpose of the Analysis

The ESOP valuation report should clearly outline the purpose of the analysis.

An ESOP transaction-related opinion—such as a fairness opinion—will state the analyst's opinion as to the fairness of a specific transaction from a financial point of view.

Alternatively, the analyst may conduct a valuation opinion on an annual basis for ESOP plan administration purposes. This analysis is typically conducted for the stock redemptions that occur under the normal operations of the ESOP.

In either case, the valuation opinion report should describe the purpose of the analysis so there is no confusion over the intended use of the report.

Valuation Date and Report Date

The valuation report should indicate (1) the valuation date and (2) the report date. The valuation date is the date "as of" which the analyst's opinion of value applies. The report date is the date the valuation report was prepared.

For example a valuation report may summarize the fair market value of an ownership interest as of December 31, 2004. However, the valuation report may not be prepared until April 15, 2005. In this case, the valuation date is December 31, 2004, and the report date is April 15, 2005.

In this example, the ESOP trustee should understand that the valuation opinion takes into account all known and knowable information available through December 31, 2004. Under the fair market value standard of value, the valuation report will typically not take into account any information that became available, or known, subsequent to the valuation date.

Level of Value and Prerogatives of Ownership Control

During the valuation analysis, the analyst will gain an understanding of the ownership control attributes (or lack thereof) associated with the ESOP ownership interest. For example, the subject ownership interest may consist of:

1. a 35 percent noncontrolling ownership interest in the employer corporation total equity,
2. a 51 percent ownership interest that has some control level attributes, or
3. a 70 percent ownership interest that has many of the features of absolute control.

The valuation report should clearly identify the subject ownership interest and describe the prerogatives of ownership control that accompany the subject interest.

For example, a 35 percent ownership interest may allow the ESOP trustee to elect one board member but may not provide any other opportunities to effectuate change at the employer corporation. In this case, the ownership interest would normally be valued as a noncontrolling ownership interest.

In contrast, a 51 percent ownership interest may allow the ESOP trustee to exercise ownership control over several aspects of the employer corporation. These prerogatives of control may include, but are not limited to:

1. the appointing of new board members and management personnel,
2. the changing or renegotiation of management compensation and perquisites,
3. the issuing or repurchasing of employer corporation shares,
4. the issuing or repaying of employer corporation debt, and
5. the changing of the strategic direction of the company.

In this case, the employer stock valuation report should (1) identify the specific control attributes of the subject ownership interest and (2) explain how these attributes were considered in the valuation process.

A holder of a 70 percent ownership interest may have not only the prerogatives of control listed in the previous paragraph, but also the ability to sell the sponsor corporation or substantially all of the sponsor corporation assets. Once again, this level of control should be identified in the

valuation report and properly reflected in the valuation analysis.

In addressing the level of ownership control within the stock valuation report, an analyst may also discuss the distribution of stock ownership. This may be particularly relevant in situations where no one shareholder has a controlling ownership interest in the sponsor corporation common stock.

SOURCES OF INFORMATION

A comprehensive valuation report will typically include a section that lists the data and documents that the analyst relied on to develop the employer stock valuation opinion.

By reviewing this section of the employer stock valuation report, the ESOP trustee will have an immediate understanding of (1) the publicly available and (2) the non-publicly-available documents that were considered in the valuation process.

The sources of information list should include not only the financial-related documents used in the valuation analysis (e.g., financial statements, empirical market data), but the non-financial-related documents as well (e.g., ESOP documents, employer corporation documents).

When properly prepared, the sources of information list should enable an independent analyst to identify the documents necessary to replicate the subject stock valuation analysis.

Description of the Subject Employer Corporation

A detailed valuation report will provide an adequate description for the reader to understand the fundamental position of the subject employer corporation.

A comprehensive description of the subject employer corporation business will normally include the following:

- a discussion of the history of the employer corporation and its current position;
- a description of the products and/or services provided by the employer corporation;
- a description of the markets served by the employer corporation;
- a description of the environment in which the employer corporation competes and how the company is positioned within that environment;

"Under the fair market value standard of value, the valuation report will typically not take into account any information that became available, or known, subsequent to the valuation date."

- a discussion of the qualifications of employer corporation management and its depth;
- a discussion of significant relationships with related parties, customers, suppliers, etc.;
- a discussion of pending litigation that is significant to the employer corporation;
- a review of recent transactions in the employer corporation stock (if any); and
- a discussion of any recent offers received for the employer corporation or its assets.

Overview of Economic and Industry-Specific Conditions

The valuation report should provide an overview of economic and industry-specific factors that affect the valuation of the subject sponsor corporation.

The economic overview may include a discussion of trends in economic growth, inflation, consumer spending, consumer confidence, interest rates, construction starts, and business spending. In each case, the analysis should be tailored to the economic factors that most directly affect the subject sponsor corporation. This section of the report may also include a discussion of leading economic indicators that give insight into the future performance of the sponsor corporation.

The industry overview section of the valuation report will typically discuss how the industry operates and recent trends affecting companies within the industry. The section may also describe the sponsor corporation's position in the industry and its market share relative to other competing firms.

Employer Corporation Financial Performance

As part of the employer stock valuation process, the financial adviser will analyze the financial performance and financial condition of the employer corporation. A summary of this financial analysis should appear in the valuation report.

The historical financial performance of the employer corporation is reflected on the company income statements and cash flow statements. The valuation report may include a discussion of the following:

- the historical growth or decline in sales,
- the historical growth or decline in aggregate profitability (i.e., gross profit, operating profit, pretax profit, and net profit),

- the historical growth or decline in profit margins,
- the historical growth or decline in cash flow, and
- the historical payments of dividends.

The analyst will also review the employer corporation balance sheet to evaluate its financial condition. The valuation report may contain a discussion of the following balance-sheet-related items:

- the employer corporation liquidity and working capital position,
- the employer corporation asset utilization by means of various financial ratios (e.g., accounts receivable turnover, inventory turnover, etc.),
- the employer corporation tangible asset base, and
- the employer corporation capital structure and leverage.

A thorough financial analysis will include not only a discussion of certain financial statement trends but also a discussion of what factors caused the respective trends.

Also useful is a discussion of how the employer corporation performed relative to other companies in the industry. This comparative financial analysis typically identifies the financial strengths and weaknesses of the employer corporation compared to other guideline/competing companies.

The comparative analysis will help the ESOP trustee understand how the employer corporation performed relative to other companies in the industry. This comparative performance analysis may be based on such factors as growth, profitability, and volatility.

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Financial Statement Normalization Adjustments

When appropriate, the analyst will make financial statement normalization adjustments (1) to the employer corporation and (2) to the selected guideline publicly traded companies. The financial statement normalization adjustments are necessary so that the employer corporation financial performance is on the same basis as the selected guideline companies' financial performance.

Some of the more common financial statements adjustments made to the employer corporation include the following:

- adjustments for extraordinary or nonrecurring income and expense items,

- adjustments for differences in inventory accounting methods,
- adjustments for nonoperating income and expense items,
- adjustments for non-arm's-length transactions/arrangements, and
- adjustments for ESOP benefit expense and normalized employee benefit expenses.

The valuation report should identify the financial statement adjustments and adequately explain the rationale for each adjustment.

Generally Accepted Business/Stock Valuation Approaches and Methods

There are three generally accepted approaches to the valuation of a business interest: the market approach, the income approach, and the asset-based approach.

The valuation report should clearly describe which approaches—and which valuation methods within each approach—were used in the analysis. In the same respect, the valuation report should explain which approaches were not used in the analysis and why they were not used.

The ESOP trustee should be concerned if the analyst changes the selected valuation methods from year to year without proper explanation and support. These unsupported changes often give the appearance that the analyst is attempting to support a predetermined value.

With regard to the market approach, and specifically the guideline publicly traded company method and the guideline merged and acquired company method, the employer stock valuation report should include the following:

- The criteria used to select the guideline companies. The selection criteria may include standard industrial code, business description, size, growth, profitability or a combination of several relevant factors.
- A detailed description of each selected guideline company. This description may include a discussion of the selected guideline company's business, its products and/or services, and its position in the market. Other information, such as whether the guideline company recently completed acquisitions, may also be relevant.
- The market-derived valuation pricing multiples that were selected for the analysis. These pricing multiples may include invested capital pricing multiples or equity pricing multiples. Industry-specific factors often influence the type of market pricing multiples that are used in the stock valuation analysis.

For example, the valuation of a commercial bank will typically involve the use of market-derived valua-

tion pricing multiples that are based on (1) the market value of equity and (2) earnings and/or book value of total equity capital.

In contrast, the valuation of a manufacturing company may require the use of market-derived valuation pricing multiples that are based on (1) the market value of invested capital and (2) invested capital earnings and/or invested capital cash flow.

- The rationale for selecting the market-derived invested capital pricing multiples that are applied to the employer corporation financial fundamentals. The reader of the valuation report should be able to understand the analyst's thought process for arriving at the selected valuation pricing multiples.

The application of an average or median market-derived pricing multiple, with no support for such a selection, is typically not appropriate.

- The rationale for the selected weighting used in the valuation synthesis. For example, if the value indication based on projected cash flow is given more (or less) weight than the value indication based on trailing 12-month cash flow, the valuation report should explain why.

With regard to the income approach, and specifically the discounted cash flow method, the employer stock valuation report should include the following:

- A discussion of who prepared the financial projections. The projections are often prepared by employer corporation management. In other cases, the projections are prepared by the analyst with input from employer corporation management.

In the case of management prepared projections, the report should explain how the analyst tested the reasonableness of the projections. In all cases, the financial projections should be supportable.

- Consideration of debt repayments and other cash requirements. The valuation analyst should consider the timing of debt repayments (both ESOP and non-ESOP related debt)—and their impact on value. The valuation report should also consider the cash requirements for necessary capital expenditures and any anticipated stock repurchase requirements.
- The appropriate matching of financial projections and the present value discount rate. For example, if the discounted cash flow method incorporates a projection of invested capital cash flow, or cash flow available to invested capital, then the present value discount rate should be the weighted average cost of capital.

In contrast, if the projection is of cash flow available to equity capital, then the present value discount rate should be the cost of equity capital.

- A discussion of the cost of capital components. This discussion would include an explanation of how the analyst estimated the cost of equity capital, the cost of debt capital, and the weighting of each cost component in a weighted average cost of capital calculation.
- Support for the selected residual value pricing multiple or residual value direct capitalization rate. In many valuations, the residual value of the employer corporation constitutes a significant portion of the employer corporation present value.

As a result, the selected residual value pricing multiple, or residual value direct capitalization rate, often has a substantial effect on the concluded value of the employer corporation. The rationale for the selected residual pricing multiple, or the selected residual growth rate within the residual direct capitalization rate, should be adequately explained and supported.

The asset-based approach is typically not used in ESOP-related employer stock valuations. This is true unless the employer corporation:

1. is a holding company that owns other operating businesses or income-generating investments or
2. is expected to generate cash flow (or some other measure of economic income) that does not fully reflect the current market value of the corporation's operating and/or nonoperating assets.

However, when the asset-based approach, and specifically an asset accumulation method, is used, the valuation report should include a discussion of how each employer corporation asset and liability was valued. This discussion would include all assets (monetary, tangible, and intangible) and all liabilities (both recorded and contingent).

The analysis should specifically address all off-balance-sheet assets and off-balance-sheet contingent liabilities that may impact the employer stock valuation.

Valuation Synthesis and Conclusion

The employer stock valuation report should contain a section that provides (1) a valuation synthesis of alternative value indications and (2) a final conclusion of employer stock value. The following factors should be included in this section of the employer stock valuation report:

- A discussion of how each value indication from each approach and method was weighted in the value conclu-

sion. An explanation should be provided for each of the selected weightings.

- A discussion of any valuation premium or discount that may be appropriate to reflect the ownership control, or lack of ownership control, attributes of the subject ESOP ownership interest. The discussion of the application of valuation adjustments should include:
 1. the rationale for each valuation premium or discount and
 2. the supporting data or factors used to estimate the valuation premium or discount.

The estimated ownership control premium should reflect the adjustments that were made to the employer corporation financial statements. In other words, if the analyst adjusted the company's financial performance for ownership control level/discretionary items, then the analyst should not reflect these same control price benefits a second time through the application of an ownership control premium.

- A discussion of nonoperating assets (or liabilities) that need to be factored into the analysis. These may include excess cash or securities, related party loans, excess land, investments in other companies, or other assets that have not been properly reflected in the valuation analysis.

- A discussion of the illiquidity, or lack of marketability, of the subject ownership interest. Most noncontrolling ownership interests in non-publicly-traded companies are relatively illiquid. However, the liquidity of the ESOP-owned employer corporation stock may be affected by a put right that is part of the plan.

The valuation analyst should consider any such put right in the estimate of the appropriate discount for lack of marketability, if any. In this regard, the analyst should consider various company-specific factors such as:

1. the employer corporation's ability to honor the put right,
 2. the size of ESOP ownership interest,
 3. demographics of the ESOP participants,
 4. the company's expected repurchase liability,
 5. the employer corporation projected cash flow,
 6. the employer corporation's ability to raise capital, and
 7. other expected demands on the employer corporation capital.
- A discussion of any contingent and limiting conditions. The valuation report should contain language that lists

"The . . . report should contain a section that provides (1) a valuation synthesis of alternative value indications and (2) a final conclusion of employer stock value."

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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ESOP FAIRNESS OPINIONS

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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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