

The Independent Financial Adviser and ESOP Feasibility, Formation, and Transactional Fairness Opinion Analyses

Valuation analysts and independent financial advisers are often asked to opine on stock purchase or sale transactions (potential or pending) involving an employee stock ownership plan (“ESOP”) and an ESOP sponsor company. This discussion focuses on the role of the independent financial adviser in (1) identifying successful sponsor company candidates for a potential ESOP formation, (2) performing an ESOP formation financial feasibility analysis, and (3) preparing an ESOP sponsor company stock purchase (or sale) transaction fairness opinion. This discussion is primarily presented from the perspective of the financial adviser to the ESOP trustee. This discussion is intended to provide guidance (1) to closely held company owners who are considering an ESOP formation and a stock sale transaction and (2) to legal, accounting, trustee, and other ESOP professionals who may be evaluating an ESOP sponsor company stock purchase or sale transaction.

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INTRODUCTION

This discussion provides guidance for closely held company owners who are considering:

1. an employee stock ownership plan (“ESOP”) formation and/or
 2. an ESOP leveraged purchase of the sponsor company stock.
1. achieve the wealth enhancement, investment diversification, and asset monetization objectives of the closely held company owners and
 2. provide a controlled ownership transition process to a friendly corporate acquirer (i.e., the sponsor company employees) through a tax-advantaged sale transaction.

This discussion also provides guidance for sponsor company bankers, leveraged ESOP financing institutions, sponsor company accountants, sponsor company legal counsel, ESOP legal counsel, and ESOP trustees.

This discussion focuses on how an ESOP formation/sponsor company ownership transition transaction can provide a mechanism to:

Independent financial advisers (“financial advisers”) who provide professional services related to the design and implementation of a ESOP sponsor company leveraged stock purchase frequently receive calls from closely held company owners. These closely held company owners may own companies of all sizes and in all industries.

Many private company owners may have some limited information regarding the economic benefits

associated with of an ESOP formation and a sponsor company stock acquisition. However, the private company owners typically do not have sufficient information to make an informed decision regarding how an ESOP leveraged stock acquisition transaction would work in their closely held company.

Unless indicated otherwise, this discussion is presented from the perspective of the financial adviser to the ESOP trustee (and not from the perspective of the financial adviser to the sponsor company or to the selling shareholders).

This discussion summarizes the attributes that independent financial advisers consider in a closely held company that may make it a “good” candidate for an ESOP formation/leveraged stock purchase transaction. This discussion is based on the typical role played in ESOP sponsor company stock purchase (or sale) transactions by:

1. the financial adviser to the ESOP trustee (i.e., the sponsor company buyer) and
2. the financial adviser to the closely held company owners (i.e., the sponsor company sellers).

As with any general discussion of a complicated issue, there will be exceptions to the ESOP formation sponsor company candidate criteria discussed herein.

This discussion also summarizes (1) the ESOP formation process and (2) the typical ESOP formation financial feasibility analysis process.

Finally, this discussion summarizes the typical role of the financial adviser in the analysis of a pending sponsor company stock purchase/sale transaction. Specifically, this discussion focuses on the purpose and the objective of the financial adviser’s fairness analysis and fairness opinion in the assessment of a pending ESOP purchase (or sale) of sponsor company stock.

ESOP FORMATION SPONSOR COMPANY CANDIDATE CRITERIA

The following discussion summarizes some of the criteria that financial advisers consider in the assessment of whether a particular closely held company may be a potential candidate (1) for an ESOP implementation and (2) for an ESOP purchase of the private company stock.

#1: Closely Held Company Owner Need for Wealth Diversification

The principal shareholders of the closely held company often have a need to diversify their personal

wealth and investment portfolios. Typically, these individuals have spent most of their careers building and managing the subject closely held company.

However, perhaps due to their dedication to the closely held company, these otherwise successful individuals typically have not diversified their personal wealth. Often, virtually all of the personal wealth of these business owners is tied up in an illiquid ownership interest in the subject closely held company.

#2: Closely Held Company Owner Desire for Personal Retirement and Ownership Succession Planning

The subject closely held company shareholders may want to begin the ownership succession planning process or may be nearing retirement age. Such shareholders may be considering what ownership transition alternatives are available to them.

For shareholders who are interested in maintaining some continuity in the management and ownership of the closely held company, an ESOP leveraged stock purchase transaction may provide a viable alternative to the sale of the subject company to a corporate acquirer.

Many closely held company owners do not begin the ownership succession planning process as early as they should. An ESOP leveraged stock acquisition transaction can be an effective mechanism for transitioning the closely held company to the next generation of management and ownership. However, it is important to begin the ESOP formation planning process as early as possible—so that the sponsor company ownership transition can be orderly and efficient.

There are numerous examples of closely held company shareholders who sold their shares to a newly formed ESOP—and then departed soon after the company sale. However, without sufficient time to adequately train and prepare the successor company management team, an ESOP leveraged stock purchase transaction may be a risky form of ownership transition.

#3: Closely Held Company Business Cycle Considerations

The best candidate for an ESOP leveraged stock acquisition transaction will be a closely held company:

1. that has been in business for a number of years and
2. that has demonstrated an established position in its marketplace.

In addition, the successful candidate for an ESOP leveraged stock acquisition transaction will be a closely held company that:

1. is currently profitable and
2. is experiencing historical and expected long-term growth.

The more reliable the subject company's expected future results of operations, the less risk there is to the ESOP investment in the sponsor company stock.

In contrast, an ESOP leveraged stock acquisition transaction in an immature sponsor company can be problematic. The sale of a development stage company's stock to an ESOP may occur at a lower transaction price than the sale of a similarly sized mature company that has developed its markets, products, and services.

In the ownership transition planning process, financial advisers considering an ESOP leveraged stock acquisition transaction should carefully analyze the growth prospects for the subject company. If the value of the potential sponsor company may significantly increase in the future, it may be in the best interests of the private company owners to:

1. sell only a small percentage of the subject company stock to the ESOP and
2. defer the sale of the remainder of the subject company stock to a later date.

Alternatively, if the subject company results of operations are expected to continue on an established growth curve, then it may be appropriate to sell the entire company to an ESOP—at its current fair market value. In this scenario, the selling stockholders will not miss out on any future increases in the subject company value.

#4: The Subject Company Size Considerations

ESOP leveraged stock acquisitions are more common in larger closely held companies than in smaller closely held companies. For the small closely held company, an ESOP leveraged stock acquisition transaction may not be practical. This consideration is due to the fact that there is a relatively fixed level of administration costs related to the initial formation—and the ongoing maintenance—of a leveraged ESOP.

In other words, the expense associated with an ESOP formation does not vary directly with either the size of the sponsor company or the value of the sponsor company stock purchase. This statement is



generally true regardless of the size of the subject closely held company.

These transaction-related costs may represent a small percentage of the company sale price for a larger company (e.g., a company with an equity value over, say, \$50 million). However, these transaction-related costs may represent a large percentage of the company sale price for a small company (e.g., a company with an equity value below, say, \$10 million).

The following discussion presents three so-called “rules of thumb” regarding the minimum practical size for an ESOP formation/leveraged employer stock purchase transaction.

The Subject Company Number of Employees

There is no legal limit regarding how many employees a closely held company must have in order to sponsor an ESOP leveraged stock acquisition. However, companies with fewer than 25 to 50 employees may find that the costs of implementing a leveraged ESOP stock purchase transaction may make such an ownership transition economically unattractive.

There is also the issue of the amount of the ESOP participant/employee annual payroll required to support the required annual contributions to the ESOP plan. This issue is important because the Employee Retirement Income Security Act of 1974 (“ERISA”) limits the amount of the annual contribution that the employer corporation can make to the ESOP—and that limit is based on a percentage of the employer corporation total annual payroll.

The National Center for Employee Ownership (“NCEO”) suggests that 25 may effectively be the minimum number of employees required to

economically sponsor a leveraged ESOP stock purchase transaction.

Experienced financial advisers often suggest that 30 to 50 employees may be a more realistic “rule of thumb” regarding the minimum number of employees required to economically accomplish an ESOP leveraged stock purchase transaction.

The Subject Company Annual Revenue

Of course, the guideline level for the profitability of closely held companies varies greatly, even within the same industry. For this reason, using annual revenue as a guideline of company suitability for an ESOP formation is not always the most helpful rule of thumb. However, a leveraged ESOP formation is rare in a sponsor company with less than \$10 million to \$25 million in annual revenue.

The Subject Company Profitability and Estimated Equity Value

In many cases, the value of the sponsor company equity can be generally estimated based on:

1. the application of a market-derived pricing multiple multiplied by
2. the sponsor company’s historical and/or prospective income.

For such sponsor company preliminary valuation purposes, subject company income is often measured as either EBIT (i.e., earnings before interest and taxes) or EBITDA (earnings before interest, taxes, depreciation, and amortization).

For example, let’s assume that the subject closely held company generates normalized ex post EBITDA of \$2,000,000. And, let’s assume that the appropriate market-derived EBITDA pricing multiples are in the range of 8x to 10x. Based on that EBITDA level and those EBITDA pricing multiples, the total enterprise value indication may be in the range of \$16 million to \$20 million (before subtracting interest-bearing long-term debt). Subtracting the subject company’s outstanding interest-bearing long-term debt would indicate the total equity value for the subject sponsor company.

That equity value would be based on a marketable, controlling ownership interest level of value basis.

A very general “rule of thumb” is that the equity value of a sponsor company should be at least \$10 million in order for an ESOP leveraged stock purchase transaction to be economically viable.

#5: A Strategic Buyer Purchase Price Is Not a Requirement of the Selling Stockholders

As a general rule, the stock purchase transaction is more likely to go well when the closely held company shareholders recognize the need to be reasonable when obtaining liquidity through a leveraged stock sale to an ESOP. In contrast, an ESOP leveraged stock purchase transaction is more likely to be unsuccessful when the closely held company stockholders demand to receive the highest maximum price for their stock.

Part of the leveraged ESOP planning process is the preparation of a post-transaction sponsor company expected cash flow analysis. The ESOP trustee and its financial adviser should carefully analyze the expected future financial condition of the subject company in the years after the sale. In this analysis of sponsor company future results of operations, the financial adviser will typically consider both (1) the most-likely and (2) the worst-case financial projection scenarios.

The objective of this expected future (post-ESOP implementation) sponsor company cash flow analysis is to ensure that the subject company:

1. will be reasonably able to amortize the ESOP leveraged stock acquisition debt and
2. will be reasonably able to react to unexpected business opportunities or contingencies as they may arise in the future.

#6: Quality of Successor Management

A closely held company candidate to sponsor an ESOP leveraged stock purchase should have a senior management team that:

1. has been in place for several years and
2. is actively involved in the ESOP formation process.

Such a sponsor company management team will mitigate the ownership transition problems that may follow the sale of the principal shareholder’s stock to the ESOP.

In a recent ESOP stock acquisition transaction, the sponsor company senior management team included several executives: the president, CFO, purchasing manager, director of manufacturing, and the company facility managers.

From the inception of the leveraged ESOP transaction planning, these sponsor company executives were all actively involved in the planning process. After the ownership transition transaction

was completed, this management team was there to ensure that the now ESOP-owned sponsor company would continue to be successful.

In contrast, the sudden departure of a key shareholder/employee can have a disruptive effect on the sponsor company. Let's consider the example of a closely held company founder who developed most of the company's business relationships over the years. If that company founder suddenly decided to retire right after selling the sponsor company stock to the newly created ESOP, then those business prospects could be imperiled.

Accordingly, financial advisers to an ESOP are particularly sensitive to key-person-dependent sponsor company sale transactions. This is because the ESOP investment in a "key-person-dependent" sponsor company carries with it higher risk—and correspondingly greater required returns.

As a part of the sponsor company stock valuation process, the financial adviser may spend a significant amount of time talking to—and assessing the competency of—the sponsor company management team.

#7: Consideration of Sponsor Company Contingent Liabilities

The sponsor company contingent liabilities are often discussed at the initial ESOP formation planning meeting. Financial advisers are sometimes involved early when the subject closely held company is, in almost all respects, a good candidate for an ESOP formation and leveraged stock purchase transaction.

However, suppose the financial adviser has performed the due diligence investigation with regard to the potential sponsor company and uncovers significant contingent liabilities. These contingent liabilities invariably may be a significant barrier to the ESOP formation and leveraged stock purchase transaction.

In one situation, the management (who were potential buyers) of a closely held manufacturer of specialty chemical products, asked the ESOP trustee and its financial adviser to analyze the financial feasibility of a leveraged ESOP stock purchase transaction. The closely held company management had some idea of what the fair market value of the company was. Therefore, the closely held company owners had some idea of what price a sale of the company to an ESOP would yield to the subject company shareholders.

In fact, the financial adviser's estimated fair market value of the company was within the range of what company management thought it should be. After additional due diligence analysis, however, the

ESOP trustee's financial adviser discovered that the subject manufacturer had a serious ground water contamination problem.

This contingent liability (i.e., the environmental cleanup costs) turned out to be a deal breaker. In this case, there could be no sale of the closely held company stock to an ESOP without a full indemnification for the environmental liability from the selling shareholders to the ESOP trust.

It is often better for all parties to delay the implementation of the ESOP until such contingent liability issues are resolved. This is because the ESOP trustee will be understandably concerned over an investment in a sponsor company with such unresolved liability issues.

#8: Management Openness to the Benefits of Broad-Based Sponsor Company Ownership

Successful ESOP formation candidates tend to be sponsor companies where the senior management fully supports the concept of broad-based employee ownership. In sponsor companies where ESOP support only resides at the lower employee levels, effective communication of the ESOP benefits throughout the organization becomes difficult.

In such instances, the formation of the ESOP will not have the expected positive impact on the sponsor company prospective results of operations.

#9: Available Collateral for the Sponsor Stock Acquisition Loan

The amount of (and the quality of) the sponsor company stock acquisition loan collateral is an important issue in any ESOP leveraged stock purchase transaction. This consideration is particularly important with regard to the ESOP acquisition of the stock of professional services firms. Unlike industrial and commercial companies, professional services firms often have relatively small amounts of tangible assets to pledge as collateral for the sponsor company stock acquisition loan.

The loan underwriting criteria with respect to ESOP sponsor company stock acquisition loans are pretty much the same as for any other kind of commercial lending. The ESOP financial institution lender is looking for a security interest in the form of loan collateral. And, the ESOP financial institution lender will often look to the sponsor company for unencumbered tangible assets to pledge as such debt collateral.

The issue of the ESOP stock acquisition loan collateral should be an early planning issue for both:

1. the sponsor company and
2. the financial adviser to the ESOP.

In the event that there is insufficient loan collateral, the sponsor company selling shareholders may have to support the ESOP stock acquisition loan with a pledge of the sale transaction proceeds. In circumstances where the sponsor company selling shareholders pledge the transaction sale proceeds as loan collateral, the selling shareholders effectively continue to be at risk for the performance of the sponsor company.

THE ESOP FORMATION FINANCIAL FEASIBILITY STUDY

Most ESOP leveraged stock acquisition transactions begin as the proposed solution to a company owner's specific problem or objective. The owner's objective may be: how can that company owner achieve liquidity from an investment in a substantial closely held company? The successful implementation of an ESOP leveraged stock acquisition involves significant planning.

An ESOP formation financial feasibility study is one important component of this planning. Such ESOP formation feasibility studies are typically performed by financial advisers to the owners of the sponsor company with significant experience and expertise in both:

1. closely held sponsor company ESOP formations and
2. ESOP leveraged stock purchase transactions.

The ESOP formation financial feasibility study may not necessarily result in a narrative written report. However, if the financial adviser follows a rigorous ESOP financial feasibility analysis process, there will be fewer problems throughout the life of the plan.

THE ESOP FORMATION FINANCIAL FEASIBILITY PROCESS

The ESOP formation planning and financial feasibility process should be thorough and unhurried. The best practical first procedure for the closely held company and the selling shareholders is to obtain enough information to permit them to become familiar with the basics of an ESOP formation.

In addition to information available from ESOP practitioners, a wealth of ESOP-related information

is readily available on the Internet. Sites such as www.nceo.org and www.esopassociation.org contain journal articles, position papers, and brochures regarding many aspects of ESOP implementations. Further, there are a number of informative ESOP-related seminars offered around the country each year.

Once the subject company selling shareholders have a basic understanding of what an ESOP is and how an ESOP works, an initial meeting with their financial adviser is appropriate. Such an initial meeting could include:

1. the financial adviser to the ESOP and
2. the ERISA counsel to the ESOP.

This meeting may also include (1) the closely held company's accountants and legal counsel and (2) the financial adviser to the selling shareholders.

One conclusion of this initial meeting should be a determination of whether a financial adviser should be retained by the selling shareholders to analyze the financial feasibility of an ESOP formation. The result of such an ESOP financial feasibility study should provide enough information for the selling shareholders to make a decision as to whether or not the subject company should proceed with the formation of an ESOP.

One often overlooked recommendation in the ESOP financial feasibility process is for the financial adviser to encourage the selling shareholders to talk to peers at other closely held companies that have implemented an ESOP. The selling shareholders should find out what has worked and what hasn't worked at those other sponsor companies.

Accordingly, the selling shareholders may be able to avoid some of the more obvious pitfalls as the ESOP formation process moves forward. Most financial advisers agree that ESOP sponsor company managers are often willing to share their thoughts and ideas.

The results of the ESOP financial feasibility analysis are then presented (1) to the selling shareholders and (2) to their financial advisers and legal counsel. Based on this ESOP financial feasibility study, a decision can be made as to whether or not to proceed with the ESOP formation and implementation.

Recognizing that there is an emphasis on confidentiality during the ESOP planning process, it is a best practice for the selling shareholders to obtain input from as many financial advisers and other professionals as is practical.

CONTENT OF A TYPICAL ESOP FORMATION FINANCIAL FEASIBILITY ANALYSIS

The financial adviser to the selling shareholders will focus on several basic procedures in conducting the ESOP financial feasibility study. These ESOP formation financial feasibility analysis procedures typically include the following:

- Determine a preliminary range of values that the ESOP may be able to pay for the sponsor company stock. This preliminary range of values is typically based on a limited financial analysis, and it is not a formal valuation opinion based on a rigorous business valuation analysis.

Nonetheless, the financial adviser will apply generally accepted valuation approaches and methods (such as a discounted cash flow analysis and a guideline publicly traded company analysis) to arrive at the preliminary range of subject company stock values.

- Investigate any barriers to a successful ESOP sponsor company stock purchase transaction (e.g., environmental, legal, corporate form, successor management, contribution deductibility issues, etc.). If conditions exist that would make the sponsor company stock sale impossible, the analysis should stop until a solution is found. Any number of potential stock purchase/sale barriers may be investigated in this phase of the feasibility analysis.

Common sponsor company stock purchase/sale barriers include the following:

1. The selling shareholders have an unrealistic expectation of the company stock value.
2. The closely held company is too small in terms of too few employees or too low of a payroll amount.
3. The successor management is inadequate.
4. The closely held company historical or expected growth rate has declined.
5. The closely held company income has been historically erratic.
6. The closely held company management has been previously unsuccessful in finding a corporate acquirer.
7. There are no unencumbered sponsor company assets with which to collateralize the ESOP stock acquisition loan.

- Assess the impact of the proposed transaction on the sponsor company after the transaction is completed (both short-term and long-term). If the company's assumption of the ESOP stock acquisition debt will change in any significant manner the way the sponsor company is operated, it is best to know this and to address this issue up front.

An example of such a change would be the need to defer future capital expenditures in order for the sponsor company cash flow to service the ESOP stock acquisition loan.

- Assess the ability of the ESOP (through the sponsor company) to finance the stock purchase transaction based on reasonable credit terms. This analysis can be performed by the sponsor company management or by the selling shareholders.

The objective of such a debt capacity analysis is to determine what kind of terms may be available for the required stock acquisition financing, including collateral, guarantees, and the use of the sale proceeds.

Generally, two or more financial institutions would be asked (1) to provide financing terms input as to the particular proposed transaction and (2) to suggest alternative structures that may seem appropriate from the lender's viewpoint.

- Establish a proposed basic transaction structure. Of course, this proposed deal structure will be subject to changes as the ESOP formation planning moves forward.

Several basic issues—such as whether an ownership control transaction will work, whether any seller financing should be considered, and whether a recapitalization may be necessary to get the deal completed—should be addressed in the proposed structure.

Many ESOP stock acquisition transactions change form as negotiations between the sellers and the ESOP trustee move forward. Nonetheless, without a basic structural framework, the ESOP formation feasibility study doesn't mean much.

- Assess the impact on income requirements, estate tax liability, and retirement planning for the selling shareholders. Often, this component of the financial feasibility analysis is performed in conjunction with the seller's financial adviser and accountant/tax adviser.

The formation of an ESOP often presents unique estate planning opportunities for the closely held company selling shareholders.

WHO IS THE FINANCIAL ADVISER'S CLIENT?

A discussion regarding who is working for whom in the ESOP formation financial feasibility process may be appropriate. In a company stock share transaction, the subject company is likely to retain its own independent financial adviser to complete its work for the benefit of the selling shareholders and/or the closely held company board of directors.

In such instances, an ESOP trustee may be retained later in the process, and the ESOP trustee then retains both a financial adviser and legal counsel. In such an instance, the ESOP trustee's financial adviser will make an independent assessment of the proposed ESOP stock purchase transaction as it is presented to the ESOP trustee. In other words, the financial adviser to the ESOP trustee may not become directly involved in the transaction planning process.

The ESOP financial adviser's work results in a transaction opinion solely for the ESOP trustee. The financial adviser to the ESOP trustee does not provide a transaction opinion for the sponsor company or for the company selling shareholders.

For smaller, middle-market companies, the financial adviser for the ESOP may conduct a feasibility analysis for the ESOP trustee.

In these cases, the financial adviser to the ESOP will address the adviser's work product to the ESOP trustee. This work product will contain all of the necessary ESOP financial feasibility analysis information.

The role of the ESOP financial adviser is solely to provide the analysis and financial opinions to the ESOP trustee at the closing of the ESOP stock purchase transaction.

EXPENSES AND TIMING OF THE ESOP FORMATION FINANCIAL FEASIBILITY STUDY

The expense of the ESOP formation feasibility study will vary depending on the facts and circumstances of the subject company and of the subject transaction. The financial adviser to the ESOP may charge a fixed fee for his or her work. Or, the financial

adviser to the ESOP may propose an hourly fee structure.

ESOP financial feasibility analyses performed for smaller companies (resulting in informal reports) tend to cost less than formal presentations. However, the engagement with the financial adviser is often structured so that if a barrier to a successful ESOP formation is found, then the adviser stops working immediately.

The ESOP financial feasibility analysis is one important component of the ESOP valuation process. In some cases, the ESOP financial feasibility analysis is a practical requirement for the ultimate success of the ESOP implementation. Therefore, the cost of such an ESOP financial feasibility study should be considered in the context of the overall ownership transition transaction. The ESOP financial feasibility analysis is simply the an early phase in the sponsor company valuation process.

An ESOP financial feasibility analysis can take only a few days of analytical time, or it can be a thorough planning process taking several weeks or months. Since the ESOP formation process is intended to provide a solution to the selling shareholders' problem or objective, a thorough ESOP formation financial feasibility study may be the best investment the selling shareholders can make.

ESOP SPONSOR COMPANY STOCK PURCHASE (OR SALE) TRANSACTION FAIRNESS OPINIONS

In the potential ESOP purchase of the sponsor company stock, the ESOP trustee has an obligation to consider the subject investment opportunity in comparison to other available investments. Other available investments are those investments that are considered reasonable alternatives to the proposed sponsor company stock purchase/sale transaction.

If appropriate due diligence investigation procedures are not followed, then the ESOP trustee may be responsible for approving an unsound investment transaction. Therefore, a written fairness opinion from an independent financial adviser is an integral component of most ESOP sponsor company stock acquisition transactions.

One objective of a transaction fairness opinion issued by the financial adviser is to ensure that the

ESOP sponsor company stock purchase transaction can withstand the scrutiny of:

1. the U.S. Department of Labor,
2. the Internal Revenue Service, and
3. the subject ESOP beneficiaries.

Typically in an ESOP sponsor company stock purchase transaction, the financial adviser is retained by the ESOP trustee. The ESOP trustee is responsible for representing the ESOP interests related to the proposed sponsor company stock purchase transaction. As part of the due diligence procedures related to the proposed stock purchase transaction, the financial adviser to the ESOP is asked to provide a written opinion, known as a fairness opinion.

The fairness opinion will analyze whether the proposed sponsor company stock purchase transaction is fair to the ESOP.

OVERVIEW OF AN ESOP SPONSOR COMPANY STOCK ACQUISITION FAIRNESS OPINION

A fairness opinion is a letter prepared by the financial adviser to the ESOP that states whether or not the proposed sponsor company stock purchase transaction is fair to the ESOP. Fairness is assessed:

1. from a financial point of view,
2. as of a specific date, and
3. based on certain assumptions, limitations, and procedures.

An ESOP stock purchase transaction fairness opinion has two purposes:

1. To provide the ESOP trustee with essential information regarding the pending sponsor company stock purchase transaction
2. To provide documentation that the ESOP trustee applied reasonable business judgment in making the sponsor company stock purchase investment decision on behalf of the ESOP

Although fairness opinions are not legally required in an ESOP sponsor company stock purchase transaction, it is prudent for the ESOP trustee to obtain such an opinion. In the event of a dispute or litigation over the sponsor company stock purchase transaction, the fairness opinion may help support a regulatory or judicial finding that the ESOP trustee made an informed business judgment.

It is noteworthy that a fairness opinion does not recommend an ESOP sponsor company stock purchase transaction. Nor does a fairness opinion provide a legal opinion on the ESOP sponsor company stock purchase transaction.

It is the responsibility of the ESOP trustee to determine whether the pending stock purchase (or sale) transaction is appropriate. The financial adviser's role is to provide an opinion of the pending stock purchase (or sale) transaction "from a financial point of view."

In order to clarify the meaning of "from a financial point of view," ESOP participants should understand what a nonfinancial point of view is. In any sponsor company stock purchase (or sale) transaction, an ESOP participant may ask such questions as:

1. Is now a good time to buy—or to sell—the sponsor company stock?
2. I bought the sponsor company stock for a higher price than the pending transaction price. How can this pending transaction price be fair to me?

These questions may be valid concerns for many ESOP participants. However, these queries involve different questions of transactional fairness that do not necessarily have anything to do with the pending transaction's financial fairness.

WHEN TO OBTAIN AN ESOP TRANSACTION FAIRNESS OPINION

Fairness opinions follow a complex analysis under a strict deadline. Therefore, the financial adviser to the ESOP will expect to receive a substantial professional fee for this transaction opinion service. Accordingly, the ESOP trustee needs to weigh the known cost against the expected benefit when obtaining a fairness opinion related to a pending ESOP sponsor company stock purchase (or sale) transaction.

Typically, the size and complexity of the sponsor company stock purchase (or sale) transaction is the primary factor that determines whether an ESOP transaction fairness opinion is needed.

The following list indicates some of the situations in which an ESOP purchase (or sale) of sponsor company stock may be subject to a regulatory or judicial challenge.

In addition, this list indicates the instances in which the ESOP trustee may wish to retain a financial adviser to provide a transactional fairness opinion:

1. The initial formation of the ESOP at the sponsor company
2. The final termination of the ESOP at the sponsor company
3. A significant purchase (initial or secondary) of stock by the ESOP
4. A significant financing vehicle related to the ESOP leveraged purchase of the sponsor company stock
5. A significant refinancing of the ESOP sponsor company stock acquisition debt
6. Whenever there is a stock purchase (or sale) transaction between the ESOP and a controlling stockholder (or a member of the sponsor company control group)
7. Stock purchase (or sale) transactions outside of the ESOP that significantly affect the capital structure of the sponsor company that may affect the value of the ESOP-owned employer shares
8. The response of the ESOP with regard to an acquirer's tender offer (solicited or unsolicited) to purchase all of (or the ESOP's ownership of) the sponsor company stock

In the first three situations, a transactional fairness opinion from an financial adviser is obviously appropriate.

There are less obvious situations where a change in the capital structure of the sponsor company could affect the value of the ESOP-owned sponsor company shares. In such circumstances, the opinion of the financial adviser to the ESOP may be helpful.

Examples of such situations include the following:

1. New shares of the sponsor company common stock are issued—this share issuance could result in the dilution of the value of the ESOP-owned sponsor company shares.
2. A preferred stock (or other preferred security) is created and distributed—this new security (a) may give another equity holder a superior right to sponsor company dividends and (b) may result in a decrease in the value of the ESOP-owned sponsor company stock.
3. The sponsor company recapitalizes and finances a large amount of long-term debt—the ESOP-owned sponsor company stock value may decrease because another stakeholder has a superior claim in the event of the sponsor company liquidation.

THE ROLE OF THE TRUSTEE IN THE ESOP SPONSOR COMPANY STOCK PURCHASE (OR SALE) TRANSACTION

Every qualified ESOP is part of a trust that is governed by ERISA. Each trust is governed by a trust document that specifies the duties and responsibilities of the ESOP trustee.

Under ERISA Section 404(a)(1), a fiduciary—that is, the ESOP trustee—must approach the employer corporation stock purchase/sale transaction “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

The sponsor company should carefully select the ESOP trustee, as the trustee's fiduciary obligations are significant. The ESOP trustee may potentially be a “party in interest”—generally defined as a corporate officer, employee, or a more than 10 percent shareholder—but the selection of such a trustee is not advisable. The ESOP trustee selection is a serious process because a fiduciary can be held personally liable for his or her actions.

Many sponsor companies will retain an institutional trustee for purposes of independence. Ultimately, it is the ESOP trustee's responsibility to make the investment decision to purchase (or sell) the sponsor company stock on behalf of the ESOP.

ERISA Section 401(a)(28)(C) provides that, after 1986, the annual valuations of the sponsor company securities that are not readily tradable must be conducted by an independent appraiser. Therefore, the financial adviser to the ESOP trustee must be independent of all parties to the leveraged ESOP stock purchase (or sale) transaction.

The financial adviser to the ESOP should be retained by—and report directly to—the ESOP trustee. The agreement between the ESOP trustee and the financial adviser should define the type of transaction opinions that the independent financial adviser is expected to prepare.

The following discussion summarizes the different types of transaction opinions that the financial adviser may be asked to provide to the ESOP trustee.

The Adequate Consideration Opinion

The first (and arguably the most important) opinion that the financial adviser may prepare is whether

the price paid by the ESOP for the sponsor company stock is greater than the adequate consideration.

Adequate consideration is defined by ERISA Section 3(18)(B) as “the fair market value of the asset as determined in good faith by the trustee or named fiduciary . . . pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor.”

Fair market value is defined by the U.S. Department of Labor proposed regulations as the amount at which the company stock would change hands between a willing buyer and a willing seller, each having reasonable knowledge of all relevant facts, neither being under any compulsion to act, and with equity to both.

In order to analyze “adequate consideration,” the financial adviser will conduct a thorough and well supported valuation analysis that:

1. considers all generally accepted business valuation approaches and methods and
2. provides the ESOP trustee with the necessary justification for the adequate consideration opinion.

Fairness from a Financial Point of View

The adequate consideration test is sometimes referred to as the absolute fairness test. Essentially, the adequate consideration question is: Does the sponsor company stock price to be paid by the ESOP exceed some benchmark that represents fair market value?

The “fairness from a financial point of view” opinion incorporates the concept of relative fairness. The financial adviser should also advise the ESOP trustee as to whether the sponsor company stock price to be paid by the ESOP is fair relative to the price that would be paid by any other investors.

The essence of the relative fairness test is a comparison of:

1. the relative investment risk accepted by each investor and
2. the expected investment return associated with that risk.

In the typical ESOP leveraged stock purchase transaction (for example, where a senior lender provides all of the acquisition financing), the fairness opinion may consider the concepts of relative fairness and absolute fairness converge.

Since there are no additional parties to the leveraged sponsor company stock purchase transaction other than the senior lender, the determination of relative

fairness is based on whether the terms of the senior financing are fair relative to the ESOP.

In a multi-investor ESOP capital structure, however, relative fairness may become a significant issue. The allocation of equity to the various stock purchase transaction participants in the ESOP

leveraged stock purchase can affect the internal rate of return (“IRR”) earned by each transaction participant. The relative IRRs can affect whether the stock purchase transaction is fair from a financial point of view.

Accordingly, in sponsor company stock purchase transactions with more than one investor, the ESOP trustee should be involved in analyzing both:

1. the sponsor company stock purchase by the ESOP and
2. the sponsor company stock purchase by the other transaction participants.

Measuring the IRR for each investor is one way to measure the fairness of the sponsor company stock purchase transaction to each of the transaction participants. As investment risk increases among the various classes of sponsor company debt and equity securities, the expected rate of return should also increase.

The subject transaction relative investment IRRs can be compared to empirical, market-derived returns of publicly traded securities with similar investment risk characteristics.

The Reasonableness of the Sponsor Company Stock Conversion Premium

The ESOP trustee may require an opinion as to the reasonableness of the stock conversion premium if:

1. the ESOP purchases a sponsor company security other than common stock and
2. that security has a dividend preference.

The stock conversion premium is measured as the price premium paid for the preferred dividend security—in excess of the value of the sponsor company common stock.

The value of a dividend preference security is typically equal to (1) the value of the sponsor

“As investment risk increases among the various classes of sponsor company debt and equity securities, the expected rate of return should also increase.”

company common stock plus (2) the value of the dividend preference. Therefore, the price premium paid for the preferred security is typically related to the value of the dividend preference.

To assess the reasonableness of the stock conversion premium, the financial adviser will typically consider guideline publicly traded securities with similar investment characteristics and risk attributes.

For both the sponsor company security and the guideline publicly traded securities, the financial adviser will typically compare the following ratios:

1. Dividend coverage ratio
2. Capitalization ratio
3. Fixed charge coverage ratio
4. Debt to equity ratio

The financial adviser performs this comparison in order to assess the relative risks applicable to the sponsor company security, and therefore, the reasonableness of the stock conversion premium.

The Reasonableness of the ESOP Stock Acquisition Debt Terms and Conditions

Since the terms of the sponsor company stock purchase transaction can also affect the purchase price, the financial adviser should also review the terms of the ESOP acquisition debt. The terms of the ESOP stock acquisition debt that can affect the stock price are as follows:

1. The interest rate
2. The term of the financing

A comparison of the ESOP stock acquisition debt terms with empirical debt market evidence can indicate whether these terms are reasonable in the current economic environment. The financial adviser's analysis of current market interest rates should indicate whether the interest rate on the ESOP stock acquisition debt is a market interest rate.

The financial adviser should also consider the implied quality rating on the ESOP stock acquisition debt. The financial adviser typically performs that comparison with appropriately rated publicly traded debt instruments.

For example, if the ESOP stock acquisition debt represents 80 percent of the sponsor company total invested capital value, that debt may be rated lower than if the ESOP stock acquisition debt represented only 20 percent of the sponsor company total invested capital value.

SUMMARY AND CONCLUSION

The criteria for an ESOP formation sponsor company candidate criteria described in this discussion can serve as a simple checklist for closely held company owners—and for their professional advisers. Closely held company owners (i.e., the potential selling shareholders) and their professional advisers can use this simple checklist as they consider the difficult issues related to:

1. closely held company ownership transition and management succession and
2. the diversification/ liquidity of the closely held company owner's investments.

Careful planning is important to the ultimate success of the implementation of ESOP leveraged purchase of the sponsor company stock. An ESOP formation financial feasibility analysis can take different forms. A written narrative feasibility analysis is not necessarily a requirement.

What is important is that the financial adviser should carefully consider the goals and objectives of:

1. the sponsor company selling shareholders,
2. the sponsor company itself, and
3. the to-be-formed ESOP participants.

The implementation of an ESOP can be one of the most important events in the life cycle of the employer corporation. The ESOP formation planning process should be performed with care, and it should involve all of the necessary financial and legal advisers.

Finally, ESOP trustees are responsible for demonstrating that, during the course of analyzing the pending sponsor company stock purchase (or sale) transaction:

1. appropriate due diligence procedures were conducted and
2. the purchase/sale transaction price was at a price not greater than fair market value.

This responsibility of the ESOP trustee is well established by judicial precedent.

Therefore, the written advice of the financial adviser to the ESOP is important evidence in the analysis of a potential sponsor company stock purchase (or sale) transaction. The benefit of obtaining a financial adviser's transactional fairness opinion is apparent if there is any chance that the ESOP trustee's investment decision may ever be challenged in the future.