Financial Considerations for Boards and Trustees in ESOP Sponsor Company Sale Transactions

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Merger and acquisition ("M&A") transactions are often highly anticipated and sometimes highly controversial events for companies in both the public market and the private market. Companies commit significant time and resources to sourcing and structuring the appropriate deal. The presence of an employee stock ownership plan ("ESOP") at the target company adds a layer of complexity to the M&A transaction. As a fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA"), the ESOP trustee has an important role to perform with respect to reviewing a proposed transaction. This discussion focuses on the roles of the sponsor company board and the ESOP trustee when a sponsor company sale is being considered. This discussion also focuses on the role of the trustees' financial adviser in reviewing the financial aspects of the proposed M&A transaction.

Introduction

The sale of a company that sponsors an employee stock ownership plan ("ESOP") typically requires additional due diligence—relative to a non-ESOP sponsor company transaction—in order to ensure that the transaction is fair to ESOP participants. The sale of an ESOP sponsor company requires special procedures and expertise in order to navigate the ESOP trust shareholder requirements to effect a successful company sale.

The Employee Retirement Income Security Act of 1974 ("ERISA") provides that ESOP trusts are managed by trustees who have fiduciary duties to:

1. the plan,
2. its participants, and
3. its beneficiaries.

In order for an ESOP sponsor company to be sold, the ESOP must receive no less than "adequate consideration" for its company stock. This requirement means that any sale transaction has to be considered prudent and financially fair:

1. to the plan,
2. to its participants, and
3. to its beneficiaries.

The ESOP trustee assesses the proposed sale transaction and determines if the terms of the proposed transaction are in the best interest of the ESOP. The trustee typically retains an independent financial adviser and legal counsel to assist it with the transaction.

The ESOP trustee typically employs these financial and legal advisers:

1. to determine the fairness of any proposed transaction,
2. to conduct financial and legal diligence with respect to the ESOP sponsor company, and

3. to ensure that the transaction is consistent with all applicable laws.

In order to determine if a proposed sale transaction is fair to the ESOP from a financial point of view, the trustee and its financial advisers should perform financial due diligence of the sponsor company. The financial due diligence involves estimating the fair market value of the sponsor company overall and of the company shares held by the ESOP. The financial adviser fairness analysis compares (1) the proceeds that the ESOP will receive as part of the proposed transaction to (2) the fair market value of the ESOP ownership interest.

The advisers should then present their findings to the trustee. The trustee will make a final determination whether to:

1. accept the proposed offer,
2. reject the proposed offer, or
3. counteroffer with different terms and conditions.

This discussion focuses on the following topics:

- Overview of the sale process for an ESOP sponsor company
- The role of the ESOP trustee in reviewing the proposed sponsor company sale transaction
- The role of the trustee's financial adviser in reviewing the proposed sponsor company sale transaction

The Sponsor Company Sale Process

The sale process often begins with a potential acquirer submitting a letter of intent to the subject sponsor company's board of directors. Even when an ESOP owns 100 percent of the outstanding stock of the sponsor company, the board of directors is usually the first to receive and consider a proposed transaction.

In other cases, the board may hire a financial adviser to actively solicit bids to acquire the sponsor company. The reasons for selling a sponsor company can vary quite a bit. However, whether the proposal is an unsolicited tender offer or a solicited purchase offer, the first step in the sale process is typically a board-level function.

For a smoother transaction process, it is helpful for the board of directors to notify the ESOP trustee of the proposed sponsor company sale transaction at the earliest possible time. The sponsor company board should consider the ESOP trustee as its partner. And, the sponsor company board should make certain that the trustee has all of the information it needs to perform a thorough analysis of the proposed transaction.

The board has a responsibility to:

1. protect the assets of the company and
2. ensure that the shareholders receive the highest return on their investment.

In this capacity, the board should evaluate any and all bona fide sponsor company purchase offers. The board may hire a financial adviser to:

1. solicit bids for the sponsor company,
2. assist with negotiating and structuring the proposed transaction, and/or
3. provide a fairness opinion related to the proposed transaction.

In circumstances where the board relies on information from the trustee's financial adviser, there is the potential for additional complexity. The trustee's financial adviser must remain independent and cannot work directly for the sponsor

company. However, it is possible for the board to be allowed to rely on the work of the trustee's financial adviser.

When considering the work of the trustee's financial adviser, the board should be mindful that the duties of the trustee's financial adviser extend only to the trustee and the ESOP—and not to the board. Therefore, complexity may arise due to the fact that the ESOP trustee's financial adviser solely acts as the adviser of the ESOP trustee.

To the extent that the board objectives and incentives are aligned with those of the ESOP, this adviser duty does not pose significant potential conflicts. However, if the two parties' motivations become misaligned, then this arrangement could present a conflict of interest.

Potential conflicts may range from information sharing conflicts and inefficiencies in the negotiation process to a failure of fiduciary responsibilities. In order to meet their respective fiduciary duties throughout the process, all parties should be aware of their responsibilities—and of whose interests they serve.

In most sponsor companies, should the board pursue an offer to sell, the company board typically negotiates the terms of the offer. However, the board and the ESOP trustee (and the trustee's advisers) should communicate early and often during the negotiation process.

Misalignment between the goals and objectives of the board and of the trustee should to be addressed early in the process. If this issue is ignored by the board, the potential offer may be jeopardized through internal squabbling which may appear to a potential buyer as indicating that a transaction is doubtful.

Even though the board may take the lead in the negotiations, the ESOP trustee has the final say in approving a transaction[1] on behalf of the ESOP.

Once a bona fide purchase offer is received by the sponsor company board, the offer should promptly be submitted to the ESOP trustee for review.

Role of the ESOP Trustee

The trustee has a fiduciary responsibility solely to the plan participants and the plan beneficiaries. Each ESOP trust is governed by a trust document that specifies the duties and responsibilities of the ESOP trustee.

The ESOP trustee will follow the terms of the plan documents to the extent that the plan terms are consistent with ERISA. In general, the ESOP trustee has exclusive authority and discretion over the management of plan assets.[2]

ERISA Sections 404(a)(1)(A) and 404(a)(1)(B) describe the exclusive benefit rule and the prudent man rule for fiduciaries of ERISA plans, respectively.

The ERISA exclusive benefit rule requires a fiduciary (the ESOP trustee) to act solely in the interest of the plan participants and beneficiaries for the exclusive purposes of providing benefits to participants and their beneficiaries and of defraying reasonable expenses of administering the plan.[3]

The exclusive benefit rule requires the fiduciary to have "an eye single to the interests of the participants and beneficiaries."[4]

The ERISA prudent man rule requires a fiduciary (the ESOP trustee) to approach its duties with respect to a plan "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 ERISA fiduciary is expected to act as a prudent expert would under similar circumstances, accounting for all relevant substantive factors as they appeared at the time without the benefit of hindsight. This standard "is not of a layperson, but rather of a prudent fiduciary with experience dealing with a similar enterprise."[5]

This ESOP trustee duty is more expansive than the general common law duty of trustees. This is because it imposes a duty greater than a reasonably prudent person—it requires that the trustee be experienced with such matters, leading many to refer to this standard as the "reasonably prudent expert standard."

The U.S. Department of Labor ("DOL") and certain courts have characterized the requisite level of fiduciary prudence under ERISA as both substantive prudence and procedural prudence. Substantive prudence refers to the merits of the decision made by the fiduciary, and procedural prudence addresses the process through which the fiduciary reaches its decision.

In the absence of a conflict of interest that would impair the fiduciary's independent judgment, the fiduciary prudence requirement is satisfied by applying substantive prudence and procedural prudence.[6]

In the context of a sponsor company sale transaction, once the board of directors recommends an offer to the shareholders, the ESOP trustee should evaluate the offer to determine whether:

1. the offer maximizes the value of the plan assets,
2. it is prudent for the ESOP to enter into the transaction, and
3. the transaction is fair to the ESOP from a relative point of view.

In order to fulfill its procedural prudence obligation, the trustee typically retains legal counsel and an independent financial adviser. These advisers assist the trustee in reviewing the legal and financial aspects of a proposed sponsor company stock purchase transaction.

The retention of advisers does not absolve the ESOP trustee of its liability in the subject transaction. The trustee is expected to exercise its own judgment, considering the advice of outside advisers. With help from its advisers, the role of the trustee is to negotiate on behalf of the ESOP trust.

The trustee should consider all viable alternatives to the proposed sale transaction in order to determine if the proposed sale transaction maximizes the value of plan assets. Such alternatives may include considering a public offering or simply rejecting the transaction. The trustee may decide that it is prudent to solicit proposals from other potential buyers.

Finally, the ESOP trustee will have to determine if the proposed transaction is prudent. In doing so, the ESOP trustee should determine if a prudent man with experience in such matters would sell the sponsor company under the proposed terms.

Prudence is a matter of judgment, but the ESOP trustee has a responsibility to ensure that the transaction is fair:

1. to the trust,
2. to its participants, and
3. to its beneficiaries.

Special care should be taken to ensure the proposed transaction meets this prudence standard, as the DOL may require that the trustee demonstrate the prudence of the transaction after the fact.

Government-imposed penalties for violation by a fiduciary of the prudence standard can be severe. Therefore, it is especially important for the ESOP trustee to use qualified advisers based on experience, knowledge, and qualifications rather than simply on the price they charge for their services.

In a sponsor company sale transaction, the ESOP trustee may be required to accept voting direction from the plan participants with respect to their allocated shares. In this case, the ESOP trustee may want to ensure that the sponsor company makes full disclosure to the participants of all the appropriate information concerning the offer. The ESOP trustee may also want to arrange for the confidential tallying of the participant directions.

The ESOP Trustee's Financial Adviser

The ESOP trustee's independent financial adviser is often asked to provide a fairness opinion to the ESOP trustee. The fairness opinion should state whether or not:

1. the ESOP trust is receiving adequate consideration and
2. the transaction is fair to the ESOP from a financial point of view.

This fair market value determination should be arrived at through a good faith process whereby the ESOP trustees and fiduciaries review all relevant information, study all reports from their advisers, and make informed, well-thought-out decisions, giving themselves sufficient time for reflection.

This determination of fair market value should comply with both Internal Revenue Service and DOL regulations.

The financial adviser typically seeks to educate the ESOP trustee on all financial aspects of the transaction. This education process is accomplished primarily, but not exclusively, by a fairness opinion and the fairness analysis. The ESOP trustee may ask the financial adviser to consider the return to the ESOP of alternatives to the proposed transaction, such as the long-term value to the ESOP if the transaction was rejected and business continued as usual.

The consideration of synergies is typically not required for a transaction to meet the adequate consideration threshold. However, it may be appropriate to consider potential synergies to assist the ESOP trustee in negotiating the best price possible. This is because the trustee's role is to maximize the value of plan assets (in this case, to maximize the sponsor company sale transaction consideration to the ESOP).

The Transaction Fairness Opinion

A fairness opinion is the opinion of a financial adviser as to whether the prospective transaction is fair from a financial point of view. A fairness opinion is frequently provided for merger, acquisition, divestiture, recapitalization, or reorganization transactions. The fairness opinion solely reflects the fairness of the proposed transaction to a specific party or transaction participant.

A fairness opinion relates to the price and the structure of the proposed transaction from a financial perspective. That is, the fairness opinion does not opine on the process that was followed to establish the transaction terms and conditions or the legal aspects of the transaction.

The transactional fairness opinion in a proposed sale of the sponsor company provides the financial adviser's opinion to the ESOP trustee with respect to the following:

- The financial fairness of the proposed transaction terms and conditions to the ESOP
- The fairness of the proposed deal structure to the ESOP
- The fairness of the proposed purchase price to the ESOP

The transactional fairness opinion is an important procedural tool. It provides the ESOP trustee with important information regarding various financial and valuation aspects of the proposed sale transaction. With this information, the ESOP trustee may be able to negotiate more effectively on behalf of the ESOP participants.

The transactional fairness opinion is also an important legal tool. It provides evidence that the ESOP trustee used reasonable business judgment in the evaluation and assessment of the proposed sale transaction.

The primary deliverable by the independent financial adviser to the ESOP trustee is the fairness opinion letter. The financial adviser often provides a presentation to the trustee outlining the fairness analysis.

The ESOP trustee should read this presentation carefully and ask relevant questions of the adviser to better understand the assumptions and comparisons used in the analysis. The trustee should assure itself that it understands the analysis and that the assumptions applied by the adviser were reasonable under the circumstances.

Adequate Consideration

In the context of a fairness opinion performed for the sale of an ESOP sponsor company, fairness is defined as not receiving less than "adequate consideration" under ERISA Section 3(18)(B).

Adequate consideration is defined in ERISA Section 3(18). The first clause of this section discusses adequate consideration for a "security for which there is a generally recognized market," which is typically not applicable for private company transactions.

ERISA Section 3(18)(B) defines adequate consideration for private company securities 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 [U.S. Secretary of Labor.]"[7]

On May 17, 1988, the DOL issued the "Proposed Regulation Relating to the Definition of Adequate Consideration" (the "DOL Proposed Regulation") to further define the term "adequate consideration."

Although the DOL Proposed Regulation was never made into law, trustees and independent financial advisers often consider the DOL Proposed Regulation when assessing ESOP sponsor company stock transactions.

The DOL Proposed Regulation defines fair market value as "the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset."[8]

The "good faith" component of ERISA Section 3(18)(B) requires two factors.

First, good faith requires a fiduciary to apply sound business principles of evaluation and to conduct a prudent investigation of the circumstances prevailing at the time of the valuation.

Second, the fiduciary performing the valuation should itself be independent to all parties to the transaction (other than the plan), or the fiduciary must rely on the report of an appraiser who is independent to all parties to the transaction (other than the plan).[9]

If the financial adviser determines that the sale transaction proceeds represent adequate consideration to the ESOP, then the transaction is considered to meet the "absolute" fairness threshold.

Relative Fairness

The trustee's financial adviser may also be asked to determine the "relative" fairness of the transaction to ESOP participants. It is possible for a transaction to be fair in the aggregate (i.e., the total price is fair to all shareholders) but still be unfair to certain owners (i.e., the ESOP participants).

The financial adviser analyzes the transaction proceeds to all shareholders and any deal incentives for the sponsor company board to determine whether the transaction is fair to the ESOP on a relative basis.

In instances where the ESOP is not the sole shareholder, different forms of consideration may be offered to the various parties to the sponsor company sale transaction. When different forms of consideration are offered, it may be appropriate for the financial adviser to perform an internal rate of return ("IRR") analysis for the transaction participants. The relative IRRs can affect whether the proposed transaction is fair to the ESOP from a financial point of view.

In a sale transaction, the ESOP trustee may prefer to receive cash proceeds as of the transaction closing date to begin winding down the ESOP trust. The ESOP trustee may negotiate to receive cash consideration up front rather than participate in an earn-out or other form of contingent consideration.

Additional transaction considerations and incentives that the financial adviser may review as part of the relative fairness analysis include, but are not limited to, rollover equity, management compensation plans, and transaction bonuses.

With regard to management compensation plans, the ESOP trustee should be assured that the terms of such programs:

1. are reasonable and
2. do not unduly affect the proceeds that would be received by the ESOP.

If the terms of the deal do not properly account for these differences, it is possible that the deal may be fair to some shareholders of the sponsor company but not to other shareholders of the selling sponsor company. Disclosing these differences is not the same thing as accounting for these differences.

It is not required that the ESOP receive exactly the same economic return as other parties in the transaction. However, it is prudent for the ESOP trustee to consider:

1. what is the ESOP's return relative to the returns to all stakeholders and
2. whether the ESOP's—and the other parties'—returns are fair relative to the risks taken.

Transaction-Specific Analysis Considerations

A fairness analysis for the sale of the sponsor company involves an opinion on the fair market value of the sponsor company equity. The financial adviser estimates the fair market value of the proceeds received by the ESOP if other than cash, especially in the case where the acquiring company's stock will be exchanged for the sponsor company shares held in the ESOP.

The following factors may be considered by the financial adviser (1) as part of the fairness analysis and/or (2) to assist the trustee in assessing the proposed transaction:[10]

- Is the sale transaction a strategic acquisition, financial acquisition, or management buy-out (which has its own special considerations)?
- What are the overall terms and structure of the sale transaction?
- What are the income tax implications of the transaction?
- Are there any earn-outs or synthetic equity plans?
- How much of the transaction sale proceeds will be held in escrow and for what purpose(s)?
- How will the transaction affect the board and any key employees; that is, are there any noncompete, nonsolicitation agreements, employment agreements, or termination agreements?

- Is there an "internal" loan (i.e., a loan between the ESOP and the sponsor company), and, if so, how will this affect the distribution of the transaction sale proceeds to ESOP participants?
- What are the ESOP participant voting and disclosure requirements?
- Are there any other transaction considerations that may affect value or terms?

The financial adviser should provide the ESOP trustee with enough information to make an informed decision with respect to the financial aspects of the proposed transaction.

If the transaction requires a pass-through vote of the ESOP participants, then the financial adviser may be asked to share its analysis directly with the ESOP participants. The objective of this procedure is to educate the ESOP participants on the financial aspects of the proposed transaction.

Summary and Conclusion

In addition to the standard board level due diligence that is performed as part of any merger or acquisition transaction, the sale of an ESOP sponsor company includes certain requirements to ensure that the ESOP participants receive adequate consideration in the proposed transaction.

If the appropriate procedures are undertaken, the presence of an ESOP trustee can be beneficial to completing a successful sale transaction. There are numerous considerations for the trustee and the trustee's financial adviser when considering the financial benefits to ESOP participants of a proposed sponsor company sale transaction.

There is typically much more involved in reviewing the financial aspects of a sponsor company sale transaction than just assessing whether the proposed purchase price is greater than fair market value.

A thorough analysis of the transaction consideration and terms performed by a financial adviser—and encompassed in a fairness opinion analysis—should give the ESOP trustee confidence in its decision to accept, reject, or further negotiate the proposed sponsor company sale transaction.

Notes:

1. The trustee typically has a fiduciary duty for approving a stock purchase transaction. An asset purchase transaction involves a pass-through vote to the ESOP participants.
2. See ERISA Section 403(a). There are two caveats to the ESOP trustee's exclusive authority and discretion over the management of plan assets. First, the ESOP trustee may be "directed" by another named fiduciary according to the plan documents and not contrary to provisions of the ERISA. Second, the ESOP trustee may delegate the management of certain plan assets to an investment manager. The ESOP trustee typically has exclusive authority when assessing a proposed ESOP employer stock purchase transaction.
3. ERISA Section 404(a)(1)(A).
4. David Ackerman, Questions and Answers on the Duties of ESOP Fiduciaries (Oakland, CA: National Center for Employee Ownership, 2008), 32.
5. Ibid., 46.
6. Ibid., 55.
7. ERISA Section 3(18)(B).
8. DOL Proposed Regulation Section 2510.3-18(B)(2).
9. Ibid., Section 3(18)(B)(3)(ii).
10. See "Fairness from a Financial Point of View: Financial Advisory to the ESOP Trustee in a Sponsor Company Sale Transaction" by Terry G. Whitehead, CPA, featured in the Willamette Management Associates Spring 2020 *Insights* edition for a specific discussion of the financial adviser's analysis with respect to a proposed transaction.

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