Fairness from a Financial Point of View: Financial Advice to the ESOP Trustee in a Sponsor Company Sale Transaction

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When confronted with a potential transaction, an Employee Stock Ownership Plan (ESOP) is represented by a trustee who typically retains the services of an independent financial adviser. The role of the financial adviser may involve providing a fairness opinion to answer the question of whether the transaction is fair from a financial point of view to the ESOP. In answering this question, the financial adviser may address certain specific elements of the transaction in addition to applying generally accepted valuation methods to develop a reasonable estimate of fair market value.

Introduction

As a fiduciary, the trustee, acting on behalf of the ESOP, typically relies on the fairness analysis and fairness opinion provided by the financial adviser as a factor in advising the ESOP to accept, reject, or negotiate an adjustment to the proposed terms of the transaction.

Although the ESOP trustee may be primarily concerned with the financial adviser's formal final opinion regarding the transaction, an understanding of the factors relied upon by the financial adviser in forming the fairness opinion is important for the ESOP trustee in fulfilling his or her fiduciary responsibility.

The Trustee and the Financial Adviser

As a fiduciary, the ESOP trustee has a responsibility to protect the assets of the ESOP (including the ESOP stock) which represents a retirement benefit for the individual employees of the sponsor company.

Although not a legal requirement, obtaining a fairness opinion can help substantiate that the ESOP trustee acted and made decisions regarding the approval or rejection of the transaction in accordance with the business judgment rule.

In the event that a dispute or grievance should arise from an ESOP participant, the ESOP trustee may be in a much more vulnerable position if he or she did not retain a financial adviser to provide a fairness opinion.

The business judgment rule is a doctrine derived from case law that considers whether directors in a corporation:

1. acted in good faith,
2. acted with similar care as an ordinarily prudent person (i.e., due care), and
3. acted in a manner reasonably believed to be in the best interest of the corporation (i.e., loyalty).

These three components encompass the fiduciary duty standard. Recognizing these considerations, it is understandably prudent for the ESOP trustee to not only obtain a fairness opinion, but to understand and critically review the analysis of the financial adviser.

In the transaction process, the ESOP trustee typically hires a financial adviser to provide an opinion regarding two primary initiatives:

1. Is the consideration to be received by the ESOP not less than the fair market value of the ownership interest
2. Are the related terms and conditions of the transaction, taken as a whole, fair and reasonable from a financial point of view to the ESOP.

This discussion focuses on certain specific considerations within the valuation process and analysis related to the determination of whether the contemplated transaction is "fair" to the ESOP "from a financial point of view."

This discussion will not review the entire transaction or valuation process, but will specifically address considerations by the financial adviser regarding the following:

- Reconciling the range of valuation method conclusions
- Recognizing the potential impact of escrows and earnouts
- Identifying potential additional transaction benefits to the selling company shareholder(s) other than the ESOP
- Consideration of additional transaction benefits to the ESOP relative to the other shareholder(s)

Valuation Method Conclusions

In order to reach an opinion regarding the consideration to be received by the ESOP, the financial adviser should first determine a reasonable estimate of the company value (i.e., fair market value).

This estimate typically involves the application of one or more generally accepted valuation methods within one or more of the three generally accepted business valuation approaches (i.e., the income approach, the market approach, and the asset-based approach).

It is generally accepted that the concept of fairness, within the context of this type of transaction analysis, considers it appropriate for the financial adviser to conclude a reasonable range of values for the sponsor company (and the sponsor company stock). As a result, a range of value may be developed within each valuation method that the financial adviser applies.

From a theoretical viewpoint, if each of the selected valuation methods is appropriately applied recognizing the facts and circumstances of the subject company, then each of the methods is likely to result in relatively similar conclusions.

However, in practice, for a variety of factors and influences, the selected valuation methods may not closely align. In these instances, the financial adviser will likely assess the strengths and weaknesses within each of the valuation methods utilized in order to provide guidance for his or her ultimate opinion of value.

Figure 1 presents a valuation method summary example as an easily recognizable conclusion of the value range for each method.

Based on the illustrative example presented in Figure 1, strictly considering price and ignoring all other factors, it is unlikely that a purchase price below the lowest method value indication of $18.5 million would be considered a fair price.

A purchase price above the low indication, strictly considering price and ignoring all other factors, would potentially represent a fair price range.

However, a price above the lowest indication of $18.5 million does not necessarily indicate that the purchase price is at least fair market value or fair from a financial point of view.

Typical Procedures in the Valuation Process of the Financial Adviser

The ESOP trustee should understand the valuation process used by the financial adviser to estimate fair market value in order to determine if the concluded value range is credible, reasonable, and appropriate.

Although each engagement has its own set of facts and circumstances which will impact the valuation approaches and methods considered and relied upon, it is a generally accepted practice for a financial adviser to apply multiple valuation methods in order to provide additional credibility and reliability to the concluded range of value.

In practice, there is no requirement for a financial adviser to rely on more than one method. However, it is typical for a financial adviser to at least conduct multiple methods for analysis to identify a reasonable potential range of values to support the ultimate conclusion and provide sufficient information for the ESOP trustee to make an informed decision.

The analysis conducted by the financial adviser should present a summary conclusion for each method considered as well as a basis of determination for the final conclusion of value (or range of value). Based on the facts and circumstances of the engagement, the financial adviser may decide to rely on a single valuation method or base his or her conclusion on consideration (i.e., a method weighting) of multiple value indications.

The financial adviser should provide the ESOP trustee with sufficient information and a credible basis for including or excluding the value indications from the final conclusion for each valuation method considered. Such information should reasonably provide a basis as to why the inclusion or exclusion of a prospective valuation method results in an appropriate fair market value estimate for the ESOP.

The initial consideration of a specific valuation approach or method by the financial adviser does not require it to be relied upon in the final value conclusion.

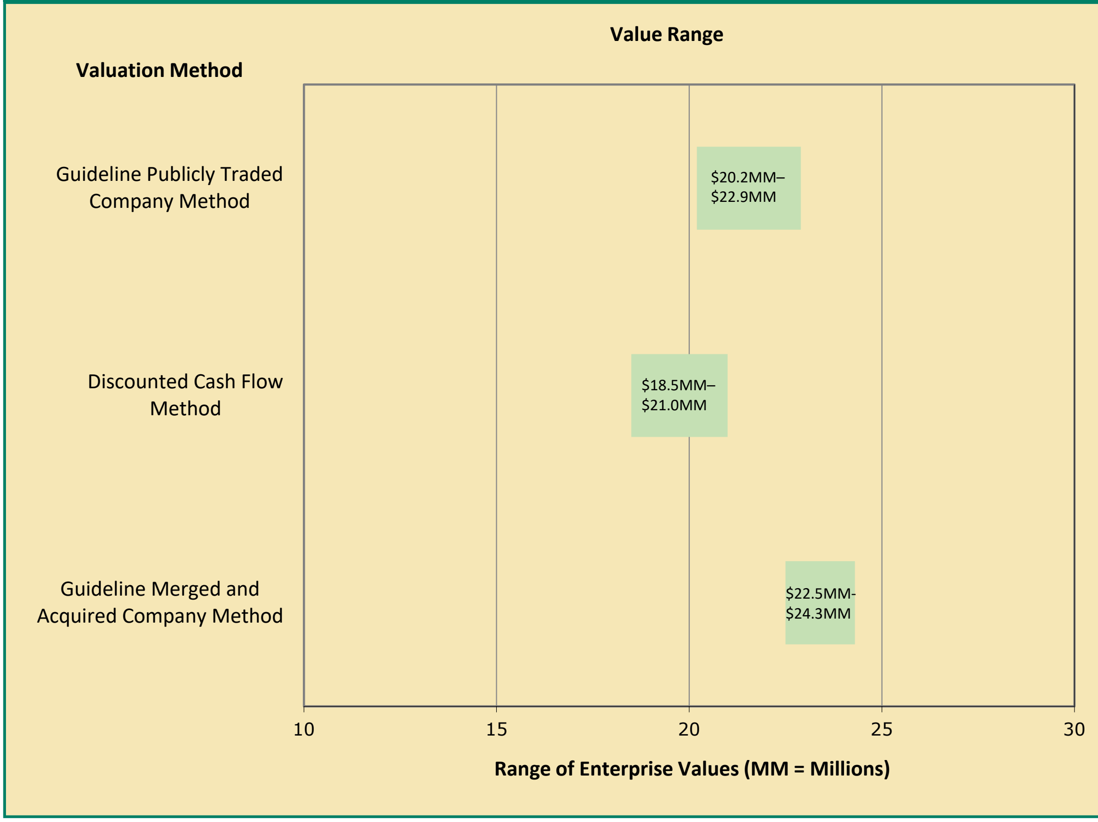
There are a variety of factors that a financial adviser may encounter during the analysis of a specific valuation method that may provide the financial adviser a basis to place greater or lesser reliance on the valuation method, or no reliance at all.

If the financial adviser does not ultimately rely on the value range indication from a specific valuation method, then a comparison of this method to the purchase price is not relevant. As a result, there may be circumstances where the financial adviser concludes a fair market value estimate that is less than the estimated value range resulting from an analysis that was not relied upon.

However, in such instances, the ESOP trustee should recognize and understand the basis for the financial adviser's determination in order to form his or her own opinion regarding the reliability and reasonableness of the financial adviser's conclusions when advising the ESOP in the transaction.

Instances where the purchase price indication is below one or more of the relied upon valuation methods does not automatically indicate that the purchase price fails to meet the required valuation threshold.

Figure 1
Valuation Summary—Illustrative Example



Escrows and Earnouts

Typically, the terms of the purchase price in a transaction are defined in a purchase agreement or some other formal document.

A purchase price other than a single lump sum of cash will generally require additional analysis by the financial adviser in order to consider the potential impact to the ESOP from a financial point of view.

Escrows

Merger and acquisition transactions commonly utilize escrow accounts to hold transaction proceeds to provide the buyer protections for unforeseen liabilities or other timing issues and uncertainties.

The financial adviser may consider various levels of escrows to be potentially received and related probabilities in order to recognize the potential impact on an otherwise unadjusted purchase price.

Although the future results and escrow payments will not be certain at the date of the transaction, based on the facts and circumstances at the time of the transaction, an estimated impact may be considered.

As an example, the following discussion considers a sample analysis for a transaction involving two escrow accounts:

1. A 90-day adjustment escrow of $1 million to primarily offset any identified changes in the final balances of working capital
2. An 18-month indemnity escrow of $1.5 million to primarily cover liabilities and other costs not immediately incurred at the time of the transaction

First, the adjustment escrow may affect the purchase price under consideration if the adjustment escrow considers a working capital balance (or other financial measure or withholding of funds) that is significantly different than the expected operating level at the closing of the transaction.

Generally, the transaction terms agreed to by the buyer and seller will include a provision for the company to retain an appropriate level of working capital. However, if an adjustment escrow is based on an arbitrary amount, it may result in a reduced purchase price paid to the sellers after the impact of the withheld adjustment escrow.

As a result, both the financial adviser and the ESOP trustee should understand the potential impact on final proceeds to the seller as a result of the adjustment escrow.

Based on the financial analysis at the date of the transaction and other relevant known or knowable factors, it is possible that none, some, or all of the adjustment escrow amount should be reduced from the otherwise unadjusted purchase price when estimating the expected proceeds to be received by the seller.

Second, the timing and magnitude of the indemnity escrow may be considered for the potential impact on the expected proceeds to be received by the seller. As an initial test of fairness, the defined purchase price should be adjusted to reflect the estimated proceeds to the ESOP (an “adjusted purchase price”).

If the adjusted purchase price is within or exceeds the indicated range of appraised values, then the impact of the escrows is not likely to result in a conclusion that the purchase price is not fair from a financial point of view.

However, if the adjusted purchase price approaches or falls below the lower end of the fair market value range, additional analysis may be necessary to clarify a reasonable impact of the escrows.

Earnouts

Portions of the purchase price may be withheld for future payments based on the post-transaction operating results of the company. These are more commonly used when the target company has a limited operating history or significant uncertainty related to the ongoing earnings of the company resulting from the change in ownership.

Although there are various ways for the financial adviser to consider such a payment structure, one common approach is a probability weighted method.

Under this method, the earnout provisions are analyzed to recognize the potential range of future payments to be received under alternative scenarios or assumptions. Next, each of the identified alternatives is weighted as to its “probability” (i.e., or likelihood compared to the other alternatives) of occurring.

The financial adviser may consult with the company’s management, as well as with any other available experts including the buyers and available market data or research, in order to identify reasonable probability estimates for each of the alternatives.

Finally, the expected timing and risk of the future payments should be considered in order to convert the future earnout alternatives to a present value as of the transaction date.

The potential impact of any earnouts should be considered when estimating a reasonable purchase price to be received by the seller. It is important to remember that the objective of the analysis is to identify whether the transaction is fair from a financial point of view.

This perspective does not require that all purchase price uncertainty is removed from the transaction, but rather, that the price is fair to the ESOP based on the facts and circumstances at the time of the transaction.

Additional Transaction Benefits

For transactions of companies with ESOPs owning less than 100 percent of the outstanding stock, it is necessary to identify and consider the transaction benefits for both the ESOP and other non-ESOP owners.

Fair from a financial point of view to the ESOP includes both:

1. a fair price (or "absolute fairness") and
2. fairness among all stockholders (or "relative fairness").

In the financial adviser's relative fairness analysis, the financial adviser will consider the fair market value of the proceeds to all of the sellers.

From the perspective of the ESOP, the terms of the transaction should be at least as favorable to the ESOP as the other non-ESOP shareholders to pass the relative fairness test.

If the terms are more favorable to the ESOP, there would not be an issue of fairness from the perspective of the ESOP. However, if the non-ESOP shareholders are viewed as receiving a premium in price or more preferable terms and conditions than the ESOP, the fair from a financial point of view requirement has likely failed.

Additional transaction benefit considerations may be realized in various forms. Presented below are examples of possible additional transaction benefits.

Future Compensation or Consulting Agreements

The buyer of a company will often require the continued employment of key individuals. In circumstances where such individuals are also shareholders in the company, it may be necessary to analyze the proposed compensation package to identify whether the terms are above market compensation levels or if the financial package resulted in a decrease of the otherwise offered purchase price for the sponsor company.

If the purchase price and future compensation of a non-ESOP shareholder is perceived to be more favorable than the purchase price for the ESOP, then the fair from a financial point of view requirement has failed and would require modification of the transaction terms.

Future Lease of Real Estate

It is common for selling shareholders to own land, buildings, or other fixed assets (the "real estate") used by the company and lease it back to the company.

In a transaction where a non-ESOP shareholder retains ownership of the real estate after the transaction, it may be appropriate for the financial adviser to review the terms of any future rent payments in order to identify any potential "shift" in purchase price to the shareholder/owner of the real estate at the detriment of the remaining shareholders and ESOP.

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Repairs or Other Purchase Price Adjustments

Purchase price adjustments and payment terms must be at least equally fair to the ESOP as they are for non-ESOP shareholders. These adjustments include the provisions for escrows and earnouts as discussed previously.

Similar to other purchase price considerations, the amount of any adjustments should be considered when comparing the purchase price to the estimated value range in order for the financial adviser to properly assess the fairness of the transaction terms to the ESOP.

Noncontrolling ESOP Ownership

Another potential benefit to the ESOP may not be directly related to the purchase price. In circumstances where the ESOP is not a controlling owner, there may be another single owner with control.

If such a control owner operates the sponsor company in a manner that does not maximize the potential of the company or future earnings, it may be an important beneficial consideration for the ESOP to complete the transaction at the offered purchase price in order to no longer be subject to the authority of the control owner.

It is not suggested that the ESOP is being treated as an oppressed shareholder, but rather a control owner has latitude to operate the company in a manner of his or her desire, which may not result in the maximization of profits or company value.

Assuming all owners (controlling and noncontrolling) are being compensated equally in the transaction, the elimination of the noncontrolling ownership status of the ESOP may be considered a valuable benefit to the ESOP from a financial point of view.

Favorable Market Conditions

Financial markets, economies, and industries may be cyclical or volatile. Certain industries, and companies operating within such industries, may find that opportunities to sell or liquidate are limited. For companies with such characteristics, finding a willing buyer may be rare.

Being relevant to a potential pool of multiple buyers may be even more rare. Under such circumstances, fairness from a financial point of view may necessarily consider these qualitative factors in addition to the typical financial calculations of value.

Both the financial adviser and the ESOP trustee should recognize and understand the overall market considerations and the attractiveness of the sponsor company in the respective marketplace in order to develop a reasonable opinion of fairness from a financial point of view.

Consideration of Additional Transaction Benefits

Upon completion of the valuation analysis and gathering of the relevant facts, the financial adviser will typically develop an opinion of how the additional transaction benefits affect the ESOP and whether the terms of the transaction (including the purchase price as well as other nonfinancial considerations) are fair to the ESOP from a financial point of view.

An example regarding consideration of additional benefits from a financial point of view is presented in Exhibit 1.

The examples identified in Exhibit 1 can be seen to be at least equally fair to the ESOP as the other shareholder(s). The fairness from a financial point of view consideration does not require the terms to be equal to all participants.

Based on the example presented in Exhibit 1, the other shareholder(s) appear to be receiving less of a benefit than the ESOP, which from the perspective of the ESOP and the consideration by the ESOP trustee, is perfectly acceptable.

Concluded Opinion

Upon the completion of the analysis, the financial adviser is expected to render an opinion to the

Exhibit 1
Consideration of the Additional Transaction Benefits

	Summary of Additional Considerations and Terms of Purchase		Terms Favor	
	ESOP	Other Shareholder(s)	ESOP	Other Shareholder(s)
Differences in Escrows:				
Adjustment Escrow	Pro rata for 90 days	Pro rata for 90 days, plus 100% over $1.0 million	X	
Indemnity Escrow	Pro rata until $1.0 million for ESOP for 18 months	Pro rata for 18 months and 100% after ESOP total of $1.0 million, plus 100% after 18 months	X	
Additional Transaction Benefits:				
Future Compensation	None	One year continued employment at market estimated compensation of $150,000 per year, plus 2 additional years consulting agreement with a maximum individual commitment of 10 hours per month for $15,000 per year	X	X
Future Lease	None	Continued rent of company facilities from shareholder based on independently assessed market rate with an initial 5-year lease term	X	X
Elimination of Noncontrolling Ownership Status	No longer subject to control owner rights and privileges	NA	X	
Market Participant Interest	Company has never been approached for acquisition in its operating history, only one interested buyer has been identified, future liquidity event not likely, eliminates potential future concern surrounding the company's ESOP repurchase liability	Terms are considered comparable to other identifiable industry transactions, the company and shareholder(s) do not have the financial capacity to materially invest at a level which would result in a meaningful change in operations or improvement in earnings	X	X

ESOP trustee regarding two primary components as to whether:

- the consideration to be received by the ESOP for the ownership interest represents "adequate consideration," and is, therefore, not less than the fair market value of the shares and
- the transaction, taken as a whole, is fair and reasonable, from a financial point of view, to the ESOP.

Figure 2 reflects a representation by the financial adviser of the analysis performed regarding the fairness from a financial point of view.

In Figure 2, the financial adviser has modeled a conservative consideration of the purchase price in the transaction under two scenarios: first, assuming the shareholders will not receive any benefit from the potential future earnouts and second, in addition to the lack of future earnouts, all of the escrows will be fully utilized and, as a result, no additional funds related to the escrows will be received by the shareholders.

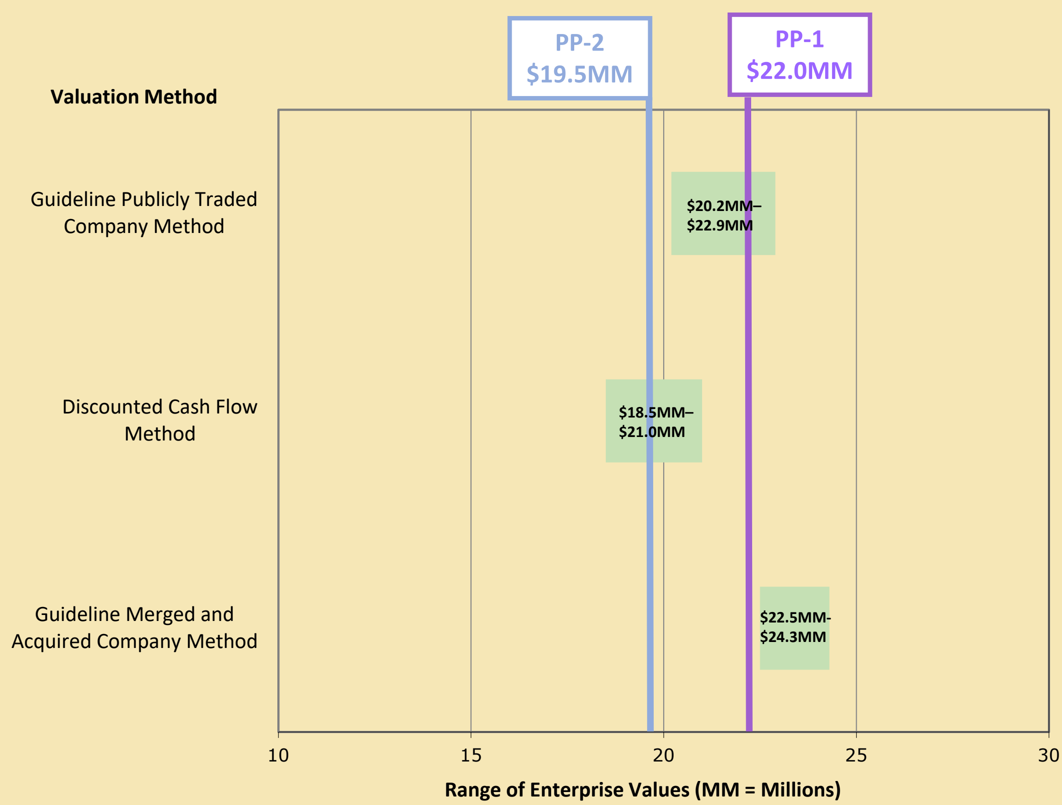
Although there are various methods and ways the financial adviser may consider the identified earnouts and escrows, the identified examples set the bar at the lowest potential purchase price and recognize that, regardless of the probability, the value to be received by the shareholders can only be greater than the indicated bars.

If the worst-case scenario still falls within the reasonable range of fair market value, then it can be reasonably concluded that the terms of the transaction price are fair from a financial point of view.

In order for the opinion of the financial adviser to be expanded to include the requirement that "the transaction, taken as a whole, is fair and reasonable . . . ," it is necessary to consider the summary of additional terms prepared by the financial adviser.

As indicated in the earlier example, the terms of the transaction examined by the financial adviser were considered to be at least as favorable to

Figure 2
Alternative Purchase Price Analyses—Illustrative Example



PP-1 = The gross purchase price of $22.0 million, net of earnouts and closing costs
PP-2 = The estimated payment at closing after subtracting all escrows from PP-1

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the ESOP compared to the other shareholder(s).

Limitations on Concluded Opinion

Although the analysis performed by the financial adviser can be substantial and significantly thorough, there are still generally recognized limitations and restrictions regarding the concluded opinion which will be included in the final fairness opinion letter.

Some of these generally recognized limitations and restrictions may include the following statements:

- We have reviewed the financial information and other internal data provided to us and other publicly available information, and while we did not verify the accuracy and completeness of such data and information, we have considered the reasonableness thereof and made certain adjustments thereto as necessary and appropriate.
- The opinion does not address (1) the business decision of the sponsor company's shareholders to proceed with the transaction or (2) the tax or legal consequences of the transaction.
- We have not been requested to, and did not, solicit third-party indications of interest from any party with respect to any transaction involving the sponsor company. Furthermore, we were not retained to, nor have we, provided any negotiation services with regard to the transaction.
- Management has represented to us that there have been no material changes in the business, financial position, or results of operations of the company since the date of the most recent company financial statement, and that there are no known contingent liabilities currently existing that may exert a material impact upon the financial operations and continuing economic viability of the sponsor company.
- This opinion does not constitute a recommendation to any shareholder of the company as to how such shareholder should vote with respect to the transaction.

As the above statements suggest, the opinion of the financial adviser does not provide a blanket determination regarding every potential impact relative to the company and the transaction. In each instance, it is likely that there are certain aspects of the transaction that may not be subject to the scope of the analysis by the financial adviser.

Ultimately, it is the responsibility of the ESOP trustee to understand the analysis prepared by the financial adviser and recognize the procedures applied as a basis to reasonably rely on the concluded opinion.

Summary and Conclusion

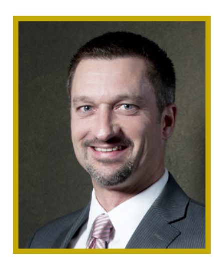
The analysis performed by a financial adviser conducting a transaction fairness opinion engagement may address certain specific questions or elements in addition to the application of generally accepted valuation methods considered to develop a reasonable estimate of fair market value for the sponsor company.

One requirement is that the transaction, taken as a whole, is fair and reasonable to the ESOP. This question, to be answered by the financial adviser as an adviser to the ESOP trustee, may involve the consideration of a number of facts and circumstances, including other potential benefits of the transaction to the ESOP and other shareholder(s).

In practice, should certain additional considerations appear to result in a potential detriment to the ESOP, the parties to the transaction are often motivated to negotiate acceptable terms so the analysis performed by the financial adviser results in an affirmed fairness opinion to the ESOP trustee.

As with any valuation analysis, the future cannot be predicted. However, the fairness analysis and opinion provide a tool to help the ESOP trustee:

1. understand the financial aspects of a proposed transaction and
2. make a decision that is in the best interest of the ESOP participants.



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