

The Role of an Independent Financial Adviser in ESOP Installation Transactions

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Transactions are highly anticipated and highly controversial events for companies in both public and private markets. Companies commit significant time and resources in sourcing the proper deal. Transactions typically involve outside consultants who may include investment bankers, deal attorneys, and accountants. Due to the unique nature and added complexity of transactions involving employee stock ownership plan (ESOP) sponsor companies, it is necessary for sponsor companies (or potential sponsor companies) to undertake additional due diligence procedures. These due diligence procedures involve hiring an external ESOP trustee to oversee the installation transaction on behalf of plan participants and having a fairness opinion provided by an independent financial adviser. The ESOP trustee represents the interests of the ESOP and the plan participants in the installation transaction. The ESOP trustee will typically rely upon the independent financial adviser regarding the financial aspects of the proposed ESOP installation transaction.

INTRODUCTION

Independent financial advisers assist ESOP trustees in fulfilling their fiduciary obligations to ESOP participants in both ESOP transaction fairness opinions and employer stock valuations (i.e., annual valuation updates) for regulatory compliance.

Transaction fairness opinions are issued by an independent financial adviser to the ESOP trustee regarding a pending purchase or sale of the sponsor company stock. Employer stock valuations are prepared annually to meet U.S. Department of Labor (DOL) and Internal Revenue Service (the “Service”) regulatory compliance standards.

Due to the standards imposed by these regulating bodies, utilizing independent ESOP trustees and independent financial advisers has become the standard for ESOP sponsor companies seeking to maintain appropriate corporate governance.

ESOP FAIRNESS OPINION ENGAGEMENTS

An ESOP trustee typically engages an independent financial adviser to perform a fairness opinion in the following instances:

1. The ESOP initial formation
2. The ESOP is party to a third-party transaction
3. The ESOP sponsor company divests one of its units
4. The ESOP sponsor company purchases another company
5. There is a tender offer to purchase all of the ESOP sponsor company stock
6. The ESOP sponsored company goes through a significant legal event such as a winding-down, liquidation, or bankruptcy

A fairness opinion is often rendered when there exists potential legal recourse by ESOP participants and/or increased Service or DOL oversight.

The role of an independent financial adviser in an ESOP transaction is to analyze a fair market value range of the ESOP sponsor company (or proposed target company) stock in order to determine whether the tendered offer is fair to ESOP participants (and/or sponsor company) from a financial point of view.

The fairness opinion states that the proposed transaction is fair to the ESOP participants, if the following occur:

1. The ESOP will not pay more than adequate consideration for the subject interest
2. The ESOP will not receive less than adequate consideration for the subject interest
3. The deal structure is fair to the ESOP in absolute terms
4. The deal structure is fair to the ESOP in relative terms
5. The deal structure is not more beneficial to other transaction participants than it is to the ESOP

The fairness opinion provides a basis for the ESOP trustee to accept or not accept the proposed transaction.

This discussion focuses on the independent financial adviser's role in a proposed purchase of a 100 percent equity ownership of the sponsor company in an ESOP installation transaction.

100 PERCENT ESOP INSTALLATION TRANSACTIONS

A 100 percent ESOP installation transaction involves the current shareholders selling all the outstanding shares of stock to the formed sponsor company ESOP. The terms of the transaction include a proposed price using a proposed deal structure. The sponsor company and ESOP will often engage an independent ESOP trustee (among other deal advisers) to represent the ESOP and its participants.

The ESOP trustee is responsible for determining the fair market value of the ESOP stock. The ESOP trustee should engage an independent financial adviser to assist the ESOP trustee in the proposed installation transaction and to render a fairness opinion.

The ESOP trustee and independent financial adviser are party to the structuring of the proposed transaction and must conduct due diligence, which

normally includes a site visit and sponsor company management interviews.

As the deal develops, the ESOP trustee relies on the financial adviser to provide his or her input as to how components of the deal structure affect the value of the underlying stock. This relationship allows the independent financial adviser to focus on the specific task of providing advice to the ESOP trustee who is responsible for decisions regarding the transaction and the related fair market value of the ESOP stock.

The independent financial adviser provides these services for the ESOP trustee to consider. Such independent analysis of the 100 percent equity ESOP installation transaction provides the ESOP trustee with the following:

1. Essential information regarding the pending transaction
2. Documentation that the ESOP fiduciary used reasonable business judgment in making an investment decision of the stock purchase of the ESOP sponsor company stock on behalf of the ESOP beneficiaries

Other parties to the 100 percent equity ESOP installation transaction, outside of the ESOP parties, often render their own valuation of the underlying shares. For example, investment banks representing the seller of company stock will typically be compensated on the purchase price and pursue the highest transaction price for the selling shareholders. A lender, approving the proposed transaction, will primarily be concerned with the impact the new deal terms will have on the outstanding loan.

Because the independent financial adviser's compensation for the 100 percent equity installation transaction is not dependent on the negotiated deal price, the independent financial adviser is able to provide an unbiased opinion of value for the underlying shares.

With numerous parties involved and multiple iterations of a deal structure, the process of structuring a 100 percent equity ESOP installation can be drawn out over many months. The financial elements of the transaction require thorough analysis by the financial adviser.

The following sections summarize these issues:

1. The purposes of the fairness opinion
2. The deliverables of the financial adviser to the ESOP trustee
3. Some transaction-specific factors commonly present in ESOP installation transactions
4. Regulatory considerations in an ESOP installation transaction

Purposes of the Fairness Opinion

The transactional fairness opinion in a 100 percent equity ESOP installation transaction provides the independent financial adviser's opinion on:

1. the financial fairness of the deal terms and conditions,
2. the fairness of the deal structure, and
3. the fairness of the proposed purchase price.

The fairness opinion is an important step in documenting the ESOP trustee's process of prudence and due diligence.

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 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 an important legal tool. It provides evidence that the ESOP trustee used reasonable business judgment in the evaluation and assessment of the proposed transaction.

Under the legal concept of business judgment, courts typically do not second guess the decisions of the ESOP trustee (or find liability for honest mistakes) provided that the ESOP trustee acted:

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

The transactional fairness opinion is an important practical tool. It provides a level of support for the proposed transaction that other parties to the capital transaction may find reassuring. The fairness opinion is not an explicit endorsement of the proposed transaction; however, the fairness opinion may persuade other parties to approve the employer corporation capital transaction if the proposed transaction is considered fair to the ESOP by an independent financial adviser.

Deliverables to the ESOP Trustee

The primary deliverable by the independent financial adviser to the ESOP trustee is the fairness



opinion letter. Additionally, the financial adviser may provide a presentation to the ESOP trustee outlining his or her analysis.

The fairness opinion letter is a brief document that communicates to the ESOP trustee whether the proposed transaction price is fair from a financial point of view. The definition of “fair” however can have different and multiple meanings based on the terms of the transaction and the scope of the fairness opinion.

The transaction price of the subject stock is compared to the fair market value of the subject stock with fair market value being defined by the DOL as “the price at which an asset would change hands between a hypothetical willing buyer and a hypothetical willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties are willing to trade, and both parties are well informed about the asset and the market for the asset.”

The fairness opinion letter addresses the following fairness criteria:

1. The fairness opinion letter concludes whether, in the opinion of the independent financial adviser, the proposed transaction value represents adequate consideration to the ESOP.

ERISA Section 3(18)(B) defines the term “adequate consideration” 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.”

2. The fairness opinion letter may address the financing terms of the transaction. Financing from financial institutions and/or selling shareholders is often involved in 100 percent equity ESOP transactions.

The ESOP trustee's financial adviser must determine that the terms of the loans are at least as favorable to the ESOP as would be the terms of comparable loans resulting from arm's-length negotiations with independent parties.

The fairness opinion letter is the property of the ESOP trustee. The fairness opinion letter:

1. only relates to the facts and circumstances of the specifically identified transaction,
2. is directed only for the use and information of the ESOP trustee, and
3. is only relevant for the specific date of the proposed transaction.

In addition to the fairness opinion letter, the independent financial adviser typically provides a presentation or report to the trustee detailing the research and analysis in support of the opinion rendered in the fairness opinion letter. Presentations have become the preferred format for delivering the financial adviser's analysis.

The presentation includes the following:

1. An overview of the transaction structure, including a discussion of the development of the transaction (tender offers) and an analysis of the financing agreements
2. A valuation analysis of the sponsor company stock, summarizing:
 - a. the independent financial adviser's due diligence meetings and discussions with company management,
 - b. the history of the ESOP company,
 - c. an analysis of the industry and current market conditions, and
 - d. the relevant valuation methods applied in developing the value of the sponsor company stock

Transaction-Specific Factors

The information and analysis supplied by the independent financial adviser varies due to the unique circumstances of each 100 percent equity ESOP installation transaction. The following discussion summarizes some of the common issues that the independent financial adviser may be asked to consider.

The independent financial adviser initially may be asked to perform a feasibility study for the proposed ESOP sponsor company. The formation of an ESOP usually involves a significant amount of leverage. The increased debt for the ESOP sponsor company and the repurchase obligations represent potential threats to the company's solvency.

A repurchase obligation is the ESOP shareholder's put option right associated with employee ownership, where the employee has the right to put their shares back to the ESOP at a predetermined price.

The independent financial adviser assists the ESOP trustee in determining the long-term feasibility of increased leverage on the ESOP sponsor company and the implications of the future ESOP stock repurchase obligations.

However, this analysis is often considered a solvency analysis, and a subsequent solvency opinion rendered by the independent financial adviser based on this analysis is (1) a completely different assignment than a fairness analysis and fairness opinion and, therefore, (2) beyond the scope of this discussion.

In the case of a leveraged ESOP transaction, the financial adviser may take additional steps to conclude whether or not the transaction price is indeed fair. These considerations include the following:

1. The terms of the debt financing used to purchase the stock
2. The ability of the company to make annual debt payments on the loan (through the ESOP)
3. The feasibility that the company will continue to operate going forward under the new ownership structure

These considerations may be addressed in the valuation of the sponsor company stock. The general processes of a leveraged ESOP transaction are as follows:

1. The company acquires financing from a bank, the seller using a seller note, or another third-party financial institution (collectively, the "lender") and lends the acquired cash to the ESOP
2. The ESOP uses the cash received from the company to purchase stock from the selling shareholders
3. The company makes annual, tax-deductible contributions to the ESOP, which uses the cash from the contribution to pay down the debt to the lender

4. Employees receive stock from the ESOP according to the vesting schedule

Some 100 percent equity ESOP installation transactions may also include an incentive program for key employees, commonly referred to as a management incentive plan (MIP). Such incentive plans may include stock appreciation rights (SARs), phantom stock, earn-outs, or warrants.

The independent financial adviser may determine whether the proposed incentive program is enough to maintain key employees while not being detrimental to the value of the company stock over the long-term.

For example, some 100 percent equity ESOP installation transactions, in order to entice certain shareholders to partake in the ESOP installation transaction, involve the creation of dilutive SARs.

SARs (or other types of synthetic equity) may be issued to the current principle shareholders to allow for stock appreciation benefits without actually owning the outstanding shares of the sponsor company.

These potential payouts of the sponsor company to non-ESOP shareholders may be considered in the sponsor company stock valuation for the ESOP installation transaction.

REGULATORY CONSIDERATIONS

The primary regulatory law governing an ESOP is the Employee Retirement Income Security Act of 1974, as amended (ERISA).

An ESOP fiduciary retains an independent financial adviser to perform a qualified appraisal, as defined by Internal Revenue Code Section 170. Section 170(f)(11)(E)(i) provides that the term “qualified appraisal” be an appraisal that is:

1. treated as a qualified appraisal under regulations or other guidance prescribed by the Secretary, and
2. conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.

Section 170(f)(11)(E)(ii) provides that the term “qualified appraiser” means an individual who:

1. has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary,

2. regularly performs appraisals for which the individual receives compensation, and
3. meets such other requirements as may be prescribed by the Secretary in regulations or other guidance.

Section 170(f)(11)(E)(iii) further provides that an individual will not be treated as a qualified appraiser unless that individual:

1. demonstrates verifiable education and experience in valuing the type of property subject to the appraisal, and
2. has not been prohibited from practicing before the Internal Revenue Service by the Secretary under Section 330(c) of Title 31 of the United States Code at any time during the three-year period ending on the date of the appraisal.

An ESOP meets the requirements of Section 409(a)28(C) if all valuations of employer securities, which are not readily tradable on an established securities market with respect to activities carried on by the plan, are by an independent appraiser.

For purposes of the preceding sentence, the term “independent appraiser” means any appraiser meeting requirements similar to the requirements of the regulations prescribed under Section 170(a)(1).

CONCLUSION

Given the complex nature of ESOPs and increasing scrutiny from the DOL, it has become a best practice of ESOP sponsored companies to hire an independent ESOP trustee and for the ESOP trustee to obtain a fairness opinion performed by an independent financial adviser for transactions involving ESOP sponsor company stock.

The financial adviser offers independence and objectivity and can opine on financial matters without conflicts of interests. The ability of the financial adviser to properly and efficiently address these issues is important to an ESOP trustee as part of their prudence and process in a 100 percent ESOP installation transaction.

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