**Fairness Opinions**

**Q&A from an ESOP Perspective**


The following question and answer format allows readers to focus on material of specific interest. Additional must-read materials related to your questions about fairness opinions and other ESOP oriented topics are included in the forthcoming book, “Is It Fair? A Guide to Understanding Fairness Opinions from a Valuation Perspective,” and on the Mercer Capital website (www.mercercapital.com) where an ongoing dialog of ESOP questions and answers can be found in our quarterly valuation periodicals and archived articles. In our experience as financial advisors to ESOP trustees, and as an ESOP-owned company, every ESOP situation usually has unique circumstances that require specific assessment. For a confidential discussion about your specific ESOP situation, please contact a Mercer Capital valuation professional.

**Q: WHY ARE FAIRNESS OPINIONS IMPORTANT?**

**A:** Prepared by an independent financial advisor, a fairness opinion is just that— an opinion that a proposed transaction is fair (or not) from a financial point of view, to shareholders of a company. A fairness opinion can assist corporate directors and executives in making decisions concerning strategic and financial events. A fairness opinion can also instill confidence among stakeholders that an action has been thoroughly vetted for its effects on the ESOP and/or the sponsoring company. These opinions can aid in substantiating that decision makers have adhered to the business judgment rule, which requires that a board exercise due care in the process of reaching a corporate decision, that the board acts independently and objectively in reaching such decisions, that decisions are made in good faith, and that there was no abuse of discretion in making the decision.

**Q: DOES A TRANSACTION INVOLVING OR AFFECTING AN ESOP REQUIRE A FAIRNESS OPINION?**

**A:** The prudent, albeit self-serving, answer is yes. Despite this author’s professional convictions that transactions affecting or potentially affecting an ESOP should include a fairness opinion, such opinions are rare. Some business owners and trustees believe that fairness opinions are time-consuming, costly, uncommon, unnecessary, or excessive for many transactions. Perhaps, in some circumstances, a fairness opinion could be viewed as nonessential. However, every ESOP installation and every ESOP termination, and virtually every significant corporate (or strategic) event in an ESOP sponsoring company would be better served to include a fairness opinion rendered from the financial perspective of the ESOP and its trustee.
That an ESOP transaction or significant corporate event that affects the shareholders or participants of an ESOP company requires a fairness opinion is not specifically codified. Nonetheless, obtaining the service can be a vital, virtually obligatory exercise for any prudent decision-maker, particularly one carrying the burden of a fiduciary obligation to future, present, and past ESOP participants.

Q: IF A “VALUATION” IS ALREADY PART OF THE PROCESS, ISN’T A FAIRNESS OPINION THE SAME THING?

A: No. A valuation of the transacting interests may be an essential underpinning for a fairness opinion but it is not the only substance of a fairness opinion. Fairness opinions frequently contain additional disclosures, observations, and assessments concerning the circumstances of, alternatives to, and other key factors surrounding a transaction.

In many cases a fairness opinion reaches beyond the instant economics of a transaction to examine the specific terms and context of a transaction. Valuations are often based on the standard of “fair market value” and are constructed using reasonable assumptions and reflections of a hypothetical and rational universe. When an actual transaction arises between specific parties, the situation often includes attributes specific to the parties and the circumstances – A.K.A. the real world versus the hypothetical world. A well-crafted fairness opinion reaches beyond the hypothetical to examine and document these real world considerations.

Q: WHAT EVENTS GIVE RISE TO THE NEED FOR A FAIRNESS OPINION?

A: The following is a list (non-comprehensive) of the types of events that give rise to the need for a fairness opinion. A good rule for decision makers concerning the assessment of need for a fairness opinion is if you suspect that any aspect of a transaction is potentially controversial, then an assessment of fairness to the party in question should be considered. The responsibilities that board directors have to their ESOP trustees and in turn the trustee’s obligations to their plan participants are serious business.

» The sale and/or issuance of stock to a newly forming ESOP
» The sale of a significant portion or substantially all of the assets or stock of an ESOP company
» The incurrence of significant debt or the financial restructuring (recapitalization) of an ESOP company
» The changing of corporate entity organization of the ESOP company (“S” election)
» Significant changes to the ESOP plan document
» The purchase of a significant asset or business segment which is beyond the normal scope of business or corporate activity
» The sale of a significant asset or business segment which is beyond the normal scope of business or corporate activity
» The redemption of stock by the company from non-ESOP shareholders
» The commitment of the company to shareholder agreements that place future obligations on the company
» Significant changes in compensation or other financial practices, particularly if such changes are different or contrary to the financial construct upon which a transaction value or ongoing plan valuation is based
» The liquidation of the ESOP company
» The termination of the ESOP
Q: ARE THERE OTHER CIRCUMSTANCES THAT MAY REQUIRE DECISION MAKERS AND FIDUCIARIES TO OBTAIN FAIRNESS OPINIONS?

A: Absolutely. Based on Mercer Capital’s experience, events that are potentially controversial, involve a conflict of interest, or involve decisions and actions other than in the ordinary course and timing of business may require a fairness opinion. As with the previous list of events, the following is not all-inclusive. Additionally, most of the following conditions relate to the sale of an ESOP company or the installation of an ESOP.

» The proposed ESOP transaction includes a stock valuation that is different than the valuation at which other stock transactions have occurred or is different than the valuation expected in a potential sale of the company.
» The proposed ESOP transaction includes a stock valuation that is different than the valuation at which actual offers for the stock or the company have occurred.
» The proposed ESOP transaction includes a valuation that is different than reflected in recent stock appraisals.
» The proposed ESOP transaction includes a valuation that is different than stock valuations called for in shareholder agreements (buy-sell, etc.).
» The proposed ESOP transaction requires high levels of debt financing.
» The proposed ESOP transaction includes a valuation that relies on changes to historical compensation and other business practices.
» The proposed ESOP transaction and its associated debt may compromise the ability of the company to secure operating and growth capital, such factors which may be a predicate to the proposed transaction valuation.
» The cost of financing does not appear to reflect market rates and/or the ESOP transaction is otherwise unable to achieve third-party (independent) financing.
» The proposed ESOP transaction entails financing that potentially dilutes shareholders (such as warrants).
» The proposed transaction valuation is not thorough, methodologically complete, and standards-compliant.
» The seller of stock to an ESOP is also the ESOP trustee.
» The issuance of stock to an ESOP involves the use of sale proceeds for non-recurring payments to non-ESOP shareholders and/or executives of the company.
» The company conducts significant business with parties that are owned or controlled by sellers of stock to a proposed ESOP.
» A proposed ESOP transaction is occurring at a time of significant change in company performance (declining revenue and/or profitability).
» A proposed ESOP transaction is occurring at a time of significant change regarding senior management, product and service offerings, closure or discontinuation of certain lines of business or locations, etc.
» Alternative transaction bids have been received that are different in price or structure, thereby leading to an interpretation as to whether the exact terms being offered reconcile to the proposed ESOP transaction valuation.
» There is concern that the shareholders, trustees and directors fully understand that considerable efforts were expended to assure fairness to all parties.
» The board desires additional information about the potential impact of the ESOP transaction and ongoing plan requirements on the company.
» An ESOP company is issuing stock options or other equity-based compensation that could adversely dilute the ESOP’s ownership position.
» An ESOP company is being sold to a related party or buyer with a current or prior relationship to the company.
An ESOP company is being sold at a valuation different than the ESOP appraisal or for consideration that is different than anticipated

An ESOP company is being sold for consideration that is above and beyond that which directly benefits shareholders (including the ESOP) on a pro rata basis (management contracts, non-competes, etc.)

An ESOP company is being sold to a buyer that intends to employ company executives, trustees, and/or board members subsequent to the closing of the transaction

An ESOP company is being sold where the company is not represented by a qualified investment banker or other intermediary whose purpose is to maximize value and deal structure for the company and the ESOP

An ESOP company is being sold where the company, its board, and/or its executives have not obtained competing bids or assessed alternative strategies for maximizing value and/or achieving liquidity

An ESOP company has elected not to respond to or to negotiate an offer submitted by a bona fide purchaser of the company

Despite the breadth of the above events circumstances, there are many other situations which likely accompany ESOP transactions and transactions of ESOP owned companies. Your transactions should be thoroughly reviewed from the financial perspective of the ESOP. The transaction process, evolution, negotiations, and other factors that comprise the event (and any circumstances) should be systematically analyzed and documented within the fairness opinion.

Q: WHAT DOES THE DELIVERABLE FAIRNESS OPINION WORK PRODUCT LOOK LIKE? WHAT DOES IT CONTAIN?

A: The fairness opinion is a brief document, typically in letter form. However, the supporting work behind the fairness opinion letter can be substantial. This supporting work is often reported and documented in the form of a fairness memorandum that incorporates all material factors, conditions, circumstances, and other considerations which were analyzed, assessed, and disclosed in the development of the opinion. The fairness opinion letter typically makes the affirmative statement the proposed transaction is fair from the financial perspective of the ESOP.

In the case of a new ESOP or the sale of an ESOP owned company, the fairness exercise virtually always includes a valuation to determine if the ESOP is paying or receiving adequate consideration for the interests it is buying or selling. Generally, the purpose of the valuation is to develop the fair market value of the ownership interest to be transacted. The fairness memorandum also includes all relevant disclosures concerning the transaction, alternatives and potential consequences related to action or inaction regarding the pending transaction, and other assessments that may be specifically requested by the trustee (or the party that requisitioned the opinion).

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