Thought Leadership

Evaluating Key Person Risk When Valuing a Closely Held Company for Marital Dissolution Purposes

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The operations, and the underlying value, of many closely held companies may be affected disproportionately by dependence on one or two key individuals. This dependence, typically referred to as "key person risk," is recognized within the valuation profession. This key person risk is often accounted for in the form of a valuation discount applied to the company's overall business value. Valuation analysts providing services in a marital dissolution setting often face the challenge of performing the necessary diligence to (1) identify whether a company is exposed to key person risk and (2) assess the impact of key person risk on the closely held business valuation.

Introduction

When valuing closely held companies for marital dissolution purposes, valuation analysts ("analysts") consider that some closely held companies rely on one individual for the company's success. Companies that rely heavily on one person for the success of the company suffer from key person risk. In these circumstances, it is important for the analyst to (1) evaluate whether key person risk exists and (2) adequately incorporate key person risk considerations into the valuation of the subject company.

If a closely held company has key person risk that is not adequately considered in the valuation, the subject company business value may be overstated. This discussion addresses how to evaluate whether key person risk exists in a closely held company. This discussion describes several methods for incorporating key person risk considerations in the business valuation process.

Key Person Risk in Closely Held Companies

When valuing closely held companies for marital dissolution purposes, the subject company is often relatively small and may rely on one person for its success. In such circumstances, it is important for the analyst to take into consideration the importance of the key person.

Typically, in smaller companies, upper-level management is comprised of relatively few employees. In such circumstances, it is not unusual for a company's future success and viability to hinge on the continued health, success, and contributions of an owner or founder. When a company is highly dependent on one individual for its continuing success, it suffers from key person risk.

The definition of a key-person discount is "an amount or percentage deducted from the value of an ownership interest to reflect the reduction in value resulting from the actual or potential loss of a key person in a business enterprise."[1] When valuing closely held companies for marital dissolution purposes, the analyst should understand key person risk and be able to evaluate whether or not it exists.

For federal gift and estate tax purposes, the U.S. Tax Court has allowed for a discount when concluding the value of companies when the existence of key person risk has been established. The value adjustment is often presented in the form of a key person discount—reflected as a percentage discount to arrive at the estimated company value, or as an implicit adjustment to an estimated company value in the form of a higher discount rate or capitalization rate.

When valuing closely held companies for marital dissolution purposes, the analyst may (1) complete sufficient diligence procedures to establish whether a company has a key person dependency and (2) identify the key person risk and incorporate elements in the valuation process that adequately address the economic impact of identified key person dependency on the value conclusion.

This discussion focuses on evaluating whether key person risk exists in a company and how to adequately address key person risk issues when valuing a closely held company for marital dissolution purposes.

Key Person Considerations

Simply being an owner of a business does not automatically qualify an individual as a key person. Similarly, just because a company is "small" does not necessarily indicate that the company operates with key person risk.

A company may suffer little to no economic harm upon the departure of a member of upper-level management if the company operating structure includes (1) adequately trained employees that can effectively assume the duties and responsibilities of the departing manager and (2) diversified revenue, supplier, and distribution sources that do not depend on the departing manager. Even small companies operating with a well-diversified management team capable of fulfilling the role of a departing key person are positioned to mitigate key person risk.

When evaluating whether a company has key person risk, the following six areas may be analyzed:[4]

1. Management and leadership skill
2. Suppliers
3. Customers
4. Innovation
5. Obtain debt or equity
6. Employee loyalty

Each of the areas is discussed below.

Management and Leadership Skill

Does a person have management and/or leadership skills that are important for the company's operations? In some closely held companies, one individual may have the leadership ability to grow the company and navigate the landscape of a changing industry. Similarly, one person may be important for defining short-term and long-term goals. This individual may have the administrative and management leadership skills required to enable the company to realize its goals. If a company is highly dependent on one individual to lead and manage the company, and this person "cannot" be replaced, then the company suffers from key person risk.

To establish the existence and significance of the level of key person risk, an analyst typically interviews the key person, as well as other employees. This type of 360 degree diligence review enables an analyst to estimate the impact that key person's departure may have on the company.

If the key person has unique skills, talents, and qualities, but it is determined that an external hire could assume the key person's role at a comparable cost, then key person risk may not be present.

Suppliers

Are relationships with suppliers largely dependent on one person? A key person may be able to obtain better prices or more exclusive products from suppliers. More favorable supplier terms provide a company with lower input costs, which positively affect the profitability of a company.

A company that can realize lower input costs can then use its higher profitability to:

1. make further profitable investments in capital equipment,
2. offer higher compensation and draw more skilled employees into the organization, and
3. increase the marketing and/or advertising budget to reach more consumers.

Typically, an analyst may perform diligence procedures to determine whether company suppliers are providing favorable terms based on a relationship with a specific individual within the company. Such a circumstance likely may support a conclusion of the presence of key person risk.

Customers

Are relationships with customers largely dependent on one person? Customers may purchase goods or services from a company because they have a personal relationship with a particular person in the company. A company or person may purchase goods or services from another company because the seller or provider produces or provides a high quality product or service. However, if the product or service is not noticeably different from comparable products or services offered by alternative providers, purchases may be attributable to a personal relationship.

In such a circumstance, the key person's relationships increase the switching costs to purchase goods or services from another provider. If a significant number of customer relationships can be attributed to one person at a company, or if a significant percentage of company revenue is generated by the relationships of one person, then key person risk may exist. The analyst may estimate what percentage of revenue is likely due to the relationships of the key person.

Innovation

Does one person in the company have a unique ability to innovate products? For companies in the technology sector, or other sectors demonstrating significant technological disruption or innovation, a key person may be important for understanding the direction the industry or products are moving.

Typically, an analyst performs diligence procedures aimed at understanding to what extent one individual enables a company to stay ahead of changing trends or innovations in the industry. If one person has been responsible for identifying changes or important trends in the industry, and the company has performed well as a result of the early identification of these shifts, the company may be exposed to key person risk.

Obtain Debt or Equity

Does one person have a unique ability to obtain debt or equity capital? In some cases, one person within a company may have an ability to raise additional equity capital through a large network of potential investors. Similarly, if one person has been responsible for raising debt, and this person cannot be replaced, then the company may be exposed to key person risk in the form of a threat to the company's continuing ability to raise additional capital on favorable terms.

Many closely held companies borrow through commercial banks, which rely more on the fundamental position of the company. Typically, an analyst performs diligence procedures aimed at understanding the key terms and conditions regarding equity and debt issuances.

If such diligence indicates that a single individual at the company has a history of achieving favorable financing terms based on relationships in the capital markets, the company may be exposed to key person risk.

Employee Loyalty

Are employees who are important to the company's operations loyal to a specific person? And, would the loyal employees leave if the key person left? In some smaller, closely held companies, strong loyalty may exist between a company founder or leader and other employees. Such loyalty could result in the departure of a number of employees should the founder or leader leave the company.

In such a circumstance, the key person may not even have unique skills or talents that the company relies on for its success. However, the company could still experience significant disruption and harm if the "charismatic" leader left, resulting in a group of other, important employees following. Generally, this is not a significant problem in larger companies with more diversified management teams.

However, in smaller companies, the departure of "everyone's favorite manager" could result in the loss of a number of employees, some of whom may have special knowledge or training and would be difficult to replace. Such a loss may be harmful to the continuing success of a small company.

When valuing a closely held company, an analyst typically performs diligence procedures to evaluate whether the company is exposed to employee defection as a result of loyalty to a particular individual or leader. Such potential losses are mitigated significantly by legally enforceable noncompetition agreements. The absence of a noncompetition agreement in such a circumstance may result in a conclusion that key person risk exists, possibly resulting in a reduction in the value of the subject company.

Compensation adjustments can be considered as a form of mitigating key person risk, but such adjustments typically have the impact of increasing operating costs, thereby reducing expected earnings and value.

An assessment of key person risk involves a diligence process and appropriate documentation. If the diligence process indicates that a company is exposed to key person risk, adjustments incorporated in the valuation process to address the risk may be deemed inappropriate absent sufficient evidence supporting the key person risk conclusions.

earnings, and it was suggested that company earnings were highly dependent on the husband and the real estate industry.

However, earnings increased each year throughout the valuation period and the company was able to obtain new clients without much difficulty. Therefore, the court found that such a high risk factor did not reflect the reality during the period subject to valuation.

In *Miller v. Miller*,[6] the wife's analyst testified that a key person discount was not applicable to the husband's practice because he could be replaced by another internal medicine doctor. Furthermore, the fact that some patients might not return was taken into account by use of the market approach and by the use of a higher capitalization rate. In the income approach, the court found that the adjustment of the capitalization rate by the wife's analyst was an appropriate method to capture the risk that some patients would not return.[7]

In the court case of *In re Marriage of Frett*,[8] the analyst determined that the husband was a key person in TechniCom, Inc., a telephone equipment installation company. In addition to a 15 percent discount for lack of marketability, the husband's analyst included a 20 percent key person discount to reflect the risk of a potential loss of the key person to the company. However, the court determined that both discounts were excessive under the facts of the case.

The previous court cases provide an idea of how key person risk has been addressed for marital dissolution purposes. The following Tax Court decisions relate to federal gift and estate tax matters. However, these decisions relate to the measurement of the key person dependence valuation discount.

In *Estate of Mitchell v. Commissioner*,[9] the court decided that the death of Paul Mitchell exerted a materially significant, detrimental impact on the future of John Paul Mitchell Systems (JPMS). The court considered John Mitchell to be "vitally important to its product development, marketing, and training. Moreover, he possessed a unique vision that enabled him to foresee fashion trends in the hair styling industry."

The presence and significance of key person risk at a company can exist in many forms. Before discussing how the analyst can incorporate key person risk in the valuation process, a review of several court cases is presented. This review is intended to (1) explain the rationale courts have used to identify the presence of key person risk and (2) present a range of key person discounts accepted by certain courts.

Representative Key Person Court Cases

When attempting to analyze whether key person risk exists and to estimate a reasonable level of adjustment to reflect the impact of key person risk, it may be instructive to review court decisions that have addressed the issue of key person risk. Several judicial decisions addressing the issue of key person risk and related discounts are discussed in the following paragraphs.

In *Kohl v. Kohl*,[5] the analysts were in general agreement about how to assess the equity risk premium including the risk-free rate and small capitalization premium. However, discrepancies arose when determining the risk factors for the specific business being valued. These risk factors included key person risk, customer concentration, and lack of marketability.

The court found that a 32 percent risk factor for dependence on a key person (Tod Kohl, the owner/operator) was not warranted. For example, a high risk was assigned to the stability of the businesses'

Since the court considered him a key person, and efforts to acquire JPMS prior to Paul Mitchell's death were contingent upon his continued service at JPMS, the court reasoned that there was inadequate management depth at JPMS after Paul Mitchell's death. The court opined that a key person discount of 10 percent should be applied after estimating the enterprise value and prior to additional discounts for lack of control and lack of marketability.[10]

In *Estate of Furman*,[11] the court was asked to determine the fair market value of a decedent's 27 Burger King restaurants. The living son, Robert, ran the company and was thought to be important to the company's success. Therefore, the taxpayer's analyst applied a 10 percent discount to reflect the reliance the company had on Robert as a key person. In considering the basis for the key person discount, the court stated:

> Where a corporation is substantially dependent upon the services of one person, and where that person would no longer be able to perform service for the corporation by reason of death or incapacity, an investor would expect some form of discount below fair market value when purchasing stock in the corporation to compensate for the loss of that key employee.

The court reasoned that a professional manager could have been hired to replace Robert. However, the court opined that the basis for the 10 percent key person discount included consideration of several additional risks the company was subject to, including the following:

1. Lack of management until a replacement was hired
2. Risk that a professional manager would require higher compensation than Robert had received
3. Risk that a professional manager would not perform as well as Robert

These decisions indicate that key person risk may have a significant influence on the value of a company. In the two Tax Court decisions discussed, the court accepted a discount for key person risk of 10 percent. However, the key person discount in any particular case will be based on consideration of the facts and circumstances specific to the case.

Adjusting for Key Person Risk

After assessing whether key person risk is present in a subject company, the analyst is faced with the task of quantifying the significance of key person risk and incorporating the impact of the key person risk in the valuation. There are three generally accepted business valuation approaches to valuing closely held companies for marital dissolution purposes: (1) the income approach, (2) the market approach, and (3) the asset approach.

Each of these approaches is discussed below. A discussion then follows regarding how to address the issue of key person risk in the valuation approaches.

Income Approach

Common income approach valuation methods include the discounted cash flow method and the direct capitalization method. The discounted cash flow method involves a projection of the subject company results of operations for a discrete, multiyear period. The discounted cash flow projection is then converted to a present value using a market-based, risk adjusted discount rate. The discounted cash flow method also involves a terminal value analysis at the end of the projection period.

The direct capitalization method involves dividing a market-derived, risk-adjusted direct capitalization rate into a normalized estimate of expected, long-term income (e.g., cash flow) for the subject company.

Market Approach

The market approach methods rely on the premise that prices of securities of companies in the same or similar lines of business provide informational value to investors. The market approach methods incorporate some form of relational analysis between a sample of guideline company security trading prices, or transaction prices, and selected financial/operating fundamentals in order to create a range of relevant pricing multiples.

These pricing multiples are used as a basis for selecting the particular pricing multiple to apply to the subject company's same fundamental value measures. The information sources considered for the purpose of completing the market approach can include data regarding privately held companies, publicly traded companies, or merged and acquired companies.

Asset-Based Approach

The asset-based approach methods consider the value of company assets (both tangible and intangible) and the value of company liabilities (both recorded and contingent).

The asset-based approach encompasses a valuation (either discrete or collective) of company assets, including current assets, tangible personal property, real estate, and intangible assets. This valuation approach also encompasses a valuation of company liabilities, including current liabilities, notes payable; and contingent liabilities.

All three valuation approaches may be considered, initially, when valuing a closely held company. However, the facts and circumstances and analyst judgment dictate which approaches will be applied.

The following discussion relates to incorporating key person risk in the income approach and market approach methods.

Key Person Risk and the Income Approach

Within the income approach, generally, there are two ways to apply a key person discount. First, the analyst can increase the discount/capitalization rate used to capitalize normalized income. The increase in the capitalization rate is intended to reflect the incremental risk the key person dependency exerts on the company's operations.

Second, the analyst can estimate the detrimental effect that the loss of the key person would exert on company revenue and profit. The estimated effect would then be used to:

1. normalize company earnings and net cash flow incorporated in the capitalization of net cash flow method or
2. develop adjusted company financial projections incorporated in the discounted cash flow method.

When developing a discount rate, an analyst typically begins with a risk-free rate and adds incremental risk components. Based on the facts and circumstances regarding the subject company, additional risk components could include an equity risk premium, a size premium, and an industry risk premium.

If an analyst determines that company-specific risk exists that is not addressed by the premiums previously identified, the analyst can then add an additional company-specific risk premium. Often, key person risk is incorporated in the development of a discount rate as a component of company-specific risk.

Due diligence procedures performed by an analyst during the valuation process should result in a solid, documented foundation for company-specific risk, including key person risk.

The second method to incorporate key person risk into an income approach business valuation involves normalizing company income or future cash flow to reflect company operations as if the key person were no longer present. A reasoned estimate regarding how company revenue would change and how operations would change on a day-to-day basis if the key person were no longer present is necessary. Typically, the impact of the loss of a key person is estimated based on due diligence interviews with the key person and management at the subject company.

Though not an exhaustive list, the six areas previously identified provide a reasonable interview foundation for the purpose of establishing whether a company is subject to key person risk and the nature of the risk. Through the interview process, an analyst may learn that a suitable replacement for a key person exists, mitigating, or potentially eliminating, the key person exposure identified.

To the extent that key person risk is identified, and the exposure cannot be eliminated effectively, revenue and earnings expected for the subject company may be lower.

Key Person Risk and the Market Approach

Key person risk can be incorporated in the market approach by adjusting the pricing multiples selected from the range of potential pricing multiples resulting from the analysis of the identified group of guideline companies.

When adjusting the selected multiples, it is important for the analyst to provide evidence in support of adjustments to the pricing multiples that reasonably corresponds with the estimated significance of the key person risk exposure.

Key Person Discount at the Company Level

Lastly, an analyst can apply a key person discount at the total company equity level. In other words, an analyst can apply a key person discount after the company's total equity value has been estimated. The advantage of applying the key person discount at the total equity level is that it does not involve any reliance on management projections or attempts at estimating normalized income based on the assumed loss of the key person.

Applying a key person discount at the total equity value level enables an analyst to avoid making multiple assumptions regarding the following:

1. Operating measures, such as future revenue and operating margins, and related growth rates

2. Customer/employee retention and supplier relationships

As a result, applying a key person discount as a percentage of total equity value represents a viable option when key person risk is identified in the valuation of a company for marital dissolution purposes.

Conclusion

An assessment of key person risk is important when valuing a company for marital dissolution purposes. This is particularly true when the subject company is relatively small. Areas an analyst can focus on in due diligence interviews to determine the existence and significance of key person risk include the following:

1. Management and leadership skill
2. Suppliers
3. Customers
4. Innovation
5. Obtaining debt or equity
6. Employee loyalty

There are several ways that the analyst can incorporate the impact of identified key person risk in the valuation process. Within the income approach methods, three alternatives were identified:

1. Adjusting company earnings and cash flow incorporated in the direct capitalization method
2. Adjusting company financial projections incorporated in the discounted cash flow method
3. Adjusting the discount rate/capitalization rate incorporated in the discounted cash flow method or the direct capitalization method

Within the market approach methods, an analyst can adjust selected pricing multiples or apply a key person risk discount at the enterprise level.

Regardless of the method(s) used to reflect the impact of identified key person risk in the valuation process, adequate rationale and documented support are necessary to support the conclusions presented.

Because key person risk may have a significant impact on the value of a company, the analyst completing a thorough and well-documented valuation that adequately considers and addresses key person risk issues can provide valuable assistance to legal counsel and the court in a marital dissolution setting.

"[A]pplying a key person discount as a percentage of total equity value represents a viable option when key person risk is identified in the valuation of a company for marital dissolution purposes."

Notes:

1. *International Glossary of Business Valuation Terms* (as adopted by the American Society of Appraisers, 2009).
2. Internal Revenue Service, Revenue Ruling 59-60, Section 4.02.
3. *IRS Valuation Training for Appeals Officers Course Book*, Business Valuation Resources, LLC, 101.
4. Shannon P. Pratt, *Discounts and Premiums*, 2nd ed. (Hoboken, NJ: John Wiley & Sons, Inc.), 260–1.
5. Kohl v. Kohl, 800 N.Y.S.2d 348 (2004).
6. Miller v. Miller, 288 Ga. 274, 705 S.E.2d 839 (2010).
7. In the case Miller v. Miller, the key person risk discount used by the wife's business valuation expert was not provided.
8. In re Marriage of Frett, 686 N.W.2d 235 (Iowa Ct. App. 2004).
9. Estate of Mitchell v. Commissioner, T.C. Memo 1997-461 (Oct. 9, 1997).
10. After determining an enterprise value and deduction for key person risk, the estate appealed the Tax Court's conclusion. On May 2, 2001, the Ninth Circuit Court of Appeals reversed and remanded Mitchell. The Ninth Circuit decision held that the Tax Court was internally inconsistent in its ruling on noncontrolling and marketability issues and failed to adequately explain its conclusion. On remand, the Tax Court again determined the same acquisition value and a 10 percent key person discount. See T.C. Memo 2002-98 (April 9, 2002).
11. Furman v. Commissioner, T.C. Memo 1998-157, (April 30, 1998).

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