

Understanding Key Person Considerations When Valuing a Private Company in a Family Law Context

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When retained by family law counsel (“counsel”) to estimate the value of a private company within a marital estate, the valuation analyst (“analyst”) may consider the potential subject company dependence on one or two key individuals. This “dependence” is typically referred to as key person dependence or “key person risk.” Key person risk is recognized within the valuation profession as a relevant company-specific risk characteristic, and it can be accounted for in several ways within a valuation analysis. Therefore, the analyst may perform appropriate due diligence to (1) identify any key person risk associated with the private company and (2) quantify and present the impact of any key person risk within the private company analysis.

INTRODUCTION

In any company, there may exist certain individuals who are key to the on-going profitability of the business. However, in a closely held business—and specifically a private company within a family law context—the potential for there to be a “key person” who is largely responsible for revenue generation, customer interaction and development, supplier interaction and development, employee interaction and development, or strategic vision development may be significant.

The dependence on an individual who is key to any of the above-referenced operating tasks is commonly referred to as “key person dependence.” Key person dependence, or more commonly referred to as key person risk, is widely recognized in the valuation profession as a relevant company-specific risk attribute.

When valuing private companies for family law purposes, the valuation analyst (“analyst”) may evaluate whether the private company has key person risk. And, the analyst should provide support for the level of a key person risk adjustment. This is because, if key person risk is not properly identified and quantified, the estimated value of the

private company may be misstated. This misstatement may result in an inequitable division of the marital assets.

This discussion describes key person risk in a private company within a family law context. This discussion also addresses how to evaluate a private company for key person risk, and provides guidance with regard to estimating a key person risk discount in the valuation of a private company.

WHAT IS KEY PERSON RISK IN A PRIVATE COMPANY?

When valuing private companies for family law purposes, the private company can often be relatively small and may rely on the expertise of one or two individuals to ensure the profitability of the enterprise. In these circumstances, it is important for the analyst to adequately consider the importance of these one or two individuals, often referred to as a “key person(s).”

Many times, in private companies, senior company management is comprised of a relatively limited

number of employees. In these circumstances, it is not unusual for a subject company's future success and viability to be reliant on the continued health, success, experience, expertise, and contributions of a key person, such as the private company owner or founder.

When a private company is highly dependent on one individual for its continuing success, it may suffer from what is commonly referred to in the valuation profession as "key person risk."

In order to account for this key person risk in the valuation of a private company within a family law context, the analyst may apply some type of discount to account for this key person risk (i.e., a "key person discount").

As presented in the *International Glossary of Business Valuation Terms*, 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 a private company ownership interest within a family law context, the analyst should understand key person risk and be able to evaluate the existence, or lack of existence, of said risk. This is because, in a family law context, the private company:

1. may not have a formal transition plan to account for the potential loss of a key person,
2. may not have a noncompete agreement to insure the subject company against the loss of a key person, and/or
3. may not have life insurance payable to the subject company to account for the potential death or disability of a key person.

For federal gift and estate tax purposes, the U.S. Tax Court has allowed for a valuation discount when estimating the value of a private company when the existence of key person risk has been appropriately established. The value adjustment to account for this key person risk is often presented in the form of a key person discount, typically reflected as:

1. an explicit percentage discount at the enterprise (or equity) level before shareholder adjustment considerations,
2. an implicit adjustment to a discount or capitalization rate when estimating the value of a private company by applying the income approach, or

3. an implicit adjustment to the long-term management financial projections (discounted cash flow method) or normalized long-term earnings (capitalization of net cash flow method) to account for the removal of the key person when estimating the value of a private company by applying the income approach.

The analyst may also apply an implicit adjustment to the selected market-derived valuation pricing multiples when estimating the value of a private company by applying the market approach.

As presented in *Business Valuation Discounts and Premiums*:

The impact or potential impact of the loss of a key person can be reflected either explicitly or implicitly. Sometimes the key person discount may be reflected in an adjustment to a discount or capitalization rate in the income approach or to valuation multiples in the market approach. Alternatively, the key person discount may be quantified as a separate discount, sometimes as a dollar amount but more often as a percentage. It is generally considered to be an enterprise level discount (taken before shareholder level adjustments); it is a function of the valuation subject and impacts the entire company.²

When valuing a private company for family law purposes, best practices suggest that 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 into the valuation process that adequately address the economic impact of the identified key person dependency.

The following discussion focusses on procedures to (1) evaluate whether key person risk exists in a private company and (2) address key person risk issues when valuing a private company for family law purposes.

IDENTIFIABLE KEY PERSON CONSIDERATIONS

Simply being an owner of a private company does not automatically result in that individual being a key person. Similarly, just because a company is "small"—in terms of revenue, assets, or employees—

does not necessarily indicate that the company operates with key person risk.

A private company may suffer little to no economic harm upon the departure of a member of senior management if the company operating structure includes:

1. adequately trained employees that can effectively assume the duties and responsibilities of the departing manager, owner, or founder and
2. diversified revenue, supplier, and distribution sources that do not depend significantly on the departing manager, owner, or founder.

Even small companies operating with a well-diversified senior management team capable of fulfilling the role of a departing key person are positioned to mitigate key person risk.

As presented in *Business Valuation Discounts and Premiums*, when analyzing whether a private company has potential key person risk, the following attributes of the key person should be evaluated by the analyst:

1. Relationships with suppliers
2. Relationships with customers
3. Employee loyalty to key person
4. Unique marketing vision, insight and ability
5. Unique technological or product innovation capability
6. Extraordinary management and leadership skill
7. Financial strength (ability to obtain debt or equity capital, personal guarantees)³

Each of the above-mentioned key person risk attributes are addressed in the following sections, which include some suggested questions the analyst can ask management in evaluating whether a subject company has key person risk. (We have combined attributes 4 and 5 for purposes of this discussion.)

Suppliers

One question the analyst may research is: “Are relationships with suppliers largely dependent on one key person?” A key person may be able to obtain better prices or more exclusive products from suppliers based on the key person’s reputation or personal relationships.

More favorable supplier terms provide a subject company with lower input expenses, which posi-

tively affect the profitability of the subject private company.

A private company that can realize lower input expenses can then use this 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.

Generally, an analyst may perform diligence procedures to determine whether company suppliers are providing favorable terms based on a relationship with a specific individual (or individuals) within the private company.

If a situation exists whereby the private company is receiving favorable terms from suppliers due to the reputation or personal relationships attributable to one or two individuals, this will likely support a conclusion of key person risk.

Customers

Another question the analyst may pose is, “Are relationships with customers largely dependent on one person?” Customers may purchase goods or services from a subject company because they have a personal relationship with a particular person (or persons) in the subject company.

In general, a company or individual may purchase goods or services from another company because the seller 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, these purchases may be attributable to some form of a personal relationship with the private customer.

In the above circumstance, the personal relationship in effect increases the switching costs to purchase the comparable products or services from another provider. This is because the customer’s personal relationship with a key person at the subject company deters them from purchasing the comparable products or services from a competitor.

If a significant number of customer relationships can be attributed to one person at a private company, or if a significant percentage of company revenue is generated by the relationships of one person, then key person risk likely exists at the private company.

Employee Loyalty

With regard to employee loyalty, a question the analyst may pose is, “Are employees who are important to the private company’s on-going operations loyal to a specific person?” And, a potential follow-up question may be, “Would the loyal employees leave if the key person left?”

In some smaller private 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 private company.

In such a circumstance, the key person may not even have unique skills or talents that the private company relies on for its on-going success. However, the company could still experience significant disruption and harm if the “charismatic” leader or founder left and a material group of other, important employees followed.

Generally, this is not a significant problem in larger companies with more diversified senior management teams.

However, in smaller companies, such as many private businesses within a marital estate, the departure of “everyone’s favorite leader” could result in the loss of a number of key employees, some of whom may have special knowledge or training that would be difficult to replace. Such a loss could be harmful to the long-term, continuing operating success of the private company.

When valuing a private company within a family law context, the analyst typically performs diligence procedures to evaluate whether the subject company is exposed to employee defection as a result of loyalty to a particular individual or leader. However, the analyst may also consider that such potential losses are mitigated significantly by legally enforceable noncompetition agreements.

The absence of a noncompetition agreement in such a circumstance may lead the analyst to the conclusion that employee loyalty key person risk exists at the private company.

Innovation—Unique Marketing Vision and Product Innovation

In evaluating potential key person risk, a question the analyst may ask company management is: “Does one person in the company have a unique ability to innovate products?” Also, “Does one person in the company have a uniquely successful marketing vision or strategy?”

For companies in the technology industry, or other industries demonstrating significant tech-

nological disruption, innovation, or other growth, a key person may be important for understanding the direction in which the industry or products are moving. Steve Jobs at Apple, Inc., would be a reasonably good example of a key person who possessed a unique vision and unique product innovation abilities.

Typically, the analyst performs diligence procedures aimed at understanding to what extent one individual enables a subject company to stay ahead of changing trends or innovations in the subject 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 industry shifts, the private company may be exposed to key person risk.

Similarly, if one person has been responsible for developing and implementing a unique marketing plan or vision, and the private company has performed well as a result of this unique marketing plan or vision, then the private company may be exposed to key person risk.

Extraordinary Management and Leadership Skill

Does a key person have management and/or leadership skills that are important to the private company’s profitable operations? In some private companies within a family law context, one individual may have the leadership ability to increase private company revenue and earnings, as well as to navigate the landscape of constantly changing foreign and domestic fiscal policies and industry dynamics.

Further, one key person may be important to defining short-term and long-term goals for the private company. This individual may have the administrative and management leadership skills required to enable the private company to realize its goals and align these goals with employee goals.

If a company is highly dependent on one individual to lead and manage the private company, and this key person is “irreplaceable,” then the private company likely suffers from management and leadership key person risk.

To evaluate the existence and level of extraordinary management and leadership skill key person risk, the analyst may interview the potential key person, as well as several other employees. This due diligence analysis may assist the analyst in estimating the impact that a potential key person’s departure may have on the on-going operations of the private 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.

It is important that the analyst not double count key person risk, as it may be difficult to bifurcate certain key person attributes between innovation—unique marketing vision attributes and product innovation—and extraordinary management and leadership skill attributes.

Financial Strength—Ability to Acquire Debt or Equity

With regard to financial strength, a question the analyst may pose is, "Does one key person have a unique ability to acquire debt or equity capital?" In some instances, one key person within a private company may have the unique ability to raise additional equity capital through a large network of potential investors.

Similarly, if one person has been responsible for obtaining debt, and this key person is deemed "irreplaceable," then the private company may be exposed to key person risk in the form of a threat to the private company's continuing ability to raise additional capital (equity or debt) on favorable terms.

Many closely held companies in a family law context borrow through commercial banks, which generally rely on the financial fundamental position of the private company in making lending decisions.

However, these banking relationships may possess some key person considerations, and the analyst should perform sufficient diligence procedures aimed at understanding the key terms and conditions regarding the acquisition of any private company equity or debt.

If such diligence indicates that a single individual at the private company has a history of achieving favorable debt financing terms based on certain relationships, or has the ability to generate additional equity based on favorable relationships in the equity markets, the private company may be exposed to key person risk.

ADJUSTING FOR KEY PERSON RISK IN THE VALUATION OF A PRIVATE COMPANY WITHIN A FAMILY LAW CONTEXT

Once the analyst has assessed whether certain key person risk is present at a private company, the next steps are as follows:



1. Quantify the significance of the key person risk
2. Incorporate the financial impact of the key person risk in the private company valuation analysis

While there are three generally accepted valuation approaches available to the analyst in valuing a private company within a family law context, the following discussion focuses on the following two business valuation approaches:

1. Market approach
2. Income approach

A brief description of each approach follows, along with a more in-depth discussion regarding the treatment of key person risk within the income approach.

Market Approach

The market approach methods that are available to the analyst rely on the principle that prices of securities of companies in the same or similar lines of business (as compared to the private company) provide informational value guidance to investors.

The market approach methods incorporate a 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 then used as a basis for selecting particular valuation pricing multiples that can be applied to the private company identical financial fundamentals. The informational sources considered for the purpose of completing the market approach can include data regarding privately held

companies, publicly traded companies, or public and private merged and acquired company transactions.

Income Approach

Within the income approach, there are a number of generally accepted valuation methods. Each method is fundamentally based on the principle that the value of an investment is a function of the income that will be generated by that investment over its expected life.

There are a number of methods that can be applied to estimate value under this premise, most of which are based on the estimation of an investment's future income, and the application of an appropriate risk-adjusted, present value discount/direct capitalization rate.

Common income approach valuation methods include (1) the discounted cash flow ("DCF") method and (2) the direct capitalization method.

The DCF method is often applied to value private companies on a going-concern basis for family law purposes. It has appeal because it directly incorporates the trade-off between risk and expected return, an important component to the investment decision and value calculation process.

The DCF method relies on the projections of the private company operating results over a discrete, multi-year period. The projected private company operating results are then converted to projected cash flows.

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 discrete projection period.

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

The following sections present a discussion of the appropriate ways to incorporate key person risk in the market approach and in the income approach when valuing a private company within a family law context.

Key Person Risk—Market Approach

Key person risk may be incorporated in the market approach by typically adjusting the selected guideline company market-derived valuation pricing multiples that are applied to the private company.

This means that, based on the analyst's evaluation of potential key person risk within the private

company, the selected guideline company market-derived valuation pricing multiples are adjusted down (i.e., decreased) in order to account for the key person risk associated with the private company.

When adjusting these guideline publicly traded selected pricing multiples, it is important for the analyst to support the reasons for:

1. decreasing the selected pricing multiples due to key person risk and
2. selecting the magnitude of the decrease of the selected pricing multiples.

A significant issue when incorporating a key person adjustment in the market approach is the high degree of judgment related to said adjustment. Put another way, it may be difficult to provide objective, quantifiable support as to why a certain valuation pricing multiple was adjusted from "2 times revenue" to "1.5 times revenue," for example.

Due to these difficulties, it may be challenging to incorporate key person risk considerations when applying the market approach to value a private company within a family law context.

Key Person Risk—Income Approach

Within the income approach, there are two common procedures that may be used to incorporate key person considerations (i.e., a key person discount) in the valuation of a private company.

The first procedure is the analyst can increase the discount rate/capitalization rate used to present value the normalized income for the private company (when applying the income approach, DCF method, or the income approach, direct capitalization method).

The increase in the discount rate/capitalization rate is intended to reflect the incremental risk the key person dependency exerts on the private company's on-going operations.

The second procedure is the analyst can estimate the projected detrimental effect that the loss of the key person would exert on the private company future operating results (i.e., projected revenue and earnings used in a DCF method analysis or a direct capitalization method analysis).

The estimated effect of the adjustment to incorporate the detrimental effect of the loss of the key person would then be used to:

1. normalize the private company income and net cash flow used in the direct capitalization method analysis (based on the assumed loss of the key person) or

2. develop adjusted private company long-term financial projections to be used in the DCF method analysis (based on the assumed loss of the key person).

When developing a discount rate/capitalization rate, the analyst will typically begin with a risk-free rate of return and add subsequent incremental risk premium components. Based on the facts and circumstances of the private company, additional risk premium 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 captured by the premiums previously identified (such as key person risk), the analyst can then add an additional company-specific risk premium to the risk-adjusted, indicated discount rate/capitalization rate.

Often, key person risk may be incorporated in the development of a discount rate as a component of company-specific risk.⁴

However, as mentioned in the “Key Person Risk—Market Approach” section, the analyst should have support for:

1. increasing the estimated discount rate/capitalization rate due to key person risk and
2. the magnitude of the increase in the estimated discount rate/capitalization rate.

This is because, similar to the information presented in the “Key Person Risk—Market Approach” section, it is often difficult to provide objective, quantifiable support as to why a discount rate/capitalization rate was “increased by 1 percent for key person considerations.”

Common questions may be, “Why not an increase of 0.5 percent, or 1.5 percent, or 2.0 percent, or 3.0 percent?” For these reasons, the analyst should thoroughly document and support the reasons why a key person adjustment was made to the indicated private company discount rate/capitalization rate.

With regard to the second procedure (i.e., estimating the projected detrimental effect that the loss of the key person would exert on the private company future operating results), the analyst may attempt to adjust the private company earnings or future cash flow in order to reflect private company operations as if the key person were no longer present.

A supportable estimate regarding how the private company revenue and operations would change on a day-to-day basis if the key person were no longer present is required.

Typically, the impact on the projected financial results of the private company due to the loss of a key person is estimated based on due diligence interviews with the key person and other management. It is important to note that while it is not an exhaustive list, the six areas previously discussed provide a reasonable interview foundation for the purpose of establishing whether a private company is exposed to key person risk and the nature of that risk.

Through the interview process, an analyst may learn that a suitable replacement for a key person actually exists, which would mitigate, or potentially eliminate, the identified key person risk exposure.

To the extent that key person risk is identified, and the exposure cannot be effectively eliminated, the private company projected revenue and earnings used in a DCF method analysis will likely be materially lower. However, being able to objectively estimate the impact of losing a key person within a long-term financial projection (or a single, normalized long-term estimate of the private company profitability) may be a difficult task.

Key Person Discount—Enterprise Level

One additional option the analyst has in addressing key person risk in the valuation of a private company within a family law context is to incorporate the relevant key person risk at the enterprise (or equity) level. This means that, rather than adjusting for key person risk in the market approach or the income approach, the analyst can apply a dollar amount or percentage adjustment to the indicated enterprise (or equity) value of the private company.

The advantage of applying the key person discount at the enterprise level is that it does not involve any reliance on management-prepared financial projections or attempts to estimate the private company normalized earnings based on the assumed loss of the key person.

Applying a key person discount at the enterprise level enables an analyst to avoid making multiple assumptions regarding:

1. operating measures, such as future revenue and operating margins, and related growth rates and
2. customer/employee retention and supplier relationships.

Further, incorporating a key person discount at the enterprise (or equity) level does not involve any reliance on comparability between guideline publicly traded or merged and acquired companies.

As a result, applying a key person discount as a dollar amount or percentage at the enterprise (or

“[T]he U.S. Tax Court has recognized enterprise (or equity) level discounts for key person considerations.”

equity) level represents a viable, and often preferred, option when key person risk is identified in the valuation of a private company for family law purposes. This is because even the U.S. Tax Court has recognized enterprise (or equity) level discounts for key person considerations.

As presented in *Business Valuation Discounts and Premiums* (and regarding *Estate of Mitchell v. Commissioner*):

Because (1) the court considered him a very key person, (2) alleged earlier offers to acquire the entire company were contingent upon his continuing service, and (3) there was a marked lack of depth of management, the court determined a 10 percent discount from the company’s enterprise stock value.

The court’s discussion of the key person factor is instructive:

We next consider the impact of Mr. Mitchell’s death on [John Paul Mitchell Systems]. Mr. Mitchell embodied JPMS to distributors, hair stylists, and salon owners. He was 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. It is clear that the loss of Mr. Mitchell, along with the structural inadequacies of JPMS, created uncertainties as to the future of JPMS at the moment of death.⁵

While there is a degree of judgment in the application of a key person discount, it is helpful from the analyst point of view to at least be able to rely on certain court decisions as support for an enterprise (or equity) level key person adjustment. This is because, should the family law matter proceed to trial, the analyst will have more objective support for the existence of, and the magnitude of, a key person valuation discount.

SUMMARY AND CONCLUSION

Key person considerations are important for the analyst when estimating the value of a private company, particularly in a family law context. This is because many private companies rely on one or two key individuals to ensure the on-going profitability of a private company. This company reliance on one

or two key individuals is often referred to as “key person risk.”

There are several procedures for the analyst to evaluate, and account for (i.e., quantify), key person risk in the valuation of private company. These procedures include the following:

1. An explicit percentage discount at the enterprise (or equity) level before shareholder adjustment considerations
2. An implicit adjustment to a discount or capitalization rate when estimating the value of a private company by applying the income approach
3. An implicit adjustment to the long-term management financial projections (in the discounted cash flow method) or normalized long-term income (in the direct capitalization method) to account for the removal of the key person when estimating the value of a private company by applying the income approach

The analyst may also apply an implicit adjustment to the selected market-derived valuation pricing multiples when estimating the value of a private company by applying the market approach.

Finally, it is not uncommon for the analyst to apply the key person adjustment to the enterprise (or equity) level, based on U.S. Tax Court judicial precedent.

Notes:

1. *International Glossary of Business Valuation Terms* (as adopted by the American Society of Appraisers, 2009).
2. Shannon P. Pratt, *Business Valuation Discounts and Premiums*, 2d ed. (New York: John Wiley & Sons, 2009), 261.
3. *Ibid.*, 260–261.
4. Other common company-specific risk attributes that may result in additional company-specific risk premiums include customer dependency and supplier dependency, for example.
5. Pratt, *Business Valuation Discounts and Premiums*, 266.

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