Unlocking the Mysteries of Key Person Value

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Speaker Biography

- Kevin R. Yeanoplos, CPA/ABV/CFF, ASA is the Director of Valuation Services for Brueggeman and Johnson Yeanoplos, P.C.
- Principal in Y/S Advisory Services
- Former Member of AICPA's National Accreditation Commission
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INTRODUCTION

- Discuss key person attributes.
- Consider factors in determining impact on value.
- Discuss methods for quantifying impact on value.
- Consider empirical evidence related to key persons.
- Discuss standard of value as it relates to key persons.
- Discuss cases involving key person issues.

Key Person Attributes

- Relationships with vendors
- Relationships with customers/clients
- Relationships with employees
- Established social/professional network
- Economic resources
- Intellectual property
- Management abilities
- Experience

Factors to Consider

- Factors to Consider in Estimating Magnitude of Key Person Discount:
  - Services Rendered and Degree of Dependence
    - Individual responsibilities and participation in operations
    - Contacts, experience, and managerial skills
    - Amount key person's actual contact with customers/clients
  - Likelihood of Loss
    - Impact on stock valuation
    - Probability of losing individual
    - Key person is responsible for company's profitability
  - Depth and Quality of Other Management
    - Ability of current management to assume responsibilities

Factors to Consider

- Factors to Consider in Estimating Magnitude of Key Person Discount (cont'd):
  - Availability and Adequacy of Potential Replacement
    - Current management or outside the organization
    - Succession plan in place?
  - Compensation Paid and Probable Compensation
    - Compensation required to replace key person dependent on number of individuals needed for replacement
  - Value of Irreplaceable Factors Lost
    - Special relationships with suppliers or customers, reputation

Factors to Consider

- Factors to Consider in Estimating Magnitude of Key Person Discount (cont'd):
  - Risks Associated with Disruption and Operation
    - Hiring new executive unfamiliar with business or undertakings
  - Lost Debt Capacity
    - Unable to borrow resources needed to continue company operations

Factors to Consider

- Potential Offsets to Loss of Key Person:
  - IRS Revenue Ruling 59-60, Section 4.02
    - *"On the other hand, there may be factors, which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former's manager's services."*

Factors to Consider

- Potential Offsets to Loss of Key Person:
  - <u>Life or Disability Insurance Proceeds</u>
    - Companies often purchase policies to mitigate the risk of losing top management personnel
  - <u>Compensation Saved</u>
    - Potential savings taken into account where compensation to key person was greater than the cost of replacement
  - <u>Employment and/or Noncompete Agreements</u>
    - Key person takes knowledge and skills to another business within the same industry

Empirical Evidence

- Larson/Wright Study – 1996, 1998, 2001
  - Appropriateness of applying key person discount in appraisal of small to medium-sized, closely held businesses.
  - <u>Background:</u>
    - Initial findings based on research from January 1, 1990 through June 30, 1995
    - Additional updates combined data through 1999
  - <u>Methodology:</u>
    - Small companies in public securities market
    - Comparison of equity value immediately before and after death

Empirical Evidence

- Larson/Wright Study – 1996, 1998, 2001
  - Results:
    - Negative reactions mean and median declines 4-6 percent range
    - Positive reactions mean and median gains 7 percent
  - Conclusion:
    - Key-person discount should not be used as means of building higher equity rate.
    - Key-person discount present in less than one-half of cases.
    - When discount appropriate, order of magnitude generally decrement of 4-6 percent in equity value.

Empirical Evidence

- Bolten/Wang Study – 1996
  - Market reaction to management changes in public companies, particularly smaller ones.
  - Background:
    - Examined *Wall Street Journal* August – November 1996
    - Announcements senior management changes above vice president
  - Methodology:
    - Capitalization below and above $280 million
    - Number of senior management listed fewer than 6, 6 to 10, 11 to 15, more than 15

Empirical Evidence

- Bolten/Wang Study – 1996
  - Results:
    - Smaller, public firms stock fell 8.65 percent
    - Larger firms stock fell 4.83 percent
  - Conclusion:
    - Lack of management depth and potential loss of key person negatively impacts valuation.
    - Degree of negative impact increases as the number on the team decreases.

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Internal Revenue Service

- IRS Revenue Ruling 59-60, Section 4.02
  - *"The loss of the manager of a so-called 'one-man' business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manger on the future expectancy of the business, and the absence of management-succession potentialities, are pertinent factors to be taken into consideration."*

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Internal Revenue Service

- *IRS Valuation Training for Appeals Officers Coursebook*
  - *"A key person is an individual whose contribution to a business is so significant that there is certainty that future earning levels will be adversely affected by the loss of the individual.*
  - *Some courts have accounted for this depressing effect on value by applying a key person discount."*

Internal Revenue Service

- *IRS Valuation Training for Appeals Officers Coursebook*
  - *"In determining whether to apply a key person discount certain factors should be considered:*
    - *Whether the claimed individual was actually responsible for the company's profit levels..*
    - *If there is a key person, whether the individual can be adequately replaced."*

Quantifying the Magnitude

- Magnitude of the Key Person Discount
  - Ideally, the estimated difference in the present value of net cash flows with and without key person involvement.
  - Still involved, projected cash flows multiplied by mean of the probability distribution of key person remaining alive and active.
  - Estimate of key person discount generally expressed as a percentage of the undiscounted enterprise value.

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Quantifying the Magnitude

- Magnitude of the Key Person Discount (cont.)
  - Jerome Osteryoung and Derek Newman
    - Key person impact cannot be thought of as applying percentage to normal valuation of business:
      - No viable research or theory substantiates this point
      - Key person loss different with each type of business
    - Each component in future income and cash-flow stream must be evaluated for the exiting key person.

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Quantifying the Magnitude

- Magnitude of the Key Person Discount (cont.)
  - Increase cost of capital for additional risk related to key person dependence.
  - Estimate the cost of life/disability/business interruption insurance needed to protect the company from loss.
  - Estimate the cost of additional management required to facilitate transition.
  - Determine a key person discount based on empirical studies.
  - Apply a subjective discount to preliminary conclusion of value.

U.S. Tax Court Cases

- Cases Involving Decedent's Estate
  - *Estate of Mitchell v. Commissioner*
    - Moment-of-death concept and focus on property transferred:
      - *"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 structural inadequacies of JPMS, created uncertainties as to the future of JPMS at the moment of death."*
    - Court determined 10 percent key person discount.

U.S. Tax Court Cases

- Cases Involving Decedent's Estate
  - *Estate of Feldmar v. Commissioner*
    - *"[United Equitable Corporation] was founded by decedent in 1972. . .Throughout the company's history, decedent had been heavily involved in the daily operation of UEC. Decedent was the creative driving force behind both UEC's innovative marketing techniques, and UEC's creation of, or acquisition and exploitation of, new products and services."*

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U.S. Tax Court Cases

- Cases Involving Decedent's Estate
  - *Estate of Feldmar v. Commissioner* (cont'd)
    - Respondent asserted no key person discount should be applied based on:
      - Life insurance policy upon decedent's life
      - Reliability of management structure controlling UEC

    Court found no merit to life insurance position, determined managers to be inexperienced and incapable. 25 percent key person discount awarded by court.

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U.S. Tax Court Cases

- Cases Involving Decedent's Estate
  - *Estate of Rodriguez v. Commissioner*
    - Expert for taxpayer adjusted pretax income to account for loss of decedent.
    - Expert for IRS did not account for loss of key person due to corporate-owned life insurance and compensation saved.
    - Court decided in favor of taxpayer that adjustment was necessary to account for loss of decedent.

U.S. Tax Court Cases

- Cases Involving Decedent's Estate
  - *Estate of Rodriguez v. Commissioner* (cont'd)
    - *"The evidence shows that the decedent was the dominant force behind Los Amigos. He worked long hours supervising every aspect of the business. At the time of his death, Los Amigos' customers and suppliers were genuinely and understandably concerned about the future of the business without decedent. In fact, Los Amigos soon lost one of its largest accounts due to an inability to maintain quality. . .no one was trained to take decedent's place."*

U.S. Tax Court Cases

- Cases Involving Decedent's Estate
  - *Estate of Huntsman v. Commissioner*
    - Key person discount necessary adjustment to value:
      - *"The decedent was the dominant force in both businesses, and his untimely death obviously reduced the value of the stock in the two corporations. However, both corporations had competent officers who were able to assume successfully the decedent's duties. Both experts agreed that some discount must be made to reflect the loss of the decedent."*

    ock prices adjusted from $33 and $11 per share to $29 and $10 per share at date of decedent's death.

U.S. Tax Court Cases

- Cases Involving Decedent's Estate
  - *Estate of Yeager v. Commissioner*
    - *"Until his death, the decedent was president, chief executive officer, and a director of Cascade Olympic, Capital Cascade, and Capitol Center. He was the only officer and director of these corporations who was involved in their day-to-day affairs. . .the presence of the decedent was critical to the operation of both Cascade Olympic and the affiliated corporations."*
    - Court decided on 10 percent discount for loss of key person.

U.S. Tax Court Cases

- Cases Involving Decedent's Estate
  - *Estate of Leichter v. Commissioner*
    - Key person discounts must be sufficiently supported:
      - Decedent and husband (predeceased the decedent by months) operated closely held corporation.
      - Estate expert applied key person discount to reflect loss of decedent's husband to the company and discount for lack of marketability.
      - Tax Court found these discounts to be duplicative.
        - » *"We found this to be an attempt to discount for the same reasons he discounted the values initially."*

U.S. Tax Court Cases

- Cases Involving Decedent's Estate
  - *Estate of Renier v. Commissioner*
    - Court rejected key person discount on grounds that expert failed to present factual support for discount.
    - Additionally, court found entire report unhelpful and deserving of no weight.

U.S. Tax Court Cases

- Case with Key Person still Active
  - *Furman v. Commissioner*
    - Court rejected methodology of IRS expert's valuation.
    - Court discussion supported key person discount:
      - *"Robert's active participation, experience, business contacts, and reputation as a Burger King franchisee contributed to value of FIC. . .The possibility of Robert's untimely death, disability, or resignation contributed to uncertainty in the value of FIC's operations and future cash flows."*

Marital Dissolution Cases

- *Rogers v. Rogers*
  - Husband owned 85% of engineering firm
    - Supreme Court of Minnesota, *"The third major defect in [wife's expert's] methodology is his apparent failure to take into account appellant's importance to [Rogers, Freels & Associates]. . .While the testimony did not establish that RFA would be worthless without appellant, it is clear that appellant is a key man – if not the key man – in RFA, and the profitability of the corporation could be substantially reduced if he were to leave."*

Marital Dissolution Cases

- *In re the Marriage of Nelson*
  - Husband had highly specialized training, solely responsible for generating business and project supervision.
  - Trial court applied 30 percent combined discount for key person and lack of marketability:
    - Court of Appeals, *"As in Rogers, the trial court's discount in this case simply does not accurately reflect appellant's importance to the corporation. . .This evidence. . .compels the conclusion that the trial court's discount was arbitrarily low."*

Marital Dissolution Cases

- *In re the Marriage of Buchanan*
  - *"The trial court's valuation reflects a 25% discount for appellant's influence and importance to the business and for the inherent risk and limitations on marketability associated with the business. . . Evidence shows J.L. Buchanan, Inc. would not cease operation if appellant left business, appellant is not the corporation's sole fee generating person and expert testimony established 25% as a reasonable discount."*

Marital Dissolution Cases

- *Feldick v. Feldick*
  - Trial court rejected assertion of key person discount on grounds that husband failed to produce support for discount.
  - Appellate court, *"[t]o the extent appellant's refusal to produce information prompted a refusal to grant a 'key person' discount, he is not entitled to relief."*

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Marital Dissolution Cases

- *Bernier v. Bernier*
  - Husband and wife equally owned two supermarkets.
  - Trial court accepted key person and cost-of-sale discounts (10 percent each):
    - Massachusetts Supreme Judicial Court ruled that trial court erred in accepting discounts since evidence showed husband's expertise was critical to supermarket success and that he would continue to maintain total ownership and control of supermarkets.

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Other Cases

- Shareholder Disputes
  - *Billigmeier v. Concorde Marketing, Inc.*
    - Majority owner terminated minority owner's employment, failed to pay commissions owed to him.
    - Trial court determined fair value of minority interest as of the date of termination:
      - Accepted key person discount of 10 percent as company did not have long established vendor relationships or a reasonable succession plan.

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Other Cases

- Shareholder Disputes
  - *Garlock v. Southeastern Gas & Power, Inc.*
    - Minority shareholders brought suit to involuntarily dissolve corporation.
    - Court determined majority shareholder engaged in oppressive conduct, appointed appraiser to determine fair value of company stock:
      - Appraiser applied, court accepted, a premium to the discount rate used in the income approach to account for "key man" status of majority shareholder.

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Other Cases

- Income Taxation
  - *Litman v. United States*
    - Case involved individual and corporate taxpayers.
    - Individual taxpayer's valuation expert applied discounts for lack of marketability – carried the most weight as held by court.
    - IRS expert adjusted for key person discount:
      - *"If they were to sell their shares, the buyer of those shares would know that one of the company insiders is selling their shares. . .and so I tried to take that into account by making an adjustment."*

Closing Thought

- No owner is as indispensable as they think they are.

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