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Life Happens: Putting a Value to a Key Person's Life

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Two months ago, I was a speaker at the National Cattlemen's Beef Association. When I arrived, the mood was somber. The night before, four family members perished in a plane crash while flying to the association meeting. Then this week, as I watched the sorrow and grief of the relatives who had loved ones onboard Malaysian Flight MH 370, I started thinking of the inevitable legal fights that follow these tragedies. Claims will be made, demands will be translated into dollars and relatives will realize money cannot replace memories.

In business we often have to put monetary values to human life, something no one wants to do. With employees, in particular, we need to value them in order to determine salary levels, benefits packages and management structure. We aren't assessing what kinds of parents they are or how much they help the community. We are just assessing their value to the company. A reason to place a monetary value on employees, particularly key employees, is to determine the loss the company will incur if they die. On the missing Malaysian flight, Austin-based Freescale Seminconductor lost 20 of its employees, some reported to be key to the company's operations. Imagine the shock waves this is sending through the company. Or consider the 2011 fatal plane crash where two Greenhill & Co. managing directors perished. Currently the spouse of one of the executives is suing the estate of the other executive. All these tragedies beg the question of what is the value of a key employee.

Who is Key?

"Key employee" does not have an exact definition in law. Consider that Facebook agreed to buy WhatsApp, a 55-employee messaging company, for $19 billion. I'm guessing in their situation, pretty much all of these employees are key in one way or another. In other cases, there may be a huge number of employees, but only a handful that are truly essential to the company.

Challenging though it may be, it's important to both determine who is key to the company and place a monetary value on these employees. Businesses can suffer from a key employee's death in several ways. In determining who is key, consider these factors:

- Will skill and experience be lost, particularly if the company is without management depth?
- Will revenue be disrupted as clients delay or withhold business?
- Could creditors exercise caution, or even call loans, while they can assess the impact to the business of the employee's death?
- Will profits be affected as expenses increase to hire and train a replacement?

How to Value a Key Employee

A company needs to determine a key employee's monetary value in order to assess opportunities to indemnify the company for the loss of that employee. For example, key person life insurance may be available to provide necessary funds to address expenses at the death of a key employee. But how do you come up with a value?

Here's one valuation method used in the life insurance industry to get a better handle on putting a company value to a key person's life. First, consider the primary assumptions driving the valuation model:

1. The size of the organization in terms of employees
2. The number of key employees
3. The difficulty of replacing the key employee.

From this, a factor can be calculated. This factor would be a multiple of the key employee's income, providing the company with a number to use for obtaining life insurance or other indemnifying techniques. Granted, sometimes these assumptions are difficult to quantify, but taken together they can provide a workable range for consideration.

An Example

A company has 50 employees, and five key employees. If the key employee being considered qualifies as "very difficult" to replace, the factor range to consider is from 2.5 to 7.5 times salary. So, if the employee makes $400,000, the key person valuation for the company would range from $1 million to $3 million. This is the base protection to be considered. In many cases, however, there are other factors that may affect valuation.

- **Buy-Sell:** If the company is worth $3 million and the key employee is a 20% owner, that is a potential $600,000 additional need.
- **Debt:** If the company has $500,000 in long-term debt, and the key employee's factor in that debt is 20%, this represents another $100,000 in potential exposure.
- **Additional Issues:** Every company has its own unique arrangements with key employees. For example, there may be a deferred compensation promise owing to the employee that could be triggered by death. These arrangements should factor into the valuation of a key employee.

Once the company comes up with the base protection, and then adds in other factors that may increase the employee's value, they have a number to work with. This number may not be precise, but it is definitely a more accurate number than zero.

No one wants to put a dollar value on a human life. Still, companies – and their employees – stand to suffer if a key employee is suddenly out of the picture. It's just good business to determine who are your key employees, what is their value to the company and how to deal with their possible loss.

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