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BUSINESS VALUATION DIGEST

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Protecting Solicitor-Expert Communications in Ontario

Introduction

Experts in an ever widening range of fields have come to play a crucial role in resolving complex litigation and in carrying forward large-scale business transactions. The course of litigation is increasingly affected by testifying experts, who are retained to give opinion evidence at trial, and consulting experts, who assist counsel with trial preparation. Outside of litigation, experts also frequently act, for example, as economic, accounting, actuarial and environmental consultants providing advice to clients in large corporate transactions. The importance of experts inside and outside of litigation has become so entrenched that the Ontario *Rules of Professional Conduct* encourage lawyers to seek advice from or to collaborate with experts when advising on matters that fall outside of their own areas of expertise.¹

Even as experts have become indispensable, attacks on the confidential nature of communications between experts and solicitors have become more pervasive. As such, it is imperative that litigation counsel recognize the ways in which solicitor-expert communications can be protected. Where, in the case of consulting

experts, the disclosure of communications and associated productions can be fairly easily avoided by way of a carefully worded engagement letter, in the case of testifying experts, the Ontario *Rules of Civil Procedure*² require disclosure of all "findings, opinions and conclusions" of experts relating to matters at issue in an action, in addition to formal expert reports. The reality is that the courts have moved towards giving this Rule the broadest possible interpretation to require that all solicitor-expert communications be disclosed.

This paper examines how solicitor-expert communications have been judicially considered in Ontario so as to better discern how expert communications can be protected from disclosure. Preserving privilege over solicitor-expert communications is vital to promote frank communications between counsel and expert to effectively assist in the formulation, conceptualization and preparation of any transaction, arrangement or legal proceeding.

1 *Ontario Rules of Professional Conduct*, adopted by Convocation June 22, 2000: Rule 2.01 & Commentary.

2 *Rules of Civil Procedure*, made under the Courts of Justice Act, R.R.O. 1990, Reg. 194.



Protecting Solicitor-Expert Communications

In Ontario, counsel can seek to protect solicitor-expert communications by relying on two forms of privilege: (a) solicitor-client privilege and (b) litigation privilege.

(a) Solicitor-Client Privilege

Solicitor-client privilege is long established and well articulated under common law. In two relatively recent cases, *Descôteaux v. Mierzukinski*³ and *R. v. Shirose*,⁴ the Supreme Court of Canada adopted the following description of solicitor-client privilege by Wigmore:⁵

Where legal advice of any kind is sought from a professional legal adviser in his capacity as such, the communications relating to that purpose, made in confidence by the client, are at his instance permanently protected from disclosure by himself or by the legal adviser, except the protection be waived.

It is equally well-known that the privilege applies: (1) to communications between a solicitor and a client; (2) where legal advice is being sought or given; and (3) where communications are intended to be confidential by the parties.⁶

The authorities have held that solicitor-client privilege can even be extended to cover communications with third parties for the purpose of facilitating the obtaining of legal advice.⁷ And it is in this context that solicitor-client privilege can protect communications with experts. This privilege is not absolute, however, and three principles limit its availability:

1. Not every communication by a third party with a lawyer which facilitates or assists in giving or receiving legal advice is protected by solicitor-client privilege;

2. Where the third party serves as a *channel of communication* between the client and solicitor, communications to or from the third party by the client or solicitor will be protected by the privilege as long as those communications meet the criteria for the existence of privilege. Thus, where a third party serves as a messenger, translator or amanuensis, communications will be protected.
3. Where the third party cannot be described as a channel of communication between the solicitor and client, the applicability of solicitor-client privilege depends on the true nature of the function that the third party was retained to perform for the client.

The Ontario Court of Appeal clarified and refined the third principle in *General Accident Assurance Co. v. Chrusz*:⁸

Client-solicitor privilege is designed to facilitate the seeking and giving of legal advice. If a client authorizes a third party to direct a solicitor to act on behalf of the client, or if the client authorizes the third party to seek legal advice from the solicitor on behalf of the client, the third party is performing a function which is central to the client-solicitor relationship. In such circumstances, the third party should be seen as standing in the shoes of the client for the purpose of communications referable to those parts of the third party's retainer.

If the third party is authorized only to gather information from outside sources and pass it on to the solicitor so that the solicitor might advise the client, or if the third party is retained to act on legal instructions from the solicitor (presumably given after the client has instructed the solicitor), the third party's function is not essential to the maintenance or operation of the client-solicitor relationship and should not be protected.

(b) Litigation Privilege

Litigation privilege protects communications between the solicitor, client and third parties, if made for the solicitor's information and for the

³ [1982] 1 S.C.R. 860 at pp. 872-73.

⁴ [1999] 1 S.C.R. 565 at p. 601.

⁵ 8 Wigmore, Evidence, 2292, McNaughton Rev. 1961.

⁶ *R. v. Solosky*, [1980] 1 S.C.R. 821 at p. 835, per Dickson J. (as he then was); recently affirmed in *Pritchard v. Ontario (Human Rights Commission)*, [2004] 1 S.C.R. 809 at para. 15.

⁷ *Susan Hosier Ltd. v. M.N.R.*, [1969] 2 Ex. C.R. 27 at p. 36; *Alcan-Colony Contracting Ltd. v. Minister of National Revenue*, [1971] 2 O.R. 365 at p. 368 (H.C.J.); *General Accident Assurance Co. v. Chrusz* (1999), 45 O.R. (3d) 321 (C.A.), ("*Chrusz*").

⁸ *Chrusz*, supra note 8 at pp. 356-57, per Doherty J.A. (dissenting in part, on other grounds).

dominant purpose of pending or contemplated litigation. In the context of litigation, solicitors often have to convey privileged information, either in writing or orally, to third parties, such as experts or others with special knowledge, in order to obtain their advice or assistance. So long as the expert remains in the role of a confidential advisor, there are sound reasons for maintaining privilege over these communications. Most importantly, litigation privilege ensures that counsel can have frank discussions with those retained to facilitate counsel's investigation and preparation for trial.

Litigation privilege differs from solicitor-client privilege in a number of significant ways. While solicitor-client privilege stands against the world, litigation privilege is a protection that applies only against an immediate adversary and only for so long as a matter remains under litigation.⁹ Moreover, where solicitor-client privilege applies only to confidential communications between the client and his solicitor, litigation privilege applies to communications of a non-confidential nature and even includes material of a non-communicative nature. Finally, as opposed to solicitor-client privilege, there is nothing sacrosanct about litigation privilege. It is merely a practical means of assuring counsel a "zone of privacy". Courts may be more willing to set aside litigation privilege where it is in the interests of justice to do so.

Experts Testifying at Trial

In Ontario, a party may call an expert to give opinion evidence at trial. Unlike other witnesses, an expert is allowed to give opinion evidence because of his special qualifications and/or experience. If the expert has been retained to give evidence at trial, the expert's findings, opinions and conclusions may be examined for discovery pursuant to Rule 31.06(3). Rule 31.06(3) provides that:

- [a] party may on examination for discovery obtain disclosure of the findings, opinions and conclusions of an expert engaged by or on behalf of the party being examined that relate to a matter in issue in the action and

of the expert's name and address, but the party being examined need not disclose the information or the name and address of the expert where,

- (a) the findings, opinions, and conclusions of the expert relating to any matter in issue in the action were made or formed in preparation for contemplated or pending litigation and for no other purpose; and
- (b) the party being examined undertakes not to call the expert at trial.

A party intending to call an expert witness is required to serve an expert's report in accordance with Rule 53.03(1). Rule 53.03(1) provides that:

- [a] party who intends to call an expert witness at trial shall, not less than 90 days before the commencement of the trial, serve on every other party to the action a report, signed by the expert, setting out his or her name, address and qualifications and the substance of his or her proposed testimony.

Similar treatment is given to medical reports under Rules 33.04 and 33.06.

Rule 31.06(3) and Rule 53.03(1) thus create a dichotomy of roles for experts retained by solicitors: testifying experts who are retained to give opinions during the course of the trial and consulting experts who are retained by solicitors to advise about the facts, theory, and strategy of a matter when litigation is pending or reasonably anticipated. When an expert is retained to give an opinion at trial, his or her opinions, findings and conclusions are discoverable prior to trial. If the expert is retained in a strictly consultative capacity, discovery of the expert's findings, opinions and conclusions is not permitted under the Rules. Rule 31.06(3) thus makes this critical distinction and recognizes the right of counsel to consult experts in the preparation of their

⁹ *Ibid.* at pp. 327-28. *Chrusz* concerned an action on a fire policy. After the insurer had paid out funds on the fire policy, a former employee of the insured came forward and indicated that the insured had inflated the claim. An investigator for the insurer took a statement from the employee and gave the employee a copy. In due course the insurer commenced an action for a return of the funds that had been paid, and the insured counterclaimed in defamation, including the employee as one of the defendants by counterclaim.

case. Privilege will apply to such consultations so long as the reports of those experts will not be relied upon at trial. As stated by Carthy J.A. in *Chrusz*, "[t]his is an example of the Rules Committee recognizing the right to proceed in privacy to obtain opinions and to maintain their confidentiality if found to be unfavourable."¹⁰

"Findings, Opinions and Conclusions"

The seminal case dealing with litigation privilege and its application to third parties, including experts, is *Chrusz*. The head note succinctly details the majority decision of the Ontario Court of Appeal:

[T]he solicitor-client privilege, which derives from the interest of all citizens to access confidential legal advice, is distinct from the litigation privilege, which derives from the needs of the adversary process. There is a tension between the litigation privilege, which is needed to facilitate adversarial preparation, and the disclosure of all the relevant facts, which is needed to assure the fair resolution of a dispute. The trend of the modern rules [with respect to litigation privilege] is to truncate what would previously have been protected from disclosure.

Adopting this reasoning, the Court of Appeal narrowed the scope of litigation privilege in order to promote the goal of a fulsome discovery process. Decisions subsequent to that in *Chrusz* have confirmed this trend.¹¹

Prior to the decision in *Chrusz*, courts in Ontario generally took a narrow interpretation of a testifying expert's "findings, opinions and conclusions", as set out in Rule 31.06(3). For example, in *Metropolitan Toronto Condominium Corp. No. 555 v. Cadillac*,¹² Master Garfield refused to order the production of notes, documentation and memoranda supporting the conclusions of the

expert in his report (the report having been produced prior to discovery). A similarly narrow approach was taken by Eberle J. in *Bell Canada v. Olympia & York Developments Ltd.* In that case, Eberle J. refused disclosure of, among other things, drafts of an expert's reports.¹³

The approach most often used, prior to *Chrusz*, to determine what constituted findings within the meaning of Rule 31.06(3) was set out in *Ontario (Attorney General) v. Ballard Estate*:¹⁴

Although there appears to be some inconsistency in the authorities with respect to the meaning of the words 'findings', in subrule 31.06(3), the cases would seem to support the proposition that the interpretation of the word 'findings' is dependent upon the facts of the particular case and the nature of the expert's report being considered. In my view, in the context of an expert's report which is a valuation report, the report is in the nature of an opinion and "findings" must be interpreted to mean the information and data obtained by the expert, contained in documents or obtained through interviews, on the basis of which conclusions are drawn and an opinion formed.

Since *Chrusz*, courts in Ontario have more consistently required the disclosure of all communications between counsel and an expert, including draft expert reports, both in the hands of the expert as well as in the hands of counsel. In *Browne (Litigation Guardian of) v. Lavery*,¹⁵ Ferguson J. noted that the weight of authority and the recent trend is to give a broad interpretation to the term "findings". In that case, the defendant was asked to produce an expert report over which litigation privilege was claimed. The plaintiff argued that the privileged expert report should be produced because it was mentioned in a second expert report that would be used at trial. The court agreed, holding that the privileged report was part of the "findings" of the testifying expert's report. In obiter, Ferguson J. went one step further and called for disclosure of all communications between counsel and an expert:¹⁶

¹⁰ *Ibid.* at 332.

¹¹ *Lecocq Logging Inc. v. Hood Logging Equipment Canada Inc.*, [2005] O.J. No. 2338 (S.C.J.).

¹² [1988] O.J. No. 1394 (H.C.J.).

¹³ Eberle J.'s reasoning suffered from a fundamental analytical error - namely, the equation of litigation privilege with solicitor-client privilege. Notwithstanding this confluence of the two categories of privilege, the *Bell Canada* decision continued to be relied on as authority for refusing disclosure of, draft expert reports.

¹⁴ [1996] O.J. No. 919 at para. 2, per Ground J. (Gen. Div.).

¹⁵ *Browne (Litigation Guardian of) v. Lavery* (2002), 58 O.R. (3d) 49 (S.C.J.), [2002] O.J. No. 564 at para. 66.

¹⁶ *Ibid.* at paras. 66-68.

[i]t is my tentative view that our system of civil litigation would function more fairly and effectively if parties were required to produce all communications which take place between counsel and an expert before completion of a report of an expert whose opinion is going to be used at trial.

...

If the communications took place before the preparation of the report, then I am inclined to think it would [be] best for our system of litigation if they were producible because they could influence the opinion and there would be no practical way of determining this without producing and examining the communications and hearing submissions on the issue.

In **Aviano International Leasing Inc. v. Boeing Canada Inc.**,¹⁷ Nordheimer J. agreed with the reasons expressed by Ferguson J. in *Browne*,¹⁸ holding that draft reports represent, at the very least, preliminary findings, opinions and conclusions and that a party ought to be able to explore with an expert whether he or she changed her views from draft to draft and, if so, why.¹⁹

Courts have also ordered, in the course of discoveries, production of:

- technical calculations prepared by the party and sent to an expert;²⁰
- field notes, raw data and records made by and used by the expert in preparing its report;²¹
- all factual and observations *considered* (i.e., all factual information and data obtained, rather than simply information and data accepted or relied upon) for the purpose of arriving at the relevant opinions and conclusions;²²
- counsel's instructing letter to the expert;²³ and
- comments by counsel on a draft expert's report.²⁴

Practical Considerations

(a) Scope of Retainer

In light of the narrowing scope of litigation privilege in Ontario and the limited use that can be made of solicitor-client privilege, it is of the utmost importance to appropriately and carefully define the scope of an expert's retainer. Indeed, this may be the single most important consideration the solicitor and client make when engaging a consulting or testifying expert.

The scope of retainer is easiest to define in circumstances where there is a reasonable prospect for litigation or when litigation has commenced. In those circumstances, it is prudent for counsel and the client to decide whether the expert will be retained as a testifying expert to give evidence at trial or whether the expert will be retained in a consultative capacity providing advice in preparation for trial. This is important for a consulting expert need not produce his findings, opinions and conclusions whereas a testifying expert's findings, opinions and conclusions are subject to discovery and an expert report must be produced.

It is more difficult to define the scope of an expert's retainer when litigation is not the dominant purpose for the engagement. For example, accountants and/or actuaries are often retained to provide advice to clients in large corporate mergers or acquisitions. What if, some time after an acquisition, a dispute arises between the parties and one party seeks production of the expert's file following commencement of litigation. Clearly, litigation privilege would not apply because litigation

17 [2002] O.J. No. 3799 (S.C.J.).

18 *Browne*, supra note 16.

19 Conversely, in *Caputo v. Imperial Tobacco Ltd.* [2002] O.J. No. 3767 (S.C.J.), Master MacLeod held that experts were not required to show earlier drafts of their reports, as expert reports would normally be covered by litigation privilege. However, Master MacLeod stated that the experts may be asked whether any opinions were expressed in earlier drafts that were eliminated from the final draft.

20 *Athabaska Airways Ltd. v. De Havilland Aircraft of Canada Ltd.* (1988), 34 C.P.C. (2d) 298 (Ont. H.C.J.).

21 See *Award Developments (Ontario) Ltd. v. Novoco Enterprises Ltd.* (in trust) (1992), 10 O.R. (3d) 186 (Gen. Div.), [1992] O.J. No. 1288.

22 See *St. Elizabeth Home Society v. Hamilton (City)*, [2004] O.J. No. 1418 (S.C.J.).

23 See *Walker v. Baskin Robbins*, [2004] O.J. No. 1930 (S.C.J.).

24 See *Flinn v. McFarland*, [2002] N.S.J. No. 547 (S.C.).

was not pending or reasonably contemplated when the expert was engaged. Does such communication fall within the rubric of solicitor-client privilege? For it do so, regard must be had to the reasons in *Chrusz* and the third party constraints espoused therein. First, the expert must have been retained for the purpose of facilitating the obtaining of legal advice. Second, the privilege will only be extended in circumstances where (i) the expert employed an expertise in assembling information provided by the client and in explaining that information to counsel; (ii) the expert acted as a "channel of communication", translating or interpreting information provided by the client; or (iii) the client authorized the expert to seek legal advice from the solicitor on behalf of the client.

A useful example of the importance of carefully defining the scope of an expert's engagement is found in the case of *Prosperine v. Ottawa-Carleton (Regional Municipality)*.²⁵ In that case, a corporation sought to claim privilege over a report prepared by its outside consultant, Peat Marwick Thorne. The report had been commissioned by a municipality to investigate into a potential fraud committed by a contractor to the municipality. The municipality claimed that the report was privileged because the consultant had been retained by an in-house solicitor and was thus covered by solicitor-client privilege and/or litigation privilege. The court rejected this argument, finding that the most that could be said on the evidence was that the consultant was retained to perform work that may have facilitated the municipality in obtaining legal advice at some later time. The contract between the municipality and the expert consultant did not refer to the purpose of the investigation as being to facilitate the giving of legal advice in anticipation of litigation, but rather referred only to the goals of quantifying the financial loss incurred and identifying improvements in the future.

Similarly, in *Ontario (Liquor Control Board) v. Lifford Wine Agencies*,²⁶ the Ontario Court of Appeal dismissed an argument made by the Liquor Control Board of Ontario (LCBO) that its expert's investigation and ensuing report were subject to solicitor-client or litigation privilege. In that case, the LCBO was appealing a decision of the Divisional Court overturning the decision of an administrative tribunal that denied the issue of a witness summons requested by a liquor licensee, Lifford Wine Agencies, on a motion to stay a hearing before the tribunal in which the possible revocation of Lifford's licence was at issue. The evidence established that a private investigator was hired by the LCBO's external counsel to interview a number of witnesses in connection with allegations of witness tampering. Lifford sought a summons to require the investigator to provide evidence before the tribunal on the stay motion and to produce transcripts or other recordings of the interviews.

The Court of Appeal agreed with the Divisional Court's conclusion that the *Chrusz* decision was dispositive of the LCBO's solicitor-client privilege claim. The investigator was authorized "only to gather information from outside sources and pass it on to the solicitor so that the solicitor might advise the client". This function was not essential to the maintenance or operation of the solicitor-client relationship between the LCBO and its external counsel.

With regard to the LCBO's claim of litigation privilege, the Court of Appeal held that it could not succeed for several reasons. First, the LCBO was not a party to the proceedings before the Liquor Control Board. Second, there was no assertion that the dominant purpose of the LCBO investigation was actual or contemplated litigation to which the LCBO was, or anticipated that it might be, a party. Finally, the calling of the expert as a witness and the production of transcripts and other recordings of the interviews conducted by him would further the important objective of ensuring the plaintiff received a fair hearing.

25 [2002] O.J. No. 3316 (S.C.J.), appeal dismissed [2003] O.J. No. 1414 (Div. Ct.).

26 [2005] O.J. No. 3042 (C.A.).

There are a number of lessons that emerge from the Prosperine and LCBO decisions. First and foremost, if an expert is being retained in a consultative capacity, regardless of whether litigation is pending, it is imperative that this be documented accordingly in the engagement letter. Language to the effect that the expert is being retained at the request of counsel for the purpose of providing legal advice should be used in the retainer. If litigation is pending or reasonably anticipated, the retainer letter should identify the reasonable prospect of litigation as the main or sole reason that the expert has been retained. Second, the duties and responsibilities of the expert should be outlined as clearly as possible in order to maintain and enforce any privilege claim that may exist.

(b) Instructing Letter

Carefully drafting the instructing letter to the expert is as important as a carefully drafted retainer. This will not only help the expert clearly understand the type of engagement he or she is embarking upon, but will help satisfy the court that the expert's opinion is credible if ordered to be produced in the course of a proceeding.²⁷ To that end, regard should be had to the words of Ferguson J. in *Browne*:²⁸

Any experienced counsel who has dealt with experts would appreciate how important it would be to know what the expert was instructed to do, what the expert was instructed not to do, what information was sent to the expert and the extent to which counsel instructed the expert as to what to say, include or omit in the report...

In my view, the disclosure of this information would best enable an opposing counsel and the court to assess whether the instructions and information provided affected the objectivity and reliability of the expert's opinion. I also note there is much contrary opinion on this subject: e.g. *Mahon v. Standard Life Assurance Co.*, [2000] O.J. No. 2042 (S.C.J.).

While Ferguson J.'s reasons dealt specifically with an expert who had been retained to give opinion evidence, the same considerations apply for the engagement of consulting experts. In order to enforce a privilege claim, it may be necessary to document the expert's role by producing the instructing letter to the court.

(c) Preparation and Distribution of Draft Reports

As previously mentioned, in Ontario, once a party has identified an expert as being a witness at trial, all other parties to the litigation may obtain disclosure of the findings, opinions and conclusions of the expert that relate to the matter in issue in the action.

As such, and in light of the emerging trend since *Chrusz*, testifying experts should be cognizant of the number of draft reports that are prepared and their distribution prior to trial. If the number of draft reports is somehow indicative of the "changing" views of the expert, it might be advisable not to prepare (or at least distribute) multiple drafts. If this is unavoidable, an expert might adopt a policy requiring drafts to be returned after review. In the circumstances, such a suggestion would be premised on the requirement that distribution be as limited as possible.

Testifying experts and counsel should also be cautious of the language used by experts in communications with the client and/or counsel and especially in draft reports. A testifying expert should operate under the assumption that everything documented by the expert will be discoverable in the action. Questions or concerns that might drastically change a preliminary opinion should be raised verbally with the client before being addressed in a draft report to avoid the possibility of a draft note being misconstrued. All written communications should be drafted in a professional manner with a careful eye to any potential prejudice that might result to his or her client's case. It is important to remember that if producible, draft reports can be used on discovery and at trial to attack the credibility and skill of the expert.

(d) Property in Experts

Another issue that should be considered by counsel when engaging the services of an

²⁷ See *Baskin Robbins*, supra note 24 at para 7.

²⁸ *Browne*, supra note 16 at paras. 69-71.

expert is the fact that there is no property in an expert witness. That is, a testifying expert retained by one party can be retained and/or have his or her opinions adopted and used by the opposing party at trial. Although communications between an expert and the solicitor who has retained him may be protected by privilege, there is no property in the facts observed, and opinions drawn, by the expert.²⁹ Lord Denning's comments in *Harmony Shipping Co. SA v. Davis*,³⁰ are illustrative. He posed a hypothetical situation in which a rich man, intending to deny his opponent the ability to prove its case, hired all the experts in an area in which few experts were to be found. Lord Denning stated:³¹

Does that mean that the other side is debarred from getting the help of any experts because all the experts have been taken up by the other side? The answer is clearly no. ... There is no property in an expert witness as to the facts he has observed and his own independent opinion on them.

The authorities have held that:³²

- (i) there is no property in a witness;
- (ii) even though a party has retained an expert and communicated privileged information to the expert, the expert can still be asked for an opinion by an opposing party and may call that expert at trial; and
- (iii) the expert may not be questioned concerning any privileged material he received from the opposing solicitor nor shall he disclose any opinion he has given to the opposing counsel.

Thus, another complication is added to the decision of whether to use an expert to give evidence at trial. If the expert will testify in court, his or her opinions can be adopted

and used by opposing counsel at trial. If the expert has been engaged solely in a consultative capacity, his or her identity does not have to be disclosed and thus his or her findings can be adequately protected.

When retaining the expert, counsel should always request that the expert sign a confidentiality agreement. In the event that the expert is later retained by opposing counsel, the client can be assured that any communications will remain private.

Editorial Comments: "The subject of Property of Experts is a legal matter. Valuation Practitioners should consult the CICBV Code of Ethics for guidance on Conflict of Interest"

(e) Inadvertent Waiver of Privilege

Finally, when retaining experts, solicitors must be cognizant of waiver of privilege. The obvious example of waiver of privilege is the decision by a party to use an expert to give opinion evidence at trial. As discussed above, by using an expert at trial, the client has waived any privilege over the expert's findings, opinions and conclusions. This may include material provided to the expert over which privilege is claimed. The matter is less clear where the party asserting the privilege refers to a privileged communication during the course of a discovery, preliminary hearing, or at trial, which communication is melded in the party's evidence. Such material can constitute "findings" of an expert within the meaning of Rule 31.06(3) as that term has been interpreted in the case law and thus would become the subject of production.

What constitutes waiver by implication was explained by Wigmore in a passage that was adopted in *The Law of Evidence* by Sopinka and Lederman as follows:³³

Judicial decision gives no clear answer to this question. In deciding it, regard must be had to the double element that are predicated in every waiver, i.e., not only the element of implied

29 See *Harmony Shipping Co. SA v. Davis*, [1979] 3 All E.R. 177 (C.A.). See also *Cousineau v. St. Joseph's Health Centre* (1990), 49 C.P.C. (2d) 306 (Ont. H.C.J.); and *Trilea Centres Inc. v. Cumming Cockburn Ltd.* (1991), 5 O.R. (3d) 598 (Gen. Div.).

30 *Harmony Shipping*, *supra* note 30.

31 *Ibid.* at p. 182.

32 *Children's Aid Society of Toronto v. D.M.*, [2001] O.J. No. 4425 (C.J.).

33 John Sopinka, *The Law of Evidence in Canada*, 2nd ed. (Toronto : Butterworths, 1999) at p. 758.

intention, but also the element of fairness and consistency. A privileged person would seldom be found to waive, if his intention not to abandon could alone control the situation. There is always also the objective consideration that when his conduct touches a certain point of disclosure, fairness requires that his privilege shall cease whether he intended that result or not. He cannot be allowed, after disclosing as much as he pleases, to withhold the remainder. He may elect to withhold or to disclose, but after a certain point his election must remain final.

A useful example of inadvertent waiver is seen in *James et al. v. Maloney*,³⁴ where the plaintiffs brought a motion to increase the amount of general damages claimed in an action that arose out of an automobile accident. In support of the motion, the plaintiffs filed an affidavit that referenced a medical report. Subsequently, the defendant cross-examined the witness on his affidavit and asked that the medical report be produced. The plaintiffs refused production. At first instance, the Master ordered production of the medical report. The plaintiffs appealed the Master's decision to Parker J., who dismissed the appeal, and then to Zuber J., who similarly dismissed the appeal. Zuber J., for his part, held that:³⁵

[I]n this case ... the mention of the medical report in question is more than a mere mention of it. The plaintiffs seek to increase the general damages claimed at a late stage in the proceedings on two bases: firstly, I gather, on the complaints of the plaintiff himself and, secondly, the information in the medical report. The medical report forms one of the bases for the motion and it strikes me that this is more than simple mention of a document that might otherwise be privileged. In my view, when the plaintiff elects to make this medical report one of the bases for the motion, he thereby waives the privilege that would otherwise attend that document.

Similarly, in *Enterprise Excellence Corp. v. Royal Bank*,³⁶ the court approached the issue of waiver of privilege in the context of a testifying expert. The plaintiffs had brought an action against Royal Bank for misappropriation of confidential information. They retained an accountant to prepare a damage report, which was an estimate of their damage. The plaintiffs gave the accountant a number of documents to assist him in preparing the report. Royal Bank sought production of these documents, plus any notes the accountants made over the course of his retainer. Hambly J. allowed the motion, ordering the plaintiffs to produce the material sought. The court held that the plaintiffs waived any privilege that attached to the damage report and any conversations with the accountant by producing this material to the accountant to assist him in preparing his report.

Conversely, in *Piché v. Lecours Lumber Co.*,³⁷ counsel for the plaintiffs sought production of the expert witness's file. Counsel for the defendants objected on the ground of solicitor-client privilege. The Divisional Court held that privilege applicable to documents in an expert's file cannot be said to have been waived simply by the calling of the witness to give evidence. Loukidelis J. derived the following principles with regard to waiver of privilege:³⁸

- (a) principles of waiver relating to a privilege claim for documents in an expert's file cannot be said to have been waived simply by calling that witness to give evidence;
- (b) the privilege can be waived in respect of those facts or premises in the expert's file which have been used to base the expert's opinion and which came to the expert's knowledge from documents supplied to that expert;

34 [1973] 1 O.R. 656 (H.C.J.).

35 *Ibid.* at 657.

36 [2000] O.J. No. 5185 (S.C.J.).

37 (1993), 13 O.R. (3d) 193 (Gen. Div.).

38 *Ibid.* at p. 201. Note, however, Ferguson J.'s comments in *Browne*, supra note 16 at para. 34, in which he questions the practical application of the Piché waiver principles.

- (c) ascertaining the availability of privilege can be accomplished in one of two ways: ...the judge can examine the documents or materials for which privilege is claimed or counsel, through cross-examination of the expert, may establish whether all or part of the file is privileged;
- (d) as a general rule, if facts are supplied that are not found in other evidence or if certain assumptions are asked to be made in the instructing documents, privilege claimed for those facts or assumptions should be considered waived.

Conclusions

It is advisable for counsel to take certain steps when retaining an expert to protect expert-solicitor communications and to enhance the likelihood of a court finding expert communications to be protected by solicitor-client or litigation privilege, in cases where it is appropriate to claim these protections. The following summarizes some of the suggestions that have been addressed:

- Mark documents as "Privileged and Confidential - Prepared at the Request of Counsel for the Purpose of Providing Legal Advice".
- When retaining the outside expert, counsel should prepare a retainer letter specifically confirming that the expert is retained for the purpose of assisting counsel in providing legal advice and/or to prepare for pending litigation.
- Ensure expert reports are directed to counsel's attention.
- Be aware that communicating with foreign counterparts may (depending on the jurisdiction) result in loss of privilege if proceedings are commenced in the foreign jurisdiction.
- Limit the number and distribution of draft reports and consider overwriting or not retaining all drafts.
- Carefully draft an instructing letter to the client indicating the scope of engagement and the reason why the expert has been retained.
- When retaining the expert, counsel should request that the expert sign a confidentiality agreement.

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BY ROBERT F. REILLY

Nonsystematic Business/Security Valuation Discounts and Premiums

Introduction

The application of valuation adjustments (i.e., discounts and premiums) is a common procedure in business/security valuations performed for transaction, financing, taxation, bankruptcy, corporate planning, litigation, and many other purposes. Valuation adjustments can either be decremental (discounts) or incremental (premiums). The most common discounts and premiums are "level of value" adjustments that analysts routinely consider in virtually all business/security valuation assignments. These level of value adjustments relate to: (1) the degree of control or lack of control and (2) the degree of marketability or lack of marketability of the subject business/security.

Quantifying level of value adjustments is a common business/security valuation procedure because different valuation approaches and methods typically conclude different levels of value. These valuation adjustments are typically called systematic adjustments. Systematic valuation adjustments apply across industries and across company types and sizes. The application of systematic valuation adjustments is influenced by:

1. the legal/economic characteristics of the subject security (e.g., does the subject security represent subject company operational/ownership control or not?);
2. the selected standard of value (e.g., fair market value, fair value, investment value, etc.); and
3. the selected premise of value (e.g., what premise of value represents the highest and best use of the subject business/security?).

This discussion focuses on nonsystematic valuation adjustments. This discussion summarizes systematic (or level of value) adjustments so we may contrast them with nonsystematic adjustments. This discussion focuses on nonsystematic valuation adjustments. As the name implies, nonsystematic adjustments typically do not apply to all business interests of the same level of value. While nonsystematic adjustments are considered in all

business/security valuations, they are typically applied less often than systematic adjustments.

Nonsystematic Valuation Adjustments

Nonsystematic valuation adjustments may be grouped in the following four categories:

1. company-specific adjustments,
2. security-specific adjustments,
3. contract-imposed adjustments, and
4. multitier adjustments.

These adjustments relate to factors that are specific to the individual valuation subject (e.g., the target block of stock). These four categories are further described later in this discussion. An example of a company-specific adjustment is key customer dependence, such as when 90 percent of the subject industrial company revenue comes from one retail customer. An example of a security-specific adjustment is supervoting rights, such as when the valuation subject is class B supervoting common stock that enjoys 100 votes per share (compared to the one vote per share enjoyed by the class A common stock).

An example of a contract-imposed adjustment is when the stock is subject to a mandatory shareholder agreement. Let's assume that a shareholder agreement allows the company to call the subject stock at any time at a call price equal to net book value.

An example of a multitier adjustment is a family limited partnership (FLP) interest that owns the nonmarketable, noncontrolling stock of a closely held corporation. The analyst may apply a multitier adjustment when the corporation owns a substantial amount of liquid assets but neither (1) the subject FLP interest nor (2) the subject closely held stock interest has the right to demand either an income or an asset liquidation.

These illustrative nonsystematic adjustments do not relate to the level of value of the subject company/security. And, these illustrative adjustments do not apply across a broad range of valuation subjects. Rather, the application of nonsystematic adjustments is specific to the facts and circumstances of each individual valuation subject. In contrast, the application of systematic discounts and premiums is common across a broad range of valuation subjects.

This discussion concludes with a list of caveats related to the identification and quantification of nonsystematic valuation adjustments. However, the following discussion mentions caveats regarding valuation adjustments in general. Analysts should consider these following caveats with regard to any business/security valuation prepared for any purpose.

General Caveats Regarding All Valuation Adjustments

Adjustments Are Made to Conclude Value

First, both systematic and nonsystematic adjustments are always made to reach a value conclusion. Adjustments are not made from a value conclusion. Inexperienced analysts are often confused by this important distinction. These analysts believe that, first, one reaches a correct value conclusion of the subject business/security. Then, one applies a discount or premium to the concluded value in order to arrive at a discounted – or inflated – value.

This misconception is both procedurally and conceptually incorrect. In fact, analysts apply valuation approaches methods to conclude value indications. Each business/security valuation method involves numerous analytical procedures. The various methods provide value indications that are preliminary until all of the applicable procedures are completed. And, one of the applicable procedures in all valuation methods is to consider (and apply, when appropriate) valuation discounts and premiums.

Therefore, valuation adjustments are applied to a preliminary value indication to arrive at a final value conclusion. Valuation adjustments are not applied to a final value conclusion to arrive at either a discounted or an inflated value conclusion.

There are Both Implicit and Explicit Adjustments

Regarding both systematic and nonsystematic adjustments, the application (and amount) of adjustments may vary based on the selected valuation approach and method. There are two components to this caveat: (1) implicit level of value systematic adjustments and (2) implicit/explicit quantification of nonsystematic adjustments.

Some valuation approaches and methods typically conclude a particular level of value. The market approach/guideline publicly traded company method typically concludes a marketable, noncontrolling interest level of value. The asset-based approach/asset accumulation method typically concludes a marketable, controlling interest level of value. The income approach/discounted cash flow method can conclude either a controlling or a noncontrolling interest level of value; the concluded level of value depends on the individual valuation variables related to (1) the cash flow projection and (2) the present value discount rate. In each of these instances, the application of a systematic level of value adjustment depends on both (1) the level of value typically concluded by the subject method and (2) the individual valuation variables used in the subject analysis.

Within the same business/security valuation, systematic adjustments may apply to some methods and not to others. And, depending on the individual variables used within the method, different amounts of the same valuation adjustment (e.g., discount for lack of marketability) may apply between the different methods used in the same analysis.

Regarding nonsystematic valuation adjustments, the analyst may implicitly make an adjustment within a valuation method. Alternatively, the analyst may apply an explicit adjustment to the value indication concluded by the same valuation method. For example, let's consider a discount for key person dependence. The key person could be the chief executive, chief salesperson, chief engineer, or

any other strategically important executive. If the valuation includes the income approach/discounted cash flow method, the analyst could either implicitly or explicitly quantify a key person dependence discount. Implicitly, the analyst could adjust the cash flow projection for the cost to recruit, hire, train, and maintain a hypothetical replacement executive (e.g., a replacement for the key executive). Explicitly, the analyst could conclude an unaffected preliminary value indication-and then subtract either a discrete percentage discount or a discrete dollar discount (for key person dependence) from the preliminary value.

As another example, let's consider a discount for lack of voting rights in the valuation of class B nonvoting common stock (e.g., a class of stock retained by the founding family). The analyst could either implicitly or explicitly quantify this valuation adjustment. If the analyst uses the market approach/guideline publicly traded company method, the valuation adjustment could be made within the analysis-to conclude an implicitly discounted value indication. Or, the analysis could be performed on an unaffected basis, and the preliminary value indication could be explicitly adjusted for the discount. Implicitly, the analyst could select only guideline company nonvoting stocks from which to extract valuation pricing multiples. The application of such pricing multiples would conclude a value that is implicitly affected by a lack of voting rights. Alternatively, the analyst could select voting guideline company stocks from which to extract valuation pricing multiples. The application of such pricing multiples would conclude a value that should be explicitly adjusted by a percentage discount for lack of voting rights.

Adjustments are Affected by Standard of Value Influences

Regarding both systematic and nonsystematic adjustments, the application of adjustments is directly affected by which standard (or definition) of value is sought. If the engagement standard of value is fair market value, then most valuation adjustments will typically apply. This is because the marketplace of willing buyers and willing sellers will generally recognize all valuation discounts and premiums. However, if the engagement standard of value is fair value (as in a statutory dissenting

shareholder rights case or a shareholder oppression case), then certain systematic level of value adjustments may not be applicable.

As a result of statutory authority or judicial precedent, fair value is often considered synonymous with pro rata business enterprise value (BEV). This pro rata BEV is considered a value that is legally "fair" to all parties in the subject litigation. This is because BEV is the only level of value where all shares of stock in the subject company have the same value per share. Pro rata BEV results in the same per share value regardless of whether the subject shares are owned by a controlling stockholder or by a noncontrolling stockholder. At the BEV level of value, no stockholder receives an economic reward for squeezing out/ oppressing another stockholder.

Under the pro rata BEV interpretation of fair value, the controlling stockholder is not allowed to pay a "discounted" price (e.g., \$10 per share) to a noncontrolling stockholder for shares that are worth a pro rata BEV value (e.g., \$20 per share) to the controlling stockholder. In statutory fair value analyses, certain valuation adjustments are not legally applicable-even if the subject stock is a nonmarketable, noncontrolling ownership interest. The conceptual basis for the pro rata BEV level of value in fair value analyses is often called "the economics of fairness."

Let's consider an investment value (or current owner value) engagement. In such an engagement, the analyst may decide not to apply a nonsystematic discount for a suboptimal product distribution function at the subject company. This is because such a discount may not be appropriate if the parent corporation wants to quantify the value to itself of a subject subsidiary. Let's assume that the corporate parent is a company like Pfizer, i.e., a pharmaceutical company recognized for its world class product distribution function. Let's assume that the corporate parent operates the subject subsidiary as a manufacturing entity that sells all of its production to a marketing/ distribution sister subsidiary. In an

investment value analysis, the lack of the subject's distribution system would not represent a value decrement to the parent corporation owner. Therefore, the investment value analysis would not include a nonsystematic discount for the lack of a distribution function.

Types of Nonsystematic Valuation Adjustments

Something that is nonsystematic is not orderly, regular, or consistent. Nonsystematic valuation adjustments are discounts or premiums that are considered-but not typically applied-in all business/security valuations. Such adjustments are specific to the individual facts and circumstances of a target business/security. Nonsystematic adjustments may be grouped into the following four categories:

1. company-specific adjustments,
2. security-specific adjustments,
3. contract-specific adjustments, and
4. multitier adjustments.

Company-Specific Valuation Adjustments

Company-specific adjustments relate to facts and circumstances that are specific to the subject business/security. Common examples include:

1. discount for key person dependence,
2. discount for key customer dependence,
3. discount for key supplier dependence,
4. discount for key product/technology dependence,
5. discount for suboptimal capital structure, and
6. discount for suboptimal cost of capital.

These company-specific factors can be either controllable or noncontrollable. For example, the subject company management may decide to use a 100 percent equity capital structure because of its aversion to financial risk. However, this is a controllable decision. On the other hand, there may only be one

domestic supplier for the company's key product component. In that case, management's reliance on the key supplier is an uncontrollable decision.

In any event, all of these factors affect value at the BEV level. These factors are not affected by the particular subject's level of value. And, these factors typically do not affect one class of security differently than another class of security. Each of the company-specific factors makes the subject company different (from an investment risk and/or expected return perspective) than the typical company in the subject industry peer group. Accordingly, these valuation adjustments are typically made at the company (invested capital or total equity) level of analysis.

Security-Specific Valuation Adjustments

Security-specific adjustments relate to facts and circumstances that are specific to the subject security. Common examples include:

1. discount for lack of voting rights,
2. premium for supervoting rights,
3. blockage discount, and
4. discount for lack of preemptive rights.

All of these factors affect the valuation at either (1) the subject class of security level (e.g., a discount for lack of voting rights may be applied to all of the nonvoting common stock) or (2) the subject specific security level (e.g., a blockage discount may be applied to a 25 percent block of stock in an inactively traded public company). Each of the factors makes the subject security different (from an investment risk and/or expected return perspective) than either (1) the typical security in the subject company or (2) a guideline/benchmark security used for comparative pricing purposes. These valuation adjustments are typically applied at the subject security (e.g., at the per share of stock) level and not at the BEV level.

Contract-Specific Valuation Adjustments

Contract-specific adjustments relate to facts and circumstances that are imposed on the subject security by a contract, agreement, regulation, or covenant. Common examples include:

1. stock subject to the buy-sell provisions of a shareholder agreement;

2. restricted publicly traded stock;
3. founder, letter, or other unlisted stock of a listed company; and
4. partnership units subject to a partnership agreement or limited liability company (LLC) units subject to an LLC agreement.

These factors affect the valuation of a specific ownership interest as the result of an exogenous influence. That exogenous influence is the result of the particular ownership interest being subject to the terms and conditions of some contract or agreement. The contract terms may involve put, call, transfer, or ownership restrictions of a stockholder, LLC, or family limited partnership (FLP) agreement. The contract terms may affect the income distribution or asset liquidation proceeds rights of the subject ownership interest. The contract terms may positively enhance the transferability of the subject ownership interest—such as the put option on ESOP-owned stock that is a contractual condition of most ESOP trust agreements.

The exogenous influence may be the result of an employment agreement. The employment agreement may prohibit an executive from selling the subject stock (1) while he or she remains an employee or (2) for a specified number of years. The exogenous influence may be the result of (1) an agreement with security underwriters or (2) a requirement of the Securities Exchange Commission (SEC) or an individual stock exchange. Unlisted shares of a publicly traded company (e.g., founder stock, letter or legend stock, or stock subject to SEC Rule 144) are subject to contractual and/or regulatory transferability restrictions.

Each of these factors makes the subject ownership interest different (from an investment risk and/or expected return perspective) than either (1) the typical security of the subject company that is not subject to the contractual/regulatory influence or (2) a guideline/benchmark security used for comparative pricing purposes. These valuation adjustments are typically applied at the subject ownership interest level (e.g., the particular block of stock or other equity units).

Multitier Valuation Adjustments

Multitier adjustments relate to facts and circumstances that are specific to the ownership of

the subject security interest. Common examples include:

1. CHC stock owned by an FLP,
2. nonconsolidated CHC stock owned by CHC,
3. any multitier ownership where a distribution will trigger the recognition of capital gains, and
4. a fractional or partial property ownership interest inside a CHC or FLP.

Multitier adjustments are sometimes referred to as inside/outside adjustments. For example, asset A is owned by asset B, which itself is owned by asset C. Asset C is the valuation subject. Typically, in order to receive income distributions, the owner of asset C must first liquidate assets A and B. Accordingly, there is a series of security-specific and/or contract-specific adjustments that should be applied in the multitier ownership interest valuation. In multitier valuations, questions arise both as to (1) the magnitude of the appropriate adjustments and (2) the sequencing (and relative magnitude) of the appropriate adjustments.

Typically, the lower level/inside adjustments are applied first, and the higher level/outside adjustments are applied second. That is, adjustments are applied to asset A, and an asset A cash equivalency value is estimated. Then, adjustments are applied to asset B, and an asset B cash equivalency value is estimated. Finally, adjustments are applied to asset C, and an asset C value is concluded.

Types of Systematic Valuation Adjustments

Systematic events occur with regularity and order. This statement is also true of systematic adjustments. They affect a broad range of valuation analyses. And, the application of systematic adjustments is a common valuation procedure. Depending on the valuation methods used, virtually all CHC business/security valuations involve either implicit or explicit systematic adjustments. Although systematic adjustments include

more than level of value adjustments, these adjustments are the most common type of systematic adjustment. There are two reasons for this. First, virtually every business/security valuation involves a specified level of value. And, second, alternative valuation methods typically produce value indications at different levels of value.

If an analysis involves two or more valuation methods, the analyst will typically have to apply some systematic adjustment in order to conform all value indications to the same level of value. All value indications should be stated on the same level of value (typically, the level of value consistent with the valuation assignment) before a valuation synthesis and conclusion can be reached.

Common systematic adjustments include:

1. discount for lack of marketability (related to any ownership interest less than an overall business enterprise),
2. discount for illiquidity (related to the analysis of the overall closely held business enterprise),
3. discount for lack of ownership/operational control,
4. premium for ownership/operational control, and
5. premium for strategic/synergistic benefits.

The above-listed adjustments relate to level of value. Many inexperienced analysts believe that there are only three or four discrete levels of value. In fact, there is a virtually continuous spectrum of levels of value. And, the spectrum typically has two axes: (1) ownership control elements and (2) marketability elements. There is a continuous spectrum of value influences ranging from (1) absolute ownership/operational control with immediate synergistic opportunities to (2) absolute lack of ownership/operational control.

For example, the owner of a 30 percent block of CHC stock may have significant elements of operational control – if there are 70 other unrelated one percent stockholders. The owner of a two percent block of CHC stock can experience the swing vote value

influences of control – if there are two other unrelated 49 percent stockholders.

The owner of 51 percent of a CHC stock has some ownership control and that block of stock would likely deserve some level of control premium. However, in many jurisdictions, a two-thirds vote is legally required for many "control events" (e.g., a corporate liquidation or a sale of substantially all of the company assets). Therefore, the owner of a 67 percent block of stock may deserve a greater control premium than the owner of a 51 percent block of stock.

The ownership of 80 percent of a company is required for a parent corporation to consolidate a subsidiary for both financial accounting and income tax reporting purposes. That's why many acquirers won't pursue a company acquisition unless they are sure of buying at least 80 percent of the outstanding stock. Therefore, the owner of an 80 percent block of stock may deserve a greater control premium than the owner of a 79 percent block of stock.

The owner of a 95 percent block of CHC stock still has fiduciary obligations to the noncontrolling stockholders. The elimination of noncontrolling stockholders eliminates both (1) this fiduciary duty and (2) the possibility of nuisance litigation claims from dissenting stockholders. Therefore, the owner of a 100 percent block of CHC stock may deserve a greater control premium than the owner of a 95 percent block of stock.

There is also a continuous spectrum of value influences with regard to marketability elements, ranging from:

1. absolute liquidity (equivalent to that enjoyed by actively traded stock listed on a public stock exchange) to
2. virtually absolute illiquidity (imposed by FLP, stockholder, buy/sell agreement, or by an other contract/agreement that restricts transfer, limits potential buyers, and dictates sale price).

While it may be impossible for analysts to conceptualize all of the discrete steps along the control/marketability continuum, these two elements of control and marketability represent a continuous spectrum of combined valuation adjustments. For illustrative purposes, Figure 1 represents several common levels of value. Where applicable, Figure 1

also presents simplified indications of the valuation discount/premium relationships among the common levels of value.

Nonsystematic valuation discounts and premiums may be quantified as either (1) a percentage adjustment or (2) a dollar amount adjustment. When both percentage and dollar amount adjustments are appropriate, the analyst should carefully consider the appropriate sequence of adjustments.

Systematic discounts and premiums (particularly level of value adjustments) are typically quantified as percentage adjustments. If both control influence and marketability influence discounts/premiums are applied as percentage adjustments, then the mathematical sequencing of the application of systematic adjustments is irrelevant. As long as they are all expressed on a percentage basis, systematic valuation adjustments usually can be applied in any order.

Adjustments are Integral to the Valuation Process

Experienced analysts understand that a valuation adjustment is meaningless without a clear answer to the question: adjustment to what? The analyst has to understand the baseline or benchmark against which any discount or premium is contemplated. The application of any discount or premium is fundamentally inappropriate unless the benchmark (against which the adjustment is compared) is clearly defined. For example, it may be inappropriate to apply a discount for lack of marketability to a value indication that is already stated on a nonmarketable basis. Likewise, it may be inappropriate to apply an ownership control premium to a value indication that is already stated on a controlling ownership interest basis.

The first valuation adjustment question for the analyst to ask is: What do I have? This question relates to the systematic and nonsystematic elements that exist in:

1. the valuation approaches and methods selected,
2. the valuation variables used,
3. the guideline or other transactional data extracted, and

4. the valuation indications derived.

These elements (which are either present or absent) represent the baseline/benchmark of the analysis.

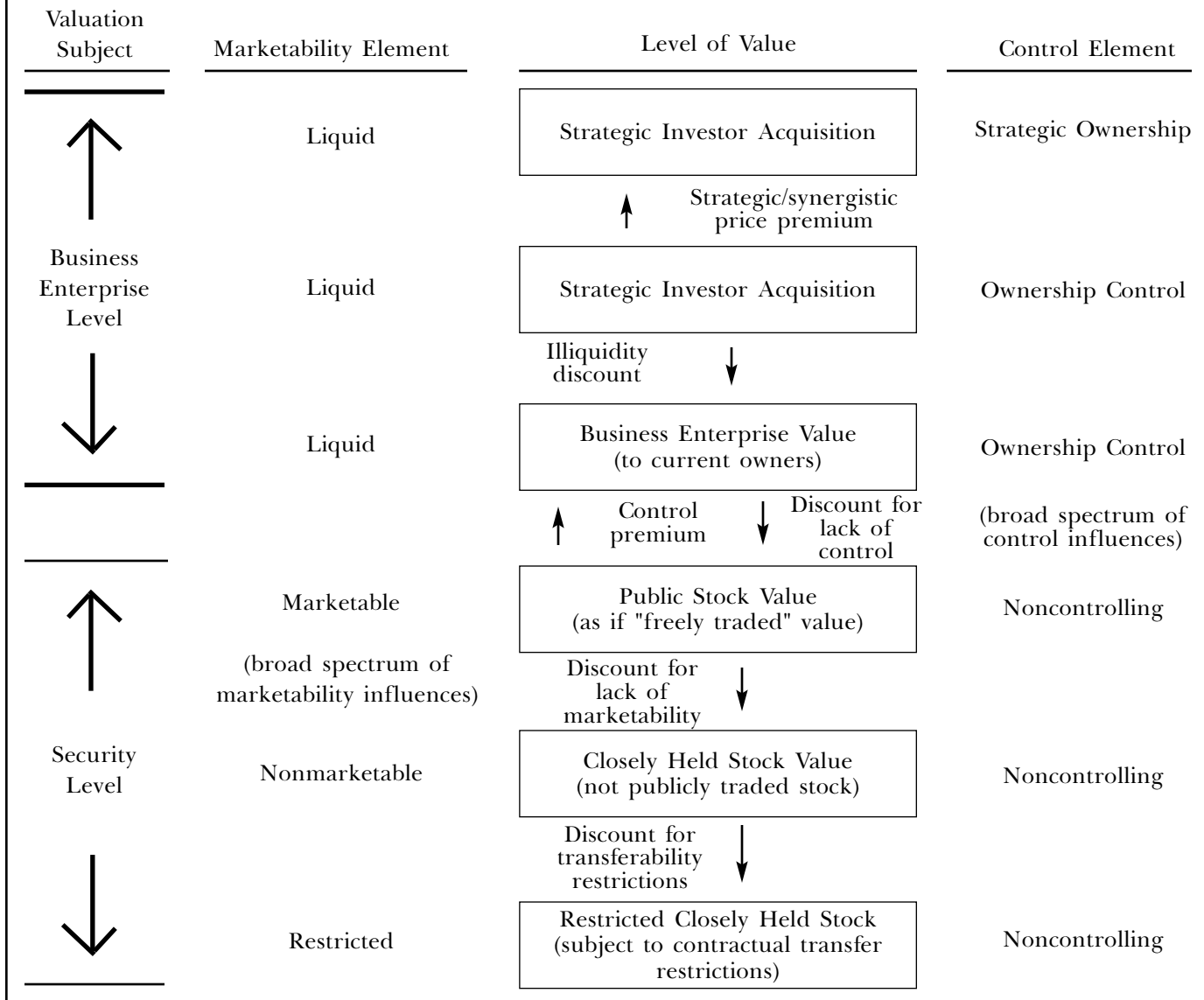
The second valuation adjustment question for the analyst to ask is: What do I want? This question relates to what systematic and nonsystematic elements exist in (1) the subject company and/or (2) the subject security/ownership interest. The analyst is looking for operational, financial, contractual, and regulatory features of the subject company/security that are different from those of the benchmark analysis. These selected features should make the subject company/security different from the benchmark analysis from an investment risk/expected return perspective.

It is obvious why the analyst should first understand the benchmark analysis. At this point in the valuation, the benchmark analysis is what the analyst has. Ideally, the benchmark analysis will perfectly match the subject company/security from an investment risk/expected return perspective. This is because an analysis of the subject company/security is what the analyst wants. If the elements in the benchmark analysis match up perfectly with the elements in the subject company/security, no valuation adjustments are needed. Of course, that is rarely the case.

The third valuation adjustment question for the analyst to ask is: How is the subject company/security different from the benchmark analysis? The analyst identifies all of the systematic and nonsystematic elements in the subject that are not in the benchmark analysis-and vice versa.

The fourth and final valuation adjustment question for the analyst to ask is: How do I get to what I want from what I have? What adjustments are needed to make the benchmark analysis value indications more applicable to the valuation subject? What valuation adjustments are needed to minimize the systematic and nonsystematic element differences between the benchmark analysis and the valuation subject? This fourth

Figure 1
Business/Security Valuation adjustments
Illustrative Level of Value Adjustments



question helps the analyst identify valuation adjustments that make the investment risk/expected return features of the benchmark analysis look more like the valuation subject. It is not the objective of valuation adjustments to make the investment risk/expected return features of the subject company/security look more like the benchmark analysis.

Valuation adjustments are only applicable to make the benchmark or baseline analysis look more like the subject company/security

from an investment risk/expected return perspective. Therefore, it is important that the analyst fully understand the systematic and nonsystematic elements of the benchmark analysis before any valuation adjustments are considered. The selection of the valuation adjustments is influenced by (1) the specific valuation approaches, methods, and procedures performed and (2) the purpose and objectives of the analysis, including (a) the standard of value and (b) the premise of value appropriate of the valuation assignment.

Illustrative Valuation Adjustments

Table 1 presents a noncomprehensive list of common valuation discounts and premiums. Table 1 does not distinguish between systematic level of value adjustments and nonsystematic adjustments. While Table 1 is not comprehensive, it provides a convenient checklist for analysts performing a business/security valuation.

Valuation Adjustment Methods

There are numerous procedures that may be used to quantify valuation adjustments. All of these individual procedures may be grouped into four categories of methods:

1. comparative empirical data regarding the valuation subject,
2. comparative income data regarding the valuation subject,
3. published empirical data regarding valuation guidelines/benchmarks, and
4. reliance on judicial/administrative guidance.

The first two of these methods use data extracted directly from the subject company/security. If data are available, these methods provide valuation adjustment indications that are specifically derived from the valuation subject. In the first method, the analyst compares the valuation subject to a benchmark/baseline that does not have the discount/premium value influence. Based on this comparison, the analyst extracts pricing data that are used to quantify the valuation adjustment. In the second method, the analyst compares some measure of the subject's income to the same income measure, adjusted to exclude the effect of the discount/premium value influence. The capitalization of this income differential provides an indication of the appropriate valuation adjustment amount.

Using the comparative empirical data method, the analyst looks for comparative sales involving the subject security, where (1) one sale doesn't have the particular discount/premium feature and (2) the otherwise comparable sale does have the particular discount/premium feature. Let's assume that there are historical sale transactions involving two classes of the company stock (one class with voting rights and one class without voting rights). The analyst

could examine these transactions and extract a discount for lack of voting rights. Let's assume that there are historical sale transactions involving (1) stock subject to a right of first refusal and (2) otherwise comparable stock not subject to a right of first refusal. The analyst could examine these transactions and extract a discount related to a contractual agreement right of first refusal.

Using the comparative income data method, the analyst identifies revenue, expense, or investment differences that are attributable to the discount/premium value influence. The analyst quantifies how the subject revenue, expenses, or investment would change if the particular discount/premium feature changes. The analyst then capitalizes the expected income change over the remaining useful life (RUL) of the income change. The present value of the projected income difference provides an estimate of the valuation discount/premium amount.

Let's assume that Fred Founder is the controlling stockholder at Alpha Corporation, a CHC. As controlling stockholder, Fred Founder pays himself a salary of \$1 million per year greater than is reasonable for a comparable executive at a comparable company. The analyst is attempting to quantify the ownership control premium associated with Founder's stock. The analyst could (1) isolate the economic benefit associated with the Founder ownership control (i.e., his excess compensation) and (2) capitalize that benefit at an appropriate capitalization rate. The capitalized excess compensation is one indication of the Founder ownership control premium.

Each of the procedures related to the empirical data and the empirical income methods involve three analyses:

1. Estimate of the income shortfall related to the valuation discount; estimate of the income excess related to the valuation premium.

Table 1
Business/Security Valuation Adjustments
Illustrative Valuation Discounts and Premiums

| <u>Valuation Discounts Related to:</u> | <u>Valuation Premiums Related to:</u> |
|--|---------------------------------------|
| Assignee ownership interest | Ownership/operational control |
| Blockage (size) of public stock | Put options |
| Built-in capital gains taxes | Strategic/synergistic benefits |
| Call options | Superliquidation preference |
| Founder/letter/legend stock | Supervoting rights |
| Illiquidity (at business enterprise level) | |
| Key customer dependence | |
| Key person dependence | |
| Key supplier dependence | |
| Key technology dependence | |
| Lack of dividend rights | |
| Lack of marketability (at security level) | |
| Lack of ownership/operational control | |
| Lack of preemptive rights | |
| Lack of voting rights | |
| Multitier ownership structure | |
| Partial/fractional ownership interest | |
| Right of first refusal | |
| SEC Rule 144 | |
| Suboptimal capital structure | |
| Suboptimal cost of capital | |
| Transferability restrictions (contractual) | |
| Unlisted stock of public company | |

2. Estimate of the cost to cure the deficiency feature.
3. Paired sales analysis of (a) transactions with the subject discount/premium feature and (b) transactions without the subject discount/premium feature.

The empirical data and empirical income methods rely on income, cost, or sales data extracted from the subject company to quantify the systematic or nonsystematic adjustment. The published empirical data method is a commonly used method to quantify discounts and premiums. It is also a commonly misused method. Many analysts rely on published studies of empirical data to derive level of value adjustments, such as a discount for lack of marketability or a premium for ownership control. There are also numerous published studies with regard

to nonsystematic valuation adjustments as well, such as a discount for lack of voting rights.

Most published empirical studies rely on the paired sales analysis procedure. These studies analyze (1) one set of sale transactions that are not affected by the subject feature and (2) one set of sale transactions that are affected by the subject feature. The percentage difference in transaction prices (or the percentage difference in transaction pricing multiples) provides an indication of the amount of the individual valuation discount or premium.

The difference in this third method (compared to the first two methods) is that both sides of the paired sales analysis comparison relate to guideline company/security transactions. In other words, none of the data analyzed in these published studies actually comes from the subject company/security. This factor should not invalidate the use of this

method. The concern regarding the use of this method is not the data source. The concern is how the analyst relies on the published study results to select subject-specific valuation adjustments. Often, analysts rely on popular published empirical studies (1) without understanding the procedural mechanics of the published study, (2) without understanding the type (e.g., industry, size, etc.) of transactions analyzed in the published study, and (3) without considering the time period of the published study (compared to the subject valuation date).

In addition, analysts often select the mean or median conclusion from the published study as the appropriate discount or premium. When this happens, the resulting analysis has not reflected the range of results indicated by published studies—such as the interquartile conclusions, the standard deviations, and the high/low observations. And, the resulting analysis has not considered (qualitatively or quantitatively) exactly what adjustment would be appropriate to the specific factors of the subject company/security.

The fourth method for quantifying valuation adjustments relies on published judicial precedent and administrative rulings—e.g., Inland Revenue Service (IRS) audit settlement agreements—for guidance. This method is sometimes used by inexperienced analysts. However, it is not recommended by experienced analysts. This method does provide the analyst with very useful information as to the reasonable range of discounts and premiums that courts and regulators have found acceptable. However, these data do not provide useful information from which to select a specific valuation adjustment related to a specific valuation.

Judicial precedent, IRS letter rulings and settlement agreements, and other administrative rulings are always fact-specific. By definition, they only apply to the specific facts and circumstances of a particular matter and/or taxpayer. They are not intended to provide general professional guidance with regard to valuation discounts and premiums. Published judicial decisions (and other rulings) are only applicable to the extent that the subject company/security facts and circumstances are identical to the published decision facts and circumstances. And, that is rarely the case.

Analyst Caveats

Table 2 presents a nonexhaustive list of 10 caveats that analysts should consider with regard to the identification and quantification of discounts and premiums. These 10 caveats apply to all four methods for quantifying adjustments.

Summary and Conclusion

This discussion focused on the identification and quantification of nonsystematic and multitier valuation adjustments. This discussion also considered the identification and quantification of systematic (e.g., level of value) valuation adjustments. This discussion described both (1) when and (2) why adjustments are applicable in business/security valuations. And, this discussion presented an illustrative list of business/security discounts and premiums.

This discussion presented (1) four methods for quantifying valuation adjustments and (2) three procedures for quantifying valuation adjustments. This discussion compared conceptual/practical strengths and weaknesses of the valuation adjustment methods. And, this discussion presented a list of caveats that analysts should consider when selecting valuation discounts and premiums.

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Table 2
Business/Security Valuation Adjustments
Analyst Caveats Regarding Discounts and Premiums

1. Analysts should thoroughly understand the valuation analysis baseline/benchmark before applying any valuation adjustments.
2. Analysts should thoroughly understand the economic influences of the specific systematic or nonsystematic feature considered; does it actually affect the investment risk and/or expected return of the subject company/security?
3. Analysts should be careful not to "double count" valuation adjustments. For example, a discount for the built-in gains tax may be a component of an overall discount for lack of marketability-and not a separate valuation adjustment.
4. When analysts use alternative procedures to quantify valuation adjustments (e.g., income shortfall/excess, cost to cure, paired sales analysis), the lowest valuation adjustment indication is often the most appropriate conclusion.
5. Analysts should not solely rely on published judicial precedent as the basis of selecting specific valuation adjustments, unless the facts and circumstances of the valuation subject are identical to that in the published decision.
6. Analysts should be aware that not all valuation methods/indications may be subject to the same valuation adjustment-or to the same magnitude (either dollar amount or percentage) of valuation adjustment.
7. Analysts should recognize that the application of valuation adjustments is influenced by the purpose and objective of the analysis (e.g., the engagement standard of value, premise of value, etc.) as well as by the specific features of the subject company/security.
8. Analysts should be sufficiently familiar with the content and intent of published empirical studies before relying on such published studies as the basis of selecting a specific discount or premium.
9. Analysts should carefully consider the time period covered in any published empirical study before relying on that published study for use as of a specific valuation date.
10. Analysts should carefully consider the dispersion of the results reported in published empirical studies. Analysts should avoid naive reliance on the mean or median results of published studies without considering whether such conclusions are applicable to the specific facts and circumstances of the valuation subject.

BY SCOTT LAWRIESEN MA, MBA, CFA, CBV

Fairness in Fairness Opinions: Lessons from Enron

In a report dated November 14, 2003, Harrison J. Goldin summarized his findings with respect to certain entities in transactions pertaining to Special Purpose Entities ("SPEs") of Enron North America Corp. ("Enron")¹. The conclusion of Mr. Goldin ("The Enron Examiner") was particularly critical of the appraiser who had completed several fairness opinions on behalf of the Enron Board of Directors.

Summary of Relevant Facts

In June 1999, Enron retained the valuation advisory services of a BigFour accounting firm (the "Appraiser") to issue a fairness opinion for Enron's Board of Directors on an SPE transaction referred to as the "Rhythms Transaction". This transaction involved the transfer of 3.4 million shares of Restricted Enron Stock from Enron to an SPE called LJM1, in exchange for \$64 million in notes received from LJM1 as well as a five-year put option on Enron's Rhythms stock received from "Swap Sub", the option counterparty. The Appraiser valued the Restricted Enron Stock between \$170 and \$223 per share, a discount of approximately 20% to 42% from the market value due to the four-year prohibition on sales of the stock.

In the fairness opinion, the Appraiser ultimately found the transaction to be fair to Enron. The Enron Examiner, after reviewing the basis for the fairness opinion, concluded that under the terms of the transaction, the deal was not fair to Enron and that the entire fairness opinion was of little to no value at all.

Specific deficiencies identified in the Appraiser's analysis included:

1. *Failure to Act as a Financial Advisor to Enron's Board*: While the engagement letter stated clearly that the fairness opinion was to be rendered "to the Board of Directors (the "Board") and management and/or special committee" the Appraiser's communication was only with management throughout the entire engagement. Apparently, the Appraiser did not meet with or present its opinion to the Board at any time (p. 321).

By not presenting its analysis and opinion to the Enron board, the Appraiser was viewed as negligent in two respects:

- i) Failing to help the Board determine whether the price and terms of the transaction were fair to shareholders; and
- ii) Failing to provide an analysis that would enable the Board to meet its fiduciary duty to the corporation and shareholders (p. 322).

2. *Failure to Disclose Conflict of Interest*: The Enron Examiner expressed the view that a key part of a thorough fairness opinion is to recognize potential conflicts of interest between the valuator and the involved parties of the transaction. It is generally accepted that independence of the financial advisors providing the fairness opinion is a cornerstone of fairness opinion reliability. If a conflict appears to be present, the advisory firm should, at the very least, disclose its conflict to the client for its consideration.

In this instance, the Appraiser's firm, being involved with LJM1 in tax advisory services, had a clear conflict of interest in rendering a fairness opinion to Enron,

¹ Report of Harrison J. Goldin, the court-appointed examiner in the Enron North America Corp. Bankruptcy Proceeding, respecting his investigation of the role of certain entities in transactions pertaining to special purpose entities, United States Bankruptcy Court, Southern District of New York, Chapter 11. Case No. 01-16034 (AJG), re: Enron Corp. et al., Debtors.

when both Enron and LJMI were parties in the transaction. The Appraiser did not attempt to communicate any form of conflict of interest to Enron board members. *"Had Enron not decided to proceed with the Rhythms Transactions, LJMI would have lost its `principal reason for existing and [the Appraiser's] tax team would have lost its client. Consequently, [the Appraiser's] fairness opinion team had a strong incentive to find the Rhythms Transaction fair"* (p. 325).

3. Timing of the [Appraisal for the] Rhythms Engagement: The Appraiser accepted the engagement to render a fairness opinion for the engagement two weeks after it closed. It delivered its fairness opinion on the transaction nearly two months after the transaction was completed (while the Appraiser still charged \$800,000 for the fairness engagement). The Enron Examiner expressed the view that this greatly questions the value of obtaining a valuation in the first place: *"Fairness opinions are usually rendered to support a board's decision to enter into a merger agreement and to help directors against claims that the decision constituted a breach of fiduciary duty."* (p. 327).
4. Relying on Unreasonable Assumptions: External advisors will inevitably rely on information they receive from management because of their knowledge about the workings of the Company. However, this does not waive an Appraiser from responsibility for using this information – the advisor should only utilize information deemed to be reasonable. In the case of the Enron opinion, the Appraiser was aware that Enron and LJMI, through the CFO's connection with both, were clearly not at arm's length, and therefore could not be expected to rely on Enron's contrary claim that the parties were at arm's length.
5. Lack of Experience in Rendering Fairness Opinions: The Enron Examiner suggested that providers of fairness opinions should have not only general experience in

valuations, but "have experience preparing fairness opinions for reasonably comparable transactions" (p. 334). In this instance, the members of the Appraiser's valuation team had, by their own admission, little to no prior experience with any valuations.

6. The Standard of Value: (p. 314) In valuing the restricted stock, the Appraiser assumed that the value to LJMI, the "buyer", was the same as the value to Enron, the "seller". This can only be assumed true if both the buyer and seller are at arm's length, which each was not due to the CFO's involvement with both Enron and LJMI, and the Appraiser's involvement with providing services to both LJMI and Enron concurrently.

Essentially, the restricted stock was valued based off the then-current market value of 3.4 million shares, less:

- (a) the value to Enron of keeping the shares off the market for four years;
and
- (b) less the future value Enron could receive from a specific buyer willing to pay to waive the sale restrictions for liquidity needs.

Upon subsequent expert review, it was found that the value of keeping the shares off the market was negligible, while the value of possible payment for waiving of the restrictions was small in this case as neither LJMI nor Swap Sub appeared to have any need for liquidity for the restriction period. The Enron Examiner made the following comments with respect to the standard of value in this instance:

- "As the provider of a fairness opinion (and recipient of a considerable fee for the service), [the Appraiser] had an obligation to ensure that its opinion had value to its intended recipient, the Enron board." (pg 323).
- "Had [the Appraiser] analyzed the specific liquidity needs of LJMI and Swap Sub in valuing the Restricted Enron Stock, it would have concluded that any value Enron could receive by waiving the transfer restrictions was far less than the 20% to 42% discount [the Appraiser] had calculated" (p. 318).

In the Enron Examiner's opinion, Enron gave up consideration of significantly higher value than estimated, making the transaction inherently unfair to Enron.

The nature of these shortcomings were such that the ENA Examiner concluded:

- (i) The evidence was sufficient for a fact finder to determine that the appraiser had committed professional malpractice and was grossly negligent in preparing and providing these opinions;
- (ii) The appraiser breached their duty of care to Enron by failing to perform its fairness opinion engagements with the skill, prudence and diligence expected of, and commonly exercised by, other members of the valuation consulting profession; and
- (iii) The evidence was also sufficient for a fact finder to conclude that the appraiser's negligent and grossly negligent conduct in rendering fairness opinions on two of the transactions were the proximate cause of actual loss or damage to Enron. By rendering fairness opinions that had no value to Enron's Board, the appraiser had caused Enron to sustain significant monetary damages.

In preparing this article, we have not undertaken the level of review taken by the Enron Examiner and cannot comment on the conclusions reached, but the areas identified by the author in their analysis highlight a number of areas appraisers should be cognizant of.

Guidance Provided through the CICBV Handbook

Appendix B to Standard 110 of the CICBV Handbook ("Appendix B") sets out disclosure standards pertaining to fairness opinions. The Handbook notes that a fairness opinion is fundamentally different from a valuation report in that the latter presents the appraisers methodology that was used to determine the value (or range of values) for the shares or assets of a business entity being appraised. A fairness opinion will generally present a professional opinion as to the fairness, from a financial point of view, of a proposed transaction to security holders (or to a group of security holders).

It should be noted that Appendix B differs significantly from Appendix A to Standard 110 ("Appendix A"). This section of the Handbook sets out disclosure standards for valuation reports that are prepared for the purposes of securities regulations or policies in the context of non-arm's length transactions (i.e. going private transactions). This standard provides specific recommendations as to the level of disclosure and support for valuation calculations, forward looking information and the inclusion of historic financial information included in the report.

The provisions of Appendix B encourage the appraiser to prepare the fairness opinion in a manner that allows the reader of the report to evaluate the basis for the appraiser's conclusion: "the Fairness Opinion should provide the principal reasons supporting the opinion conclusion in sufficient detail to allow the reader to understand the basis of the Fairness Opinion and to form a reasoned view on the opinion conclusion." However, limits are placed on the level of required disclosure: "The disclosure standards do not require that the level of disclosure provided be sufficient to enable the reader to perform his or her own Fairness Opinion."

The authors of Appendix B guide appraisers to go beyond a quantitative exercise. The authors draw attention to the need to consider specific facts of the proposed transaction that can have a material impact on the fairness conclusion. "In essence, the range of values as determined may only comprise one of the factors that the opinion provider considered in the particular circumstances." In considering the fairness of the proposed transaction it is also noted that if other preferable alternatives exist to that which is proposed they need to be taken into consideration. This is problematic as an appraiser would not necessarily be aware of discussions management may have had with other parties and/or other alternatives they were contemplating. Regardless, there would

be an impetus to ensure that this is considered and management is questioned on their motives.

The Role of Other Sections of the Handbook - CICBV Code of Ethics

The Standards provide specific guidance on the preparation of appraisals (in this instance a fairness opinion). However, broader guidelines as set out in the CICBV Code of Ethics should also be referred to in accepting and then completing a fairness opinion.

General Principles

103 -- A member or registered student shall perform his (her) professional services with integrity, good faith and due care and shall sustain his (her) professional competence by keeping informed of, and complying with, developments in practice standards and recommendations.

General Standards of Conduct

203.1 – A member or registered student shall perform his (her) professional services with integrity, good faith and due care.

203.2 – A member or registered student has a duty, in the practice of his (her) profession, to be competent, conscientious, knowledgeable, diligent, and efficient.

Maintaining Professional Competence (pg. 4)

204 – A member or registered student shall maintain professional competence by keeping informed of, and complying with, developments in the Institute's Practice Standards and Recommendations in all functions in which he (she) practices. A member or registered student shall not undertake to provide professional services, which he (she) is not competent to provide

by virtue of training or experience or is unable to become competent without undue delay, risk or expense to the client.

With reference to the six deficiencies noted by the Enron Examiner (accepting his version of fact) it can be seen that each of these principles were violated.

Conclusion

After reviewing the Enron matter it is clear that the potential for a fairness opinion file to go astray is high. The CICBV Handbook standards provide a general framework and some guidance, but the exercise of sound judgment by the appraiser is vital in not only completing the analysis of the company of interest, but also in ensuring that the correct skill set is brought to the file in delivering an analysis that adequately meets the end user's needs.

"For more information, visit the CICBV website at: http://www.cicbv.ca/aboutus/documents/2004PracticeStandardsAppendixB-website_000.pdf

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BY ROGER J. GRABOWSKI MA, ASA

Equity Risk Premium: What Is the Current Evidence?

Do you still use the historical realized equity premiums since 1926 as reported in Ibbotson Associates' *SBBI Yearbook* when you develop your discount rates?¹ Are you aware of recent research questioning the use of those realized equity premiums as an estimate of the equity risk premium (ERP)?^{2,3} Or do you simply choose to ignore the research?

ERP is a forward-looking concept. ERP is an expectation as of the valuation date for which no "market quotes" are observable. While you can observe premiums realized over time by referring to historical data, such calculated premiums serve only as estimates for the expected ERP. If we are to truly mimic the market, then our goal should be to estimate the true expected ERP as of the valuation date. To do that you need to look beyond the realized premiums.

While there is no one universally accepted standard for estimating ERP, you need to be aware of recent research and not blindly continue using the historical realized equity premiums reported in the *SBBI Yearbook*. The methods used can be broadly categorized into one of two approaches: the Realized Return, or ex post approach, and the Forward-looking Return, or ex ante approach.

Ex Post Approach

The realized return approach employs the premium that investors have realized, on the average, over some historical holding period (historical realized premium). The underlying theory is that the past provides an indicator of how the market will behave in the future, and investors' expectations are influenced by the historical performance of the market. If periodic (say, monthly) returns are serially independent (i.e., not correlated) and if expected returns are stable through time, the arithmetic average of historical returns provides an unbiased estimate of expected future returns. A more indirect justification for use of the historical approach is the contention that, for whatever reason, securities in the past have been priced in such a way as to earn the returns observed. By using the historical realized premium

in applying the income approach to valuation (i.e., in the discounted cash flow valuation method), one may, to some extent, replicate this level of pricing.

Academics often formulate their research in terms of the equity risk premium relative to Treasury bills. But the variability of Treasury bill returns is such that one can hardly consider them riskless. Further, we are generally valuing closely held businesses. Those investments are generally thought of as long-term, and long-term government bonds are the benchmark security we use in developing discount rates. Therefore, in this article I have reported the research results in terms of the premium over long-term government bonds in calculating the historical realized premium.⁴

In applying the realized return method, the analyst selects the number of years of historical return data to include in the average. One school of thought holds that the future is best estimated using a very long horizon of past returns. Another school of thought holds that the future is best measured by the (relatively) recent past. These differences in opinion result in disagreement as to the number of years to include in the average.

While the 2005 *SBBI Yearbook* contains summaries of returns on U.S. stocks and bonds derived from data accumulated by the Center for Research in Security Prices (CRSP) at the University of Chicago since 1926, good stock market data are available back to 1871, and less reliable data are available from various sources back to the end of the eighteenth century. Data for yields on government bonds are also available for these periods.⁵ Table 1 displays realized average annual premiums of stock market returns (relative to the income return on long-term government bonds) for alternative periods through 2004.

The historical realized premium is measured by comparing the stock market returns realized during the period to the income return on bonds. While the stock market return is not known when investing at the beginning of the period, the rate of interest promised on a long-term government bond is known in terms of the yield to maturity. Therefore, analysts measure the stock market returns realized over the expected returns on bonds. An investor makes a decision to invest in the stock market today by comparing the expected return from that investment to the return on a benchmark security (in this case, the long-term government bond) given the rate of return today on that benchmark security. The realized return approach is based on the expectation that history will repeat itself and such a premium return will again be realized (on the average) in the future.

Table 1
Historical Realized Equity Risk
Premiums: Stock
Market Returns vs. Treasury Bonds

| Period | Arithmetic Average (%) | Geometric Average (%) |
|------------------------|------------------------|-----------------------|
| 20 Years (since 1985) | 7.4 | 6.1 |
| 30 Years (since 1975) | 6.9 | 5.8 |
| 40 Years (since 1965) | 4.4 | 3.1 |
| 50 Years (since 1955) | 5.6 | 4.3 |
| 79 Years (since 1926) | 7.2 | 5.2 |
| 105 Years (since 1900) | 6.8 | 4.9 |
| 133 Years (since 1872) | 5.2 | 4.3 |
| 207 Years (since 1798) | 5.1 | 3.6 |

Selection of the Observation Period

The historical realized premium derived from realized returns is sensitive to the period chosen for the average. For example, if one includes in the average only observed premiums in the immediate past period, that ex post premium may be the inverse of the ex ante estimate analysts are looking to develop. Almost all practitioners who use historical data focus on a longer-run view of

historical returns. But selection of the period over which to measure those returns is key.

The selection of 1926 as a starting point is a happenstance of the arbitrary selection of that date by the founders of the CRSP database. The average calculated using 1926 return data as a beginning point may be too heavily influenced by the unusually low interest rates during the 1930s to mid-1950s. Some observers have suggested that the period, which includes the 1930s, 1940s, and the immediate post-World War II boom period, may have exhibited an unusually high average realized return premium. If we disaggregate the 79 years reported in the *SBB* *Yearbook* into two subperiods, the first covering the periods before and after the mid-1950s, we get the following comparative figures for stock and bond returns as shown in Table 2.

The period since the mid-1950s has been characterized by a more stable stock market and a more volatile bond market compared to the earlier period. Interest rates have become more volatile in the latter period.⁶ The effect is amplified in the volatility of bond total returns.⁷ These data indicate that the *relative* risk of stocks versus bonds is lower today, which indicates that the equity risk premium is likely lower today as well.

Evidence since 1871 clearly supports the premise that the difference between stock yields and bond yields is a function of the long-run difference in volatility between stocks and bonds.⁸ If one examines the volatility in real (with inflation removed) stock returns (as measured by the rolling ten-year average standard deviation of real stock returns), one finds that the volatility beginning in 1929 dramatically increased and that the volatility since the mid-1950s has returned to prior levels.⁹ Thus, the historical arithmetic average realized premium reported in the *SBB* *Yearbook* as measured from 1926 likely overstates expected returns as of 2005.

If the average expected return on stocks has changed through time, averages of realized returns using the longest available data become questionable. A short-run horizon may give a better estimate if changes in economic conditions have created a different expected return environment than that of more remote past periods. For example, why not use the average realized return over the past twenty-year period? A drawback of

using averages over shorter periods is that they are susceptible to large errors in measuring the true ERP due to high volatility of annual stock returns. Also, the average of the realized premiums over the past twenty years may overstate today's expected returns due to the general downward movement of interest rates since 1981.

Even using long-term observations, the volatility of annual stock returns is high. For example, the standard deviation of the realized average return for the entire seventy-nine-year period 1926-2004 is approximately 20%. Even assuming that the seventy-nine-year average gives an unbiased estimate, a 95% confidence interval for the unobserved true ERP still spans a range of approximately 4.3%-10.1%.

Which Average – Arithmetic or Geometric?

Realized return premiums measured using geometric (compound) averages are always less than those using the arithmetic average. Choosing which average to use remains a matter of disagreement among practitioners. The arithmetic average receives the most support in the literature.¹⁰ Other authors recommend a geometric average.¹¹ Still others support something in between.¹²

The use of the arithmetic average relies on the assumption that (1) market returns are serially independent (not correlated) and (2) the distribution of market returns is stable (not time-varying). Under these assumptions, an arithmetic average

gives an unbiased estimate of expected future returns. Empirical studies generally indicate a fairly low degree of serial correlation, supporting use of the arithmetic average. Moreover, the more observations, the more accurate the estimate will be.

But even if one agrees that stock returns are serially independent, the arithmetic average of one-year realized premiums may not be the best estimate of future premiums. Textbook models of stock returns (e.g., CAPM) are generally single-period models that estimate returns over unspecified investment horizons. As the investment horizon increases the arithmetic average of realized premiums decreases asymptotically to the geometric average of the entire realized premium series. As a result, some recommend using the midpoint of the arithmetic average of one-year realized premiums and the geometric average of the entire realized premium series as the best estimate of the future premiums when one is using historical realized premiums as the basis for their future ERP estimate.¹³

Expected ERP versus Realized Equity Premiums

Much has recently been written comparing the realized returns as reported in sources such as the *SBBI Yearbook* with the ERP that must have been expected by investors given the underlying economics of publicly traded companies (i.e., expected growth in earnings or expected growth in dividends) and the underlying economics of the economy (i.e., expected growth in gross domestic product). Such studies conclude that investors could not have expected as large an ERP as the equity premiums actually realized.

For example, Eugene Fama and Kenneth French examine the unconditional expected stock returns from fundamentals, estimated as the sum of the average dividend yield and the average growth rate of dividends or earnings derived from studying historical observed relationships for 1872-2000.¹⁴ They conclude that investors during the period 1951-2000 should have expected an ERP

Table 2
Historical Realized Returns:
Relative Volatility of
Stock Returns to Bond Returns

| | Realized Equity Risk Premiums over Treasury Bond Income Returns: Nominal (i.e., without Inflation Removed) | |
|---------------------------------|--|-----------|
| | 1926-1957 | 1958-2004 |
| Arithmetic Averages (%) | 9.5 | 5.6 |
| Geometric Average (%) | 6.6 | 4.3 |
| Standard Deviations: | | |
| Stock Market Annual Returns (%) | 24.8 | 16.9 |
| Long-Term Treasury Bond: | | |
| Income Returns (%) | .5 | 2.4 |
| Total Returns (%) | 4.9 | 11.1 |
| Ratio of Equity to Bond: | | |
| Total Return Volatility | 5.0 | 1.5 |

lower than the actual realized premium over Treasury bills. Their calculations indicate an expected ERP of approximately 2.9% and 4.5% (after converting their results to the equivalent arithmetic average premium over long-term government bonds).¹⁵ Fama and French believe that the greater premium realized during those years was due to an unanticipated decline in the discount rate. They report:

The bias-adjusted expected return estimates for 1951 to 2000 from fundamentals are a lot (more than 2.6 percent per year) lower than bias-adjusted estimates from realized returns. Based on this and other evidence, our message is that the unconditional expected equity premium of the last 50 years is probably far below the realized premium.^{14,16}

Roger Ibbotson and Peng Chen report on their study of estimated forward-looking long-term sustainable equity returns and expected ERPs.¹⁷ They first analyzed historical equity returns by decomposing returns into factors including inflation, earnings, dividends, price-to-earnings ratio, dividend-payout ratio, book value, return on equity, and gross domestic product per capita. They forecast what could have been expected as an ERP through supply-side models built from historical data. In the most recent update to this study reported in the *SBBi Yearbook*, Ibbotson Associates determined that the long-term ERP that could have been expected given the underlying economics was approximately 6.1% on an arithmetic basis (for 1926–2004) compared to the historical realized risk premium of 7.2%. The greater-than-expected historical realized equity returns were caused by an unexpected increase in market multiples relative to economic fundamentals (i.e., decline in the discount rates).

What caused the decline in discount rates that led to the unexpected capital gain? The marginal income tax rate declined (the marginal tax rate on corporate distributions averaged 43% in the 1955–1962 period and averaged only 17% in the 1987–2000 period), and equity investments could not be

held “tax free” in 1962. By 2000, however, equity investment could be held “tax deferred” in defined benefit and contribution pension plans and in individual retirement accounts. The decrease in income tax rates on corporate distributions and the inflow of retirement plan investment capital into equity investments combined to lower discount rates and increase market multiples relative to economic fundamentals.¹⁸

Assuming that investors did not expect such changes, the true ERP during this period has been less than the historical realized premium calculated as the arithmetic average of excess returns realized since 1926. Further, assuming that the likelihood of changes in such factors being repeated are remote, and investors do not expect another such decline in discount rates, the true ERP as of today can also be expected to be less than the historical realized premium.

Ex Ante Approaches

Merrill Lynch publishes “bottom-up” expected return estimates for the S&P 500 stock index derived from averaging return estimates for stocks in the S&P 500. While Merrill Lynch does not cover every company in the S&P 500 index, it does cover a high percentage of the companies as measured in market value terms. Merrill Lynch uses a multistage dividend discount model to calculate expected returns for several hundred companies using projections from its own securities analysts. The resulting data are published monthly in the Merrill Lynch publication *Quantitative Profiles*. The Merrill Lynch expected return estimates have indicated an implied ERP ranging from 3% to 7% in recent years, with an average over the last fifteen years of approximately 4.6%. The expected premium was approximately 5.9% at the end of 2004.

One survey of more than 500 finance and economics professors at leading universities found that, for long-term investments, the median forecast ERP (premium over Treasury bills) was 5%, with the interquartile range of 4%–7%.¹⁹ Adjusting for the horizon premium for long-term bonds versus Treasury bills, these results translate to a median forecast ERP (premium over Treasury bonds) of 3.6%, with an interquartile range of 2.6%–5.6%.

Another study reports the results from a series of surveys of chief financial officers of U.S. corporations conducted from mid-2000 to the end of 2004. That study reports that the range of ERP given a ten-year investment horizon was 3.6%–4.7% (premium over ten-year Treasury bonds). The most recent survey reports an ERP given a ten-year investment horizon was 3.3%.²⁰

Elroy Dimson, Paul Marsh, and Mike Staunton studied the realized equity returns and historical equity premiums for sixteen countries (including the United States) from 1900 to the end of 2002.²¹ They observe larger equity returns earned in the second half of the twentieth century compared to the first half due to (1) corporate cash flows growing faster than investors anticipated fueled by rapid technological change and unprecedented growth in productivity and efficiency, (2) transaction and monitoring costs falling over the course of the century, (3) inflation rates generally declining over the final two decades of the century, and the resulting increase in real interest rates, and (4) required rates of return on equity declining due to diminished business and investment risks. They conclude that the observed increase in the overall price-to-dividend ratio during the century is attributable to the long-term decrease in the required risk premium and that the decrease will not continue into the future. After removing the growth in the overall price-to-dividend ratio and assuming that the standard deviation of annual returns on equity will approximately equal the historical standard deviation, their analysis indicates an estimate of ERP in early 2003 of approximately 5.7% (arithmetic average) versus government bonds.²² The authors note that

further adjustments should almost certainly be made to historical risk premiums to reflect long-term changes in capital market conditions. Since, in most countries corporate cash flows historically exceeded investors' expectations, a further downward adjustment is in order.²³

They conclude that a further downward adjustment in the expected ERP of approximately 100 basis points is plausible.

Professor Dimson recently presented an update of this work to 2005. His current estimates of the ERP are essentially equivalent to his earlier estimates.²⁴

The *SBBI Yearbook* reports on an update to the

work authored by Roger Ibbotson and Peng Chen, forecasting ERP based on the contribution of earnings growth to price to earnings ratio growth and on growth in per capital gross domestic product (a "supply-side" approach).²⁵ They remove the increase in historical returns due to the overall increase in price-to-earnings ratio from 1926 to 2004, resulting in an estimate of ERP at the end of 2004 of approximately 6.1% (arithmetic average).

William Goetzmann and Roger Ibbotson, commenting on the supply-side approach of estimating expected risk premiums, note:

These forecasts tend to give somewhat lower forecasts than historical risk premiums, primarily because part of the total returns of the stock market have come from price-earnings ratio expansion. This expansion is not predicted to continue indefinitely, and should logically be removed from the expected risk premium.²⁶

Tim Koller, Marc Goedhart, and David Wessels conclude on their assessment of the research and evidence:

Although many in the finance profession disagree about how to measure the [ERP], we believe 4.5 to 5.5 percent is the appropriate range.²⁷

Conclusion

Estimating the ERP is one of the most important issues when you estimate the cost of capital of the subject business. One needs to consider a variety of alternative sources including examining realized returns over various periods and employing forward-looking estimates such as those implied from projections of future prices, dividends, and earnings.

What is a reasonable estimate of ERP in 2005? While giving consideration to long-run historical arithmetic averages realized returns, I conclude that the post-1925 historical arithmetic average of one-year realized premiums as reported in the *SBBI Yearbook* results in an expected ERP estimate that is too high.

Dimson, Marsh, and Staunton find a historical expected premium that is lower than the post-1900 historical realized premium. Even Ibbotson Associates finds a historical expected premium that is lower than the post-1925 historical realized premium. Other researchers using analogous approaches have indicated even lower historical expected premiums. Moreover, long-run historical averages over alternative periods generally indicate a lower premium than the post-1925 average.

Some appraisers express dismay over the necessity of considering a forward ERP since it adds complexity to their cost-of-capital calculations. They ask why they should change their current practice of relying exclusively on the post-1925 historical arithmetic average of one-year realized premiums reported in the *SBB* Yearbook as their estimate of the ERP. My reply is that valuation is a forward-looking concept, not an exercise in mechanical application of formulas. Correct valuation requires applying value drivers reflected in today's market pricing. Appraisers readily accept that current market multiples (e.g., price-to-earnings multiples) may differ from historical multiples and that current market multiples reflect a market consensus of current expectations. Why should they be reluctant to examine current expectations as to the ERP? Our role as appraisers is to mimic the market. In my experience, one often cannot match current market pricing for equities using the post-1925 historical arithmetic average of one-year realized premiums as the basis for developing discount rates.

After considering the evidence, any reasonable long-term estimate of the normal ERP as of 2005 should be in the range of 3.5% to 6%.

Where in this range is the current ERP? Research has shown that ERP is cyclical during the business cycle. When the economy is near or in recession (and reflected in the relatively low prices of stocks), the *conditional* ERP is more likely to be at the higher end of the range. When the economy improves

(with expectations of improvements reflected in higher stock prices), the *conditional* ERP moves toward the mid-point of the range. When the economy is near its peak (and reflected in the relatively high prices of stocks), the conditional ERP is more likely at the lower end of the range. I will let the reader decide where his valuation date lies in the business cycle. But currently I believe a reasonable current estimate of the ERP is approximately 5%.

Endnotes

1. Ibbotson Associates, *Stocks, Bonds, Bills and Inflation Valuation Edition Yearbook (SBB* Yearbook) (Chicago: Ibbotson Associates, published yearly).
2. Readers interested in more detailed information on the ERP issue are invited to attend the American Society of Appraisers' Center for Advanced Business Valuation Studies Cost of Capital course and to read Roger J. Grabowski and David W. King, "Equity Risk Premium," in *The Handbook of Business Valuation and Intellectual Property Analysis*, ed. Robert F. Reilly and Robert P. Schweihs (Columbus, OH: McGraw-Hill, 2004), chap. 1, pp. 3-30, "Equity Risk Premium: What Valuation Consultants Need to Know about Current Research," *Valuation Strategies* (September/October 2003), and "Equity Risk Premium: What Valuation Consultants Need to Know about Current Research - 2005 Update," *Valuation Strategies* (September/October 2005).
3. The equity risk premium (ERP; sometimes referred to as the market risk premium) is defined as the extra return (over the expected yield on government securities) that investors expect to receive from an investment in a diversified portfolio of common stocks. $ERP = R_m - R_f$, where R_m is the expected return on a fully diversified portfolio of equity securities and R_f is the rate of return expected on an investment free of default risk.
4. In applying the ERP in, say, the CAPM, one must use the return on a risk-free security with a term (maturity) consistent with the benchmark security used in developing the ERP. For example, this article measures ERP in terms of the premium over that of long-term

- government bonds. In CAPM, $k_e = R_f + (\text{Beta} \times \text{ERP})$. The R_f used as of the valuation date should be the yield on a long-term government bond because the data cited herein have been developed comparing equity returns to the income return (i.e., the yield promised at issue date) of long-term government bonds.
5. See Lawrence Fisher and James Lorie, "Rates of Return on Investments in Common Stocks," *Journal of Business* 37, no. 1(1964): 1-21; Jack W. Wilson and Charles P. Jones, "A Comparison of Annual Stock Market Returns: 1871-1925 with 1926-1985," *Journal of Business* 60, no. 2 (1987): 239-258; G. William Schwert, "Indexes of Common Stock Returns from 1802 to 1987," *Journal of Business* 60, no. 3 (1990): 239; Roger Ibbotson and Gary P. Brinson, *Global Investing* (Columbus, OH: McGraw-Hill, 1993); Jack W. Wilson and Charles P. Jones, "An Analysis of the S&P 500 Index and Cowles's Extensions: Price Indexes and Stock Returns, 1870-1999," *Journal of Business* 75, no. 3 (2002): 505; Stephen Wright, "Measures of Stock Market Value and Returns for the US Nonfinancial Corporate Sector, 1900-2000," *Review of Income and Wealth* 50, no. 4 (2004): 561-584; William N. Goetzmann, Roger G. Ibbotson, and Liang Peng, "A New Historical Database for the NYSE, 1815 to 1925: Performance and Predictability," *Journal of Financial Markets* 4 (2001): 1-32; Elroy Dimson, Paul Marsh, and Mike Staunton, *Triumph of the Optimists: 101 Years of Global Investment Returns* (Princeton, N.J.: Princeton University Press, 2002), with annual updates of their Global Returns data-base for sixteen countries including the United States, available at www.ibbotson.com.
 6. As reflected in Ibbotson Associates' Long-Term Treasury Bond Income Return statistics.
 7. As reflected in Ibbotson Associates' Long-Term Treasury Bond Total Returns, which include the capital gains and losses associated with interest rate fluctuations.
 8. Clifford S. Asness, "Stocks versus Bonds: Explaining the Equity Risk Premium," *Financial Analysts Journal* 56, no. 2 (March/April 2000): 96.
 9. Laurence Booth, "The Capital Asset Pricing Model: Equity Risk Premiums and the Privately-Held Business," paper presented at the 1998 Canadian Institute of Chartered Business Valuators/American Society of Appraisers Joint Business Valuation Conference, Toronto, September 1998, p. 23.
 10. E.g., Paul Kaplan, "Why the Expected Rate of Return Is an Arithmetic Average," *Business Valuation Review* 14, no. 3 (September 1995): 126; 2005 *SBBI Yearbook* (n. 1 above), pp. 75-77; Mark P. Kritzman, "What Practitioners Need to Know about Future Value," *Financial Analysts Journal* 50, no. 3 (May/June 1994): 12; Zvi Bodie, Alex Kane, and Alan J. Marcus, *Investments* (Chicago: Richard D. Irwin, Inc., 1989), p. 720.
 11. E.g., Aswath Damodaran, *Investment Valuation*, 2d ed. (New York: John Wiley & Sons, Inc., 2002), p.161.
 12. Tom Copeland, Jim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies*, 3d ed. (New York: John Wiley & Sons, Inc., 2000), p. 218; Tim Koller, Marc Goedhart and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, 4th ed. (New York: John Wiley & Sons, Inc., 2005), pp. 299- 302; Bradford Cornell, *The Equity Risk Premium* (New York: John Wiley & Sons, Inc., 1999), p. 36; J. Michael Julius, "Market Returns in Rolling Multi-year Holding Periods: An Alternative Interpretation to Ibbotson Data," *Business Valuation Review* 15, no. 2 (June 1996): 57.
 13. Note 12 above.
 14. Kenneth R. Fama and Eugene French, "The Equity Premium," *Journal of Finance* 75, no. 2 (April 2002): 637.
 15. Fama and French estimate that the expected ERP using dividend growth rates was approximately 2.55%, and approximately 4.32% using earnings growth rates (geometric averages compared to Treasury bills). One method of converting the geometric average into an arithmetic average is to assume the returns are independently log-normally

- distributed over time. Then the arithmetic and geometric averages approximately follow the relationship: Arithmetic average of returns for the period = Geometric average of returns for the period + (variance of returns for the period/2). These are approximately equivalent to arithmetic average realized premium of 4.1% and 5.8% compared to Treasury bills. The arithmetic average realized premium (relative to Treasury bills) for 1951–2000 was 8.74%. The approximate differences (relative to Treasury bonds) are $(8.74\% - 4.1\% - \text{horizon premium of } 1.19\%) = 3.45\%$ and $(8.74\% - 5.8\% - 1.19\%) = 1.75\%$.
16. Fama and French.
 17. Robert G. Ibbotson and Peng Chen, “Long-Run Stock Returns, Participating in the Real Economy,” *Financial Analysts Journal* 59, no. 1 (January/February 2003): 88, updated in the 2005 *SBBI Yearbook*, pp. 90–96.
 18. Ellen R. McGrattan and Edward C. Prescott, “Is the Market Overvalued?” *Federal Reserve Bank of Minneapolis Quarterly Review* 24 (2000): 20–40, and “Taxes, Regulations and Asset Prices,” Federal Reserve Bank of Minneapolis Working Paper no. 610, July 2001.
 19. Ivo Welch, “The Equity Premium Consensus Forecast Revisited,” Cowles Foundation Discussion Paper no. 1325, Yale University, New Haven, CT, September 2001.
 20. John R. Graham and Campbell R. Harvey, “Expectations of Equity Risk Premia, Volatility and Asymmetry from a Corporate Finance Perspective,” National Bureau of Economic Research Working Paper No. 8678, December 2001, updated quarterly by *Duke CFO Outlook Survey* (www.cfosurvey.org).
 21. Elroy Dimson, Paul Marsh, and Mike Staunton, “Global Evidence on the Equity Premium,” 15–4 *Journal of Applied Corporate Finance* 15, no. 4 (Summer 2003): 27–38.
 22. Based on my conversion of premium over total returns on bonds as reported by the authors to premium over income returns on bonds and removing the impact of the growth in price-dividend ratios from the geometric average historical premium (3.8% on a geometric basis) converted to an approximate arithmetic average.
 23. Dimson, Marsh and Staunton, “Global Evidence on the Equity Premium.” p. 13.
 24. Elroy Dimson, “Global Evidence on the Equity Risk Premium” National Association of Certified Valuation Analysts 12th Annual Consultant’s Conference, Philadelphia, June 2005. See also *The Global Investment Returns Yearbook 2005* (ABN-AMRO/London Business School, 2005).
 25. Ibbotson and Chen; Roger Ibbotson, “Equity Risk Premium Forum,” Association for Investment Management and Research, New York City, November 8, 2001, pp. 100–104, 108.
 26. William N. Goetzmann and Roger G. Ibbotson, “History and the Equity Risk Premium,” Yale International Center for Finance Working Paper no. 05–04, New Haven, CT, April 2005, p 8.
 27. Koller et al. (n. 12 above), p 306. Roger

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