

# Cross-Examination Techniques for Financial Experts

By Mark H. Sobel and Barry S. Sobel

Often, the largest economic dispute in the context of a divorce trial has nothing to do with the marriage, the lifestyle or the parties' respective contributions to the marriage. Rather, it is the evaluation and determination of the fair value of a closely held business subject to equitable distribution. This article will explore the cross-examination techniques that we believe are effective in demonstrating to the tribunal the subjective nature of expert testimony and the various ways to attack those subjective determinations by the experts.

While expert opinion is allowed under Evidence Rule 702 to provide the tribunal with an assessment of the value of a closely held business, these evaluations are fraught with significant subjectivity. Thus, while it enters the Court's domain through expert testimony, this expert testimony is far from a precise science. In fact, existing case law confirms that business valuation "is not an exact science." Cases both within our matrimonial spectrum such as *Bowen*<sup>1</sup> and *Levine*<sup>2</sup> set forth a clear acknowledgment that business valuation is far from an objective scientific analysis. In fact, relying upon those cases, our Supreme Court in *Balsimides*<sup>3</sup> and *Lawson Mardon Wheaton, Inc.*<sup>4</sup> clearly opine that such types of analysis are far from a purely objective evaluation.

Given the above, any cross-examination of a forensic expert should include questioning the witness to confirm that what they engaged in was not a science, was not precise, carried a significant amount of subjectivity, and that reasonable minds could differ on ultimate conclusion. This should be the first area of inquiry during cross-examination so that the Court has within its mental impressions prior to the precise facts of your case the level of subjectivity involved. This clear understanding should include that what the Court is hearing is a subjective view (although based upon objective facts), which can be interpreted in a variety of ways by a variety of experts, all of whom may reach a variety of conclusions. After exploring the initial overall conceptual framework that the entirety of this expert's opinion has in it a great deal of subjectivity, the cross-examination should next focus upon the clearly subjective components

of the evaluation. Most business valuations in our area of practice generally use either a "discounted cash flow" or an "excess earnings" methodology, both of which focus upon the normalized income of the entity and project a value based upon that normalized income. If the valuation is a valuation based upon net assets, or another non-income-based model, the analysis of the cross examination must be varied to deal with that specific methodology. However, since most valuations are based upon what we call an "income model," this article will focus upon these types of reports and the cross-examination flowing therefrom.

Importantly, there are at least four subjective components of an income valuation that you can get virtually every expert to agree are subjective. They are as follows:

1. The normalization of the actual income of the company;
2. The reasonable compensation for the owner of the company;
3. The specific company risk associated with the company; and
4. The long-term growth rate of projected income in the future.

Each one of these four components exists in the valuation, and each one contains subjective evaluations by the expert. It is therefore recommended that each one of these four components be separately examined and a separate admission obtained regarding the fact that these items are subjective. Effective cross-examination in this area must focus upon the adjustments to "normalize" the income of the entity being evaluated. These adjustments generally include a look at prerequisites that the owner obtains from the company, whether that's the use of a car or a cell phone, vacations, expense accounts, and a variety of other potential areas where the actual reported income of the entity is significantly lowered by expenses which are not truly business related. These adjustments represent evaluative judgments which a forensic accountant does not have any specialized knowledge about and, for each of these adjustments, examination as to both the why and the amount of the normalization should be questioned.

Similarly, the reasonable compensation to be paid to essentially replace the “owner,” which generally focuses upon standardized data that may have little to do with the individual requirements of that particular owner, in that particular job, with that particular experience, are again subjective determinations that should be examined. Similarly, the long-term growth projected out for the company (usually at a rate of inflation) needs to be examined as to whether that comports with the actual economic data available at the time period of the valuation for that particular business.

Finally, the specific company risk used in an income model which evaluates the additional risk and the effect of that additional risk on the capitalization rate, must be explored. Generally, this is an area where there is little to no hard data, causing tremendous variations in expert opinions as to a company’s specific risk. By way of limited example, a business which has limited customers is undoubtedly far more risky than a business with many customers, each of which represent a small portion of the overall income of that company. Other areas to examine within this context include: Does one party either have control over the significant customers of the company? Is that client base protected? Are there restrictive covenants in place? All of these areas will provide repeated admissions by the expert that each one of these areas is infused with a significant amount of subjectivity in terms of reaching the conclusions as to these four integral parts of any income valuation model.

An effective cross-examination into these areas requires a substantial amount of preparation and a substantial amount of pre-planned mathematical calculations based upon anticipated testimony from the business evaluator. Many lawyers differ in pursuit of such information and the effectiveness, appropriateness, and strategy of depositing an expert prior to trial. Our experience has been that we generally seek such depositions but do so very differently from the cross-examination technique referenced above. While cross-examination by its notion is adversarial, a deposition need not be, and often should not be as it is an event to gather information. The deposition should include all the factors considered by the expert on these components, all the knowledge that the expert has regarding the business, all the work that the expert undertook relating to this assignment and all information reviewed, all analysis undertaken and all conclusions drawn by that expert on the key components of the conclusion. By so doing, the expert’s trial testimony will

not be allowed to be varied substantially from the report and from the deposition previously provided. Other counsel believe such depositions can sometimes alert the expert to areas of concern in the report and prepare them for that in cross-examination, but careful use of a deposition does not have to run that risk. On balance, knowing the explanation for various points set forth in the expert’s report is a fundamental aspect of the preparation for effective cross-examination of such an expert.

With the above subjectivity components in mind, and with a complete deposition accomplished, the following three areas are essential to an effective cross-examination at trial:

1. Extensive knowledge of the particular business is required. Thus, in order to engage in effective cross-examination, the dynamics of the particular business being evaluated must be known. That includes an examination of the location and operation of the business, any dynamic changes in the business over time, the forecast for the future regarding the specific business and any and all competitive aspects of the business or lack of competitive aspects of the business.
2. A review of all applicable contractual agreements must be undertaken. This would include: examination of any significant contracts regarding business operations (whether leases or existing contracts with customers), as well as the ability for contracts to be altered or renewed. Additionally, the existence of any buy/sell agreements, keyman insurance with subsequent valuation for such keyman policies, and the existence or absence of any restrictive covenants or prohibitions regarding business activity need to be explored as a component of the business evaluator’s examination.
3. The expert should be questioned as to the expert’s previous reports, previous lectures, and previous publications. In this arena, speaking with your colleagues, going to lectures, and obtaining past reports written by expert provide a vital resource of information knowing how that expert handled other cases in which reasonable compensation, long-term growth, specific company risk and normalization of income were evaluated. Such information can provide comparisons to analyze why those aspects of the evaluation differed or did not differ from those presented in the particular case before the court.

After carrying out these objectives, it is important to explore the methodology the expert used. That would include both the valuation process and the valuation

techniques. By way of limited example, even given the use of an income model within the context of our area of practice which is by far the most prevalent methodology, there are components that differ within such an income methodology. For example, discounted cash flow and capitalization of earnings models both use income factors but do so very differently - one anticipates and explains “outlier” year or years and the other does not. If you are seeing different methodologies used by the experts in different reports, questions as to why that methodology was chosen become an important area of examination. This is especially true if a particular expert generally uses one form of income model but in your specific case used a different form of income model.

Next, the expert’s understanding of the standard of value used in New Jersey is an important area of inquiry. Since *Brown*,<sup>5</sup> the standard of fair market value has been replaced by fair value, which is generally thought of as a fair market valuation approach without reduction for marketability discounts or minority discounts. That, however, is a superficial understanding of the standard of value. Fair value may or may not include analysis of those areas, but that should not be the limitation for the analysis. Issues such as value to the holder, the age of the owner, tax deferrals, and excess capital in the business will affect the ultimate valuation and should be explored both in the deposition and then during the cross-examination. *Brown* does not stand for a universal statement that fair value must never allow for minority discounts or marketability discounts. Fact patterns exist which would justify these discounts and should be explored as well.

Similarly, the expert’s opinion as to both active and passive factors which may increase or decrease the value in the business over time need to be analyzed. Active components which deal with the owner’s efforts, determinations, and decisions regarding the trajectory of the business subsequent to the filing of the complaint for divorce may affect the overall valuation but may not be part of the marital enterprise nor divisible as part of the divorce process. Passive factors for which that owner has no effect upon, may result in a different analysis on the spectrum of valuation. In analyzing those factors, they need to be differentiated between those which are specific to that business and those which are of just a general economic nature.

Once an examination of all of these areas of subjectivity and potential reasonable differentiation by experts as to conclusions are completed, the last area of cross-

examination needs to focus on the effects these determinations had on the ultimate value opined by the expert.

This is an area that is often not pursued with a pre-set financial analysis. Often, counsel end the cross-examination after getting effective testimony as to subjectivity and the differentials of that subjectivity without “closing the loop.” To complete the cross-examination of the expert, a chart should be prepared for each one of these subjective evaluation differentials which isolates these differences. This will focus the Court’s attention on the differential and ultimate valuation for this one particular element you are discussing leaving the remaining comments of the expert’s valuation constant. Thus, by way of example, if the reasonable compensation component is an area where there is significant differential of perspective, the gradations of that differential should be laid out so that the Court is aware that for each specific gradation, whether that’s \$10,000 or \$50,000 in terms of reasonable compensation, the ultimate effect on the valuation becomes quite significant. This will further assist the Court in understanding that, while a Court might view the differential as small, the ultimate effect of that differential creates a huge difference in the final conclusion of value. Similarly, the other three subjective components dealing with long-term growth, normalization of income and specific company risk have the same type of statistical variations. Most important among those is the specific company risk where small variations can create significant differences in ultimate value. Once each of those individual differences are then examined, quantified, and the differential in ultimate value of conclusion explored, cumulatively the cross-examination should then package all of these differences to provide the Court with an ultimate differentiation for the combined effect of each one of the subjective variables. In this way, you have provided the Court with the valuation determinations for each one of the differences as well as the valuation determinations for the combination of all of the variables within the same valuation conclusion.

Finally, after providing the Court all of that clear financial data and clear financial conclusions, you may conclude the cross-examination, depending upon which side you are with, by placing that expert at the hypothetical sale of that company and having them opine by switching places – i.e., by placing the expert in the position of now giving advice to the other side as to their willingness to either sell or buy the entity for that value given all of the potential risks to provide the Court with

a realistic real life scenario. You may seek to place the expert at a hypothetical sale negotiation of that company and ask them to opine about their position when that client turns to them and asks you for the professional opinion as to “is that a number I should be buying or selling the entity.” This often provides a real-life scenario for the Court when we are dealing with hypothetical sales that do not routinely occur.

The final three areas for examination should then focus upon if there had been an incremental increase in the value of the business from the time of the marriage to the time of the divorce, why that increase in value occurred. Did it occur due to active efforts by the titled spouse or were general market conditions the primary factor? The use and identification of factors which are passive versus active in this area may have a dramatic impact upon how the incremental increase in growth is treated by the Court by way of equitable distribution. It is therefore important to identify the components of active factors increasing the value of the business and passive factors increasing the value of the business. It is also imperative to cross-examine regarding risk factors that exist as to whether these particular attributes are ones which can be controlled by the business or beyond the control of the business.

Next, the precise billing information of the expert often provides information as to what the expert focused upon, where the expert spent time and what the expert’s concerns were. Inquire about the appropriate level of payment for such a sale and what restrictions would need to be put into place such as restrictive covenants to prevent the taking of the goodwill of that business somewhere else. This is often a perfect juxtaposition of real-life values and realities of purchase versus a theoretical expert’s opinion of value.

The above areas of cross-examination can be used for virtually any business evaluator. While not all of them may produce effective cross-examination, some of them certainly will. They should all be areas for investigation in the preliminary phases of the case so that the cross-examination can focus on the ones that will be most effective for your particular client. The key points to remember is that this examination is an examination of one person’s significantly subjective opinion on value. As a result, that subjective opinion on value also includes that expert’s subjective determinations regarding the economic view of the industry, the economic view of the economy in general, the subjective determinations as to future growth or not of the business. Such an opinion is never – and should never be -- considered the same as a purely scientific objectively verifiable analysis which is absolute in its nature. By structuring an examination in such a way, using the above principles, the soft underbelly of what had seemed to be scientific absolutes developed during the direct examination of the expert can often become nothing more than an individual’s predilections as to subjective valuation theory and subjective valuation components. If you have the Court thinking along these lines, then you have accomplished your task of conducting an effective cross-examination. ■

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## Endnotes

1. *Bowen v. Bowen*, 96 N.J. 36 (1984).
2. *Levine v. Levine*, 162 N.J. Super. (Ch. Div. 1970).
3. *Balsimides v. Protamen Chemicals, Inc.*, 160 N.J. 352 (1999).
4. *Lawson Mardon Wheaton, Inc. v. Smith*, 160 N.J. 383 (1999).
5. *Brown v. Brown*, 348 N.J. Super. 466 (App. Div. 2002).