The Valuation Trial of *Nellson Nutraceutical*: Emerging Trends and Courtroom Basics

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The recent trial to determine the enterprise value of Nellson Nutraceutical Inc. is noteworthy for bankruptcy litigators because it addresses (1) an emerging trend in bankruptcy cases—multi-layered capital structures—and (2) a courtroom basic: tendering the testimony of an expert witness. In addition, the *Nellson Nutraceutical* case may be read as a cautionary tale—a warning to private-equity sponsors or controlling shareholders against manipulating a debtor's financial projections in hopes of achieving a favorable valuation to find value in an equity position.[2]


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Background

In early January 2006, Nellson Neutraceutical and certain affiliates (collectively, Nellson or debtors) filed petitions for relief under chapter 11 in the bankruptcy court in Delaware. Nellson is a privately-held formulator and manufacturer of nutritional bars for the weight-loss and sports training industries.

Nellson's equity owner is a fund affiliated with the former Fremont Partners (now Calera Capital) (Fremont), a San Francisco-based private-equity firm. Nellson's debt consists of three tranches: (1) first-lien secured debt totaling $255 million; (2) second-lien debt totaling $75 million and (3) unsecured debt to vendors and other unsecured creditors totaling approximately $10 million. Including fees, charges and interest, Nellson owes approximately $365 million to creditors; thus, the equity-holders would not be "in the money" unless the enterprise value of Nellson exceeded $365 million. Each tranche was actively represented during the valuation proceedings: UBS AG, Stamford Brach (UBS) is the administrative and collateral agent for the first and second lienholders; the first lienholders formed an informal committee (informal committee); and the unsecured creditors are represented by the official committee of unsecured creditors (official committee).

Just three months after Nellson filed its petition for relief, pursuant to §506(a), Nellson filed a motion to determine, *inter alia*, the enterprise value of the debtors and the secured claims of the pre-petition secured lenders (the motion). Nellson's motion was generally supported by "significant creditor constituencies." Debtors' Motion, ¶3 (docket number 333). The court set a discovery schedule and a trial date to determine solely the enterprise value of the debtors. The valuation trial began in September 2006, lasted 23 days, and concluded in December 2006.

At trial, the debtors, UBS, the informal committee and the official committee each presented an expert witness to opine on the debtors' enterprise value. Although the experts for UBS, the informal committee and the official committee disagreed over the appropriate valuation methodology and the enterprise value, the three experts "used generally accepted valuation methodologies to arrive at results that are within approximately 10 percent of each other." *Nellson II*, 2007 WL 201134, at *19. Moreover, the creditors' experts agreed that the debtors' enterprise value was less than $365 million, and thus, Fremont's equity was "out of the money." *Id.* at *20.

However, the court was in a "conundrum" because the experts had relied on the debtors' long-range business plan to formulate their valuation opinions, but the evidence at trial "overwhelmingly established that the [long-range business plan] was not management's best and most honest thinking about the debtors' financial future but rather was manipulated at the direction of and in cooperation with the debtors' controlling shareholder to bolster the perceived value of the debtors' business solely for purposes of this litigation." *Nellson II* at *1.

The debtors' expert, James Harris of Seneca Financial Group Inc., tendered an opinion that the debtors' enterprise value was over $404 million, which, if accepted, would put Fremont in the money. Unlike the creditors' experts—and contrary to standard valuation practice—Mr. Harris based his valuation exclusively on a discounted cash-flow analysis (DCF) and did not rely on two other standard valuation methodologies—a comparable transaction analysis or a comparable company analysis. *Nellson I* at 371. In addition, in performing his DCF analysis, Mr. Harris used a metric of value for determining the debtors' terminal value that is typically used as a credit statistic, not as a cornerstone of a valuation opinion. *Id.* at 374.

Following Mr. Harris' testimony, UBS and the informal committee filed a motion *in limine* (in which the official committee later joined) to exclude Mr. Harris' testimony and his expert report. The court held that Mr. Harris' testimony was not reliable and therefore not admissible under Federal Rule of Evidence 702. *See, generally, Nellson I.* After considering the creditors' expert's opinions, the court made an *ex post* adjustment to the opinions to compensate

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Feature

1 This article represents the views of the author and not necessarily the views of Barack Ferrazzano.

2 See In re Nellson Neutraceutical Inc., 2007 WL 201134, *19 (Bankr. D. Del. Jan. 18, 2007) ("In sum, Fremont [the private equity sponsor] utilized its control over Nellson to manipulate both the business planning and valuation process to come up with an artificially inflated enterprise value in order to claim some residual value for their existing equity position. There is no other credible interpretation of the evidence before the court."). The valuation trial resulted in two reported decisions: In re Nellson Neutraceutical Inc., 356 B.R. 364 (Bankr. D. Del. 2006) (decision regarding admissibility of debtors' expert witness' testimony and report) (hereinafter "Nellson I"), and the aforementioned In re Nellson Neutraceutical Inc., 2007 WL 201134 (Bankr. D. Del. Jan. 18, 2007) (hereinafter "Nellson II") (decision regarding the valuation of debtors' enterprise value). On May 3, 2007, the debtors filed an application for authority to retain a financial advisor to provide the debtors with services relating to a sale transaction. That matter is set for hearing on May 25, 2007 (docket number 1288), when this issue went to press.

for the manipulated long-range business plan and the debtors' deteriorating business, and concluded that the debtors' enterprise value is $320 million, which put Fremont out of the money. *Nellson II* at *1.

Early Valuation of Collateral when First- and Second-Lien Lenders Are Involved

The *Nellson Nutraceutical* case illustrates the added complexity that second-lien lenders can present when seated at the negotiation table. A multi-layered capital structure with cross-ownership over debt tranches can complicate negotiations and frustrate a consensual reorganization plan. To facilitate a consensual plan, a debtor with multi-layered capital structures may seek to address valuation issues early in the case before the plan-confirmation process. Indeed, Nellson sought an early valuation because of the "enormous divergence of opinion" regarding the debtors' capital structure and enterprise value, and "all significant creditor constituencies agree[d] that litigation of the 'valuation issue' [was] a necessary predicate to a consensual plan of reorganization." Debtors' Motion, ¶¶1, 24 (docket number 333).

A valuation of the secured creditors' collateral early in the bankruptcy case may significantly alter the dynamics of the case. If the court determines that first and second lienholders are fully secured, then there will likely be little inter-creditor dispute over valuation. If, however, there is not enough security for first lienholders, then disputes with second-lien lenders will likely arise. Further, if second lienholders are partially secured or unsecured, second lienholders will likely have diminished negotiating leverage. Thus, an early determination of the value of the secured parties' collateral may directly influence the course of inter-creditor negotiations and determine whether a consensual plan is feasible.

Admissibility of Expert Testimony

The *Nellson* case is also instructive for its analysis of the admissibility of expert witness testimony. Obviously, the debtors' valuation strategy backfired. What went wrong?

Fed. R. Evid. 702 provides:

> If scientific, technical or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training or education may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

Fed. R. Evid. 702.

The proponent of the testimony—in this case, the debtors—bears the burden of demonstrating by a preponderance of the evidence that the evidence is admissible. *Nellson I* at 372 (*citing Daubert v. Merrell Dow Pharms.*, 509 U.S. 570, 592, n.10 (1993)). "Rule 702 embodies a trilogy of restrictions on expert testimony: qualification, reliability and fit. All three criteria must be met before the court can admit the testimony into evidence." *Id.* at 366-67, (*citing Schneider v. Fried*, 320 F.3d 396, 402 (3d Cir. 2003)). Despite extensive *voir dire* by UBS and the informal committee challenging Mr. Harris' qualifications as a valuation expert, the court determined that Mr. Harris was qualified as an expert on enterprise valuation. *Id.* at 372. The second and third requirements for the admission of expert testimony requires the trial court to ensure that the "expert's testimony both rests on a reliable foundation and is relevant to the task at hand." *Id.,* (*citing Daubert*, 509 U.S. at 597).

The Supreme Court has identified several factors that may be considered when deciding whether an expert's testimony is reliable: (1) whether a technique can be, and has been, tested; (2) whether the technique has been subjected to peer review and publication; (3) a technique's known or potential rate of error and the existence and maintenance of standards controlling the technique's operation; and (4) whether the technique has gained general acceptance in the relevant scientific community. *Id.* (internal citations omitted); *see also Daubert*, 509 U.S. at 593-94; *Kumho Tire Co. Ltd. v. Carmichael*, 526 U.S. 137 (1999) (extending the *Daubert* standard to nonscientific testimony). The Third Circuit has identified three additional factors that courts should consider along with the *Daubert* factors: (1) the degree to which the expert testifying is qualified, (2) the relationship of a technique to more-established modes of scientific analysis and (3) the nonjudicial uses to which the scientific technique are put. *Id.* at 373 (*citing United States v. Downing*, 753 F.2d 1224, 1238-39 (3d Cir. 1985)). The Third Circuit has explained that the "test of admissibility is not whether a particular scientific opinion has the best foundation, or even whether the opinion is supported by the best methodology or unassailable research. Rather, the test is whether the particular opinion is based on valid reasoning and reliable methodology." *Id.* at 373, (*citing In re TMI Litigation*, 193 F.3d 613, 665 (3d Cir. 1999), *amended on other grounds,* 199 F.3d 158 (2000), *cert. denied,* 530 U.S. 1225 (2000)).

Expert testimony must also be relevant to be admissible. *Id.; see also* Fed. R. Evid. 702. "If the factual basis of an expert's opinion is so fundamentally unsupported because the expert fully relies on altered facts and speculation, or fails to consider the relevant facts in reaching a conclusion, the expert's opinion can offer no assistance to the trier of fact, and is not admissible on relevance grounds." *Nellson I* at 373 (internal citations omitted).

After considering the *Daubert* factors and the additional factors cited by the Third Circuit, the *Nellson Neutraceutical* court concluded that Mr. Harris' testimony was not admissible because it was not reliable. *See, generally, Nellson I* at 374-76. Specifically, the court found that the Mr. Harris' use of a particular metric (EBITDA minus Cap Ex) to calculate the debtors' terminal value under his DCF analysis was "unprecedented both in the legal context and in the relevant scientific community." *Id.* at 374. The court held that Mr. Harris "simply invented the methodology...to determine a company's terminal value under a DCF analysis." *Id.* Indeed, Mr. Harris had never previously used the methodology for enterprise valuation, nor had any other testifying expert in any U.S. courts. *Id.* Nor was Mr. Harris able to identify any treatises or articles that validated his methodology. *Id.*

UBS and the informal committee moved to exclude Mr. Harris' testimony on the additional ground that it was not relevant. *Id.* at 377. They argued that Mr. Harris should not have relied upon the debtors' long-range business plan because Mr. Harris knew, or should have known, that the business plan was manipulated by Fremont in anticipation of the valuation trial. *Id.*; *see also Nellson II* at *1. Despite evidence that the debtors'

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private-equity sponsor manipulated the debtor's long-range business plan for purposes of inflating the company's enterprise value, the court did not exclude Mr. Harris's testimony on relevance grounds because the record did not support a finding that Mr. Harris knew or should have known that such data was unreliable. *Id.*

After refusing to admit Mr. Harris' testimony and report into evidence, the court considered the creditors' experts' opinions, made adjustments thereto, and found the debtors' enterprise value to be $320 million, more than 20 percent less than what the debtors contended. *Nellson II* at *1.

Epilogue

Following the court's valuation opinion, the debtors sought approval of a settlement agreement with Fremont and the second-lien lenders that provided, *inter alia*, (1) the debtors' release in favor of Fremont of any claims the debtors' may have against Fremont relating to a $55 million recapitalization dividend paid to Fremont in 2004, and (2) that Fremont would be given 2 percent of any equity in a reorganized debtor. The court denied the debtors' motion.

The debtors had the exclusive right to file a plan until March 26, 2007. To date, no plan has been filed. After "the court had expressed, for lack of a better term, some concern about where the process was at the last hearing," UBS requested a status hearing, which was held on March 29, 2007, to "tell the court where we thought we were, where the process was headed, what land mines we had hit and [what land mines we] managed to miss...." *See* transcript of proceedings on March 29, 2007 (docket number 1230). ■