

2007

William Borghetti v. System & Computer Technology, Inc. : Brief of Appellee

Utah Court of Appeals

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IN THE UTAH SUPREME COURT

WILLIAM BORGHETTI, et al,	:	
	:	
Plaintiffs/Appellants,	:	
	:	Appellate Case No. 20070513-SC
vs.	:	
	:	District Court Case No. 040921012
SYSTEM & COMPUTER	:	
TECHNOLOGY, INC., et al,	:	
Defendants/Appellees.	:	
	:	

**BRIEF OF APPELLEE/CROSS-APPELLANT
(ORAL ARGUMENT REQUESTED)**

**APPEAL FROM THE THIRD JUDICIAL DISTRICT COURT IN
AND FOR SALT LAKE COUNTY, STATE OF UTAH,
HONORABLE JOHN PAUL KENNEDY**

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CLATE C

DEC - 7 2007

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JURISDICTIONAL STATEMENT

The Utah Supreme Court has jurisdiction over this appeal pursuant to Utah Code Ann. § 78-2-2(3)(j), because this is an appeal from a order of the district court over which the Court of Appeals does not have original appellate jurisdiction.

STATEMENT OF THE ISSUES PRESENTED FOR REVIEW

The issues presented on appeal are as follows:

1. Did the district court correctly grant Defendants' Motions for Summary Judgment where Plaintiffs failed to present any evidence that the company in which they held common shares had a value in excess of the company's liquidation preferences?
2. Did the district court err when it denied Defendants' Motion to Strike the Testimony of Plaintiffs' Damages Expert Avner Kalay as mooted by the grant of Defendants' Motions for Summary Judgment.

STANDARD OF REVIEW

A district court's decision to grant or deny summary judgment is reviewed for correctness. *Harline v. Barker*, 912 P.3d 433, 438 (Utah 1996). In conducting this *de novo* review, the appellate court should "apply the same standard as that applied by the trial court." *Durham v. Margetts*, 571 P.2d 1332, 1334 (Utah 1977). The standard applied by the trial court is set forth in Rule 56(c) of the Utah Civil Procedure. Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Utah R. Civ. P. 56(c).

The decision to grant or deny a motion to strike expert testimony is reviewed for an abuse of discretion. *See, e.g., In re G.B.*, 2002 UT 270, ¶ 10, 53 P.3d 963. On appeal, this Court must determine whether the trial court “has exceeded the range of discretion allowed for” decision on a motion to strike. *See Rivera v. State Farm Mutual Automobile Ins. Co.*, 2000 UT 36, ¶ 7 n.2, 1 P.3d 539.

STATEMENT OF THE CASE

In September 2002, Defendant Systems & Computers Technology, Inc. (“SCT”) paid \$42 million for Defendant Campus Pipeline, Inc. (“CP” “Campus Pipeline” or the “Company”). Prior to the SCT merger, Campus Pipeline approached “dozens and dozens” of other companies to gauge their interest in purchasing Campus Pipeline. No company offered anything close to what SCT paid. Because Campus Pipeline had contractually promised the first \$80 million received in any merger to the Company’s preferred shareholders, those shareholders received roughly half of their original investment in the transaction while the common shareholders received nothing.

Plaintiffs, who held common shares, brought this action claiming that the merger with SCT was the product of fraud, unjust enrichment and breach of fiduciary duty. In discovery, Plaintiffs failed to adduce any evidence that the Company had a value that exceeded its liquidation preferences. Indeed, Plaintiffs’ own expert conceded that the Company was worth far less than the \$80 million promised to the preferred shareholders.

Defendants moved for summary judgment. The trial court noted that Plaintiffs had failed to present any evidence that the Company possessed a value in excess of its liquidation preferences and, as a result, correctly concluded that Plaintiffs had failed to present evidence

of damages as a matter of law. The trial court granted summary judgment and denied as moot Defendants' Motion to Strike the testimony of Plaintiffs' expert.

STATEMENT OF FACTS

The following facts were undisputed by Plaintiffs.

The Parties

Campus Pipeline was a software company that provided software to colleges and universities that would permit students to register for classes, pay tuition, and interface with university administration over the Internet. (R. at 4338.) Plaintiff William Borghetti was one of Campus Pipeline's founders. (R. at 1856, 4291.) The other Plaintiffs are Borghetti's family members or entities of which Borghetti and his spouse are the managing members. (R. at 1856, 4291-92.) (For ease of reference, all Plaintiffs will be referred to herein as "Borghetti.") Defendants are the former directors, officers and investors of Campus Pipeline. (R. at 1856-57, 4292-93.)

Campus Pipeline's Beginnings and Efforts to Raise Capital

Defendant SCT was an early customer of, and investor in, Campus Pipeline. In late 1998, SCT agreed to purchase 60% of the Company's common stock for between \$7 and \$7.5 million. (R. at 1860, 4295-96.) To raise funds in August 1999, CP sold preferred shares to venture capitalists and other institutional investors. (R. at 1860, 4296.) These "Series A" investors purchased more than 4.5 million preferred shares at a price of \$6.075 per share for a total investment of approximately \$28 million. (*Id.*) In the spring of 2000, CP sold approximately 3.3 million "Series B" preferred shares at a price of \$16.31 per share for a total investment of almost \$55 million. (*Id.*)

The Series A and Series B preferred shares provided rights not available to common shareholders, including liquidation preferences. These preferences gave CP's preferred shareholders a contractual right to receive the first \$80.9 million received by the Company in any merger to repay their original investment. (R. at 1860-61, 4296-97.) The preferred shareholders would then be permitted to participate in distributions in excess of the liquidation preference until they had received an amount equal to three times their original investment. (R. at 1861, 4296-97.)

Campus Pipeline's Response to Changed Market Conditions

Shortly after the Series B financing had closed, the Internet stock-bubble burst. The economic downturn dramatically impacted CP's business and prospects. By the end of 2000, the Company had lost \$30.9 million. (R. at 1862, 1864, 4298, 4300.) The Company discussed ways it could adapt to the changed economy. For example, in February 2001, CP's executive management team met with its three outside Board Members, Dr. David Gardner, David Peterschmidt and Fred Harman, to discuss CP's business. (R. at 1864, 4300.) The participants discussed the challenges of growing the business given its relationship with SCT. Campus Pipeline was dependent upon SCT as a reseller of its product to SCT's customer base. In fact, 60% of CP's revenue was derived from licenses sold by SCT. (R. at 1871, 4310.) Therefore, any move away from SCT could cause a major loss of revenue if SCT sold products that competed with CP's product. (R. at 1864, 4300-01.)

The participants discussed various responses to the challenges, including surpassing SCT in product development, partnering with other non-SCT vendors, and buying or merging with another company to strengthen the Company's competitive position. (R. at 1864, 4300.)

The participants also discussed dozens of companies that might make attractive partners for CP and how the Company could best pursue relationships with them. (R. at 1864, 4301.)

Efforts to Find a Merger Partner and Continued Financial Losses

Campus Pipeline began to contact companies, such as Sun and IBM, that it believed might have an interest in purchasing CP. (R. at 1866, 4303.) In fact, between April 2001 and September 2002, Scott Doughman, the Campus Pipeline employee primarily charged with exploring merger and acquisition opportunities, contacted over 40 companies about partnering with or acquiring CP. (*Id.*)

At the January 22, 2002 Meeting of the CP Board of Directors, Doughman again discussed CP's prospects. (R. at 1867, 4304.) During the meeting, Doughman described how the burst in the Internet bubble had forced the Company's business plan to change from one based on advertising revenue to one based on licensing its software. (*Id.*) Doughman also detailed the Company's prospects and the types of companies that might be interested in merging with or acquiring CP. (R. at 1867, 4305.) Doughman opined that SCT would likely be willing to pay the most for CP, given CP's strategic importance to SCT. (*Id.*) The Board ultimately authorized the Company to pursue merger discussions with SCT. (*Id.*)

In May 2002, SCT offered to purchase CP. (R. at 1869, 4307.) SCT offered \$33 million in SCT stock with the opportunity to earn \$17 million more in stock over 18 months if the Company hit certain revenue targets. (*Id.*) CP was not happy with the offer, believing it to be a "low-ball" number. (*Id.*)

CP considered a number of responses including not providing a counter-offer, asking SCT to sweeten its offer or countering with an offer of its own. (*Id.*) On May 13, 2002, the

Company retained Defendant Thomas Weisel Partners, LLC (“TWP”) to provide services in connection with a potential merger. (*Id.*) TWP was to be paid \$800,000 if the Company merged with either SCT or Blackboard (another company with whom CP had discussed merging) and a minimum \$1 million fee if the Company merged with an entity other than SCT or Blackboard. (R. at 1869-70, 4307.)

On May 31, 2002, the Company made a counter-offer to SCT of \$75 million with \$50 million to be paid at closing and the opportunity to earn an additional \$25 million over 6 months. (R. at 1870, 4308.) Doughman testified that CP was after “the highest thing it could get.” (*Id.*) CP’s Chief Financial Officer, Tyler Thatcher, described the offer as “the biggest number out there that we can make with a straight face.” (*Id.*)

SCT responded on June 6, 2002 with an email to CP’s outside director Fred Harman. In that email, SCT said that it would not counter the Company’s \$75 million offer. (*Id.*) SCT noted that CP had a “history of missing forecasts” as evidenced by the fact that CP had an “easy” first quarter 2002 revenue target that it did not hit. (*Id.*) SCT recommended that the parties wait until additional results were in to see if SCT would be “in a position to make a meaningful increase to [its] offer.” (*Id.*)

The Company had, indeed, missed its first quarter revenue target and posted a \$5.1 million quarterly loss. (*Id.*) Internally, CP decided that the best response would be to focus on improving its financial position and to re-start discussions with other potential merger partners, like Blackboard and PeopleSoft. (R. at 1870-71, 4308-09.)

For its part, SCT communicated to its board (in a memorandum not shared with CP) that it believed that its May 8 offer had been fair and that the due diligence conducted while

the parties negotiated confirmed that CP had been “fully valued” by the earlier offer. (R. at 1871, 4309.) SCT stated that given the magnitude of CP’s counter-offer, “there was little opportunity to accomplish anything productive during further negotiations.” (*Id.*) SCT told its board that although it hoped ultimately to acquire CP at “an acceptable price and with acceptable terms,” it would be “developing an alternate approach to filling this segment of [its] solution strategy for the higher education market.”¹ (R. at 1871, 4309-10.)

CP closed its second quarter on June 30, 2002. For the first time in its corporate history, CP had achieved its revenue target, having exceeded its \$6.68 million target by \$260,000. (R. at 1872, 4310.) This target was achieved mainly due to the licensing of its product to a large university system and due to the recognition of \$1 million in deferred revenue. (R. at 1873, 4312.) Despite hitting its revenue target, the Company lost \$2.9 million, bringing its losses for the first half of 2002 to approximately \$8 million. (R. at 1872, 4310.) As the second quarter closed, CP continued to recognize the financial struggles it faced. The Company’s Chief Executive Officer sent an email stating that even if the Company met its revenue targets, “[t]wo systems deals do not a company make” and CP still had “serious constraints.” (*Id.*) The “market [was] limited” and CP was “still significantly dependent on SCT.” (R. at 1872, 4310-11.) To maintain \$6 to \$7 million in quarterly revenue, CP “need[ed] a story that [was] greater than [its] current operating plan.” (*Id.*)

¹ Had they been aware of it, SCT’s internal response would have confirmed CP’s management’s fears that SCT was considering selling non-CP products and that if SCT decided to sell a non-CP product, CP could lose 60% of its revenue. (R. at 1871, 4310.)

The Company's Chief Operating Officer testified that the second quarter:

was an abnormally high quarter because of that single transaction. And, you know, sitting from my seat, I was very worried about the, the ability to replicate such performance in a very difficult purchasing period . . . for schools. School higher education budgets were shrinking dramatically. And their willingness to spend on technology related . . . investments . . . was dissipating.

(R. at 1873-74, 4312.) He further testified, "I believed . . . that we were going to run out of money before we broke even." (R. at 1874, 4312.)

Doughman also recognized the problems the Company faced growing revenue. In a June 20, 2002 analysis, Doughman's team examined the revenue targets and recognized that to hit its revenue goals without sales coming from SCT would require CP to sell to its customers three and a half times what SCT, a much larger company, sold to its customers. (R. at 1872, 4311.) The Company concluded that there would be no way to increase revenue without hiring additional employees and incurring additional expenses. (R. at 1873, 4311.)

On August 15, 2002, SCT made another offer to purchase CP. (R. at 1875, 4313.) SCT offered \$35 million in cash and \$5 million in warrants.² (*Id.*) On August 28, 2002, after consultation with TWP, the Company countered SCT's offer. (*Id.*) The CP counter asked for \$42 million in cash. (*Id.*) SCT accepted the counter-offer with some minor modifications. (*Id.*)

² The Company continued to discuss merger opportunities with other companies, including Blackboard. (R. at 1875, 4314.) Eventually, it became clear that whatever offer the Company might receive from Blackboard would be less than SCT's offer. (*Id.*)

On September 5, 2002, the CP Board of Directors held a Special Meeting. (*Id.*) TWP presented the terms of the proposed transaction. (*Id.*) The Board, with the SCT members excused, voted to proceed with a merger with SCT. (*Id.*) Between September 5 and September 30, 2002, SCT and CP (and their lawyers and bankers) exchanged multiple versions of a definitive merger agreement. (R. at 1876, 4315.)

On September 30, 2002, the CP Board of Directors met to discuss the merger. (*Id.*) The SCT-affiliated directors attending the meeting were asked to leave before consideration of the merger took place. (*Id.*) TWP presented a fairness opinion and the non-SCT directors discussed the TWP valuation contained in that opinion. (*Id.*)

By the time TWP presented the fairness opinion, it knew that the financial projections on which the opinion was based likely overstated CP's value. (R. at 1876, 4315-16.) The materials TWP presented to the non-SCT members of the CP Board noted that the Company estimated it would miss its third quarter revenue projections. (R. at 1877, 4316.) TWP concluded that "the significant shortfall in the 3Q '02 revenue, combined with management's view that business conditions are worsening, casts doubts upon the ability of [the Company] to achieve the forecasted growth." (*Id.*)

After discussion, the non-SCT members of the CP Board approved the merger with SCT. (*Id.*) The SCT Board met separately and approved the merger. (R. at 1877, 4316-17.) Even though Borghetti voted his shares against the merger, a majority of CP's shareholders approved merging with SCT. (R. at 1881-82, 4322.)

Despite contacting "dozens and dozens" of companies about a potential acquisition, CP never received an offer "anywhere near" the \$42 million SCT paid. (R. at 1877, 4317.)

Indeed, eCollege made an offer about the time of the SCT merger that translated into an all-stock deal worth only \$27 million. (R. at 1878, 4317.)

The Expert Opinion of Avner Kalay

In March 2006, Borghetti identified Dr. Avner Kalay as an expert witness and presented his report. (R. at 1771, 1789-90.) Kalay did not value CP using any generally accepted appraisal methods (the income, asset, or market approaches). Instead, Kalay treated the “equity” in CP as “a call option to buy the firm assets where the exercise price is \$82.93 million and the time to expiration is 10 years.”³ (R. at 1801.) Kalay used \$82.93 million as the exercise price of this “option” because that is the amount of liquidation preferences he believed would have to be paid to preferred shareholders before any merger consideration could be paid to common shareholders. (R. at 1801.) Kalay chose 10 years as the expiration date of the “options” because that is the time he believed it would have taken CP to pay the preferred shareholders the liquidation preferences. (R. at 1801-04.)

Despite the fact that CP had experienced only one quarter in its entire corporate history where it hit its quarterly revenue target, Kalay assumed that between the years 2004-2015, CP would have enjoyed year after year annual growth of 20%. (R. at 1802.) Kalay admitted that he had conducted no research on CP’s industry to justify that assumption. (R. at 1850-51.) Kalay opined that his bullish growth predictions were actually conservative, because using the Black-Scholes option pricing method: “*projections of more modest growth*

³ Kalay used 10 years to describe his work, but he actually assumed 10.78 years as the expiration date. (R. at 1804.)

of revenues would have *increased the estimate of damages* as a longer time to expiration of the option *increases* its value.” (R. at 1803) (emphasis added).

Kalay’s report opined that CP was worth between \$73.7 million and \$83.2 million at the time of the merger. (R. at 1809.) At his deposition, Kalay made a “very slight modification” which reduced his opinion to a value between \$63.6 million and \$72.9 million. (R. at 1844-46.) After this “very slight” ten million dollar modification, even the high end of Kalay’s valuation *fell millions of dollars below the liquidation preferences* held by the preferred shareholders. (R. at 1883-84, 4324.)

Kalay’s valuation differed materially from five valuations conducted before and after the merger using more traditional valuation analyses, all of which placed the valuation of Campus Pipeline at less than \$45 million based upon 2002 actual and estimated revenues. (R. at 1883-84, 4323-24.) For example, at the time Borghetti was considering bringing an appraisal action, he asked Tucker Allen, a valuations firm, to analyze the value of CP at the time of the merger. (R. at 1883, 4323.) Tucker Allen reported that it did not see a valuation in excess of \$40 million. (*Id.*)

The Tucker Allen valuation comports with the TWP valuation performed at the time of the merger which placed CP’s value as no more than \$44.8 million based upon 2002 actual and estimated revenues using the liquidation, market and income approaches. (R. at 1883, 4324.) The Tucker Allen valuation was also consistent with work ThinkEquity performed prior to the merger, which opined that the proposed \$42 million price for CP was fair. (R. at 1883, 4324.)

Moreover, in an expert report dated May 31, 2006, LECG opined that the value of Campus Pipeline at the time of the merger was approximately \$36.28 million.⁴ (*Id.*) Another expert valuation, conducted by Roger Grabowski (an expert retained by Defendants Jeff Williams and Bendinger Crockett) opined that CP's value at the time of the merger was approximately \$35 million. (*Id.*)

The Trial Court Grants Summary Judgment

Defendants moved for summary judgment on all claims Borghetti asserted; Defendants also moved to strike the Affidavit and Report of Avner Kalay. After extensive briefing and argument, the district court noted that Borghetti did not dispute: (1) that the Campus Pipeline preferred shareholders possessed liquidation preferences that entitled them to the first \$80.9 million Campus Pipeline received in any merger; (2) that SCT purchased Campus Pipeline for \$42 million; and (3) that Borghetti's own expert opined that the value of the Company on the date of the merger was between \$63.3 million and \$72.9 million. (R. at 5359-60.) Based on this, the Court found there was no genuine issue of fact on the issue of whether the Company's value exceeded the liquidation preferences on the date of the merger and therefore Borghetti had failed to come forward with proof of damages. (R. at 5360-61.)

⁴ Below, Borghetti purported to dispute factual statements about the conclusions TWP, ThinkEquity, and LECG reached concerning Campus Pipeline's value. (R. at 4324.) To dispute those facts, Borghetti merely stated "Disputed; Report of Avner Kalay." (*Id.*) Although Kalay may disagree with the conclusions of TWP, ThinkEquity, and LECG, nothing in his report disputes that they reached the conclusions as outlined above.

Because of this ruling, the Court denied Defendants' Motion to Strike the Expert Testimony of Avner Kalay as moot. (R. at 5361.)

SUMMARY OF THE ARGUMENT

Borghetti admits that Campus Pipeline's preferred shareholders were entitled to the first \$80.9 million the Company received in any merger. Borghetti, and his expert, admit that on the date SCT merged with Campus Pipeline the Company was worth \$10 million less than those preferences. Nevertheless, Borghetti argues that the trial court erred when it reached the unremarkable conclusion that if the Company was worth less than its liquidation preferences, its common shareholders, like Borghetti, were not entitled to any merger proceeds and did not suffer damages.

Borghetti now argues that the trial court should have denied the Motions for Summary Judgment and permitted him to present his case to a jury because his expert also opined that if Borghetti's common stock were treated like an *option to purchase common stock*, rather than *common stock itself*, it had a theoretical value of as much as \$6 million. Despite the fact that courts have rejected attempts to value common stock as an option, and despite the fact that Borghetti failed to point to even a single case accepting such a valuation, he claims the trial court erred.

Borghetti's claims fail for several reasons. First, Delaware law did not require, as Borghetti contends, that the trial court accept his "option-based" valuation as evidence of the fair value of his shares on the date of the merger. Second, Borghetti's failure to present evidence of a value exceeding the liquidation preferences not only impacts the damages analysis, but dooms his ability to create a genuine issue of fact on one of the *prima facie*

elements of his breach of fiduciary claim. Third, Borghetti's appeal fails to meaningfully address his non breach of fiduciary causes of action; his expert report did not opine as to the damages he allegedly suffered because of fraud and unjust enrichment; and nothing in his appellate papers explains why the Court erred in granting summary judgment on those claims.

Perhaps an even more fundamental question for this Court is why it should permit expert testimony that treats common stock like an option to purchase common stock to come into evidence at all. Utah Rule of Evidence 702, as well as *State v. Rimmasch* and its progeny, instruct trial courts to act as gatekeepers to ensure that expert testimony meets certain standards for admission. Here, the trial court erred in failing to perform that role. Several courts have rejected a valuation of common stock based upon the Black-Scholes method Dr. Kalay performed. Even if it could be considered a reliable method in this context, Dr. Kalay's admittedly unsupported assumptions (that the Company would grow at 20% a year for 15 years and that despite such marvelous growth, the preferred shareholders would cash out of the company with no return on their investment) make the application of the method so unreliable that his testimony should not have been considered. If the trial court had granted Defendants' Motion to Strike, Borghetti would have had absolutely no evidence of damages and could not defeat summary judgment.

ARGUMENT

I. THE DISTRICT COURT CORRECTLY CONCLUDED THAT BORGHETTI FAILED TO COME FORWARD WITH EVIDENCE OF DAMAGES SUFFICIENT TO CREATE A GENUINE ISSUE OF MATERIAL FACT.

Borghetti argues that the district court erred by limiting its analysis to the Company's "market value" and not considering the "fair value" of Borghetti's shares on the date of the merger. Borghetti is wrong for at least three reasons: 1) the Court did not limit its analysis to "market value"; 2) Borghetti failed to demonstrate that his damages theory was based upon a generally accepted valuation technique; and 3) Borghetti's argument that his shares had "fair value" lacks legal foundation.

A. The District Court Did Not Limit Its Analysis to Market Value.

Borghetti claims that the district court erred because he believes that the court looked only at the market value of the Company and "market value is not solely determinative of 'fair value.'" (Borghetti Mem., 6, 11.) Borghetti provides no record support for his contention that the trial court focused solely on the market value of the company. Indeed, the court did not so limit its analysis.

While the district court was presented with undisputed evidence concerning the companies Campus Pipeline approached to discuss a merger and undisputed evidence that none of these companies was willing to offer anything close to the \$42 million SCT paid, the district court was presented with additional evidence of the Company's value. (R. at 1877-78; 4316-17.) The evidence before the Court included six valuations of Campus Pipeline (including two from Borghetti)—each placing the value of the Company at the time of the merger below the liquidation preference. With exception of the Kalay valuation, the other

valuations used generally accepted valuation methods (including the income, market and asset approaches) to determine the value of Campus Pipeline. (R. at 1883, 3034, 3110, 3118, 3208, 4324.) Each of these techniques yielded a value millions of dollars below the Company's liquidation preferences.

Even Borghetti's expert did not limit himself to an opinion of market value. Indeed, Kalay stated that his technique was a variation on the income approach to valuation, (R. at 2443-44), and assigned a value to CP that although greater than that reached by the other five valuation experts ultimately fell well short of the more than \$80 million in liquidation preferences held by the CP preferred shareholders. (R. at 1883-84, 4324.)

The district court examined this record and concluded that even if it accepted Borghetti's expert's opinion at face value, Borghetti had come forward with no evidence of damages. Even if the Company was worth the \$72.9 million Kalay opined, all of that merger consideration would have flowed to the preferred shareholders (who still would not have recouped their original investment nor had their liquidation preferences satisfied). Because there is absolutely no evidence in the record to support a finding that the Company had a value, market or otherwise, in excess of its liquidation preferences at the time of the merger, the trial court correctly concluded that Borghetti could not prove damages as a matter of law.

B. Borghetti Cites No Law for the Proposition that Delaware Law Permits Him to Value His Common Stock as if it Were an Option to Purchase Stock.

Borghetti next takes the trial court to task for purportedly failing to follow the instruction of *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712 (Del. 1983).⁵ Borghetti argues *Weinberger* stands for the proposition that Courts must liberally construe valuation methods and include “all relevant factors” in its analysis.⁶ (Borghetti Mem., 9.) According to Borghetti, this means that the trial court was duty bound to accept his expert’s opinion that if Borghetti’s stock was viewed as an option to purchase common stock, rather than stock itself, it had a positive value. Borghetti ignores, however, that although *Weinberger* liberalized Delaware law with respect to what could be considered, it did not require courts to adopt any and all opinions of value a party’s expert may offer. Delaware courts have not hesitated to strike evidence of value if it is not based upon a generally accepted method. *See e.g., M.G. Bancorporation, Inc. v. LeBeau*, 737 A.2d 513, 522-23 (Del. Ch. 1999) (rejecting use of the

⁵ Delaware law should apply to the substance of Borghetti’s breach of fiduciary duty claim. Pursuant to the internal affairs doctrine, “the law of the state of incorporation normally determines issues relating to *internal* affairs of the corporation.” *First Nat’l City Bank v. Banco Para El Comercio Exterior De Cuba*, 462 U.S. 611, 621 (1983) (emphasis in original). The internal affairs doctrine applies when “liabilities of officers or directors to the corporation **and its stockholders**” are at issue. *Shaffer v. Heitner*, 433 U.S. 186, 215 n.44 (1977) (emphasis added); *see also McDermott Inc. v. Lewis*, 531 A.2d 206, 215 (Del. 1987) (internal affairs doctrine applies to “matters *peculiar* to corporations, that is, those activities concerning the relationships *inter se* of the corporation, its directors, officers and shareholders”) (emphasis in original). CP was a Delaware corporation. Utah has codified the internal affairs doctrine. *See* Utah Code Ann. § 16-10a-1505(3).

⁶ The *Weinberger* Court ruled that Delaware courts are not limited to the so-called “Delaware block” valuation method to determine the “fair price” of a company, but may also

“capital market” approach to valuation). Delaware courts have adopted the reliability standards interpreted in *Daubert v. Merrell Dow Pharmaceuticals* and *Kumho Tire Co. v. Carmichael* and require that the proponent of the valuation bear the burden of demonstrating that the valuation technique is generally accepted. *M.G. Bancorporation*, 737 A.2d at 522-523.

Nevertheless, Borghetti’s Memorandum simply assumes, without citation, that his expert’s opinion must be a “relevant factor” for valuation purposes. Borghetti cites no case demonstrating that Delaware has permitted a valuation treating common stock as an option. No such case exists.⁷

However, several courts outside of Delaware have rejected such a valuation. Notably, the United States Tax Court examined the differences between common stock and options to purchase common stock and “reject[ed] the application of the Black-Scholes model to the valuation of common stock.” *See Snyder v. Commissioner of Internal Revenue*, 93 T.C. 529, 545 (1989). In *Snyder*, the Respondent sought to value shares of common stock in a closely held corporation. *Id.* at 539. The Respondent’s expert witness treated the stock “as if it were a call option on the underlying 300 shares of Gore stock” and used the Black-Scholes method

consider “other generally accepted techniques used in the financial community and the courts.” 457 A.2d at 712.

⁷ To be clear, the Delaware Courts have permitted parties to value options with Black-Scholes. *See, e.g., In Re: Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 38 n.8 (Del. 2005). Delaware Courts have not accepted Black-Scholes as a method of valuing common stock as if it were an option, as Borghetti’s expert has done here.

to assign them a value.⁸ *Id.* at 540. The court noted that it had previously considered the application of Black-Scholes to value stock options, but had never applied it to value common stock. *Id.* at 541.

In refusing to admit the expert's valuation based upon Black-Scholes, the court cited several problems with the expert's analysis:

The gravest, by far, is that the Black-Scholes method is designed to value call options, not common stock. In general, the common stock bears the risk of full loss and enjoys the benefit of any future appreciation. An option presents a risk of loss only to the extent of the option price and conveys the right to enjoy potential appreciation in value in corporate ownership for a set and limited time. Black and Scholes define an option as 'a security giving the right to buy or sell an asset, subject to certain conditions, within a specified period of time.' Common stock represents ownership of the corporation, not simply the potential to acquire it

Id. The *Snyder* Court reasoned "[a]n option to purchase has an exercise date, and its limited existence is an important factor in the Black-Scholes method of valuation." *Id.* at 541. The Court noted the unreliability of Black-Scholes by selecting a wide range of possible exercise dates – from 15 days to 20 years – to arrive at a wide range of values for the common stock – from \$111,000 to \$2.4 million. *Id.* at 541.

Citing the "unsuitability" of the Black-Scholes method for valuing common stock, the court stated, "[t]here is no basis for assuming a time period of any particular duration, largely because the objective in this case is to value common stock and not to value an option to

⁸ This mirrors the language of Kalay's report which treated Plaintiff's common stock as "a call option where the exercise price is \$82.93 million." (R. at 1801.)

purchase.” *Id.* at 541-42. Therefore, the court rejected the application of the Black-Scholes model to the valuation of common stock. *Id.* at 545.⁹

Similarly, a United States Bankruptcy Court, applying *Daubert*, rejected the use of a valuation based upon the Black-Scholes method even though the parties had stipulated to its use. *See In re Med Diversified, Inc.*, 334 B.R. 89, 102-03 (Bankr. E.D.N.Y. 2005). The *Med Diversified* court concluded, “[t]he Black-Scholes Method has simply not been shown to provide a reliable measure of the value of an option to purchase 100% of controlled shares in a privately held company” *Id.* at 103.

Weinberger simply does not contemplate creating a value for common stock by treating it as something that it is not.¹⁰ The trial court did not err in refusing to find damages based upon an opinion that turned common stock into options.

⁹ The Tax Court later echoed this decision. *See Hutchens Non-Marital Trust v. Commissioner of Internal Revenue*, T.C. Memo. 1993-600, 1993 WL 522147, *25 (“Mr. May’s analysis does not overcome the misgivings we have expressed in the past about the use of the Black Scholes method to value corporate stock”).

¹⁰ Borghetti also asserts that his common stock also has value if it is viewed as a lottery ticket. (Borghetti Memo., 12.) Undoubtedly Borghetti’s common stock would have value if it was considered to be many things it is not; the common stock would have had much greater value if it had been signed by Abraham Lincoln, painted by Picasso or etched on bricks of gold. Unfortunately for Borghetti, and for many of the Defendants in this action who also held common stock, their CP shares were not lottery tickets, works of art or even options to purchase stock if the Company one day had value greater than the liquidation preferences. Borghetti held common shares in a company that was hemorrhaging money. All evidence before the trial court demonstrated that when viewed as shares, CP’s common stock was worth less than CP’s liquidation preferences.

C. Borghetti's Argument That His Shares Had Value at the Time of the Merger Far in Excess of the Actual Value of the Company Is Based on the Faulty Premise That Directors of Financially Troubled Firms Have a Duty to Stay in Business.

By asking this Court to find that his shares had a value on the date of the merger, Borghetti argues that he had some entitlement to the continued operation of the Company. Borghetti asserts that his stock was a “lottery ticket” and in essence argues that he: (1) had a right to keep the Company operating until it could return a value in excess of the liquidation preferences; or (2) the Board of Directors had a duty to refuse to recommend a merger until the preferred shareholders were willing to compromise their contractual rights and permit the common shareholders to receive some portion of the merger consideration.

Borghetti's argument is not novel, but it has been squarely rejected. *See Orban v. Field*, No. Civ.A. 12820, 1997 WL 153831 (Del. Ch. April 1, 1997). *Orban* challenged the merger between Office Mart and Staples. Orban, an Office Mart common shareholder, claimed the merger breached fiduciary duties owed to him because the liquidation preferences required that all merger consideration flow to the preferred shareholders. Like here, the common shareholders in that merger received nothing. *Id.* at *7.

The Chancery Court recognized that the Board was faced with the following dilemma: whether the Board should “support the common stock's (Mr. Orban's) effort to extract value from the preferred position or whether it [should] seek to accomplish the negotiated transaction, which it believed to be the transaction at the highest available price.” *Id.* at *9. The Court granted summary judgment on the breach of fiduciary duty claim, stating “it would be bizarre to take this fact of legal life so far as to assert, as Mr. Orban must, that the Board

had a duty to the common stock to refrain from recognizing the corporation's legal obligations to its other classes of voting securities." *Id.*

The Chancery Court reasoned that "[w]hereas the preferred stockholders had existing legal preferences, the common stockholders had no legal right to a portion of the merger consideration under Delaware law or the corporate charter." *Id.* The court also emphasized that the preferred shareholders who had negotiated the merger were "receiving *less than [their] liquidation preference in the merger.*" *Id.* at *2 (emphasis in original). Against this factual backdrop, the Delaware Chancery Court found no breach of fiduciary duty and granted summary judgment.¹¹ *Id.* at *11; *see also In re Encore S'holders Litig.*, No. 16044, 2000 WL 823373, *4-9 (Del. Ch. June 16, 2000) (granting motion to dismiss complaint by common shareholder that proceeds of sales of corporate assets were used to pay liquidation preferences while common shareholders received no consideration); *Blackmore Partners, Inc. v. Link Energy, LLC*, No. Civ.A. 454-N, 2005 WL 2709639, *8-9 (Del. Ch. Oct. 14, 2005) (granting summary judgment on a challenge to a transaction where the company's creditors received value but shareholders did not).

In this case, as in *Orban*, it would be bizarre to insist that CP's Board of Directors had a duty to refrain from considering the corporation's legal obligations to its preferred shareholders. Campus Pipeline took more than \$80 million dollars from the preferred

¹¹ Borghetti argued below that *Orban* should not control because facts in that case were different than some of the facts in this case. However, nothing in *Orban* suggested that its holding was limited to the particular facts of that case.

shareholders when the technology economy was strong. (R. at 1860, 4296.) When the Internet bubble burst, the Board of Directors was not obligated, as Borghetti argues, to treat the common stock as a lottery ticket. Delaware law simply did not require the Company's board to ignore the rights of the preferred shareholders, the financial condition of the Company, and a merger that would salvage half of the preferred shareholders' original investment in hopes of perhaps one day growing the Company to a valuation that exceeded the liquidation preferences. Simply stated, Delaware law has rejected Borghetti's argument that the Company could not merge unless it returned value for the common shareholders.

Borghetti relied below on *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) and *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997) in support of his argument that the CP Directors breached a fiduciary duty as a matter of law by recommending a merger at a price under the liquidation preference. Borghetti's reliance on these cases was misplaced.

The *Revlon* decision does not suggest that a board of directors may never sell for less than the company's liquidation preferences. Rather, *Revlon* requires that once a company has decided to sell itself, its only concern should be "obtaining the highest price for the benefit of the stockholders." 506 A.2d at 182. Borghetti reads this case as requiring a company to get the best price for common shareholders and not the company as a whole, and argued below that *Revlon* dictates that a company may not be sold when only the preferred shareholders will receive merger consideration. In fact, *Revlon* does not even mention preferred shareholders or draw distinctions between common and preferred shareholders. Rather, the *Revlon* decision balances the interests of "stockholders" against "noteholders" and analyzes

the extent to which a company may consider “*constituencies other than shareholders.*” *Id.* at 176 (emphasis added). *Revlon* simply requires directors to obtain the highest price reasonably possible for the company, without regard to how that price is distributed among classes of shareholders. *Id.* at 182.

In this case, Borghetti did not adduce any evidence suggesting that the CP directors did not obtain the highest value reasonably possible for CP. There is no evidence in the record to suggest that the price SCT paid for CP (\$42 million) was not the highest price reasonably available. In fact, there is no evidence of another potential buyer who was willing to pay anything close to \$42 million. Borghetti does not dispute that CP talked to “dozens and dozens” of companies about a transaction and that the last offer CP received prior to the merger was \$27 million. (R. at 1877-78, 4317.) Accordingly, there is no evidence that CP’s directors did not comply with their *Revlon* duties to obtain the best price for the Company.

Borghetti also mischaracterized the *Equity-Linked* decision. In *Equity-Linked*, the directors obtained additional financing to keep the company afloat rather than sell the company at a price below the liquidation preferences. 705 A.2d at 1041-42. The court held that the directors’ decision did not constitute a breach of fiduciary duty owed to preferred shareholders. *Id.* at 1042. However, the *Equity-Linked* decision did not, as Borghetti argued below, hold that a corporate board *may never sell* for a price that returns no value to the common shareholders. In fact, the court expressly held that the board “could have a made a

different business judgment” and sold the company at a price less than the company’s liquidation preferences.¹² *Id.*

Therefore, Borghetti’s argument that the CP Directors committed a *per se* breach of fiduciary duty by selling the Company for less than its liquidation preferences is incorrect. Borghetti’s argument that the CP Directors breached their fiduciary duties when they decided not to continue operations should be rejected.

II. SUMMARY JUDGMENT IS PROPER ON THE INDEPENDENT GROUNDS THAT BORGHETTI’S SUBSTANTIVE CLAIMS FAIL AS A MATTER OF LAW.

A. Borghetti’s Breach of Fiduciary Duty Claim Fails Because the Merger Transaction Passes Entire Fairness Review.

Summary judgment on Borghetti’s breach of fiduciary duty claim was appropriate on the independent ground that the merger with SCT passes the most stringent of tests Delaware law applies to merger transactions—the entire fairness standard.¹³

¹² It is understandable that the Delaware courts would not want to create a rule that would tie the hands of Boards of Directors and make it impossible to sell a company for less than its liquidation preferences no matter how dire the company’s prospects might be. One of the problems with such an approach would be deciding where that duty ended and the Board’s ability to exercise its business judgment resumed. Could a Board properly sell a company when it possessed sufficient value to pay liquidation preferences and have enough left over to distribute a penny a share to common shareholders? Would such a rule require that a Board operate a company until common shareholders could receive a dollar or five dollars a share? Or, to be consistent with Borghetti’s logic, would the rule require that the company continue its business until the common shareholders had value equal to the liquidation preferences?

¹³ Although the trial court did not grant the Motions for Summary Judgment on this basis, this Court may nevertheless affirm that judgment on the grounds that the SCT transaction passes entire fairness scrutiny. *See State v. South*, 924 P.2d 354, 356 (Utah 1996)

The entire fairness standard requires the Court to examine both the substantive and procedural fairness of the merger.¹⁴ *ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 930 (Del. Ch. 1999). In other words, the Court must be satisfied that the transaction was the product of fair price and fair dealing. *Id.*; see also *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). The SCT transaction withstands this scrutiny as a matter of law. For analytical convenience, the substantive and procedural fairness of the merger is set forth separately below, “but the ultimate issue . . . is the entire fairness of the overall transaction.” *Oliver v. Boston Univ.*, No. Civ.A. 16570, 2006 WL 1064169, *18 (Del. Ch. April 14, 2006).

1. There Is No Evidence That the Price Paid By SCT Was Unfair.

In order to recover damages on a claim for breach of fiduciary duty in the context of a merger, there must be evidence that the price paid for the company was unfair. The concept of fair price “relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.” *Cinemara, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995) (quoting *Weinberger*, 457 A.2d at 711). “[A]lthough the burden of proving fair price [shifts to the defendant on an entire fairness review], once a sufficient showing of fair value of the company [is] presented, the party

(“appellate courts may ‘affirm the trial court’s decision . . . on any proper grounds, even though the trial court assigned another reason for its ruling.’”)

¹⁴ Two other less stringent tests may also be applied in certain situations to evaluate merger transactions under Delaware law—the *Revlon* test and the Business Judgment Rule. Because the merger transaction passes muster under the most strict entire fairness review, it necessarily passes muster under all less stringent review procedures.

attacking the merger [is] required to come forward with sufficient credible evidence to persuade the finder of fact of the merit of a greater figure proposed.” *Kahn v. Lynch Communications Sys., Inc.*, 669 A.2d 79, 88 (Del. 1995) (citing *Cinemara*, 663 A.2d at 1177).

Borghetti presented absolutely no evidence to the district court showing that the price SCT paid was unfair or that there existed an opportunity to receive a higher price. There is no evidence there was another potential buyer who was willing to pay anything close to \$42 million. In his deposition, Borghetti listed seven companies he believed might have been willing to pay more for CP. (R. at 1866.) Discovery demonstrated that not only had CP approached those companies, it spoke with many others and found none of them were willing to pay more than SCT. *Id.* The undisputed evidence demonstrates that the last offer CP received prior to the merger was \$27 million. (R. at 1878, 4317.) Simply put, there is no record evidence supporting Borghetti’s assertion that the price paid by SCT for the Company was unfair.

2. There Is No Evidence That the Merger Transaction Was the Product of Unfair Dealing.

The concept of unfair dealing, or procedural fairness, “embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained.”

Cinemara, 663 A.2d at 1162 (quoting *Weinberger*, 457 A.2d at 711).¹⁵ “[E]stablishment of an independent special committee can serve as powerful evidence of fair dealing.” *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1145 (Del. Ch. 2006). Where a transaction is approved by an independent committee, the *Gesoff* Court held that the following non-exhaustive factors may be considered to determine the procedural fairness of a merger: 1) composition and independence of the independent committee; 2) whether the committee has a clear mandate to negotiate and has the “‘critical power’ to say ‘no’ to the transaction”; 3) committee members’ access to knowledgeable and independent advisors; and 4) whether the committee engaged in arms-length negotiations. *Id.* at 1145-48.

First, as to the composition and independence of the independent committee, Delaware courts have held that independence from the *acquiring company* “is the *sine qua non* of the entire negotiation process.” *Id.* at 1146. Furthermore, Delaware courts “place[] more trust in a multiple-member committee.” *Id.* In this case, on April 25, 2002, the CP Board of Directors established a special independent committee to negotiate with SCT on behalf of CP. (R. at 1869, 4307.) The independent committee was comprised of three directors not affiliated with SCT: Fred Harman, David Peterschmidt, and Dr. David Gardner. (*Id.*) Harman and Peterschmidt were affiliated with entities that owned preferred shares.

¹⁵ Delaware courts have held that fair price may be the “preponderant consideration” in evaluating the fairness of a merger, *see Weinberger*, 457 A.2d at 711, and that “[t]he absence of certain elements of fair dealing does not mandate a decision that the transaction was not entirely fair.” *Kahn*, 669 A.2d at 83 ; *see also* Sidney J. Nurkin, et al., Practicing Law Institute, Fiduciary Duties of Boards of Directors of Financially Troubled Corporations,

(R. at 1856-57, 4292.) Dr. Gardner, who held common stock, was the former President of the Universities of Utah and California. (R. at 1857, 4292-93.)

Despite the fact that none of the committee members were affiliated with SCT, as *Gesoff* recommends, Borghetti argued below that the independent committee lacked independence because two of its three members were affiliated with entities that held preferred shares. (R. at 4585-87.) As described above, Borghetti did not dispute that after satisfying the liquidation preferences, the preferred shareholders were entitled to participate in a pro-rata distribution of the remaining proceeds with the common shareholders in an amount up to three times the liquidation preferences. (R. at 1861, 4296-97.) In other words, these directors had every incentive to get every penny they could from SCT and were therefore independent from it.

Borghetti also argued below that this was not sufficient grounds for independence because the preferred shareholders would prefer to “cash-out” of the company once their preferences were satisfied. Not only does this ignore that the SCT merger returned only 50% of the preferred shareholder’s original investment, it ignores economic reality. By arguing that the preferred shareholders would “cash-out” for their liquidation preferences, Borghetti imagines a world where venture capitalists generously give interest free loans to companies with no expectation of making a profit. Such a world does not exist. Contrary to Borghetti’s belief, the venture capitalists who invested more than \$80 million in CP actually hoped to

683 PLI/Pat 213, 217 (2001) (Under Delaware law, “if the price is fair, the merger can pass the ‘entire fairness’ test even though elements of fair dealing are absent”).

make money on that investment. The independent committee had every financial incentive to get as much as possible for CP from SCT. Merely holding preferred shares did not disqualify any member of the CP Board from serving on the independent committee.

Borghetti also argued below that the members of the independent committee had an interest in the CP/SCT merger because they were entitled to receive compensation in connection with the merger. (R. at 4585-87.) However, only one of the three members of the independent committee, Gardner, received a bonus in connection with the CP/SCT merger. (R. at 3024-25, 4365.) Borghetti adduced no evidence that Gardner knew he would receive a bonus upon the completion of the merger. However, even if he had, because the CP bonus program was not contingent on a merger with SCT and because bonuses were paid out of a pool of 12.5% of the consideration received in any merger, (R. at 4319), Gardner would have had every incentive to obtain as much as possible for the Company and was therefore independent from SCT as well.¹⁶ Therefore, Gardner's receipt of a bonus payment aligned his interests with the other shareholders and does not constitute a conflict of interest.

Second, the undisputed evidence shows that the independent committee had a clear mandate to negotiate with SCT. The relevant question is whether the independent committee operates in a way that shows it has real bargaining power; the power to say "no" to a deal proposed by the majority shareholder. *Gesoff*, 902 A.2d at 1146. Not only did the

¹⁶ It is also undisputed that Gardner was not a member of the committee that decided who would participate in the bonus plan and at what level. (R. at 4320.) Thus, there is no evidence that Gardner even knew he would be a recipient of a bonus at the time he served on the independent committee.

independent committee have the power to say no to SCT, the committee said no to SCT—twice. The undisputed evidence demonstrates that the parties called off negotiations for more than two months when they could not agree on a price. (R. at 1870-71, 1875, 4308-09, 4313.) The undisputed evidence also shows that the independent committee rejected SCT’s first two offers. (R. at 1869-70, 1875, 4307-08, 4314.) The record further shows that the independent committee aggressively pursued other non-SCT merger opportunities. (R. at 1873-75, 4311, 4313-14.)

Third, the record shows that the independent committee had access to knowledgeable advisors. On May 13, 2002, the independent committee retained TWP, an investment bank, to advise it during negotiations. (R. at 1869-70, 4307.) TWP had an incentive to assist CP to merge with an entity other than SCT because it would receive a larger fee if the company sold to an entity other than SCT. (*Id.*)

Fourth, the record evidence shows that the committee engaged in arms-length negotiations. To pass entire fairness scrutiny, negotiations need not be a “death struggle.” *Gesoff*, 902 A.2d at 1148. “But they should be vigorous and spirited, and provide evidence that the special committee and the [acquiring company] are not colluding to injure the minority stockholders.” *Id.* “In order to satisfy entire fairness, the committee must act with informed diligence, and seek the best result available for its constituents, given the facts at hand.” *Id.* As described above, the independent committee engaged in an offer/counteroffer negotiation with SCT. Furthermore, the undisputed evidence shows that negotiations between SCT and CP’s independent committee stalled for 2 ½ months—between May 31, 2002 when the independent committee countered SCT’s first offer, and August 15, 2002

when SCT made its second offer to purchase CP. (R. at 1870, 1875, 4308, 4313.) During this 2 ½ month hiatus, the undisputed evidence shows that CP discussed a merger with Blackboard, which ultimately proved unworkable. (R. at 1873-75, 4311, 4313-14.)

On this record, there are no genuine issues of material fact that prevent the Court from finding, as a matter of law, that the merger was heavily negotiated by an independent committee and therefore procedurally fair. Because there were no genuine issues of material fact on the issues of substantive and procedural fairness, the trial court could have properly found that the merger passed entire fairness scrutiny as a matter of law. Summary judgment could have been entered on that basis as well.

B. Borghetti's Fraud Claims Fail Because He Presented No Evidence That He Suffered Damages as a Result of Fraud.

Under Utah law, to prevail on a fraud claim, a plaintiff must show injury resulting from the fraud. *See, e.g., Taylor v. Gasor, Inc.*, 607 P.2d 293, 294 (Utah 1980). However, Borghetti put forward absolutely no evidence of any damages caused by the alleged fraud.

Because Borghetti did not sell his shares in the merger and because Borghetti conceded that he had not been defrauded into either buying or selling shares, Borghetti's fraud claim was whittled down to a common law "holders" claim. In other words, Borghetti claimed he was induced to hold his shares when, with hindsight, he would have preferred to sell.¹⁷ (R. at 2608-10.) Specifically, Borghetti claims that he was induced to hold his CP

¹⁷ Utah courts have never recognized a "holders" claim, and the growing consensus among other jurisdictions is that plaintiffs are not permitted to bring claims based upon a theory that they were induced to hold (rather than buy or sell) their shares. In fact, the

shares by two of the Defendants, Chad Muir and Darin Gilson, whom Borghetti claims made statements to him at unspecified dates concerning their ability to add value to the Company as a whole and to William Borghetti personally.¹⁸ (R. at 2585, 2608-10.)

The few courts that have recognized common law “holder” claims “impose heightened pleading standards on plaintiffs and require them to allege specific reliance on the alleged misrepresentations.” *In re WorldCom Sec. Litig.*, 336 F. Supp. 2d 310, 320 (S.D.N.Y. 2004). For example, the California Supreme Court held that plaintiffs asserting “holder” claims are required to prove “how many shares the plaintiff would have sold, and when the sale would have taken place.” *Small v. Fritz Cos., Inc.*, 65 P.3d 1255, 1265 (Cal. 2003). Thus, even if Utah law were to follow the minority position and permit Borghetti to base a claim on holding his stock, Borghetti has produced no evidence concerning the number of shares he would have sold, when these sales would have taken place, and the price he could have

“majority [of courts] have not recognized ‘holder’ claims.” *In re Enron Corp. Sec. Derivative & ERISA Litig.*, 490 F. Supp. 2d 784, 819 n.43 (S.D. Tex. 2007); *see also In re WorldCom Sec. Litig.*, 336 F. Supp. 2d 310, 319 (S.D.N.Y. 2004) (“[c]ourts in other jurisdictions have rejected common law claims by ‘holders’ for a variety of reasons.”); *In re WorldCom Sec. Litig.*, No. 02 Civ.3288, 2006 WL 728518, *5 (S.D.N.Y. March 22, 2006) (“the growing consensus in the common law of other jurisdictions” is that holder claims are not recognized). Nevertheless, for the reasons stated above, even if this Court were to permit relief based on a “holders” fraud theory, Borghetti’s purported holders claim would still fail as a matter of law.

¹⁸ There is no evidence in the Record that Muir and Gilson had anything other than an intent to add value to the Company and Borghetti at the time these statements were made. Muir and Gilson held significant blocks of common stock and had every financial incentive to make their stock, and Borghetti’s, as valuable as possible. Borghetti even admits that he “did not know what [Muir and Gilson] believed” at the time they allegedly made these statements. (R. at 4294.)

obtained for his shares. Borghetti's general assertion that he would have sold more stock but for the comments of two directors is the only evidence he presented.

Borghetti's self-serving statement is insufficient to prove damages under Utah law. Borghetti conceded that the only purported evidence of damages he has in this case is Kalay's opinion concerning the value of his shares at the time of the merger. This opinion, however, does not address damages on a holders claim. Without more concrete evidence, all a jury could do is impermissibly guess as to what Borghetti might have sold, when, and for what price. *See Carlson Distrib. Co. v. Salt Lake Brewing Co.*, 2004 UT App 227, ¶ 19, 95 P.3d 1171 (quoting *Penelko, Inc. v. John Price Assocs., Inc.*, 642 P.2d 1229, 1233 (Utah 1982)) (evidence of damages "must not be so indefinite as to allow the jury to speculate freely as to the amount of damages or lost profits"). Because Borghetti presented no evidence of fraud damages, this Court should uphold the grant of summary judgment on his fraud claims.

C. Borghetti's Unjust Enrichment Claim Fails Because There Is No Evidence That Defendants Retained a Benefit to Borghetti's Detriment.

In order for Borghetti to recover on a theory of unjust enrichment, he must show that Defendants retained a benefit to his detriment. *See Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 393 (Del. Ch. 1999) (stating that a relationship between the alleged enrichment and impoverishment is a required element for an unjust enrichment claim); *see also Hess v. Johnston*, 2007 UT App 213, ¶ 21, 163 P.3d 747 ("Unjust enrichment occurs when a person has and retains money or benefits that in justice and equity belong to

another”). In this case, Borghetti’s unjust enrichment claim fails because he has not shown a relationship between Defendants’ alleged enrichment and his alleged impoverishment.

Borghetti claims that the Company’s directors, officers, and employees were unjustly enriched by the “retention bonuses and termination fees” that they received pursuant to the Company’s bonus plan. (R. at 17.) The bonus plan set aside 12.5% of the merger proceeds as retention incentives for certain managers and employees in connection with any merger transaction. (R. at 1879-80, 4319-20.) The Company adopted the plan because key employees had left and others were receiving offers to leave. (R. at 1879, 4318.) The bonus plan was created to encourage employees to stay with the Company through a merger. (R. at 1878-79, 4318-19.) The bonus plan was approved by a unanimous vote of the Company’s disinterested Compensation Committee, none of whom were eligible to receive bonuses. (R. at 1879-80, 4319-20.) Borghetti did not challenge the approval of the bonus plan, nor did he adduce any facts to show that offering such a plan breached fiduciary duties. In fact, the only evidence in the record concerning the fairness of the bonus plan was that it was common for companies with underwater stock to offer such programs to incentivize their employees to stay. (*Id.*)

In any event, Borghetti cannot show that the retention bonuses received by some Defendants were taken out of merger consideration that would have otherwise flown to him. The Company was acquired for a value far less than the \$80.9 million of liquidation preferences held by preferred shareholders. (R. at 1860-61, 4296-97.) Thus, because the merger consideration received for the Company did not exceed \$80.9 million, any enrichment allegedly received by Defendants because of the bonus plan came out of the merger proceeds

received by the preferred shareholders. If this Court were to find unjust enrichment, the bonus payments would need to be repaid to the preferred shareholders and not Borghetti.

Borghetti also claims that SCT was unjustly enriched because it purchased CP at a “highly undervalued price.” (R. at 17.) However, there is no evidence in the record showing that SCT paid an “undervalued” price for the Company. In fact, there is no evidence that there was another potential buyer who was willing to pay anything close to the \$42 million price paid by SCT. (R. at 1878, 4317.) The only evidence Borghetti could conceivably offer to show a greater value for CP than what SCT paid is the valuation of Kalay. However, even the high end of Kalay’s valuation—\$72 million—sets a top value for CP millions of dollars below the liquidation preferences. As such, even if this Court accepts Kalay’s opinion at face value, and finds that the Company may have been worth as much as \$72 million, any restitution payments would belong to the preferred shareholders, not Borghetti. Accordingly, Borghetti’s unjust enrichment claim fails as a matter of law.

III. THE TRIAL COURT ERRED WHEN IT DENIED DEFENDANTS’ MOTION TO STRIKE THE TESTIMONY OF BORGHETTI’S DAMAGES EXPERT.

After granting the Defendants’ Motions for Summary Judgment, the district court denied Defendants’ Motion to Strike the Testimony of Plaintiffs’ Damages Expert, Avner Kalay, as moot. (R. at 5361.) However, if this Court disagrees with the district court’s decision concerning Borghetti’s failure to put forward evidence of damages, then the district court erred when it denied Defendants’ Motion to Strike the testimony of Borghetti’s damages expert, which testimony is Borghetti’s only purported evidence of damages. Indeed, this Court could rule as an initial matter that the testimony of Borghetti’s damages expert

does not meet the *Rimmasch/Crosby* standards for admissibility and affirm summary judgment, because Borghetti presented no other evidence of damages.

Interpreting Rule 702, this Court has imposed an exacting three-step analysis for the admissibility of scientific expert opinion testimony. *State v. Crosby*, 927 P.2d 638, 640-41 (Utah 1996); *State v. Rimmasch*, 775 P.2d 388, 397-98 (Utah 1989). First, for expert opinion to be admissible, it must be more than just “generally accepted,” it must also be “inherently reliable.” *Crosby*, 927 P.2d at 640-41; *Rimmasch*, 775 P.2d at 396-97. Evidence that is not inherently reliable cannot, as a matter of law, assist the trier of fact to understand the evidence or to determine a fact in issue and is therefore inadmissible. *Crosby*, 927 P.2d at 640.

Second, the trial court must determine whether the scientific principles or techniques employed by the expert have been properly applied to the facts of the particular case. *Crosby*, 927 P.2d at 641; *Rimmasch*, 775 P.2d at 398.

Third, if the court finds that steps one and two have been met, it must still find that the evidence is more probative than prejudicial pursuant to Rule 403 of the Utah Rules of Evidence. *Crosby*, 927 P.2d at 641; *Rimmasch*, 775 P.2d at 398.

A. The Black-Scholes Formula is not an Inherently Reliable Method When Used to Value Common Stock.

The threshold step in the *Rimmasch/Crosby* analysis is determining whether the scientific principles and techniques underlying an expert’s testimony are “inherently reliable.” *Crosby*, 927 P.2d at 641 (citing *Rimmasch*, 775 P.2d at 400). To apply this standard, a trial court should “tak[e] into account general scientific acceptance and

widespread practical application, [but] must focus in all events on proof of inherent reliability.” *Id.* (quoting *Phillips v. Jackson*, 615 P.2d 1228, 1234 (Utah 1980)). Stated differently, “scientific testimony deduced from a ‘well-recognized scientific principle or discovery’ is admissible if the scientific principle from which the deduction is made is ‘sufficiently established to have gained general acceptance in the particular field in which it belongs.’” *Kofford v. Flora*, 744 P.2d 1343, 1346-47 (Utah 1987) (quoting *Phillips*, 615 P.2d at 1233)). Thus, inherent reliability is based upon the general acceptance and widespread application of the scientific method at issue. The proponent of the scientific evidence has the burden of showing that the scientific principles or techniques meet the inherent reliability standard. *Rimmasch*, 775 P.2d at 398.¹⁹

In this case, the district court should have determined that the Black-Scholes method was not inherently reliable when it was used to value the common stock of a privately traded company. As explained in Section I.B., several courts have ruled that although Black-Scholes is a reliable method for pricing options, it is unreliable, and therefore inadmissible, when used to value common stock. *See, e.g., Snyder*, 93 T.C. at 545, *supra* at 18-19 (“reject[ing] the application of the Black-Scholes model to the valuation of common stock.”); *see also In re Med Diversified, Inc.*, 334 B.R. at 103, *supra* at 20 (“[t]he Black-Scholes

¹⁹ Although a court may take judicial notice of the inherent reliability of some scientific evidence, judicial notice is not proper when the testimony’s “reliability is not beyond being reasonably questioned.” *Rimmasch*, 775 P.2d at 398. As explained herein, as evidenced by the number of courts that have refused to permit Black-Scholes to be used in this context, its reliability is not beyond being reasonably questioned.

Method has simply not been shown to provide a reliable measure of the value of an option to purchase 100% of controlled shares in a privately held company”).²⁰

Other courts have rejected attempts to use the Black-Scholes method outside of the options valuation context. *See, e.g., In re Apple Computer, Inc. Sec. Litig.*, 243 F. Supp. 2d 1012, 1028 (N.D. Cal. 2002) (“this Court is not aware of any other court that has used the Black-Scholes model to establish scienter in a securities fraud case. Even if the sales Plaintiffs analyze were relevant, the Court would not find that the model could be used to establish scienter in this situation”); *In re the Marriage of Robinson*, 35 P.3d 89, 95 (Ariz. Ct. App. 2001) (“we question the practicality of these models [including Black-Scholes] for determining a parent’s child support obligation”); *Louisiana State Employees Ret. Sys. v. Citrix Sys., Inc.*, No. Civ.A. 18298, 2001 WL 1131364, *7 (Del. Ch. Sept. 19, 2001) (“I have previously indicated my concerns with the application of the Black-Scholes model when determining the significance of the benefit achieved at settlement where its use may be pivotal in influencing the size of the fee awarded to plaintiff’s counsel”). This Court should join the legion of others who have refused to permit expert testimony based upon the Black-Scholes method outside the context of valuing options.

²⁰ The federal test for admissibility of expert testimony, set forth by the United States Supreme Court in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), is “similar” to the *Rimmasch/Crosby* test. *Crosby*, 927 P.2d at 641-42. However, the *Rimmasch/Crosby* test, unlike the *Daubert* test, “provides a detailed and rigorous outline for trial courts to follow when making determinations concerning the admissibility of scientific evidence,” and thus “superimposes a more restrictive test whenever scientific evidence is at issue.” *Id.* at 642. Thus the standards this Court should apply to Kalay’s testimony are more restrictive than those utilized by the court in *Med Diversified*, 334 B.R at 103, *supra* at 20.

Given Kalay's admissions concerning the functioning of Black-Scholes, Borghetti would have been hard pressed to meet his burden of showing the inherent reliability of the Black-Scholes method in this context. Kalay admitted that, using the Black-Scholes method, *lower revenue* translates into a longer time to pay off the option and *generates a higher valuation* than if the company enjoyed greater revenues. (R. at 1802-03.) It is hard to imagine how a valuations formula where lower revenue yields a greater value can be deemed inherently reliable.

The same analysis holds true for volatility. According to Kalay, the more volatile a stock is, the more it is worth using the Black-Scholes formula. Moreover, Kalay testified that an "option always have [sic] positive value." (R. at 2441.) This should be contrasted with common stock which can lose value and become worthless. Certainly, a method that turns traditional valuation methodologies, and common sense, on its head, cannot be said to be inherently reliable.

It is telling that Kalay, who has more than 25 years of finance experience, who lists 16 different retentions as an expert witness on his resume, including work for the Securities and Exchange Commission, could not list a single instance in which he had used the Black-Scholes method to value 100% of the common stock of a company outside the classroom setting. (R. at 1847, 1852-54.) It is also telling that even though Kalay opined that the Black-Scholes formula should generate results that approximate the traditional income valuation method, Kalay never performed the standard income analysis as a check on his use of Black-Scholes. (R. at 1849.) It is similarly telling that Kalay's opinion generates valuations far

greater than five other valuations (performed both before and after the onset of litigation) that applied traditional valuation methodologies. (R. at 1883-84, 4323-24.)

The Black-Scholes valuation method is not inherently reliable in this context. Black-Scholes represents a method that has been rejected by courts when valuing common stock; and has never been applied by Kalay outside of the classroom setting.

B. Even Assuming Black-Scholes Was Reliable When Valuing Common Stock, Kalay Misapplies Black-Scholes.

Even if the Court were to find that Black-Scholes is “inherently reliable” when valuing common stock, the Court must continue to the second step in the *Rimmasch/Crosby* test and analyze Kalay’s methodology to determine whether it is properly applied to the facts of the instant case. *Crosby*, 927 P.2d at 641. Kalay fails to properly apply Black-Scholes to the facts of this case for a number of reasons. First, as detailed above, applying the Black-Scholes method to value common stock leads to unreliable conclusions.

Second, Kalay uses baseless, unreliable and speculative assumptions as inputs in the Black-Scholes model. Most notably, Kalay assumes that CP, which had only hit its revenue target in one quarter during its entire corporate existence, would enjoy year after year growth of 20 percent during the period 2004-2015. (R. at 1802.) In deposition, Kalay admitted that he had done no research on the industry to see if that assumption was reasonable. (R. at

1850-51.) As such, Kalay's 10.78 year growth estimate (R. at 1804) is based upon nothing tangible and is mere speculation used to pump up his valuation.²¹

Third, because the Black-Scholes formula requires as an input the date the option matures, Kalay assumes that the CP "option" would mature as soon as CP (growing 20% year after year) had sufficient cash to pay the liquidation preferences. (R. at 1801-04.) Kalay also assumes that the preferred shareholders would demand to be cashed out of CP as soon as possible and would be cashed out for the precise amount of their liquidation preference. In other words, Kalay would have to tell the jury that his analysis is based on the assumption that the preferred shareholders would invest more than \$80 million in CP and then pull out their funds, *with no return on their investment*, as soon as the Company (which in Kalay's world had been experiencing 20% annual growth rates) had the ability to pay them. Although that may be an interesting assumption in a classroom, Kalay has no basis to assume that the venture capitalists who invested in CP would behave in such an economically irrational manner.

²¹ Kalay's 10.78 year growth estimate is also easily manipulated. Unlike a true option, which has a set expiration date, in order to treat common stock as an option Kalay had to pick an expiration date. Kalay selected 10.78 years because that is the amount of time he believes it would take to pay the preferred shareholders the more than \$80 million in liquidation preferences owed to them. (R. at 1801.) The chosen date has significance, of course, because the option has more value the longer the date is projected out. Had Kalay assumed an expiration date of 5 years, 8 years, or even 10.77 years, Borghetti's common stock, even if treated as an option, would still have been worth less than the Company's liquidation preferences. As the *Snyder* Court recognized, "[t]here is no basis for assuming a time period of any particular duration, largely because the objective in this case is to value common stock and not to value an option to purchase." *Snyder*, 93 T.C. at 541-42.

Thus, even if the Black-Scholes method could be used in this context, Kalay's unrealistic and speculative assumptions undercut the reliability of its use.

C. Kalay's Testimony is More Prejudicial Than Probative.

The final *Rimmasch/Crosby* prong tracks Utah Rule of Evidence 403. *Crosby*, 927 P.2d at 641. That Rule provides that relevant evidence may “be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury” Utah R. Evid. 403. The Court must balance the probative value of the evidence against the dangers its admission poses. If there are weaknesses in the testimony based on scientific premises, accuracy of determining the existence or nonexistence of a fact in issue, or testing or validation of the method in similar situations, then it is relatively easier to show that the dangers of admission outweigh the probativeness of the testimony. *Rimmasch*, 775 P.2d at 398 n.8.

The testimony Kalay seeks to provide will be more prejudicial than probative. Kalay's testimony is prejudicial because a jury, unversed in valuation science, might be impressed by a Finance Professor from the University of Utah claiming to have used a prize-winning technique. On the other side of the ledger, Kalay's testimony has no probative value whatsoever. As explained above, Kalay's revised opinion places the top value of CP at the time of the merger well under the liquidation preference owned by the preferred shareholders. (R. at 1883-84, 4324.) Because the preferred shareholders were entitled to the first \$80.9 million the Company received in a liquidation event, any valuation below that amount results in no damages to Borghetti. Kalay's opinion that CP was worth between \$63.6 million and \$72.9 million at the time of the merger proves nothing that helps Borghetti.

Rather, Kalay's opinion only confirms what the District Court found below: Borghetti suffered no damages on account of the merger.

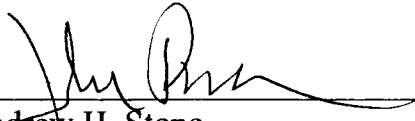
CONCLUSION

In his brief, Borghetti argues that his Campus Pipeline common stock was like a lottery ticket, and that he suffered damages when the CP Board of Directors recommended to the shareholders that they cut their losses and sell the company to SCT while it still had some value. Borghetti asks this Court to permit him to present evidence to a jury that even though the Company was worth less than its liquidation preferences, if viewed as an option, his common stock was worth millions.

That opinion fails to meet the reliability standards of the Utah Rules of Evidence and should not be admitted into evidence, either before the jury or to defeat summary judgment. As such, Defendants ask this Court to reverse the trial court's decision to deny the Motion to Strike. However, even if that opinion comes into evidence, the trial court did not err in granting summary judgment because even accepting Kalay's opinion at face value it does not show that Borghetti's stock had a value in excess of the Company's liquidation preferences. Without evidence that he was entitled to some share of the merger proceeds, Borghetti's claims must fail.

DATED this 7th day of December, 2007.

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CERTIFICATE OF SERVICE

I hereby certify that on the 2nd day of December, 2007, I caused to be mailed, postage prepaid, two correct copies of the foregoing **BRIEF OF APPELLEE** to the following:

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