IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

MARK SCULLY v. US WATS, INC., KEVIN O'HARE, AARON BROWN and STEPHEN PARKER	: : : : : :	CIVIL ACTION NO. 97-4051

MEMORANDUM AND ORDER

Fullam, Sr. J. July , 1999

On June 9, 1999, pursuant to an Adjudication filed on June 8th, and later amended, I entered judgment in favor of the plaintiff and against the defendants US Wats, Inc., Aaron Brown and Stephen Parker. All parties have filed motions to alter and amend the judgment. Review of these materials persuades me that further clarification of the Court's reasoning, and the legal theories upon which judgment was entered, is desirable.

Many of my factual findings in the earlier Adjudication were not sufficiently explicit.

Liability in this case is predicated upon several related lines of argument. I have found as a fact that, in May 1995, plaintiff entered into a contract of employment for a period of two years, ending on or about May 23, 1997. As part of that contract, plaintiff entered into a separate written stock-option contract, under which he was entitled to purchase 850,000 shares of US Wats stock for 75 cents a share; these options were to vest at various stated times over a two-year period. In December 1996, the defendants Brown and Parker surreptitiously hired the defendant O'Hare to replace plaintiff as president of the corporation, but all three assured plaintiff that his continued employment until May 1997 was assured; and plaintiff agreed to continue in his employment for that period.

Instead, on December 30, 1996, without advance notice, plaintiff was summarily fired. And the defendants took the position that all of plaintiff's stock-options had terminated as of December 30, 1996.

The evidence made clear that plaintiff had amply fulfilled all of the terms of his employment, and that the defendants had no just cause for terminating his employment. The real reason for the defendants' actions, or at least a principal reason, lay in the fact that the corporation, which was entirely controlled by Messrs. Brown and Parker, had granted more stock options than it could possibly fulfill; and, unless some of the outstanding stock options could be eliminated before December 31, 1996, accurate filings with the SEC would reveal the true state of the corporation's affairs. Plaintiff's options to purchase 600,000 of the 850,000 shares had already vested; and in view of plaintiff's forthcoming termination in May 1997, and in view of defendants' knowledge that plaintiff would be receiving a substantial sum of money from another investment in January 1997, and would therefore be likely to exercise his options, (which were definitely "in the money") the defendants Brown and Parker carried out their plan to (1) replace plaintiff before the end of 1996, (2) persuade him that he would remain in the company's employ through May 1997, and would therefore see no need to take immediate action with respect to exercising his options, and (3) fire him as of December 30, 1996, without advance notice, so that he would be unable to exercise his options before the termination of his employment.

Defendants were relying upon a provision in plaintiff's May 1995 stock-option agreement, to the effect that the option would expire automatically if plaintiff should leave the corporation's employ. Unfortunately for the defendants, they overlooked a provision in that same agreement which incorporated all of the terms and conditions of the company's stock-option plan, <u>as amended from time to time</u>; and made clear that, in case of conflict, the provisions of the plan would supersede the terms of the individual stock-option agreement. In 1996, the stock-option plan was amended to provide that stock-options could be exercised within 30 days after termination of employment. For the reasons set forth in my earlier Adjudication, I concluded that a proper interpretation of these documents means that plaintiff had 30 days after termination of his employment in which to exercise his stock-options, both because that is the correct interpretation of the language of the documents, and also because, at the very least, the documents gave rise to ambiguities which must be resolved against the drafters of the documents, the defendants.

In his complaint in this action, plaintiff sought recovery for (1) breach of the two-year employment contract; (2) breach of the supplemental six-month contract arrived at in December 1996; (3) breach of the written stock-option agreement; (4) civil conspiracy; and (5) violation of the Pennsylvania Wage Payment and Collection Law. In my earlier Adjudication, I found that the defendants did breach plaintiff's employment contract (both two-year and six month), and did breach the stock-option agreement. By implication, but apparently not with sufficient explicitness, I ruled that the defendants Brown and Parker were also liable for civil conspiracy. I did not rule on the statutory claim.

In their respective motions for reconsideration, the defendants disagree with my factual findings, and also urge that there is no basis for imposing liability upon the individual defendants, since they were not parties to the employment contract or the stock-option agreement. Plaintiff seeks to modify the judgment by adding the penalties and attorney's fees authorized by the Pennsylvania Wage Payment and Collection statute. And, in varying degrees, all parties object to my calculation of damages.

I. Liability Issues

Understandably, defendants emphasize those portions of the evidentiary record which favor their position, and argue that I must have overlooked that evidence in order to find that there was a two-year contract of employment. They point to plaintiff's alleged refusal to enter into a written employment contract to that effect, and note that the corporation's filings with the SEC did not list plaintiff as having an employment contract, but rather as serving at the pleasure of the Board of Directors. I concluded, however, that the totality of the circumstances made it clear that both sides had agreed on a two-year term of employment. The defendants themselves undoubtedly wanted him to stay for two years, and contemplated that he would do so. Plaintiff did not refuse to agree to a two-year term, he simply stated that a written contract was not necessary. With respect to the SEC filings, it was clear that plaintiff himself had no involvement in or knowledge of such filings (he was in charge of operations, and unaware of 10-K matters). Moreover, the persons who did have involvement in the 10-K filings were of the view that only written employment contracts needed to be disclosed. This same failure to recognize the legal efficacy of an oral contract seems to have persuaded the defendants that they could repudiate their oral agreements with the plaintiff.

The individual liability of the defendants Brown and Parker is predicated upon two legal theories, their "alter ego" responsibility for the actions of the corporation, and their liability for civil conspiracy. There can be no doubt that the corporation was entirely controlled by these two gentlemen, who were its founders and principal shareholders. Although there was a board of directors, the directors did not meet at stated times, but were consulted by telephone and kept informed of major developments. The corporate formalities were not observed: there were no minutes of meetings, resolutions, etc. And it is clear that these defendants conspired to cheat the plaintiff of the fruits of his employment and the "turnaround" success he had achieved for them. I therefore conclude that liability is properly imposed against the defendants Brown and Parker as well as the corporation. Because the evidence is not so clear as to the defendant O'Hare's culpable participation in the conspiracy (he was a recent arrival, doing the bidding of his new employers), and because the alter ego theory does not apply to him, I have declined to impose liability upon the defendant O'Hare.

On the other hand, the omission, in my earlier Adjudication, of any discussion of plaintiff's claims under the Pennsylvania Wage Payment and Collection Law, 43 P.S. §260.1 et seq. was intended to reflect my conclusion that the defendants are not liable to the plaintiff under that statute, a conclusion I now make explicit.

I recognize that at least one court has predicted that the Pennsylvania Supreme Court would hold that failure to honor employee stock-options is a violation of the statute, and triggers an award of penalties and counsel fees. See Regier v. Rhone-Poulenc Rorer, Inc., 1995 U.S. Dist. LEXIS 9384. Although it is true that the statutory definition of “wages” includes various forms of compensation “earned” by the employee, I note that the statute explicitly requires that all “wages” be paid by cash or check, §260.3, a requirement that cannot very well be applied to stock-options.

But assuming that stock-options can be included in the statutory definition of “wages,” I do not believe the statute was violated in the present case. First of all, there is the question of when it can properly be said that a stock-option has been “earned,” in the context of a two-year employment agreement. Plaintiff may be correct in arguing that, once a stock-option is vested, it has been earned. But nothing is payable at that time; and it is reasonably clear that the statute simply requires the employer to pay the employee whatever is due at the time of termination of the employment arrangement. And there seem to be virtually insurmountable difficulties in assigning a dollar value which could form the basis of the percentage penalty contemplated by the statute. Indeed, the Internal Revenue Code and regulations, as carried into effect by the stock-option plans in this case, preclude the employee from obtaining any financial benefit from the option, which would give rise to income tax liabilities and the application of withholding requirements, far into the future.

There is, on the other hand, overwhelming authority for the proposition that it is necessary to distinguish between wages earned and unpaid, on the one hand, and wages or other compensation which would have become due but for the employer’s breach of contract. If the employer wrongfully discharges the employee, but pays all wages up to the date of termination, there is no violation of the statute. Allende v. Winter Fruit Distributors, Inc., 709 F. Supp. 597, 599 (E.D. Pa. 1989); Hirsch v. Bennett, 1991 U.S. Dist. LEXIS 5993 (E.D. Pa. 1989); Sendi v. NCR Comten, Inc., 619 F.Supp. 1577 (E.D. Pa. 1985), aff’d, 800 F.2d 1138 (3d Cir. 1986).

I note that plaintiff’s argument is somewhat inconsistent in this respect. As will be discussed more fully in the succeeding section on damages, plaintiff has argued throughout this case that his damages should be assessed as of the date, one year after exercise of his stock-option, on which he could first have sold the stock obtained pursuant to the option. Although acknowledging that ordinarily, in the case of a breach of a contract to sell stock, the damages are determined as of the date of the breach, see: Burford v. Wilmington Trust Co., 841 F.2d 51, 56 (3d Cir. 1988). Plaintiff has argued that, in this case, because breach of an employment contract is involved as well as breach of the option agreement itself, the normal rule does not apply. This theory is at odds with the notion that a violation of the Pennsylvania statute has occurred.

To summarize, I decline to award penalties or counsel fees under the Pennsylvania statute.

II. Damages

As noted in my earlier Adjudication, determining the proper measure of damages in this case is not an easy task. Defendants are, of course, liable for failing to pay plaintiff's salary for the balance of his contract term (reduced by the amount plaintiff earned or should have earned from other employment). If plaintiff had attempted to show damages from loss of the rent-free apartment and company car, that amount would also have been a permissible element of the award; but there was no evidence on those issues. The principal issue has to do with the repudiation of plaintiff's stock-option agreement. Plaintiff attempted to exercise his option with respect to the 600,000 shares as to which the option had already vested. The attempt to exercise occurred on January 23, 1997. On that date, the shares were selling on the open market for 1.375 dollars per share or .625 dollars more than the option price.

If the defendants had not repudiated the attempted exercise, plaintiff would have received restricted stock which he could not sell to anyone until a year had passed. As it happens, one year after plaintiff attempted to exercise his option, the shares were selling on the open market at two dollars per share. Plaintiff, with the support of expert testimony, thus calculates his damages at more than one million dollars ($750,000 for the vested 600,000 shares, plus additional sums for the 250,000 shares which would have vested and would have been exercised, but for defendants' breach of the employment contract).

There is room for a great deal of confusion as to just what is being valued. Is it the option itself? The option agreement was non-transferrable, and could not have been sold to anyone at any time. Is it the stock which plaintiff should have been permitted to acquire? The stock could not have been sold to anyone for at least a year. What is the appropriate discount for this restriction? Should further discounts be applied because of "blockage" (i.e., presumed inability to sell that amount of stock at one time, without depressing the market value per share). Should a further adjustment be made by way of a premium for the effect of such a large block of stock upon control of the corporation?

The expert witnesses for each side have manipulated these factors in opposing ways. According to defendants' expert, the options themselves were virtually without value. If the stock itself is what is being valued, the market price at date of exercise, 1.375 dollars, should be discounted by up to 45 percent because of its restricted nature. Thus, according to defendants, under this theory, what plaintiff lost was the ability to purchase, for 75 cents per share, stock which was then worth .7625 dollars per share.

Plaintiff's expert, on the other hand, contended that the appropriate discount would be less than 29 percent. Because I found plaintiff's expert more persuasive than defendants', I concluded that an appropriate discount would have been 30 percent. If that figure had been applied, plaintiff's damages attributable to the first 600,000 shares would have been $127,500, if damages were calculated as of January 23, 1997. And, on the theory that the repudiation of the option agreement in January applied equally to the remaining 250,000 shares, and that those damages should also be calculated as of January 23, 1997, there would be an additional $53,125 in damages, making a total of $180,625.

I chose not to adopt either of these approaches, however, because I concluded they did not reflect the realities of the situation. To attempt to measure plaintiff's damages by the hypothetical value of restricted shares of stock ignores the reality that there were no restricted shares of stock available for purchase. Viewing all of the various contracts together, it is quite apparent that plaintiff's whole purpose in entering into these arrangements was the expectation that, as a result of his efforts, the company would experience a big improvement in its fortunes, and plaintiff would share in that prosperity. Defendants wrongfully deprived plaintiff of that opportunity, and should not be permitted to insist that plaintiff's chance for future profit ended as of January 23, 1997, and is reflected by the hypothetical value of non-existent shares of stock. It is true that, if plaintiff had been paid in cash, on January 23, 1997, an amount equal to the discounted value of restricted shares, and could have obtained such shares in exchange for that money, he would then have been put in as good a position as he would have been had the contract been complied with. But since no such shares could have been purchased, the payment of the discounted figure in cash would not have placed plaintiff in as good a position as he would have been in if the contract had been honored.

On the other hand, to adopt plaintiff's theory that the damages should be calculated as of January 1998, when the restriction would be eliminated, is also inappropriate. When he exercised his option, no one could be absolutely certain that the stock would rise in price. To adopt plaintiff's theory would place plaintiff in a much better position than he would have been in had the breach not occurred, since it would eliminate all down-side risk. It would convert an opportunity for future profit into a guarantee of future profit.

As set forth in my earlier Adjudication, I have concluded that plaintiff's damages should place plaintiff, as nearly as possible, in the same position he would have occupied had the contract been performed. He would have obtained stock which would enable him to share in the bright prospects of the company. Although plaintiff did not receive the shares he was entitled to, and could not obtain identical shares on the open market, he could have, had he chosen to do so, obtained non-restricted shares at their then market price, 1.375 dollars per share. I therefore conclude that the correct measure of damages is the additional cost to plaintiff of obtaining shares on the open market to replace the shares denied him by the defendants. In my view, any lesser sum would fail to compensate plaintiff fully; any greater sum would not take into account plaintiff's obligation to mitigate damages.

An Order follows.

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MARK SCULLY	:	CIVIL ACTION
	:	
v.	:	
	:	
US WATS, INC., KEVIN O'HARE, AARON BROWN and STEPHEN PARKER	:	NO. 97-4051

ORDER

AND NOW, this day of July, 1999 IT IS ORDERED:

1. Plaintiff's Motion to Alter and Amend the Judgment is DENIED.

2. Defendants' Motion to Alter and Amend the Judgment is DENIED.

John P. Fullam, Sr. J.