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

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

ADJUDICATION

Fullam, Sr. J. June , 1999

Plaintiff was formerly employed as president of the defendant US Wats, Inc. The defendant O’Hare succeeded plaintiff as president, and the defendants Brown and Parker were, at the pertinent times, the principal shareholders and directors of US Wats, Inc. Plaintiff alleges that the defendants breached his employment contract, and improperly refused to fulfill their obligations under a stock option agreement. Defendants contend that plaintiff was an at-will employee and that his stock options had expired with the termination of his employment. Alternatively, defendants contend that their failure to honor plaintiff’s stock options caused little or no damage to plaintiff.

The case was tried non-jury. My findings of fact are summarized in the discussion which follows.

I. BACKGROUND

The defendant US Wats, Inc., a New York corporation with its principal place of business in Bala Cynwyd, Pennsylvania, is engaged in the business of providing a full range of switch-based long distance telephone services to business clients nationwide. Wats was founded by the defendants Brown and Parker, in 1989.

US Wats, Inc. initially contracted with plaintiff to perform consulting services for a six-month period, commencing in the fall of 1994. Under that arrangement, plaintiff was paid $7,500 per month, and had an option (exercisable by one of plaintiff’s companies, Olney Telecom, Inc.) to purchase 150,000 shares of US Wats stock. US Wats, Inc. was experiencing financial difficulties, and plaintiff’s consulting services proved very beneficial. Messrs. Brown and Parker were so impressed with plaintiff’s services as consultant that they wished to obtain his services on a full-time basis, to achieve a “turnaround” of their company. Plaintiff was busy with his own company at the time, and was committed to an entrepreneurial role - i.e., one in which he could share in the benefits of ownership. After several meetings and discussions, the parties achieved an oral agreement, effective as of May 23, 1995. I find that the oral agreement then achieved did amount to a two-year contract of employment, under which plaintiff was to serve as president and CEO of US Wats, Inc. for a two-year period, at a salary equal to the salaries being paid Messrs. Brown and Parker. Plaintiff was also to be provided an automobile at company expense, an apartment in Philadelphia at company expense, and the option to purchase 850 shares of US Wats stock over a two-year period. Defendants did offer to put the agreement in writing, but plaintiff said that would not be necessary. Only the stock-option agreement was committed to writing.

Plaintiff entered upon his duties with enthusiasm, and the fortunes of the company greatly improved. There were, however, some occasions in mid-1996 when plaintiff felt that Parker and Brown were taking actions detrimental to the long-term welfare of the company; and Messrs. Parker and Brown became concerned that plaintiff was working too closely with various key employees, and that these employees were becoming loyal to plaintiff rather than to the owners of the company.

In early December 1996, without consulting plaintiff, Parker and Brown hired the defendant O’Hare to replace plaintiff as president of the company. Plaintiff learned of the change when O’Hare, with whom plaintiff had previously been friendly, broke the news to him at a dinner in a restaurant on December 19, 1996. O’Hare assured plaintiff that this did not mean that plaintiff was being terminated, but rather that O’Hare would need plaintiff’s help during the transition to O’Hare’s taking over management. All concerned were aware that plaintiff’s tenure with the company was scheduled to expire in a few months, and that plaintiff would be leaving the company at the end of his contract.

Plaintiff agreed to continue with the company through June 1997, and to aid in the transition. Plaintiff’s only concern was his stock option, and O’Hare assured him that he need not have any worries on that score.

When the change in management was announced to the employees at a meeting on December 19, 1996, Parker, Brown and O’Hare all assured the assembled employees that plaintiff was staying on with the company, and plaintiff assured the employees of his continued presence and support for the new management team. A few days later, Brown wrote plaintiff an effusive note, describing plaintiff as an “Ace” and his speech to the employees a “class act.” On December 30, 1996, again without any advance notice, plaintiff was fired. On January 14, 1997, plaintiff attempted to exercise the options for 600 shares of stock which had already vested, but the offer was rejected.

My finding that plaintiff had a two-year employment contract which, by its terms, would expire on May 23, 1997, is based upon the following: I accept plaintiff’s testimony on this subject as entirely credible. Both Brown and Parker admitted (1) that they very much wanted plaintiff to stay with the company for two years; (2) plaintiff agreed to stay for two years; (3) they offered plaintiff a written contract for two years, but plaintiff did not feel a written contract was necessary; and (4) the stock options, which admittedly were a key component of the transaction so far as plaintiff was concerned, were exercisable over a two-year period. The company's stock option plan which was then in effect specified that such options could be exercised only during the continuation of employment by the company; hence, it is quite clear that all concerned contemplated that plaintiff would remain in the company's employ for a two-year period.

I note also that, even if the original discussions were to be regarded as insufficient to establish a binding contract for two years, it is clear that the events of December 18th and 19th, 1996, achieved a contract of continued employment for six months from that date.

Having concluded that plaintiff had a two-year contract of employment, I must now address the issue of breach. On the basis of the overwhelming evidence, I find that the termination of plaintiff's employment on December 30, 1996 was indeed a breach of the contract. Defendants' attempts to establish that plaintiff provided just cause for his termination cannot be taken seriously. Defendants freely admit that plaintiff was accomplishing all that he was expected to accomplish, and more.

The company was in the process of completing a very satisfactory "turnaround," as evidenced by, among other things, the significant increases in the value of its stock. Plaintiff had achieved significant cost-savings. Even if, as the defendants apparently believed, various key employees were developing loyalties to plaintiff, rather than Messrs. Parker and Brown, that would not amount to just cause for terminating plaintiff's employment.

I turn now to the more difficult issues in the case, those having to do with damages.

II. <u>HAD PLAINTIFF'S STOCK OPTIONS EXPIRED?</u>

I conclude that plaintiff's attempted exercise of his stock options on January 14, 1997 was timely and appropriate, and that the defendants wrongfully refused to comply. My reasoning is as follows:

Plaintiff's options were issued originally in accordance with the 1993 stock option plan adopted by the company. Under the terms of that plan, stock options could be exercised only during continued employment. But, since plaintiff's employment was wrongfully terminated - <u>i.e.</u>, since he had a contractual right to continue to be employed on January 14, 1997 - the defendants' breach of that employment contract cannot entitle the defendants to cancel the stock options which were an essential part of that contract of employment.

Alternatively, I conclude that, when the 1993 stock option agreement was merged into the 1996 stock option agreement, the 1996 agreement became the operative instrument. In the first place, plaintiff's written stock option agreement provides that the option "is subject in all respects to the terms and conditions of the Plan now in effect and as they may be amended from time to time..." The 1996 plan states that it is "a merger and amendment and restatement of the prior plans..." (Plaintiff's Exhibit 13, Section 1, paragraph 2). The 1996 plan plainly provides that, upon termination of employment "for any reason other than death, disability or Cause...prior to the expiration date fixed for his or her Option, such Option may be exercised [within 30 days] after termination."

Thus, under the terms of the 1996 Plan, plaintiff had until January 30, 1997 to exercise the options which had thus far vested (the option for 600,000 shares).

I recognize that the 1996 Plan, in Section 1, also includes:

> The Plan, as amended and restated, effective August 13, 1996, constitutes a merger and amendments of the prior Plans (as defined in Section 2 hereof). Such merger and amendment and restatement shall not, in and of itself, affect prior options (as defined in Section 2 hereof) which are outstanding as of August 12, 1996.

Defendants argue that this language means that, since plaintiff's stock options were issued pursuant to a "prior plan," only the terms of the "prior plan" govern the time within which plaintiff's options might be exercised, hence plaintiff's options expired at the termination of his employment. I disagree. Given the fact that the "prior plan" stated that plaintiff's options would be governed by later amendments which might be adopted from time to time, it seems clear that the 1996 Plan was incorporated into the 1993 plan, and vice-versa. Moreover, given the language of the 1993 plan, it cannot be said that permitting the exercise of plaintiff's options for 30 days after termination of employment would be brought about by the 1996 plan "in and of itself"; rather, it would be the 1996 plan in conjunction with the 1993 plan which thus "affected" plaintiff's options.

Finally, the most that can be said of defendants' argument on this issue is that it establishes ambiguities which should be resolved against the defendants, as the drafters of the ambiguous provisions.

III. DAMAGES

Plaintiff was to have been paid the same salary as Messrs. Brown and Parker each received, namely, $165,000 per year. Although plaintiff claims such damages for the entire balance of his two-year contract, I conclude that, given plaintiff's obligation to take reasonable measures to mitigate damages, and given the fact that he landed on his feet within two months after his firing, he has established a right to salary continuation for two months, which amounts to a total of $27,700. Interest on that sum aggregates $3,742.20. Plaintiff will therefore be awarded $31,442.20 for lost salary.

The principal dispute between the parties, and the most difficult issues in the case, have to do with the proper measure of damages for defendants' wrongful repudiation of the stock option agreement. At the date plaintiff attempted to exercise his option to purchase 600,000 shares of Wats' stock, for the option price of 75 cents per share, the stock was trading on the open market at $1.375 per share. To complicate matters, however, (1) plaintiff would have been required to retain the stock for at least one year before he could sell it; and (2) his stock options were not transferrable. Thus, his measure of damages cannot very well be based upon the price at which he could have sold his stock options if the company had not repudiated them, nor does the price at which the stock was being traded represent the actual value of the shares plaintiff would have received, absent repudiation. Restricted shares are generally regarded as subject to a discount from market price, because of the restriction. On the basis of conflicting evidence in this case, I conclude that an appropriate discount would be 30 percent (plaintiff's expert suggests 29 percent, defendants' expert suggests 45 percent). On this issue, I find plaintiff's expert more nearly persuasive than defendants'.

Plaintiff makes much of the fact that, if the defendants had honored his option agreement, he would necessarily have retained the stock for one year, at which time the market price had risen to in excess of $2 per share. Defendant, on the other hand, argues that plaintiff's damages should be measured as of the date of breach, viz, January 23, 1997. On that basis, defendants' calculate plaintiff's loss at approximately $10,000 or less.

I do not fully accept either approach. By reason of defendants' breach of contract, plaintiff was deprived of the opportunity to obtain stock which he could have sold a year later at a significant profit. But in order to avail himself of that opportunity, he would have been required to invest $617,500 (850,000 shares at 75 cents per share). By reason of the defendants' breach, it became necessary for plaintiff to invest $1,166,750 (850,000 shares at $1.375) in order to achieve the same opportunity. It is true, of course, that if plaintiff had gone into the open market to purchase the shares with a view toward reselling them one year later, he would have owned, during the one-year period, stock which was worth more than the restricted stock of which he was deprived. But the advantages of owning unrestricted shares would have been counterbalanced, to some extent, by the fact that he would have been risking much more money.

It is also true that, when his options were repudiated, plaintiff did not in fact go into the open market to "cover." But plaintiff should not be made to suffer because, as a result of his illegal firing, he lacked the ready funds to make such an investment, or because less expensive, restricted, shares were not available for purchase. Although the increased cost of "cover" may not be a perfect measurement of plaintiff's damages, in my view it represents a reasonable approximation, and is more nearly accurate than the other alternatives advanced by the parties. Damages should be determined as of the date of breach, taking into account the reasonable expectations of the parties at that time. Plaintiff cannot therefore hold the defendant liable for the million-dollar profit he would have made if he had obtained the shares and sold them a year later. If the stock had declined in value, he would have suffered losses; and neither party had the benefit of hindsight in assessing their positions at the time of the breach. On the other hand, the fact that plaintiff could not have obtained value by transferring his option to another does not mean he suffered no damage when deprived of the right to exercise his options. We are concerned with what plaintiff actually lost as a result of defendants' breach. Plaintiff lost the opportunity to buy stock at 75 cents per share, as opposed to $1.375 per share. His damages are therefore measured by the difference between those two prices, and, for the 850,000 shares involved, aggregated

$549,250. Interest on that sum, at 6%, comes to $65,910. Plaintiff's damages attributable to repudiation of his stock option agreement thus totals $615,260. Plaintiff's total damages, loss of salary plus stock option damages, aggregates $646,700.

Judgment will therefore be entered for that amount in favor of the plaintiff and against the defendants US Wats, Inc., Aaron Brown and Stephen Parker. I am not persuaded that the evidence justifies imposing liability upon the defendant O'Hare, who appears not to have been a moving force in causing plaintiff's damages.

An Order follows.

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ORDER

AND NOW, this   day of June, 1999, judgment is entered in favor of the plaintiff Mark Scully and against the defendants US Wats, Inc., Aaron Brown and Stephen Parker in the sum of $646,700.

As to the defendant Kevin O'Hare, the complaint is DISMISSED.

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John P. Fullam, Sr. J.