RAISING THE STAKES: WHEN A WORKING SHAREHOLDER TAKES YOUR CLIENTS

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ABSTRACT

By limiting enforceability of employee restrictive covenants to less than five years and in many cases less than three years, the state courts have unknowingly created a financial incentive for corporations and employees to break the law. It appears more viable for a company to break the law and pay the economic damages than it is to abide by the law and compete honestly.

To assist litigators in identifying and correcting this legal anomaly, this paper presents additional economic damage theories that should be considered when analyzing cases where a working shareholder resigns from a company and takes clients with him.

Additionally, this paper makes corporate policy recommendations for companies who want to ensure that their intellectual property is safeguarded, despite the unfriendly laws surrounding restrictive covenants.

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INTRODUCTION

Forensic accountants, economists and other forensic professionals (Forensic Professional or FP) personally benefit from seeing the world through numerous lenses. FPs examine the world frequently through the strict language of the law, whereas other times they interpret the law for purposes of calculating fair and equitable damages. Still, experience has shown that most of an FP's time is consumed evaluating the alignment of incentives and decision-making criteria, or preparing, assessing and suggesting changes to mathematical models and economic estimates.

The FP also benefits from reading a tremendous amount of varied literature, from case to common law, microeconomic to macroeconomic policy, behavioral economics and social psychology, to industry and employment analysis. Yet, despite the FP's knowledge and broad perspective they hardly ever take advantage of their expertise by suggesting changes to corporate strategy or policy, or the alignment of incentives between shareholders and employees. Perhaps the reason for this has to do with inexperience of the industry, or a general sense of apathy for this sort of work, but I suggest that they can be a worthwhile contributor to the literature in the future, and perhaps offer the FP additional consulting fee opportunities.

In light of this, one of the primary purposes of this paper is to demonstrate that FPs have skills and knowledge that can not only offer guidance and assistance to the trier-of-fact but can also deliver meaningful insight to corporate leaders, employees and shareholders well in advance of costly and dreadful litigation. To argue this point, I present a new corporate policy, suggesting that corporations may want to consider allocating more shares to employees as a preventative tool against unwanted client solicitation from former employees. Not only was this idea well received by the litigating attorney, but the Company harmed in the case is considering the implementation of these ideas as well. The policy identified below was recognized while in the process of examining economic damages for a Plaintiff who was suing one of its employees for a breach of a restrictive covenant.

There are a more than a few secondary and tertiary purposes for this paper. The paper highlights behaviors in which an economic expert can work

collaboratively with a trial team, and when bringing all of their industry expertise to a case can add tremendous value to their clients, and to the trier-of-fact. The study also demonstrates how an economic expert can use various economic arguments and damages theories to better construct a sound and fair testimony. Furthermore, this paper highlights anomalies in the law, which when presented in an economic framework, can help counsel and the trier-of-fact understand the most accurate calculation of damages to a client. Last, the findings in this paper highlight poor incentives which were created unknowingly by state courts with respect to the calculation of damages for the breach of restrictive covenants. By understanding these incentives, the state courts may be sympathetic to the shortcomings of their case decisions, and adjust accordingly – should they decide to do so.

The outcome of this paper presents policy recommendations for corporate leaders and shareholders, recommends damages theories which should be considered by counsel when a breach of restrictive covenant is considered, and highlights for the trier-of-fact areas of restrictive covenant law which can be manipulated by unethical corporate actors.

I. THE UNDERLYING COMPLAINT

FPs are many times involved in cases where the engaging attorney requests that damages be calculated for only one or a few legal counts argued in the complaint. Recent experience has shown that this request is many times related to a client's limited legal budget, counsel's confidence in proving liability for select counts, or counsel has begun settlement discussions with relation to a specific count. To this end, I address a recent case where there were many counts included in the complaint but only two counts that were justly considered by the Plaintiff's counsel: (1) breach of non-compete, and (2) breach of non-solicitation. However, I highlight that the complaint also included a count for a breach of fiduciary duty, which was not considered by counsel, but is important to the recommendations discussed below.

In the case, Plaintiff's counsel requested that my firm calculate economic damages to the Plaintiff for a breach of a non-compete and non-solicitation agreement only. When prompted as to the reasoning behind this decision, counsel made it known that the Defendant had previously suggested their willingness to pay damages under these counts, hoping for an early settlement.

For confidentiality purposes, the names of the Plaintiffs and Defendants have been redacted, the industry in which the Plaintiffs operate has been purposefully removed, the dates modified, and the case venue is purposefully vague but applicable to most jurisdictions in the United States. The financial numbers for the Plaintiff and Defendant have been changed and intentionally rounded to the nearest million, and all financial figures are presented in United

States nominal dollars. Notwithstanding, all other case facts are to be considered true. The case settled just a few days before Trial began.

II. THE CASE

A. *The Tape Corporation*

The Tape Corporation (Tape or Company) is a privately-owned, Delaware C-Corporation with offices throughout the United States and is owned by less than one hundred shareholders, with brothers Jim and Chris Cricket (Crickets or Plaintiffs) owning 75% of the outstanding common stock of Tape. The Company does not have any other forms of stock authorized.

As of December 31, 2017, the Company had gross sales of $120 million, with Operating Income, EBITDA and Before Tax Cash Flow Margins of 22.3%, 31.5% and 26.9%, respectively. Most recently, Tape received an equity investment of $33.3 million from a well-respected sovereign wealth fund. This money was used for growth purposes. The fund received 10% of the post-money common stock in Tape. Based on a $300 million pre-money value, the Company has a 2.5x Price-to-Sales, 11.2x Price-to-Operating Income, 7.9x Price-to-EBITDA and a 9.3x Price-to-Before Tax Cash Flow value metrics. The sovereign wealth fund is anticipating more investments in Tape as the Cricket family considers future sales of its stock over the next ten years. Approximately ninety employees, both present and retired own the remaining 15%.

Historically, the Company has provided incentives for employees to purchase its common stock. Most recently, the Company has allowed employees to purchase stock at a 15% discount to its most recent valuation. In addition to purchasing common stock, high-performing senior members of the management team receive periodic stock grants, which vest over time. The Company is funded exclusively by equity in the form of common stock, has no long-term debt, but from time to time utilizes a short-term credit line.

B. *Peter Pettigrew*

Peter Pettigrew (Defendant or Peter) was one of the most productive sales people at the Company, and over the period of his employment, was awarded various stock grants for his outstanding performance. From time to time, Peter also took advantage of purchasing the Company's common stock at a discount. Peter owns 0.1% of the Company, with an approximate worth of $333,300 (post-money value of $333,000,000 x 0.1%). Peter was hired in or around March 15, 2013 as a junior sales employee servicing accounts on the east coast of the United States and was promoted in late 2015 to the northeast regional sales manager. Peter was promoted again in January 2018 as the senior vice president of sales for the east

coast, which also happened to be the most financially productive region for the Company. Peter reported to Chris Cricket, the President of Tape.

During his time at the Company, Peter was successful at generating new business, but he was also given accounts (House Accounts) from the Company. When employees left the Company, many of the accounts that were no longer serviced by the departing employee would be given to Peter or other sales personnel. Peter, and all other sales employees were paid on the sales from the House Accounts that they serviced. Peter was also paid on any new business that he or his sales team closed.

By almost all accounts, Peter was known in the Company as a high performer and a solid business leader. Due to his high performance, the Company embraced Peter and shared sensitive information with him including, but not limited to, profitability of the Company, strategic plans, survey results from client research, employee performance results, information about high-risk clients, and similar sensitive and confidential information. Peter was also the fifth highest paid executive at the Company, making approximately $500,000 to $700,000 per year. Peter had the largest number of accounts in the entire Company, 70% of which were House Accounts given to him by the Company.

The Company, including all of Peter's clients, experienced very few cancellations from its customers. Based on the previous ten years of operating history, the Company experienced a 1% client cancellation rate each year, most of which were acquired by another company, went out of business or experienced a strategic pivot into a new industry. Due to the continuous R&D by the Company, and the continued new products coming to the market, the Company's clients continued to spend more per year, with a historical ten-year growth rate of about 25%. By almost all measures, Tape was a successful company.

C. Non-Solicit Agreement and Non-Compete Agreement

Just prior to beginning his work with Tape, Peter signed a non-solicitation agreement (NSA) prohibiting him from contacting any of Tape's clients for a period of three years from when he resigned or was terminated from the Company. A client (Client) was defined in the NSA as any customer that Tape sold products too in any of the previous three years prior to termination or resignation, and the client must not have cancelled in any of the previous three years prior to termination or resignation. Peter also had a non-compete agreement (NCA) which stated that Peter could not share any proprietary information, trade secrets or other intellectual property of the Company to another party, should Peter resign or be terminated from Tape. Similar to the NSA, the life of the NCA was for three years after termination or resignation.

D. Screwtape

In early June of 2018, Peter was approached by a nationally recognized recruiting firm, which was tasked to find a replacement for the Executive Vice President and the Global Head of Sales for Screwtape (Screwtape of Defendant), a competitor to Tape. Screwtape was a much larger company than Tape, with approximately $750 million in sales and global operations. Screwtape grew mainly from company acquisitions and aggressive employee recruiting.

Although not actively looking for a new position, Peter interviewed with Screwtape. After some negotiations Peter was presented with a lucrative offer from Screwtape with sales commissions substantially greater than what Tape was currently paying and a special incentive for any Tape clients that would move with Peter after his resignation. Peter made Screwtape aware of his NSA and NCA, and Screwtape guaranteed Peter that it would cover any and all legal expenses associated with his resignation from Tape. The CEO of Screwtape acknowledged this was a competitive tactic that they used to lure away top talent from their competitors, while gaining additional sales and profit in the process. In addition, the CEO made it known via her deposition that Screwtape would litigate any future lawsuits stemming from its recruiting efforts. Peter resigned from Tape on the morning of June 30, 2018.

E. Employment at Screwtape

Peter accepted the offer from Screwtape on June 30, 2018 and by December 31, 2018 Peter solicited six million-dollars of annualized client sales from Tape. The solicited accounts represented approximately 50% of Peter's business. Table 1 (below) shows the actual sales, operating profit, EBITDA, and before-tax cash flow for years ending December 31, 2014 to December 31, 2018. I have simplified the structure of these accounts for purposes of this paper. Over the 2014 to 2018 time period, the annual Client sales grew by 35.12% per year.

Table 1 – Solicited Sales and Profits

	December 31 (millions)				
	2014	2015	2016	2017	2018
Sales	$1.80	$4.30	$4.70	$5.30	$6.00
Cost of Sales (20%)	.36	.86	.94	1.06	1.20
Gross Profit	1.44	3.44	3.76	4.24	4.80
Operating Profit (before tax)	0.32	0.77	0.85	0.95	1.08
EBITDA	0.43	1.03	1.13	1.27	1.44
Before-Tax Cash Flow (BTCF)	0.31	0.73	0.80	0.90	1.02

Based on the admission of the CEO of Screwtape during her deposition and the various stages of settlement negotiations, she believed that Screwtape's economic damages would be approximately $2.72 million-dollars, or three years' worth of historical BTCF[1] stemming from the solicited Clients ($2.72=$0.80+$0.90+$1.02). The CEO also suggested that in some instances Screwtape paid three years of future BTCF from the solicited Clients, and in very rare cases they paid the profits, which Screwtape recognized over a three-year period. As long as the economic damages were calculated to be less than three times the historical or forecasted BTCF, the CEO seemed to be somewhat detached. The CEO's assumption of damages to be paid in restrictive covenant cases had some association with the case law.

III. BREACH OF CONTRACT DAMAGES – NON-COMPETE AND NON-SOLICITATION

Based on the CEO of Screwtape's historical understanding, the economic damages associated with a breach of restrictive covenant are associated with one of three damages remedies, though for purposes of this paper, I only address the first two:

(1) Disgorgement of Breaching Party's Profits,
(2) Nonbreaching Party's Lost Profits, or
(3) Liquidated Damages.[2]

To recover damages under the disgorgement of the breaching party's profits remedy, the plaintiff may recover the profits of the defendant only if the plaintiff can show that they would have continued to service the Client, absent the breach. The issue that aries with this approach is that many times the defendant has not secured enough of the profits that would have otherwise gone to the plaintiff, at the time of dispute to warrant its use. For instance, in this case, the Defendant only secured profits from the Clients for a very short period of time (June 30, 2018 to December 31, 2018) and therefore there were not many profits to recover. Typically, this approach provides a lower damages threshold. Due to this problem, plaintiffs look to the loss of their own profits (nonbreaching party's lost profits) based on future estimates.

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1 The courts have yet to define a uniform standard for lost profits. For cases where the author has been involved, the standard used by his firm is mainly before-tax lost cash flow when the Company will have to pay taxes on any award granted in the litigation.

2 *See In re* Hallahan, 936 F.2d 1496 (7th Cir. 1991); Premix, Inc. v. Zappitelli, Metlife Capital Fin. Corp. v. Wash. Ave. Assocs. L.P., 159 N.J. 484, 504 (N.J. 1999); 561 F. Supp. 269 (N.D. Ohio 1983); 1 ROBERT L. DUNN, RECOVERY OF DAMAGES FOR LOST PROFITS, 206–16 (Lawpress Corp. 6th ed. 2005) [hereinafter RECOVERY OF DAMAGES FOR LOST PROFITS]; Michael L. Rich, *Breach of Restrictive Covenants: What are the Damages?*, 206 4 N.J.L.J. 346, 346–47 (2011) [hereinafter Rich, *Breach of Restictive Covenants*].

To calculate the loss of profits, the FP forecasts the present value of the historical and future losses to the plaintiff.[3,4] The future loss profits are many times based on calculating the business life of the client, after considering cancellations. As way of example, if a Client has a 50% yearly cancellation rate, the life span of the Client base would be two years. As explained above, Tape had a 1% yearly cancellation rate, suggesting that its lost profits would be calculated for one-hundred years into the future.[5] As will be shown later, this causes real problems for the trier-of-fact, considering that the defendant can purchase the entire Client base for a market value based on the trading characteristics of the firm; in this case, almost always less than one hundred times the value of the profits.

This begs the question, how many years of lost profits will the trier-of-fact award the plaintiff, should liability for a breach of restrictive covenant be proven true? Should the defendant pay one time the value of the lost profits of the plaintiff's business, three times, ten times or one hundred times?

Based on the above information with respect to remedies, and based on review of case law and various state statues there does not appear to be reference to a universally accepted standard for calculating the loss of future profits in a breach of restrictive covenant case. Despite this lack of clarity, the accepted notion running through the various governing state laws is clear - the goal is to put the plaintiff in the same position they would have been in had it not been for the wrongful action. Would this be true, is there any indication to suggest a three year loss period, as suggested by the CEO of Screwtape?

A. Reasonable Enforceability of Covenant

Most restrictive covenants tend to have a life of one to five years. In most cases the courts consider covenants greater than five years unreasonable.[6] Some courts, such as Florida suggest that a restrictive covenant greater than two years is unreasonable.[7] Other states such as New Jersey have considered a new law limiting restrictive covenant enforceability to twelve months, while Connecticut seems to allow two years.[8,9]Other states such California, Oklahoma, Rhode Island, North

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[3] Rich, *Breach of Restrictive Covenants*, *supra* note 2.

[4] Platinum Mgmt., Inc. v. Dahms, 285 N.J. Super. 274, 311–12 (Law Div. 1995).

[5] In actuality, based on discounting the future cash flows each year by any sum will result in an asymptotic curve, where damages will continue on into the future. For most cases, we stop calculating future damages when the future damages in any given year fall below the historical average revenue by client. There is much debate in how this is handled by various experts.

[6] Daniel Schwartz, *How Long Can You Enforce a Non- Compete Agreement For?* CONN. EMP. L. BLOG, (Sept. 15, 2014), https://www.ctemploymentlawblog.com/2014/09/articles/how-long-can-you-enforce-a-non-compete-agreement-for/.

[7] Fla. Stat. § 542.335 (2019) (discussing valid restraints of trade and commerce).

[8] Assemb. Bill No. 1769, 218th Leg. Sess., (N.J. 2018).

[9] Weiss v. Wiederlight 208 Conn. 525, 530–32 (Conn. 1988).

Dakota, Massachusetts, Missouri and Oregon have shown hostility toward almost all sorts of restrictive covenants.[10]Most of the states which take a hostile view toward restrictive covenants do so because they believe the covenant restricts the employee's ability to garner employment and promotion elsewhere. In the case of *Edwards v. Arthur Anderson LLP*, the Supreme Court of California held that non-solicitations limit a person from performing their trade.[11,12]It seems like any period greater than five years is unreasonable and any future loss period less than three years seems most plausible.

After reviewing multiple states laws and court decisions there also seems to be a void in the literature with respect to employees who are also shareholders, and who violate restrictive covenants. Based on the preliminary research, we posed the question to the trial team… "are shareholders held to the same standard as employees when it comes to violating a restrictive covenant or when it comes to taking business from one company to another?" It seems reasonable that shareholders, or shareholder employees are held or can be held to a higher standard when it comes to violating a restrictive covenant or engaging in other violations, such as breaching their fiduciary duty, or possibly oppressing other shareholders from their behavior.

B. Screwtape's Rationale

Now consider Peter's restrictive covenant which is enforceable, assumedly, for three years after the date he resigned. His covenant suggests that it would be legal for him to start soliciting the Clients on the first day of his fourth year after his resignation. Had this been the case, it would take Peter some additional time to re-establish connections and build a relationship again with many of his former Clients. For purposes hereof, it should take Peter four years to sell products to his former Clients, had he obeyed the restrictive covenant. It will take three years for the NSA and NCA to expire, and an additional year to rebuild relationships and entice Clients to purchase Screwtape products.

Based on these assumptions, Screwtape trusts that the Court will provide no more than four years of lost profits.

C. The Legal but Unethical Motivation

The CEO of Screwtape and her executive team were making decisions that, although not ethical, were very financially efficient. The Screwtape executive

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[10] Joshua Horn, *Differing State Laws on Restrictive Covenants*, FOX ROTHSCHILD LLP (August 2017), https://www.foxrothschild.com/publications/differing-state-laws-on-restrictive-covenants/.

[11] Edwards v. Arthur Andersen LLP*,* 44 Cal. 4th 937, 946 (2008).

[12] *See* Horn, *supra* note 10 for more information on the enforceability of restrictive covenants by state.

team believed that the economic damages associated with soliciting a new employee and their clients was worth it, despite the possible economic damages from the breach of a restrictive covenant, as described below.

Based on the admission of the CEO during her deposition, Screwtape, as a tradeable asset had a Price-to-Sales multiple of 1.8x, Price-to-Operating Income of 14.0x, Price-to-EBITDA multiple of 12.5x, and a Price-to-Before Tax Cash Flow multiple of 11.0x. For each dollar gained in sales, EBITDA or Before Tax Cash Flow would result in an increase in the value to Screwtape shareholders.

Take for example a hypothetical corporate acquisition made by Screwtape. If Screwtape were to buy a company and pay less than 14.0x the operating income, 12.5x the EBITDA, 11.0x the before tax cash flow or 1.8x the sales of the company in which they were purchasing then Screwtape would be increasing its own value on the date of acquisition. Assume that Screwtape purchased a company that reported ten million dollars of before tax cash flow, and assume it paid forty million dollars for the asset, effectively a price-to-before tax cash flow of 4x.[13] After the acquisition, Screwtape would have increased its before tax cash flow by ten million dollars. Using Screwtape's Price to Before Tax Cash Flow multiple of 11.0x would imply that there was a $110 million-dollars of increased value ($10 million- dollars * 11.0x) from the acquisition, less the forty million that it paid in cash or debt, providing a net increase of seventy million dollars. This is what is considered to be a value accretive transaction.

This same idea holds true with respect to Screwtape's behavior in soliciting executives and their employees. If Screwtape can hire an executive from a competitor, and at the same time acquire that competitor's clients, while paying less than 14.0x the operating income, 12.5x the EBITDA, 11.0x the before tax cash flow or 1.8x the sales of the solicited clients, then the Company is increasing its shareholder value. Screwtape also understood that many of the financially weaker companies in the industry where it recruited executives and where violations of restrictive covenants occurred would not pursue legal action. Considering this, Screwtape would not pay for many of the clients it solicited in this illegal manner, leaving the company with the ability to pay higher prices when litigation is pursued by the harmed party, and where the harmed party requires damages greater than those traditionally provided in restrictive covenant cases.

D. Calculating Damages

In the following table, I calculate the value of the Clients to both Screwtape and Tape by taking the BTCF of the Clients, as reported by Tape, multiplied by each of the companies BTCF-to-Sale Multiple. As previously explained, the BTCF

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[13] This is the same multiple as assumed Screwtape would pay for the Clients.

of Screwtape is 11.0x and Tape is 9.3x, suggesting that the value of the Clients is greater to Screwtape.

Table 2 – Gain and Loss of Absolute Value

Company	Before Tax Cash Flow Multiple	Before Tax Cash Flow of Clients in 2018 (millions)	Shareholder Value (millions)
[A]	[B]	[C]	[D]
Screwtape	11.0x	$1.02	$11.2
Tape	9.3	$1.02	$9.5

The market value of the Clients to Tape is $9.5 million-dollars, and the value of the Clients to Screwtape is $11.2 million-dollars.

Now, consider the premise that Screwtape will pay four times the value of the BTCF of $1.02 million-dollars or $4.08 million-dollars. Should Screwtape prevail in court and pay $4.08 million-dollars, then it would benefit from its illegal actions with a $7.14 million-dollar accretion in shareholder value ($11.2 million-dollar increase in value less the purchase price of the Clients for $4.08 million-dollars). With this increase comes a decrease in the shareholder value to Tape. Considering the value of the Clients to Tape is $9.5 million-dollars, and assuming Tape would receive $4.08 million-dollars suggests a net decrease in the value of $5.4 million-dollars ($9.5 million-dollars less the money received from the Screwtape of $4.08 million-dollars). The absolute change in shareholder value is $12.5 million-dollar ($7.14 gain to Screwtape – ($5.4) loss to Tape).

To analyze this loss from a different angle I provide Table 3 (below) to showcase the mediated profits. Column B (below) provides the actual results of Tape's Clients for the year ending December 31, 2018, column C provides the actual costs that will remain with Tape after the Clients leave Tape, and column D provides the difference between columns C and B.

Table 3 – Mediated Profits

Account	2018 (Before Allegations)	2018 (After Allegations)	2018 Difference
[A]	[B]	[C]	[D]
Sales	$6.0	-	
Cost of Sales (20%)	1.2	-	
Gross Profit	4.8		
Fixed Expenses	3.72	1.86	
Before Tax Operating Profit	1.08	(1.86)	
Depreciation and Amortization	.36	.36	
EBITDA	1.44	(2.22)	
Capital Expense	.42	-	
Before Tax Cash Flow	1.02	(2.22)	(3.24)

Tape's management team, despite its best efforts at litigation, needed to stem the financial losses to the Company and therefore reduced costs associated with the actions of Peter. As shown above, the fixed expenses of the Clients were originally $3.72 million-dollars, and after the Clients left, the fixed expenses were reduced to $1.86 million-dollars. This reduction was mainly driven by compensation to Peter, his administrative assistant, and junior support staff who were terminated shortly after Peter resigned. Tape also forecasted that it would be able to reduce all of the Costs of Sales and all of its Capital expense but was unable to reduce the Depreciation and Amortization expenses. As shown above, the Company was expected to make a BTCF profit of $1.02 million-dollars, but will actually end up with a ($2.22) million-dollar BTCF loss, calculating a change in BTCF of $3.24 million-dollars ($1.02-($2.22)). Considering that Tape has a Price to BTCF of 9.3x, and assuming a change in BTCF of $3.24 million-dollars, I calculate that the actual damage in value to Tape is **$26.05** million-dollars ($3.24 million as change in BTCF * 9.3 as the Price to BTCF - $4.08 million-dollars the price Screwtape was willing to pay).

The gain to Screwtape also needs further analysis. Table 4 (below) presents the financial benefits to Screwtape, based on information obtained during depositions taken from Peter and the CEO. Considering that Screwtape was a much larger company with a much greater infrastructure than Tape, they achieved better economies to scale. We calculated that Screwtape will have a slightly lower cost of sales, approximately 18%. This lower cost is due to almost no increase in fixed costs considering that Peter will move into an office space that is presently vacant, will share an administrative assistant, and will utilize all existing staff that Screwtape is presently paying for. Screwtape would have a negligible capital expense and negligible depreciation costs. The BTCF to Screwtape is expected to be $4.82 million-dollars, considerably greater than the BTCF to Tape.

Table 4 – Value of Tape's Clients to Screwtape

Account	2018 (Financial Results to Screwtape)
Sales	$6.00
Cost of Sales (18%)	1.08
Gross Profit	4.92
Fixed Expenses	1.0
Before Tax Operating Profit	3.92
Depreciation and Amortization	.05
EBITDA	3.97
Capex	.15
Before Tax Cash Flow	3.82

When analyzing the gain to Screwtape, it was suggested that the BTCF would be much greater than the results expected with Tape. The increase in the BTCF to Screwtape is because it will acquire the Clients but will not acquire the fixed costs associated with these Clients, thus providing substantially greater profits. As mentioned above, considering that Screwtape trades at approximately 11.0x BTCF suggests that the real increase in value is $37.94 million-dollars ($3.82 million-dollars BTCF to Screwtape * Screwtape's BTCF multiple of 11.0x - $4.08 million-dollars the price Screwtape was willing to pay).

To summarize these values, Tape loses $26.05 million-dollars of shareholder value and Screwtape gains $37.94 million-dollars, an absolute change in shareholder value of $63.99 million-dollars. Considering the magnitude of this change, it is no wonder why some companies may be enticed to engage in such illegal behavior. Notwithstanding this ultimate change in value, there are other factors that may have an impact on the losses here. With the reduction in market value of Tape and the loss of Peter, the Company may experience decreased financing opportunities, reduced economies to scale, increased pricing pressure, and possible other losses not considered here.

The previous two analyses were provided to demonstrate that Screwtape had substantially more to gain when illegally soliciting the Clients than they led on. Although they seemed to justify the action of solicitation with a willingness to pay the lost profits, the amount they offered appears to be minimal when compared to the loss of value experienced by Tape.

IV. ALTERNATIVE DAMAGES THEORIES TO CONSIDER

Although state courts appear to have an admirable goal in protecting the worker's rights to meaningful employment and ensuring employee competition, they have created a negative externality associated with their decisions. By limiting enforceability of restrictive covenants to less than five years and in many cases less than three years, the state courts have unknowingly created a financial incentive for corporations and employees to break the law. Shown previously, Screwtape has a substantial gain in shareholder value, offset by what appears to be a rather inconsequential payment of lost profits to the Plaintiff. Taking this into account, it seems as if it is more financially worthwhile for a company to break the law and pay the economic damages in the form of lost profits, than to abide by the law and compete honestly.

Now after understanding this misalignment of incentives, what can a company like Tape do when it wants to compete without breaking the law, yet at the same time keep its competitors from having an unfair advantage?

After much deliberation with the Plaintiff's counsel, the economic team proposed a few ideas. First, we proposed an unassuming question to the group -- *how can Tape be made whole, yet avoid the economic damage calculations under*

a breach of restrictive covenant which has shown to not capture the full economic damages? We gathered that the Court had no intention of providing an incentive for a company to break the law, while hurting an innocent company in the process. To assist in making the Plaintiff whole, the economic team proposed two different, yet interconnected, damages theories which both rely upon shareholder oppression and breach of fiduciary duty cases. First, we looked at calculating damages using breach of fiduciary duty or shareholder oppression case law. Second, we relied on an equitable remedy that the court has used to eliminate the poorly aligned incentives where a majority shareholder has a financial incentive to hurt a minority shareholder.

Although the final legal complaint did not specifically mention shareholder oppression, it did provide for a count of breach of fiduciary duty and a breach of the duty of loyalty, as well as multiple counts regarding the breach of restrictive covenants. In many state courts, where there is a case of shareholder oppression, breach of fiduciary duty or breach of the duty of loyalty, the court provides that the shareholder or the party which was harmed is entitled to the economic damages which make the oppressed whole again.

If the damages are temporary, then the harmed party is entitled to lost profits or other similar short-term awards, and if the damages are permanent, the harmed party is entitled to permanent lost profits, loss of equity, or enterprise/shareholder value. In Basho Technologies Holdco B, LLC v. Georgetown Basho Investors, LLC*, C.A. No. 11802-VCL (Del. Ch., July 6, 2018)* the Delaware Court of Chancery suggested that any shareholder which has the ability to exercise control over the business affairs of a corporation can be found liable for a breach of fiduciary duty and the breach of the duty of loyalty, including minority shareholders. Considering Peter is not only an employee but also a minority shareholder, he has shown to have control over the Company by way of soliciting 50% of the Clients, not to mention he had access to intellectual property and proprietary Client information. In the previously mentioned case, the court argued that as long as there is a relationship between the harm and the economic damages, the law shall not require certainty in the award of damages, and damage calculations without economic certainty are permissible so long as the court has a basis to make a responsible estimate of damages. Once a breach of duty is established, uncertainties in awarding damages are generally resolved against the wrongdoer."[14]

Similarly, in *Balsamides v. Protameen Chemicals, Inc.* the New Jersey Court argued that because of the wrongful actions of a minority shareholder, the oppressor (minority shareholder) must sell his shares to the Company at a

[14] Basho Technologies Holdco B, LLC v. Georgetown Basho Investors, LLC*,* C.A. No. 11802-VCL, 2018 Del. Ch. LEXIS 222 at *114–15.

substantial discount.[15] In the case of *Lawson Mardon Wheaton v. Smith*, the New Jersey Court created a precedent in calculating economic damages by not allowing an oppressing majority shareholder to benefit from their oppression. Simply put, in most non-litigated finance transactions when a minority interest wants to sell his or her shares, he or she would normally receive a per share value less than the majority share value. This is mainly due to limited control of the minority interest. Additionally, many times these shares are ownership interests in privately held companies where there is a limited group of qualified investors willing to purchase the shares. Considering this, many times these shares also receive a form of discount for limited marketability. Together these discounts have created an incentive for the majority shareholder to mistreat, oppress or breach its fiduciary duties to the minority owner, all in hopes of purchasing the minority shares at a deep discount. Instantly upon purchasing the minority shares, the majority shareholder would have a windfall as the minority shares purchased at a discount would now be worth the same as the majority shares. In many respects, majority shareholders, prior to *Balsamides* were incentivized to oppress shareholders. The economic team argued this same concept of equity applies to damages experienced by Tape.

Very similar to anomalies in the law which eventually shaped the *Balsamides* or *Lawson Mardon Whe*aton court decisions, Screwtape has taken advantage of a similar legal anomaly. Screwtape was motivated to hire new sales professionals from Tape and acquire their Clients without paying any fees to Tape for doing so, unless of course Tape were to sue. In the same way that the majority shareholders have a financial incentive to oppress minority shareholders, Screwtape has an incentive to hire sales people who bring with them clients, revenue and profit for little to no costs. Using the same economic logic in the *Balsamides* or *Lawson Mardon Wheaton* cases, any economic damages award that is less than the value of the loss of equity to the Plaintiff results in a discount to the Defendant, providing incentive to do so again.

Considering this argument, the value of the Clients to Tape, assuming it wanted to sell the Clients in the first place would be approximately $9.5 million-dollars ($1.02 BTCF to Tape x 9.3 BTCF-To-Price) and the value of the Clients to Screwtape would be $42.02 million-dollars ($3.82 million-dollars BTCF to Screwtape x 11.0 BTCF-To-Price). In both instances, the value of Tape is much greater than $4.08 million-dollars originally proposed by the CEO of Screwtape. However, it should be taken into consideration that Tape was not in agreement with Screwtape to sell the Clients, and so the $9.5 million-dollars seems inequitable, not to mention the stranded costs that Tape will have to absorb in the short term. Furthermore, even with a $9.5 million-dollar purchase price, Screwtape still has an

[15] Michael L. Rich, *'Fair Value' and Discounting in N.J. Shareholder Oppression Case*, 194 N.J.L.J. 510, 511 (2008).

incentive to break the law, considering the value of the Clients to the purchase price is $42.02 million-dollars. Based on the analysis thus far, it seems reasonable for the trier-of-fact to consider the damages to Tape to be $42.02 million-dollars. This award can be justified based on the notion that the Plaintiff can claim disgorgement of the profits of the Defendant.[16] Perhaps, the damages award can also be justified under the same equitable notions as expressed in the *Balsamides* and *Marson Larden Wheaton* cases. It seems that the only way to curtail the behaviors of companies who violate the law yet continue to gain from their behavior is to charge the company the value of the profits in which they illegally solicit.

V. NEW POLICY CONSIDERATIONS

When a market is competitive, it becomes challenging for a company to continue to make profits each year, and it is even more challenging to secure enough financial resources needed to perform the research and development necessary to sustain the business.

Similarly, in a competitive market it is important that employees have the mobility to move from company to company should they desire to do so. However, what is not efficient is allowing employees to take intellectual property with them as they leave one company to join another. Should this be allowed, it removes the incentives for competitors to spend money on research, development, employee training and other initiatives which have historically provided some form of competitive advantage.

The negative downstream effects when companies reduce or eliminate their spending on research and development has societal level implications, such as the reduction in innovative technologies, the continuous downward pressure on price which is normally associated with competitive markets, and limited company growth which has a negative impact on employee hiring.

When analyzing the above case from a macro-economic view, it seems as though by allowing companies to solicit employees, while breaking the law and benefitting in the process creates a moral hazard in the marketplace. Should one think through the possible effects of this, it seems as though it may make more sense to illegally solicit employees, break the law, and pay the restrictive covenant price while gaining not only financially, but also possibly acquiring know-how and best practices from the solicited employees. This reminds me of the old idiom about marriage, 'why buy the cow, when the milk is for free'. Although the illegally solicited clients and all the benefits associated with them are not free – they are

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[16] *See In re* Hallahan, 936 F.2d 1496, 1502 (7th Cir. 1991); Premix, Inc. v. Zappitelli, 561 F. Supp. 269, 279 (N.D. Ohio 1983); MetLife Capital Fin. Corp. v. Wash. Ave. Assocs. L.P., 159 N.J. 484, 504 (N.J. 1999); Rich, *Breach of Restrictive Covenants*, *supra* note 2; RECOVERY OF DAMAGES FOR LOST PROFITS, *supra* note 2, at 211.

indeed cheap when compared to the alternatives of paying market price for the clients, and the intangible benefits gained such as know-how and best practices.

Thinking through all of the implications stemming from these legal anomalies, it seems important to better align the incentives of the corporation with those of its employees, and what better way to do this than through mutual corporate ownership. Shareholders are normally disinclined to give away shares in a company in which they invest because by doing so the shareholder becomes diluted and can potentially lose value. Opposing this view is the employee who believes they deserve shares based on their work performance, their tenure, or the fact they may not be paid market-based rates.

So often the shareholder who is disinclined to vote in favor of an employee shareholder plan is not well versed on the benefits or the risks. An employee who does not own shares, yet chooses to leave one company to join another has a fair amount of intellectual property, at his or her disposal, which is very important to either the former or new company. The amount of information that an employee can take when they leave a company can have permanent and devastating effects on the said company – despite there being some form of restrictive covenant in place. Perhaps, with great litigators the company may receive a small award for the unbecoming acts of their former employee however, as previously shown the negative financial impact can be much greater than the award, even when the company prevails. In the above example, Tape lost a minimum of $9.5 million-dollars in value due to the destructive behavior of one employee. However, considering Peter was a shareholder it allowed Tape to pursue other avenues of loss – including breach of fiduciary duty as a shareholder and shareholder oppression. This highlights the potential for the expansion of a not so new corporate policy. Rather than focusing exclusively on ineffectual restrictive covenants as risk mitigation tactics, perhaps companies should award shares or provide discount purchase plans to employees so that if one of its working shareholders engages in behaviors that hurt the company, then the company has additional avenues to fully remedy its damages.

From the employee's perspective, they would benefit as well. Employees are provided additional forms of compensation, have a vote or say in the affairs of the company, and are possibly motivated and feel a greater sense of connection with their work, to name only a few benefits. Corporations with formal employee stock plans have shown that the productivity of employees increases.[17] In other literature, it has been shown that when employees own shares team efforts increase, and others have shown that when employees are stockholders they perform better

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[17] E. Han. Kim & Paige Ouimet, *Broad-Based Employee Stock Ownership: Motives and Outcomes*, 69 J. of Fin., 1273, 1277–78 (2014).

when trying to solve complicated problems.[18][19] I have provided only a few of the benefits to employee stockholder ownership but the literature seems compelling and suggests that corporations indeed benefit when employees are stockholders.

When combining the risk mitigation aspects of stock ownership with productivity and related benefits, the case for companies to gift or provide discounted stock purchase plans seems compelling. By doing so, the company provides itself a firmer foundation from which to litigate for damages should an event occur, and it further aligns the motivations of the employees with the company.

CONCLUSIONS AND FURTHER CONSIDERATIONS

This paper has walked through a scenario where a company was harmed by a competitor who illegally solicited one of its employees and who took a substantial amount of revenue and profits with it – despite the competitor knowing that a restrictive covenant was in place. Disregarding all of the legal remedies afforded to the Plaintiff, the Defendant was fixated on the more obvious legal claim – breach of restrictive covenant. After multiple discussions with the Plaintiff's legal team, and after uncovering additional facts it became known that the vacating employee was also a shareholder, thus opening more legal remedies for the company to pursue damages. The case highlights some anomalies in the law. Violators of restrictive covenants are typically required to pay three to five times the lost profits of the harmed party which is normally a price much less than what the violator would pay if they were to legally purchase the clients from the plaintiff. Additionally, it was argued within various case law and literature that the trier-of-fact may want to consider disgorgement of long-term profits as a way to ensure that actions such as those engaged by the defendant are minimalized. I suggested that the same equitable arguments made in the *Balsamides* and *Lawson Marden Wheaton* cases are relevant to the case at hand, and that the trier-of-fact may want to consider removing the possibility of oppressive acts, and award damages based on the gains of the defendant. Lastly, the paper has shown that for companies who want to protect their intellectual property should consider additional safeguards that go further then restrictive covenants. It has been shown and argued that by giving away more equity, the company may be in a much better position when it comes to pursuing any future litigation.

Additional research quantifying the optimal point of shares given or awarded to employees versus the risk of loss from intellectual property

[18] Derek C. Jones & Takao Kato, *The Productivity Effects of Employee Stock-Ownership Plans and Bonuses: Evidence from Japan*, 85 AMERICAN ECONOMIC REVIEW 391, 391–414.

[19] RICHARD B. FREEMAN ET AL., WORKER RESPONSES TO SHIRKING UNDER SHARED CAPITALISM AT WORK: EMPLOYEE OWNERSHIP, PROFIT AND GAIN SHARING, AND BROAD-BASED STOCK OPTIONS (Richard B. Freeman et al. eds., 2010 University of Chicago Press).

misappropriation seems ripe for discovery. There seems possible an optimal point where risk is minimalized when converting employees to working shareholders. Additionally, it seems that the management literature which focuses on the benefits of employees owning stock in the company in which they work may want to further consider the risk mitigation benefits found here.