

Chancery court allows Straight Path stockholders to pursue direct claims against company's former controlling stockholder

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On 25 June 2018 the Delaware Court of Chancery denied a motion to dismiss the claims of Straight Path Communications Inc's stockholders against the company's controlling shareholder. The minority stockholders alleged that the controlling stockholder used his position to extract significant personal benefits from the sale of Straight Path to Verizon.⁽¹⁾

Facts

IDT, which is controlled by its former CEO, Howard Jonas, was Straight Path's former parent company. When IDT spun out Straight Path in 2013, it agreed to indemnify Straight Path for liabilities arising from pre-spin-off conduct. Following that spin-off, Straight Path entered into a consent decree with the Federal Communications Commission (FCC) which, among other things, required Straight Path to pay a \$100 million fine. The consent decree also required Straight Path to sell its spectrum licences and deliver 20% of the proceeds from that sale to the FCC. The actions giving rise to the fines arose prior to the spin-off and were therefore indemnifiable by IDT.

Straight Path formed a special committee in connection with its FCC-mandated sale of spectrum licences. That committee also considered a sale of the entire company, as well as a potential indemnification claim against IDT. With respect to the indemnification claim, the special committee determined that potential bidders would be hesitant to pursue claims against IDT, so it considered creating a separate litigation trust that could pursue the claims.

In addition to majority voting control over both IDT and Straight Path, Jonas had consent rights with respect to any significant transactions that required approval by Straight Path's stockholders, including a merger or a sale of significant assets. On learning of the special committee's discussions regarding potentially establishing a litigation trust to pursue the indemnification claim against IDT, Jonas allegedly contacted each member of the committee and threatened to scuttle the transaction process if the committee pursued that claim or established a litigation trust. Jonas was also alleged to have personally threatened the committee members and their counsel. At this point, the Straight Path special committee had been able to precipitate a competitive sales process, which resulted in multiple premium offers to acquire the company.

To avoid jeopardising the potential transaction, the committee agreed to settle the IDT indemnification claim for \$10 million and sell certain Straight Path IP assets to IDT for \$6 million – even though the FCC consent decree valued those assets at \$50 million and the indemnification claim appears to have been worth far more than \$10 million.

Decision

In evaluating the defendants' motion to dismiss, the Court of Chancery first determined that the

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stockholder plaintiffs' claim was direct and not a derivative claim that would have been extinguished by the closing of the transaction. The court then noted that as a controlling stockholder, Jonas owed a fiduciary duty to the corporation and its minority stockholders and was prohibited from benefiting himself at the expense of the other stockholders. Based on the facts alleged, the court determined that the settlement agreement with IDT deprived the company's stockholders of the value of the indemnification claim against IDT, which was potentially worth over \$500 million, and may have underpaid in acquiring the Straight Path IP assets. Therefore, the court found it to be a reasonable inference that Jonas, through IDT, could have breached his fiduciary duties by improperly diverting merger consideration that would have otherwise gone to the stockholders.

Comment

This case is another example of how controllers must exercise caution in transactions where they could reasonably be perceived to have extracted a benefit not otherwise available to minority stockholders.

Following the court's decision, at the request of IDT and Jonas, the Court of Chancery certified an interlocutory appeal to the Delaware Supreme Court.

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Endnotes

(1) *In re Straight Path Commc'ns Inc Consol S'holder Litig*, CA 2017-0486-SG (Del Ch 25 June 2018).

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