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THE SIGNIFICANCE OF DERIVATIVE ACTION IN INDIA: AN ANALYSIS OF SECTION 245 OF THE COMPANIES ACT, 2013 BY TANVI KINI*

Introduction

Derivative action means a lawsuit brought by a shareholder of a corporation on behalf of the corporation to enforce or defend a legal right or claim. It is popularly known as Stockholder's Derivative Suit or Class Action. This suit is usually brought by shareholders against insiders such as the directors, management, and other key managerial personnel, when there is a fraud, mismanagement, dishonestly and corruption while dealing in the company's affairs. Black's Law Dictionary defines 'derivative action' as,

> A suit by a shareholder to enforce a corporate cause of action. The corporation is a necessary party, and the relief which is granted is a judgement against a third person in favour of the corporation.[1]

In effect, the shareholders of the company through their claims are acting on behalf of the company because the respective director(s) or management personnel are failing to exercise his authority for the benefit of the shareholders and the whole company. Derivative litigation has never been the only option for suing corporate directors who have allegedly violated their fiduciary duties.[2] If a shareholder has been personally harmed by the director or the management, he can directly sue rather than taking the course of derivative action. Although direct action is more beneficial in some respects, it has two obvious limitations from the plaintiffs' viewpoint as explained by Scholar David Skeel Jr. First, the plaintiff must persuade the court that the injury is indeed direct. Second, the small stakes of most stakeholders in a large corporation make solo litigation unattractive for them and the attorney.[3]

Derivative suit is a good cause of action in cases where:

- the issues in dispute are common to all the members of the class[4];
- the persons affected are so large in number that bringing all of them to court become impractical[5].

This concept helps keep a check on directors and the management. It also acts as a tool for corporate governance. Scholars Coffee and Schwartz argue that the derivative action plays an

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[1] Refer *Price* v. *Gurney*, Ohio, 65 S.Ct. 513, 516, 324 U.S. 100, 89 L.Ed. 776.
[2] David A. Skeel Jr., *The Accidental Elegance of Aronson v. Lewis*, Faculty Scholarship, Penn Law: Legal Scholarship Repository Paper 182 (2007)
[3] Ibid., p. 11
[4] Minny Narang et al., Class Action Suits: Measure of Progressive Activisim in India, 2 Paripex-Indian Journal of Research ISSN 2250-1991 (December, 2013)
[5] Ibid.

important role in deterring directors from breaching their duties and punishing breaches.[6] While other scholars argue that derivative litigation is a useful deterrent to manage dishonesty.[7] In deterring managerial misconduct, the derivative action also helps to align the interests of the managers with those of the company.[8] It is also a key element in reducing the agency costs inherent in the management of public companies.[9] All in all, the shareholder derivative action is the chief regulator of corporate management[10]; nevertheless, it is neither the initial nor the primary protection for shareholders against managerial misconduct.[11]

In India, this concept is still young. The recurring trends of misconduct by company's management makes it necessary for opportunity to made out to even the smallest of shareholders to take action against the management. Derivative action which was recently introduced under heading 'Prevention of Oppression and Management' in the Companies Act, 2013[12] as was suggest by the J.J. Irani Committee in 2004, protects not only major but minor stakeholders and shareholders of the company.

The position in English Law: A Brief

In England, prior to the Companies Act, 2006 ("Act"), it was difficult for shareholders to file derivative suits. Through common rule popularly known as the '*Rule in Foss v. Harbottle'* or the '*Proper Plaintiff Rule'*, English law affirmed the fundamental right of the company through its organs to make the litigation decision in relation to a breach of an obligation *owed to it.*[13] Derivative actions could only be brought in relation to breaches of duty which injured the company and benefited the directors personally and where the directors in breach of duty – the wrongdoers - controlled the general meeting through their shares.[14]

The proper plaintiff rule set forth in *Foss* v. *Harbottle*[15] provides that only the company itself can bring litigation for the infringement of obligations owed to it and only if the company is disabled from acting (such as where there is a wrongdoer control of the general meeting) will the law countenance a derivative action.[16] Wigman VC based this decision on two propositions: first, that the company itself had been wronged, therefore only the company could sue through its board and shareholders, second, that it made no sense for the court to entertain an action which could at any subsequent time be ratified and cured by the general

[6] John C. Coffee et al., *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 Columbia Law Review 261 at 302-9 (1981)
[7] Oliver C Schreiner, *The Shareholder's Derivative Action – A Comparative Study of Procedures*, 96 South African Law Journal 203 at 211(1979)
[8] Kristina de Vere Stevens, *Should We Toss Foss?: Toward an Australian Statutory Derivative Action*, 25 Australian Business Law Review 127 at 130 (1997)
[9] Ian Ramsay, *Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action*, 15 University of New South Wales Law Journal 149 at 156 (1992)
[10] *Cohen* v. *Beneficial Industrial Loan Corporation* 337 US 541, 548 (1949)
[11] American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, Proposed Final Draft 1992, p. 587
[12] Chapter XVI, Companies Act, 2013
[13] David Kershaw, *The Rule in Foss v Harbottle is Dead; Long Live the Rule in Foss v. Harbottle*, (LSE Legal Studies, Working Paper No. 5/2013)
[14] Ibid.
[15] (1843) 67 ER 189
[16] David Kershaw, *The Rule in Foss v Harbottle is Dead; Long Live the Rule in Foss v. Harbottle*,(LSE Legal Studies Working Paper, No. 5/2013)

meeting.[17] There are of course certain exceptions to this rule to protect basic rights of the minority, which are necessary to protection irrespective of the majority's vote:

i. Ultra Vires and Illegality: The directors of the company or majority shareholders could not act beyond their powers i.e. action could be taken for an ultra vires act of the director. Action could also be taken for illegal activities. The shareholder has a right to action since he has a right to have the company to conduct itself in accordance with the agreed terms and the law. This principle was applied in *Smith v. Croft (No. 2)*[18] and *Cockburn v. Newbridge Sanitary Steam Laundry Co*[19].
ii. Actions required a Special Majority: This principle has no application in situations where the act or conduct of the company can only be done by a special majority or special resolution. In *Edwards v. Halliwell*[20], a member of a trade union obtained a declaration that an alteration to the union contributions was invalid as it had not been made following a two-thirds majority vote as required by the union rules.
iii. Action by Shareholder: This is an individual action taken by shareholders to enforce some right belonging to him or her personally. Minority shareholders have the right to institute action against the directors if they prevent him from enjoying an act which he is lawfully entitled to. For example, in *Pender* v. *Lushington*[21], the shareholders voting rights were rightfully restored to him.
iv. Fraud on Minority: Minority shareholders can bring an action against if they perceive fraud in the action of the directors or the majority shareholders. In *Cooks* v. *Deeks*, a shareholder could bring an action against the director for diverting to themselves a contractual opportunity which, in equity, belonged to the company.[22]

The rule in Foss v. Harbottle was perceived by many as too complex, incoherent and too restrictive.[23] The Law Commission was requested to consider the state of the law and make recommendation; and now the current position is quite different.

Under the Companies Act, 2006, a derivative claim can be brought by the shareholders in accordance with the Act and removes any wrong-based restrictions by providing that a claim may be brought in relation to any breach of duty, negligence, default or breach of trust[24] by the director (which was not so under the Common Law rule). The 'fraud' precondition to the 'fraud on the minority' exception has clearly, therefore, been abolished.[25] This in itself is a notable change, which increases the exposure of directors to liability for breaches of the duty of care.[26] It must be noted, that the Companies Act, 2006 does not explicitly supersede the rule in Foss v. Harbottle.

The Position in India: Companies Act, 2013

[17] Ibid.
[18] [1988] Ch 114
[19] [1915] 1 IR 237
[20] [1950] 2 All ER 1064
[21] [1877] 6 Ch D 70
[22] [1916] 1 AC 554
[23] David Kershaw, *The Rule in Foss v Harbottle is Dead; Long Live the Rule in Foss v. Harbottle,* (LSE Legal Studies Working Paper, No. 5/2013)
[24] Section 260(3) of the Companies Act, 2006
[25] David Kershaw, *The Rule in Foss v Harbottle is Dead; Long Live the Rule in Foss v. Harbottle,*(LSE Legal Studies Working Paper, No. 5/2013)
[26] Ibid.

As previously mentioned the concept of derivative action is new to India and has been introduced in the Companies Act, 2013 for the first time under 'Chapter XVI, Prevention of Oppression and Mismanagement'. Section 245 of the Companies Act, 2013 provides that shareholders i.e. either member(s) or depositor(s) can file an application before the National Company Law Tribunal ("NCLT") on behalf of the other members or depositors in order to: (A) restrain the company from committing an act which is ultra vires the Articles or Memorandum of the company[27], (B) restrain the company from breaching any provision of the Articles or Memorandum[28], (C) to declare a resolution altering the Memorandum or Articles as void if it suppresses material facts or was obtained by mis-statement to the members or depositors[29], (D) restrain directors from acting on such resolutions[30], (E) restrain the company from acting contrary to the provision of the Act or any other law in force[31], (F) restrain the company from acting against a resolution passed by the shareholders[32], (G) claim damages, compensation or any other suitable action as enumerated under Section 245(1)(g) against the company, its directors, the auditor, audit firm of the company, an expert, advisor, consultant or any other person misleading statement made to the company.

While considering the application, the NCLT take into account: (1) whether the applicants are acting in good faith[33]; (2) evidence as to the involvement of any person other than the directors or officers of the company[34]; (3) whether the applicants could have pursued the action in their own and individual rights[35]; (4) evidence as to the views of the members or depositors who have no personal interest, direct or indirect in the matter in question[36]; (5) whether the cause of action is an act or omission that is yet to occur can be authorised by the company before it occurs or ratified by the company before it occurs[37]; (6) whether the cause action is an act or omission that has already occurred can be ratified by the company.[38]

Section 245(5) states that if the application filed is admitted, the Tribunal shall issue a public notice to all the members of the class by publishing the same and shall consolidate all similar applications prevalent into a single application. This section states that two class action applications for the same cause of action shall not be allowed and that the cost for derivative suit shall be borne by the company or the person responsible for the oppressive act. The Companies Act, 2013 makes the decision of the NCLT binding on the company and all its members, depositors, auditors, consultant, advisor or any person associated with the company.[39] The Act makes punishable any non-compliance with the NCLT decision[40] and also, applicants whose claims are found to be vexatious or frivolous.[41]

[27] Section 245(1)(a) of the Act
[28] Section 245(1)(b) of the Act
[29] Section 245(1)(c) of the Act
[30] Section 245 (1)(d) of the Act
[31] Section 245(1) (e) of the Act.
[32] Section 245(1) (f) of the Act.
[33] Section 245 (4) (a) of the Act.
[34] Section 245(4)(b) of the Act.
[35] Section 245(4)(c) of the Act.
[36] Section 245(4)(d) of the Act.
[37] Section 245(4)(e) of the Act.
[38] Section 245(4)(f) of the Act.
[39] Section 245(6) of the Act.
[40] Section 245(7) of the Act.
[41] Section 245(8) of the Act.

An application made the management under Section 245 is different from an application made to Tribunal under Section 241 and 244 of the Act, which also provide for relief on the ground of mismanagement of the company. Under Section 241 and 244, the members and Central Government can apply, whereas under Section 245 the members and depositors of the company can apply. In the former, application is made against the company and its management (managing director, manager or any of the directors. In the latter, action is taken against company, directors, auditors, experts or advisors, consultants or any other person as mentioned. Public notice is not required under Section 241/244, and is required under section 245. The scope of matters for which relief may be requested is larger under section 245 of the Act.

Therefore this section relating to prevention of oppression and mismanagement permits shareholders and depositors of a company to take up any matter of mismanagement or fraudulent practice with the tribunal. Shareholders and depositors under this section can not only restrain the company's management from continuing the unlawful act but can also claim damages and compensation for any damage done to them. Therefore, this act imposes both civil and criminal liability on the directors, managers, and management of the company for corrupt practices and unlawful conduct.

Significance of Derivative Actions in India

The derivative action must provide a balance between giving an effective remedy to shareholders while at the same time allowing directors of a company reasonable freedom from shareholder interference.[42] Section 245 has brought a significant change to the current legal system:

> **Protects Minority Rights:** Derivative action is a blessing for shareholders who hold small shares in the company. Minority shareholders are in all likelihood not able to vote or oppose a proposal made in the company, they may feel that it is pointless venting frustrations on decisions taken by directors and hope that institutional investors will take up the cudgel on their behalf.[43] Section 245 protects minority shareholders from any form of managerial misconduct. In *Darius Rutton Kavasmaneck* v. *Gharda Chemicals Limited and Others*[44], the High Court of Bombay stated:
>
> > "It is open for a minority shareholder to take action against the wrong doers for the benefit of the Company if majority shareholders are preventing the Company itself from taking any such action as they are the people committing the wrong."
>
> In large companies, managers are given significant power and discretion to run the business. This discretion is so broad that it effectively means management control of these companies. Such broad control can lead managers to act in their own interests rather than in the interests of shareholders.[45] Shareholder litigation ensures that

[42] Ian Ramsay et al., Litigation by Shareholders and Directors: An empirical study of the statutory derivative action, The University of Melbourne, Legal Studies Research Paper No. 250
[43] Mahabane, *Shareholder Activism: Investors Show Signs of Revolt*, Financial Mail 44-45 (April, 2001)
[44] Suit No. 2932 of 2011, Decided on December 12, 2014
[45] Ian Ramsay, *Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action*, 15 University of New South Wales Law Journal 149 at 156 (1992)

shareholders are weary of the company's affairs and empowers shareholders. It serves as a useful tool for combating abuse of power by management and controlling shareholders. In *Daniels* v. *Daniels*[46], Justice Templeman concluded by saying,

> "A minority shareholder who has no other remedy may sue where directors use their powers intentionally or unintentionally, fraudulently or negligently, in a manner which benefits themselves at the expense of the company."

Shareholder Activism: Shareholder activism means a vigorous action by an owner or a person with an interest in a company.[47] It is a mixture of socially responsible investment, corporate governance and shareholder capitalism.[48] Shareholder activism can take different forms: proxy battles, publicity campaigns, shareholder resolutions, litigation, negotiations with management and derivative action. Collective shareholder activism in the form of a litigation suit against the management on the behalf of the company and other shareholders could be called derivative action. Scholars argue that some form of shareholder involvement in needed to improve corporate governance and to maximize shareholder value. Promotion of good corporate governance practice is one of the many beneficial effects of strong shareholder activism. It also has positive consequences on social aspects of the corporation: increasing the number of women holding seats in boards, fighting corruption, and improving sustainability.[49]

Corporate Governance and Good Practice: The Satyam Scam in 2009, famously known as "Indian Enron" revealed the inadequacy and ambiguity of the Companies Act, 1956 with regard to stakeholders 'protection and prevention of white collar crimes.[50] This crisis opened the eyes of Indian investors and brought the need for investor protection to the forefront. The introduction of derivative action will ensure good corporate governance. According to the Kumaramangalam Birla Committee,

> "Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors to satisfy themselves that an appropriate governance structure is in place."

Shareholders action acts as a channel to monitor the acts of the directors, and remedy any damage done by the management's misconduct or fraudulent practices. This

[46] [1978] 2 All ER 89
[47] Motlatsi Lekhesa, *Shareholder Activism: The Birth of a New Phenomenon in South African Corporate law*, Faculty of Law Department of Mercantile law, University of the Free State (November 27, 2009), *available at:* http://etd.uovs.ac.za/ETD-db/theses/available/etd-11222010-135634/unrestricted/LekhesaMW.pdf
[48] Ibid.
[49] Myriam Denis, Shareholder Activism as Means to Promote Good Corporate Governance, Berkeley Law, *available at:* http://www.law.berkeley.edu/files/bclbe/Shareholder_Activism_to_Promote_Good_Corporate_Governance_-_Myriam_Denis-1.pdf
[50] Arya Tripathy, *Investor Protection Measures under Companies Act, 2013- Lessons from the Past*, PSA E-Newsline, December 2014

statutory right grants shareholders the power to address important corporate issues which considerably improves corporate governance[51] and encourages good practice.

Monitors any person or entity associated the Company: This Section under the new companies act provides that damages can be claimed from persons connected to the company for any fraudulent misconduct. The auditors and audit firm of the company can be held liable by shareholders action for any improper or misleading statement made in the audit report or for any other unlawful or fraudulent act.[52] Compensation or damages can also be claimed from experts, advisors or consultants of the company for any unlawful act or incorrect statement made to the company.[53] The Act provides that when an action is taken against an audit firm, the liability shall be of the firm as well as each of the partners involved in making the improper or misleading statement in the audit report or fraudulent conduct.[54] Section 245(6) states that any order passed by the Tribunal is binding on the respective audit firm, auditors, experts, advisors, consultants or any person associated with the company. These clauses ensure that a constant check in kept on any person or entity having influence on or making decisions for the company, leaving no room for even negligent or reckless acts of the company.

Cost Effective: In *Wallersteiner* v. *Moir* (No.2)[55], Lord Denning held that a shareholder who brings a derivative action should be entitled to be indemnified by the company for all costs incurred in bringing the action, because if the action succeeds, the company will take the benefit. Under the Companies Act, 2013, if the application made by members or depositors is admitted by the NCLT, the costs or expenses connected with the litigation shall be defrayed by the company or the person responsible for the oppressive act. In situations where the application is not admitted by the NCLT, the cost of litigation is borne by the applicants collectively therefore the cost per member is relatively less. Derivative action is more affordable and preferable in cases where minority shareholders with the same grievance want to take action against the management.

Time Effective: In a country like India where the judiciary is burdened with a backlog of cases, shareholders action is a practical solution. When hundreds of shareholders want to take action against the management on the company's behalf, it would be senseless and ineffective to file separate suits. A class action against the respective director or manager would prove more efficient, where more than hundreds of members are able to claim compensation in one suit. It saves the time of not only the parties to the suit but also the Court.

[51] Bebchuk, Lucian A., *The Case for Increasing Shareholder Power*, Harvard Law Review, Vol. 118, No. 3, pp. 833-914, January 2005; Harvard Law and Economics Discussion Paper No. 500
[52] Section 245(1)(g)(ii) of the Companies Act, 2013
[53] Section 245(1)(g)(iii) of the Companies Act, 2013
[54] Section 245(2) of the Act
[55] [1975] QB 373.

Limitations of Section 245 under the Companies Act, 2013 Although the concept has brought a positive change to Indian corporate law, this section can be criticized for the following reasons:

Requisite Number of Members and Depositors: This section imposed a minimum number of members or depositors that must be party to the suit i.e. not less than 100 members or any percentage of the total members as prescribed for companies having share capital, not less than one-fifth of the total number of members in case of a company not having share capital and not less that hundred depositors or any such prescribed percentage. Section 245 does not give the Tribunal any discretionary power to admit applications from a class of members or depositors who are unable to comply with the minimum number. This clause imposes a huge restriction on the shareholders and depositors, and defeats the purpose of having such a provision in the Act.

Burden on Shareholders: While considering the application, the NCLT conducts a thorough check on the credibility of the applicants. The NCLT takes into consideration the intention whether bona fide or not, the evidence brought before it, alternate remedy available, and whether the action can be ratified or not. There appears to be a burden on the shareholders to justify their claim against the accused directors. If the action is not in consonance with the clauses prescribed, the NCLT can reject the application. This increases the pressure on shareholders and depositors justify their claim.

Loser Pays All: Another major limitation is that if the NCLT rejects the application, the shareholders and depositors must pay all the litigation costs. Further, if the application is found to be frivolous or vexatious, the applicants will have to pay an amount not exceeding one lakh rupees to the opposite party.[56] This is a major drawback for the applicants. Also, the companies act does not mention under what situations an application would be considered frivolous or vexatious.

Excludes Other Stakeholders: The Act only empowers depositors and shareholders to proceed under derivative action. It fails to include other stakeholders of the company such as creditors, debenture holders, suppliers, and other persons who hold interest in the company. It should be noted, that a fraudulent act by a director could affect the whole company and all interested parties, not only the shareholder and depositors. Therefore, other stakeholders should also be permitted to file a class action against the management.

Recommendations

Reduce Burden on Shareholders or Depositors: Firstly, the minimum number of shareholders and depositors required to apply to the NCLT should be reduced. Shareholders and depositors in smaller companies may find 100 members large a number to comply with. Also, if the company prescribes the minimum number required, decision making power and control is largely left in the hands of the management. In addition, on shareholders who have paid all the calls and sums due are eligible to join the application, making it even more difficult to attain the requisite number. Such practice will only lead to more corporate scams and white collar crimes

[56] Section 245(8) of the Companies Act, 2013

in our country. Secondly, there is a heavy burden on shareholders to prove their case to the NCLT. It is the accused manager or directors that should be under the microscope, not the shareholders. Shareholders are already burdened by the injustice done to them by the management, and therefore the onus should not be on them to prove whether their application is justified or not. Evidentiary value must however be taken into consideration.

Remove Penalty on Shareholders: The fine of rupees one lakh imposed on shareholders under Section 245(8) should be removed. Shareholders may refrain from taking action against fraudulent directors as a result of such a fine imposed on them, resulting in lower shareholder activism and involvement in the company. Also, a set of guidelines or conditions must be laid down as to what would constitute a "frivolous or vexatious" application. The two words seem very vague and ambiguous.

Include Other Stakeholders: Fraudulent activities conducted by the company affects not only the shareholders and depositors, but other stakeholders of the company as well. Stakeholders such as debenture holders, suppliers, and creditors play a key role in the company. Although not owners of the company, they are essential for the company's functioning. These stakeholders should also be included under the ambit of Section 245.

Discretionary Power to be given to NCLT: The tribunal should have certain discretionary powers to admit class action in peculiar or rare cases. Although the tribunal considers several aspects before deciding a case, it should be given additional powers to hear and decide matters. It should also be given power to make certain exceptions in cases where the application does not comply with the clauses prescribed in the Act.

Conclusion: The statutory recognition of derivative action in Indian corporate law is a step in the right direction. It has to an extent restored the rightful title "owner" of the company shareholders. Classes of shareholders and depositors can now file a lawsuit against the management of the company for fraudulent or unlawful actions. It saves both the time and money of shareholders and protects minority shareholders. Derivative action also serves as a good corporate governance mechanism and encourages shareholder activism. Nevertheless, Section 245 of the Companies Act, 2013 places several restrictions on shareholders. The company under the current law still holds immense power and control over the shareholders, for instance, the company can prescribe the minimum number of shareholders required to apply to the NCLT. Also, derivative action does not completely ensure corporate governance and good practice in the company. The tribunal thoroughly scrutinizes the application made by shareholders and depositors, making the application more about the shareholders than the company. There are still several hindrances that restrict shareholders from filing a lawsuit against the company's management.