

IN BRIEF – COMPANY LAW & DISPUTES



THE EXISTENTIAL THREAT FACED BY DERIVATIVE ACTION IN INDIA

Derivative Action, an infrequently used arrow in the quiver of the counsel representing minority shareholders in India faces an existential threat. Two decisions over the last few years (one of the High Court of Delhi¹ and another of the High Court of Judicature at Madras²) have sounded the death knell for Derivative Action in India in its present shape and form.

Derivative Action, in layman's terms, is an action/ proceeding instituted before a civil court, by a shareholder on behalf of a company, for enforcement of the company's rights, under certain limited and peculiar circumstances, such as fraud on the minority, etc.

Generally, a company³, being a body corporate, would be the only party entitled to sue for redressal of any wrong done to it. Since a company, however, is an artificial person, it must act through its directors and where the wrong is being done to the company by the directors in control, the company obviously cannot take action on its own behalf. It is in these circumstances that the Derivative

Action by some shareholders (even if they are in a minority) becomes necessary to protect the interest of the company⁴.

Consider the following statistics:

- As on October 31, 2021, a total of 22,48,969 companies were registered in the country⁵;
- As on October 31, 2022, a total of 24,20,775 companies were registered in the country⁶.
- During the period of December 1, 2022 to October 31, 2023, a total of 1,57,504 companies were registered⁷ at the rate of over 14,000 new company registrations a month.

It is but a natural consequence of the above spurt in the number of companies registered in India, that there will be a rise in disputes, whether between shareholders or the shareholders and the company or the shareholders and the board of directors. One form of redressal which was available hitherto, in India, to a shareholder (irrespective of the number and extent of shares held by him/ her) to protect the interests of a company and ensure restitution when the company itself did not act, was the common law remedy of 'Derivative Action', before the jurisdictional civil court. Derivative Action in India does not stem from any statute and is not a statutory right available to shareholders in India (whilst it is presently so in various other jurisdictions, including the United States of America and the United Kingdom).

Derivative Action can trace its origins under common law to the judgment of the Court of Chancery, United Kingdom in *Foss vs. Harbottle*⁸. The judgment in *Foss*, was pronounced in proceedings instituted by shareholders of a company against few other shareholders, directors and solicitors of the company. The allegation was that various fraudulent and illegal transactions by the defendants resulted in the property of the company being misapplied, alienated and wasted. The Court of Chancery in *Foss* while reiterating that the corporation/ company and its shareholders are distinct and the rule was that the corporation/ company should sue in its own name and in its corporate character (or in the name of someone whom the law has appointed to be its representative) (*proper plaintiff* rule), examined whether in the facts of that case,

¹ ICP Investments (Mauritius) Limited vs. Uppal Housing Private Limited and others, 2019 SCC Online Del 10604

² Valluvar Kuzhumam Private Limited vs. APC Drilling & Construction Private Limited and others, CRP (NPD) No. 2044 of 2022 and CMP Nos. 10516 and 10518 of 2022, order dated 30.11.2022

³ As defined in Section 2(20) of the Companies Act, 2013

⁴ Starlight Real Estate (Ascot) Mauritius Limited vs. Jagrati Trade Services Private

Limited, AIR 2018 Cal 173

⁵ Annual Report 2021-22 of the Ministry of Corporate Affairs, Government of India

⁶ Annual Report 2022-23 of the Ministry of Corporate Affairs, Government of India.

⁷ Ibid

⁸ (1843) 2 Hare 461

the plaintiffs had justified a departure from the said *proper plaintiff* rule. While the Court of Chancery in that case held that the plaintiffs therein had failed to justify that the facts of that case required a departure from the *proper plaintiff* rule, the decisions subsequent to *Foss* have carved out exceptions to the *proper plaintiff* rule which form the basis for Derivative Action in India.

Derivative Action was hitherto a separate class of proceedings, not to be confused with actions instituted by the company itself, representative action by shareholders for enforcement of their class rights (which finds its place in Section 245 of the Companies Act, 2013) or even personal actions by shareholders for enforcement of their personal rights (for instance under shareholders agreements or the articles of association of a company).

In *ICP Investments*, the Delhi High Court was adjudicating a rejection of a plaint application, filed in a derivative suit instituted by a shareholder seeking declaratory reliefs on behalf of the company against its other shareholders. The application pertained to alleged fraud and misrepresentation perpetrated by the other shareholders who were in control of the company, to the detriment of the company. The Delhi High Court held that Derivative Action, in common law, is *per se* not maintainable to the extent that the statutory regime for oppression and mismanagement is equipped to deal with it and the proper remedy would be under Section 241⁹ of the Companies Act, 2013, before the National Company Law Tribunal (*NCLT*). On the facts of that case, the Delhi High Court went on to specifically hold that a relief of declaration (as was sought therein and which under Section 34 of the Specific Relief Act, 1963 is a discretionary relief), would not be exercised in favor of the plaintiff when a statutory remedy for a relief is available (before the NCLT under Sections 241 to 244 of the Companies Act, 2013).

In *Vallavar Kuzhumam*, the Madras High Court while considering a revision petition against an order of rejection of a plaint filed by certain shareholders in the form of a derivative suit, specifically considered the question of whether a civil court or the NCLT has jurisdiction to entertain derivative suits and the scope of Section 242 of the Companies Act, 2013. After an elaborate discussion on the history of derivative action and its treatment in different jurisdictions/ countries, the Madras High Court held that “*Even though the legislature in its wisdom did not provide a special chapter for derivative action, the phrases included under Sections 241 and 242 of the Companies Act, would show that even without reserving a special chapter, scope for such an action is very much available in India before the Special Tribunals. Since the Special Act gives right, provides remedy, confers powers upon Special Tribunals and explicitly bars the jurisdiction of the Civil Courts for all actions that can be taken by a member of the company in pursuant to his rights given under sec. 241, the civil court has got no jurisdiction to entertain such matters, which is inclusive of derivative claims as well.*”

In both the judgments of *ICP Investments* and *Vallavar Kuzhumam*, the Delhi High Court and the Madras High Court seem to have arrived at their findings on *inter alia* the following considerations:

- a) The scheme of the Companies Act, 2013 and the various provisions that reflect that any member of the company is eligible to file an application

under Section 241, if the affairs of the company are being carried out in a manner prejudicial to the interests of the company, which is akin to Derivative Action on behalf of the company. This is expressly different from other jurisdictions where Derivative Action finds statutory recognition. In those jurisdictions, while there is also a specific recognition of proceedings for oppression and mismanagement, they can be instituted only when the affairs of a company are being conducted in a manner prejudicial to the members/ shareholders and not when the affairs of the company were being conducted in a manner prejudicial to the company itself as under the Indian Companies Act, 2013 and hence the separate provision for Derivative Action in those jurisdictions;

- b) The whole range of reliefs listed under Section 242(2) of the Companies Act, 2013 that can be granted by the NCLT, along with the residuary powers conferred on the NCLT under Section 420 of the Companies Act to pass such ‘orders thereon as it thinks fit’ would ensure that the interests of the company are protected;
- c) The powers of the NCLT to formulate procedure beyond the bounds of the Code of Civil Procedure, 1908 subject to the principles of natural justice, mandate for a time bound disposal, appellate remedies along with power to punish for contempt, would reassert that the civil court’s jurisdiction is not required;
- d) Since the Companies Act, 2013 provides rights, effective remedies and machinery for effective redressal of concerns of actions being taken prejudicial to a company’s interest, the bar under Section 430 of the Companies Act, 2013 would bar the jurisdiction of a civil court to entertain Derivative Action.

While it can possibly be argued that the judgments of the Delhi High Court and Madras High Court may not be binding on the courts of the rest of the country, it is pertinent to note that the Hon’ble Supreme Court of India dismissed a special leave petition¹⁰ challenging the validity of the judgment of the Madras High Court in *Valluvar Kuzhumam*, and thereby left the findings of the Madras High Court intact.

Keeping aside the argument on the nature of reliefs which can be sought before the NCLT, the efficacy of proceedings before the NCLT and whether they can in fact act as an effective substitute to Derivative Action which was being instituted before the civil court, one immediate challenge which is perceived, in view of the judgments in *ICP Investments* and *Vallavar Kuzhumam*, is that a shareholder who could hitherto institute Derivative Action irrespective of the number of shares held or the extent of his/ her shareholding would now need to fulfil the eligibility requirements under Section 244 of the Companies Act, 2013 (pertaining to the number/ extent of her shareholding or alternatively seek prior consent to make an application) before instituting proceedings before the NCLT. This would no doubt make it more difficult for a shareholder to institute proceedings to secure the interests of a company, akin to the common law ‘Derivative Action’.

While there is no substantive judgment of the Hon’ble Supreme Court of India on the validity of Derivative Action before a civil court in India, the recent decisions of the Delhi High Court and Madras High Court reflect the evolving view that

⁹ Application to Tribunal for relief in cases of oppression etc.,

¹⁰ Valluvar Kuzhumam Private Limited vs. APC Drilling and Construction Private Limited and others, SLP (C) No. 1575/2023, Order dated 06.02.2023

Derivative Actions are now subsumed under the provisions of the Companies Act of 2013 and that a Derivative Action, as a common law remedy, is not *per se* maintainable before a civil court in its erstwhile shape and form.

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