Is the Derivative Action Regime in India a Historical Relic?

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Summary

In 1843, the Court of Chancery pronounced its landmark judgment in Foss v. Harbottle.((1843) 67 ER 189) *The judgment sparked the evolution of a critical common law remedy, in the form of derivative actions, to protect a company's interests. Soon courts in other countries, including India, adopted this approach, allowing interested parties to initiate suits on behalf of companies. Over time, most countries, including the United Kingdom, proceeded to codify derivative actions into a statutory remedy. India however continued with the common law route.*

Indian civil courts have been entertaining derivative actions, initiated by interested parties on a company's behalf, for several years now. However, recently an interesting judicial trend has emerged wherein High Courts are restricting the jurisdiction to consider such actions solely to the National Company Law Tribunal (NCPL), a specialized forum established for adjudicating upon company law related matters.

In this article, we discuss the reasons leading to this new trend, the position taken by the High Courts on derivative actions in three recent judgments, the shortcomings of this approach and its impact on the future of corrective actions which may be initiated by third parties on the company's behalf in India.

1 Introduction

In common law, a derivative action is an action on behalf of the company and *for* the company. However, a company, being an artificial person, cannot act on its own and is dependent upon its Board of Directors and shareholders. Problems arise when the directors, who are in control of the company's affairs, or the majority shareholders, start acting against the company's interests. In such cases, the company cannot protect itself and becomes a vehicle for perpetuating oppressive and prejudicial acts. Through judicial development, common law now recognizes the right of an *interested* party to initiate a derivative action on the company's behalf to protect the company's interests. Such an action is solely to enforce the company's rights as opposed to the personal right of the individual initiating such an action.

Derivative actions have consistently been recognized as a legitimate remedy under common law against illegal acts of insiders in a company, such as majority shareholders and directors. The evolution of such actions dates back to the decision of the Court of Chancery in *Foss v. Harbottle*.[1]

For several years now, derivative suits have been instituted in India, with aggrieved parties knocking on the doors of civil courts to raise complaints of such insider illegal acts. In the regime governed by the [Indian] Companies Act, 1956 ('**1956 Act'**), these proceedings were instituted as civil proceedings before Indian civil courts and not before the specialized company tribunals known as the 'Company Law Boards (CLBs)'. In 2013, the Indian Parliament brought out the [Indian] Companies Act, 2013 ('**2013 Act'**) which has replaced the 1956 Act.

Section 430 of the 2013 Act bars the jurisdiction of civil courts '*in respect of any matter which the Tribunal or the Appellate Tribunal is empowered to determine by or under this Act or any other law for the time being in force*'. This statutory bar, which was belatedly brought into effect on 1 June 2016, has put a question mark on the viability of derivative actions as a legitimate remedy before civil courts.

In this article, we consider three judgments of Indian Courts, two of the Delhi High Court and another of the Madras High Court, where the High Courts have concluded that derivative actions may not be viable under the 2013 Act given the bar under section 430. We discuss the potential shortcomings of this approach and the impact this will have on the right of interested parties to initiate a corrective action on the company's behalf.

2 Evolution of the Derivative Action Regime in India and the Practice Followed under the Erstwhile Statutory Framework

In India, a derivative action has not been a codified statutory remedy.[2] This is in stark contrast to other countries like the United States of America and the United Kingdom where the respective company law statutes contain a separate chapter on derivative actions.[3]

The origins of the derivative action regime in India can instead be traced to common law, with the Federal Court's decision in *Dr Satya Charan Law v. Rameshwar Prasad Bajoria*.[4] After analysing foreign judgments which dealt with derivative actions, the Federal Court had inter alia observed that the:

> *correct position seems to us to be that ordinarily the directors of a company are the only persons who can conduct litigation in the name of the company, but when they are themselves the wrongdoers against the company and have acted mala fide or beyond their powers, and their personal interest is in conflict with their duty in such a way that they cannot or will not take steps to seek redress for the wrong done to the company, the majority of the shareholders must in such a case be entitled to take steps to redress the wrong. There is no provision in the articles of association to meet the contingency, and therefore the rule which has been laid down in a long line of cases that in such circumstances the majority of the shareholders can sue in the name of the company must apply.*

This decision paved the way for a common law driven derivative action regime in India.

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[1] (1843) 67 ER 189.

[2] When the Indian Companies Bill, 2011, was being considered, the Standing Committee of Finance had received a suggestion from experts/organizations for incorporating a specific provision for derivative actions. However, the Ministry of Corporate Affairs felt that such a remedy should not be included in a hurry and did not act upon the suggestion, given the advanced stage of the Companies Bill. Sr. No. 124(iv), at 88 (Jun. 2012), https://eparlib.nic.in/bitstream/123456789/64157/1/15_Finance_57.pdf.

[3] Chapter 7-D, United States Model Business Corporation Act in the United States of America and Chapter in Part 11 of the Companies Act, 2006, in the United Kingdom.

[4] 1949 SCCOnline FC 35.

When the Federal Court passed this judgment, the Companies Act, 1913, was in force in India. Under the said Act, there was no specialized forum, akin to the present National Company Law Tribunal ('**NCLT**') to consider company law related matters. Instead, the concerned High Courts and District Courts had the jurisdiction to consider such disputes.[5] As such, all such matters were necessarily considered by civil courts.

The Companies Act, 1913, was followed by the erstwhile 1956 Act. The 1956 Act for the first time introduced the concept of a specialized forum to consider company law related matters in the form of the CLB. The CLB however was only established after more than thirty years, with the CLB Regulations being notified in 1991. However, even at this stage, the 1956 Act did not provide for any bar on the jurisdiction of civil courts to consider company law related matters.

This changed in 2003, when an express bar on the jurisdiction of civil courts in the form of section 10GB was introduced in the 1956 Act. Section 10GB was a part of a set of amendments implemented by the Companies (Second Amendment) Act, 2002, which led to the inclusion of Parts 1B–1C in the 1956 Act and provided for the establishment of the NCLT and National Company Law Appellate Tribunal ('**NCLAT'**). Section 10GB, which was a part of Part 1C, barred civil courts from entertaining any matter which the NCLT or NCLAT were empowered to determine by or under the 1956 Act or any other law for the time being in force. Interestingly however, Part 1B and Part 1C were subsequently struck down as unconstitutional by the Supreme Court in its judgment in *Union of India v. R. Gandhi, President, Madras Bar Association*.[6] This resulted in the statutory bar contained in section 10GB becoming ineffective.

Given the above, one may argue that until section 430 of the 2013 Act was brought into force in 2016, for all practical purposes, there was no bar on civil courts from hearing company law related disputes. Consequently, civil courts continued to entertain derivative suits, despite the existence of a specialized forum in the form of the CLB and subsequently, the NCLT and NCLAT.

3 Is a New Judicial Trend Now Emerging in India?

There appears to be a change in the judicial outlook towards derivative actions, after the section 430 bar was brought into force. In 2018, the Delhi High Court ruled on the issue in *SAS Hospitality Pvt. Ltd. & Anr. v. Surya Constructions Pvt. Ltd. & Ors.*[7] In this case, the High Court assessed the maintainability of a derivative action brought by SAS Hospitality Private Limited ('**SAS'**) on behalf of Surya Constructions Private Limited ('**SCPL**'), through the lens of the 2013 Act and considered the issue particularly in the context of the bar contained in section 430.

SAS was the majority shareholder of SCPL, holding 99.96% of the shares. SAS claimed that certain shares of SCPL were allotted in an illegal and clandestine manner, by misusing SCPL's funds. SAS contended that no payment was received towards such allotted shares and filed a derivative suit on behalf of SCPL, to challenge the said allotment. The defendants challenged the jurisdiction of the High Court to entertain such a derivative action, highlighting the express bar contained in section 430 of the 2013 Act.

While considering this issue, the Delhi High Court observed that the NCLT is a tribunal which has been constituted to have exclusive jurisdiction over the conduct of the company's affairs. It has further been vested with far-reaching powers in respect of management and administration of companies.[8] Particularly, section 420 vests the NCLT with powers to '*pass such orders thereon as it thinks fit*'. The High Court further observed that the bar contained in section 430 of the 2013 Act is in '*respect of entertaining "any suit", or "any proceedings" which the NCLT is "empowered to determine"*'. The NCLT is empowered to determine whether the allotment of shares was in accordance with the 2013 Act or not. It is inter alia also empowered to determine if, in the interregnum, the persons to whom the shares were allotted ought to exercise any voting rights.

In view of the above, the Delhi High Court conclusively decided that since the '*bar under section 430 of the 2013 Act being absolute in nature, this Court is of the view that the jurisdiction to adjudicate the disputes raised in the present case vests with the NCLT*'.[9]

A similar analysis was undertaken by the Delhi High Court in *ICP Investments (Mauritius) Ltd. v. Uppal Housing Pvt. Ltd. and Ors.*[10] In this case, a derivative action was instituted by ICP Investments (Mauritius) Limited ('**ICP'**) on behalf of Umang Housing Private Limited ('**UHPL**'), as its 52% shareholder. Uppal Housing Private Limited ('**Uppal'**) held the balance shareholding of UHPL. ICP claimed that Uppal had, as a shareholder, surreptitiously secured huge sums of monies from UHPL towards purportedly acquiring floor space index, by making false promises. Uppal had thereafter kept the fund for a period of nine years and no benefit had accrued to UHPL. Consequently, ICP sent an email to UHPL's Board, suggesting that it should seek a refund of the monies from Uppal. However, Uppal responded that the monies would be refunded only when certain land was sold. ICP alleged that since it was clear that UHPL would not make any demand to seek refund of the funds advanced, it was filing a derivative action on its behalf.

After due consideration of the facts and existing statutory framework, the Delhi High Court observed that the legislature had constituted the NCLT and the NCLAT and vested them with jurisdiction over all company law matters, including claims arising from section 241. Further, the legislature had put in place an express bar on the jurisdiction of civil courts to consider matters which the NCLT and the NCLAT were empowered to hear, in the form of section 430. Accordingly, the Delhi High Court concluded that '*derivative actions in common law, to the extent the statutory regime for oppression and mismanagement is equipped to deal with, are no longer maintainable in India, and the proper remedy for suits such as the present one would be under section 241 before the NCLT*'.[11]

Recently, in November 2022, the Madras High Court came to a similar conclusion in *Valluvar Kuzhumam Private Limited v. APC Drilling & Construction Private Limited & Ors.*[12]

[5] Section 3.
[6] (2010) 11 SCC 1.
[7] 2018 SCC Online Del 11909.

[8] Paragraph 10.
[9] Paragraph 19.
[10] 2019 SCC OnLine Del 10604.
[11] Paragraph 39.
[12] CRP (NPD) NO. 2044/ 2022.

('**VKPL Case**'). In this case, a derivative suit was filed by Valluvar Kuzzhumam Private Limited ('**VKPL**') on behalf of APC Drilling & Construction Private Limited ('**APC India**'), in which it held 11.63% shareholding. VKPL claimed that two directors of APC India, who were majority shareholders of APC India and constituted the majority of its Board as well, were acting against APC India's interests and selling shares held by it in a foreign entity at a grossly undervalued consideration. Since the directors, who were also brothers, were in control of APC India, VKPL was constrained to initiate a derivative action on APC India's behalf to put an end to their illegal acts.

In the backdrop of the above factual matrix, the Madras High Court analysed section 241 of the 2013 Act. The Court observed that in terms of section 241, any shareholder is eligible to make a complaint if the company's affairs are being undertaken in a way prejudicial to the company's interest. As such, if the shareholder's *locus standi* to initiate such an action is read along with the object of protecting the company's interest '*it will give an inescapable conclusion that such action can be nothing but derivative action on behalf of the company*'.[13] The Court further took note of the wide range of reliefs listed under section 242(2) that may be granted by the NCLT along with its residuary power under section 420 to pass such '*orders thereon as it thinks fit*' in any of the proceedings brought before the same. The Court observed that this would only ensure that the person aggrieved or person interested need not knock on the doors of the civil courts to protect the company's interest. In this regard, the Madras High Court further observed that:

> *the powers of the Tribunal to formulate procedure beyond the bounds of Civil Procedure Code, subject to the principles of natural justice, mandate for time bound disposal, appellate remedies along with the power to punish for contempt would only reassert that the Civil Court's jurisdiction is not required and its bar is complete.*[14]

The Madras High Court next analysed section 430 and observed that the whole objective of establishing the NCLT and the NCLAT is to avoid multiple forums for initiating actions under the company law.

Given the legislative intent and construct of the 2013 Act, the Madras High Court concluded that as:

> *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.*[15]

VKPL challenged the above judgment before the Supreme Court by filing a Special Leave Petition.[16] The Supreme Court, however, *vide* its order dated 6 February 2023, declined to entertain the Special Leave Petition.

4 Implication of the Supreme Court's Refusal to Interfere and the Road Ahead

The Supreme Court's decision not to interfere with the Madras High Court's judgment further fortifies the change in the Indian judicial outlook of neatly boxing derivative actions within the limited framework of section 241 of the 2013 Act. It signals the end of a common law driven derivative action regime and ushers a new era of a statutorily streamlined remedy.

One may even argue that this change is a natural progression, particularly given the (1) construct of section 241; (2) codification of directorial duties for the first time in India[17] versus the earlier reliance on fiduciary duties; (3) legislative intent of constituting the NCLT and NCLAT as a one stop specialized forum for adjudicating upon all company law related matters; and (4) most importantly, the implementation of the statutory bar contained in section 430.

One must, however, be conscious that limiting derivative actions to section 241 results in the emergence of a discriminatory remedy, wherein only shareholders fulfilling the eligibility criteria under section 244 have an automatic right to initiate a derivative action. In terms of section 244, an action under section 241 can only be initiated by shareholders who (1) hold not less than one-tenth of the company's issued share capital; or (2) not less than 100 members or one-tenth of the total members, whichever is less. For companies not having share capital, the aggrieved party must not be less than one-fifth of the total members. In case any shareholder does not meet this criteria, section 244 contains a discretionary solution empowering the NCLT to '*waive all or any of the requirements*', upon an application being made in this regard.

In view of the above eligibility requirements, shareholders who do not fit this criterion are left at the mercy of the NCLT's discretion, forced to appeal to the NCLT's wisdom and be dependent upon its indulgence to sustain such an action.

Additionally, Courts must not lose sight of the fact that a derivative action is a remedial action catering to the company's interests and is not a shareholder redressal action. Such an action may be initiated by any interested person, including an independent director, on the company's behalf, against any act prejudicing the company's interests. If the scope of derivative actions is limited to section 241, it would deprive such category of litigants of their right to approach the Courts for and on behalf of the company. The only party who would suffer in such a scenario would be the company itself. As acknowledged by the Madras High Court in the VKPL Case, derivative actions are indispensable to the company's interest, when the people in control of the company's affairs act contrary to the company's interests.

It is hoped that in the future, suitable legal provisions will be introduced to address the above lacunas, so that the remedy of derivative action retains all its traits and continues to remain an important shield to protect the company's interests.

[13] Paragraph 78.

[14] Paragraph 87.

[15] Paragraph 91.

[16] Petition for Special Leave to Appeal (C) No. 1575/2023.

[17] Section 166, 2013 Act.