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Investors protection: The derivative action

Dr. Gyanendra Kumar Sahu

Assistant Professor P.G. Department of Law, Utkal University, Bhubaneswar, Odisha, India

Abstract
Capital market has emerged as a powerful tool of socio- economic growth in the post globalised world. It has attracted the investors from socio-economic groups, big and small. Historically, the ups and downs in the securities market has always played a significant role in shaping the life and economy of the nation. Thus, investors' confidence in the capital market which is ought to be based on a sound financial system of transparency and efficient system of protection and justice has assumed an important role for any developed / developing economy .To strengthen the securities market and to gain investors' confidence, the past decade witnessed wide ranging legislative interventions. So as to protect investors ' interest in securities, promote development and regulate securities market. Derivative actions are convenient mode of realisation of securities interest and protection thereof has gained currency in western countries like USA and UK. Derivative actions are claims brought by individual shareholders, acting on behalf of a company, against the company's directors. A shareholder Derivative suit is a lawsuit brought by a shareholder on behalf of a corporation against a third party. Often the third party is an insider of the corporation, such as an executive officer or director. Shareholder derivative suits are unique because under traditional corporate law, management is responsible for bringing and defending the corporation against suit. In Derivative actions the plaintiffs are shareholders who aim to represent the company in corporate claims against directors, controlling shareholders, and other parties when persons who are at the helm of affairs of the corporation fail to take appropriate action and perform their duties. As securities investment is a largely growing feature of Indian economy and society, it is imperative that India shapes its legal framework to make Derivative suit a reality for securing the interest of Indian investors.

Keywords: *derivative,* corporation, ultra vires

Introduction
A company is regarded by law as an independent entity, which is owned by its Members [1]. In order for the company to operate and make decisions, the members or shareholders delegate management responsibility to a Board of Directors. It is the responsibility of a director to act in the best interests of the shareholders, to make them fully informed about the actions of the company, to ensure that the company remains solvent and to comply with statutory obligations. Formal powers and rules are set out in the Memorandum and Articles of Association [2]. Directors may take any decisions to run the company provided they do not infringe the Memorandum and Articles or the Companies Acts [3]. The Corporate directors have a unique position in that they are both the decision making body for the association, as well as the protectors of members' investment. Directors must act in good faith and for the best interests of the cooperative [4]. This means keeping within the authorized powers of the board and obeying the laws of the land. Any deviation from this may result in company and personal liability. The rights of the shareholders of a company are paramount to the concept of Corporate Governance. The company can never ignore the interests of its members and shareholders. In India Investors are the backbones of the securities market. Protection of their interest is essential for sustenance of their interest in securities and hence development of the market .The legal reforms began with the enactment of the SEBI Act, 1992, which established SEBI with statutory responsibilities to protect the interest of investors in securities.
While, under traditional corporate law, shareholders are the owners of a corporation, they are not empowered to control the day-to-day operations of the corporation. One of the assumptions of corporate law is that stock ownership is separate from control [5]. For this reason it is mandatory that a system of accountability exists. To provide protection to the investors in an effective way besides all these regulatory and penal measures, Derivative action suit emerge as a new form of remedy. Derivative actions creates a mechanism which is available directly to the shareholders. Despite this, there are certain shortcomings with regard to derivative suits in India which need to be addressed in order to establish a proper and smooth functioning of derivative actions as a utility for shareholders.Derivative suits permit a shareholder to bring an action in the name of the corporation against the parties allegedly causing harm to the corporation. If the directors, officers, or employees of the corporation are not willing to file an action, a shareholder may first petition them to proceed. If such petition fails, the shareholder may take it upon himself to bring an action on behalf of the corporation. Any proceeds of a successful action are awarded to the corporation and not to the individual shareholders that initiate the action.

Derivative action
A derivative action is the right of a shareholder of the company to file a suit on Behalf of the company. Shareholder Derivative suit is a lawsuit brought by a shareholder on behalf of a corporation against a third party.
Often, the third party is an insider of the corporation, such as an executive officer or director. Shareholder derivative suits are unique because under traditional corporate law, management is responsible for bringing and defending the

corporation against suit. Shareholder derivative suits permit a shareholder to initiate a suit when management has failed to do so.in order to enable the court to do justice to a company controlled by miscreant directors or shareholders [6]. Such an action is referred to as a "derivate" action since the right to sue is derived from the company. The shareholders as such have no such right. If they wish to file suit for the infringement of their personal rights, the nature of the suit would be required to be otherwise [7]. A derivative suit is filed to enforce the rights of the company itself and to protect it from its negligent/ inefficient/ corrupt management.

In the United Kingdom, an action brought by a minority shareholder may not be upheld under the doctrine set out in *Foss v Harbottle* in 1843 [8]. Exceptions to the doctrine involve *ultra vires* and the "fraud on minority". According to Blair and Stout's "Team Production Theory of Corporate Law" [9], the purpose of the suit is not to protect the shareholders, but to protect the corporation itself. The UK Companies Act, 2006 defines a "derivative claim" as one which is brought by a member of a company in respect of a 'cause of action vested in the company and seeking relief on behalf of the company [10]"

In India, perhaps the only source for a comprehensive and contemporary definition of "derivative suit/ action" would be in the J.J. Irani Committee Report of 2005 [11]. Even in the recent Bombay High Court decision [12], the court merely recognized the concept of a derivative action without giving it a definition in the Indian context or providing parameters for the application of such authority by shareholders. Even the judgments since then which have dealt with suits involving derivative actions have similarly failed to do the same [13].

Claimant of Derivative Actions

The celebrated case of *Foss v. Harbottle* [14] had, for decades established the principle of 'proper plaintiff' which follows that the appropriate or proper plaintiff in a suit which aims at the redressal of the wrongs committed against the company is the company itself. It is the policy of the courts to not hear a claim concerning the affairs of a company which is brought by a member or members of the company and not the company itself. Three discernible reasons can be mentioned for explaining the court's policy of not hearing such a claim are following:

- A fear of multiplicity of claims.
- Disputes among members should be settled by the members themselves in the general meeting where the majority should prevail;
- Refusal to be involved in disputes over business policy;

Thus derivative actions are a departure from the *Foss v. Harbottle* rule since they allow the very action which *Foss v. Harbottle* aimed at preventing. However, such a departure is not unqualified. It is only when certain conditions have been satisfied that a case can be considered as an exception to the proper plaintiff rule and derivative action allowed to be filed. Most of the exceptions to the proper plaintiff rule where the same would not apply are based on the observations of Lord Jenkins in *Edwards v. Halliwell*. They are as follows [15]:

- The existence of a cause of action in favor of the corporation
- The suitor must be a stockholder of the beneficiary corporation
- Where the action amounts to a fraud on the minority and the culprits of such fraud are in charge of the company. This is the only exception to the *Foss v. Harbottle* rule which applies to derivative actions since the others are personal rather than derivative.
- Where an action is either illegal or *ultra vires* the company.
- Where the personal rights of the shareholder have been infringed.
- In cases where the actions of directors have been in breach of their fiduciary duties owed to the company.

Derivative Actions v/s Class Actions

The corporate system vests power and control in the hands of a few men who are collectively known as "management." [16] Corporate management is an institution created by law because of the obvious impracticability for all the shareholders who, in the final analysis, are the beneficial owners of the corporation to manage its affairs. Corporate management consists of the board of directors and the senior officers of the corporation. Since power is always susceptible of abuse, the omnipresent problem is how to prevent or remedy possible abuses by those in the corporate hierarchy which may be injurious to the corporation and to the shareholders. In most such cases, there is a corporate right of action but in some situations there is only an individual right of action by the shareholders. When the injury is suffered directly by an individual shareholder, as when his right to vote is unlawfully withheld or his right to inspect corporate books arbitrarily denied,

an action may be brought by the injured stockholder in his own name and for his own benefit against the corporation, and this is called a shareholder's individual suit. When the injury is suffered directly by several shareholders, one of them may bring suit in his own behalf and in behalf of all other shareholders similarly situated. This is called a shareholder's representative or class suit. But when the injury is inflicted upon the corporation itself by those who are in control, as when the corporate assets are wasted or used in a manner contrary to the provisions of its charter, resulting in the impairment of the value of the stockholders' shares, the corporation has the right to file the suit to redress the wrong. But if by reason of the control wielded by those who are in power,it aribtrarily refuses to sue, a shareholder may compel the assertion of the right which the corporation fails to assert by filing a suit in behalf and for the benefit of the corporation. This is known as the shareholders' derivative suit.'

Two forms of representative actions are generally recognised – 'Class actions' and 'derivative actions'.The difference is that while in class action suits the plaintiff represents an entire class of members who share a common interest, in derivative actions the plaintiffs are shareholders who aim to represent the company in corporate claims against directors, controlling shareholders, and other parties, when persons who are at the helm of affairs of the corporation fail to take appropriate action and perform their duties [17]. Thus, in the case of class actions, the cause of action vests with the shareholders and the award is made out to the suing class of shareholders, whereas in the case of derivative actions, the cause of action vests with the company and the court's award is delivered to the company [18].

Another major difference with great implications is the fact that while class action has been recognised by the Companies Bill, 2009 [19] no such mention has been made for derivative action, without any regard for the recommendations of the *J.J. Irani Committee Report*. The ramifications of this non-inclusion are manifold. One is left to wonder as to whether the

legislature has purposely left out derivative actions, and if so, what then is it's legal standing in Indian jurisprudence? Would the judgments of the Bombay High Court be then be rendered invalid or can they be seen as an acceptance, in India, of the rule of derivative actions?

Derivative Action's in Indian Corporate Governance

"It is a fundamental principle of company law in India that a company is a legal person, with its own corporate identity, separate and distinct from the directors or shareholders, and with its own property rights and interests to which alone it is interested. If it is defrauded by a wrongdoer, the company is the only one to sue for the damage. Such is the rule in Foss v. Harbottle (1831) 2 Hare 461. The rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue. Likewise, when it is defrauded by insiders of a minor kind, once again the company is the only person who can sue. But suppose it is defrauded by insiders who control its affairs - by directors who hold a majority of the shares – who then can sue for damages? Those directors themselves are the wrongdoers. If a board meeting is held they will not authorise the proceedings to be taken by the company against themselves… In one way or another some means must be found out for the company to sue. Otherwise the law would fail in its purpose. Injustice would be done without redress. The company could sue 'in the name of someone whom the law has appointed to be its representative.' Thus, in the appropriate circumstances a shareholder is entitled to bring the action as a representative of the company - a derivative action. Derivative actions form part of the law of many common law jurisdictions which are set for Corporate.The Derivative actions are useful for a better system of corporate governance. This opinion is backed by the following reasons:'

- Giving shareholders effective remedies maintains investor confidence by punishing improper conduct.
- In deterring managerial misconduct, the derivative action helps align the interests of the managers with those of the company.
- Derivative action can be a key element in reducing agency costs inherent in the management of public companies.
- In "limited fund" cases, a Derivative action ensures that all plaintiffs receive relief and that early-filing plaintiffs do not raid the fund (*i.e.,* the defendant) of all its assets before other plaintiffs may be compensated is that class treatment of claims that may be the only way to impose the costs of wrongdoing on the wrongdoer. A Derivative action in such a situation centralizes all claims and compensation into one venue where a court can equitably divide the assets amongst all the plaintiffs if they win the case.

Limitations of Derivative Actions in the Indian Legal Scenario

However, despite the positive implications of derivative actions for investor confidence and corporate governance, there is a grave need to be wary of the ramifications of giving such unbridled power to any shareholder of a company. As a consequence of derivative actions, a shareholder holding even one share in any company, can bring a suit before a court of law on the allegation that there has been some form of misconduct/misfeasance in the management of the company. The court would then be obliged to decide two questions – *Firstly*, whether the case which it is hearing is a valid case for a shareholder bringing a claim by his/ her derivative rights in the company? *Secondly*, if the above question is answered in the affirmative, the Court would have to go into the merits of the case and decide upon the issue under dispute as to whether the Company's management were guilty of fraud or not?

This is an expected outcome of the shareholder wielding such immense power. But the problems which arise from such derivative rights are as follows:

i) The purpose of the proper plaintiff rule in *Foss v. Harbottle* is lost as the floodgates have now been opened for any member of the company to file a suit against its management in court. The very essence of the above rule was that only the correct party should be allowed to approach the court in order to avoid frivolous litigation [20]. Derivative rights merely open the gates for an increased volume of such frivolity.
ii) The Indian judicial system is already under much strain, workload and pressure from the piling of cases. Their caseload is in arrears, with the pendency of cases having become a national phenomenon in High Courts and the Supreme Court with various authorities making a reference to the impending dangers if such pendency was allowed to continue piling up. Giving shareholders such power to file suits in court will only result in an increase in the pendency of cases.
iii) It has been observed in other countries, where the practice of derivative actions has been prevalent for a longer period of time that "many such suits are "misguided because they produce small awards to their plaintiffs, and are, at worst, frivolous claims designed to extort an award of attorneys' fees [21]." The problem of attorney's fees has been voiced on other occasions as well and there is a strong opinion [22] that at the end of the day, it is the attorney who at the best advantage. More often than not, the attorneys glean litigants into filing suits, for their own personal profits, and at the end of the case, irrespective of which way the case went, they walk away with a handsome payment.
iv) The shareholders' ability to file derivative actions comes with mounting costs. "Through derivatives suits, shareholders with minor investments can force corporations to expend large amounts of time and money that may be better utilized in other ways. Additionally, the threat of derivative litigation may make corporate managers too risk-averse, especially because reasonable people can differ over the wisdom of many corporate transactions [23]." These costs are ultimately incurred by the corporation and are taken out of the profits of the company, thus reducing shareholder welfare. So the end effect is upon the shareholders themselves.
v) One of the most significant criticisms of derivative suits is that they are simply ineffective. "Even if derivativesuits were underutilized and a substantial amount of the benefits accrued to the plaintiffs' counsel, a target firm could have residual benefits in terms of corporate governance changes mandated by the settlement agreement. Yet it was conclusively found that (1) there was little evidence of specific deterrence, with only increased top management turnover in sued firms; (2) general deterrence is probably weak; and (3) there was mixed evidence of indirect benefits, in particular advantages for block-shareholders.

vi) The final and most important drawback with regard to derivative actions in the Indian framework is its complete absence from the Companies Bill, 2009. The problem is not only as has been identified above, that is, what are the implications of derivative actions being recognised by the Courts but not by the Indian Parliament? Another problem is that, with respect to the derivative actions, it is not enough to simply define and provide for derivative actions. Any statutory provision must lay down guidelines for the exercise of such a right and should provide parameters or limits to ensure the absence of frivolous litigation and to reduce the scope of misuse of the provision. If the legislature fails in this regard, perhaps the responsibility then falls upon the courts to issue rules and guidelines in the form of judicial legislation as it has done on previous occasions.

Conclusion

The availability of alternative remedies for an aggrieved shareholder is an important factor in determining whether the court will grant permission to continue a derivative action. The court will look at the bigger picture of what is best for the company as well as what is best for the member. In cases where a company is controlled by wrongdoing directors who are also major shareholders it is likely that an action will be more appropriate. What this means is that it may only be in limited cases that the new derivative action will be a useful tool for activist shareholders who want to apply pressure on directors. They will instead be directed towards an action. This means that any legal action will have to be personally financed by the member and the most likely remedy will be a buyout of shares at a fair value, which in the case of a very small minority shareholding may not be worth pursuing.

There is no doubt of the importance of derivative actions as a tool for corporate governance and managerial accountability of the directors. The rule in *Foss v. Harbottle* cannot be exclusive and must come with an exception. Individual shareholders, by virtue of being members of the company, must be given a right, not only to participate in the proceedings of the company, but also to voice their concerns regarding the management of the company. Specifically when these concerns are not heard due to the misconduct of the directors of the company, it becomes the prerogative of the shareholder to approach the court for protection of the interests of the company and redressal of the wrongs committed upon it. However, this cannot be done without ensuring that such concern is not baseless and frivolous and that it has some substantial legal backing. To guarantee the same, a mechanism must be worked out keeping in mindful of the above six drawbacks of derivative actions without sacrificing its role as a tool for better corporate governance.

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9. Margaret M. Blair, Virginia Law Review, Vol. 85, No. 2, pp. 248-328, March 1999
10. Section 260(1) of the UK Companies Act, 2006.
11. J.J. Irani Committee Report on Company Law, Chapter VI, Recommendation 10.1 (2006) 1 Comp LJ 25 (Journal) states that:
12. "In case of fraud on the minority by wrongdoers, who are in control and prevent the company itself bringing an action in its own name, derivative actions in respect of such wrong non-ratifiable decisions, have been allowed by courts. Such derivative actions are brought out by shareholder(s) on behalf of the company, and not in their personal capacity (ies), in respect of wrong done to the company."
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