
REIMAGINING DERIVATIVE SUITS: A CALL FOR LEGISLATIVE ACTION

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ABSTRACT

Disputes between shareholders members and directors has been an issue in the Corporate world through the years. Allegations by the minority shareholders reverberate in courtrooms throughout the world. Indian law provides for various reliefs for oppression and mismanagement but how effective they are is a point of debate. This paper highlights one such relief; Derivative Actions are suits that are filed by the shareholder on behalf of the company against its officers or directors. It is an action that is brought to either compel the corporation to sue or an action that is brought on behalf of the corporation to redress the harm caused to the corporation. These suits have not been statutorily recognised however through case precedents Section 241 of the Companies Act, 2013 offers shareholders a new channel however it imposes constraints, ultimately turning out to be a "paper tiger."

Furthermore, the company retains significant control over the process, and the tribunal's scrutiny can make filing a lawsuit challenging. This paper analyses the situation of shareholder derivative action suits in India and aims to showcase that Sections 241 may not be the best avenue for shareholders therefore advocating for its statutory. Although derivative suits are a relatively recent development in India, their significance in the corporate sphere requires careful examination. Hence through this paper we shall examine these provisions, their suitability in the corporate sphere, and whether they are beneficial or detrimental.

Keywords: Derivative suits, Section 241, Corporate governance, minority shareholders, Statutory recognition, Private wrongs, Legal framework, Jurisdiction.

I. INTRODUCTION

Corporate democracy, like sovereign democracy, caters to the majority's will. The majority rule upholds a contractual agreement between shareholders that prioritizes group decision-making over individual interests. Efficiency is added by giving the board of directors the authority to make business decisions. But what can be done to stop minority shareholders from being swept away by the tyranny of the majority?¹ In this case, company law steps in to control the actions of dominant individuals so that they don't negatively impact the interests of minority shareholders. A derivative suit is one of these remedies. By enabling shareholders to file a lawsuit on the company's behalf to right wrongs committed by its officers or directors, this legal system makes sure that fraud or negligent leadership won't jeopardize the corporate entity. Sections 241² and 244³ of the Companies Act, 2013⁴ largely establish the present framework for shareholder remedies, even though they have been a feature of Indian company law since the middle of the 20th century. While India's legal landscape has embraced the concept of derivative actions, its application has been fraught with complexities and challenges. This paper aims to provide a thorough analysis of derivative actions as a remedy for aggrieved shareholders in India. With the potential notification of these sections, this paper also seeks to explore existing literature on derivative suits, examining the current interpretation and application of derivative actions in India showcasing the need for statutory recognition.

II. HISTORICAL CONTEXT

The historical foundations of derivative actions in India can be traced back to the English Companies Act, of 1948, specifically Section 210, which introduced the concept of oppression

¹ Varottil, U. (2020). *Unpacking the Scope Of Oppression, Prejudice And Mismanagement Under Company Law In India*. [online] papers.ssrn.com. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3659751 [Accessed 18 Oct. 2024].

² Section 241, The Companies Act, 2013.

³ Section 244, The Companies Act, 2013.

⁴ The Companies Act, 2013 (India).

remedies for shareholders. This provision was subsequently incorporated into Indian Company law through Section 397 of the Companies Act, 1956.⁵

The Indian context is rooted in the need to provide a remedy for shareholders facing oppressive or discriminatory conduct by the company or its management. The oppression remedy offered a more efficient alternative to the costly and time-consuming process of winding up a company.

Over the years, Indian courts have developed a substantial body of jurisprudence on the oppression remedy, drawing inspiration from English case law. This jurisprudence has shaped the interpretation and application of derivative actions in India, guiding shareholders seeking to protect their rights and interests.

III. Legal Analysis: The Scope and Limitations of Derivative Actions in India

The scope and limitations of derivative actions by shareholders in India are a complex issue, influenced by various factors including the legal framework, judicial interpretations, and the specific circumstances of each case. While derivative actions can be beneficial for protecting corporate interests, their applicability in India is subject to certain constraints. Unlike many other Asian jurisdictions, India does not have a specific statutory provision for derivative actions. The legal framework for these actions is primarily derived from common law principles and judicial interpretations. This unique position makes India an interesting case study for analysing the scope and limitations of derivative actions in a developing economy with a dispersed shareholder base.

Indian courts have generally applied the *Foss v. Harbottle*⁶ rule, which states that only the company itself can bring an action to redress wrongs committed against it. Since they have not experienced any direct harm, a single shareholder lacks the locus standi to file a lawsuit. According to a judicial extension of this idea, if a majority of shareholders may approve the act that first caused the injury, it would be pointless to permit a minority shareholder to file a lawsuit for damages to the business. Therefore, the question of who, when, and how to file these lawsuits in India comes up. In several cases, throughout the years since the Companies

⁶ (1843) 2 Har 461

Act 2013 went into effect, courts have ruled that Section 241⁷ of the Act provides for the continuation of derivative proceedings. Even though the legislators did not intend for derivative actions to fall under the purview of Section 241, courts are free to disregard this. The rule against surplusage, which states that language in laws or provisions should be interpreted to prevent repetition of any part, can be used as support. The phrase "interests of the company" is given effect when reading in derivative actions under Section 241, which might be used to avoid redundancy.⁸ Through this paper, I will be exploring how the courts have used Section 241 to incorporate derivative suits and their limitations in the Indian context.⁹

IV. Beyond Personal Wrongs: Clarifying the Scope of Derivative Actions Under Section 241

While courts have recognized derivative actions as falling under Section 241¹⁰ through various case precedents, the author argues that this approach, while intended to protect minority shareholders, ultimately conflates corporate and personal wrongs. This conflation undermines the distinct nature of derivative actions and can lead to unintended consequences. Individual shareholders can seek redress for personal wrongs, such as oppression, mismanagement, or prejudice, through legal means. However, when a company suffers a wrong, only the company itself can take action to rectify it. This type of action is known as a derivative suit. The Companies Act 2013 has brought various changes one such change is that it has consolidated the oppression and mismanagement remedies and at the same time introduced an additional remedy called prejudice within a single provision i.e., Section 241¹¹. A prejudice can be invoked when it is caused not only by shareholders but also by the company. Hence, one may think that this is statutory recognition of derivative action. This was the exact situation in the ICP Investments case¹².

⁷ *Id* at 2

⁸ Agarwal, R. (2023). *Section 241 of the Companies Act, 2013: An Avenue for Derivative Actions - IndiaCorpLaw*. [online] IndiaCorpLaw. Available at: <https://indiacorplaw.in/2023/06/section-241-of-the-companies-act-2013-an-avenue-for-derivative-actions.html> [Accessed 18 Oct. 2024].

⁹ Khanna, V. and Varottil, U. (2012) 'The rarity of derivative actions in India:: reasons and consequences', in D.W. Puchniak, H. Baum, and M. Ewing-Chow (eds.) *The Derivative Action in Asia: A Comparative and Functional Approach*. Cambridge: Cambridge University Press (International Corporate Law and Financial Market Regulation), pp. 369–397.

¹⁰ *Id* at 2

¹¹ *ibid*

¹² ICP Investments (Mauritius) Ltd. v. Uppal Housing (P) Ltd., 2019 SCC OnLine Del 12371

There is currently no definitive court ruling on whether a particular clause should only be applied when a company's harm is accompanied by evidence of personal wrongdoing. Some argue that the clause should be applied only in cases of personal wrongdoing, while others contend that Section 241 of the Companies Act 2013 can be applied to all corporate wrongs. This interpretation is supported by some judgments from Singapore, which distinguish between purely private wrongs and private wrongs that also involve some corporate wrongdoing. Additionally, the fact that a company may be granted a remedy under Section 241 in a direct action does not change the nature of the action from direct to derivative action.¹³

The court's conflation of direct and corporate claims is problematic. Unlike direct claims, which require no substantive filters, common law derivative claims in India involve several criteria for admissibility. Moreover, the remedies sought and the benefits of these actions differ significantly. The lack of clarity surrounding these distinctions is a major obstacle to the success of derivative actions in India. The ICP Investments case is a prime example of this confusion. To establish a more effective protection regime, it is important to clearly define the causes of action that can lead to derivative actions and separate them from other private reliefs. Additionally, lessons should be learned from the experience with common law derivative actions to address issues like litigation costs. This will ensure a more feasible, accessible, and efficient protection regime that benefits both the company and minority shareholders. If the findings in the ICP Investments case stand, it could not only add to the confusion surrounding derivative actions but also diminish shareholders' ability to seek remedies for corporate wrongs and weaken corporate governance¹⁴

Furthermore, even though the court's decision to include derivative suits can be viewed as a step in the right direction for minority shareholders' rights, there appear to be several obstacles that a shareholder may encounter, including the ones listed below, which highlight the necessity for statutory recognition of the principle.

¹³ cbclseconduser (2022). *Confused Jurisprudence on Derivative Actions in India - NLIU CBCL*. [online] NLIU CBCL. Available at: <https://cbcl.nliu.ac.in/company-law/confused-jurisprudence-on-derivative-actions-in-india/> [Accessed 18 Oct. 2024]

¹⁴ *ibid*

1. **Stringent Conditions:** A shareholder must prove one of the exceptions to the rule in *Foss v. Harbottle*¹⁵ to initiate a claim. In this exception, the word "fraud" is employed in a broader equitable sense that refers to the unjust discrimination against minorities rather than its technical meaning. It entails the majority appropriating benefits at the minority's expense. When shareholders file a derivative action, they must show that the act in question benefited the majority of shareholders or other insiders, that the advantage was achieved at the expense of the company, or that the firm suffered a loss or other negative consequence¹⁶. The courts in India have with great discretion decided through various judgements if a case could constitute a circumstance where even the director has benefitted from that action. ¹⁷In *Needle Industries (India) Ltd. v. Needle Industries Newey (India) Holding Ltd*, the Supreme Court of India held that "if the directors incidentally benefit from an issue of further shares which, it can be shown, is otherwise for the benefit of the company, then such incidental benefit would be overlooked"¹⁸. Furthermore, this exception of fraud on minorities can only be invoked when the minority shareholder can prove that the wrongdoer has sufficient control over the company. This is because the court believes in the concept of good faith and believes that this individual would never bring harm to the company. Usually determining control over the company is very straightforward however as seen with the recent trends the number of more widely-held Companies makes this determination not so easy.¹⁹
2. **Clean hands doctrine:** The "clean hands" theory has also been tacitly recognized by Indian courts. But in reality, the concept has created a great deal of inconvenience, mainly because of its hazy boundaries. The doctrine has been argued to be misguided because, although the concept of the 'clean hands' requirement is indefinite, the propriety of the shareholder should not be relevant in an action brought on behalf of the company when the benefit of the action augurs to the company and not the shareholder bringing the action. ²⁰

¹⁵ (1843) 2 Har 461

¹⁶ Varottil, U. (2021). *Directors' Liability and Climate Risk: White Paper on India*. [online] Available at: <https://celi.ubc.ca/wp-content/uploads/2021/10/Directors-Liability-and-Climate-Risk-White-Paper-on-India.pdf> [Accessed 18 Oct. 2024].

¹⁷ *Id* at 2

¹⁸ *Needle Industries (India) Ltd. v. Needle Industries Newey (India) Holding Ltd.*, (1981) 3 SCC 333

¹⁹ *Id* at 2

²⁰ *Id* at 9

3. **High Costs:** Bringing a derivative suit can be costly due to court fees, stamp duties, and legal expenses. These costs can be prohibitive for individual shareholders, particularly in cases where the potential recovery may not justify the expenditure.
4. **Institutional Factors:**
 - ❖ **Absence of a Plaintiff Bar:** Unlike in some other jurisdictions, India does not have an active plaintiff bar that specializes in derivative suits. This means that shareholders must bear the full costs of bringing the action, which can discourage litigation.
 - ❖ **Lengthy Litigation:** The Indian legal system can be slow and inefficient, leading to lengthy litigation processes. This can make it difficult for shareholders to recover damages or obtain other relief promptly.
 - ❖ **Limited Damages:** Courts in India may be reluctant to award significant damages in derivative suits, particularly if the wrongdoing is not egregious or the harm caused is difficult to quantify. This can reduce the incentive for shareholders to bring these actions.
 - ❖ **Institutional Environment:** The overall institutional environment in India may not be conducive to derivative suits. For example, the lack of transparency and accountability in corporate governance can make it difficult to identify and address wrongdoing.

V. ORDER 1 RULE 8

Now that we have established that Section 241²¹ is a misfit for Derivative suits, it remains unclear where shareholders should file such suits in cases of oppression or mismanagement. One option that has been explored is Order 1 Rule 8 of the Civil Procedure Code, 1908.²² This rule allows one person to sue or defend on behalf of others with the same interest. While this could seem applicable to derivative actions, recent judicial developments and the Companies Act, 2013 have raised questions about the civil courts' jurisdiction in such matters. Several High Court judgments have suggested that the NCLT (National Company Law Tribunal) has exclusive jurisdiction over derivative actions. This implies that shareholders may be limited

²¹ *Id* at 2

²² Order 1 Rule 8, The Civil Procedure Code, 1908.

to the remedies provided under Section 241, despite its limitations. The interplay between Order 1 Rule 8 and the NCLT's jurisdiction creates uncertainty for shareholders seeking to protect their company's interests.

How does the civil court lose its jurisdiction over certain cases? The court in the case of *Dhulabhai v. State of Madhya Pradesh*²³ laid down seven principles through which one can understand if the jurisdiction of the civil court is barred. Essentially, it was necessary to demonstrate that, first, the legislation gave the tribunal's orders finality, and second, that the act expressly prohibited the civil court from exercising its jurisdiction. This was further supported by appropriate remedies that the tribunal may provide.

According to Section 430 of the Companies Act, Civil Courts are barred from deciding on any matters that the act gives the NCLT exclusive jurisdiction on matters laid down therein.²⁴ In *Sas Hospitality v. Surya Constructions*,²⁵ the Delhi High Court stated the exclusivity of the NCLT's jurisdiction under Section 430. The Court observed that "under sections 241 and 242²⁶ the NCLT has broad powers which allow it to pass any such order as it thinks fit." This would mean that even if civil courts would have jurisdiction over such company law matters as long as the NCLT has authority to pass orders on those cases the civil courts would not be able to do anything.

The Court thus concluded that the instant case would come within the domain of the NCLT. The Madras High Court's decision in *Valluvar Kuzhumam Private Limited v. APC Drilling & Construction Private Limited & Ors*²⁷ further strengthened the NCLT's role in derivative actions. The court held that Section 241 of the Companies Act, which governs derivative actions, is primarily intended to be exercised before the NCLT. The Supreme Court's refusal to interfere with the Madras High Court's judgment in the VKPL case solidified the trend of confining derivative actions within the framework of Section 241. This shift from common law-based derivative actions to a statutory regime has significant implications.

²³ *Dhulabhai v. State of Madhya Pradesh*, (1968) 22 STC 416

²⁴ Singh, P. (2023). *Derivative Action – Where Does the Jurisdiction Lie? - IndiaCorpLaw*. [online] IndiaCorpLaw. Available at: <https://indiacorplaw.in/2023/02/derivative-action-where-does-the-jurisdiction-lie.html> [Accessed 18 Oct. 2024].

²⁵ *SAS Hospitality (P) Ltd. v. Surya Constructions (P) Ltd.*, 2018 SCC OnLine Del 11909

²⁶ Section 242, The Companies Act, 2013.

²⁷ *Valluvar Kuzhumam Private Limited v. APC Drilling & Construction Private Limited & Ors.*, (2022)

While the exclusive jurisdiction of the NCLT provides a centralized forum for resolving derivative actions, it also raises concerns about accessibility and potential limitations. The eligibility criteria under Section 244, which require a certain percentage of shareholding or number of members, may exclude some shareholders from pursuing derivative actions. Additionally, the focus on Section 241 might lead to a narrow interpretation of derivative actions, potentially restricting their application to specific types of corporate wrongs. While Section 241 provides a remedy for oppression and mismanagement, it may not be sufficient to address all forms of corporate misconduct. The Madras High Court in *Valluvar Kuzhumam v. APC Drilling & Construction* recognized the broader scope of derivative actions, noting that they are "indispensable to the company's interest" when insiders act against the company's interests.²⁸

The judicial landscape surrounding derivative actions in India has undergone a significant transformation since the introduction of Section 430²⁹. While the NCLT's exclusive jurisdiction provides a centralized forum, it also raises concerns about accessibility and the potential limitations of Section 241.

VI. JUDICIAL ANALYSIS

Derivative Action in India is not statutorily recognised hence it is rooted in common law principles. *Foss V Harbottle*³⁰ set the earliest corporate law principle i.e., the proper plaintiff rule. According to this rule, only a company has locus standi to bring an action, a shareholder cannot bring a suit in such a case. In the next couple of years, the case of *Edwards v. Halliwell* 1950³¹ laid down the three exceptions to *Foss v. Harbottle*³². It was affirmed that a majority of shareholders in a company cannot approve actions that are beyond the company's legal authority or that deceive minority shareholders. This act of a shareholder of the company is called derivative action.³³ Courts in various decisions had accepted this common law derivative action under the existing corporate law jurisprudence³⁴. However

²⁸ *ibid*

²⁹ Section 430, The Companies Act, 2013.

³⁰ (1843) 2 Har 461

³¹ All ER 1064

³² (1843) 2 Har 461

³³ *Id* at 24

³⁴ *ibid*

with the recent development in the case of ICP Investments (Mauritius) Ltd v Uppal Housing Pvt Ltd,³⁵ this year-long common law principle was changed. The court in this case stated that Section 241 of the Companies Act 2013 would incorporate derivative suits. “The rationale of the court is that Section 241 allows a member of the company to file a petition when the affairs of the company are conducted in a way that is prejudicial to the company’s interest”. Further, the Court went on to say that its common law remedy will no longer exist because Section 241 now encompasses derivative action.³⁶

The concept of derivative suits, while recognized in Indian corporate law through Section 241 of the Companies Act, 2013, is plagued by several shortcomings that hinder its effective application. The current framework, primarily governed by Section 244, imposes stringent conditions on shareholders seeking to bring such suits. These conditions, such as the requirement for a minimum number of shareholders (either 100 or 1/10th of the total members) or a minimum shareholding of 1/10th of the issued share capital, often create a significant barrier for individual shareholders.

The threshold requirements outlined in Section 244 effectively limit the ability of individual shareholders to exercise this right. In many cases, the numerical requirements may be so high that it becomes impractical or impossible for a single shareholder to meet them, effectively discouraging the pursuit of derivative actions.

Moreover, the courts have often adopted a cautious approach when dealing with derivative suits under Section 241, applying various stringent conditions that can further undermine the morale of shareholders. As found in a study “Over the last sixty years, only about ten derivative actions have reached the High Courts or the Supreme Court. Of these, only three were allowed to be pursued by shareholders, and others were dismissed on various grounds. The insignificance of derivative actions becomes crystallized when their rarity is juxtaposed with the fact that there are over 700,000 active Companies in India and nearly 30 million cases pending before various Indian courts.³⁷

In this part, I describe the conflicting rulings from several Indian High Courts that ultimately resulted in higher ex-ante fees for derivative action claims. These conflicting rulings add to

³⁵ *Id* at 12

³⁶ *Id* at 24

³⁷ Varottil, U. (2012). The Advent of Shareholder Activism in India. *SSRN Electronic Journal*. doi:<https://doi.org/10.2139/ssrn.2165162>.

the already confused condition of the law, which results from the absence of a clear statute rule on the subject. First of all, Indian law is unclear about the criterion that must be followed when allowing these kinds of lawsuits. The "clean hands doctrine" has occasionally been applied by the courts to dismiss certain derivative lawsuits outright. In the case of *Darius Rutton Kavasmaneck v. Gharda Chemicals Ltd*³⁸, for instance, the Bombay High Court used the "clean hands doctrine" and dismissed the case at a preliminary stage. Regardless, in a few cases the Indian courts have been much more open, in the case of *Rajeev Saumitra v. Neetu Singh*³⁹, the Court disregarded the "clean hands doctrine" laid down in *Darius*, based on the facts of this case. Unlike the strict rules imposed by *Darius*, the court in this case was fairly lenient. The inconsistent rulings by different High Courts can confuse petitioners about whether their cases will be accepted, as there is no consistent standard applied by Indian courts in this area.⁴⁰

The grounds to bring a derivative suit in India because of all the reasons stated above are very narrow furthermore these unambiguous standards often increase the cost of bringing such suits. The Delhi High Court in *ICP Investments (Mauritius) Ltd. v. Uppal Housing (P) Ltd.*⁴¹ tried to expand the grounds for such suits by departing from *Foss V Harbottle*⁴², however, rather than enlarging the grounds, it further narrowed them⁴³. Recently the court in the case of *Needle Industries (India) Ltd. v. Needle Industries Newey (India) Holding Ltd.*⁴⁴ ruled out cases if the benefit accrued to accused directors was incidental then it would not amount to a derivative suit. Such judgments by the courts not only make it difficult but the lack of clarity makes it difficult for the shareholders to file these suits.⁴⁵

VII.TRENDS AND TIDES: A CAUTIOUS APPROACH TO THE FUTURE

Derivative actions act as a crucial remedy for improving the rights of minority shareholders. A strong system that permits derivative suits would be preferred in light of the expansion of

³⁸ *Darius Rutton Kavasmaneck v. Gharda Chemicals Ltd.*, 2015 SCC OnLine Bom 4813

⁴⁰ Jha, A. and Misra, U. (2023). Is the Derivative Action Regime in India a Historical Relic? *Business Law Review*, [online] 44(Issue 5), pp.180–182. doi:<https://doi.org/10.54648/bula2023022>.

⁴¹ *Id* at 12

⁴² (1843) 2 Har 461

⁴³ Indulia, B. (2022b). *Shareholder Derivative Action Suits in India: Avoiding the Influence of Foss v. Harbottle and Taking Cue from the UK Law*. [online] SCC Blog. Available at: <https://www.sconline.com/blog/post/2022/08/10/shareholder-derivative-action-suits-in-india-avoiding-the-influence-of-foss-v-harbottle-and-taking-cue-from-the-uk-law/>.

⁴⁴ *Needle Industries (India) Ltd. v. Needle Industries Newey (India) Holding Ltd.*, (1981) 3 SCC 333

⁴⁵ *Id* at 43 .

the Indian capital markets and the rise in small shareholders. Derivative litigation is uncommon in India, nonetheless, due to substantial barriers posed by substantive and procedural laws as well as other institutional, cultural, and economic considerations. The derivative action mechanism does not seem to be sufficiently stimulated by current ideas for revising Indian company law. The author does not believe that the traditional derivative action is the only way to improve enforcement in India. There may be other options, such as arbitration, but we believe that improving derivative actions will help to strengthen the overall enforcement of corporate laws in India. We recommend establishing a statutory derivative suit regime. To address these shortcomings and establish a robust framework for derivative suits, several reforms are essential:

1. **Statutory Recognition:** The current ambiguity surrounding common law derivative proceedings should be eliminated by explicitly including provisions for derivative cases within the Companies Act. This would provide such lawsuits with a strong legal basis.
2. **Procedural Streamlining:** The procedural requirements for derivative suits should be streamlined to reduce barriers and encourage their use. This could include simplifying the filing process, establishing clear timelines, and limiting unnecessary procedural hurdles.
3. **Funding Mechanisms:** Access to funding is a significant obstacle for many shareholders considering derivative actions. Establishing mechanisms to provide financial support, such as company-funded litigation or third-party funding options, would alleviate this burden and encourage more shareholders to pursue such actions.
4. **Clearer Director Duties:** The law governing directors' duties must be codified to provide a clear and enforceable framework for assessing potential breaches. This would enhance the ability of shareholders to identify and address wrongdoing within Companies.⁴⁶

By implementing these reforms, India can create a more conducive environment for derivative suits. This would empower shareholders to protect their interests, hold Companies accountable for misconduct, and ultimately improve the overall quality of corporate governance in the country. While these reforms are essential, it is important to acknowledge

⁴⁶ *Id* at 1

that challenges such as delays in the Indian judicial system and the lack of a specialized plaintiff bar may persist. However, by addressing the substantive law, procedural clarity, and funding mechanisms, significant progress can be made in making derivative suits a more accessible and effective tool for Indian shareholders.