ARBITRABILITY OF DERIVATIVE ACTION CLAIMS

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ABSTRACT

There is no provision under Indian law that covers derivative actions by shareholders in India. While courts have generally adopted a stance against the arbitrability of oppression and mismanagement matters, their stance on derivative action suits is unclear. In derivative actions, remedies are sought at the behest of the company. The justification to rationalize the non-arbitrability of oppression and mismanagement matters cannot always apply to derivative action suits. This article aims to analyse the reasons why derivate claims are required to be arbitrated. Along with giving an Indian perspective on the issue, the author will also discuss the stance in different countries across the globe.

Keywords: Companies Act, Shareholders, Arbitration Agreement, Rights

Introduction

No Indian legislation covers derivative actions by shareholders. But the Companies Act, 2013 under its XVI, titled "Prevention of Oppression and Mismanagement", throws light on the matter, however, briefly. The stance adopted by the courts is also uncertain.[1] Before moving any further, it is essential to understand oppression, mismanagement, and class action claims and how they are different from derivative actions.[2] It's also crucial to distinguish between corporate and personal wrongs. A corporate wrong occurs when a corporation is the victim of wrongdoing, giving the company a legal basis to pursue the wrongdoer. A shareholder may launch a derivative action on behalf of the company if the company fails to bring such an action. Whereas, when the shareholder is the victim of the wrong and pursues a legal action on their own behalf, it is called a derivative claim. As a result, the justification for non-arbitrability in oppression and mismanagement proceedings often does not apply to derivative action suits.[3]

A Look at Various Courts' Stances

The High Court of Bombay in Onyx Musicabsolute.Com Pvt. Ltd. v. Yash Raj Films Pvt. Ltd. & Ors.[4] was entertaining an application under Section 9 of the Arbitration and Conciliation Act, 1996,[5] which of the nature of derivative action. In the present case, Plaintiff No. 1 and In the present case, plaintiff no. 1 and defendant no. 1 entered into a joint venture and formed defendant No. 2, in which each owned half. Following that, defendants no. 1 and no. 2 signed a licencing deal under which the latter would be granted mobile rights to the former's films. Disputes developed as a result of defendant no. 1 allegedly breaching the agreement by licencing some films to a third party rather than to defendant no. 2. The plaintiff asked for an injunction under Section 9 to prevent defendant no. 1 from licencing rights to a third party. The court declined to enjoin defendant no. 1 under the Section for two reasons:

1. The licence agreement containing the arbitration clause was between defendants no. 1 and 2, not the plaintiff, disqualifying it from invoking the clause; and

[1] Rakesh Malhotra v. Rajinder Malhotra, (2015) 2 CompLJ 288 (Bom); Sporting Pastime India Ltd. v. Kasturi & Sons Ltd. (2007) 1 ARBLR 99 (Mad).
[2] Umakanth Varottil, *The Continued Influence of Foss v. Harbottle in India*, INDIA CORP LAW (last visited March 7 2022) The Continued Influence of Foss v. Harbottle in India - IndiaCorpLaw
[3] Rashmi Mehra v. Eac Trading Ltd. (2006).
[4] (2008) 6 Bom CR 418.
[5] Interim measures that a party may, before, or during arbitral proceedings or at any time after the making of the arbitral award but before it is enforced in accordance with section 36, apply to a court.

2. Because the Section 9 petition was essentially a derivative action, it was much better suited for a public forum rather than a private mode of dispute resolution such as arbitration.

However, it made no mention of Rashmi Mehra, a case decided by the same court just a few years before.

Rajiv Vyas v. Johnwin Manavalan Groge Mandavalan & Ors.[6] and Welspun Enterprises Ltd. v. ARSS Infrastructure Projects Ltd.[7] later overruled Onyx. In Rajiv Vyas, the petitioner (who owned around 33.3 per cent of the total shares) and the respondents formed a corporate company through a shareholders' agreement. Later, when the respondents attempted to alienate some company rights, the petitioner sought arbitration and filed an application under Section 9 of the Act to prevent the respondents from acting against the company's interests. The court granted the application since the shareholders' agreement included an arbitration clause, and the respondents' actions impacted not only the firm but also the petitioner. Welspun also relied on Rajiv Vyas rather than Onyx, accepting the Section 9 application despite the petition including pleas to preserve both the shareholders' personal and the company's rights. It explained that if the shareholders have a shareholders' agreement, and if a shareholder wants to protect his rights as well as the company's as a result of a breach by another shareholder, they would be permitted to pursue arbitration when there is an arbitration clause.

Observations

There are two factors that might make a derivative action claim arbitrable, both of which come with their own set of difficulties.

I. There must be an agreement to arbitrate between the shareholders or between the shareholders and the third party who would be sued on the company's behalf. Because the contract in Rashmi Mehra did not contain an arbitration clause, this rule does not appear to be as hard as Onyx makes it out to be. Instead, there were dozens of new interconnected contracts, with only one of them containing an arbitration clause. A shareholder can invoke arbitration under an ancillary agreement. The court further observed that an Arbitration Agreement was the backbone of the entire transaction. An argument in support of arbitrability of the derivative action claim in Onyx can be

[6] (2010) ARBLR 162 Bom.
[7] (2015) ARBLR 560 Bom.

presented. The plaintiff (shareholder), as previously stated, was not a party to the breached licencing agreement; instead, defendants no. 1 and 2 were. The licence agreement, on the other hand, specified that it would continue to be valid as long as the joint venture between the plaintiff and defendants no. 1 and 2 remained in full force and effect. Like the Rashmi Mehra's interconnectedness test, even if the plaintiff was not a party to the licence agreement, it could have obtained the right to arbitrate on behalf of the company through viz the joint venture agreement because the former's validity was entirely dependent on the latter's, making the latter the "backbone" of the entire transaction.

This logic is consistent with the nature of a derivative action claim that a shareholder is operating in the company's place to protect its interests. Because the derivative action is initiated on behalf of the company, even if the shareholder is not a named party. In re: Salomon Inc. Shareholders' Derivative Litigation,[8] the court held that because the corporation is the primary plaintiff in a derivative action, a pre-dispute arbitration agreement between the corporation and a third party would ultimately subject the shareholders to arbitration as well.

II. Even though an arbitration clause exists, according to Onyx, the court might reject to submit the matter to the tribunal on the grounds that it is better equipped to an adjudication by the court instead, suggesting that public policy could be harmed. This reasoning appears to be retrograde, especially as it is already well-established in the United States of America that shareholders of closely held, privately held firms can arbitrate derivative claims. For example, in Lane v. Abel-Bey,[9] a New York court rejected the argument that arbitration of derivative action claims was prohibited by public purpose; instead, it stated that this would not be the case in privately owned and close organisations. Likewise, in Onyx, the plaintiff-shareholder addressed the court on behalf of a private, closed corporation. Furthermore, refusing to arbitrate derivative claims on the basis of public policy, especially in a private corporation with only two shareholders, would be a direct violation of the concept of party consent, which the court holds so dearly.

[8] 91 CIV. 5500 (RRP) (1995).
[9] 70 A.D.2d 838 (1979).

Another issue arises as a result of Rajiv Vyas and Welspun's decisions. The applications were viewed as harming both the shareholders and the company's rights in both decisions. Only a portion of it was regarded as a derivative action, which was enough to allow arbitration. In fact, Rajiv Vyas set itself apart from Onyx on this point, which is unexpected given that an injunction comparable to the one sought in Onyx was sought by a shareholder with even fewer shares than the plaintiff-shareholder in Onyx. Nonetheless, the court concluded that refusing to award the injunction would result in irreparable harm not only to the company's interests but also to the shareholder. Both sought similar reliefs, but the court in Rajiv Vyas came to a different judgement, concluding that the reliefs sought were partly personal and partially derivative, making the matter subject to arbitration. The Supreme Court in Sukanya Holdings Pvt. Ltd. v. Jayesh H. Pandya[10] concluded that a cause of action could not be bifurcated when referring an issue to arbitration, which appears to be at odds with the court's approach. If the court deemed Rajiv Vyas to be an exception to Sukanya Holdings, there appears to be no justification for the court to dismiss arbitration for even wholly derived claims affecting only the corporation's rights. Nonetheless, there appear to be no hard and fast rules for determining whether reliefs sought in the company's name are derivative or personal. The judiciary must sort these out because the criteria for arbitrability of derivative claims are based on them.

Conclusion

Despite being untenable and flawed, courts have often utilised Onyx to refuse arbitration of derivative claims. Given that Indian courts have begun to adopt a general pro-arbitration stance, there's no reason why derivative action claims can't be arbitrated if the required intent is there. Because the Companies Act, 2013 does not provide for derivative action claims, these claims must rely on judicial rulings, which have been subjected to diverse interpretations and approaches. It is past time for the Indian judiciary to take a position on the arbitrability of derivative claims that is commensurate with international standards.

[10] (2003) 5 SCC 531 (India).