

A Critical Analysis on Significance of Derivative Action and Class Action Suit in Investor Protection

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Abstract

Capital market has risen as an effective tool of socio-economic development in the post globalized world. It has pulled in the investors from socio-economic groups, of all shapes and sizes. In this way, investors' trust in the capital market which must be in the light of a sound financial system of transparency and effective arrangement of security and equity has accepted a vital part for any developed/developing economy. To reinforce the securities market and to pick up investors' confidence, the previous decade witnessed colossal legislative interventions to ensure investors' interest for securities, advance development and regulate securities market. The effectiveness of class action as a powerful device to protect investors has been argued on the grounds that in 'a large number of cases where a large number of individuals have a common claim, fragmented and meritorious claims will neither be litigated because of the imperfections of the legal system nor tackled by the regulatory systems' Class action claims as an advantageous method of acknowledgment of securities market and protection thereof has gained currencies in western nations like USA and UK. As securities investment is to a great extent developing component of Indian economy and society, it is primary that India shapes their lawful structure to influence class action suit a reality for securing the interest of Indian investors. The aim of this paper is to examine the effectiveness of the Class Action suit when compared to Class action suits in US.

Key Words:Class action, derivative action, investor protection, companies act 2013, bill of peace.

1. Introduction

Shareholders activism is an advancing term in India, which implies a dynamic support of investors in all the aspects of the good corporate governance and battling against the misleading and mistaken acts of the company. Individual shareholders do not take a lawful action against a company, either by virtue of absence of enough motivation or discovering it economically unaffordable, or in light of the fact that the law requires a specific level of shareholding for to take action against a company. Hence, small and retail investors generally find that it's hard to be heard and rather their grievances are reviewed either from the company or courts in general. Indian Companies Act 2013 (hereinafter, the Act), provides investor activism and protection of investors of each kind. One such arrangement is that of class action suits under Section 245 of the Act. This is a noteworthy change from the prior administration, which did not have any such provision.

A class action suit is a lawsuit that permits large number of people with a typical interest in the matter to sue or to be sued as a group. It is a procedural mechanism empowering at least one of the aggrieved plaintiffs to file and indict a case in the interest of a bigger group or class, wherein such class has rights and grievances. Class actions are especially useful for all little and minority shareholders who will most likely be unable to manage the cost of an experienced lawyer all alone. Also, they increase the effectiveness of the legal framework by reducing the quantity of decisions for the similar issue, thereby saving time and assets. It provides them with a medium to battle as one unit against the errant company or administration, accordingly reduce the number of suits, expenses of litigation and expanding their odds of achievement simultaneously.

The Class action suit is essentially a representative suit that seeks to combine people seeking remedies for the same cause of action to jointly bring an action in the court against defenders in contrast to a conventional suit where the plaintiff represents himself. While in case of a derivative action suit where the benefits go the company, in case of class action the plaintiff's are the beneficiaries. The effectiveness of class action as a powerful device to protect investors has been argued on the grounds that in 'a large number of cases where a large number of individuals have a common claim, fragmented and meritorious claims will neither be litigated because of the imperfections of the legal system nor tackled by the regulatory systems'. In such cases, collective action consolidating such small claims appears feasible. **The aim of this paper is to examine the effectiveness of the Class Action suit when compared to Class action suits in US.**

2. Statement of Problem

The efficiency of Class Action suit as per the Companies Act, 2013 is largely in question since there are many flaws in the provisions relating to the Class Action suit. Class Action suit is largely dependent on significant number of applications from the shareholders as mentioned in the Section 245(3) of the Act. Therefore there exists insufficiency of provisions of Class Action suit in protection of minority shareholders and absence of more stringent laws to protect the minority shareholder's right.

3. Review of Literature

Investor's confidence in the capital market which is ought to be based upon sound financial system of transparency and efficient system of protection and justice has assumed an important role in any developing country. (Wedderburn 1964) Shareholders activism is an evolving term in India, which means an active participation of shareholders in all the aspects of good corporate governance and fighting against the deceitful and incorrect acts of a company. (Sinha 2015) There has been little scholarly debate on Section 245 primarily due to its unfamiliarity on Indian shores. (Majumdar 2016) The term 'shareholder litigation' comprises all civil actions brought by shareholders against managerial wrongdoings within companies in order to recover economic losses caused by them. (Ltd 2013) The efficacy of India's legal system as a tool for investor protection necessitates a more nuanced treatment. (Varottil 2012) Moreover, the focus of such a regulatory approach tends to target issuer companies and intermediaries involved in the capital markets so as to deter wrongdoing. (Varottil 2014) There exists a strong correlation between the level of protection conferred upon minority investors through the instrumentality of the law and the state of the equity capital markets in given economy (La Porta et al. 2002) Class Action in the Companies Act, 2013 is a statutory embodiment of the common law heritage of Derivative Action, procedural extension of Representative Suits and a substantive expansion of the remedy of oppression and mismanagement. (Chen 2017) The provision for class action suit was brought in to provide stakeholders an edge in retrenching their rights. The provisions were introduced to bring together stakeholders with common interest on a shared platform so as to lower costs of litigation and boost the efficiency of the legal adjudication. (Payne 2002) The intention behind introducing the class action provision was indeed a noble one expected to benefit the stakeholders by empowering them additionally to proceed against the company with minimal costs of litigation. (Hoffmann & Fieseler 2017) But sadly, the idea forthwith loses its nobility when one peruses the provisions only to find them unclear, ambiguous, vague and hazy. (Vigneswaran 2018) The rule in *Foss v. Harbottle* provides that individual shareholders have no cause of action in law for any wrongs done to the corporation and that if an action is to be brought in respect of such losses, it must be brought either by the corporation itself (through management) or by way of a derivative action. (Shakya 2014) The company is

liable for its contracts and torts; the shareholder has no such liability. The company acquires causes of action for breaches of contract and for torts which damage the company. (Khuntia 2014) 'Minority shareholders' is the weakest strata of a company and the rule laid down in *Foss v. Harbottle* acts as a bar to the actions initiated by them. Subsequent evolution of the rule has shown that the rule has been used to restrict the minority opinion. An important implication of the section 245 is that the liability extends to the auditors and the firm with respect to fraudulent and unlawful acts committed along with directors and experts. (Pardow 2011) It is also important to ask here whether there is really any social and legal value in class action lawsuits. In small claims class actions, there would be little value of supporting litigation in which individual class members have trivial interests. (Puchniak et al. 2012) The individual claimants, because they have so little at stake, would not exercise any control over the litigation or would elect to opt out of the class and pursue individual claims. (Pandya 2014) Small and retail investors who would otherwise not have asserted their rights through litigations under existing remedies owing to costs and adjudication delays have an effective redressal tool in the form of class action. (Scarlett 2011) The Class action mechanism through the strength of collective action empowers small investors to seek settlement of their small claims, which may not otherwise warrant individual action. This mechanism will serve as an alternative to regulatory enforcement of investor protection laws. (Booth 2007) While there is now a statutory provision for class action, initiating such action needs a strong vigilance on the part of retail investors to stay alert to the actions of the management. (Alexander 2000) The legislation and court rules should have given more power to the courts to examine class action applications. Courts should carefully review the applications and deny class status to small claims cases with little social value in the adjudicating the claims. (Khanna & Varottil n.d.)

Objectives

1. To analyse significance of Class Action suit.
2. To examine the effectiveness of Derivative Suit.
3. To study the effectiveness of Section 245 of the Companies Act, 2013.

Hypothesis

H₀: The remedy of Class Action suit is not sufficient to protect shareholder's right.

H_a: The remedy of Class Action suit is sufficient to protect shareholder's right.

Research Question

Whether the Class Action suits are sufficient to protect the interests of investors?

4. Materials and Methods

In this study, the researcher has opted doctrinal research methodology for knowing the judicial response of the significance of the Class Action suit. This data is mainly collected through secondary sources of information like books and journals and ample e-sources have also been referred.

Significance of Class Action Suit over Derivative Suit 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.

Usually, the third party is an insider of the company, 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.¹ 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. Such an action is referred to as a “derivative” 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.² A derivative suit is filed to enforce the rights of the company itself and to protect it from its negligent/ inefficient/ corrupt management.

Derivative Actions in Indian Corporate Governance

It is a fundamental principle of company law in India that a company is a juristic person, with its own separate corporate identity, separate and unique 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*.³

The rule is sufficiently simple to apply when the company is defrauded by outsiders. The company itself is the only party which can sue. Likewise when it is defrauded by insiders of a similar kind, once again the company is the only person who can sue. But suppose it is deceived by office bearers who control its affairs - by directors who hold a majority of the shares – then who can sue for damages? Those directors themselves are committing fraud. If a board meeting is held they will not approve the suit to be taken by the company against themselves. Otherwise the law would fail in its purpose. Injustice would be done without redress. The company could sue ‘in the name of someone whom

¹ Nurcombe v. Nurcombe, [1985] 1 W.L.R 370.

² Charlesworth & Morse on Company Law (15th ed., Sweet & Maxwell, 1996) at p. 401.

³ (1831) 2 Hare 461.

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. (Puchniak et al. 2012)⁴

An earlier study found that “over the 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.”(Varottil 2014)⁵ Even in the recent Bombay High Court decision, 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.⁶

Limitations of Derivative Actions in the Indian Legal Scenario

However, notwithstanding the positive ramifications of derivative actions for investor confidence and corporate governance, there is a grave need to be careful about the repercussions of giving such unbridled power to any shareholder of a company. As a result of derivative actions, a shareholder holding even one share in any company, can bring a suit under the court of law on the assertion that there has been some type of wrongdoing in the administration of the company. The court would then be obliged to choose two questions – Firstly, regardless of whether the case which it is hearing is a legitimate case for a shareholder bringing a case by his/her derivative rights in the company? Secondly, if the above question is replied in the affirmative, the Court would need to go into the benefits of the case and settle on the issue under debate regarding whether the Company's administration were guilty of fraud or not?

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." (French 2017)⁷ Corporate administration is an organisation made by law as a result of the impracticability for every investors who, in the final analysis, are the advantageous proprietors of the corporation to deal with its affairs. Corporate administration comprises of the top managerial staff and the senior officers of the corporation. Since power is constantly defenceless for its abuse, the primary issue is the way to avert or cure conceivable misuse by those in the top level corporate which might be damaging to the corporation and to the shareholders. In most cases, there is a corporate right of action however in a few circumstances there is just an

⁴ Puchniak, D.W., Baum, H. & Ewing-Chow, M., 2012. *The Derivative Action in Asia: A Comparative and Functional Approach*.

⁵ Varottil, U., 2014. The Protection of Minority Investors and the Compensation of Their Losses: A Case Study of India. SSRN Electronic Journal

⁶ Nirad Amilal Mehta v. Genelec Limited and Ors., (2009) 1 Comp LJ 361 (Bom).

⁷ French, D., 2017. *Mayson, French and Ryan on Company Law*, Oxford University Press.

individual right of action by the shareholders.

At the point when the damage is endured directly by an individual shareholder, as when his right to vote is unlawfully withheld or his right to assess corporate books arbitrarily denied, an action might be brought by the injured shareholder in his own name and for his own advantage against the corporation, and this is known as an shareholder's individual suit. At the point when the damage is endured specifically by a few investors, one of them may get suit his own benefit and for sake of every single other investor sufficiently suffered. This is known as an investor's representative or class suit. (Khanna & Varottil n.d.)⁸ But, when the damage is incurred upon the corporation itself by the individuals who are in charge, as when the corporate resources are squandered, resulting in the disability of the estimation of the investors' shares, the corporation has the right to record the suit to redress the issue. But if by reason of the control wielded by those who are in power, it arbitrarily 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. (Varottil 2012)⁹ 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.

Origin of Class Action

The class action suit started in the equity courts of seventeenth-century England as a bill of peace.(Yeazell 1987)¹⁰ English courts would enable a bill of peace to be heard if the quantity of prosecutors was large to the point that joining their cases in a lawsuit was unrealistic or pragmatic; the individuals from the gathering had a joint interest for the inquiry to be settled; and the parties named in the suit could sufficiently speak to the interests of people who were absent from the action however whose rights would be affected by the result. If the court enabled a bill of peace to continue, the judgment that came about would bind all individuals from the group.

⁸ Khanna, V. & Varottil, U., The rarity of derivative actions in India. In *The Derivative Action in Asia*. pp. 369–397.

⁹ Varottil, U., 2012. The Advent of Shareholder Activism in India. *SSRN Electronic Journal*.

¹⁰ Yeazell, S.C., 1987. *From Medieval Group Litigation to the Modern Class Action*.

The King of Brobdingnag gave it for his opinion that, "whoever could make two ears of corn, or two blades of grass to grow upon a spot of ground where only one grew before, would deserve better of mankind, and do more essential service to his country than the whole race of politicians put together." (Chafee 1932)¹¹ For justice, the beneficiary is the one who makes one lawsuit grow where two grew before. And this purpose is called bill of peace in equity.

The two primary reasons justifying the use of the Bill of Peace are

1. Multiplicity of actions is avoided, time and energy are saved as large and unmanageable number of persons club and join their grievances in a single suit.
2. Law provides a right to get redress against the wrongs that are not worth pursuing individually.

Class Action suit in United States of America

Justice Story, in *West vs Randall*¹² wrote that in equity courts, "all persons materially interested, either as plaintiffs or defendants in the subject matter of a bill ought to be made parties to the suit, however numerous they maybe," so that the court could "make a complete decree between the parties [and] prevent future litigation by taking away the necessity of a multiplicity of suits".

At first, a class action could be acquired just equity cases, debate in which the parties did not really look for monetary damages but rather may want some other sort of help. The adoption of Rule 23 of the Federal Rules of Civil Procedure in 1938 expanded the extent of the class action suit, giving that cases in law looking for money damages and additionally cases in equity could be brought as class actions.

The wording of Rule 23 of the United States Rules does not fix a conclusive number as specified in Section 245 for documenting a class action suit. The United States provision likewise gives that question of law or fact should basically be regular to the class; it expressly says that the assurance of class interest is of principal significance. (Varottil 2014; Chen 2017)¹³

It is significant to say that Section 245 of Companies Act, 2013 only provides issuing a public notice as recommended. The way that individual notice must be given is totally absent which can make future obstacles. Individual significance cannot be undermined. The significance of notice plays an important part in deciding the individual decision and autonomy which must not be disposed of at any cost. In the cases which include considerable damage to people and still, at the end of the day seeing the class as the sole contesting party does not think little of the estimation of individual notice be given to each one of those who

¹¹ Chafee, Z., 1932. Bills of Peace with Multiple Parties. *Harvard law review*, 45(8), p.1297.

¹² 29 F. Cas. 718, 2 [C.C.R.I. Mason] 181 [1820] [No. 17, 424].

¹³ Chen, W., 2017. An Overview of Shareholder Litigation. In *A Comparative Study of Funding Shareholder Litigation*. pp. 15–66.

can be effortlessly related to reasonable effort. Rule 23 additionally discusses the likelihood of subclasses and every subclass be dealt as a class. Such mention is totally missing in Section 245. (Varottil 2014; Chen 2017)¹⁴

Hence it is seen that class actions are useful and important legal tools in United States, and when the individual damages claimed is too small to make it worth filing a suit, a class action helps in unifying the stake of the plaintiffs and making the litigation feasible.

The Satyam Debacle

The absence of class action system to change the grievances of investors in securities fraud in India was underscored when retail investors of Satyam Computer Services Ltd lost wealth because of the disclosures of the accounting fraud and the subsequent fall in the costs of Satyam shares quoted on the NSE and the BSE. Interestingly, the holders of the American Depository Receipts (ADR) of Satyam recorded on the NASDAQ looked for help through class actions claims against Satyam and the Managing Director on the grounds of misdirecting financial information and the subsequent misfortune to the depository receipt holders coming about because of the fall in the estimation of their holdings.

While Indian shareholders and investors endured because of absence of a provision on class action suits, the interests of their partners in United States were protected by a settlement of \$125 million from Satyam and \$25.5 million from Price Waterhouse Cooper. (Sinha 2015)¹⁵ The difference with which Indian and American security holders of Satyam were managed, re-established the interest of the Ministry of Corporate Affairs in class action suits. The powerlessness of shareholders and creditors to put risk upon the auditors also found its way into Section 245.

Imbalance in the Provisions Relating to Class Action Suit under Companies Act, 2013

Plaintiffs in Case of Class Action Suits

The Act does not provide any remedy to other stakeholders under the provision for class action. Thus, creditors, consumers, employees etc. cannot organise themselves as a group and demand for compensation or damages from the company. In the USA however, the different stakeholders too can file class action suits against incumbent companies.

Immoral Minority Shareholders

Such actions are open for misuse by immoral minority shareholders in furtherance of their vested interest thereby hampering the efficacy of the entire

¹⁴ Varottil, U., 2014. The Protection of Minority Investors and the Compensation of Their Losses: A Case Study of India. *SSRN Electronic Journal*.

¹⁵ Sinha, S., 2015. *The Company Law of India - Business Law: Indian Law Series*, Createspace Independent Publishing Platform.

corporate and legal system of a country. At 100, the Act sets a low limit for the number of people required for a class action suit. This number can even reduce, if the percentages required to be set by the Act itself⁶, lower the number of shareholders. Thus, very few shareholders could join hands, and seek judicial remedy in the form of class action, even though the transaction might actually be beneficial for the company as a whole.

Broad Inference

Amongst the orders which can be sought in a proceeding under Section 245(1)(g) as follows:

“to claim damages or compensation or demand any other suitable action from or against

(iii) any expert or advisor or consultant *or any other person* for any incorrect or misleading statement made to the company or for any fraudulent, unlawful or wrongful act or conduct or any likely act or conduct on his part...”.

This casts a very wide net on the persons who can be implicated in a class action suit. Common sense does not allow one to say that *any other person* would mean any person even remotely related to the impugned action. However, the Act does not make it clear what could be a possible cause of action in case such a person is made a defendant.

Segregation of Damages and Compensation

Under Section 245(1)(g), class action suits can be filed for claiming damages or compensation for certain acts or omissions of directors, auditors, consultant or any other person. Although this is a noble endeavour, the problem lies in the fact that the Act does not provide how these damages and compensations will be distributed amongst the claimants. As far as members are concerned, some may claim to have suffered more injury due to the high percentage of their holdings in comparison to the others. There is no guideline in the Act that would help the Tribunal to determine how to distribute the monetary rewards.

Further, it has been noted in various class action suits that that victims receive no compensation or benefits for their association. Sometimes it is felt that the compensation awarded may have been greater if the case was pursued by an individual rather than a group.

A possible solution to the same could be coming out with a formula that would divide the damages and compensation on the basis of the shareholdings of the aggrieved parties. This would ensure an equitable distribution of damages is made and each member is compensated in proportion to her holding.

Contingency Model

In US, plaintiff law firms work on a contingency model, where they take no fees upfront and usually collect a third of the settlement amount. In India, the

Bar Council prohibits a contingency model. It is therefore, unlikely that law firms would have any incentives to fight cases.

Definition of 'Depositor'

As far as depositors are concerned, the Act does not provide any definition of the same. Even though, a definition of 'deposits' is available, the same is not very helpful in determining who are depositors. The Ministry of Corporate Affairs has passed Companies (Acceptance of Deposits) Rules 2013, under which a depositor is defined as:

- Any member of the company who has made a deposit with the company in accordance with sub-section (2) of Section 73 of the Act; or
- Any person who has made a deposit with a public company in accordance with section 76 of the Act.

This is a twisting definition and brings us back to the Act itself. Further, in the context of class action suits by depositors, it is observed that there is an overlap between Section 754 and Section 245 (1)(g)(i). The former provides for damages for fraud and the latter for damages, compensation or any other suitable action against the company or its directors for any fraudulent, unlawful or wrongful act or omission or conduct or any likely act or omission or conduct on its or their part. Thus, there is possibility of duplicity of suits on the same cause of action.

5. Conclusion

The Class Action Lawsuits are subject to many criticisms as well. Among them is the huge fees for attorney who normally charge conditional / contingency fees which is proportionate leaving behind very small portion of money with class members and the second being the time taken for a final judgment, which may take years. However, it is necessary to deal with a misapprehension that class actions are not possible in India. The civil procedure law allows combination of suits that relate to the same cause of action, and hence it could be possible for plaintiffs to bring suits similar to class actions in the U.S. But, the difference lies in the economics: the incentives that trigger class actions do not exist. Indian rules on legal practice do not permit lawyers to charge contingency fees.

Another glaring oversight that seems to dilute the provisions of Section 245 is the omission of creditors from the list of eligible claimants. While it is true that companies do have contractual obligations towards creditors, the same could be said of depositors and shareholders as well. The provisions of Section 245 simply ensure a straightforward remedy to a set of aggrieved stakeholders of a company. To oust creditors from that set of stakeholders would be unjust and detrimental to them. While shareholder derivative actions are rare in India, the proper application of Section 245 may somewhat alleviate that situation. Delays in the Indian judicial system, high costs of bringing civil suits, and the prohibition on success-based fees which typically motivate counsels for the

plaintiff all lead to the minimal utilization of shareholder derivative suits in the Indian context. However, it is unclear as to whether Section 245 would address derivative actions as well. Hence the null hypothesis is proved.

6. Suggestions

- Class action litigation as an avenue for private enforcement of securities laws in the US is successful due to the share of the contingency fees to the attorneys who handle such cases. In India, this concept of contingency fees must be allowed such that it creates both awareness and interests to the attorneys in India.
- Due to the fixed requirement of minimum members to initiate a Class Action suit in India, small and retail investors would be affected since they are in minority and easily can be suppressed by the majority shareholders and therefore they must not be neglected merely on the basis that they could not clear the criteria needed. In certain cases, individual concerns can be entertained.
- In some cases, due to the overcrowding of the investors in a class action suit leads to small percentage of compensation given to them compared with the losses occurred to them and in such cases the members must be equitably compensated.
- The Companies Act, 2013 did not mention about the funding of the class action suit and SEBI must provide with proper mechanism about the funding of suit and it must ensure that Investor Education and Protection Fund is spent usefully.

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