INTERNATIONAL JOURNAL FOR LEGAL RESEARCH AND ANALYSIS

Open Access, Refereed Journal Multi Disciplinary
Peer Reviewed

www.ijlra.com

 ISSN: 2582-6433

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 ISSN: 2582-6433

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 ISSN: 2582-6433

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 ISSN: 2582-6433

CORPORATE LAW - I
THE SURVIVAL OF THE DERIVATIVE SUIT: AN EVALUATION AND A PROPOSAL FOR LEGISLATIVE REFORM

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DERIVATIVE SUITS IN UNITED STATES AND INDIA

One could argue that derivatives are the corollaries of courts' "penetration of the corporate veil." In the event that the Company sustains harm, the shareholders initiate derivative lawsuits on behalf of all common shareholders. In these kinds of situations, the Company bears both the legal fees and any relief that the Court grants it.

UNITED STATES

Post the 1980s , there have been considerable changes in the derivative suit jurisprudence. In the Zapata Corporation dispute, the Delaware Court of Chancery and Supreme Court clarified the role of the demand requirement. The Delaware Court of Chancery maintained the exhaustion-of-remedies stance, despite subsequent federal court developments. The court ruled that if a corporation ignores a claim alleging directors breach fiduciary duty, the stockholder has the right to launch a derivative suit to correct the error. Delaware Supreme Court reversed, distinguishing derivative proceedings where demand is required but the board declines to sue from those where demand is deemed futile. According to the business judgement rule, the board's decision to not sue is protected unless it is wrongful.[1]

Even when demand is excused, the board retains control over the litigation. This authority can nominate an SLC, whose decision follows a two-step process. The corporation must demonstrate the SLC's independence, good faith, and reasonable inquiry and conclusions. The court may substitute its own business judgement even if the burden is met.

[1] Janet Johnson, The Business Judgment Rule: A Review of Its Application to the Problem of Illegal Foreign Payments, 6 J. CORP. L. 481, 481 (1981).

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In the Aronson case, the court ruled that majority ownership does not negate the board's independence. In addition to control, the petitioner must prove personal or other relationships that bind directors to the controlling person.[2]

When determining if an action is in the corporation's best interest, the board or SLC may not consider monetary recovery for conduct covered by exculpatory provisions. In Joy v. North, the court rejected the SLC's recommendation for a Connecticut bank to stop a derivative claim over problematic loans to a developer, following the second step of the Zapata test. Court ruled termination was unjustified due to "the probability of a substantial net return" for the corporation from the claim.[3]

COMPENSATION FUNCTION REMOVED

A large number of states adopted the exculpatory statutes to protect the directors. The statutes were created to address the issue of competent individuals avoiding board service owing to personal liability concerns. Case law surrounding the board's oversight function implies a probable progression from "gross negligence" to "conscious disregard" to "bad faith. "Incumbent and prospective directors may focus on who interprets and applies exculpatory statutes (court or board committee). [4]

The exculpatory statutes abolished a prominent aspect of the derivative suit's compensating purpose. Although partially theoretical, the right to recovery for judgement or supervision faults no longer exists. Thus, the derivative suit's basis increasingly relies on its deterrent role.

SLC: A DIFFERENT VIEW

In Miller v. Register & Tribune Syndicate, Inc., the plaintiff challenged the corporation's selling of stock to directors and key employees for allegedly inadequate consideration.

According to the Iowa Supreme Court, if a majority of directors are defendants, the board cannot authorise an SLC to terminate the derivative action of the corporation. In Alford v. Shaw asserted that the "Shaw group," majority and controlling shareholder of All American Assurance Company

[2] Joseph R. Daughen & Peter Binzen, The Wreck Of The Penn Central 17, 259(1971); Robert Townsend, Book Review, N.Y. Times, Dec. 12, 1971, At Br 3.
[3] Melvin A. Eisenberg, The Structure Of The Corporation: A Legal Analysis 139-85 (1976);
[4] Roberta S. Karmel, Regulation By Prosecution: The Securities And Exchange Commission Vs. Corporate America 149 (1982)

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("AAA"), engaged in self-dealing and asset looting. Both the North Carolina Court of Appeals and Supreme Court found that the business judgement rule did not protect the SLC's decision from judicial review.

RISE OF ALTERNATIVE MECHANISMS

Since Gall and other SLC cases were decided, regulatory and enforcement tools have grown, challenging the derivative suit's position as "the chief regulator of corporate management." Most notable was the SEC's enforcement programme. The stigma of corporate wrongdoing, even without official consequence, is more significant for outside directors whose career prospects depend on their reputation and public image. The Enron directors' case illustrates this clearly. Increased corporate and financial news coverage ensures that any newsworthy misdeeds are adequately publicised.

DATA ANALYSIS OF DERIVATIVE SUITS

In this section, we will analyse the number of cases decided by courts in Delaware between 2000 to 2010 and make an attempt on providing a generalization based on the results of these cases.

With respect to the cases of corporate impropriety, Courts dismissed 57 cases for lack of demand, excused demand in 16, out of which it dismissed two cases on merits. If the opinions in the data set reflect the underlying case, the message is apparent. The demand requirement and early motion to dismiss processes effectively screen plaintiffs with Corporate Impropriety allegations, preventing access to courts and discovery rights. Plaintiffs had a lower success percentage in fraud claims compared to Corporate Impropriety proceedings, only surviving dismissal in six of forty-five verdicts. Demand-required cases outnumbered demand-excused cases by 26 to 6. In oversight cases, Courts excused demand in only two of seventeen cases and dismissed the rest. Similar reasoning was used in all cases: the business judgement rule safeguarded the board's choice and the plaintiff failed to prove otherwise Evidence suggests that stricter demand standards and SLC deference may be lowering the importance of derivative litigation in prominent instances. Claims of self-dealing and intercompany dealing are most successful in passing demand requirements. Courts dismissed only four of the 35 claims in these areas due to demand. These findings suggest a slight deviation from Aronson's strictness when a controlling shareholder is involved.

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MBCA: THE FINAL LINK IN DEMAND REQUIREMENT

In 1990, the MBCA took a strict approach to derivative litigation. All cases require demand, and courts must accept independent directors' dismissal recommendations if made in good faith after a fair examination. Currently, twenty-one states have passed these provisions. These statutes invalidated case law in several states that had a more flexible approach to derivative suits. Texas is the largest state to embrace MBCA derivative suit rules. Prior Texas case law acknowledged the board's ultimate authority in deciding whether to sue on behalf of the corporation, but the MBCA revisions went further.

Demand was excused when the accused held control of the corporation, either as shareholders or on the board. The 1979 ruling stated that the board had no authority to terminate the shareholder's claim in demand-excused cases, a point the Texas Supreme Court left open on appeal. When a shareholder action requires demand, they must prove fraud, oppression, or abuse of power in the board's inaction to overcome the requirement, thus giving certain situations for actions which MBCA does not provide. On the whole, the MBCA rules seem to have reduced the danger of derivative litigation in Texas as a deterrent.

INDIAN JURISPRUDENCE

Indian derivative cases are still based on Common law, even though many governments have codified them in Company regulation regulations. Despite numerous jurisdictions like the UK, Singapore, and Hong Kong amending their company law statutes to incorporate derivative litigation, India's Companies Act, 2013 debates are mute on the matter.

LAW IN INDIA ON DERIVATIVE SUITS

It was suggested multiple times before the Companies Act, 2013 was passed, that derivative action lawsuits be included in the new Act. Nevertheless, the new Act had no clear language about derivative lawsuits. Regarding derivative action lawsuits, there is an obvious statutory vacuum. Nevertheless, Section 245 of the Act introduced the concept of "class action suits." Is it possible for Section 245 to serve as a rule governing class action lawsuits? It is important to remember that minority shareholders have access to an additional remedy in the form of class action lawsuits under Section 245. Even though some of the features in Section 245 are similar to those in

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"derivative action suits," this does not imply that Section 245 deals with derivative actions.[5] The primary distinction between "class action suits" and "derivative action suits" is that the former typically give shareholders the opportunity to file a lawsuit on behalf of an entire "class" of similarly situated shareholders whose rights have been violated. Conversely, in cases when the company's directors or management have acted against the company's best interests, a shareholder may choose to file a "derivative action suit" on behalf of the corporate body. Because even a single shareholder may file a derivative action suit, the requirement of establishing a distinct class with a similar interest is thus entirely eliminated from derivative action lawsuits. Nevertheless, Section 245 of the Act does not satisfy this fundamental need, which is the ability of a single shareholder to bring legal action. To file the claim under Section 245 of the law, 100 people must join together. It's also crucial to remember that in a "derivative action suit," the corporation files the lawsuit against the management. Nevertheless, Section 245 even permits the petitioner to sue the company for damages, which is contrary to the core idea of "derivative action suits."[6] It is acceptable that Section 245 contains some aspects of derivative action lawsuits, such as the clause stating that the business will cover litigation expenses or permitting shareholders or depositors to file a lawsuit on the company's behalf. However, the clause cannot be regarded as a provision for derivative action claims since it does not meet the fundamental characteristics of derivation action suits.

JUDICAL PERSCEPTION ON DERIVATIVE SUITS

The grounds for derivative action proceedings in India are narrow. The common law precedent of Foss v. Harbottle still guides Indian derivative action cases. According to the Foss case, shareholders can sue on behalf of the company in three rare cases. Fraud, illegality, and act requiring special resolution are the exclusions. These three reasons barely allow stockholders to bring a derivative action claim. In certain cases, such as Needle Industries (India) Ltd. v. Needle Industries Newey (India) Holding Ltd., the Indian courts have imposed additional qualifications on these exceptional allowances. Specifically, the court dismissed the case if the benefit received by the accused directors was incidental.

In addition to the extra common law precepts such as the clean hands concept, representative suits as established by the Indian Civil Procedure Code are one of the procedural barriers to such suits.[7]

[5] Alwyn Sebastian, "Introduction of class action suits in India: A blindfold on corporate governance" in Bimal Patel, Mamta Biswal and Joshua Aston (eds), International Contracts I: Jurisdictional Issues and Global Commercial and Investment Governance ...
[6] Umakanth Varottil, "A Comment on a Delhi High Court Ruling on Shareholder Derivative Actions".
[7] Nicholas Calcina Howson, 'When "Good" Corporate Governance Makes "Bad" (Financial) Firms: The Global Crisis and the Limits of Private Law,' 108 Mich. L. Rev. First Impressions 44, 47 (2009)

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The purpose of the joinder in both cases was to prevent multiple lawsuits. However, the plaintiffs in the two cases are not the same because the representative lawsuit names the company as a defendant, whilst the other lawsuit is filed on behalf of the corporation and bases its claim on the plaintiff shareholder's claim, making the company the primary plaintiff. In Jaideep Halwasiya v. Rasoi Ltd., the court made this distinction while also pointing out that derivative claims were only permitted in situations when the wrongdoer could not otherwise be held accountable for their actions, indicating a deficiency of litigation.

In ICP Investments (Mauritius) Ltd. v. Uppal Housing (P) Ltd.23, the Delhi High Court tried to move from a common law approach, but it restricted the grounds. This High Court case linked derivative action claims to Section 241 of the Companies Act, 2013. The shareholder-centric remedy under Section 241 addresses shareholder persecution. Individual shareholder oppression is fundamentally distinct from derivative action litigation. In this case, the Court made a commendable effort to depart from Foss judgment but nevertheless confined derivative action grounds to oppression and mismanagement.[8]

BUSINESS JUDGEMENT RULE IN INDIA

Although the Supreme Court hasn't expressly adopted this theory, several of its elements have permeated Indian jurisprudence. Section 463(1) of the Companies Act, 2013, for example, states that a party to a lawsuit alleging negligence, default, breach of duty, misfeasance, or breach of trust may be fully or partially released from liability if the court determines that the party acted in good faith and reasonably, taking into account the circumstances. However, this immunity is not a legally recognised right or privilege; rather, it is completely up to the judges' discretion.

By granting this protection to certain directors for their judgements, Indian courts have implicitly embraced the theory. In the case of Miheer H. Mafatlal v. Mafatlal Industries, the Supreme Court of India ruled that in situations where the director's actions were "just, fair, and reasonable, according to a reasonable business man, taking a commercial decision beneficial to the company," the court would not become involved.

The Bombay High Court held in Re Cadbury India Limited that courts are not bound by the ipse dixit of the majority. This decision necessitates an impartial assessment of Cadbury's financial statements, since it must not be inequitable to any shareholder class. As a result, minority

[8] Raymond B. Marcin, 'Searching for the Origin of the Class Action,' 23 CATH. U. L. REV. 515, 517–24 (1974)

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shareholders' rights and interests are now given more weight by Indian courts, giving them the ability to closely examine the choices and conduct of directors. Therefore, it is the board of directors' responsibility to demonstrate that their actions served the company's best interests and did not discriminate against any of its owners.

In contrast, when the arm's length principle is applied in third-party transactions, immunity is provided under the business judgement doctrine in the US case. A substantial presumption favouring the board decision is created by the rule. The criterion strongly favours choices made by loyal and knowledgeable directors on the board, unless it cannot be "attributed to any rational business purpose." Therefore, a plaintiff contesting a board decision has the first burden of proving otherwise. The business judgement rule protects directors and their conduct from further judicial scrutiny if a plaintiff does not present evidence that they breached any one of the following: fiduciary duty, good faith, loyalty, or due care.[9]

However, as established in Globe Motors Ltd. v. Mehta Teja Singh, such disclosure of interest and exercise of arm's length principle have been recognised as being inapplicable in the Indian setting. In this case, the Court observed that when a sizable portion of the board shows interest in a particular transaction, even if those interested directors disclose their interest and abstain from decision-making, their mere presence can encourage the entire board to backbite, putting their personal interests ahead of the company's.

REASONS FOR PAUCITY OF DERIVATIVE SUITS

Given that there are millions of Indian businesses and that there are over 30 million cases pending in Indian courts, the lack of derivative actions in India appears perplexing. However, as we will show, the effective initiation of derivative lawsuits is both unappealing and extremely difficult due to a mix of substantive legal and procedural obstacles, alternative remedies, and other considerations.

The first reason is the same as discussed previously, i.e., the ruling in Foss v. Harbottle,37 whereby, when an injury is caused to a company, it is only the company that can initiate action against the wrongdoer. In order to file a derivative case, plaintiff shareholders have to go past a few formalities. We concentrate on the "clean hands" theory and the somewhat peculiar use of

[9] R. Romano, 'The shareholder suit: litigation without foundation?' (Reference Romano1991), Journal of Law, Economics, and Organization

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order I, rule 8, to bring lawsuits that seem to be derivative actions. A shareholder plaintiff may only file a lawsuit on the company's behalf if it serves the company's interests and isn't motivated by personal gain or some other nefarious motive. The "clean hands" notion has also been implicitly recognised by Indian courts. But in reality, the theory has caused a great deal of hardship, especially because of its vague boundaries. Though the "breadth of the "clean hands" requirement is far from clear," it has also been argued that the doctrine is misguided because the benefit of an action brought on behalf of the company goes to the company and not the shareholder who brought the action, so the propriety of the shareholder should not matter. The court must approve the suit under order 1 rule 8. All interested parties must be notified (at the plaintiff's expense) of the suit's institution and may seek to join it.55 Such cases list the firm as a pro forma defendant, even if no relief is sought.56 The corporation will benefit from the suit despite being a defendant. This resembles a derivative action, however it is problematic, as evidenced when the firm is identified as a defendant despite being the victim. Most order I, rule 8 suits are 'representative', not derivative.[10]

Shareholders benefit from bringing direct proceedings outside of civil court, even when derivative actions under common law are possible. Alternative remedies fall into two categories: (1) oppression and mismanagement cases, mostly in unlisted enterprises; and (2) Securities and Exchange Board of India actions, only for listed companies.

Culturally, business families and the state dominate company ownership, making it harder for small minority shareholders to 'take on the establishment'. The leader of family-owned firms, which make up a large share of Indian businesses (including public listed corporations), has rigorous control and enormous authority. It's rare to dispute a head's authority and operation. In state-owned firms, powerful bureaucrats with political connections are the dominant shareholders. India adopts the English practise that the loser pays the opponent's and his or her own reasonable legal fees. Indian courts are inclined to award acceptable (and not exceptional) expenses to the winning party, but retail shareholders suing huge firms may receive substantial amounts if they fail.

[10] Vikramaditya Khanna and Umakanth Varottil, 'The Rarity of Derivative Actions in India,' Berkeley Business Law Journal, Vol. 9, Issue 1 (2012), pp. 1-28.

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SUGGESTIONS

The first of the three key developments in the UK was that petitioners can now sue for negligence, breach of duty, and trust. Second, the "good faith" doctrine supplanted the "clean hands doctrine". Third, prima facie proof was used at first. Incorporating these three UK modifications into Indian law could improve derivative suits. By lowering ex-ante expenses, such moves will encourage shareholders to file derivative action claims. Reducing derivative suit admission requirements reduces ex ante costs. Three UK improvements may help achieve this goal. First, increasing the grounds for filing a petition will encourage the petitioner to represent the corporation in court. Second, the "good faith doctrine" and prima facie criteria can reduce ex-ante expenses enough. If the petitioner has tight requirements at the start of the trial, it greatly raises costs and may deter them from filing suits. Prima facie standard reduces expenses and helps the court discover and reject bogus petitions early. The "clean hands doctrine" burdens petitioners unnecessary. The petitioner files derivative litigation on behalf of the firm, therefore we don't need to consider whether the petitioner is clean. Instead, we must consider the petition's merits. These UK laws can help maintain an appropriate balance between eliminating frivolous petitions and decreasing petitioner litigation expenses. Thus, an efficient derivative action legislative scheme in India can encourage shareholders to sue for derivative action claims.

CONCLUSION

One useful instrument for guaranteeing improved corporate governance standards is derivative litigation. With the expansion of the Indian capital markets and the rise in small shareholders, it could be preferable to have a strong system that makes derivative litigation easier. Yet, we discover that derivative cases are uncommon in India due to substantial barriers posed by substantive law, procedural law, and other institutional, economic, and cultural issues. It doesn't seem that even the current plans for changing Indian company law will be enough to promote the use of the derivative action mechanism. We point out that our reasoning is not intended to imply that using a typical derivative action is the best (or only) strategy to enhance enforcement in India. In fact, there might be better options available (such arbitration forms). However, we do propose that strengthening derivative actions in India will strengthen India's corporate law enforcement system as a whole.