

Dispute Resolution Hotline

February 25, 2016

DERIVATIVE ACTION BY A SHAREHOLDER: DIRECTOR LIABLE FOR THE BREACHES OF ITS FIDUCIARY DUTIES

- Civil courts are appropriate *fora* for the institution of derivative suits.
- Director making an undue gain liable to pay such amounts to the company.
- Section 397 and 398 of the Companies Act, 1956 do not completely bar the jurisdiction of a civil court

BACKGROUND

The Delhi High Court ("**Court**") in *Rajeev Saumitra vs Neetu Singh*¹ while dealing with a derivative action has held that a director was liable to pay to the company any undue gains realised from breach of duties prescribed by Section 166 of the Companies Act, 2013 ("**2013 Act**").

Section 166 of the 2013 Act provides for fiduciary duties of directors such as the duty to act in good faith, the duty to act in the best interests of the company, its employees, the shareholders, and the community and for the protection of the environment, etc. As per Section 166(5) a director is prohibited from making any undue gain or advantage by virtue of its directorship in the company and is liable repay any undue gains to the company.

FACTS

The Plaintiff and Defendant were both directors of Paramount Coaching Centre ("**PCC**") and held 50% of the shareholding each. The Defendant incorporated another company, in which she was the controlling shareholder and also set up a one person company, that were competitors to PCC ("**Competing Businesses**").

The Plaintiff in his capacity as shareholder of PCC filed a civil suit claiming *inter alia* that the Defendant:

1. caused wrongful losses to PCC; and
2. was profiting from the operation of the Competing Businesses by usurping the goodwill accrued in PCC and the intellectual property of PCC.

The suit was instituted by the Plaintiff on behalf of PCC as a derivative action since PCC was unable to pass a resolution for the institution a suit in its own name, as 50% of the shares were held by the Defendant.

JUDGMENT

The Defendant objected to the maintainability of the derivative action on several grounds including that the appropriate remedy in the given circumstances was to approach company law board for oppression and mismanagement, that the suit filed was in respect of the plaintiff's individual membership rights, and that the defendant started a competing business under certain compelling circumstances.

The Court relied on the judgment in *Starlite Real Estate (ASCOT) Mauritius Ltd. & Ors. v. Jagrati Trade Services Pvt. Ltd.*² to find that

"In a derivative action, the company would be the only party entitled to sue for redressal of any wrong done to it. However, since a company is an artificial person, it must act through its directors. Where the wrong is being done to the company by the directors in control, the company obviously cannot take action on its own behalf. It is in these circumstances that the derivative action by some shareholders (even if they are in a minority) becomes necessary to protect the interest of the company. The minority shareholders sue on behalf of themselves and all other shareholders except those who are defendants, and may join the company as a defendant."

Adverting to the decision of the Delhi High Court in *Norma (India) Ltd v. Sameer Khandelwal and Ors*³ the Court noted that

"It is settled law that jurisdiction of the company law board under the Companies Act in relation to Section 397 of the said Act is a concurrent jurisdiction which may be exercised by civil courts where allegations pertaining to oppression and mismanagement partake the character of a civil dispute."

The Court further noted that a director was not permitted to retain secret profits which were made by using information, property or opportunities that belonged to the company. A company could seek accounts for the secret profits made, damages for fraud or the rescission of a transaction that enabled the director to made secret profits.

The Court observed that in case a director placed itself in a position where its personal interests were in conflict with

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its duties to the company, without the consent of the company, the director would be liable to “pay over to the company which he or she has betrayed by disloyalty”.

The Court was of the opinion that the Defendant had acted in contravention of Section 166(5) of the Companies Act by seeking to usurp the goodwill and intellectual property of PCC. The Court found that any undue gain made by the Defendant was payable to PCC.

ANALYSIS

Duties of a director were initially elaborated by judges since companies law was not exhaustive in relation to the duties that were owed by a director to a company. From general principles such as a duty to exercise a reasonable degree of skill and care in carrying out duties and to act in good faith; the law relating to the duties of directors has evolved into specific duties owed by directors to the company, shareholders as well as various stakeholders. India has followed the approach favoured by common law jurisdictions like the United Kingdom to codify wide ranging principles relating to the duties of directors.

An interesting question is whether a director who is resigning/ retiring can make preparatory steps towards setting up a competing business. The doctrine of corporate opportunity pits a director's freedom to exploit its own skills and talent against fiduciary duties owed by it to the company. In *Foster Bryant Surveying Ltd v. Bryant*,⁴ the English Court of Appeal was of the opinion that a merit based approach would have to be taken: where a director had acted dishonestly and had diverted business he would be liable for breach of his duties whereas if his conduct was without fault he would not be liable.

Nominee directors are appointed to monitor the activities of the company in order to ensure transparency and probity of company affairs. Contemporaneously, their role extends to ensuring that the interests of the nominating institution are duly protected. Therefore, a nominee director has to ensure that the interests of the concerned parties are in harmony.⁵ In case any conflict of interests arise, a nominee director is expected to serve the interest of the board in preference to the group that appointed him.⁶

The Court's decision indicates that a nominee director may be made liable for any breach of its duties under Section 166 of the Companies Act. However, the jurisprudence on this subject indicates that a nominee director of a company is entitled to follow the wishes of his nominator, if he is of the bona fide belief that the nominator's interests and the interests of the company are identical.⁷

Derivative suits are an important facet of corporate governance and are integral part of the arsenal of remedies present before a shareholder to assert its rights. However, the law in India still remains unclear. Section 245 of the Companies Act allows for the initiation of a class action suit by a member or a depositor only behalf of the members or depositors of a company.

In United Kingdom, principles of common law that govern derivative actions have been crystallised in the relevant legislations allowing a person to seek reliefs on behalf of a company. Considering the impetus given towards codification of common law principles in the 2013 Act, it is time that the principles relating to a derivative action also be codified.

— Mithun Verghis, Ashish Kabra & Vyapak Desai
You can direct your queries or comments to the authors

¹ Decided on January 27, 2016 by the Delhi High Court in I.A. NO. 17545 OF 2015 and CS (OS) NO. 2528 OF 2015.

² Decided on 14th May, 2015 by the High Court of Calcutta in G.A. No. 2437/2014 and CS No. 284/2014

³ 2007(93) DRJ 318

⁴ [2007] EWCA Civ 200

⁵ See *Scottish Co-operative Wholesale Society Ltd vs. Meyer*, (1958) 3 All ER 66, held where the nominee director pleaded the interest of the nominator and ignored that of the host company resulting in suppression of the share value of the latter company, the nominee directors were guilty of oppressing the shareholders of the latter company. *Boulting vs. Association of Cinematograph, Television and Allied Technicians*, (1963) 1 All ER 716 (CA)

⁶ *Bennets vs. Board of Fire Commissioners of New South Wales*, (1967) 87 NSWWRN 307

⁷ *Levin vs. Clarke* (1962) NSW 686 (Aust) and in *Re, Broadcasting Station, 2GB Pty. Ltd.*, (1964-5) NSW 1648 (Aust)

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