Kluwer Arbitration Blog

Can Derivative Action Claims Be Arbitrated? Scenes From A Convoluted Indian Approach

Ansh Desai (Gujarat National Law University) · Thursday, October 7th, 2021

There is no statutory provision that covers derivative actions by shareholders in India. However, the chapter on Prevention of Oppression and Mismanagement in the Companies Act, 2013 ("**the Companies Act**") comes the closest. While Indian courts have generally adopted a stance against the arbitrability of oppression and mismanagement matters (*Rakesh Malhotra v. Rajinder Malhotra*, *Sporting Pastime India Ltd. v. Kasturi & Sons Ltd.*), their stance on derivative action suits is unclear. At the outset, oppression, mismanagement, and class action claims are considered to be quite different from typical derivative action suits in the Indian context because of two reasons: (1) derivative suits implicate corporate/economic rights of the shareholders instead of their personal rights; and (2) due to this, in oppression, mismanagement, and class action lawsuits, the shareholders file applications on behalf of members for personal reliefs to protect themselves, whereas in derivative actions remedies are sought on behalf of the company. In that regard, the rationale to justify the non-arbitrability of oppression and mismanagement matters cannot always apply to derivative action suits. Thus, derivative action claims were first held to be arbitrable in "**Rashmi Mehra**") by the Bombay High Court that distinguishes them from oppression and mismanagement cases.

Review of Judgments

The status quo changed when the Bombay High Court delivered its judgement in *Onyx Musicabsolute.Com Pvt. Ltd. v. Yash Raj Films Pvt. Ltd. & Ors.* ("**Onyx**") after dealing with an application under ("**the Act**"), which was essentially in the nature of a derivative action. Section 9 of the Act deals with interim measures that can be granted by the Court before or during the arbitral process, or any time after the arbitral award is made but before its enforcement. In *Onyx*, the plaintiff and defendant no. 1 formed defendant no. 2 as a joint venture, each holding 50% of the shares. Thereafter defendant no. 1 and no. 2 entered into a licensing agreement where mobile rights of films produced by the former would be licensed to the latter. Certain disputes arose due to defendant no. 1 allegedly breaching the agreement and licensing certain films to a third party instead of defendant no. 2. Arbitration proceedings were initiated, pending which an injunction was requested by the plaintiff under Section 9 to bar defendant no. 1 from licensing rights to the third party. The court refused to enjoin defendant no. 1 under Section 9, citing two reasons: first, the license agreement containing the arbitration clause was between the defendant no. 1 and 2 and not the plaintiff, which disentitled it from invoking said clause; and second, since the Section 9 petition

was essentially in the form of a derivative action, it was much better suited for a public forum and not a private mode of dispute resolution such as arbitration. Interestingly, it did not refer to *Rashmi Mehra*, a judgment delivered by the same court only a couple of years earlier.

Onyx was later distinguished in *Rajiv Vyas v. Johnwin Manavalan Groge Mandavalan & Ors.* ("**Rajiv Vyas**") and *Welspun Enterprises Ltd. v. ARSS Infrastructure Projects Ltd.* ("**Welspun**"). In *Rajiv Vyas*, the petitioner (holding approx. 33.3% of the total shares) and the respondents entered into a shareholders' agreement to form an entity for their business. When the respondents tried to alienate certain rights of the company, the petitioner initiated arbitration proceedings and filed an application under Section 9 of the Act to restrain the respondents from acting against the interests of the company. Since the shareholders' agreement contained an arbitration clause and the conduct of the respondents affected not only the company but also the petitioner, the court allowed the Section 9 application. *Welspun* also relied on *Rajiv Vyas* instead of *Onyx*, thereby allowing the Section 9 application despite the petition partly containing requests to protect the personal rights of the shareholders, and partly to protect the company's. It reasoned that if there is a shareholders' agreement between the shareholders, and if one shareholder wants to protect his rights as well as the rights of the company itself by virtue of any breach committed by another shareholder, he would be entitled to pursue arbitration provided such shareholders' agreement contains an arbitration clause.

Observations and issues

There are two elements that could make a derivative action claim arbitrable, each associated with certain challenges.

First: There should be an agreement to arbitrate between the shareholders, or the shareholders and the third party against whom reliefs are to be claimed on behalf of the company. This does not seem to be as rigid a rule as *Onyx* makes it out to be, since, in *Rashmi Mehra*, the contract did not contain an arbitration clause. Instead, there were several interconnected contracts, only one of which provided for an arbitration agreement. The court held that since the contract containing the arbitration clause was the backbone of the entire transaction, a shareholder could invoke arbitration under an ancillary agreement and bring derivative action matters before the tribunal. A similar argument could be made in favour of arbitrability of the derivative action claim in *Onyx* as well. As mentioned before, the plaintiff-shareholder was not a party to the breached licensing agreement, but rather the defendants no.1 and no. 2 (the company) were. However, the license agreement stated that it would remain valid as long as the JV agreement concluded between the plaintiff, defendants no. 1 and no. 2 remained in full force and effect. Therefore, applying the interconnectedness test laid down by *Rashmi Mehra*, even if the plaintiff was not a party to the license agreement, it could have derived the right to arbitrate on behalf of the company through the JV agreement since the validity of the former was wholly dependent on the validity of the latter, making it the "backbone" of the entire transaction.

In a way, this reasoning is in concert with the very nature of what a derivative action claim is: a shareholder simply acting in the shoes of the company to secure its interests. Since the derivative action is brought on behalf of the company, the shareholder would be bound by the company's intention to arbitrate even if the shareholder is not a specifically-stated party. This is the very principle *In re: Salomon Inc. Shareholders' Derivative Litigation* relied on to allow arbitrability of

derivative claims in the US, adducing that since the company is the true plaintiff in a derivative action, a pre-dispute arbitration agreement between the company and a third-party would inevitably bind the shareholders to arbitration as well.

Second: According to *Onyx* even if an arbitration clause exists, the court can refuse referral of the dispute to the tribunal on the ground that it is better suited to adjudication by the public forum, implying that public policy is affected. This rationale seems rather regressive, especially considering that in the US, it is already well-established that shareholders of close, privately-owned corporations can arbitrate derivative claims. For example, in Lane v. Abel-Bey, a New York court explicitly dismissed the contention of public policy precluding arbitration of derivative action claims, holding instead that this would not be the case in privately owned, close corporations. This was also the situation in *Onyx*, where the company on behalf of which the plaintiff-shareholder approached the court was a private, closed one. Further, refusing arbitration of derivative claims on the premise of public policy, especially in a private company with merely two shareholders, would go starkly against party consent, a principle so dearly held on a pedestal by the court itself.

Another problem flows from the decisions of *Rajiv Vyas* and *Welspun*. Both decisions considered the Section 9 applications as affecting the shareholders' as well as the company's rights. It was considered to be a derivative action only in part, which was enough to permit arbitration. In fact, *Rajiv Vyas* distinguished itself from *Onyx* on this very ground, surprisingly so since an injunction similar to the one in *Onyx* was sought by a shareholder with even less shareholding than the plaintiff-shareholder in *Onyx*. Yet, the court opined that not granting the injunction would cause irreparable injury not only to the interests of the company but also to the plaintiff in his capacity as a shareholder. Similar reliefs were claimed in both, but the court reached a different conclusion in *Rajiv Vyas*, reasoning that the reliefs claimed were in part personal and in part derivative, making the dispute amenable to arbitration. This approach of the court seemingly stands against the test of *Sukanya Holdings Pvt. Ltd. v. Jayesh H. Pandya* ("**Sukanya Holdings**"), which held that a cause of action cannot be bifurcated when referring a dispute to arbitration. If, on the other hand, the court considered *Rajiv Vyas* to be an exception to *Sukanya Holdings*, there seems to be no reason for the court to refuse arbitration for even fully derivative claims that affect solely the corporation's rights. Nevertheless, there appears to be no straitjacket criteria to determine which reliefs claimed in the name of the company are derivative or personal. These need to be culled out by the judiciary as the test for arbitrability of derivative claims hinges on the same.

Concluding remarks

Onyx has been used time and again by courts to refuse arbitration of derivative claims despite it being untenable and flawed. Given that Indian courts have started adopting a general policy in favour of arbitration, there is no reason why derivative action claims cannot be arbitrated when the requisite intent is present. Since the Companies Act does not provide for derivative action claims, such claims continue to rely on judicial determinations only, which as demonstrated in this post, have faced differing interpretations and approaches. It is high time the Indian judiciary adopts an approach consistent with international standards regarding the arbitrability of derivative claims.

To make sure you do not miss out on regular updates from the Kluwer Arbitration Blog, please subscribe here. To submit a proposal for a blog post, please consult our Editorial Guidelines.

This entry was posted on Thursday, October 7th, 2021 at 8:00 am and is filed under Arbitrability, Derivative Claims, India
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.