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The Case of *Darius Kavasmaneck* v *Gharda Chemicals*: A Missed Opportunity in The Jurisprudence of Derivative Actions?

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Derivative actions, despite being a rarity in India, are an essential tool at the hands of a minority shareholder in protecting the interests of the company against mismanagement at the hands of the management of the company. Since the law on derivative suits has not been codified to this date, the jurisprudence has largely evolved through the efforts of the judiciary. The case of Darius Rutton Kavasmaneck v *Gharda Chemicals marks a crucial point in this development as the country strives to enhance the corporate governance regime. This paper seeks to analyse the judgment in light of the common law practice as well as the law in the United Kingdom.*

I. Introduction

The case of *Darius Rutton Kavasmaneck* v *Gharda Chemicals Ltd.*[1] marks a critical point in the development of the law regarding derivative action in India. At a time when India is beset with the lack of minority shareholder protection, the evolution of a robust derivative action mechanism is essential.

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1 2014 SCC OnLine Bom 1851 : (2015) 191 Comp Cas 52.

The case at hand is a derivative suit filed by a minority shareholder on behalf of the company, against the directors of the company. Considering the rarity of derivative action in the country, the manner in which the Bombay High Court has dealt with the suit holds great significance in helping develop the nascent field of derivative suits in India.

The Plaintiff, Darius Kavasmaneck, is a minority shareholder of the company, Gharda Chemicals, and holds 12 percent of the shares in the company. The directors of the company are the defendants in the case, however, the case has been brought primarily against Defendant No. 2, who is an estranged uncle of the Plaintiff and holds 60 percent of the shares in the company. The Defendant No. 2 is the registered owner of certain patents which the company also uses free of royalties. The present notice of motion is filed by the Plaintiff to claim that the company is the rightful owner of the patents and consequently, to restrain Defendant No. 2 from dealing with the patents in any manner. It is the contention of the Plaintiff that the Defendant being the managing director of the company, owes a fiduciary duty to the company, and any patent obtained in the course of his employment must belong to the company. The claims of the Plaintiff were rejected and the application was dismissed by a Single Judge of the Bombay High Court. The suit was rejected on the grounds that it did not fulfill the pre-requisites of a derivative suit. Further, the judgment has now been upheld by a Division Bench of the Bombay High Court without disturbing the findings of the Single Judge Bench.[2]

The analysis used by the court in this will have a huge bearing on the cases to follow and consequently, the manner in which the law on derivative actions develops in India. At a time when it seems the protection awarded to minority shareholders under the Companies Act, 2013 is being constantly diluted,[3] courts must exercise sufficient caution while dealing with derivative actions.

II. History of Derivative Actions

Derivative suits are known to be the pillars of corporate litigation across the world. On the hand, ... They have been regarded as tools of accountability

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[2] Darius Rutton Kavasmaneck v Gharda Chemicals Ltd., 2015 SCC OnLine Bom 4813 : (2015) 5 Bom CR 162.

[3] Palak Shah, *Experts Ask Sebi To Stand Its Ground On Related Party Transactions To Protect Minority Shareholders*, The Economic Times, (10 July, 2015), http://articles.economictimes.indiatimes.com/2015-07-10/news/64282545_1_related-party-transactions-minority-shareholders-new-companies-act.

of a company and the backbone of a strong corporate governance regime of a country.[4] On the other hand, they have often been viewed as vehicles of extorting money by disgruntled shareholders.[5] Widely differing views on the issue entails that a discussion on the most appropriate mechanism of derivative action along with judicial clarity on the subject is much needed.

It has been observed that ownership structures with dispersed shareholding and weak institutional structures are most suitable to developing a flourishing derivative action mechanism.[6] Owing to the absence of such a conducive environment, derivative suits have been and potentially will be a rarity in India.[7] However, the Indian economy has been rapidly transitioning to an environment with dispersed shareholding and weaker institutional structures, making it increasingly suitable for derivative suits.[8]

Derivative action in India is a part of common law practice and is yet to find its codified place in the company laws. The newly formulated Companies Act, 2013 while introducing class action suits, has failed to include a specific provision for derivative action. This is so, despite a recommendation being made by the Standing Committee to include a separate provision for derivative suits.[9] Class action suits are inherently different from derivative suits as they represent members or shareholders having a similar interest and are often against the company itself.[10] Alternatively, derivative suits are brought on behalf of the company against an injury suffered by the company at the hands of the management of the company or a third party.[11] As a result of this oversight in the Act, the jurisprudence on derivative action is entirely dependent on the common law principles espoused and followed by the judiciary in this regard. Unfortunately, the courts too have failed to draw the distinction between the terms and have used them interchangeably in the

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4 Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L., ECON. & ORG. 67 (1991).

5 William M. Mullooly & John W. Fuhrman, *A Proposed Reform in the Law Affecting Shareholders' Derivative Actions*, 24 ST. JOHN'S L. R. 327 (2013); Richard W. Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside*, 60 WASH. U. L. Q. 311, 331-35 (1982).

6 Vikramaditya Khanna & Umakanth Varottil, *The Rarity of Derivative Actions in India: Reasons and Consequences*, *in* THE DERIVATIVE ACTION IN ASIA 369, 372-373 (Dan W. Puchniak et al. eds., 2012).

7 *Id*. at 373.

8 *Supra*, note 7.

9 FIFTY SEVENTH REPORT OF THE STANDING COMMITTEE ON FINANCE, *Companies Bill, 2011* 73-74 (June, 2012).

10 Jaideep Halwasiya v Rasoi Ltd., 2008 SCC OnLine Cal 871 : (2009) 150 Comp Cas 1.

11 Note, *Distinguishing Between Direct and Derivative Shareholder Suits*, 110U. PA. L. REV 1147 (1962).

past.[12] This is unlike jurisdictions around the world which have usually been quick to distinguish the two.[13] In India, only recently has the Calcutta High Court recognised the distinction between the two.[14]

Courts in India have primarily relied on the common law principles developed in the United Kingdom with regard to derivative suits.[15] Meanwhile, the UK has codified its derivative action mechanism by way of the Companies Act, 2006.[16] Despite the codification of the concept in the UK, pre-codification judicial pronouncements of the English courts have played a vital role in shaping the law in India.

Prior to the introduction of the Companies Act, 2006 in the UK, the leading case concerning the subject was *Foss* v *Harbottle*.[17] The rule in *Foss* v *Harbottle* states that the company is a separate legal personality and the company alone is the 'proper Plaintiff' to sue on a wrong suffered by it.[18] Conversely, there are exceptions to this rule in order to protect minority interests in the company. Among the limited exceptions, the primary exception is that of a fraud on the minority, which must be caused by a wrongdoer who is in control of the company.[19] Ordinarily to bring a derivative suit, the shareholder was required to show that it fell within the exceptions to the rule in *Foss* v *Harbottle*.[20] It was also the case that the question of the Plaintiff's standing to sue was to be determined as a preliminary matter.[21] The Plaintiff bringing the suit must have approached the court with clean hands, as established in the commonly cited cases of *Towers* v *African Tug Co*.[22] and *Nurcombe* v *Nurcombe*.[23] Ulterior motive of the Plaintiff weighed strongly against the case, and the court promptly disallowed such claims.[24] Additionally, the action was to be in the best interest of the company and a majority of the independent shareholders of the company were required to support it.[25] Therefore, the rule laid down in *Foss* v *Harbottle* was treated

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[12] Spectrum Technologies USA Inc. v Spectrum Power Generation Co. Ltd., 2000 SCC OnLine Del 472 : (2002) 3 CLC 539.
[13] Wallersteiner v Moir (No. 2), 1975 QB 373 : (1975) 2 WLR 389 : (1975) 1 All ER 849.
[14] Jaideep Halwasiya v Rasoi Ltd., 2008 SCC OnLine Cal 871 : (2009) 150 Comp Cas 1 at 4.
[15] Khanna & Varottil, *supra*, note 6, at 383.
[16] The Companies Act, 2006, c. 46, Part 11.
[17] (1843) 2 Hare 461.
[18] (1843) 2 Hare 461.
[19] Arad Reisberg, Derivative Actions And Corporate Governance: Theory And Operation 90 (2007).
[20] Prudential Assurance Co. Ltd. v Newman Industries Ltd. (No. 2)., 1982 Ch 204 : (1982) 2 WLR 31: (1982) 1 All ER 354.
[21] 1982 Ch204 : (1982) 2 WLR 31 : (1982) 1 All ER 354.
[22] (1904) 1 Ch 558.
[23] (1985) 1 WLR 370 : (1985) 1 All ER 65.
[24] Barrett v Duckett, (1995) 1 BCLC 243.
[25] Smith v Croft, 1998 Ch 114.

as sacrosanct by English and Indian courts alike, and exceptions were made in limited circumstances.

With the coming of the new Act in the UK, the law has undergone a drastic change. The requirement to fall under the exception to the rule in *Foss* v *Harbottle* has now been replaced with a judicial discretion to grant permission in accordance with the statutory provisions.[26] The application for permission is a two-stage process. Firstly, the shareholder must establish a *prima facie* case.[27] Once established, the court then determines whether the claim must be allowed to proceed based on factors such as good faith of the Plaintiff, best interest of the company, existence of alternate remedies, the view of independent members of the company, among others.[28]

What remains to be seen is whether the Bombay High Court in the present case has evolved with the evolution of the law concerning derivative suits in UK or whether it has chosen to apply the principles of the past.

III. THE CASE OF *DARIUS KAVASMANECK* V *GHARDA CHEMICALS*

The High Court in this case disallowed the notice of motion of the Plaintiff and relied heavily on certain factors to arrive at its decision. The court categorically recognized the suit to be a derivative action and applied the factors accordingly. In its analysis, the court emphatically clarified that since the reliefs sought would have a bearing on the final reliefs, the suit must be treated as a full fledged trial, dismissing the Plaintiff's claim that only a *prima facie* case must be shown to exist. The bench focused on three main factors to determine the case. *Firstly*, the intent or motive of the Plaintiff, *secondly*, best interest of the company and *lastly*, the opinion of the independent members of the company.

In understanding the motive of the Plaintiff, the court looked to the clean hands doctrine in *Nurcombe* v *Nurcombe*.[29] On examining the past cases

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[26] Andrew Keay & Joan Loughrey, *Something Old, Something New, Something Borrowed: an Analysis of the New Derivative Action under the Companies Act 2006*, 124L. Q. RE V 469 (2008).

[27] Companies Act, 2006, § 261 (2).

[28] *Id*. at§§ 263 (3), 263 (4) &172. The requirement of 'best interest of the company' was a common law principle advocated by the Law Commission Report on Shareholder Remedies. However, the recommendation did not find a direct place in the Act. Nevertheless, §172 prescribes a duty to promote the success of the company and is one of the factors laid down under § 263 as well.

[29] Nurcombe v Nurcombe, (1985) 1 WLR 370 : (1985) 1 All ER 65.

brought about by the Plaintiff against the Defendant, the court was of the belief that the Plaintiff was driven by family hostilities and personal interests in bringing this suit. Secondly, the Plaintiff was alleged to have sold his shares to a rival company and seemed to be acting at their behest. Since the action was for an ulterior purpose, according to the bench, the claim could not proceed.[30] Alternatively, independent shareholders holding about 13% of the shares in the company were of the opinion that the suit should not be pursued. Lastly, it was found that if the Plaintiff's contention was accepted, there was a chance of revocation of the patent of the Defendant and since the company was currently enjoying the benefits of the patent royalty fee, the action was not in the best interests of the company. Consequently, the notice of motion was dismissed.

The reasoning used by the bench to come to this conclusion is problematic in several ways. It is a well-accepted principle that the there are two stages in the determination of the claim in a derivative suit.[31] The court while recognizing the first stage of establishing a *prima facie* case, failed to make an express mention of the two-stage process. At the first stage, the Plaintiff was merely required to show that a *prima facie* case existed. The prima facie test is an established test required for interim injunctions.[32] In case of interim injunctions a substantial chance of success must be shown.[33] However, when applied to derivative suits this would constitute a fairly stiff test to pass and has been sufficiently warned against as it would lead to a mini-trial at a preliminary stage.[34] Precedent suggests that the test is less strict in case of common law derivative actions in comparison with interim injunction applications and a 50 percent chance of success need not be proved.[35] The court in the present case has failed to recognize this principle laid down in *Prudential Assurance* and has categorically held that the notice would be treated as a suit in itself, forcing a threshold test on the merits of the case. Thus, the court first recognized that a *prima facie* case is to be established, but refused to accept the lower threshold test in case of derivative suits as opposed to injunction applications.

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30 Barrett v Duckett, (1995) 1 BCLC 243.

31 Smith v Croft,1998 Ch 114.

32 F. Hoffmann-La Roche & Co. A.G. v Secy. of State for Trade and Industry, 1975 AC 295: (1973) 3 WLR 805: (1973)3 All ER 945.

33 HEYDON & LOUGHLAN, CASES AND MATERIALS ON EQUITY AND TRUSTS, 978 (5th ed. 1997).

34 HARALD BAUM & DAN W. PUCHNIAK, THE DERIVATIVE ACTION: AN ECONOMIC, HISTORICAL AND PRACTICE-ORIENTED APPROACH 71 (1st ed. 2012); Law Commission, Shareholder Remedies: REPORT ON A REFERENCE UNDER SECTION 3(1)(E) OF THE LAW COMMISSIONS ACT 1965 7 (Law Com. No.246, Cm. 3769, 1997).

35 Prudential Assurance Co. Ltd. v Newman Industries Ltd. (No. 2)., 1982 Ch 204 : (1982) 2 WLR 31: (1982) 1 All ER 354.

Despite understanding that only a *prima facie* case was to be established in the first stage, the court followed its stance on holding a mini trial and continued to delve into the factors that are ordinarily considered in the second stage of the suit. The first factor discussed by the bench is that of the clean hands doctrine. A great amount of emphasis was laid on the past conduct of the Plaintiff and whether he approached the court with 'clean hands'. Ulterior motive of the Plaintiff was given great importance in this case, despite being said previously that having a personal interest does not preclude a Plaintiff from bringing a derivative action.[36] Meanwhile, the doctrine of 'clean hands' has been replaced with the 'good faith' doctrine in the UK. Since the suit is not a personal claim but a derivative claim brought on behalf of the company, the conduct of the Plaintiff should be irrelevant in determining a claim of the company.[37] The court has placed reliance on the *Nurcombe* case which in turn relies on the *Towers* judgment. In *Towers* the court failed to draw the distinction between a direct action of the shareholders and a derivative actions and hence, courts must be careful in applying the case.[38] Judges in *Nurcombe* too espoused a similar position.[39] Therefore, the judgments relied on by the bench used a doctrine relevant to personal actions, in a case of derivative action. Although the clean hands doctrine has been commonly applied in the past, albeit inappropriately, the court in this case missed the opportunity to move towards the more suitable doctrine of good faith. It is also relevant to note that the application of the good faith doctrine may not have had a bearing on the final outcome of the case. This is because of the ambiguity in the phrase 'good faith' which would have nevertheless entailed a discussion of the Plaintiff's motives based on past conduct. But the situation is peculiar to the particular fact scenario and an application of the right doctrine would have allowed for a better development of the law at a time when the subject is still evolving.

Interest of the company is another factor that is commonly taken into consideration. The court was of the opinion that *firstly*, since the company was enjoying the benefit of the patent of the defendant royalty free, the suit would not be in the best interest of the company. *Secondly*, the Plaintiff's pledge of shares to a rival company also weighed against him in holding that the action was not in the best interest of the company. It was felt that accepting the contention would make the susceptible to revocation under the Patents Act. However, considering the facts of the case, this factor should

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[36] Barrett v Duckett, (1995) 1 BCLC 243.

[37] Jennifer Payne, "*Clean Hands" in Derivative Actions*, 61(1) Cambridge L.J. 77 (Mar.2002).

[38] Towers v African Tug Co., (1904) 1 Ch 558, 571.

[39] Nurcombe v Nurcombe, (1985) 1 WLR 370, 378 : (1985) 1 All ER 65.

not have precluded the court from granting leave. The decision could have simply determined that the Defendant No. 1 was the rightful owner of the patent *after* having allowed the application to proceed at the preliminary stage.

Lastly, the court took into consideration the views of the independent members of the company. Relying on the *ratio decidendi* in *Smith* v *Croft*,[40] the court observed that shareholders holding 13 per cent of the shareholding of the company did not support the suit. These disinterested shareholders are the family members of the Plaintiff casting a huge shadow on their supposedly neutral position considering the history of family hostilities in the Kavasmaneck family. Other minority shareholders' views have not been mentioned in the judgment. It seems that the bench has selectively relied on the evidence produced to determine the opinion of the shareholders, quite possibly veiling the true position of the disinterested members.

After having weighed the factors against the Plaintiff at the preliminary stage, the court decided against elaborating on whether there were alternative remedies available to the Plaintiff or the company in this case. Consequently, the court faultily conducted a full-fledged trial at the very first stage and refused to allow the application based on the factors discussed.

IV. CONCLUSION

At this juncture of evolving company laws in India, the case of *Darius Kavasmaneck* marks a crucial point. Derivative actions have long been recognized as keeping checks and balances on the powers of the corporate management.[41] Despite the risk of frivolous litigation, derivative suits have been considered to be tools of accountability and in many instances, a manner of protection of minority shareholders.

Derivative action mechanism has vastly evolved throughout jurisdictions. India remains the only leading Asian country without a codified law on the subject[42] and therefore relies heavily on common law principles. As a result, the judgment at hand is watershed in shaping the law on derivative action.

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[40] Smith v Croft, 1998 Ch 114.

[41] Cohen v Beneficial Industrial Loan Corpn., 93 L Ed 1528 : 337 US 541, 548 (1949).

[42] Dan W. Puchniak, *The Complexity of Derivative Actions in Asia: An Inconvenient Truth*, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 90, 93 (Dan W. Puchniak et al. eds., 2012).

The case, however, deviates from the procedure adopted across common law jurisdictions. The court rightly recognizes that a mere *prima facie* case must be established at the preliminary stage. Subsequently, it must be determined whether the claim must be allowed to proceed based on certain key factors. However, it deviates from this position by conducting a trial of sorts using these factors in the preliminary stage itself. Alternatively, it also fails to apply a more suitable doctrine, i.e. the doctrine of good faith, in place of the doctrine of clean hands, which is now statutorily recognized in the UK. The court also seems to have selectively relied on the evidence produced to come to its conclusion.

Had the court expressly recognized the principles followed in derivative claims and discussed the factors accordingly, the judgment would have set a good precedent for the cases to follow. Unfortunately, the case was a missed opportunity of the judiciary to establish a strong logical sequence to deal with derivative claims.