



An overview of progressive activism- the class action suit.

KEYWORDS

class action, minority protection, regulatory framework and corporate governance.

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ABSTRACT

One of the essential features of an incorporated association is the separation of ownership and management. Conceptually even though the shareholders are considered the owners of the company there are merely spectators to the actions of the Directors. Shareholder activism is a term used to explain the active participation of the shareholders to fight against the erroneous acts of the management. The Companies Bill, 2011 proposes to bring in many developments in the regulations governing the Indian Corporate sector that aim towards enhancing the protection of stakeholder rights and interests. One such development is the inclusion of the clause on Class action which if implemented will be an effective tool in the hands of the minority shareholders against the oppressive practices of the Management. Under Clause 245 of the proposed bill, a class action can be initiated by such specified number of member or members, depositor or depositors or any class of them, as the case may be, may, if they are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the company or its members or depositors. In the backdrop of the highly debated, reported and analysed Satyam Case, an entity that suffered silently is the Company's small shareholders whose wealth has been eroded within a span of days with no fault of theirs. Small investors in India awakened to the concept on Class action when their American Counter made the company agree to pay \$125 million (over Rs 625 crore) in settlement due to a strong class action framework in the US. A widely used redressal mechanism in the US and the UK, it has now found place in the Indian regulatory framework. The paper aims to understand the implications of the class action and the mechanism through which it can be implemented. It will be an exploratory study focusing on the issues relating to small shareholders and how far the tool of class action with help in fostering shareholder activism.

1.1 Introduction:

Any legal remedy is considered effective if it is affordable, has widest public reach and at the same time compensates the victims adequately. The traditional methods of seeking justice have proven to be ineffective because of the absence of one or more of these essential conditions. Class action also known as representative or derivative action is a form of law suit where large number of people collectively bring a claim through group action.

The increasing use of class actions to seek redressal, originate from its definite advantages over the traditional litigation. Class actions are cost effective and increase judicial efficiency as they unite several plaintiffs' under one cause giving it strength. As this strength comes from the sheer numbers they have the power to pull up corporations for poor management, unethical practices, and corporate governance failures. Claims which may seem insignificant at the micro level attain importance at the macro level and hence compel justice to be in favour of the victims. In cases of bankruptcy, while individual's law suits operate on first come first serve basis, class actions ensure that payments are made across to all the parties. They place fewer obligations on the class members than conventional lawsuits. Courts would not like to litigate multiple cases based on a similar nature; In this context class action is an effective tool over a conventional law suit because of its mutual benefits to the Legal fraternity as well as the public.

In order to qualify for a status of a 'class action' the claim must have some basic elements. To begin with the law suit needs adequate number of affected parties who are seeking compensation against a single corporate action/common injury. The cause of action must affect many people so that it is practicable for a few representative plaintiffs' to address all the claims than file individually.

1.2 Class action: A new tool?

First introduced in the US in 1938 through Rule 23 of the Federal Rules of Civil procedure, it had gained momentum over the years and has become the most preferred way of litigation enabling social and economic reforms. Later The Class Action Fairness Act of 2005 was introduced which expanded

federal jurisdiction over many large class-action lawsuits (where amount in controversy exceeds \$5 Million) and mass actions taken in the United States. Class actions are usually filed by consumers in case of defects or deficiency in products and services, by shareholders in case of destruction of wealth due to mis management, employees in case of breach of employment terms or unfair labour practices.

1.3 Objectives of the study:

The paper attempts to understand the implications of class action as a tool for investor protection in the context of the capital market. The investor base in the capital market in India is huge and investors are a heterogeneous group. They may be Institutional investors, High net worth individuals, small or retail investors or corporate entities. Not all investors need equal degree of protection. It is the small investor or the minority shareholder who needs maximum protection. The reason being he is gullible, easily swayed by the promises of post listing gains or quick market appreciation. Their objectives of investing are safety, liquidity and return on investment. Protection of Investors is of utmost importance as it is his faith in the stock market that is the foundation stone for its future growth. The J.J Irani committee working on the draft companies Bill has recommended that effective measures be initiated for protecting the interests of stakeholders and investors, including small investors, through legal basis for sound corporate governance practices. An underlying theme of the recommendations is asserting shareholders' democracy. In spite of legislative measures, there are fraudulent companies which are cheating the investors.

Whenever any retail investor faces an institutional failure he does not get help from any quarter and has to accept it as a bad luck. The scams remain under investigation with no concrete steps taken against default companies.

The Companies Bill, 2011 proposes to bring in many developments in the regulations governing the Indian Corporate sector that aim towards enhancing the protection of stakeholder rights and interests. One such development is the inclusion of the clause on Class action which if implemented will be an effective tool in the hands of the minority shareholders against the oppressive practices of the Management.

Can class action be of aid to such small/retail investors is what this paper attempts to study.

1.4 Research Methodology: The study is explorative as it attempts to understand the implications of the new bill. The sources of information are secondary from official websites of the Ministry of Corporate Affairs, SEBI and existing published and unpublished work on the subject.

1.5 Review of Literature:

Across the globe there is a wealth of literature on the effectiveness of class action. 1 Alberto Cassone and Giovani B. Ramello (2011) have used economic categories to show how the reorganization of civil litigation in case of class action is not merely aimed at providing a more efficient litigation technology but also serves to create a well defined economic organisation ultimately aimed at providing a set of goods first and foremost among which are justice and efficiency. Class action suits help the Company management clean. Companies are increasingly the targets of shareholder class actions for nondisclosure and misleading statements Murthy Krishnan (2011). A.V. Raja1 & Francis Xavier (2007) argue that PIL can be justified as an economically efficient choice of redressal over private litigation and class action because the latter involves high transaction costs.

2Duffy, Michael J. (2011) has studied the desirability of Companies in Australia, which were limiting their liability arising from shareholder class action by amendments in the Constitution. The author argues that it is unlikely that company constitutions could eliminate or reduce such liability.

The Federal Court of Australia has held in the case of *Sons of Gwalia Limited v Margaretic* that "The shareholders of a Company, which is in administration, can make claims against the administrator for continuous breach of disclosure guidelines and misleading and deceptive statements and conduct of the Company and such shareholders can be ranked equally with the unsecured creditors rather than making them stand in the queue after the creditors. Accordingly, the shareholders who buy shares in a Company, which becomes bankrupt shortly, relying on the misleading statements or incomplete disclosure by the Company will have an action as a creditor against the liquidator or administrator for any loss suffered as a result of that reliance."

1.6 Protection of the minority shareholders: the need The cardinal rule of Company law is the rule of the majority over minority. This rationale has been laid in the case of *Foss V. Harbottle* which upholds the separate legal personality of the Company. The shareholders do not exercise control over the affairs of the company unless they are holding majority shares. Although there are a number of rights given to the shareholders by virtue of the contract of membership as enumerated in the companies Act, 1956 in the case of most companies the shareholder is a passive owner dependent on the wisdom of the Board of Directors to run the company. The role of independent directors is to address the concerns of the minority shareholders. Although there is an option to company to adopt proportionate representation for the appointment of small shareholder's director but this option is rarely used. The specific minority appointed director/independent director could also play an important role in investor protection. The provisions contained for representative suits in Section 397 and 398 in the existing Companies Act, 1956 for oppression and mismanagement give protection to a certain extent.

3The Indian Civil Procedure Code under Order-1, Rule-8 permits representative actions whereby a large body of persons who are interested in a matter can bring action together as a group and one or several of them shall act as a representative on behalf of the group. But this has not been an incentive considering adjudication delays. However, there is no specific provision for class action litigations under existing Indi-

anCompanies Act.

Shareholder activism is a term used to explain the active participation of the shareholders to fight against the erroneous acts of the management. When Companies fail to follow ethical corporate practices the people who suffer the most are the minority share holders.

In the highly reported, debated and analyzed Satyam Case, an entity that suffered silently is the Company's small investors whose wealth has been eroded within a span of days with no fault of theirs. Small investors in India awakened to the concept on Class action when a suit was filed on behalf of the purchasers of the American Depository Receipts of Satyam alleging violation of federal laws by issuing false financial statements. They made the company agree to pay \$125 million (over Rs 625 crore) in settlement due to a strong class action framework in the US. A suit was also filed against its audit firm PwC for recklessly disregarding the accounting fraud by Satyam

More recently investors who invested on the Initial Public offering of Facebook suffered losses because of the price of the scrip falling drastically on listing. A Class action suit was filed against its Co-founder Marc Zuckerberg alleging that he had inside information that the stock price was overvalued and hence had offloaded his shares prior to listing. The concept of class which is a widely used consumer redressal mechanism in the US and the UK, has now found place in the Indian regulatory framework.

1.7 Implications of class action introduced in Companies bill 2011:

Clause 245 of the proposed Companies bill empowers shareholders and depositors to claim damages or compensation from or against a company or its directors including audit firms, experts or advisors for any fraudulent, unlawful act or conduct of the affairs of the company prejudicial to the interests of the company or its members or depositors. The requisite number of members for filing a class action suit provided in sub-section (1) is not less than hundred or such percentage of members as may be prescribed whichever less is. In case of a company not having a share capital, not less than one fifth of the total number of its members can make the application for restraining the Company from committing an Ultra Vires Act or breach of the Company's Memorandum and Articles of Association. They can claim damages or compensation or demand any other suitable action against the company or its directors.

On admission of application, the Tribunal shall issue a public notice to all members of that class. All similar applications prevalent in any jurisdiction would be consolidated into a single application. Class members are allowed to choose the lead applicant and in the event of their failure to do so, the Tribunal has the power to appoint a lead applicant who shall be in charge of the proceedings from the applicants' side. The cost or expenses is to be defrayed by the company or any other person responsible for any oppressive act.

The cause of class action has got further strengthened with Securities and Exchange Board of India (SEBI) also notified SEBI (Investor Protection and Education Fund) Regulations, 2009 according to which SEBI will establish an Investor Protection and Education Fund which will be used inter-alia, for "aiding investors' associations recognized by the Board to undertake legal proceedings in the interest of investors in securities that are listed or proposed to be listed" – clause 5 (2) (d) of the Regulations. The aid will be subject to certain conditions as stipulated under Regulation 6. Aid provided shall not exceed 75% of total expenditure on legal proceedings and it will be provided on first come first serve basis. An eight-member advisory committee will decide on the disbursement of the aid which will be provided only when SEBI is not a party or has not initiated enforcement action against the Company.

The Investor Education and Protection Fund established under Sec 205C of the Companies Act, 1956 for the protection of investors has issued guidelines for funding NGO's to fight class action suits. An NGO registered under the IEPF can seek funding with the prior approval of the Department of Company affairs. Funding would not be provided when government Departments or other regulatory bodies are made respondents. Aid will be provided only for legal expenses in cases where the judgment is in favour of the investors not exceeding 5% of the budget of IEPF of that year, out of which 20% of the expenses will be borne by the voluntary organization.

1.8 Limitations of class action:

As atleast 100 members are needed to file a class action suit, the cost of collecting information and the cost of coordinating the members to achieve collective interest is the first challenge. The role of investor association is hence critical for the success of such collaborative action. However in India not all small/retail investors are members of investors associations. There are 26 investor association registered with SEBI till date. Majority of them are from bigger cities. They are not spread across the country. Moreover the funding by SEBI would be provided only if there are thousand or more investors affected. Hence if a genuine shareholder does not get much support, he will be denied compensation. These provisions limit benefits of class action to a select few.

A possibility that large firms can buyout smaller associations of retail investors cannot be ruled out.

Significant checks and balances have to be introducing to ensure that only genuine actions are entertained by the NCLT. Before considering a suit it has to be probed whether the shareholders are acting in good faith or have any personal interest in the action, or whether the act or omission involved has been authorised or ratified by the shareholders. Having

joined a class action the members cannot resort to individual litigation.

The success of Class action in the US springs from an incentive in the form of contingency fees which makes the law firms pursue the class action and win the compensation for the victims. As it is not the case in India, it will solely be the strength of the investor association/group that will decide whether or not we will see more shareholder activism.

1.9 Suggestions and Conclusion:

To admit the limitations of class action is not necessarily to dismiss it. An outstanding legal innovation, class action needs to be fine tuned to suit the requirements of the Indian framework. SEBI needs to take a proactive role not just in funding but encouraging investors to be a part of investor associations. The benefits of class action should be a part of the curriculum for Investor education. Investor awareness programmes should not be promotional activities but should enlighten the investors about their rights and obligations. Investors need to develop an equity culture to understand the corporate actions and pull up companies for mismanagement and fraud.

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