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Case Commentary: Dale and Carrington Investments (P) Ltd. v P.K. Prathapan and Ors.

Sakshi Shankar^a Ankita Mishra^b

^aOP Jindal Global University, Sonipat, India ^bOP Jindal Global University, Sonipat, India

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INTRODUCTION

A company had been set up by Appellant No. 2, Ramanujam, for Respondent No. 1, Prathapan, in order to manage a hotel in Kerala, wherein an initial amount had already been paid by Prathapan and his family to acquire the aforementioned hotel. However, Ramanujam had not contributed any amount towards the initial payment, and shares were allotted to Prathapan and his wife in exchange for the amount paid by them. Prathapan's brother and brother-in-law were the directors of the company along with Ramanujam. An advance of Rs. 3000/- for share capital pending allotment was shown until 1993 which was raised to Rs.6,68,500/- in 1994 in the balance sheet. Further, 6,865 equity shares were allotted to Ramanujam by himself on October 24, 1994 post the alleged Board meeting. Due to this, Prathapan became a minority shareholder from the earlier position of the majority shareholder in the company, and an increase in authorized share capital took place from Rs. 15 lakhs to Rs. 35 lakhs. These allotments were challenged and petitioned in the Company Law Board ("CLB") by Prathapan, on the basis of the act being oppressive and in favor of Ramanujam, the

Managing Director (“MD”). The basis of Prathapan’s contention was that there was no initial monetary contribution by Ramanujam, who was, in fact, acting solely for his personal gain by virtue of his MD position. Prathapan also claimed that his funds for the company were withdrawn by Ramanujam for personal benefit.

PROCEEDINGS AND CONTENTIONS

The CLB held Ramanujam guilty of committing an oppressive act by not informing or offering further share capital to Prathapan and gave Prathapan a choice to gain relief by selling his shares to Ramanujam. Prathapan further challenged CLB’s decision and the Kerala High Court allowed Prathapan’s appeal for questioning the relief and held Ramanujam guilty for committing a fraudulent act by allotting the 6,865 shares to himself and directed him to set aside this allotment of shares. Aggrieved by this, Ramanujam appealed to the Supreme Court.

ISSUES

The primary issues of the case were to determine the (i) validity of allotment of the additional equity shares that made Ramanujam the majority shareholder and validity of the relief granted, (ii) whether the allotment was done with bona fide intentions, and (iii) whether there was a director’s fiduciary duty towards the shareholders of the company.

RULES

The relevant provisions from the Companies Act, 1956 (“CA”) for this case are:

Section 291: Power of directors to act on behalf of the company, and exercise powers that authorize them to do acts that only the company is authorized to do.¹

Sections 397 and 398: Oppression and mismanagement within the company respectively²

Section 10-F: Regarding the Company Law Board³

¹ Companies Act, 1956, s. 291

² Companies Act, 1956, s. 397, 398

³ Companies Act, 1956, s. 10(F)

Section 81: Further issue of capital⁴.

HELD AND ANALYSIS

In this case, the Supreme Court examined the allotment of additional shares, wherein the study of the minutes of meetings as well as the lack of evidence supporting the aforementioned decision concluded the invalidity of the allotment of shares and set aside the allotment. The judgment stated that “the facts of the case do not pose any difficulty, particularly for the reason that the MD has neither placed on record anything to justify the issue of further share capital nor has it been shown that proper procedure was followed in allotting the additional share capital.”⁵ It was observed by the Court that a pertinent requirement of additional funds was issued but no trail of documents supported the requirement, and such an act by Ramanujan was due to the prioritization of personal gains over company needs and benefits. Furthermore, whether the issuance of additional shares was a bona fide act, which was necessary, was questionable. The Court accentuated that the company was a legal entity that acts through its Board of Directors and an individual director does not have the power or authority to act on the behalf of the company, unless specified, which was not the case here. “The fiduciary capacity within which the directors have to act enjoins upon them a duty to act on behalf of a company with utmost good faith, utmost care, skill, and due diligence and in the interest of the company they represent.”⁶ They also have a fiduciary duty to issue additional shares for the doctrine of “proper purpose”⁷. Although Section 81 of Companies Act, 1956 was inapplicable to private companies, the Court pointed out that it instructs the right of shareholders to receive the particulars of shares being issued and that such an act was conducted in good faith. It was also considered by the Court that the private companies essentially owe good faith to one another with respect to sharing capital. “In the present case, Article 4(iii) of the Articles of Association (“AOA”) prohibits any invitation to the public for the subscription of shares or debentures of the company. The intention from this appears to be that the share capital of the company remains within a close-

⁴ Companies Act, 1956, s. 81

⁵ *Dale and Carrington Investments (P) Ltd v P.K. Prathapan and Ors.* (2005) 1 SCC 212

⁶ *Dale and Carrington Investments (P) Ltd* (n 4)

⁷ *Hogg v Cramphorn Ltd.* [1967] Ch 254

knit group.”⁸ In this case, the company’s management was supposed to be a closely-knit network, and if such good faith was tampered with, the misuse of power and breach of trust would hold the directors accountable by virtue of the AOA. The act of reducing the status of a majority shareholder to a minority shareholder by misrepresentation was considered as an oppressive act by the Court and the oppressed shareholder, Prathapan, was allowed to manage the company within the power provided to him, but the additional shares allotted to Ramanujam would be set aside nonetheless. It was established that any action taken by the director, Ramanujam here, must be bona fide and must fulfill the ‘proper purpose’ doctrine, and if it failed to do so, such action taken cannot be upheld and must be set aside, which in this case was the setting aside of the allotment of additional shares. Furthermore, the Supreme Court stated that “the only relief that has to be granted in the present case is to undo the advantage gained by Ramanujam through his manipulations and fraud. The allotment of all the additional shares in favor of Ramanujam has to be set aside.”⁹

There are several other cases that discuss this basic principle. It was stated in *Alexander v Automatic Telephone Co.* that “directors who use their powers to obtain benefits for themselves at the expense of the shareholders, without informing them of the fact, cannot retain those benefits and must account for them to the company, so that all the shareholders may participate in them”¹⁰. *Needle Industries* concluded that “if the Directors succeed in maintaining their control over the company or in newly acquiring it, it does not amount to an abuse of their fiduciary power, but it is objectionable if such power is utilized solely for the benefit of Directors or merely for extraneous purposes like maintenance or acquisition of control over the company’s affairs”¹¹. *Piercy v Mills* also decided that “Directors are not entitled to exercise their powers of issuing shares merely for the purpose of gaining or maintaining control over the company’s matters, or solely for the purpose of defeating the wishes of the existing majority shareholders”¹² while *Punt v Symons* stated that “where shares

⁸ Dale and Carrington Investments (P) Ltd (n 4)

⁹ *Ibid*

¹⁰ *Alexander v Automatic Telephone Co.* [1990] 2 Ch 56

¹¹ *Needle Industries (India) Ltd. and Others v Needle Industries Newey (India) Holding Ltd. and Others* (1981) AIR 1298

¹² *Piercy v Mills & Co.* [1920] 1 Ch 78

had been issued by Directors for the purpose of controlling the holder of the greater number of shares by obtaining a majority of voting power rather than for the general benefit of the company, they ought to be restrained from holding such meetings at which the votes of the new majority shareholders were to have been used”¹³. Such precedents enabled the Supreme Court to establish the precedent that in situations where the authority of Directors is exercised towards extraneous purposes such as for maintenance or acquisition of control over the company’s affairs, such actions cannot be upheld or encouraged whatsoever.¹⁴

The jurisprudence of the duties that are owed by the directors to the company (and to the shareholders in some cases) has developed over multiple decades through several case laws, some of which are mentioned above in this case. When the Companies Act, 2013 was enacted, such duties of directors were finally codified and were mentioned in Section 166 of Companies Act, 2013, which consisted of (7) sub-sections outlining various duties of directors. It can be observed that the ratio of the present case had already combined these duties into a single broad category of ‘fiduciary duties’ that were to be followed by the directors, long before they were actually codified in 2013. This implies that this case played an important role during the codification of these duties, which led the ‘fiduciary duty to become a statutory duty of the director, which would bind the directors to comply with these duties, irrespective of its mention in the Memorandum of Association (“MOA”) and AOA of the company. The present case was tried under the jurisdiction of the Companies Act, 1956. However, if tried under the Companies Act, 2013, the case of *Dale and Carrington v Prathapan* would have led to the filing of the case under Section 166(2), wherein the director is required to “act in a bona fide manner with proper purpose”¹⁵ along with the application of Section 241 which deals with “oppression and mismanagement”¹⁶. This would have then led to the outcome of the director being in breach of his statutory duties towards the shareholders and the company. Further, Section 166(7) of the Companies Act, 2013 deals with the penance of the violation of this

¹³ *Punt v Symons & Co Ltd* [1903] 2 Ch 506

¹⁴ Abhay Shetty & AaryaPachisia, ‘Analysis of Dale and Carrington Investments (P) Ltd v PK Prathapan and Ors. – (2005) 1 SCC 212’ (*Taxguru*, 21 October 2020) <<https://taxguru.in/company-law/analysis-dale-carrington-investments-p-v-p-k-prathapan-ors-2005-1-scc-212.html>>accessed 05 February 2022

¹⁵ Companies Act, 2013, s. 166(2)

¹⁶ Companies Act, 2013, s. 241

provision¹⁷. Had the case been tried to post the 2013 Act, MD Ramanujam, would not only have to refund the amount that he fraudulently gained through the allotment of shares to himself back to the company, but he would additionally be liable to pay a fine of Rs.1lakh to Rs.5lakh.

An important criticism of this judgment is with respect to its facts-based nature. In this case, the MD was held liable to disclose the important information regarding the allotment of additional shares to the shareholders by virtue of his fiduciary duty owed to them. Whereas, the general rule regarding the same is that directors do not owe a fiduciary duty to shareholders. This leads to a slight ambiguity regarding the scope of applicability of this judgment due to its dependency on the facts-situation of each distinct case. The ratio of this decision is only a valid precedent as long as the director exercised his powers with malafide intentions for personal gain or without due procedure. However, in a situation where the director failed to disclose such important information, but with a bona fide intention and in furtherance of the interests of the company, this precedent will not be applicable. Therefore, there is a fine line for the valid applicability of this judgment since it depends on the discretion of the judge and his interpretation of the facts situation. However, the present case does not act as an absolute authority or law for a director to maintain a fiduciary duty towards shareholders to disclose matters and transactions that are not directly related to the affairs and functioning of the company.

CONCLUSION

Although the judgement is facts-specific and cannot be used as a general rule since it would derail the primary duty of directors to act in the best interest of the company, the definition and scope of fiduciary duty and the rule of disclosing information to shareholders was made clear through this case, which can be applied only situations where the intention behind the allotment of shares is malafide rather than for the company's benefit¹⁸. The principal-agent relationship exists between the company and directors but does not extend to the

¹⁷ Companies Act, 2013, s. 166(7)

¹⁸*Ibid*

shareholders, unless in exceptional situations. The Court concluded that “it is inevitable that neither the allotment of additional shares in favor of Ramanujam was bona fide nor it was in the interest of the Appellant company nor a proper and legal procedure was followed to make the allotment. The motive for the allotment was malafide, the only intention being to gain control of the company.”¹⁹ Therefore, the shares allotted to Ramanujam were set aside by the Supreme Court, and rightly so.

¹⁹ Dale and Carrington Investments (P) Ltd (n 1)