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# **DIRECTORS' DUTIES & LIABILITIES IN THE TWILIGHT ZONE OF A COMPANY UNDER INDIAN JURISPRUDENCE**

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## **ABSTRACT**

This essay serves as a practical guide for company directors, offering key insights into corporate decision-making across various financial stages. It examines the evolving responsibilities of directors, particularly as a company transitions from solvency to the twilight zone—the critical phase approaching insolvency. At this stage, ensuring accountability to creditors becomes paramount, even as Indian courts and the Insolvency and Bankruptcy Board of India (IBBI) continue to refine the legal framework surrounding these duties.

Initially, when a company is financially sound, shareholders hold the dominant economic stake, guiding corporate policies and strategic decisions. However, as financial distress sets in, the economic interests of creditors gain prominence, necessitating a shift in directors' fiduciary obligations. This essay explores why shareholders cannot ratify breaches of duty during this phase, reinforcing the need for directors to exercise independent judgment and prioritize creditor rights.

Grounded in current legislation and judicial advisories issued by Indian courts and the IBBI, this article offers a structured analysis of corporate governance during financial distress. It aims to provide clarity on how directors should navigate these evolving duties to maintain compliance and uphold creditor interests effectively.

## **INTRODUCTION**

<sup>1</sup>The issue of directors' duties and the relationships between the company and external stakeholders are of paramount importance, not only in the solvent state of the company, but also in the insolvent state. Thus, nature and expectation of the duties of the board of directors also varies with the changing financial status of a company. The table below shows three

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<sup>1</sup> <https://ibbi.gov.in/uploads/meetings/e8e306852963ae62b5fe59c298edb97d.pdf>

distinct phases and primary duties of directors in each, as a general understanding of legal positions across jurisdictions.

S.No	Financial Situation	Primary duties towards	Relevant Legislation
1	Solvent	Shareholders	Companies Act
2	Company is solvent but starts to face or foresee financial trouble (“twilight zone” or “Zone of insolvency” or borderline	It covers broad spectrum of actions which directors can undertake to mitigate losses and they will be evaluated as being in capacity of “reasonable competent director”, which could include not incurring further debts and making active efforts of rehabilitation of the company	Companies Act, 2013 Section 166(2)-(6)
3	Insolvent and in formal insolvency proceeding	Creditors	Insolvency Laws

<sup>2</sup>

When a company starts running into financial trouble—especially when it's close to becoming insolvent—the role and responsibilities of directors begin to change in important ways. This period is often tricky, as the company isn't yet in formal insolvency, but it's no longer on stable ground either.

In these situations, directors or shareholders, even with the best intentions, might make decisions that unintentionally harm the company's value or put creditors at a disadvantage. That's why many courts around the world agree on a key point: as a company approaches insolvency, directors must start thinking less about what's best for shareholders and more about protecting the interests of creditors.

At this stage, creditors become the ones taking on the most risk, so the directors' main job shifts to safeguarding the company's remaining assets. Whether the goal is to help the business recover or to ensure that debts are repaid fairly, the priority becomes preserving value rather than pursuing riskier strategies that could make things worse.

<sup>2</sup> <https://ibbi.gov.in/uploads/meetings/e8e306852963ae62b5fe59c298edb97d.pdf> para 32

## THE ROLE AND AVAILABILITY OF LEGISLATIVE SOURCES IN INDIAN JURISPRUDENCE

<sup>3</sup>The IBBI published a working paper titled “*Director’s Duties in Different Stages of the Financial Situation of a Company*”, which referenced the *UNCITRAL Legislative Guide on Insolvency Law* concerning directors. The paper suggested adopting these principles to regulate directors’ obligations during the period leading up to insolvency.

The the goal is to stop directors from ‘externalising the costs’ of a company’s adverse financial circumstances by placing all of the risks of continued trade on the company’s creditors. The core disadvantage of this liability-based approach is that directors may become overly risk-averse, seeking to avoid any prospect of personal liability by prematurely closing a viable (but distressed) business that otherwise could have survived. This in turn limits the development of a stronger rescue culture as part of local insolvency processes.

<sup>4</sup>Hence, Directors could ensure that they obtain accurate, relevant and timely information, in particular by informing themselves independently (and not relying solely on management advice) of the financial situation of the company, the extent of creditor pressure and any court or recovery actions taken by creditors or disputes with creditors.

Directors could ensure that modify management practices to focus on a range of interested parties, which might include creditors, employees, suppliers, customers, governments, shareholders, as well as, in some circumstances, environmental concerns, in order to determine the appropriate action to take. In the period when insolvency becomes imminent or unavoidable, shifting the focus from maximising value for shareholders to also take account of the interests of creditors provides an incentive for directors to minimise the harm to creditors (who will be the key stakeholders once insolvency proceedings commence), that might be the result of excessively risky, reckless or grossly negligent conduct. Holding meetings with relevant groups of creditors might be an appropriate mechanism for assessing those interests;

This twilight zone is critical for the survival of company and preservation of its value, whatever it may worth. The **IBC** while consolidates the winding-up This twilight zone is critical for the

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<sup>3</sup> <https://ibbi.gov.in/uploads/meetings/e8e306852963ae62b5fe59c298edb97d.pdf>

<sup>4</sup> (recommendations 255 and 256) [https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/19-11273\\_part\\_4\\_ebook.pdf](https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/19-11273_part_4_ebook.pdf)

survival of company and preservation of its value, whatever it may worth. **Section 43** of the IBC imposes duty upon the company (and indirectly upon the directors) to not prefer a particular creditor over fellow creditors, outside of the ordinary course of business within the claw back period of 2 years. If such an arrangement has been undertaken, the NCLT under **Section 44** of IBC will require the company to reverse the transaction and vest within itself the disposed property. Similarly, **Section 45** of IBC also bars the directors from significantly undervaluing the corporate property and shall be required to reverse the transaction when it is declaring as void by the NCLT.

## **<sup>5</sup>THE SHIFT IN DUTIES: FROM SHAREHOLDER- CENTRIC TO CREDITOR-CENTRIC**

<sup>6</sup>Section 166(2) of the Indian Companies Act, 2013 – Establishes directors 'duty to act in the best interests of the company, which courts have interpreted to include creditors when insolvency is imminent.

### **Interpretation of Directors Duties by Indian Courts**

<sup>7</sup>The literature review of the limited Section 166 cases suggests that there has not been a **single case initiated as direct-action claim** by creditors for breach of director duties.

<sup>8</sup>The judicial bodies can take reference to the existing position in the context of director liability during borderline insolvency to interpret the liability standards until legislative clarity is brought about. In fact, in the Jet Airways and Videocon Case, the NCLAT and NCLT took reference from the extant international position on cross-border and group insolvency instances to resolve the dispute in absence of any legislative provision to the effect under the IBC.

However, there are few case laws which can help us dear an indirect interpretation on the director's duty to protect the creator's rights.

Even though the directors are elected by shareholders, they do not owe any fiduciary relationship with them but they have exclusive right to run the company. This was made clear

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<sup>5</sup> <https://ibbi.gov.in/uploads/engagement/WinnerUtsavMitraNLIUBhopal.pdf>

<sup>6</sup> <https://ibclaw.in/section-166-effect-of-order/>

<sup>7</sup> Vijay Singh, Directors 'Fiduciary Duties to the Company: A Comparative Study of the UK and Indian Companies Act, Oxford Trusts & Trustees (2021).

<sup>8</sup> <https://www.iima.ac.in/sites/default/files/rnpfiles/812680252021-08-02.pdf>

in the case of <sup>9</sup>*Sangramsinh P Gaekwad and Others v. Shantadevi P Gaekwad (Dead) through Legal Representatives and Others*, where the court observed that “the directors are under no fiduciary duty to shareholders, which clarifies that the directors cannot be ratified by the shareholders if they are protecting the interests of the creditors when the company is on the verge of insolvency

In <sup>10</sup>*Bank of Poona Limited v. Narayandas Shriman Somani*, the Court said that “the directors of a company have a peculiar position in the management of a company since it must act through others. They are treated as being in a fiduciary position and greatest good faith is expected in the discharge of their duties. This provision is enacted so that they would be prevented from acting in such a manner that duty and self-interest should conflict. This section would appear to be intended for the protection of the interests of the company and if that is so the contract could not be avoided by the defaulting director.” In short, good faith is expected in the discharge of their duties and the directors shall not use it for their personal gain. This case law could be directly interpreted with section 166 (2) of the Indian Companies Act, 2013 as it states the directors to act in the good faith of the company to which courts have interpreted to include creditors when insolvency is imminent.

### **Liability of directors during borderline insolvency**

The wrongful trading standards under **Section 66 of IBC** imputes liability upon directors during borderline insolvency if the director had knowledge (actual or constructive) of impending insolvency of the company. Further, when directors omission to avoid the impending insolvency and also exercise due diligence to minimise losses to creditors also constitutes ground to impute **Section 66 IBC** liability. The case laws are yet to develop on the effective interpretation of the phrase “ –standard of knowledge”; however, importantly the standard takes into consideration subjective factors based upon fact-by-fact analysis to impute liability. As, the terms “reasonable prospect of avoiding insolvency”, “due diligence” and “potential loss” are not defined within the IBC, it can result in interpretational problems among Courts, leading to increased transactional costs for the parties.

In addition to civil liability, the directors are also subjected to criminal penalties for defrauding the creditors both during insolvency and borderline insolvency. The concerned director of the company is subjected to imprisonment of maximum term of 5 years, and with a maximum fine

<sup>9</sup> <https://www.scconline.com/Members/BrowseResult.aspx>

<sup>10</sup> <https://indiankanoon.org/doc/865283/>

of Rs. 1 crore for defrauding creditors under **Section 69 of IBC. Section 337** of the companies Act, 2013 imposes penal liabilities on directors and other officers for certain fraudulent activities as the company nears insolvency, serving as a mechanism for retribution for actions detrimental to creditors and other stakeholders. This section ensures that directors are criminally accountable for their conduct, prescribing penalties including imprisonment, fines, or both, thereby deterring fraudulent activities during financially unstable periods.

**Section 286** targets former directors and managers who exited the company within one year before its insolvency, on the premise that their actions might have contributed to the company's financial decline. These individuals are treated as if they were members of an unlimited liability company, meaning they could be called upon to contribute to the company's assets to cover its debts as if the company had begun winding up the day they left their positions. This provision caps their liability to prevent unfair excess but ensures accountability for their actions during their tenure.

## CONCLUSION

There is not much legislations or litigations (case laws) available for directors to interpret their authority during the twilight zone of the company, However there is enough substance for the creditors to act in the best interest of the company and secure creditor rights during the twilight period as it can be interpreted from the above mentioned case laws of *Sangramsingh P Gaekwad and Others v. Shantadevi P Gaekwad (Dead) and Others & Bank of Poona Limited v. Narayandas Shriman Somani*.

However, there are also enough legislations that imputes liability upon the directors during borderline insolvency if the director had knowledge (actual or constructive) of impending insolvency of the company and did not exercise due diligence to minimise losses to creditors under section 66 of IBC.