

The Paradox of Directors' Duties Nearing Insolvency, in Indian Law

BY LAW SCHOOL POLICY REVIEW ON 17 JUL 2026

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Abstract: When a company slides near insolvency, Indian law places its directors at a statutorily conflicted position. Section 166 of the Companies Act, 2013 (“CA 2013”) codifies directorial duty to shareholder primacy and a loosely defined set of stakeholders, with creditors being absent from the list. While Section 66(2) of the Insolvency and Bankruptcy Code, 2016 (“IBC”) imposes personal liability for failures to protect creditor interests ex post facto, i.e. once insolvency proceedings have commenced. The paradox is therefore structural, since the sole creditor-protective provision is inaccessible during the very period in which protection is most required. This article argues that creditors must be expressly incorporated into Section 166(2). It further argues that when creditor interests are considered, balanced or treated as paramount, it must be left to judicial discretion on the factual matrix of each case, rather than being drawn by a single line.

I. INTRODUCTION

In [*Percival v. Wright*](#), Swinfen-Eady J held that duties of the directors run to the company as a separate legal entity, and not individually to their shareholders. Incidentally, in a solvent company, creditors are paid in the ordinary course, and the director who acts in the company’s best interests incidentally acts in creditors’ interests too. For most of the Indian corporate history, this remained the norm, from [*Nanalal Zaver v. Bombay Life Assurance Co. Ltd.*](#) through [*Sangramsinh P. Gaekwad v. Shantadevi P. Gaekwad*](#), with the Supreme Court consistently affirming that directors owe their fiduciary duties to the company rather than to individual shareholders; until [*Reliance Natural Resources Ltd. v. Reliance Industries Ltd.*](#), and the subsequent codification of director duties under [Section 166](#) of the CA 2013. The conflict emerges in what scholars have [termed](#) as the “twilight zone” of financial distress, the period preceding formal insolvency during which shareholder and creditor interests diverge. Owing to the known problem of risk-shifting in corporate finance, shareholders holding residual equity, whose claims are near worthless, may rationally prefer high-risk strategies, since the upside belongs to them, while the downside falls entirely on creditors whose fixed claims are already threatened. The directors in the middle must choose, and in Indian law, there is no operative

instruction for that [choice](#). The choice is invariably forced because the either path excludes the another. As preferring the shareholder's choice exposes creditors to a downside they never priced, but protecting creditors means going against the Section 166 mandate and leads to subordinating shareholder primacy. Section 166 offers no such guidance even in the event of a conflict between the interests of shareholders, consistent with the pluralist reading of the provision, which accords no stakeholder interest priority over another ([Naniwadekar and Varotttil](#)). Before attempting to resolve the issue, we first locate it, so the analysis begins with the legislative framework, where the conflict is actually written into statute, with the precise boundary between of the prospective duty and the retrospective sanction. Having framed the paradox, the conflict is a creature of statute, Part II begins where it is written, demarking Section 166 and Section 66(2) and delving to the precise point at which the prospective duty stops and the retrospective sanction begins. Part III then deals with how comparative jurisprudence has answered the same question, tracing the creditor-duty common law built from *Kinsela* to *Sequana*. Part IV turns to the United States' unique contractarian refusal to recognise such a duty and its application to Indian law. Part V returns home, confirming that no Indian authority yet fills the twilight-zone gap. Part VI offers a reform, making the case for writing creditors into Section 166(2) and for a threshold of protection calibrated by courts, case by case, rather than being fixed by a single line, before a brief conclusion to conclude the review.

Now the two distinct provisions that frame this choice are examined below.

II. THE LEGISLATIVE FRAMEWORK

Before examining them in detail, it is worth noting why creditors were left out of the prospective duty in the first place – Section 166 was drafted on the recommendations of the [J.J. Irani Expert Committee on Company Law](#) (May 2005) for a going-concern company with shareholders as the primary reference point. The stakeholder interests that did make it into the provision, i.e. employees, community, environment, reflect the Gandhian trusteeship theory that the [European Corporate Governance Institute](#) has noted as shaping the provision, alongside the Davos Manifesto's broader conception of corporate purpose. The CA 2013 was a statement of social aspiration and a legal instrument, alongside the mandatory CSR spending under [Section 135](#). Before 2013, directorial duties in India were almost entirely soft law or judge-made, inherited from English equity in the form of the “no conflict” and “no profit” rules. For creditors, as the implicit reasoning ran, did not require a directorial duty because they held the protection of contract.

A. SECTION 166, THE COMPANIES ACT, 2013

Naniwadekar and Varotttil treat Section 166 as an [Enlightened Shareholder Value \(“ESV”\) model](#), consistent with [Section 172\(1\)](#) of the UK Companies Act 2006, which directs directors to promote the success of the company with stakeholder interests considered instrumental to the said primary objective, and treats creditor interests as outside the zone of directorial concern except insofar as they affect shareholder returns. The provision connects its list with an “and” rather than a hierarchy, leading to stakeholder pluralism. Prior to the 2013 Act, India first departed from *Percival* through the Supreme Court's *obiter* in *Reliance Natural Resources Ltd.*, that directors “have a fiduciary responsibility to the shareholders”, a holding that conflated the company as legal entity with its shareholders as individuals. With the pluralistic reading, there remains a lack of guidance when stakeholder interests are to conflict. Both interpretations share the same problem, as there is no basis for a director in financial distress to prioritise or even consider creditors without risking a shareholder interest. Therefore, a director sensing distress conserves the assets to preserve the creditor pool acts today without any statutory requirement and exposes themselves to a challenge for departing from shareholder primacy – but as Subsection B shows, it is precisely this omission to protect creditors that [Section 66\(2\)](#) will later penalise once insolvency has set in. Meaning, the provision punishes the failure to do what the Companies Act gives directors no present authority to do.

B. SECTION 66(2), IBC

Section 66(2) of the IBC as earlier pointed to, threatens personal liability for failures to protect creditors, but comes to light only after CIRP has commenced and the twilight zone has ended. Meaning, the consequence precedes the framework. Modelled on [Section 214](#) of the UK Insolvency Act 1986, Section 66(2) of the IBC provides that a director is liable where they “knew or ought to have known that there was no reasonable prospect of avoiding the commencement of CIRP” and “did not exercise due diligence in minimising the

potential loss to creditors.” The Explanation clause codifies an objective standard, thereby producing a dual subjective/objective knowledge clause. The [Bankruptcy Law Reforms Committee Report of 2015](#), which furnished the rationale for this provision, identified that directors possessing knowledge of impending insolvency who fail to act on it should bear the consequences. The problem of Section 66(2) is that its retrospective by design, being present without the prospective creditor-duty framework that in the UK is present alongside it. The historical justification offered for such an omission is in the contractual protection in favour of the creditor, and the same is The Delaware Supreme Court in [NACEPF Inc. v. Gheewala](#) relied on this reasoning to reject creditor duties, and the argument that fiduciary duties would chill legitimate risk-taking by directors who might fear that any decision disadvantageous to a creditor could generate personal liability is not without force in that context. While it may carry force in the Delaware context, it is considerably less persuasive in the Indian framework, for reasons developed in the following section.

C. INADEQUACY OF THE CONTRACTUAL RATIONALE

The contractual rationale has plausibility for financial creditors who negotiate covenants, price insolvency risk into interest rates and extract security over company assets. The reasoning presupposes a creditor who is a veteran information-rich bargainer able to price and police insolvency risk before it materialises. On that premise a free-standing creditor duty is redundant at best and, at worst, possibly harmful on the very risk-taking that benefits the residual claimants. Transposed to India, the premise falls flat as the dominant creditor class is operational rather than financial, and it is precisely that class which cannot contract for protection; and the IBC’s own definitional distinction exists for it [[Section 5\(7\) and \(20\)-\(21\)](#)]. Operational creditors are suppliers of goods and services, employees, tax authorities and tort claimants do not negotiate insolvency covenants.

Further, the contractual self-protection argument assumes that creditors can adequately protect themselves through contract. Yet financial distress is precisely the circumstance in which contractual protections become most vulnerable to opportunistic conduct. A director has every incentive to undertake transactions that preserve technical contractual compliance while depleting enterprise value. This may occur through the prioritisation of bank debt containing cross-default clauses at the expense of operational creditors, or through the disposal of assets at undervalue to generate short-term liquidity. The IBC’s avoidance provisions under Sections 43-51 are precisely so, because contractual arrangements alone cannot prevent such destructive conduct. Those provisions, however, operate retrospectively, since they do not provide directors with *ante* guidance during the vicinity of insolvency.

Although, winding-up provisions in the range of Sections 271 to 347 of the CA 2013 contain several creditor-facing provisions that are worth mapping, because they demonstrate that the gap is specific to the pre-insolvency period rather than a wholesale legislative choice to ignore creditors. [Section 339](#) imposes personal liability for fraudulent conduct of business on any person who was knowingly party to such conduct during winding-up. [Section 340](#) allows tribunals to direct officers who have misapplied or retained company property to make restitution. [Section 347](#) provides criminal penalties for officers who conceal, destroy, or falsify company documents during liquidation. [Section 271](#) and [Section 272](#) define the circumstances for winding up by tribunal, and include both the cash-flow test (inability to pay debts as they fall due) and the balance-sheet test (liabilities exceeding assets). [Section 230](#) permits schemes of arrangement with creditors before insolvency proceedings. Therefore, the Companies Act does protect the creditors at the point of dissolution and through the mechanics of winding-up as well, yet the period of financial distress that precedes either of those formal triggers remains unprotected. This unprotected interval is where other common law jurisdictions have judicially developed an authority, that the analysis now turns to.

III. COMMON LAW’S POSITION

From its Australian origin in *Kinsela*, through its English adoption, the intent is to settle what the common law decided prior turning to what India should adopt. Subsection A traces the duty’s origin, and the consolidation across *Kinsela*, its English adoption in *West Mercia* and its extension to borderline insolvency in *Colin Gwyer*; Subsection B takes up the most recent and authoritative English law position in *BTI v. Sequana*.

A. KINSELA TO COLIN GWYER

The creditor duty originates in Street CJ's analysis in the Australian case [*Kinsela v. Russell Kinsela Pty Ltd.*](#), where a company in severe financial difficulty had executed a lease in favour of its directors, benefiting them at creditors' expense. Street CJ articulated the principle that in a solvent company, shareholders are the residual claimants and the company's interests are equivalent to theirs, and where the company is insolvent, the interests of creditors intrude because, through the mechanism of liquidation, they become the prospective owners of the company's assets. English law adopted this reasoning in [*West Mercia Safetywear Ltd. v. Dodd*](#), where Dillon LJ endorsed *Kinsela* wholesale, confirming the creditor duty in English law. In 2002, [*Colin Gwyer & Associates Ltd. v. London Wharf \(Limehouse\) Ltd.*](#) then extended the analysis to borderline insolvency, confirming that the duty engages before the company has technically crossed the insolvency threshold.

B. BTI V. SEQUANA

The UK Supreme Court's decision in [*BTI 2014 LLC v. Sequana SA*](#) is the most recent authoritative treatment of creditor duty, and one that is also often miscited. For a brief of facts: AWA, wholly owned by Sequana SA, had ceased trading but carried large contingent environmental liabilities. In May 2009, AWA's directors declared a €135 million dividend to Sequana. AWA was solvent on both balance-sheet and cash-flow tests at that moment; the risk of insolvency was real but not more probable than not. AWA entered insolvent administration in 2018. BTI, as assignee of AWA's claims, sued the directors for breach of creditor duty.

The Supreme Court unanimously dismissed the appeal. The duty of insolvency being a real risk had not been triggered in May 2009. Lord Reed's leading judgment at [77] confirmed the framework that, when the company is solvent, the duty to act in the interests of the company is equivalent to a duty to act in the interests of shareholders, and when the company is insolvent, bordering on insolvency, or when insolvency is inevitable – creditor interests progressively engage, when insolvency is inevitable – creditor interests become paramount and shareholder interests recede.

The graduated sliding scale described in Lady Arden's judgment at [303] of the creditor interests to be balanced at intermediate stages and treated as paramount when insolvency is inevitable, is *obiter*. This point is overlooked in much of the publicly available literature discussing this topic. The subsequent decisions in [*Hunt v. Singh*](#), added a knowledge gateway requiring actual or constructive awareness of insolvency before the duty engages, and [*Re BHS Group Limited*](#), which ordered £110 million in equitable compensation against directors who traded without adequate regard to creditor interests, confirm that the *Sequana* framework is judicially administrable. Thereby, it is a principle that can be calibrated to facts. The contrasting position now comes from the jurisdiction that consciously declined to adopt it, to which the analysis now turns.

IV. US'S POSITION

The Delaware's position in *Gheewala* held that directors owe fiduciary duties to the corporation and its shareholders, alongside a deliberate refusal to extend directorial duties to creditors even as the company approaches insolvency. Delaware's contractarian logic has genuine force in its own market, owing to the institutional lenders and bondholders of a Delaware corporation typically do negotiate covenants and monitor compliance through information rights. It has no force for the creditor class that constitutes the most significant constituency in Indian insolvency.

In [*Essar Steel India Ltd v. Satish Kumar Gupta*](#), the Supreme Court of India confirmed the Committee of Creditors' supremacy during CIRP and the primacy of commercial wisdom in the resolution process. [Section 53](#)'s waterfall prioritises secured financial creditors over shareholders. If Indian insolvency law is creditor-centric from CIRP commencement onwards, a shareholder-primary regime during the twilight zone is a regime that protects shareholders until they stop mattering and protects creditors once they start controlling. Operational creditors who are accruing losses in real time as the company is the something intended to be pressed on through this review. Whether Indian law has correctly answered that question, or merely evaded it, is examined in the next Part.

V. INDIA'S POSITION

No reported Indian decision has squarely addressed the twilight-zone duty question. NCLT and NCLAT jurisprudence under Section 66(2) has not developed a coherent framework for twilight-zone conduct. Tribunals have focused on the mechanics of the Resolution Professional's application, the computation of contribution and the distinction between intentional and negligent conduct. In [*Nandkishor Vishnupant Deshpande v. Worldwide Online Services Pvt. Ltd.*](#), the tribunal confirmed that Section 66(1)'s fraudulent trading provision does not require *mens rea* from outsiders who merely benefit from the fraud, but the subjective/objective dual standard in Section 66(2) has not been developed into a test that guides directors in real time. With neither the CA 2013, nor case laws having developed to fill the twilight-zone gap, the review now turns to what could be done about it.

VI. PROSPECTIVE REFORMS

A. THE CASE FOR INCLUDING CREDITORS

The objections to adding creditors to Section 166(2) have been addressed in Parts II and IV. What remains is to specify what inclusion would actually do, because the mechanism matters as much as the outcome. As Mohnot and Merchant wrote, inclusion in Section 166(2) [does not confer](#) standing to sue. Stakeholders already listed have no justiciable right to enforce directorial duties toward them; their presence in the provision operates as a constraint on directors and not a cause of action, unless gone through a class action lawsuit ([Section 245](#), CA 2013). Adding creditors would work identically. The practical consequence is that a director in financial distress who curtails dividends, declines to incur obligations the company cannot service or halts value-depleting transactions in order to preserve the creditor pool would have statutory authority for those decisions. Currently, any such decision is exposed to shareholder challenge as a departure from Section 166(2)'s existing orientation.

B. WHY THE THRESHOLD MUST NOT BE FIXED

The tougher question is addressed in Section 214 of the UK Insolvency Act 1986, adjudicated in *Sequana*, and central to any Indian reform is: at what point, and to what degree, do creditor interests enter the directorial calculus?

The cash-flow test of whether the company is paying its creditors on time, is superior to the balance-sheet test. It is considerably harder to manipulate than balance-sheet valuations of contingent assets and deferred liabilities, and both tests are already embedded in the IBC's definitional provisions at [Sections 3\(12\)](#), [3\(13\)\(e\)](#) and [55\(aa\)](#). This is because balance-sheet solvency can fall back to judgement-laden inputs, such as the carrying value of goodwill or related-party assets; each of which management can defer, re-estimate or revalue to keep reported net worth positive, as the inflated asset books that preceded the IL&FS and Bhushan Steel collapsed illustrate. Whereas a missed payment to a supplier, lender or tax authority, by contrast, is an externally observable event fixed by a date and an amount, therefore far harder to dress up a cheque that has bounced than a valuation that has not yet been tested. The cash-flow trigger therefore both resists manipulation and signals distress at a point when directorial intervention can still preserve value. The cash-flow test should therefore serve as the primary trigger. Although till a certain degree, no formula can truly capture all the variety of directorial conduct that the twilight zone encompasses, be it the severity of distress or the likelihood of recovery.

This is what Lady Arden's sliding scale in *Sequana* at [303] was attempting to address. Its *obiter* character makes it a calibratory principle, rather than a binding formula. The "reasonably competent person" standard already present in Section 66(2)'s Explanation clause and the care, skill, and diligence standard in Section 166(3) provide the normative infrastructure for this assessment. They require only connection to a positive, real-time duty rather than confinement to retrospective liability.

VII. CONCLUSION

The appropriate recommendation is therefore two-folded. First, creditors should be added to Section 166(2), whether by legislative amendment, which is the clean solution, or by judicial reading that draws on the

company's separate legal personality, the entity-primary baseline of *Percival* and [Dale & Carrington](#), and the IBC's creditor-centric post-insolvency architecture. Second, the content of the duty of when creditor interests must be considered, balanced, or treated as paramount, must be left to courts to calibrate on the factual matrix of each case, with *Sequana* as persuasive authority for the threshold of imminent or bordering-on insolvency, known or ought to have been known, as the operative baseline.

This is not meant to draw a test, rather a grant of judicial discretion, anchored in an existing body of common law authority that Indian courts are constitutionally competent to apply. The [Bhushan Power & Steel](#) and countless other litigations show the consequence of the alternative, where directors without guidance are not incentivised to alter their conduct until formal insolvency becomes unavoidable, by which point the losses that could have been mitigated have already been imposed on creditors who had no mechanism to compel or even observe the choices being made.

Note: This formulation is intended primarily as a theoretical framework, and does not purport to address the practical institutional constraints associated with insolvency adjudication in India, including judicial backlog, pendency and enforcement inefficiencies.

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