
INDEPENDENT DIRECTOR ACCOUNTABILITY IN THE TWILIGHT ZONE OF INSOLVENCY: LIABILITY TOWARDS SUBSIDIARY CREDITORS AND STAKEHOLDER PROTECTION FRAMEWORK

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ABSTRACT

The twilight zone of insolvency presents a complex regulatory challenge as companies operate on the brink of financial collapse while maintaining technical solvency. During this precarious period, independent directors of parent companies face unprecedented dilemmas when evaluating related party loan approvals to financially distressed subsidiaries. The existing protection under Section 149(12) of the Companies Act 2013, which shields independent directors from liability unless actual knowledge of misconduct can be demonstrated, creates significant gaps in accountability when subsidiary creditors suffer substantial losses.

This research addresses two fundamental questions that emerge from the intersection of corporate governance and insolvency law. The primary inquiry examines whether independent directors of parent companies can be held liable to subsidiary creditors during the twilight zone when they approve material-related party transactions without conducting adequate financial health assessments. Although subsidiary creditors suffer direct effects from insufficient director monitoring, the analysis shows that present legal frameworks do not clearly define culpability paths, leaving them without effective remedy. The secondary research topic investigates whether extensive reform of current liability frameworks is necessary to improve protection for various company stakeholders during financial hardship. The analysis demonstrates that traditional shareholder-centric governance models become inadequate when companies operate in the twilight zone, necessitating expanded duties toward creditors, employees, and other affected parties.

The study proposes a graduated liability framework designed for the Twilight Zone period. Under this framework, independent directors who authorize loans to subsidiaries from significantly linked parties without adhering to the required due diligence criteria are subject to direct accountability. At the same time, the proposed method encourages thorough thinking rather than risk-averse decision-making by providing critical protections for directors

who follow tougher procedural criteria.

The research bridges traditional director responsibility concepts with corporate group structures' specific issues during financial hardship, contributing to corporate governance literature. The results suggest that regulatory change should focus on fair accountability mechanisms that protect stakeholder interests while preserving independent directors' independence and corporate governance knowledge.

Keywords: Twilight zone insolvency, Independent director liability, Subsidiary creditor protection, Corporate group governance, Section 149(12) reform, Stakeholder accountability, Financial distress management.

1. Introduction

1.1 The Twilight Zone Challenge in Corporate Groups

In times of great financial difficulty, organizations on the verge of bankruptcy must adapt to new governance rules. This may necessitate the appointment of independent directors to act as impartial stewards, balancing the traditional emphasis on shareholder interests with the expanding ambitions of creditors, employees, and other stakeholders. This move enables a broader approach to decision-making, promoting stability and justice amid volatile financial crises. Parent company independent directors considerably affect subsidiary viability by approving or rejecting inter-company loans, guarantees, and other financial assistance measures. Their judgments during the twilight zone can influence whether subsidiaries survive financial troubles or fail, which directly impacts subsidiary creditors, who frequently lack direct recourse to parent company decision-makers. Independent directors of parent companies possess significant influence over subsidiary survival through their approval or rejection of inter-company loans, guarantees, and other financial support mechanisms. Their decisions during the twilight zone can determine whether subsidiaries survive financial difficulties or collapse, directly impacting subsidiary creditors who often lack direct recourse against parent company decision-makers.

Section 149(12) of the Companies Act 2013 protects independent directors by requiring proof of actual knowledge before liability may be proven. While this protection is critical for regulatory reasons in typical corporate cases, it creates significant loopholes in the twilight zone, where director decisions have far-reaching consequences for many stakeholder groups. Independent directors can authorize significant related-party loans to financially troubled

subsidiaries while claiming Section 149(12) protection, thereby shielding themselves from liability to subsidiaries' creditors who incur direct losses.

1.2 Research Questions and Scope

This research addresses two interconnected questions that emerge from the intersection of corporate governance, insolvency law, and group liability principles:

Primary Research Question: Whether and to what extent can independent directors of parent companies be held liable toward subsidiary creditors during the twilight zone of insolvency when they approve material-related party transactions without conducting adequate due diligence regarding the subsidiary's financial condition?

Secondary Research Question: Should existing liability frameworks be reformed to create enhanced protection for various corporate stakeholders during the twilight zone, and how should such reformed liability structures be designed to balance director protection with stakeholder accountability?

The research includes an evaluation of existing statutory provisions, judicial interpretations, regulatory guidelines, and foreign comparative frameworks. The study focuses on related party loans and financial aid transactions that exceed materiality requirements, recognizing that smaller transactions may not warrant higher responsibility standards.

1.3 Methodology and Structure

This corporate arrangement can lead to disagreements when subsidiaries enter the twilight zone while parent firms remain financially sound. Autonomous directors frequently find themselves in a challenging balancing act. They are under growing pressure to reduce subsidiary losses, which might lead to conflicts with creditors seeking repayment and supporting failing subsidiaries. On the other hand, this risks worsening their financial situation and jeopardizing the organization's overall viability.

2. Theoretical Foundations of Twilight Zone Governance

2.1 Evolution of Director Duties During Financial Distress

By its smooth and guiding principles, traditional corporate law emphasizes directors'

unwavering duty to shareholders, fostering a sense of stability, promoting continuous growth, and establishing long-term trust in the business community. However, as corporations approach insolvency, the only focus on shareholder interests becomes problematic since shareholders, as residual claimants, have little holdings in troubled enterprises, whereas creditors are exposed to significant losses.

The Twilight Zone doctrine emerged from judicial recognition that director duties must evolve as companies approach insolvency. The Delaware Chancery Court's decision in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation* established that directors of corporations operating in the zone of insolvency owe duties to the corporate enterprise as a whole, including creditors, rather than exclusively to shareholders. This principle reflects the economic reality that creditors become the primary stakeholders with financial interests at risk when companies face potential insolvency.

The Twilight Zone idea covers the temporal gap between the start of financial trouble and official bankruptcy procedures. During this time, firms remain nominally solvent and operate under conventional corporate governance systems, but their economic situation raises risks for creditors and other stakeholders. Traditional director obligations centered on long-term shareholder value generation may conflict with short-term creditor protection requirements, resulting in governance quandaries that present legal frameworks that fail to resolve.

2.2 Corporate Group Dynamics and Stakeholder Complexity

Corporate groupings complicate Twilight Zone governance because parent corporations oversee subsidiary activities while keeping legal entities separate. Independent directors of parent firms significantly affect subsidiary survival due to their power over inter-company transactions. Yet, they are primarily responsible to parent company shareholders rather than subsidiary creditors.

This structural structure can lead to disputes when subsidiaries approach the twilight zone while parent corporations remain financially healthy. Autonomous directors usually find themselves caught in a tricky balancing act. They are under increased pressure to decrease subsidiary losses, which may result in clashes with creditors seeking repayment and supporting failing subsidiaries. On the other hand, they risk deteriorating their financial status and jeopardizing the organization's overall existence.

The challenge intensifies when considering the diverse stakeholder groups affected by independent director decisions during the Twilight Zone. Subsidiary creditors lack direct contractual relationships with parent company directors yet suffer direct consequences from related party transaction decisions. Parent company shareholders maintain traditional expectations of value maximization despite changed economic circumstances. Employees, suppliers, customers, and communities may face significant disruption if subsidiaries fail due to inadequate parent company support.

2.3 Limitations of Current Liability Frameworks

Section 149(12) of the Companies Act 2013 reflects legislative recognition that independent directors require protection from frivolous litigation to encourage qualified individuals to serve in independent director roles. The provision establishes that independent directors face liability only when acts of omission or commission occur with their knowledge, are attributable through board processes, and involve their consent, connivance, or lack of diligence.

While this protection serves essential policy objectives, it creates problematic gaps during the twilight zone when director decisions carry heightened consequences for multiple stakeholder groups. Proving actual knowledge becomes particularly challenging in related party transaction contexts where independent directors may deliberately avoid seeking detailed information about subsidiary financial conditions to maintain plausible deniability.

The current framework also fails to recognize the distinctive characteristics of Twilight Zone governance that justify enhanced director accountability. Unlike normal business circumstances, where director decisions primarily affect shareholders who voluntarily assume investment risks, Twilight Zone decisions directly impact creditors who enter contractual relationships based on different risk assessments and legal protections.

3. Current Legal Framework Analysis

3.1 Section 149(12): Statutory Interpretation and Judicial Application

Section 149(12) establishes a qualified immunity standard for independent directors, protecting them from liability unless specific conditions are met. The provision requires that acts of omission or commission occur "with their knowledge, attributable through Board processes, and with their consent or connivance or where they had not acted diligently."

Judicial interpretation has generally favored restrictive readings of adequate knowledge for liability purposes. Courts have distinguished between actual and constructive knowledge, requiring clear evidence that directors possessed specific information about problematic transactions rather than inferring knowledge from circumstances that should have prompted the inquiry.

The knowledge requirement creates challenges in related party transaction contexts where independent directors may receive limited information about subsidiary financial conditions. Management presentations frequently emphasize favorable features while downplaying financial issues, allowing boards to authorize large loans while making believable claims of ignorance about borrower misery.

The "attributable through Board processes" requirement adds another layer of complexity because it suggests that directors can only be held liable for matters formally considered through board procedures. This limitation may exclude liability for failures to seek information or conduct appropriate due diligence that should have been undertaken before board consideration.

3.2 Related Party Transaction Regulatory Framework

The Companies Act 2013, SEBI LODR Regulations, and many regulations and recommendations provide the regulatory framework that governs related party transactions. Section 188 mandates board permission for defined kinds of related party transactions that exceed predetermined levels, although SEBI regulations impose extra disclosure and approval obligations on listed businesses.

However, these frameworks primarily concern disclosure and procedural compliance rather than substantive evaluation requirements. Independent directors must approve related party transactions, but the law provides limited guidance regarding the depth of analysis required or the standards for evaluating transaction appropriateness.

The materiality thresholds established by regulations may not adequately reflect the significance of related party loans during the twilight zone when subsidiary survival depends on continued parent company support. A loan that appears immaterial relative to the parent

company's size may represent crucial support for a distressed subsidiary. However, regulatory frameworks treat it as a routine transaction requiring minimal scrutiny.

3.3 Creditor Protection Mechanisms and Limitations

Existing creditor protection mechanisms operate primarily through contractual arrangements, security interests, and insolvency law procedures. Creditors may negotiate loan covenants, cross-default clauses, and other contractual protections, but these mechanisms often prove inadequate when debtors enter the twilight zone.

Subsidiary creditors face particular challenges because their contractual relationships are with subsidiaries rather than parent companies, limiting their ability to control parent company decisions that affect subsidiary financial stability. They may lack information about parent company board deliberations regarding subsidiary support and have no direct recourse against parent company directors who make adverse decisions.

The fraudulent preference and undervalued transaction provisions in insolvency law provide some retrospective protection, but these mechanisms only become available after formal insolvency proceedings commence. During the twilight zone, creditors have limited ability to challenge related party transactions that deplete subsidiary assets or compromise subsidiary financial stability.

3.4 International Comparative Frameworks

United States jurisprudence provides significant insights through the development of the Twilight Zone doctrine in Delaware courts. The business judgment rule traditionally protects directors who make informed decisions in good faith, but this protection erodes when companies operate in the zone of insolvency. Delaware courts have established that directors must consider creditor interests alongside shareholder interests when companies face potential insolvency.

The United Kingdom approach through the Companies Act 2006 establishes specific duties of care, skill, and diligence that apply regardless of the company's financial condition. Section 214 of the Insolvency Act 1986 creates wrongful trading liability for directors who continue operating companies when insolvency becomes unavoidable. This framework provides clearer standards for director accountability during financial distress.

German corporate law addresses group liability through specific provisions recognizing economic integration despite legal entity separation. The Konzernrecht framework establishes enhanced duties for parent company directors regarding subsidiary operations, providing potential models for reform of Indian corporate group governance.

Australian corporation law includes specific provisions addressing director duties during financial distress, including insolvent trading prohibitions and safe harbor provisions for directors who seek professional advice. These mechanisms balance director protection with creditor rights more effectively than purely immunity-based approaches.

4. Case Study Analysis: Twilight Zone Failures

4.1 Case Study 1: Reliance Communications and Subsidiary Creditor Losses

Reliance Communications' corporate group collapse exemplifies twilight zone governance shortcomings. During 2017-2018, when group firms faced rising financial challenges, independent directors of the main company granted considerable inter-company loans to failing subsidiaries. Subsidiary creditors, including equipment suppliers and service providers, suffered significant losses when subsidiaries ultimately entered insolvency proceedings.

Independent directors claimed protection under Section 149(12), arguing they lacked knowledge of subsidiary financial deterioration and relied on management representations regarding loan necessity and repayment prospects. The case demonstrates how current liability frameworks allow directors to approve substantially related party transactions while avoiding accountability to affected creditors.

Analysis of board meeting minutes reveals that independent directors received limited financial information about subsidiary conditions before approving inter-company loans. Directors did not request detailed cash flow projections, debt analysis, or independent financial assessments before approving several hundred crores loans. This pattern of deliberate ignorance enabled directors to maintain plausible deniability while subsidiary creditors faced mounting losses.

4.2 Case Study 2: IL&FS Group and Stakeholder Impact

The IL&FS crisis shows systemic flaws in corporate governance throughout the Twilight Zone period. Independent directors from numerous group firms authorized complicated inter-

company transactions without properly controlling the group's financial soundness. The collapse impacted various parties, including institutional investors, private depositors, infrastructure project participants, and financial institution borrowers. Government intervention was required to prevent systemic harm, demonstrating the inadequacy of private governance systems in the face of large-scale corporate crises. Despite evidence of governance failings, independent directors of group businesses sought protection under existing liability restrictions.

The case highlights how present frameworks fail to address the systemic concerns created by huge business entities operating in the twilight zone. Traditional entity-specific director duties become insufficient when group-wide coordination is necessary to address financial distress effectively.

4.3 Case Study 3: Videocon Industries and Related Party Transaction Abuse

The Videocon Industries case reveals how related party transactions can be used to transfer value between group entities during financial distress, disadvantaging subsidiary creditors. Independent directors approved substantial loans between group companies while financial conditions deteriorated.

Investigation revealed that some related party loans lacked adequate documentation regarding repayment terms, security arrangements, or business justification. Independent directors approved transactions based on brief management presentations without conducting an independent analysis of borrower financial capacity.

The case demonstrates how present legal frameworks enable boards to authorise potentially harmful transactions while claiming exemption from accountability to harmed creditors. Despite being directly affected by weak director monitoring, subsidiary creditors had no meaningful redress.

5. Proposed Reform Framework

5.1 Graduated Liability Structure for Twilight Zone Governance

The paper proposes establishing a tiered responsibility framework that identifies the Twilight Zone as a distinct governance age requiring heightened director accountability. This framework

will be implemented by making relevant changes to Section 149(12) and related provisions. The study suggests creating a graded liability structure that recognizes the Twilight Zone as a separate governance era that necessitates increased director accountability. This framework will be implemented by appropriate adjustments to Section 149(12) and associated sections.

Tier 1: Enhanced Due Diligence Requirements Independent directors approving related party transactions above Rs. 10 crores involving subsidiaries showing financial distress indicators would face mandatory due diligence requirements. These requirements would include reviewing subsidiary financial statements, cash flow analysis, debt service capacity assessment, and independent valuation of transaction terms.

Tier 2: Automatic Liability for Gross Negligence Directors who approve substantial related party transactions without meeting prescribed due diligence standards would face automatic liability to subsidiary creditors regardless of actual knowledge claims. This tier would apply to transactions above Rs. 25 crores involving subsidiaries with negative net worth or debt service coverage ratios below specified thresholds.

Tier 3: Safe Harbor Protection Directors who comply with enhanced due diligence requirements and document their analysis would receive strengthened protection from liability claims. Directors who comply with expanded due diligence standards and document their research will be more safeguarded against liability claims. This safe harbor would encourage extensive examination rather than risk-averse decision-making.

5.2 Financial Distress Indicators and Trigger Mechanisms

The proposed framework requires clear identification of circumstances triggering enhanced director duties. Financial distress indicators include debt-to-equity ratios exceeding specified levels, negative operating cash flows, debt service coverage ratios below minimum thresholds, and auditor-going concern qualifications.

Trigger mechanisms would operate automatically when subsidiaries meet specified criteria, eliminating director discretion regarding whether enhanced duties apply. This approach prevents directors from avoiding enhanced accountability through the selective application of definitions of financial distress.

The framework would establish quarterly assessments of subsidiary financial conditions with

mandatory disclosure when distress indicators are present. Independent directors would get specialized training on twilight zone governance obligations and accessible analytical tools.

5.3 Stakeholder Protection Mechanisms

Beyond director liability, the proposed framework includes complementary stakeholder protection mechanisms. Subsidiary creditors would receive enhanced disclosure rights regarding parent company board decisions affecting subsidiary operations. Creditor committees could request independent financial analysis of proposed related party transactions above specified thresholds.

Employee protection would operate through mandatory consultation requirements before substantially related party transactions that could affect subsidiary employment levels. Environmental and social impact assessments would be required for transactions affecting subsidiaries with significant community presence.

The framework would establish specialized tribunals with expertise in corporate group governance and insolvency matters to adjudicate disputes arising from twilight zone governance decisions. These tribunals would operate with expedited procedures recognizing the time-sensitive nature of financial distress situations.

5.4 Implementation and Transition Considerations

Implementation would be phased in over eighteen months, allowing corporations to change governance practices and train directors on new obligations. The framework would initially apply to listed corporations and large private enterprises that satisfy specific conditions. Transition provisions would insulate directors from retrospective liability and promote the speedy implementation of increased governance measures. Professional development programs would be designed to provide directors with the skills required for effective Twilight Zone governance.

6. Conclusion

6.1 Research Findings Summary

This study reveals that present legal frameworks fail to handle the unique issues of independent

director responsibility in the twilight zone of insolvency, notably duty to subsidiary creditors. The study shows a few key facts-

Primary Research Question Response: Independent directors of parent companies currently face minimal liability to subsidiary creditors during the twilight zone due to the restrictive interpretation of Section 149(12) and the absence of direct duty relationships. The actual knowledge requirement enables directors to approve substantially related party transactions while claiming ignorance of subsidiary financial distress, leaving creditors without effective recourse.

Secondary Research Question Response: Existing liability frameworks require comprehensive reform to adequately address twilight zone governance challenges. The current shareholder-centric model becomes inappropriate when companies operate near insolvency, necessitating expanded duties toward creditors and other stakeholders who face direct consequences from director decisions.

The study concludes that the twilight zone is a separate governance phase in which classic corporation law concepts clash with rising insolvency concerns. Current frameworks do not give sufficient advice for directors negotiating competing stakeholder interests amid financial hardship.

6.2 Policy Implications and Recommendations

The findings suggest several particular policy proposals for improving corporate governance in the Twilight Zone:

Immediate Reforms:

Amendment of Section 149(12) to establish specific exceptions for related party transactions during financial distress.

Introduction of mandatory due diligence standards for material inter-company transactions involving distressed subsidiaries.

Creation of safe harbor provisions protecting directors who comply with enhanced procedural requirements.

Medium-term Developments:

Establishment of specialized governance standards for corporate groups operating in financial distress.

Development of professional competency requirements for independent directors serving distressed companies.

Introduction of stakeholder consultation mechanisms for material-related party transactions.

Long-term Structural Changes:

Integration of corporate governance and insolvency law frameworks to address twilight zone governance comprehensively.

Development of group-wide governance standards recognizing economic integration despite legal entity separation.

Creating specialized judicial instruments to resolve twilight zone governance disputes.

6.3 Contribution to Academic Literature

This research contributes to corporate governance scholarship by bridging the gap between traditional director liability principles and the emerging challenges of twilight zone governance in corporate groups. The work provides the first comprehensive analysis of independent director liability to subsidiary creditors during financial distress under Indian corporate law.

The proposed graded responsibility structure uniquely balances director protection and stakeholder accountability in the Twilight Zone. This work goes beyond Indian corporation law and offers insights for other jurisdictions dealing with comparable governance difficulties.

The research technique combines doctrinal analysis with empirical case study evaluation and creates a reproducible framework for analyzing corporate governance difficulties in various settings. The comparative research provides insights into worldwide best practices that might guide future reform initiatives.

6.4 Areas for Future Research

Several areas emerge for future research development:

Empirical Studies: Quantitative analysis of twilight zone governance outcomes across different corporate group structures and regulatory environments would provide additional validation for the proposed reforms.

Comparative Analysis: A thorough assessment of how other countries handle business group governance amid financial hardship may provide further reform opportunities.

Stakeholder Impact Assessment: Research exploring the diverse effects of twilight zone governance failures on different stakeholder groups might help policymakers build more nuanced policies.

Implementation Studies: Analysing corporate governance reform implementation in different situations may give insights into the effective application of twilight zone governance norms.

The research establishes a foundation for continued scholarly and policy development regarding one of the most challenging aspects of contemporary corporate governance: ensuring accountability during the critical period when companies transition from financial stability toward potential insolvency.