

IBC AND MSME INSOLVENCY

Since the majority of MSMEs facing insolvency are more likely to liquidate and not go into reorganization/restructuring (by virtue of their size), frameworks should not only focus on reorganization/restructuring, but also on expeditious liquidation mechanisms

The government is in the process of finalising regulations for fast track resolution under the Insolvency and Bankruptcy Code 2016 (IBC). The draft regulations placed in the public domain propose that the fast track process of insolvency resolution under IBC comprising 90 days will be available to small companies with paid up capital not exceeding INR 50 lakh or such higher amount as may be prescribed not exceeding INR 5 crore; or with turnover not exceeding INR 2 crore or such higher amount as may be prescribed but not exceeding INR 20 crore. A holding company or a subsidiary company will not be able to avail the benefits of the fast track process. The benefits of fast track will also be available to start-ups up to five years from the date of incorporation if their turnover does not exceed INR 20 crore in any financial year, and they are working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property.

While making the fast track resolution process available to small companies and start-ups is a welcome move, the Indian micro, small and medium enterprises (MSMEs) sector will not benefit from these regulations. While the IBC and fast track regulations apply only to limited liability companies and limited liability partnerships, over 97 per cent Indian MSMEs are proprietorships or partnerships. Proprietorship is the most commonly adopted ownership structure (94.5 per cent of all MSMEs), primarily because this structure requires lower legal overheads. The other ownership structures adopted by enterprises include partnership and cooperative (1.2 per cent), private and public limited company (0.8 per cent) and other forms (3.5 per cent). Mature small, medium and new knowledge-based enterprises in the sector are mostly structured as private limited or public limited companies. But that number is nearly insignificant. In 2009-10, the Indian MSME sector was estimated to include 29.8 million enterprises, out of which 28 million are unregistered and only 1.8 million registered.



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MSMEs form the foundation of the Indian economy. They represent the majority of businesses and are key drivers of employment, economic growth, and entrepreneurship. The MSME sector is an important pillar of the Indian economy as it contributes greatly to growth of the Indian economy with a vast network of around 30 million units, creating employment for about 70 million, manufacturing more than 6,000 products, contributing about 45% to manufacturing output and about 40% of exports, directly and indirectly. This sector assumes even greater importance now as the country moves towards a faster and inclusive growth agenda. Moreover, it is the MSME sector, which can help realize the target of proposed Indian National Manufacturing Policy of raising the share of the manufacturing sector in GDP from around 16% at present to 25% by the end of 2022.

MSMEs vary in size and nature. The term "MSME" encompasses a wide-ranging spectrum of businesses. Most MSMEs fall into the "micro" category, which usually includes sole proprietorships and single-employee businesses. Small enterprises may have more than one owner and multiple employees but may have an informal business structure. Firms at the other end – labeled as "medium" enterprises – may be starkly different from their micro and small counterparts and have hundreds of employees. Yet they may not be corporatized. MSMEs, for a variety of reasons, forgo formal registration of their enterprise and operate without limited liability. This practice is seen around the world, but it is particularly common in developing economies. However, for many entrepreneurs and shareholders, the difference between an informal and formal corporate structure is limited – in many cases, MSME lenders require personal guarantees to secure loans, meaning the main advantage of a limited liability corporate structure is significantly reduced.

Although MSMEs contribute significantly to overall economy of the country, they face certain disadvantages,

some of the credit-related issues being: availability of adequate and timely credit; high cost of credit; collateral requirements; access to equity capital; and rehabilitation of distressed enterprises. MSMEs are exposed to acute difficulty of weathering macroeconomic and financial shocks. Furthermore, they may lack the sophistication or knowledge to properly address complex processes with limited resources. The combination of challenges that MSMEs face makes them prone to insolvency. Just as there are large numbers of MSMEs, there are large numbers of MSME insolvencies. But MSME insolvencies cannot be treated on par with corporate resolution. There remains a question of whether broad parameters for corporate insolvency systems, as reflected in international standards, can effectively respond to the needs of MSMEs. Nor do they typically fall under the rules of insolvency of natural persons.

MSME insolvency faces unique challenges and issues. Complex insolvency systems deter MSMEs from resorting to formal procedures to tackle financial distress. Unsophisticated MSMEs struggle to understand this complexity; thus discouraging timely use of insolvency by MSMEs. Creditors have few incentives to deal with MSME debtors through legal processes. Creditor passivity often arises when creditors weigh the amount they estimate they will receive from participating in the insolvency process against the amount of time and money this effort requires. If the costs outweigh the return, then creditors make the rational decision to not get involved. Secured creditors typically focus on enforcement of security at the first sign of financial distress and thus efficiencies may be lost. MSME debtors may lack good records and reliable financial information. This makes it harder to assess the viability of the MSME debtor and erodes creditor trust in the MSME debtor and the effectiveness of insolvency processes. Post-insolvency financing is hardly available. MSMEs rely on family and friends for help. MSMEs often lack the resources to cover the costs and fees for a formal insolvency procedure. MSMEs are often financed with a mixture of corporate debt and personal debt taken on by the entrepreneur (including potentially personal guarantees being granted). The failure of the MSME may thus have severe consequences for the entrepreneur and his/her family including social stigma.

Prior to entering an insolvency proceeding, many MSMEs are disadvantaged because they lack the sophistication to identify and react to financial distress. This may result in MSMEs waiting too long before initiating the insolvency process. This problem is particularly acute for MSMEs given the limited incentives they have for starting a complex and burdensome proceeding, often without an effective business rescue framework, as is the case in many of the insolvency processes around the world. Also, the social barriers and reputational stigma associated with the insolvency system may discourage MSME representatives from resorting to formal insolvency proceedings.

The insolvency process itself can be difficult for MSMEs. Of particular concern is the complexity and length of typical

insolvency processes. Smaller MSMEs may lack funds to cover the expenses of an insolvency process or fail to generate an expectation for unsecured creditors to receive any returns. Therefore, while insolvency laws require that creditors prove their claims, monitor the company either individually or via a creditors' committee, vote on restructuring proposals, etc., there are very limited incentives for creditors to actively participate in the process. Finally, as mentioned earlier, MSMEs usually have more acute issues in obtaining finance during restructuring even if it is viable.

Another particular issue that arises for MSME insolvency is the overlap and conflicts between regimes for insolvency of businesses and regimes for insolvency of natural persons. Whereas one of the main purposes of a business insolvency regime is to ensure the orderly resolution of debt and distribution of value to creditors whenever the business is unviable (frequently involving the dissolution of the debtor company), the purpose of a personal insolvency regime is to couple, and also balance the distribution of value to creditors with a basis for the debtor to continue his/her economic life (since, once the insolvency process for a natural person is concluded, the debtor will usually still be in existence). The nature of many MSMEs, particularly micro-businesses, is such that a clear distinction between the business and the persons operating it does not always exist and it is not clear which insolvency regime (business or personal) is better suited to apply to MSMEs. A MSME may be incorporated as a corporate entity or unincorporated; from a legal standpoint, this has several consequences for the limitation of liability and applicability of a personal or corporate insolvency law regime to the business, depending on each country's legislation.

Countries have adopted different approaches toward the issue of MSME insolvency. Many countries treat MSME insolvency with the same general procedures applicable to large corporations or conversely, natural persons. Some other countries have tried to address the needs of MSME insolvency by tailoring their insolvency laws. They have done this by shortening timelines for MSMEs, or eliminating certain formalities from "standard" insolvency law. Other countries have implemented tailored procedures that are specific to MSMEs, or provided some degree of procedural unification for personal guarantors and companies undergoing connected insolvencies. What these country experiences show is that there are typically two ways in which MSME insolvency is being addressed – either by making slight modifications or allowing exemptions from certain requirements to the existing provisions in the insolvency legislation, or by drafting entirely new provisions that target MSMEs, such as in the cases of Japan and Korea.

Effective insolvency regimes, if properly implemented, may mitigate many of the challenges facing MSMEs. They are amongst the most powerful engines of growth of the Indian economy. MSMEs are also effective vehicles for employment generation. India's cities have been experiencing the burden

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of a consistently growing population, comprising an ever-increasing proportion of migrants in search of employment and livelihood. City infrastructure is already stretched, and policy makers are seeking solutions to mitigate issues arising from migrant population growth. Rural MSMEs and those based outside of large cities, offer a viable alternative for employment to local labor, hence presenting an opportunity for people to participate in productive, non-farm activities, without needing to migrate to urban areas. With adequate financial and non-financial resources, as well as capacity building, the MSME sector can grow and contribute to economic development considerably higher than it is doing currently. It is important to support them by providing a simpler mechanism for their resolution and liquidation in the event of distress. Having an efficient, expeditious insolvency system in place that rescues MSMEs or swiftly reallocates their productive assets to more efficient activities is paramount.

However, this does not suggest that a separate law is needed for them. A separate set of regulations to deal with insolvency of MSMEs is needed. In its Report on the Treatment of MSME Insolvency released recently, the World Bank recommends that due to the lack of sophistication on the part of MSMEs, they need out-of-court assistance such as mediation, debt counselling, financial education, or the appointment of a trustee. Since the majority of MSMEs facing insolvency are more likely to liquidate and not go into reorganization/restructuring (by virtue of their size), frameworks should not only focus on reorganization/restructuring, but also on expeditious liquidation mechanisms. The Indian government should develop regulations that are at the intersection of personal insolvency frameworks and corporate insolvency.



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