FISME's submission in Sub-group on Insolvency and exit
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Exit and Closure for MSMEs:
Need for Modern Codes for Insolvency and Bankruptcy Mechanism

Introduction

Temporary stresses and also eventual closure in many cases are inevitable in business. In fact with intense global competition, risks associated with business are greater than ever before. It is critical to have an effective and fair mechanism to deal with untoward business eventualities such as failure, sickness, closure and like.

When a business fails there are chiefly three types of creditors whose liabilities need to be settled:

a. Statutory dues (liabilities towards authorities of Central and State taxation; labour, electricity, water, State Financial Corporations etc.)
b. Liabilities towards Banks and Financial Institutions
c. Liabilities to sundry creditors (buyers, suppliers and others)

With regards to statutory dues, respective Acts provide for appropriate legal recourse for recovering dues from individuals, firms or companies through prescription of fines, attachment of assets and also, in most cases, imprisonment. The final recovery procedures, whether on behalf of central or state governments, are effected by state governments through their administrative machinery.

The banks and financial institutions also have several options for restructuring a stressed account and recovering their dues. There is State Level Inter-Institutional Committee (SLIC) route for revival or restructuring when more than one Financial Institutions are involved or 'One Time Settlement' (OTS) or restructuring of the Sick[1] as per RBI guidelines or finally recovery of dues through the DRT Act and the SARFAESI Act.

[1] *RBI (Master Circular July 2008) defines '**sickness'** as 'a unit is considered as sick when any of the borrower account of the unit remains substandard for more than 6 months or there is erosion in the*

Though, sundry creditors can file civil suites to recover their dues, most prefer out-of-court settlements through alternative mechanisms such as arbitration.

Current Problems

When under extended duress, a unit has to brave the actions born out of default on statutory dues on the one hand, pacify the bankers and financial institutions for not pressing for repayment or initiating legal course and mollify the buyers, suppliers and employees on the other hand. In the current dispensation, following problems are encountered:

1. Whereas a sick firm can apply for rehabilitation to the financial institutions, there is no protection available to the firm in the interim from other creditors and liabilities particularly statutory ones. All the while when the entrepreneur struggles to revive the unit or in process of getting himself declared insolvent, because of his inability to pay statutory taxes or settle liabilities, he could be sued, penalized under several regulations and imprisoned. Because of a lack of single institutional mechanism which could coordinate with these multiple agencies, most work at cross purpose.

2. Particularly bothersome are the procedures for recovery of statutory dues under archaic Land Revenue Acts of the States which are routinely employed to imprison entrepreneurs even while the process of the restructuring of the firm is underway. The problem with recovery as arrears of land revenue is the implicit scope for discretion. While the arrest and detention is prescribed as only one of the resorts, the provisions are greatly misused for hand-twisting and rent seeking. These laws are the single biggest cause of misery and hardship for entrepreneurs facing failure.

3. Because of absence of an effective institutional mechanism re-structuring or exit[2], they are classified as sick and are kept in state of 'suspended animation'. Given the

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net worth due to accumulated cash losses to the extent of 50% of its net worth during the previous accounting year and the unit has been in commercial production for at least two years'.
2 Globally, the right to 'exit' connotes the right of promoter to close or sell off a business after settling his liabilities without jeopardizing his future prospects. In India 'exit' is generally understood in a narrow perspective: a right sought by large corporate sector for closure of business without mandatory approval from Government beyond a certain limit of number of employees. The paper uses the former definition of exit.

conditions, it is no surprise that the Small Scale Sector suffers from the huge backlog of sick units. As on March 2007, the number of sick units is 1,14,132 (Working Group on Rehabilitation of sick SMEs, 2008, RBI). A recent report of 'Working Group on Rehabilitation of Sick SMEs' (RBI, 2007) highlights the shortcomings of the current dispensation succinctly. It states: "..the normal action plan of any banker when a small unit is in stress is to stop operations in the account, serve a recall notice and initiate action under SARFAESI Act. Efforts for rehabilitation, if any, are ad hoc and not properly structured after viability study or analysis of the root causes of sickness etc. The bank staff puts in efforts to avoid classification of the account as NPA. All focus of the banks is centered on the asset classification and not health classification".

4. Theoretically, the legal remedy to escape attachment of assets and accompanying imprisonment in the event of failure to pay the statutory dues, the entrepreneur could take shelter through insolvency under either the Presidency Town Insolvency Act, 1909, or the Provincial Town Insolvency Act, 1920, as the case may be. Practically, however, both the laws are entirely outdated and the route is all but dysfunctional (Annexure-A).

5. While a mechanism for State Level Inter-Institutional Committee (SLIIC) was set up for restructuring of sick MSMEs, its jurisdiction is limited to institutional credit only leaving aside restructuring of multi-agency statutory liabilities. There is no doubt that the mechanism is largely ineffective.

Therefore, while on one hand there is absence of bankruptcy law and specialist courts which can take up cases of stressed units and preside over restructuring or closure. On the other, insolvency laws meant to provide the dignified exit to entrepreneurs in case of failure is dysfunctional.

Other MSME specific issues in Exit and Closure

There are several MSME specific issues with regards to exit and closure.

1. With 97% of Small Enterprises being either proprietorship or partnership firms, neither the winding up provisions nor the benefit of limited liability under Companies Act are available for bulk of the sector. In practice, the liability of promoters is

unlimited not only in the case of firms but also in case of Companies as promoters are invariably made to sign up personal guarantees for loan applications as well as in tax related matters. Typically the recovery process under current dispensation entails arrest and detention of the person and attachment and sale of debtor's assets. Not only all personal belongings of debtor are attached and auctioned but also of all their guarantors.

2. Though the BIFR mechanism does not cover MSMEs, creation of such a mechanism for MSMEs alone will not serve much purpose because of two reasons. Firstly, the number of sick units is too large to be handled by BIFR type of body. Secondly, the size of the units in terms of capital employed- both human and material, does not warrant a top heavy and complex institutional set up but a lean and thin but geographically dispersed set up.

The way ahead

A fair and effective mechanism for insolvency and bankruptcy is considered a prerequisite for inducing risk taking and for enterprise creation in an economy. What is needed is the following:

a. Amendments in the Insolvency Acts of 1909 and 1920.
b. New legislation on bankruptcy incorporating MSME perspective
c. Setting up of specialized bankruptcy and insolvency courts (fast track) and a cadre of specialists providing a 'single window' to address all related issues: restructuring, liquidation, bankruptcy and insolvency.
d. Removal of clause of imprisonment and detention under Land Revenue Act

To operationalize the process, a high powered committee may be set up (on lines of the one recommending amendments in Companies Act) by Ministry of MSME or Ministry of Corporate Affairs.

Annexure-A

A Brief Note on Insolvency Mechanism in India

In the case of individuals there are two Insolvency Acts, one for the presidency towns -The presidency-Towns Insolvency Act, 1909 and other for the rest of the country-The Provincial Insolvency Act, 1920. Under the Insolvency Act of 1920 which is applicable throughout India except for the Presidency Townships, the jurisdiction of courts is significantly restricted. 'In fact court can admit insolvency proceedings which are a shade better than Roman laws[3]'. The conditions attached are almost impossible to meet and terms are hugely subjective[*]. Moreover, many of these conditions fall under criminal courts having their own timetable, independent of insolvency courts resulting in enormous delays.

Secondly, during the interim period when the insolvency petition is pending for disposal, there is no protection available against the proceedings for recovery initiated under different

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[3] An Economic and Legal Perspective, Prof. Bibek Debroy 2005

[*] Sec 41 of insolvency Act states that:

1. The Court shall refuse to grant an absolute order of discharge on proof of any of the following facts, namely:-
   (a) that the insolvent's assets are not of a value equal to eight annas in the rupee on the amount of his unsecured liabilities, unless he satisfies the Court that the fact that the assets are not of a value equal to eight annas in the rupee on the amount of his unsecured liabilities has arisen from circumstances for which he cannot justify be held responsible;
   (b) that the insolvent has omitted to keep such books of account as usual and proper in the business carried on by him and as sufficiently disclose his business transactions and financial position within the three years immediately preceding his insolvency;
   (c) that the insolvent has continued to trade after knowing himself to be insolvent;
   (d) that the insolvent has contracted any debt provable under this Act without having at the time of contracting it any reasonable or probable ground of expectation(the burden of proving which shall lie on him) that would be able to pay it;
   (e) that the insolvent has failed to account satisfactorily for any loss of assets or for any deficiency of assets to meet his liabilities;
   (f) that the insolvent has brought on, or contributed to, his insolvency by rash and hazardous speculations, or by unjustifiable extravagance in living, or by gambling, or by culpable neglect of his business affairs;
   (g) that the insolvent has, within three months preceding the date of the presentation of the petition, when unable to pay his debts as they become due, given an undue preference to any of his creditors ;
   (h) that the insolvent has on any previous occasion been adjudged an insolvent or made a composition or arrangement with his creditors;
   (i) that the insolvent has concealed or removed his property or any part thereof, or has been guilty of any other fraud or fraudulent breach of trust.

(1) For the purpose of this section, the report of the receiver shall be deemed to be evidence; and the Court may presume the correctness of any statement contained therein.

(2) The powers of suspending, and of attaching conditions to, an insolvent's discharge may be exercised concurrently."

Acts for recovery of statutory dues. There is no BIFR[†] type of mechanism for small enterprises. All the while when the entrepreneur struggles to revive the unit or in process of getting himself insolvent, because of his inability to pay statutory taxes or settle liabilities, he could be sued and penalized under several regulations (mentioned in previous section: creditors' options). Further, rules are such that under a single Act (for example of Provident Fund), multiple jail sentences could be secured under one case against the entrepreneur.

In brief, in current dispensation under the two Acts, there is no protection from 'criminal cases' and all personal belongings are attached and auctioned as economic offences are routinely defined as 'criminal' in Indian jurisprudence. The prevailing legal system does not recognize 'financial stress' that a unit may face. For example, when a unit is facing financial crisis, it is natural that it might default on post-dated cheques. In such an eventuality also, the default becomes a criminal offence punishable under Section 138 of the Negotiable Instruments Act (dishonour of cheque) with imprisonment. Similar is the case with provisions of Indian Contracts Act of 1872 and several other economic legislations.

Further, all guarantors and directors - which form the critical social safety net of the small entrepreneur, are involved and in the eventuality of failure they also get implicated and the whole safety net crumbles.

Finally, the cost of being labeled as 'insolvent' is extremely punitive in law[*] and annihilates all future prospects of an honorable living in the future. The entrepreneur delays and avoids this till the end.

[Excerpts from the FISME Policy Paper. 'Towards establishing modern insolvency and bankruptcy codes for small enterprises' 2008]

[†] Board for Industrial and Financial Reconstruction (BIFR), is the designated authority responsible for liquidation or restructuring of large and medium enterprises in India. It is governed by Sick Industrial Companies (Special Provisions) Act, 1985. Having failed to live up to its objective, the BIFR mechanism is set to be repealed and Company Law Board (CLB) is being prepared for taking over BIFR functions also.

[*] Position of not-discharged insolvent:

(1) A not discharged insolvent shall not remain a partner in any firm. (Section 34(1) Indian Partnership Act)
(2) A not discharged insolvent cannot become a director in any company. (Section 274(1)(b) Companies Act)
(3) A not discharged insolvent shall have no competence to contract.
(4) A not discharged insolvent shall have no right to any property or assets as the entire properties belonging to him vests in the Court. (Section 28(2) Insolvency Act)

Position of Discharged insolvent:

(1) A discharged insolvent is not discharged from any debt due to the Government. (Section 44(a))
(2) A discharged insolvent is discharged subject to the condition attached to his discharge. (Section 41(1)(c))