Report of the Sub-Group on Exit Policy for MSMEs

A Sub-Group on Exit Policy for MSMEs has been constituted, the composition and scope of work of which are enclosed at Annexure A

Issues

The Micro, Small & Medium enterprises represent entrepreneurial effort at individual level, and are often driven by innovation and creativity. Having limited access to capital and staying power, they are particularly vulnerable to business environment. Minor business disruptions can cause otherwise bright and innovative ideas to lose their bearings and be driven to insolvency. Therefore there is a need for insolvency of MSMEs to be dealt with in a manner that enable viable enterprises facing temporary credit disruptions to continue while allowing unviable entities to close down speedily, liberating various economic resources –financial or human for alternative deployment in the economy. This requires a comprehensive and sensitive treatment of insolvency of MSMEs

The micro, small and medium enterprises (MSME) sector constitutes an important segment of our national economy. The number of enterprises is estimated to be about 26 million, providing employment to an estimated 60 million persons. The MSME sector is estimated to contribute to about 45% of the total manufactured output and nearly 40% to India's exports.

An overwhelming majority of small businesses in India are either proprietorships or partnerships. According to the 4th Census of Micro Small and Medium Enterprises, this group constitutes more than 94% of all such units in India. Only 3% of the MSMEs are incorporated as Companies.

The MSME sector remains in a state of dynamic flux- with a large number of start-ups counterbalanced by a substantial number of exits. This is typical of entrepreneurial search for not only business viability but of activities that provide the most suitable outlet to talent. Therefore efficient exit is as important to this sector as easy entry.

Unlike limited liability entities, where the liability of the shareholder is limited to the extent of the contribution made or due from him, in proprietorships or partnerships there is no separation of personal and business liability. When a business fails, not only do the assets of the business

but the entrepreneur's personal assets also get attached to pay off business dues. Further, all guarantors which are drawn from the critical social safety net of the small entrepreneur, are also personally involved and in the eventuality of failure they also get implicated and the whole safety net crumbles.

Insolvency of corporate entities such as companies and LLPs is governed by the Companies Act, 1956, the Sick Industrial Companies (Special Powers) Act,1985 (SICA), SARFAESI Act 2002, the Limited Liability Partnerships Act 2008 etc. in these enactments avenues have been provided for revival and rehabilitation of companies or restructuring of the financial assets involved. Speedy recourse to secured lending is provided under the Recovery of Debts by Banks and Financial Institutions Act 1992. The corporate entities thus not only have a diversified legislative framework but this framework has continuously been reformed and developed. The latest instance being the winding Up Rules for LLP which have been placed in the parliament(for the mandatory period of 30 days) prior to notification and the comprehensive insolvency code included in the Companies Bill 2009 recently introduced in the Parliament. Insolvency in in proprietorship or partnership firms, on the other hand, is governed by the Provincial Insolvency Act 1920, which has largely remained static. Here the focus is not revival followed by structured exit in case of failure, but of recovery of outstanding dues through a court driven process. The relevant courts under the Act are District Courts which take their own time adjudicating the petitions and are apt to enforce the processes of seizing debtor estates, appointing receivers and punitive remedies against the debtor including imprisonment rather than enabling any revival or turnaround. Indeed adjudicatory order on an insolvency petition under this Act lays the entrepreneur open to action including arrest and detention in a civil prison as if business failure were a criminal Act. The provision for arrangements under this act are also aimed at composition of debt due rather than rehabilitation. During the interim period when the insolvency petition is pending for disposal, there is no absolute stay against the proceedings initiated under different Acts such as for recovery of statutory dues. An insolvent obtaining credit of more than 50 rupees from any person with out informing him that he is an undischarged insolvent lays himself open to imprisonment of upto six months. All the while when the entrepreneur struggles to revive the unit, he is confronted with considerable social stigma and could be sued and penalized under several regulations. If he is unable to settle or otherwise compound the debt, he continues to be

declared insolvent, significantly impairing his capacity to ever raise finance (or even seek employment in most cases) again.

Administrative mechanisms for revival exist for businesses availing bank loans, but only a very small percent of MSEs use bank finance and then too, these measures have not been very effective. When a business is in distress it has the option of trying for re-structuring of its debt; or enters a One Time Settlement (OTS) with the bank. RBI has also constituted Committees to review rehabilitation of SME units through State Level Inter Institutional Committees (SLIIC) comprising of banks, financial institutions, state government reps and industry associations.

These measures do not provide protection from statutory dues or other creditor action. For revival a distressed unit requires a 'holding off' or a "standstill" period where all creditor action is 'stayed' so that the unit and its stakeholders can focus on revival. Such revival has to be based on a statutory mechanism which is binding on all concerned stakeholders and agencies. Even as purely debt management measures, these mechanisms have not been very effective. No time frame is set either for rehabilitation or OTS while at this juncture time is of great essence; banks do not find most cases viable because proposals for revival are appraised by interested stakeholders (lending banks) leading to conflict of interest; entrepreneurs lack the skills and knowledge, or the financial resources required to prepare and execute viable plans. When cases are not found viable, banks take legal recourse for recovery of their dues through DRT and SARFESI Acts.

The experience of SLIIC mechanism has not been satisfactory, particularly because over a period of time it has become a statistical review committee rather than a committee which examines critically and enables rehabilitation. There is no scope for direct borrower interface with the monitoring process.

Some State governments have introduced their own schemes for revival of sick MSEs which provide for a single mechanism to deal with all creditors with support through government funding. Under the Small Scale Revival Scheme 2006 of the Government of Andhra Pradesh, potentially viable proposals are forwarded by the financing banks/institutions to the State Level Special Cells for concessional sanctions. The concessions provided by financing institutions and the Government departments are financed through a revival and rehabilitation Fund earmarked in the Budget. A State Level Committee headed by the Commissioner of Industries has been set up

for processing and extending relief and concessions as also to formally approve the recommendations of the Banks/Financial Institutions. The Fund is also kept at his disposal. The details of the scheme are enclosed at Annexure B.

This scheme too has not been successful as the lending banks being 'appraisers' and financiers focus on their own recoveries and not on revival.

International Practice :

In many countries reform has taken place that allows insolvency of businesses to be dealt with in a comprehensive manner that enables revival or rescue before liquidation and winding up. Insolvency is treated as a commercial phenomenon requiring to be dealt with in accordance with commercial principles in a framework of fairness and equity. There is an independent institutionalized process of providing a grace period for businesses to deal with distress. This is intended to enable a revival plan if the business is inherently viable, puts all creditors on hold pending revival, gets business out of holding period if it revives or takes action on winding up if the business is unrevivable. The entire process is completed in a time bound period of 12 – 24 months. Both personal as well as business insolvency are dealt with on the basis of similar principles with ease of filing for bankruptcy and securing of certain protection from creditor action once this is done. The system prevalent in the US is enclosed at Annexure C.

Recommendations :

In Process:

1. Recently the Limited Liability Partnership Act 2008 (LLP) has been enacted which provides for a flexible governance structure to be determined by the partners themselves by mutual agreement, easy compliance requirements in comparison to companies, combined with limitation of liability to the extent of the partners contribution. LLPS are also vested with separate corporate identity under the statute distinct from that of their partners and as such are subject to regulation by the central government under the Constitution. Under the Act, provision has been made for enabling schemes of revival as well as liquidation and winding up through rules to be notified as subordinate legislation. The necessary rules based on the best international

practices as brought by UNCITRAL have already been prepared and laid before the parliament for the mandatory period of 30 days after which they can be notified. The General rules already enacted under the LLP Act include provision for revival as a component of arrangements relating to LLPs. The entire framework is expected to be in place by January 2010. The LLP Act 2008, therefore, allows MSMEs an easy access to corporatisation and its attendant benefits of revival and exit.

2. The Ministry of Corporate Affairs has also introduced the companies Bill 2009 in the Parliament where it has been taken up by the Parliamentary Standing Committee for examination. The Companies Bill includes a provision for a one person company, a concept already in existence in many countries. This allows a single person, as a shareholder to set up a company with limited liability. This company would be subject to various compliance requirements under the Companies Act which would however be comparatively lighter since this entity with only one shareholder, need not implement and comply with detailed procedural requirements necessary to ensure participation by shareholders and for protection of their interests. This form provides a useful corporate alternative to the proprietor ship firm.

3. These are recent initiatives and would provide alternate corporate options to entrepreneurs. M/MSME and MCA may organize awareness campaigns across the country.

4. There is also a need to incentivise the non-corporate entities to convert to these forms. A graded corporate tax structure can be introduced with base rates lower than the income tax slab rates.

5. It may also be ensured that the registration and transaction costs for adopting the LLP or SPC mode are kept low.

Proposed :

Short term : Administrative Mechanism

1. For immediate relief to MSME units, an administrative mechanism may be put in place at the state and district level, to consider rehabilitation of units found to be unviable and hence rejected by the banks/financial institutions. The States may be required to formulate schemes on the pattern of Andhra Pradesh scheme, which lays down a rehabilitation package comprising of reliefs and concessions in taxes, energy, land charges and interest rebate to banks/ financial institutions.

   The scheme may be applicable to units permanently registered with Department of Industries. State level Committees may be set up with parallel formations at the district level. The State Level Committees may be headed by Commissioner of Industries and comprise of representative of concerned State Government Departments, banks, RBI and MSME-DI. Alternatively, the SLIIC can be strengthened with additional members from the State Government Departments. The committee will formally approve the recommendations of the district level committees as also process and extend reliefs and concessions. The district level committees will be convened by GM, DIC. The DICs will form the Secretariat for these committees and all applications will be received and monitored by them. A panel of Technical Officers/ Chartered Accountants will be drawn by the DICs who would help the entrepreneurs in preparing their rehabilitation plan.

   When a proposal is rejected by the Banks/ financial institutions, the entrepreneur may approach GM, DIC who will scrutinize the proposal in the light of the state scheme and help prepare a rehabilitation package to put before the District Level Committee. The District Level Committee may either recommend to the State Level Committee or reject it. The entire process will be completed within two months and during this period the bank dues will be put on 'hold'.

2. The central Government may set up a rehabilitation fund under the Ministry of MSME with a corpus of Rs.1000 crore, to provide bridge finance towards promoters' contribution in the approved package. The MoMSME may formulate an appropriate scheme to operate the fund.

3. Statutory dues: there should be an equal standstill period for statutory dues. State Governments may securitize these by one time payment at a discount to various bodies

and agencies such as state electricity utilities etc. and step into the shoes of such bodies with status of an unsecured creditor to the enterprise.

Long term measures : Personal Insolvency Code

Unlike corporate entities which are governed by the Companies Act, 1956 or the LLP Act 2008 – both central legislation, non-corporate entities are state subjects. The Provincial Insolvency Act 1920 enacted prior to independence has been retained as legislation amenable to state amendments. Thus any overhaul or changes in these acts would require consultation with states.

A revised and reformed insolvency code may have to be enacted to enable be set up for proprietorship and partnership firms, with 4 critical elements:

- An specialized quasi-judicial body, to appraise viability and set up time bound revival/ closure plans.
- enabling provisions for a holding period for revival.
- Segregation of business assets from personal assets based on reasonable norms
- Speedy winding up in case the business is determined as non-revivable.

The Ministry of MSME/ Ministry of Law may bring out a model Act for the states on the above lines and encourage the states to adopt the same through a suitable scheme of incentives.

Annexure A

Sub-Group on Exit Policy

Composition

(i)	Secretary, Ministry of Corporate Affairs	Chairman
(ii)	AS&DC (MSME)	Member
(iii)	Shri Anil Bhardwaj, FISME	Member
(iv)	Shri Vijay Kalantri, AIAI	Member

Shri Arun Maira, Member, Planning Commission would associate himself with the Sub-Group subject to his convenience.

Scope of Work :

(a) To examine the existing mechanism available to MSEs in respect of insolvency/ bankruptcy and exit;

(b) To study the best international practices in this context; and

(c) To recommend an institutional mechanism that provides for a stay on creditor action for a reasonable time to allow distressed company to revive before the court orders liquidation.

Annexure B

Andhra Pradesh Small Scale Revival Scheme 2006 – Revised Guidelines

The Scheme focuses on sick units that are considered potentially viable by the financing banks/institutions for feasibility of revival and rehabilitation. The State Level Special Cells considers the recommendations of the financial institutions for sanction of rehabilitation/revival packages as per guidelines. The scheme with a package involves part compensation of a few sacrifices by the financing institutions and the Government involved. For compensating sacrifices, the State Government has set up a revival and rehabilitation Fund [named as A.P. Small Scale Sick Industries Revival and Rehabilitation Fund (APSSSIRR Fund)] with an earmarked Fund in the Budget. The applicability of the scheme is to industrial units/ancillary units (except Rice Mills) permanently registered as micro and small enterprise (MSE) with Department of Industries. The relief and concessions provided under the Scheme are as under:

(i) Grant of permission to mortgage surplus land by exemption under section 20 of the Urban Land Ceiling Act in favour of banks/financial institutions;

(ii) Pro-active action by the Labour Department for amicable settlement of disputes between management and representatives of labour;

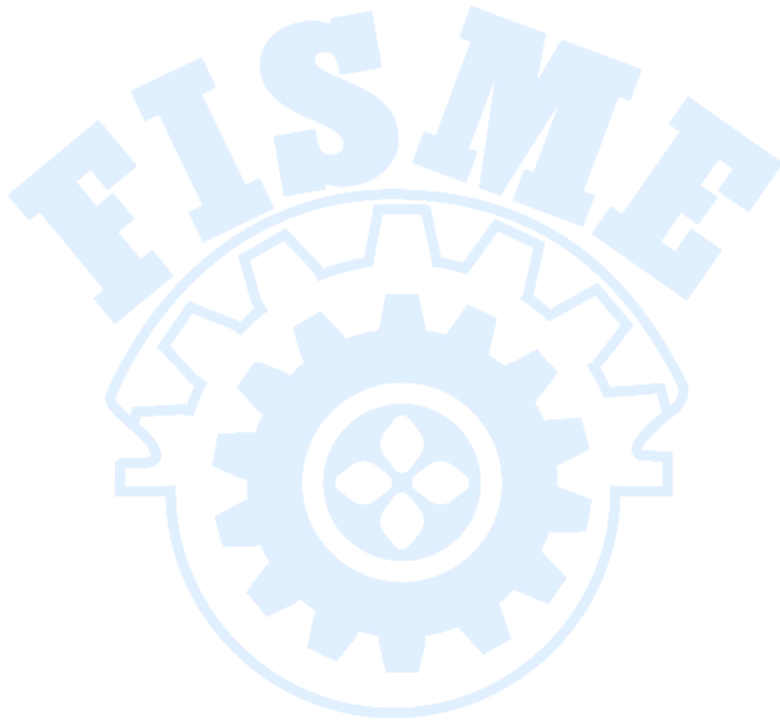
(iii) 6% interest subsidy to all identified/eligible sick units, subject to a maximum of Rs.2 lakh per year, for a maximum period of 3 years;

(iv) Deferment of arrears of payments of purchase tax, sales tax and interest towards non-payment of sales tax for 3 years from the date of grant of revival package; and

(v) Subsidy in dues of energy charges to the extent of 15% of interest charged from out of the percentage of the total interest charged, subject to a maximum of Rs.5 lakh or Rs.3 lakh (depending on the option availed for repayment of dues).

A State Level Committee headed by the Commissioner of Industries has been set up for processing and extending relief and concessions as also to formally approve the recommendations of the Banks/Financial Institutions. After approval by the State Level Rehabilitation Committee, APTRANSCO/DISCOM submits a report to the Commissioner of Industries on details of connection made, charges to be reimbursed by the Government and to be paid by the beneficiary. Based on the report, the Commissioner of Industries reimburses the eligible interest to APTRANSCO from the "APSSSIRR Fund" kept at his disposal. The

Commissioner of Industries also draws the eligible interest subsidy from “APSSSIRR Fund” and pays the same to the Bank/ Financial Institution concerned.



Annexure C

Bankruptcy Procedures of USA

Chapter 11 is a chapter of the United States Bankruptcy Code, which permits reorganization under the bankruptcy laws of the United States. Chapter 11 bankruptcy is available to every business, whether organized as a corporation or sole proprietorship, and to individuals, although it is most prominently used by corporate entities. In contrast, Chapter 7 governs the process of a liquidation bankruptcy. When a business is unable to service its debt or pay its creditors, the business or its creditors can file with a federal bankruptcy court for protection under either Chapter 7 or Chapter 11.

In chapter 7 the business ceases operations, a trustee sells all of its assets, and then distributes the proceeds to its creditors. Any residual amount is returned to the owners of the company. In Chapter 11, in most instances the

debtor remains in control of its business operations as a *debtor in possession*, and is subject to the oversight and jurisdiction of the court.

Debtors in Chapter 11 have the exclusive right to propose a plan of reorganization for a period of time (in most cases 120 days) which has to be approved by all creditors. Bankruptcy petitions filed under Chapter 11 invoke an automatic stay which requires all creditors to cease collection attempts, and makes post-petition debt collection void. If a plan cannot be confirmed, the court may either convert the case to a liquidation under Chapter 7, or if in the best interests of the creditors and the estate, the case may be dismissed resulting in a return to the status quo before bankruptcy. If the case is dismissed, creditors will look to non-bankruptcy law in order to satisfy their claims.