FISME POLICY PAPER

SME Policy Series

Towards Establishing Modern Insolvency and Bankruptcy Codes for Small Enterprises in India

by
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Issue 1 January 2009

Towards Establishing Modern Insolvency and Bankruptcy Codes for Small Enterprises in India*

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The author is indebted to Mr. Dinesh Singhal - a successful entrepreneur and past president of FISME, for his relentless efforts for keeping the issue of modern insolvency and bankruptcy codes a top priority in FISME. This paper draws liberally from the previous work of Prof. Bibek Debroy- noted economist, Dr. Laveesh Bhandari and Mr. Piyush Bajpayee of Indicus Analytics on exit problems faced by small industries in India. The policy options and recommendations parts of the paper are largely based on the discussions held during the Workshop FISME organized jointly with SIDBI on 2nd July, 2008 in New Delhi, chaired by Mr. Dinesh Rai (Secretary, Ministry of MSME) with experts such as Mr. Rakesh Rewari (DMD, SIDBI), Mr. M.R. Umarji (Indian Banks Association), Mr. Shardul Shroff (Law firm-Amarchand Mangaldas), Prof. Debroy and Dr. Bhandari.

Published by

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EXECUTIVE SUMMARY

Balancing the rights of creditors and debtors post failure or closure of business, is a complex but a critical issue. Countries attempt to strike this balance through legislations on insolvency and bankruptcy by providing a way of dealing with unpaid debts, sharing of debtor's assets among creditors fairly and ensuring a way out to the debtor. A fair and effective mechanism for insolvency and bankruptcy is considered a prerequisite for inducing risk taking and for enterprise creation in an economy. The paper analyses the issue in the context of India and small enterprises in particular. It highlights the absence of bankruptcy laws and demonstrates dysfunctionality of insolvency provisions. It brings forth that, firstly, the debate in India so far has focused only on Companies and not Proprietorship or Partnership firms- which constitute 97% of small enterprises. Secondly, recent legislative developments have focused on provisions of recovery of dues from the perspective of financial institutions only and have overlooked the critical area of debtor's unsettled statutory dues which are governed by multiple laws set in Colonial era, leaving the exit problems of small enterprise unresolved. Most such laws result in confiscation of assets and debtor's prison under archaic provisions mandating that dues be collected as arrears of land revenue. The paper argues that without resolving the latter, even the former provisions will also fail to achieve their stated objectives. It concludes with a set of suggestions and a way forward recommending an urgent need for establishment of inter-ministerial multi-stake-holder high-powered group towards establishing modern codes for insolvency and bankruptcy for small enterprise owners and individuals.

"..Post 1991, attention has been paid in India to legal constraints inhibiting entry.

Much less attention has been paid to legal constraints inhibiting functioning.

And so far as exit is concerned,
no attention has been paid whatsoever,
and this argument is stronger
if one focuses small scale enterprises alone."

- Prof. Bibek Debroy

INTRODUCTION

The question as to what treatment should be meted out to a person who fails to meet his commitment to pay back or pay for the resources he had consumed, has remained a complex but important question since time immemorial.

The Roman Laws (around 450 BC) went to the extent of vesting the right to the creditor for depriving the debtor of his life or limbs or vesting in him the right to sell him and his family into slavery (Nadler 1954). The English laws even allowed creditors to seize debtors' land, profits, and 'chattels' - a comprehensive term for all kinds of property, debtors taken in execution, captives, apprentices accounted for as chattels, while also allowing creditors to imprison'† .

With the internationalization of trade amidst greater odds and risks, the colonial laws on 'insolvency' and 'bankruptcy' began to evolve around 13th century to settle issues after a business failure. In England during the sixteenth century the Law Merchant, and thereafter, the common law and equity, gave creditors the wherewithal to enforce their debts. Even these early provisions were made for 'composition'* with creditors, in order to give the debtor a chance to start anew (Holdsworth 1903~38).

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† Godol. Orph. Leg. part 3, chap. 6, Sec.1

* Composition settlement is probably the oldest form of rehabilitation consisting of an agreement between an insolvent debtor and his creditors, under the terms of which the creditors agree to accept an amount less than the whole of their claims. This amount must be distributed pro rata to all of the creditors in discharge of the entire debt.

Societies, particularly the major trading nations, gradually adopted a more benign attitude towards debtors, realizing the futility of excessive harshness. In later centuries, the United States has been on the forefront of establishing a legal system for insolvency and bankruptcy. Immediately after independence, the US introduced a new legislation on bankruptcy in 1789. Since then, it has updated/revised the related provisions more than 14 times - the last being in 1978.

Economists in the 20th century onwards paid greater attention to effects of insolvency regulations on the economic growth of a nation. As Wood (1995) noted: "Insolvency law.. ..is the piercing indicator of the doctrine that divides the world's legal system in the context of financial law. It is the destructive force of bankruptcy, which has molded the central tenets of a commercial law, and it is bankruptcy, which is the ultimate test of a jurisdiction's ability to realize its own view of fairness, equity and legal civilization."

Accommodating the regional and national variations, the legislations on insolvency and bankruptcy all over the world attempt to address the following key issues with varying degrees of success:

a. Providing a way of dealing with debts which a debtor cannot pay

b. Freeing the debtor from overwhelming debts so that it can make a fresh start, subject to some restrictions

c. Ensuring that debtor's assets are shared out fairly among the creditors.

Over the centuries, the insolvency and bankruptcy regimes have evolved into a complex subject shaped by prevailing sociological, political and economic thoughts. In the era characterized by free flow of capital and goods across national frontiers, fierce competition among nations and companies and resultant uncertainties within which businesses have to operate, the issue has assumed a new significance.

This paper attempts to examine the insolvency and bankruptcy scenario in India with a qualification that it does so chiefly from the perspective of small enterprises - an area that has been largely overlooked during debate on insolvency and bankruptcy issues in India. After explaining insolvency and bankruptcy terms, the paper discusses the related legal provisions in India. It analyzes the options that the individuals and companies have in case of business failure and limitations of each of the options. Finally, after providing the summary of discussions, it concludes with an actionable agenda for policy makers and stakeholders.

DEFINING INSOLVENCY AND BANKRUPTCY

The two terms Insolvency and Bankruptcy, though generally used together, are not synonymous. Historically, the terms insolvency and bankruptcy represented different bodies of English law and different attitudes toward creditors. Bankruptcy was an involuntary procedure designed to protect creditors through the confiscation and equal division of the debtor's property among the creditors. Debtors often faced imprisonment, at the expense of creditors. The second body of law purported to protect debtors, who would voluntarily declare insolvency, give all their property to the court, and be discharged from the 'debtors ' prison'.

Insolvency is a term used to describe the 'state' of a company or a person that is unable to pay their creditors[1]. It is a financial condition when its assets no longer exceed its liabilities, commonly referred to as 'balance-sheet' insolvency, or when the person or entity can no longer meet debt obligations, commonly referred to as 'cash-flow' insolvency[2].

Bankruptcy, on the other hand, is a 'status' (granted by law). It is a legally declared inability or impairment of ability of an individual or an organization to pay creditors. Bankruptcy is a 'legal' state of insolvency.

1 Corporate Insolvency Law In Singapore

2 See Debt Restructuring by John D. Honsberger (1990); The Law of bankruptcy by Nadler Charles E, (Chicago 1948); A history of bankruptcy law by Noel, Francis R (Washington DC 1919) and writings of J Franks, O Hart, S DeVaney, W Torous and K Nyborg.

Creditors may file a bankruptcy petition against a debtor - known as "involuntary bankruptcy", in an effort to recoup a portion of what they are owed. In the majority of cases, however, bankruptcy is initiated by the debtor - termed as "voluntary bankruptcy" that is filed by the bankrupt individual or organization. A company deemed to be in this condition may choose protection under the law to allow a chance to reorganize or liquidate in an orderly fashion.

Therefore, while the insolvency is a term used to describe the state of a person/company unable to pay its creditors, bankruptcy is a legal instrument to deal with a person/company in the state of insolvency or simply put, insolvency describes a person's financial state, while bankruptcy is the legal status of a person that has been adjudicated bankrupt by the courts.

While a bankruptcy adjudication may be obtained without proving the debtor's true insolvency, it is held generally that the debtor's insolvency is reasonably to be inferred under the circumstances. Mere insolvency does not afford enough ground for lenders to petition for involuntary bankruptcy of the borrower, or force a liquidation of his or her assets. Regardless of the uncoordinated appearance of insolvency and bankruptcy, the underlying links between the two are important as they determine who can become bankrupt and at what point the bankruptcy procedure begins. Therefore, it is argued that in the bankruptcy sense, insolvency means that net assets at fair market value are less than liabilities, which can necessitate the liquidation of assets through a court-ordered bankruptcy process (Becker, 1992).

THE INDIAN CONTEXT

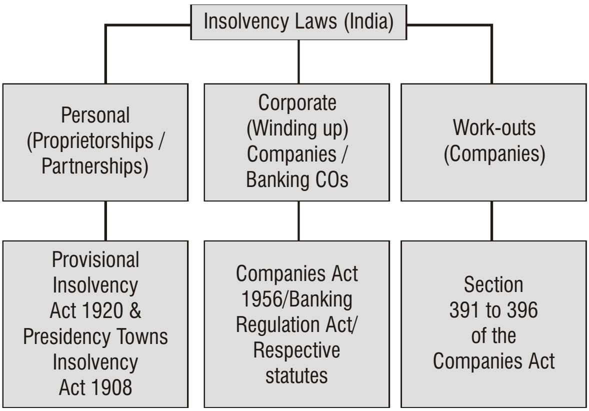
With regard to the insolvency and bankruptcy regime the Indian scenario has some peculiar features. Firstly, India does not have a comprehensive policy or law on bankruptcy. Individuals are declared 'insolvent' in the event of the individual's inability to meet his/her total liability. A company may also be wound up if it is unable to pay its debt. In the case of individuals there are two Insolvency Acts, one for the presidency towns and the other for the rest of the country: The Presidency-Towns Insolvency Act, 1909 and The Provincial Insolvency Act, 1920 respectively. During the pre-independence period the word 'bankruptcy' was never used in the Indian legal system[#] . Insolvency was used for denoting an individual or a firm that is not able to meet the liability. In the case of a company, the system included winding up and dissolution.

Secondly, the overwhelming majority of businesses in India are either proprietorship or partnerships. With regards to small scale Industries (SSIs*), as per the 3rd census of Small Scale Industries (Ministry of Micro Small and Medium Enterpries), the group constitutes more than 97.3% of all units in India. It is obvious that hardly 2% of small units are incorporated as Companies.

[#] Bankruptcy and insolvency, both these words are used in the Constitution of India. But there was no statute or regulation legislated upon bankruptcy.

* The term SSI was used historically in India prior to the MSMED Act 2006. The current legal terminology is Micro, Small and Medium Enterprises definition of which is based on their investment in plant and machinery excluding that of land and building as upto Rs. 2.5 Mn; from Rs. 2.5~50 Mn and from Rs. 50~ ~100 Mn respectively.

Thirdly, though the need for bankruptcy laws is increasingly being felt in the country, as is evident from several important committees** and groups set up by the Reserve Bank of India and the Government during the last decade, the discussion has been limited to 'corporates' and excluded 'firms' and individuals. Another expert committee, the J.J. Irani Committee, set up to suggest amendments in the Companies Act also overlooks the personal liability aspect of directors of small companies.



Fourthly, the discussions in India so far have been unduly influenced by the need for restructuring or liquidation from the standpoint of financial institutions only. Not much attention has been paid to liabilities arising out of statutory dues and the rehabilitation of the debtor. The major pieces of legislation born during

** Two noteworthy groups are: Panel set up under Chairmanship of Justice V.B. Balakrishana Eradi and another Advisory Group on Bankruptcy Laws under Chairmanship of Dr.N.L. Mitra.

the period, substantiate this claim: The Recovery of Debts due to Banks and Financial Institutions Act, 1993 (DRT Act) and The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), which enshrine the contractual right of the secured creditor to take possession of securities in the event of default and sell them for realization of the loan.

OPTIONS AND LIMITATIONS

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

a. Statutory dues (such as central and state taxes, dues of labour, of utilities such as electricity, water, finance by state institutions etc.)

b. Dues to Banks and Financial Institutions

c. Dues to sundry creditors (buyers, suppliers and others)

I. CREDITORS' OPTIONS

a. For recovery of statutory dues

Public institutions and departments including utilities are governed by respective Acts which provide for appropriate legal recource for recovering statutory dues from individuals, firms or companies prescribing fines, attachment of assets and also, in most cases, imprisonment. To illustrate this, the most common dues and their relevant provisions are:

- Taxes (Central, State or Municipal): Provisions under Acts for Income Tax, Excise, State Taxes - VAT etc. (recovery as arrears of land revenue; with fine and/or imprisonment)

- State Financial Corporations (recovery as arrears of land revenue; with fine and imprisonment)

- Electricity Dues (recovery as arrears of land revenue; with fine and imprisonment)

- Industrial Disputes Act (fine and imprisonment)
- Payment of Gratuity Act (recovery as arrears of land revenue; with fine and imprisonment)
- Payment of Wages Act (recovery as arrears of land revenue; with fine and imprisonment)
- Payment of Bonus Act (recovery as arrears of land revenue; with fine and imprisonment)
- Employer's Provident Funds & Misc. Provisions Act (recovery as arrears of land revenue; with arrest and detention/imprisonment)
- Employees State Insurance Act (recovery as arrears of land revenue; with arrest and detention/ imprisonment)

Therefore, provisions for recovery of statutory dues are well laid out. The final recovery procedures, whether on behalf of central or state governments, are effected by state governments through their administrative machinery.

b. Options for Financial Institutions

There are two lines of approach that banking and financial institutions take. The first is when a business falls in the domain of sickness* - a term having very India specific connotations. If there is more than one financial institution involved, the case is referred to the

* According to Reserve Bank of India (Master Circular July 2008) 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 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'

State Level Inter-Institutional Committee (SLIIC) for revival or restructuring. Banks also could either opt for 'One Time Settlement' (OTS) or for the restructuring of the failed/'sick' enterprise under guidelines issued by the Reserve Bank of India. Secondly, they could also initiate proceedings to recover dues and attach goods and property under the DRT Act and the SARFAESI Act as the case may be.

c. Options for sundry creditors

The sundry creditors can file civil suites to recover their dues. However, usually most creditors prefer out-of-court settlements through the informal and formal mechanisms of dispute resolution. In almost all major wholesale markets of India the system of arbitration is widely used.

II. OPTIONS FOR THE DEBTOR - THE ENTREPRENEUR

What are the options for the debtor - the entrepreneur? The most commonly used approach is 'delay till further delay becomes untenable and hope for restructuring or OTS in the meantime'**. It is important to understand the interplay of forces at this juncture. Suddenly, the entrepreneur has to fight the battle on several fronts: 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.

** Presentation by Dr. Laveesh Bhandari (http://www.fisme.org.in)

The critical lifeline goes in the hands of bankers. If at that moment the account is seized and credit limits revoked, even a potentially viable unit skids into sickness. The first priority becomes restructuring. If that fails or is delayed, the next is OTS. When that too fails or is delayed, the 'domino effect' gets into motion irreversibly: pressures of creditors keep mounting day by day and a vicious cycle of threats, show-causes, legal notices and fines eventually leading to arrests and imprisonment.

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, the route is all but dysfunctional.

One option that some entrepreneurs exercise successfully is to sell out to more resourceful persons. Obviously, this option can only be exercised before the start of the 'domino effect'.

ANALYSIS OF CURRENT SCENARIO

I. THE INSOLVENCY MECHANISM

Let us first examine the insolvency mechanism. 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[4]'. 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

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[4] 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."

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 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. 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.

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† 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.

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, therefore, delays and avoids this till the end.

Therefore, insolvency mechanism for individuals is largely dysfunctional.

II. RECOVERY OF DUES BY BANKING AND FINANCIAL INSTITUTIONS (FIs)

By the time a unit is 'declared' sick by the bank and some preliminary process of rehabilitation starts, the time lag is between 6 to 24 months. At this juncture time is of great essence, but the system lacks any sensitivity towards urgency. There is no time-frame for rehabilitation or OTS. The SLIIC suffers from huge delays (in many states its meetings are not held for years) and even if it does take a decision, participating financial institutions are not bound to follow its recommendation and are free to chart their own course. Successful restructuring, therefore, is rare as it demands agreement among lenders on a

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* 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))

coordinated strategy which is seldom achieved. Of late OTS has become an option of choice and is exercised frequently. However, settlement is time consuming as either the entrepreneur finds the terms too harsh or bankers find the offer too low. There are institutional rigidities too: in many cases the bank managers face departmental questions as to why the legal course was not pursued to recover dues in stead of settling on lesser amount through OTS.

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".

Secondly, whereas a sick firm can apply for rehabilitation to the Financial Institutions, there is no protection available to the firm from other creditors and liabilities. Interim to the rehabilitation/restructuring process, the unit would have defaulted on many other statutory obligations and in all probability would have got decrees for attachment of property issued from several departments simultaneously.

The whole process looks like a state of anarchy as any one or many public bodies could acquire assets and sell them off. Chilling stories* are abound where assets are acquired under the decree by the departments and sold sometimes even at one hundredth of the market price of the assets in connivance with the bidders. Also, asset stripping by entrepreneurs during the period is not very uncommon. Many a times by the time the banks come to know of this, the assets would have already been appropriated and the entrepreneur would either be behind bars or would have absconded or in extreme cases, would have committed suicide. (According to Prof. Debroy the number of failed businessmen committing suicide exceeds substantially the rate of suicides amongst

Incidence of Sickness in Small Industries

(Year-wise Number of Accounts and Amount Outstanding)

			(Rs. crores)
Year	All India Data		
	No. of A/cs	Amt O/s	Amt o/s per a/c
1999	306221	4313.48	0.014
2000	304235	4608.43	0.015
2001	249630	4505.54	0.018
2002	177336	4818.92	0.027
2003	167980	5706.35	0.034
2004	143366	5772.64	0.040
2005	138041	5380.13	0.039
2006	126824	4981.13	0.044
2007	114132	5266.65	0.046

[Source: RBI]

* Case Studies and Inferences (by Piyush Bajpayee) "Small Scale Industry in India: Large Scale Exit Problems": ed. by Bibek Debroy and Laveesh Bhandari 2005

farmers in India). However, it is extremely rare that bankers and financial institution insist on imprisonment. The only exceptions are the State Financial Corporations where it is done routinely.

Finally, the absence of an exit route means that the firm is kept in a state of 'suspended animation' and is routinely declared sick! Given the 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 stood at 1,14,132 (Working Group on Rehabilitation of sick SMEs, 2008, RBI). Most fear that the actual numbers are much greater than this.

III. LIQUIDATION

While the Companies Act provides for cause and method of winding of companies, there is no such mechanism available for small enterprises 97% of whom are either proprietorships or partnerships. Even in cases of small enterprises incorporated as 'Companies', the standard practice of taking 'personal guarantee' of the promoters and guarantors insisted by the bankers and many statutory provisions, makes the entrepreneur personally liable, defeating the very purpose of incorporation and limited liability. There is no mechanism available for liquidation of unregistered proprietorships and partnerships, which is the case for most of the small enterprises. For registered ones also, the liabilities of the partners are unlimited and the only recourse lies through the two Insolvency Acts referred to earlier.

IV. SPECIFIC PROBLEM AREAS

Recovery as arrears of land revenue:

Ultimately the onus of recovery of statutory dues (or dues ordered to be collected by courts) falls on the administrative machinery of the state where the defaulting unit is located. Almost all related statutes provide for recovery clauses and accordingly the request for recovery is sent by the respective department to 'Collector' of the District who shall proceed to recover from the said person the amount specified therein as if it were an arrear of land revenue. For example, Section 146 of The UP Land Revenue Act 1901 states: 'an arrear of revenue may be recovered by one or more of the following processes: (a) by serving a writ of demand or a citation to appear on any of the defaulters. (b) by arrest and detention of the person; (c) by attachment and sale of his movable property. Most state laws have similar provisions.

'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, given the problems associated with attachment and sale of movable property, de facto rather than de jure, arrest and detention becomes the only option' (Debroy et al 2005).

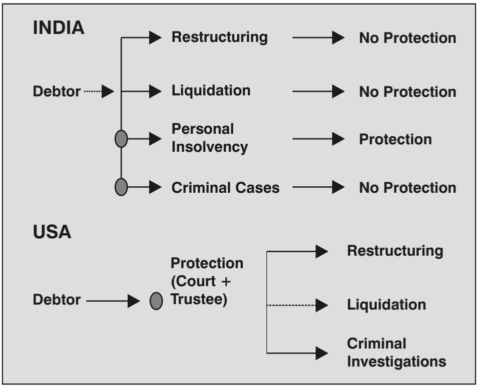
Criminal Offences

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.

COMPARISON BETWEEN INDIAN AND US LAWS

The US laws on bankruptcy and insolvency are acclaimed to be the most sought after pieces of legislation. Chapter 11 of the US Bankruptcy Code (amended in 1978), covers both the reorganization and liquidation. The key elements of the code are: once the application under chapter-11 is filed, a stay is placed on creditors' claims, creditors are classified according to the types of claims and a judge supervises the plan of action and decides whether the firm is to be re-organized or liquidated. In the mean time, during the process, the incumbent is usually allowed to run the firm. Considered as a pro-debtor law, it provides immediate protection to the promoter from the creditors and secondly, it does not force seizure of normal functioning of the unit till a decision is made.

The differences between US code and Indian laws are depicted below:



[Source: Piyush Bajpayee and Dr. Laveesh Bhandari, Indicus Analytics]

It is obvious that protection to a debtor is available in the Indian case only through personal insolvency. As we have seen, that too is dysfunctional.

SUMMARY

The discussions of preceding sections of the paper are summarized thus:

i. The case of small enterprise is fundamentally different from corporates both in terms of personal liabilities of promoters and related legal provisions. The liabilities among small enterprises in case of default are unlimited and there is no BIFR like mechanism for them.

ii. There is no mechanism for addressing eventualities born out of 'temporary stresses' in life of enterprise. While the ineffectual mechanism of SLIIC does exit - jurisdiction of which is limited to institutional credit only - there is absolutely no system for restructuring of multi-agency statutory liabilities.

iii. The insolvency mechanism under the two Acts is largely dysfunctional both because of inefficient and uninterested judicial dispensation for insolvency cases as well as because of extremely harsh conditions post insolvency that are meted out to entrepreneur.

iv. There is no wholesome mechanism for bankruptcy in India. Therefore, there is no functional system for recovering debts when creditors include government agencies (center and state), public institutions (center and state), banks/FIs and private parties. The two Acts promulgated for recovery of dues by banks and FIs (DRT Act and SARFAESI Act) are set to result into long complex legal battles with other government agencies which also set out to recover statutory dues simultaneously. There are overlapping areas of jurisdiction and also white spots where none has any jurisdiction. In the quagmire of legal battles, the life of entrepreneure is ruined and productive assets get locked for years.

v. There being no single administrative mechanism for insolvency and bankruptcy, there is no one to decide whether or when the firm is to be liquidated or be sent for restructuring. Therefore, even a temporary stress or shock is enough to bring a small unit to 'sickness' and eventually to 'closure'.

vi. The present legal dispensation leaves many questions unanswered:

a. What to do when a business is termed as a failure and exit is just not recognized as a possibility?

b. Should default on account of 'sickness' or 'failure' be treated as criminal?

c. Is there any justification bringing in colonial and dysfunctional elements equating defaults as default of land revenue?

d. Is it justified to equate defaults in payment of business inputs like electricity with statutory defaults?

CONCLUSION

1. Temporary stresses in business and also eventual closure in many cases are inevitable in the era of global competition. A critical question in such situations is how the rights and responsibilities of debtors and creditors are balanced. World over such a balance is strived to be achieved through a set of insolvency and bankruptcy laws and procedures.

2. On the one hand, the dysfunctional insolvency system and absence of a wholesome bankruptcy system in India for smaller units deprives the entrepreneur of an honourable exit after failure and of exercising the second chance to re-establish his business. On the other hand, the creditors - especially banks - cannot take control of distressed assets and put them again to productive use quickly and efficiently. While the effect of the former is that entrepreneurs increasingly shun establishing manufacturing units and consider it 'not worth the trouble'. The latter results in further squeezing of credit flow to the small entrepreneurs as banks consider them more risky. This results in a vicious cycle.

3. The preceding discussion makes it abundantly clear that from the perspective of small enterprises there is an urgent need to completely overhaul the insolvency and bankruptcy mechanism in India in

line with changed economic realities. Such a framework should pave the way for:

- An honourable exit for the entrepreneur
- Identification of temporary financial stresses and genuine business failures
- Second chance opportunities to those who have exited with suitable safeguards to prevent frauds.

4. The agenda for change should encompass:

i. The need to sensitize stakeholders on the importance of having a credible and effective insolvency and bankruptcy regime on the one hand and need to instill a more benign and nuanced attitude towards economic failure in society, on the other.

ii. Need for adoption of international best practices including the time taken in completing the insolvency and bankruptcy exercise.

iii. Specific intervention is required in following areas:

- Need for substantive amendments in Insolvency Acts (Presidency Town Insolvency Act, 1909 and Provincial Town Insolvency Act, 1920) or replacement by new (single and comprehensive) law
- Enactment of comprehensive Bankruptcy Law mechanism covering non-corporate entities

- Suitable revisits to other central and state statutes affecting current recovery procedures and clauses of imprisonment

- Constitution of Authority/Registrar/Central Registry System where all the orders declaring a person as insolvent may be filed

- Instituting a time bound restructuring mechanism for small scale sector learning from the shortcomings of the BIFR and providing effective protection against jail sentences during the restructuring exercise.

- Need to institute 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. .

iv. Till the time the aforesaid measures are implemented, to provide appropriate interim relief the following steps could be considered:

- The SLIIC mechanism of RBI may be made more effective for restructuring

- Review of the RBI guidelines on OTS and restructuring

- While proceeding for recovery, States should make necessary changes in rules restraining district officials to award jail sentences only in 'rarest of rare cases'

THE WAY FORWARD:

While the objective of the paper has been to highlight the gaps in the existing framework from perspective of small enterprises and the socio-economic need for change in current dispensation, proposing the specific legal provisions is beyond its scope. The latter calls for a much broad-based and a comprehensive initiative with adequate political support. Even before that, perhaps, detailed studies are needed to specify the contours and expanse of the appropriate legal changes.

Who will kick start the process of change and how? As we have seen the current debate on insolvency and bankruptcy in India completely overlooks the perspective of small enterprise and an individual. Therefore, initiation of such an exercise would necessitate that the Ministry of MSMEs assumes the leadership role because of the complexity of jurisdiction overlapping various Central and State statutes. As a first step a high-powered group needs to be constituted with experts drawn from law, economics and small industries. Simultaneously, the associations of MSMEs have to shoulder the responsibility equally to sensitize the political leadership of the country and their own members about the urgency of the issue.

■■■

TERMS MOST COMMONLY MISCONSTRUED AND MISUNDERSTOOD: 'SICKNESS', 'FAILURE', 'EXIT' AND 'CLOSURE'

According to the RBI (Master Circular July 2008) 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 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'.. It is evident that the definition focuses on only the financial aspect of business and does not take into account the liabilities towards other creditors. In the discussion of need for bankruptcy and insolvency regime, 'sickness' constitutes a small part of a larger set of issues such as failure, exit or closure.

'Failure' is terminal- a business that has terminated operations with a loss to creditors. A sick unit is not necessarily a failed unit; prolonged sickness may lead to failure though. Failure denotes a result of a series of reversals in fortunes of company.

In India **'exit'** is used in rather narrow perspective: a right sought by large corporates for closure of business without mandatory approval from Government beyond a certain limit of number of employees. 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.

'Closure' denotes seizing operations voluntarily (for example by retiring) or in-voluntarily (for example by forced bankruptcy through creditors). Desire or need to close a business does not mean failure.

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INSOLVENCY AND BANKRUPTCY: QUOTES FROM AROUND THE WORLD

"Who will win in globalization?" A country that has " …...the bankruptcy laws and courts that actually encourage people who fail in business venture to declare bankruptcy and try again, perhaps fail again, declare bankruptcy and then try again before succeeding and creating the next amazon.com".

- *Thomas Freidman ‘The Lexus and The Olive Tree’*

’’We need to infuse in our people a culture of innovation and enterprise, and a readiness to take calculated risks. We also need to infuse in our society a willingness to accept failure as a learning process so as to encourage those who do not succeed in the first instance and give them the chance to succeed.’’

- Dr Tony Tan, Singapore’s Deputy Prime Minister, while launching Technopreneurship 21 Initiative

There is an urgent need of reducing the stigma of failure and renew our efforts which aim.. "to promote a better understanding of failure; break the automatic conceptual link of ’bankruptcy’ with ’bad behaviour; demonstrate the benefits of starting afresh for economy, employment and growth; and encourage prevention among entrepreneurs in the ’danger zone’."

- From "Best Procedure Project on Restructuring, Bankruptcy and a Fresh Start", EC 2002

Entrepreneurs aren't infallible - but who is? Einstein said, anyone who has never made a mistake has never tried anything new. As a society, we haven't come up with the inventions and new thinking that has made us all so much richer over the centuries by steadfastly avoiding mistakes - but rather by learning from them.

- From "2nd chance entrepreneurs in action": a campaign by European Commission Strategy

"Ensure that entrepreneurs who have faced bankruptcy quickly get a second chance"

- The 2nd of 10 Commandments from Small Business Act, EU (adopted on 25th June 2008)

"..failed entrepreneurs learn from their mistakes and are more successful at the next attempt. Since encouraging bankrupts to try again would contribute positively to economic growth, a fresh start for bankrupts should be promoted. Measures to improve the chances of continuing or starting a new business include removing outdated and harmful restrictions, disqualifications and prohibitions imposed on those subject to bankruptcy proceedings, as well as early discharge from remaining debts, subject to certain criteria".

- Director General (Entrepreneurship) European Commission on business failure and starting afresh

"Discharged from past obligations encouraged a number of highfliers to redouble their entrepreneurial efforts. These bankrupts.. produced spectacular post-failure success. Collectively, the ventures of risk-taking former bankrupts helped to consolidate a business culture predicated on creative destruction."

- Navigating Failure: Bankruptcy and Commercial Society in Antebellum America by Edward J. Balleisen

"The concept of the debtors' prison is extremely antiquated...the last known instance of debtor's prison in the United States was around 1833 when it was eliminated by Federal decree. In Great Britain, debtor's prisons were made unlawful by the Debtors Act of 1869."

- Bankruptcy Law Network

"Severity of punishment for entrepreneurs who fail is important because it influences the start-up rates and the possibilities for learning."

- Johan Wiklund, Professor, Jönköping International Business School, Sweden

FISME POLICY PAPERS

FISME Policy papers form the troika of series of publications focusing a distinct set of issues. All papers are research based and are intended to induce a more informed debate on issues of contemporary importance in SME space in India.

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The series focuses on issues of policy and regulatory environment for SMEs in India, brings forth best practices and aims to contribute to creation of enabling environment for development and growth of entrepreneurs in India.

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FEDERATION OF INDIAN MICRO AND SMALL & MEDIUM ENTERPRISES (FISME) - AN INTRODUCTION

FISME came into being in 1995 as a Federation of geographical and sectoral associations of Small and Medium Enterprises (SMEs) in India spread across districts and states. It was established as National Alliance of Young Entrepreneurs (NAYE) in 1967- when Indian government started monumental initiatives for small industry promotion. India was a different country then, inward looking, interventionist and hugely protectionist. NAYE had a contextual agenda which suited that era. After India's embarking upon liberalization in 1991 and its accession to WTO in 1995, it called for a fundamentally different approach for SME promotion. NAYE along with 8 state level associations gave birth to FISME to lead SMEs in the changed economic realities.

Its mindset, mission and activities have been shaped by these national and global developments. It focuses primarily on trade and market access issues and reforms with the twin objective of establishing entrepreneurial and competitive environment at home and greater market access for Indian SMEs in India and abroad.

The key thematic areas of work at FISME constitute:

a. Internationalization of SMEs- which reflects in our activities such as networking with SME associations abroad and organization of trade fairs, trade delegations, hand-holding-training, BDS development among others.

b. Mainstreaming of trade issues among SMEs and their associations - engaging us in continuous research, sensitization on trade issues and organization of collective initiatives

c. Strong orientation for reforms in regulatory environment and promotional policies in tune with changing world trade order to enhance competitiveness of SMEs vis-a-vis their larger domestic counterparts and foreign firms-engaging us in research, bringing out policy and position papers and organization of campaigns.

FISME is widely perceived as the progressive face of Indian SMEs and is regarded as such by Government of India. Member of quasi-judicial body of 'Advisory Committee' formed under MSME Act 2006 and Member of Board of Trade (Ministry of Commerce and Industry), it is well represented in and consulted by SME policy making set up in the country. FISME works in close cooperation with major multilateral and bilateral bodies in India UNIDO, ILO, UNCTAD, DFID, GTZ among others.

Currently, as Tier-I partner, it is leading 22 provincial SME bodies (in 18 states) under multilateral project 'Strategies and preparedness for trade and globalization in India' supported by UNCTAD, DFID and Ministry of Commerce & Industry.

More at http://www.fisme.org.in

"Balancing the rights of creditors and debtors post failure or closure of business, is a complex but a critical issue. Countries attempt to strike this balance through legislations on insolvency and bankruptcy by providing a way of dealing with unpaid debts, sharing of debtor's assets among creditors fairly and ensuring a way out to the debtor. A fair and effective mechanism for insolvency and bankruptcy is considered a prerequisite for inducing risk taking and for enterprise creation in an economy.

In case of India, particularly for small enterprises, either the critical elements of such a mechanism dysfunctional or missing entirely."

Federation of Indian Micro and Small & Medium Enterprises (FISME)