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Insolvency Resolution Process For Non-Corporate MSMEs

The Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, aimed to promote and develop MSMEs and address delayed payments, though its practical effectiveness has been limited due to enforceability issues. The Insolvency and Bankruptcy Code (IBC) offers a comprehensive framework for insolvency resolution but primarily benefits corporate entities. While the Pre-packaged Insolvency Resolution Process (PPIRP), a hybrid model with informal pre-initiation and formal post-initiation phases, is currently available only to corporate MSMEs, most MSMEs in India are unincorporated (proprietorships or partnerships) and thus fall outside its purview. This significant disparity means a vast number of MSMEs, which form the backbone of the Indian economy, cannot leverage the PPIRP for their turnaround. To address some of the challenges, the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018, introduced Section 240A, which relaxes the strict eligibility criteria of Section 29A for corporate MSMEs. This allows promoters, unless they are willful defaulters or fall under specific disqualifications, to bid for the resolution plan of their own MSME, preventing forced liquidation due to a lack of other bidders. This amendment reflects the understanding that for MSMEs, promoters are often the most likely interested parties for a resolution. However, the absence of a similar comprehensive and formalized pre-pack resolution process for unincorporated MSMEs under Part III of the Code remains a notable gap. International practices, such as the Company Voluntary Arrangement (CVA) and Individual Voluntary Arrangement (IVA) in the UK, Chapter 11 and Chapter 13 bankruptcies in the US, and streamlined consumer proposals in Canada and debt agreements in Australia, offer various mechanisms for both corporate and non-corporate entities to restructure debt and avoid liquidation, providing valuable insights for potential reforms in India. The MSMED Act, 2006, this law has measures for the promotion, development, and enhancement of competitiveness of MSMEs. The Act also specifies how payment delays and related disputes are to be settled. In case of a default, the MSME could approach the Facilitation Council which can help with payment or impose a penalty or pass a decree. But in practice, this mechanism has met with limited success.

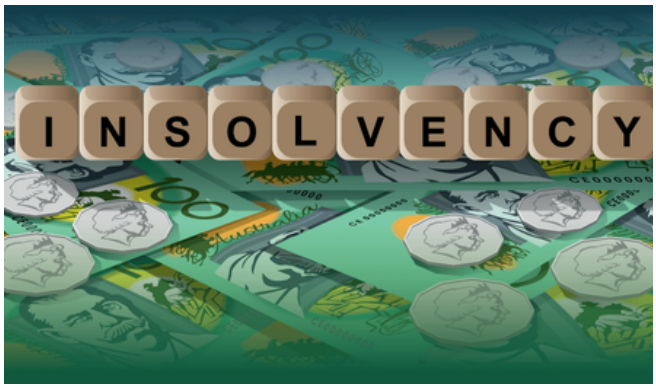
Although the Act addresses the issue of delayed payment, the said process has been highly questionable owing to the enforceability of the awards passed by the council.

Resolution under IBC: The IBC becomes relevant to MSMEs mostly when they are operational creditors to large debtors. There are cases where MSME can also be a financial creditor. The IBC provides a comprehensive framework for the resolution of insolvency and bankruptcy of corporate persons, LLP, individuals, partnership firms, and sole proprietorship firms in a time-bound manner for maximisation of value of assets.

The pre-packaged insolvency resolution process (PPIRP/Pre-Pack) at present applies only to corporate MSMEs. Most MSMEs by virtue of being a partnership or proprietorship firms have to resort to the standard corporate insolvency resolution process (CIRP).

The Insolvency and Bankruptcy Code (Second Amendment) Act, 2018 (Second Amendment) has brought relief to the MSME by relaxing the applicability of the provisions of section 29A of the Code.

THE SECOND AMENDMENT INTRODUCED SECTION 240A, which provides certain relaxations to MSMEs with respect to the applicability of restrictive provision of section 29A. The intention behind the enactment of this provision was to grant exemptions to corporate debtors (CDs) which are MSME(s), by permitting a promoter who is not a wilful defaulter or covered under any other specific disqualification as provided under section 29A, to bid for the resolution plan of an MSME.



The second amendment also empowers the Central Government to allow further exemptions or modifications with respect to the MSME sector, if required, in the public interest. With the introduction of these mindful exemptions, it is expected that the MSMEs may find bidders, and may not have to undergo liquidation.

In recognition of the importance of MSMEs to the Indian economy and the unique challenges faced by them, the Insolvency Law Committee (ILC) recommended the exemption of the application of certain provisions of the Code on MSMEs.

Illustratively, since usually only promoters of an MSME are likely to be interested in acquiring it, the applicability of section 29A has been restricted only to disqualify wilful defaulters from bidding for MSMEs.

The Supreme Court in Swiss Ribbon's case reiterated that the rationale for excluding such industries from the eligibility criteria laid down in section 29A (c) and (h) is because qua such industries, other resolution applicants may not be forthcoming, which then will inevitably not lead to resolution, but liquidation.

RESOLUTION & BANKRUPTCY PROCESS FOR NON-CORPORATE MSMEs

Although Part III of the Code provides for a resolution and bankruptcy process to address the insolvency of proprietorships and partnership firms, its provisions are yet to be notified. It is found that a vast number of MSMEs in the country fall outside the purview of PPIRP for their turnaround under IBC as these are not registered companies.

As noted above, in 2015-16, there were 633.88 lakh unincorporated non-agriculture MSMEs in the country engaged in different economic activities. These far outnumber the MSMEs which are registered as companies around 780,000 or 60% of all active companies in the country which will benefit from the PPIRP.

These companies represent just above 1% of all the unincorporated MSMEs, implying that the informal sector businesses far outnumber the organised sector and will not be covered by the PPIRP. Extending an insolvency resolution scheme under IBC to unincorporated entities and proprietorships, however, is hugely challenging given the large number of such enterprises.

The United Nations Commission on International Trade Law (UNCITRAL) referred to pre-packs as 'expedited reorganisation proceedings'. In attempting to understand the pre-pack and framing the provisions of pre-pack for the Indian scenario, the ILC, in its report has studied several global jurisdictions, including the United Kingdom (UK), the United States (US), in order to frame relevant law for our country. There is no doubt that the UK and US continue to be the lead flag bearers of prepack arrangements, but pre-packs for unincorporated MSMEs is yet to be formally brought under Part III of the Code.

Therefore, it is imperative to examine the treatment of non-corporate MSMEs under other jurisdictions so that the pre-pack resolution process for non-corporate MSMEs in India, can be brought into existence that will benefit the un-incorporated MSMEs in India.

CASE LAW UPDATE

CoC can decide to return rented property occupied by Corporate Debtor | Section 14(1)(d) of the IBC does not bar the return of possession of rented asset, not in the interest, during CIRP.

Sincere Securities Pvt. Ltd. & Ors. vs. Chandrakant Khemka & Ors.

The present Civil Appeal No. 12812 of 2024, u/s 62 of the Insolvency and Bankruptcy Code, 2016 (IBC), challenges the order dated 12.11.2024 of the National Company Law Appellate Tribunal (NCLAT), which allowed Company Appeal (AT) (Insolvency) No. 1064 of 2023 filed by Chandrakant Khemka (hereinafter referred as 'Respondent No. 1') and set aside the order dated 07.08.2023 of the National Company Law Tribunal (NCLT), Kolkata Bench in CP(IB) No. 1377/KB/2020, whereby possession of the disputed property was directed to be delivered to the appellants.

On 13.02.2019, Nandini Impex Pvt. Ltd. (later a Corporate Debtor under IBC), represented by Respondent No. 1, executed a Memorandum of Understanding (MoU) with Noble Dealcom Pvt. Ltd. along with Jodhpur Properties and Finance Pvt. Ltd. (Appellant Nos. 2 and 3) for financial assistance of ₹3 crores, secured by depositing title deeds of the rear portion of the ground floor of White House, Rani Jhansi Road, New Delhi. Another MoU dated 15.02.2019 was executed with Sincere Securities Pvt. Ltd. (Appellant No. 1) for a ₹3 crore loan, secured by title deeds of the front portion. Upon default, conveyance deeds dated 27.02.2020 transferred ownership of both portions to the appellants, but simultaneous Leave and License Agreements allowed Nandini Impex to retain possession at ₹6 lakhs monthly rent per portion. Following default in rent payments, the appellants terminated the agreements on 08.05.2020 and filed eviction suits. Meanwhile, UCO Bank (Respondent No. 3) filed a Section 7 IBC petition, admitted on 20.09.2022, initiating the Corporate Insolvency Resolution Process (CIRP), with the Respondent No. 3 as sole member of the Committee of Creditors (CoC). The appellants, as operational creditors, filed claims which were fully admitted.

On 06.04.2023, after the Resolution Professional's report, the CoC decided that the property was unnecessary and financially burdensome and requested its return to the appellants. Respondent No. 1 objected, leading to interlocutory applications before the NCLT, which on 07.08.2023 directed return of possession. On appeal, the NCLAT held that Section 14(1)(d) IBC barred recovery of property from the CD during CIRP and remanded the matter. The Supreme Court recorded that both the Resolution Professional including the new RP, and the CoC supported returning the property due to high rental costs and limited operations, while Respondent No. 1 alone opposed it without offering to bear the cost.

Supreme Court's Observations:

The Supreme Court emphasized that the "commercial wisdom" of the Committee of Creditors (CoC) holds paramount status during the (CIRP) and is non-justiciable. Referring to K. Sashidhar v. Indian Overseas Bank (2019) 12 SCC 150, it reiterated that once the CoC, after due deliberation, takes a collective business decision, the AA cannot question or evaluate its justness. The IBC framework was designed for a time-bound resolution process, replacing the earlier regime that allowed indefinite protection to debtors, and to accord primacy to informed, expert- backed decisions of financial creditors.

In this case, UCO Bank, the sole CoC member, decided that retaining the property was not in the CIRP's interest due to its high rental cost and the CD's limited operations. Both the then RP and the new RP, supported this view, with the latter confirming by affidavit that retention was neither feasible nor necessary. The Apex Court noted that this was not a unilateral recovery attempt by the owner barred under Section 14(1)(d) IBC, but a decision by the CoC and the RP to return the property to avoid substantial financial burden.

All stakeholders except Respondent No. 1, agreed to the return. His claim that rent would be secured under IBC provisions was found untenable, especially as he was unwilling to bear the costs. The Court held that his opposition appeared intended to stall the process for reasons unconnected to the CIRP, and there was no justification for the NCLAT's remand order. The CoC's decision, rooted in its commercial wisdom, was entitled to full respect and required immediate implementation.

Order/Judgement: The Supreme Court set aside the NCLAT's order dated 12.11.2024 and restored the NCLT's order dated 07.08.2023 directing return of possession to the appellants. The RP was directed to implement the order expeditiously.