



THE ENACTMENT OF INSOLVENCY AND BANKRUPTCY CODE, 2016 AND ITS IMPACT ON THE FUNCTIONING OF SMALL AND MEDIUM ENTERPRISES (SMEs): A CRITICAL ANALYSIS

SIMRAN SONDHI

LLM STUDENT

SCHOOL OF LAW

CHRIST (DEEMED TO BE) UNIVERSITY, BENGALURU

ABSTRACT

The Insolvency and Bankruptcy Code (IBC) of 2016 stands as a pivotal legislation in India's legal framework, providing a structured framework for insolvency and bankruptcy proceedings. This paper delves into the impact of the IBC on Small and Medium Enterprises (SMEs) in India, exploring both its positive and negative effects on this vital sector of the economy. While the IBC has introduced streamlined insolvency resolution processes for SMEs, enhancing debt recovery efficiency, it has also posed challenges. The exclusion of SME promoters from the resolution process has complicated the revival prospects for these businesses. The paper suggests a tailored approach within the IBC framework to address the unique challenges faced by SMEs, advocating for a separate resolution regime, provisions for out-of-court settlements, and increased flexibility for SME promoters. These recommendations aim to strengthen the IBC's role in fostering the growth and resilience of SMEs in the Indian economy. The paper also discusses the historical context of insolvency and bankruptcy laws in India, the legal framework of the IBC, and its relevance to SMEs. It highlights the role of the National Company Law Tribunal (NCLT) in managing insolvency cases related to SMEs and the recent amendments to the IBC aimed at providing relief to MSMEs. Through these discussions, the paper offers insights into the challenges and suggestions for enhancing the effectiveness of the IBC in addressing the insolvency issues faced by SMEs in India.

Keywords- Insolvency and Bankruptcy Code, SMEs, PPIRP, NCLT, Insolvency resolution

INTRODUCTION

The Micro, Small and Medium Enterprise (MSME) sector has emerged as a vital element of the Indian economy, playing a significant role in generating employment opportunities, fostering innovation, and facilitating inclusive economic growth. It also accounts for 45 % of total industrial production, 40% of total exports and contributes very significantly to the GDP. Manufacturing segment within the MSME contributes

to 7.09% of GDP. MSMEs also contribute to 30.50% of services. The total contribution of MSMEs to the GDP is 37.54.¹

SME is an acronym that denotes small and medium enterprises, referring to business entities characterised by a smaller workforce and a comparatively lower annual revenue in comparison to larger enterprises. The acronym MSME refers to micro, small, and medium enterprises, designated by the Indian government, serves as a specific classification system for businesses, taking into account their investment in plant and machinery or equipment, as well as their turnover. The term "SME" is a broad concept that can vary in its definition across different countries, contingent upon diverse criteria such as employee count, investment, turnover, or balance sheet total. Hence, it can be stated that MSME in India corresponds to the concept of SME. The classification of Micro, Small and Medium Enterprises is defined under the MSME Act 2006 amendment dated June 1, 2020.

(a) Micro Enterprise: Where the investment in Plant and Machinery or Equipment does not exceed one crore rupees and turnover does not exceed five crore rupees.

(b) Small Enterprise: Where the investment in Plant and Machinery or Equipment does not exceed ten crore rupees and turnover does not exceed fifty crore rupees.

(c) Medium Enterprises: Where the investment in Plant and Machinery or Equipment does not exceed fifty crore rupees and turnover does not exceed two hundred and fifty crore rupees.²

SMEs often face challenges in maintaining financial stability, despite their considerable significance. The occurrence of instability can be attributed to various factors, including market volatility, restricted credit availability, and operational inefficiencies. Prior to the enactment of the Insolvency and Bankruptcy Code (IBC), the insolvency and bankruptcy process in India encountered notable obstacles marked by delays, uncertainties, and inefficiencies. This posed a significant challenge for small and medium-sized enterprises (SMEs) seeking to tackle financial difficulties or attract investments.

The Code of 2016 was formulated with the objective of providing a comprehensive solution to effectively address the afore-mentioned concerns. The primary aim of this initiative is to achieve a harmonious equilibrium among the interests of creditors, debtors, and other relevant stakeholders, while concurrently instituting a clear and efficient framework for the resolution of insolvency proceedings. The provided Code outlined a method that is limited by time constraints, which aims to address insolvency issues and potentially revive struggling businesses. Furthermore, the enactment of the aforementioned legislation introduced innovative concepts such as insolvency professionals and the establishment of the National Company Law Tribunal (NCLT) to oversee the resolution process.

LEGAL FRAMEWORK OF IBC AND ITS RELEVANCE TO SME: THE ROLE OF NCLT

Some of the relevant sections of the Insolvency and Bankruptcy Code, 2016 which are relevant to SMEs-

SECTION 4³- Application of IBC, 2016

This Part shall apply to matters relating to the insolvency and liquidation of corporate debtors where the minimum amount of the default is [one crore rupees]:

Provided that the Central Government may, by notification, specify the minimum amount of default of higher value which shall not be more than one crore rupees.

[Provided further that the Central Government may, by notification, specify such minimum amount of default of higher value, which shall not be more than one crore rupees, for matters relating to the prepackaged insolvency resolution process of corporate debtors under Chapter III-A.]

¹ SME Chamber of India, <https://www.smechamberofindia.com/about-msme-in-india.php> (last visited Oct. 29, 2023).

² MSME- Development Institute, Kolkata, <https://sisikolkata.gov.in/msme-definition.html> (last visited Oct. 29, 2023).

³ Insolvency and Bankruptcy Code, 2016, S 4, No. 31, Acts of Parliament, 2016 (India).

SECTION 54A- 54P- A Pre-Packaged Insolvency Resolution Process⁴

- 54A- Corporate debtors eligible for pre-packaged insolvency resolution process.
- 54B- Duties of insolvency professional before initiation of pre-packaged insolvency resolution process.
- 54C- Application to initiate pre-packaged insolvency resolution process.
- 54D- Time-limit for completion of pre-packaged insolvency resolution process
- 54E- Declaration of moratorium and public announcement during pre-packaged insolvency resolution process.
- 54F- Duties and powers of resolution professional during pre-packaged insolvency resolution process.
- 54G- List of claims and preliminary information memorandum.
- 54H- Management of affairs of corporate debtor.
- 54I- Committee of creditors.
- 54J- Vesting management of corporate debtor with resolution professional.
- 54K- Consideration and approval of resolution plan.
- 54L- Approval of resolution plan.
- 54M- Appeal against order under section 54L.
- 54N- Termination of pre-packaged insolvency resolution process.
- 54O- Initiation of corporate insolvency resolution process.
- 54P- Application of provisions of Chapters II, III, VI and VII to this Chapter.

SECTION 55-58- Fast track Corporate Insolvency Resolution Process⁵

- 55- Fast track corporate insolvency resolution process.
- 56- Time period for completion of fast track corporate insolvency resolution process.
- 57- Manner of initiating fast track corporate insolvency resolution process.
- 58- Applicability of Chapter II to this Chapter.

SECTION 29A- Person not eligible to be resolution applicant.⁶

A person shall not be eligible to submit a resolution plan, if such person, or any other person acting jointly or in concert with such person-

- (a) is an undischarged insolvent;
- (b) is a wilful defaulter in accordance with the guidelines of the Reserve Bank of India issued under the Banking Regulation Act, 1949;
- (c) an account of a corporate debtor under the management or control of such person or of whom such person is a promoter
- (d) has been convicted for any offence punishable with imprisonment—
 - (i) for two years or more under any Act specified under the Twelfth Schedule; or
 - (ii) for seven years or more under any other law for the time being in force:
- (e) is disqualified to act as a director under the Companies Act, 2013;
- (f) is prohibited by the Securities and Exchange Board of India from trading in securities or accessing the securities markets;

⁴ Insolvency and Bankruptcy Code, 2016, S 54A-54P, No. 31, Acts of Parliament, 2016 (India).

⁵ Insolvency and Bankruptcy Code, 2016, S 55-58, No. 31, Acts of Parliament, 2016 (India).

⁶ Insolvency and Bankruptcy Code, 2016, S 29A, No. 31, Acts of Parliament, 2016 (India).

(g) has been a promoter or in the management or control of a corporate debtor

(h) has executed [a guarantee] in favour of a creditor in respect of a corporate debtor against which an application for insolvency resolution made by such creditor has been admitted under this Code

(i) [is] subject to any disability, corresponding to clauses (a) to (h), under any law in a jurisdiction outside India; or

(j) has a connected person not eligible under clauses (a) to (i)

SECTION 240A- Application of this Code to micro, small and medium enterprises.⁷

(1) Notwithstanding anything to the contrary contained in this Code, the provisions of clauses (c) and (h) of section 29A shall not apply to the resolution applicant in respect of corporate insolvency resolution process² [or prepackaged insolvency resolution process] of any micro, small and medium enterprises.

(2) Subject to sub-section (1), the Central Government may, in the public interest, by notification, direct that any of the provisions of this Code shall--

(a) not apply to micro, small and medium enterprises; or

(b) apply to micro, small and medium enterprises, with such modifications as may be specified in the notification.

NCLT plays a significant role in managing insolvency cases pertaining to SMEs in accordance with the provisions outlined in the IBC. The NCLT is vested with the power to dismiss insolvency applications in cases where they are determined to be frivolous or vexatious.

However, the NCLT faces substantial obstacles when it comes to resolving insolvencies of SMEs. One significant concern pertains to the deficiency in expertise regarding the management of SME insolvencies. This arises from the pre-dominant legal backgrounds of its members, which may result in a dearth of specialised knowledge essential for the successful resolution of SMEs. In addition, the NCLT frequently encounters a substantial volume of cases, leading to protracted resolution procedures that can have adverse effects on SMEs. To tackle these concerns, pertaining to SME's. One potential approach to address this issue could be to offer specialised training to judges in the NCLT or to establish separate tribunals specifically designed to handle insolvencies of SMEs.⁸

IMPACT ON SMES

The enactment of IBC, 2016 was anticipated to revolutionise the management of financially distressed companies, with a particular focus on SMEs, by enhancing the efficacy of the procedure. It introduced of a comprehensive framework in 2016, establishment of the Insolvency and Bankruptcy Board of India for improved execution, and set timeframes for resolution procedures.⁹ SMEs, frequently encounter payment delays when larger businesses experience financial hardships, leading to cash flow constraints. IBC assists financially distressed companies in navigating their distress and promoting creditors to evaluate the feasibility of the company and devise practical strategies for its revival. It introduces Insolvency Professionals (IPs) to enhance efficiency in negotiations and dispute resolution.

The Insolvency and Bankruptcy Code (Second Amendment) Ordinance, 2018 alleviates the constraints of Section 29A, which aimed to deter unethical promoters from obtaining assets at discounted rates but inadvertently resulted in complications for MSMEs, limiting potential resolution applicants. Acknowledging the importance of MSMEs within the Indian economy, the government exempted these entities from Section

⁷ Insolvency and Bankruptcy Code, 2016, S 240A, No. 31, Acts of Parliament, 2016 (India).

⁸ Shreya Patel, *The Impact of the Insolvency and Bankruptcy Code (IBC) on Small and Medium Enterprises (SMEs) in India*, LawBhoomi (Oct. 28th, 2023, 10:13PM), <https://lawbhoomi.com/the-impact-of-the-insolvency-and-bankruptcy-code-ibc-on-small-and-medium-enterprises-smes-in-india/>

⁹ Praveen, *Insolvency and Bankruptcy Code, 2016 (IBC 2016)- A ray of Hope for Distressed SMEs in India*, SME Advisors (Oct. 30, 2023, 3:27 PM), <https://smeadvisors.in/2017/03/15/insolvency-and-bankruptcy-code-2016-ibc-2016-a-ray-of-hope-for-distressed-smes-in-india/>.

29A through Section 240A of the IBC, which provides relief to MSMEs by exempting them from specific disqualifications.¹⁰

The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021, established a Pre-Packaged Insolvency Resolution Process (PPIRP) within the IBC framework. It intends to establish a streamlined insolvency resolution mechanism that offers enhanced efficiency of MSMEs. COVID-19 pandemic caused financial stress for many organisations to which IBC responded by establishing a proficient substitute of insolvency resolution mechanism corporate MSMEs, PPIRP. It aims to facilitate expeditious, economical, and value-enhancing results for all parties involved, while minimising disruptions to business continuity and safeguarding employment opportunities.¹¹

Key Features of Pre-Packaged Insolvency Resolution Process:

Pre-Commencement Requirements

The pre-pack procedure begins with a pre-filing phase in which unrelated creditors and corporate debtors must meet specific criteria. A 66% majority of the unaffiliated creditors must also approve the procedure. The process cannot begin until these conditions are satisfied.

Admission of Application for Initiating Pre-Pack Process

A corporate debtor may apply to start the process within the allotted time after fulfilling the pre-commencement requirements. A report from the suggested resolution professional attesting to the corporate debtor's eligibility and adherence to the fundamental requirements of the resolution plan must be submitted with this application. The process must begin when the Adjudicating Authority (AA) admits the application, which must happen within 14 days.

Conduct of the Pre-Pack Process

The Committee of Creditors (CoC) has 90 days to approve a resolution plan, and the AA has 30 days to adjudicate. The pre-pack process must be finished within 120 days of the date of admission. Subject to legal restrictions, the corporate debtor maintains control over its operations, with the resolution professional supervising and assisting the process.

Consideration and Approval of Resolution Plans

The corporate debtor first presents the CoC with a base resolution plan for approval. The plan is approved and forwarded to the AA if the requirements are met. If not, a notice to the public is sent out, and a resolution plan is assessed and chosen. The chosen plan is put up against the base resolution plan, and the plan that receives the highest score advances to the CoC and AA for final approval.

Closure of the Process¹²

The pre-pack process can conclude in one of four ways: either the AA approves the resolution plan that the CoC has approved or terminates the process, the CoC passes a resolution to begin the CIRP, or the AA orders liquidation subject to certain requirements.

¹⁰ Sameer Jain, *Deciphering the Position of MSME(s) under the Scheme of IBC*, PSL Advocates & Solicitors (Oct. 30, 2023, 2:39 PM), <https://www.pslchambers.com/article/the-viewpoint-deciphering-the-position-of-msmes-under-the-scheme-of-ibc/#:~:text=In%20this%20background%2C%20an%20appreciable,to%20all%20the%20corporate%20entities%2C>.

¹¹ Insolvency and Bankruptcy Board of India, <https://www.ibbi.gov.in/uploads/whatsnew/a650764a464bc60fe330bce464d5607d.pdf> (last visited Oct. 28, 2023).

¹² Debanshu Mukherjee, Aishwarya Satija et. Al, *Pre-Packaged Insolvency Resolution under Insolvency and Bankruptcy Code (IBC): An Overview*, Vidhi Centre for Legal Policy (Oct. 30, 2023, 2:23 PM), <https://vidhilegalpolicy.in/blog/pre-packaged-insolvency-resolution-under-the-insolvency-and-bankruptcy-code-ibc-an-overview/>.

LEGAL AND REGULATORY CHALLENGES AND SUGGESTIONS¹³

Resurrecting MSMEs, through PPIRP faces several challenges. Notably, securing additional capital or debt, impeding debt restructuring and recovery. The 90-day deadline for Resolution Plan approval, plus an additional 30 days for Adjudicating Authority approval, lacks clear decision parameters, lacks clear timely decisions. Guidelines from the Reserve Bank of India or the Indian Banks' Association are recommended.

High leverage in stressed assets while maintaining Capital and Reserves, which necessitates an equity infusion, which may be difficult for MSMEs. Converting debt into equity and maintaining personal guarantees until the Base Resolution Plan is successfully implemented could be a solution.

Identifying Preferential, Undervalued, Extortionate, and Fraudulent (PUFE) transactions within set timeline is difficult requiring audits prior to the start of PPIRP.

Finally, the success of the PPIRP is dependent on addressing these challenges and establishing clear parameters for efficient MSME insolvency resolution. A dedicated MSME-specific resolution regime within IBC, empowered by Section 240A for amendments, is crucial for success.

CONCLUSION

For Small and Medium Enterprises (SMEs), the Insolvency & Bankruptcy Code (IBC) of 2016 has presented both opportunities and challenges. This law is a noteworthy milestone in India's legal system. By providing SMEs with a structured method for more effective debt recovery from corporate debtors, IBC expedited the insolvency process. To speed up resolutions, changes were made to Section 240A and the PPIRP. SMEs, who are frequently viewed as unsecured operational creditors, encounter challenges in fully recouping their obligations under current resolution schemes. Costs and complexity are increased when there are no provisions for out-of-court settlements. The IBC framework should consider customised solutions, unique resolution regimes, out-of-court settlement options, and increased flexibility for SME promoters in order to better serve SMEs. IBC's journey is still ongoing, with the potential to improve support for SMEs and the Indian economy.

¹³ Pre-packaged insolvency resolution under IBC for MSMEs: Challenges that may arise in implementation, Financial Express, May 15, 2021.