Exit Options for Distressed Micro, Small and Medium Enterprise in India

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Abstract: MSME Sector is a major contributor to the country’s economy, the sector has got many hurdles to deal with like adequate and timely funding backups, exit options NPA, sickness of MSME’s. the sector is into a continuous state of problems as there is an equal number startups coming into the sector and leaving too. This state of flux is not only difficult for the business viability but also for the entry of the new talent into the sector. Thus, the exit and the trouble-free entry are also very pivotal for this sector. Indian MSME sector needs to have personal insolvency code and a national level exit policy. The exit from the industry should be as easy the entry. Banks should also support the distressed industries in financial. And should try to rebuild the trust of the small-scale businesses on them. MSME is a pivotal sector towards the growth of the Indian economy. India lacks a proper exit policy for its distressed industries. The exit of the firm should be made as easy as the entry. Otherwise the industry will remain in a continuous state of struggle.

1. Introduction

The Micro, Small and Medium Enterprise of India Plays a very important role towards the contribution of the country’s financial development. The 2015-16 Annual Report of the ministry of finance states that the contribution of MSME sector towards GDP is 37%. After agriculture, the MSME provides the largest percentage of the employment to the country. The sector deals in almost every kind of product and caters the need of not only the global market but also the international market. The MSME sector has provided employment to almost 26 million people of the country and the manufacturing and export contribution is 45% and 40% respectively [1].

Prolonged sickness of the enterprise may lead to its death. Therefore, to avoid the death or more technically the exit of the enterprise from the market, there has to be a proper framework for the revival and rehabilitation of the distressed industries. There has to be a mechanism to minimize the chances of an enterprise going towards distress. The symptoms of the distress should be identified and cured beforehand so that we may not lose an innovative industry or talent which may benefit the country. The project talks about the exit option for the distressed MSME. Distress of MSME means that there must be satisfactory exit or rehabilitation provision. However, there are no clear figures on how many MSMEs are distressed. Government figures suggest a range of between 10% and 15%. Non-government studies suggest at least 50%. Even minor business disruptions can cause firms with otherwise bright and innovative ideas to lose their bearings and be driven to insolvency. Therefore, there is a need to deal with the insolvency of MSMEs in a manner that would enable viable enterprises weather temporary credit disruptions, while allowing unviable entities to close down speedily, liberating various economic resources – financial or human for alternative deployment in the economy.

MSME as it stands for the micro, small and medium enterprise is defined in the MSME development Act, 2006: - the micro enterprise in manufacturing are defined as the one not having more than 25 lakhs of investment in the plant and the machinery and not more than 10 lakhs of investment in plant and machinery for the enterprises providing services. The small enterprises are defined as the one having the investment in plant and machinery ranging in between 25lakh to 5 crore (manufacturing) and investment ranging from 10 lakhs to 2 crore (service). The medium enterprise is the one ranging investment from 5 crores to 10 crores in plant and machinery (manufacturing) and from 2 crores to 5 crores of investment in plant and machinery(service).

Most of the MSME’s are in the form of either partnership or as proprietorship, only 3% of all are registered as companies [2]. The sector is not like the LLP’s where the liability of the shareholder is limited by their contribution made to the partnership. In MSME sector as stated above also the majority of the enterprises are partnership firm or the proprietary firms where their liabilities are stretched till the personal liability as well. At the
time of the failure of the business, the personal assets of the persons are also attached to the assets of the business to clear the debts and dues. And if the assets of the business and the personal assets of the owner are not sufficient of pay off the debt the guarantor is also pulled into the net and his asset is also taken into account to pay off the debts.

Instead of being a major contributor to the country’s economy, the sector has got many hurdles to deal with like adequate and timely funding backups, exit options NPA, sickness of MSME’s, the sector is into a continuous state of problems as there is an equal number startups coming into the sector and leaving too. This state of flux is not only difficult for the business viability but also for the entry of the new talent into the sector. Thus, the exit and the trouble-free entry are also very pivotal for this sector.

Exit policies are for the time bound revival and rehabilitation of the sick industries. In India, we still lack proper rules for the exit policies of MSME. The objective for the exit nowadays is to join the hands of big firms and come out of the sickness of the firm. Firm face hurdles because of the lack of financial help to them. There are many exit strategies prevalent in India like sale of the firm to some big entrepreneur but the most common is the sale or lease of the asset in return of the capital.

From time to government has also come up with certain frameworks for the revival and the rehabilitation of these distressed industries. In this paper, the distress of the enterprises, various committee reports, legislation for the revival, restructure, and insolvency have been analyzed along with this, various methods of raising fund have also been discussed.

1. Regulatory Framework

MSME Development Act, 2006

The MSME Act defines the micro, small and medium enterprise as MSME as it stands for the micro, small and medium enterprise is defined in the MSME development Act, 2006: - the micro enterprise in manufacturing are defined as the one not having more than 25 lakhs of investment in the plant and the machinery and not more than 10 lakhs of investment in plant and machinery for the enterprises providing services. The small enterprises are defined as the one having the investment in plant and machinery ranging in between 25lakh to 5 crore (manufacturing) and investment ranging from 10 lakhs to 2 crore (service). The medium enterprise is the one ranging investment from 5 crore to 10 crore in plant and machinery (manufacturing) and from 2 crore to 5 crore of investment in plant and machinery (service).

Section 25 of the Act talks about the closure of the enterprise. The central government has the power to make laws in that regard and come with the exit policies from time to time. No such exit policy is given by the government till the date. This leads the distressed enterprise into much more distress. Closing down a business entity is very difficult in India as compared to entering into one. The ministry of MSME on the urge to tackle down the issue of NPA and Exit policy came up with a revival plan and the MSME draft bill 2015[3]. The bill talks about adding chapter V-A to the Act which talks about the scheme of revival and exit policy of the MSME. The bill is still pending the parliament. If the bill is passed it will provide recourse to the distressed MSME and will let them close easily without any hurdle.

Committee on the Exit Policy of Distressed MSME

On 26th September 2015, a committee was set to analyze the financial architecture of the MSME. The committee was formed after the union budget of 2015- 2016. The sub groups of the committee come up with the report on the exit policy of the MSME. The report has talked About the need of the proper insolvency legislation for the MSME and the national level exit policies. The committee has made certain recommendations such as; - setting up of rehabilitation fund, standstill period of statutory dues, setting up of personal insolvency code, etc.

Revival and Rehabilitation

Revival of MSME takes place when an industry is at a stage of financial distress, debts and is not able meet its customer’s requirement hence is not making any profit. Revival is necessary so that we may not lose out some advantageous talents from the market. Revival gives another opportunity to the enterprise to re-establish itself. But most of the enterprises are not able to overcome this distress because of the lack of the finances. Currently, India lacks a national level exit policy which has the effect to waste of capital resources, human efforts, etc. The draft consultation paper launched by the ministry of MSME also discusses about the need for the exit policies. There is an urgent need to frame a policy for either revival or the timely exit of the enterprise from the market.
There can be many factors for a firm undergoing distress such as financial distress, debts, lack of technology, human resources, market challenges, recession, etc. The symptoms of the distress should be analyzed beforehand and tackled with. The government can also engage a third party to conduct the study. This process should be conducted swiftly to ensure timely implementation.

Once the setbacks for the distress of industry is analyzed, prompt action is needed, if there exist a chance of the rehabilitation of the industry the government with other financial instructions like bank, etc execute a revival plan. Sometimes a very little effort is needed to lift up loss making enterprise. Some of the measures which can be considered are a rehabilitation package for the unit, interest free loans for a specific period, a fund created to assist such units, holding off of creditor action for a period, insurance against disasters or rebate on delayed payment. In case the reasons for losses are not financial, the government could propose change in management, training, or assistance in marketing activities[4].

Exit Policy

If at the analysis stage it is found out that the rehabilitation of the enterprise is not possible, then without wasting much time and effort the enterprise should be allowed exercise its exit option. But for this we need a proper exit policy at hand. This should include the provision for taking back the locked resources, partition of personal assets from the business, winding up and the protection of interest of the investors and the creditors.

Administrative revival is there in which, these enterprises can take bank loans but they generally don’t opt for bank loans because it would create burden on them and their profit level also almost nothing. These distressed enterprises also have the option to try for the re-structuring of its debts; or they can also go for one time settlement with the bank.

Reserve Bank of India has established a committee for to re-analyze the rehabilitation of the MSME’s via SLIIC i.e. State Level Inter Institutional Committees which is constituted of various financial institutions, state government representative, banks, etc. No protections from the creditors have been provided as in the measures. For the purpose of revival, a holding period is described during which all creditor actions are stayed which allows the enterprise and its stakeholder to focus only on the revival. There is no time frame for the rehabilitation or the OTS of the enterprise. Most of the case of rehabilitation is rejected by the banks as the proposal for the revival is initiated by the stakeholders of the bank such as lending bank. This gives rise to conflict of interest. The entrepreneurs lack knowledge and finances to execute a fruitful action plan. When banks do not find these cases worthy enough, they execute proceedings against the entrepreneurs in DRT under the SARFESI Act.

The working of the RBI’s State Level Inter Institutional Committees has also not been viable as with time this committee has also just become a statistical review committee and has failed to examine the rehabilitation of the distressed enterprises.

The Ministry of MSME has informed a Framework for Revival and Rehabilitation of Micro, Small & Medium Enterprises, as per the power given under section 9 of the Micro, Small and Medium Enterprises Development Act, 2006.

In India, the current instrument for tending to recovery, restoration and exit of small ventures is extremely feeble. The latest Doing Business (DB) Report, a joint venture of the World Bank and the International Finance Corporation, positions India 137 out of the 189 economies for settling bankruptcies. It takes note of that settling bankruptcy takes 4.3 years overall and costs 9.0% of the account holder’s domain, with the in all probability result being that the organization will be sold as piecemeal deal.

Pending an itemized modification of the lawful system for settling insolvency/bankruptcy, there is a felt requirement for exceptional administration for recovery and exit of MSMEs. The MSMEs confronting indebtedness/bankruptcy should be given legitimate chances to restore their units. This could be through a plan for re-association and restoration, which adjusts the interests of the loan bosses and borrowers.

International Practice

In numerous nations changes have occurred that permits insolvency of organizations to be managed with in a complete way that empowers recovery or protect before liquidation and winding up. Insolvency is dealt with as a business framework requiring to be managed in understanding with business standards in a system of decency and value. There is a procedure of giving an effortlessness period to organizations to manage trouble called stand still or holding off period. This is expected to empower a restoration arrange if the
business is inalienably practical, puts all loan creditors on hold pending recovery, gets enterprise out of holding period on the off chance that it resuscitates or makes a move on twisting up if the business is beyond revival. The whole procedure is finished in a period bound time of 12 – 24 months. Both individual and in addition business bankruptcy is managed on the premise of similar standards with the ease filing for bankruptcy and protections from the debtors.

2. Fund Raising Option for MSME

Asset Based Finance

Financing based on the assets kept as security includes lending on assets, purchase order finance, factoring, leasing and warehouse receipts, these types of lending differ from the tradition financing such as debt finance, as here the firm is being financed on the basis of the value of their current specified assets and not on it credit worthiness. Working capital and term dues are therefore backed by assets, for example, exchange debt claims, stock, machines, equipment and land.

The main feature of such kind of lending is that the enterprise has access to the finance without undergoing into many formalities as that of getting financed from bank like auditing, monitoring, legal costs, etc, no such formal balance sheet or cash flow status is required in the asset financing. The traditional way of financing often reduces the profit level. Moreover, in asset backed financing even if the firms lack credit worthiness or is under losses or looking for a growth opportunity get access to an easy mode of finance. The most advantageous part is that the asset financing does not even require a guarantor nor the ownership of the company gets diluted.

There are basically two types of asset based financing i.e. the tangible asset based and the intangible assets based. The tangible asset based lending is done when the plan, machinery or the land is used as a security for the finances. In intangible asset based financing the intangible asset like patents etc are given as a security for the loans.

However advantageous these types of financing are to the borrowers, it also carries some risk for the lenders such as- collateral risk i.e. the risk of depreciation of the asset at a later stage, legal risk i.e. the of non-or wrongful compliance with some legal requirement, collateral illiquidity- the risk of process of liquidating the asset will be time consuming of costly, etc. To mitigate the risk of collateral illiquidity the lenders take the asset at a discounted value. Sometimes lenders appoint some advisory firm to decide the credit value of the asset.

As the new financing players such as hedge funds, cash backed companies, traditional finance companies have entered into the market the asset based finance has lost its value and is being considered less for the traditional commercial finance companies, hedge funds and cash-rich companies seeking to diversify their business [5].

Warehouse Receipts

Ware house receipt is another kind of asset based lending where the firm gets financed in accordance with their ware house stock. This warehouse must be certified one only. The manufacturer and the trader keep their stock at the warehouse and in return they get a receipt acknowledging their stock at the warehouse. This receipt is than kept as collateral to obtain the loan from the lender and lender puts a lien on the stock so that it is traded further.

Factoring

Factoring is short term supplier funding mechanism in which a seller firm receives the finances from a specified institution which is known as factor by giving their receivable accounts in exchange, resultant from the sale to the customers. It can also be termed as that the factor now holds the right to collect the money due to the seller from their customer at the due date, by financing the firm on the receivable at a discount. The gap between the amount given by the factor to the firm and the face value of the receivables is known as the reserve account. This amount is paid to the firm deducting the interest and the service charges after the receivables are paid by the firm’s customer to the factor. Factor is better option as opposed to the conventional bank financing, but it is an even better option as against the asset based financing. As in factoring no debt is due on the firm to be paid at a letter date. In India, a Factoring Regulation Bill was passed by the Parliament in 2011, which regulates the assignment of receivables in favor of a factor, and was expected to address, among other issues, the problem of delayed payments to micro and small firms by large companies.

Purchase Order Finance

Purchase Order Finance is a much-specified kind of financing in which a firm is financed to complete its specified order towards a customer. These financing techniques help to fulfill a
specified target and hence help the firm to best utilize the opportunity and obtain growth in the market. The lenders provide the finance to the firm after analyzing the creditworthiness of the order to be supplied to the customer. Once the order is complete, the lender either directly incur the dues from the receivable of the firm like factoring or the firm directly make payment to the lender. Principle amount, interest and the service charges are incurred by the lender. The risk is here being transferred to the more trustworthy customers generally the big firms or the government.

**Leasing**

In lease agreements, the asset holder i.e. the lessor provides the lessee the right to use his goods for fixed period of time and in turn the lessee pays him a specified amount of money.

Specifically, a lease is an agreement whereby the owner of an asset (lessor) provides a customer (lessee) with the right to use the asset for a specified period of time, in exchange for a series of payments. However, the ownership remains with the lessor until the end of the contract, the transfer of ownership to lessee depends. The lessee acts like the owner of the asset and the liability of the risk, insurance and the maintenance is also on him.

Contract for hire purchase is also a similar to lease where the firm gets the money in installments for the use of the assets. Here the firm giving their asset on hire also gets the principal amount and also the interest on in. No such upfront cash down payment or the security deposit is required for the lease agreements as it is a pivotal condition in traditional bank financing.

**Crowdfunding**

Crowd funding is a relatively recent phenomenon whereby a large number of individuals pool their often relatively small financial resources to support efforts, projects or campaigns initiated by other people. The process of several individuals pooling their financial resources happens via an internet-based online “Crowd-Funding platform”. Crowd funding is basically of two types i.e. Reward based crowdfunding and financial return crowdfunding. In reward based crowdfunding there is just some reward in return of the investment or the money is given out of donation expecting nothing in return. But in financial return crowdfunding which is again of two types i.e. equity based and peer to peer landing the money is given with the expectation to either to get some equity shares of the company or the principle amount with certain rate of return respectively.

FR crowd-funding globally has grown rapidly in the last 5 years; the peer-to-peer lending market doubles each year. It accounts for approximately $6.4 billion outstanding globally. FR crowd-funding market is worth over $1 billion in the USA, the UK and China, and is taking off in many other jurisdictions across the world. However, India still lacks a legislation to regulate such a way of financing. Two potential areas of financial innovation that have seen strong growth in recent years are peer-to-peer lending and equity crowdfunding. There are two main factors contributing to the rapid rise of FR crowd-funding: 1) technological innovation; and 2) the financial crisis of 2008[6].

In India, enterprises generally go for the reward based crowdfunding and not others as these are not regulated and may lead them to penal laws. Crowdfunding generally attracts the small firms who lack credit worthiness and also have almost nothing to keep as security for the tradition bank lending.

**3. Conclusion**

The Micro, Small and Medium Enterprise of India Plays a very important role towards the contribution of the country’s financial development. The 2015-16 Annual Report of the ministry of finance states that the contribution of MSME sector towards GDP is 37%. After agriculture, the MSME provides the largest percentage of the employment to the country. The sector deals in almost every kind of product and caters the need of not only the global market but also the international market. The MSME sector has provided employment to almost 26 million people of the country and the manufacturing and export contribution is 45% and 40% respectively.

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References


