



[Mayank Jain](#)

Rajiv Gandhi National University Of Law, Patiala

Safeguarding the Interests of MSMEs as Operational Creditors

Introduction

Micro, Small & Medium Enterprises (MSMEs) provide goods/services to corporates on credit basis but the bills of these small businesses are not honoured on time and it is because of this reason, their working capital is affected, leading to job losses, thereby affecting economy as a whole. Since MSMEs form the backbone of the Indian Economy and contribute over 28% to GDP and around 45% to manufacturing output^[1], it becomes essential to protect these small businesses from their accounts being declared as non-performing assets (NPAs) because of their limited capital/size.

Recently, Minister of MSMEs has pleaded to all the stakeholders for the payment of outstanding dues of MSMEs including the private sector as a part of recent economic package. As a result of this package, Government will take many positive steps to prevent liquidity crunch among MSMEs by stepping in for providing 100% credit guarantee for Rs.3 lakh crore worth of collateral-free loan and creating Rs.50,000 crore fund thereby infusing equity in viable MSMEs.^[2] Nevertheless, a well-designed legislation which addresses liquidity issue of MSMEs is required which can bring corporate debtor on negotiation table.

Furthermore, The Federation of Indian Micro and Small & Medium Enterprises (FISME) has reported that 25,000 small scale vendors could be affected and another 75,000 is likely to be affected.^[3] Thus, in order to reduce the grievances of MSMEs and to lower their own NPAs, there is a need for robust mechanism for recovery of their dues. Their survival is based upon the effective recovery laws. After more than 3 years of passing of Insolvency & Bankruptcy Code, 2016 (hereinafter referred to as “**Code**”), the issue still remains vital as to the appropriate forum for MSMEs for recovery of their dues, whether to approach NCLT, or MSME Facilitation Council.

Protection Undermined in IBC

Under Insolvency & Bankruptcy Code, 2016, MSMEs are given the status of “Operational creditors” and they can invoke Section 9 and drag corporate debtor to NCLT by delivering a demand notice on the occurrence of a default.^[4] But, the issue which arises is that there is no difference between MSMEs and other Operational Creditors. Operational creditors are guaranteed liquidation value (estimated amount received in case company is to be liquidated) only but in reality, the resolution plans in various NCLTs suggest that hardly any amount is recovered by Operational creditors. Also,

there are various other reasons on the basis of which discrimination is being done to MSMEs under IBC.

A data has been prepared by Confederation of Indian Industry and Consultancy firm Sumedha Fiscal Services, according to which out of 12 largest defaulting accounts listed by RBI, 10 accounts have a total claim of Rs.39,000 Crore to be claimed by Operational Creditors but the actual claim admitted is only Rs.9,550 Crore which is around 24% of the total claim.[5] It shows the recoverability of amount by OCs.

Thus, the discrimination is being done to Operational Creditors in various ways-

1. No say in Committee of Creditors-

Although Insolvency & Bankruptcy Board of India (IBBI) has realized the importance of including Operational Creditors in Committee of Creditors (CoC) which approves the resolution plan of the corporate debtor but presently, Committee of Creditors comprise only of Financial Creditors[6] (FCs), which leave Operational creditors out of the participation in resolution plan. The entire decision will be taken by FCs only. CoC has the ultimate responsibility to approve the resolution plan for revival of corporate debtor, based on feasibility and viability and present the same to Adjudicating Authority for final approval and the same is based on the doctrine of commercial wisdom of CoC.[7]

The difference between the rights of FCs and OCs has been justified by Bankruptcy Law Reforms Committee by stating that Operational creditors are generally disinterested in revival of company, rather they are interested in liquidation.[8] Furthermore, Section 24(3) connotes that OCs can participate in CoC if the debt owed to them exceeds 10%. Despite this, they do not have any voting rights. Even if OCs are given voting rights in CoC, as they are not interested in the company as a going concern, rather their aim is just to recover dues. In that scenario, they will always vote in the favour of liquidation, rather than revival, which is against the interest of the corporate debtor. Therefore, the entire recovery of MSMEs under the Code would be based on discretion of financial creditors who approve the resolution plan.

2. Low priority in waterfall mechanism-

Operational creditors are ranked very low in the waterfall mechanism provided under Section 53 of the Code. It says that in case of liquidation, the payments will be made to OCs after the payments have been done to Secured and Unsecured financial creditors as their claims are categorized under "any remaining debts and dues".[9]

Also, the Supreme Court in *Essar Steel Case* has clarified that for the purpose of distribution of funds out of insolvency proceedings, rights of financial creditors will prevail over Operational creditors.[10]

If the payments of small vendors are kept in a priority so low, it may not be the ideal forum for their own protection, if any of the resolution plan is not able to fructify.

3. No proceedings for disputed debt-

Unlike Operational Creditors, Financial Creditors can start the proceedings for disputed debt. While,

OCs cannot start the same if the debt is disputed by corporate debtor. After the decision of the Supreme Court in *Mobilox Innovations Private Limited*, the Adjudicating Authority looks into the following questions while determining application under S.9-

3.1 If the operational debt is more than Rs.1 lakh

3.2 If the documentary evidence adduced by Operational Creditor shows the debt is payable and the same has not been paid

3.3 If there is any dispute between parties or any pendency of suit or arbitration proceedings before receipt of demand notice.[11]

If any of the elements is missing, NCLT will reject the application. Thus, if corporate debtor can show that dispute existed (suit or arbitration proceedings) before the petition is admitted, the same could be rejected, thus, it is not always necessary that petition of an operational creditor would be admitted.

Supreme Court has also clarified IBBI (IRP for Corporate Persons) Regulations, 2016 and Section 30(2) by holding 'equitable treatment of all classes of creditors' does not amount to paying operational creditors equal amount in CIRP. The court also cleared that the rights of FCs will prevail over the OCs in the distribution of the funds received from the insolvency proceeds because of the fact that FCs are the primary investors for the corporate debtor. Furthermore, it has been cleared by Supreme Court that IBC has to be used to bring corporate debtor on its feet and it is not merely recovery legislation.[12]

MSME Facilitation Council - Quicker Settlement

The undermined protection under the Code for MSMEs takes us to the question which arises is if there is any other avenue for the recovery of dues by MSMEs. The answer is in affirmative. MSMED Act, 2006 provides for mechanism in case of delayed payments to MSMEs.

The Act mandates the payment by buyer in case of goods supplied or services rendered, if there is an agreement to the same. If there is no fixation of time period, payment has to be made, a limit of 45 days is prescribed for such payment.[13] In case, buyer fails to make payment according to this provision, buyer will be liable to pay compound interest with monthly rests to supplier at three times the bank rate notified by RBI.[14]

A party may make a reference to Micro and Small Enterprises Facilitation Council (hereinafter referred to as 'MSMEFC') and on the receipt of the reference; it shall conduct conciliation or seek the assistance of any institution or Centre for providing ADR services.[15] In case the conciliation fails and dispute remains unsettled, the Council shall take up the matter for Arbitration itself or refer the same to any institution. Every reference has to be decided within 90 days. The Act also makes provision for depositing 75% of the amount if the buyer wants to file an appeal.[16]

Ministry of MSME has recently launched a portal - MSME Samadhan Portal which has eased the process for small vendors by online filing of claims with respective state's MSME Facilitation Council. Applications are then converted into cases by MSEFC. MSMEs would feel empowered to file claims against big industries owing to this initiative, thereby easing the recovery process. Thus, MSMED Act provides for payment of principal amount along with interest for delay of more than 45

days while in IBC, the statutory protection has been limited to liquidation value only which is very low.

MSME Dues under CIRP Costs - Alternative Solution

The Federation of Indian Micro and Small & Medium Enterprises (FISME) has recently made a suggestion to include the dues payable to MSMEs under CIRP costs. If the resolution plan gets approved, it must include the CIRP costs to be paid in priority to all other claims.

An alternative solution could lean in the favour by including the dues outstanding to MSMEs under CIRP costs. According to FISME, even after including the dues of MSMEs under CIRP costs, the burden on financial creditors would be minimal as they would not be affected much, thereby protecting interests of all.

Section 30(2) mandates the Resolution professional to ensure that the resolution plan contains payment of IRPC (Insolvency Resolution Process Costs) in priority to repayment of other debts of the Corporate Debtor.[17] CIRP costs include the interim finance, fee payable to person as RP, and costs incurred by RP in running the business of Corporate Debtor.[18] It can be made out that all these payments are priority payment. Insolvency and Law Committee report dated 26th March, 2018 has realized the importance of expansion of the scope of Essential goods & services in the Regulations being provided to corporate debtor so that their payments are done on priority basis.[19] A coherent reading of Section 5(13) and Regulation 32 state that the payments included under CIRP costs are priority payments over other claims.

Considering the same, an attempt can be made so as to include the dues of MSMEs under the domain of "CIRP costs". Including the same would be in consonance with the Preamble of the Code as balancing the 'interest of stakeholders' and 'availability of credit' and also with the observation of Supreme Court that interest of all the stakeholders have to be looked after.[20]

Therefore, MSMEs being an important stakeholder in CIRP, in order to uplift the status of MSMEs from already undermined mechanism, an effort can be made to ensure enough credit available in the market, which is essential for a growing economy and also promote growth and employment in MSMEs.

Non- Obstante Clause

Section 238 of the Code is a non-obstante clause which gives effect to the provisions of the Code despite anything contrary to this law.[21] The issue arises when, proceedings under the Code has been initiated and now no actions which could take place under MSMED Act. All the pending proceedings are stalled or even the execution of award made under MSMED Act is stalled, leaving MSMEs in clouds. According to the Code, their claim is based on acceptance of the same by IRP/RP and even if accepted, legislative protection is limited to liquidation value only. Thus, it becomes essential to protect the interests of MSMEs from corners of non-obstante clause.

Although MSMED Act also has non-obstante clause, but the Supreme Court has clarified the non-obstante clause of the latter legislation would prevail[22] because of the reason that Legislature is aware of the previous legislation and its non-obstante clause. In an NCLT order in *Mahesh Sureka v. Marathe Hospitality*[23], the Bench declared the attachment order of Economic Offences Wing as

nullity and non-est in law relying on Section 238 of the Code.

Thus, the entire purpose of MSMED Act gets defeated when under the Code there is also no protection because the proceedings under MSMED Act would be stayed. Thus, even in the scenario where proceeding is pending under MSMED Act and the CIRP has been initiated against the Corporate Debtor, even if the payment under MSMED Act gets stalled or proceeding gets stayed, MSMEs would be protected if suggestion to include their dues under CIRP costs transpires. Alternatively, a balanced law is required taking into consideration the interests of all stakeholders and it does not affect the insolvency process.

Conclusion and Road Ahead

The author opines in the favour that MSMEs should approach MSMED Facilitation Council first and then exhaust the remedy under IBC when the remedy provided under 2006 Act fails to fructify. MSMEs should drag corporate debtors to NCLT only when the management has become unresponsive to the dues of its creditors. Therefore, in my opinion, an effort should be made by the Union Government for stricter implementation of MSMED Act, 2006 and bring in provisions providing for hefty penalty and other stringer process in case buyer fails to make payments on time and facilitating the dues to these small vendors easily. If the proposal to include dues to MSMEs under CIRP costs materializes, an effort should be made to keep a check if the big corporates are not operating through small vendors and benefitting themselves over secured creditors. Stricter implementation of law would be an ideal solution in this.

Thus, ensuring the dues of MSMEs in a time bound manner would help manufacturing sector in its aim to increase its share in GDP from 16% to 25% by the end of 2022. This will have overall positive effect on ranking of India in the Ease of Doing Business Report, and also the Indian Economy.

Reference:

[1] Ministry of Micro, Small & Medium Enterprises, Government of India, *Annual Report 2018-19*, available at: <https://msme.gov.in/sites/default/files/Annualrprt.pdf>, last seen on 10/05/2020

[2] <https://www.financialexpress.com/industry/sme/msme-fin-loans-for-msmes-collateral-free-loans-nirmala-sitharaman-business-rs-20-lakh-crore-economic-package/1957930/>

[3] <https://smestreet.in/lighthouse/over-25000-msmes-complaints-for-insolvency-process-fisme/>

[4] S. 8, Insolvency & Bankruptcy Code, 2016.

[5] *The Insolvency and Bankruptcy Code, 2016: Evolving Dynamics*, Sumedha Management, available at: http://www.sumedhamanagement.com/reports/WHITE_PAPER_1.pdf, last seen on 10/10/2020.

[6] S. 21(2), Insolvency & Bankruptcy Code, 2016.

[7] K. Sashidhar v. Indian Overseas Bank & Ors., 2019 SCC OnLine SC 257.

[8] https://ibbi.gov.in/BLRCReportVol1_04112015.pdf

[9] S. 53, Insolvency & Bankruptcy Code, 2016.

[10] Committee of Creditors of Essar Steel India Limited v. Satish Kumar Gupta, 2019 SCC OnLine SC 1478.

[11] Mobilox Innovations Private Limited v. Kirusa Software Private Limited, Civil Appeal No. 9405 of 2017 (Supreme Court, 21/09/2017).

[12] Swiss Ribbons Private Limited v. Union of India, W.P. 99/2018 (Supreme Court, 25/01/2019).

[13] S. 15, The Micro, Small and Medium Enterprises Development Act, 2006.

[14] S. 16, The Micro, Small and Medium Enterprises Development Act, 2006.

[15] S. 18, The Micro, Small and Medium Enterprises Development Act, 2006.

[16] S. 19, The Micro, Small and Medium Enterprises Development Act, 2006.

[17] S. 30(2), Insolvency & Bankruptcy Code, 2016.

[18] Section 5(13) of Insolvency & Bankruptcy Code, 2016 r/w Regulation 31 of CIRP Regulations.

[19] *Discussion paper on Corporate Insolvency Resolution Process*, available at: <https://ibbi.gov.in/webfront/Discussion%20Paper%20%20CIRP%20%203%20Nov.pdf>, last seen on 13/05/2020.

[20] Supra 12.

[21] S. 238, Insolvency & Bankruptcy Code, 2016.

[22] *Solidaire India Limited V. Fairgrowth Financial Services Limited*, (2001) 3 SCC 71.

[23] C.P. (IB) 3603/MB/2018.

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