29

New Thinking on Resolution of Small Firms

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The budget speech of 2015 included a series of measures for supporting micro, small and medium enterprises (MSMEs). One of these was an announcement for a reform of the bankruptcy system to create a new comprehensive bill to replace existing laws. When the Insolvency and Bankruptcy Code, 2016 (IBC) was passed by Parliament in 2016, it became a single resolution framework for the distress of all persons in India, covering both corporate default resolution and individual default resolution. The question that arises is whether the law, as it stands today, serves well to resolve the corporate insolvency of MSMEs efficiently. The reason to differentiate between MSME and the larger firms in corporate insolvency resolution is often that the MSME have features closer to an individual than a firm in terms of a smaller degree of existing organisational capital to be preserved and lower complexity in credit relationships. This suggests that it should be easy to wind up these entities and for the entrepreneurs to start afresh. On the other hand, small businesses assets are more tightly interlinked with personal assets of the entrepreneur. While a single creditor, who has the dominant power in negotiations during an insolvency, can put a possibly viable enterprise into premature closure, the lack of clear separation between business and personal assets can make this a long-drawn-out process.

The international discussion about insolvency resolution for MSMEs tend towards having a more explicit role of the debtor in triggering insolvency resolution and allowing for a debtor-in-possession model during the resolution process. In order to manage the moral hazard problems in a debtor-in-possession approach, there is a greater onus placed on disclosure by the debtor. Information is to be disclosed in pre-defined, standardised formats at regular frequency and strict monitoring by third parties. Further, information captured and monitored about the business assets of the business during the entire life of the business, as opposed to just during the time of distress, helps with clarity of asset partitioning during insolvency and bankruptcy resolution. In this spirit, the United Nations Commission on International Trade Law (UNCITRAL) draft legislation[1] on MSMEs recommends a business registry framework where MSMEs can be registered and information available about them to improve their access to finance as well as to enhance the availability of their business opportunities.

Thus, a central element in facilitating the development of the MSMEs, while maintaining their objectives, comes at the cost of higher information disclosure and monitoring. In this paper, we conclude with the suggestion that the IBC was designed with features that are strengths in the operations of an MSME as a going concern as well as for an MSME which entered into financial distress. Of these, a key feature is the institutional infrastructure of regulated information utilities, which can enable filing and storage of information by debtors. This was originally visualised to allow secure yet easy access of credit and asset security information to all parties in the IBC ecosystem including creditors, insolvency professionals as well as the judiciary. What is useful to note is that such a system can also enable a platform for mandatory reporting and disclosures by the debtor during the insolvency and bankruptcy proceedings in a low cost manner. From the perspective of the IBC, these are functions that can readily be satisfied by the information utilities which was visualised as a repository of information about credit contracts as well as the assets and operations of the debtor.

FACTS ABOUT SMALL ENTERPRISES IN INDIA

MSMEs are widely seen as a source of employment in the economy and, because of this, are perceived as important for economic growth. This makes them a target of policy interest. The starting point in designing public policy is to know and understand who the MSMEs are, including what the objectives of the enterprises are, what their assets and liabilities are, and the details of the operations of their business models. Unfortunately, there is little information that is readily available about the MSMEs, either in terms of organised data-sets or in terms of existing research. Most studies about the choices and behaviour of firms tend to be restricted to the large sized, long lived, and listed firms because there is ready information available about them and whose behaviour is explained using profit maximising objective functions. However, Hurst and Pugsley (2011)[2] argue that the small business entrepreneur does not necessarily go into business to target larger scale of operations or to achieve large profits, but instead for non-pecuniary benefits.[3] This suggests that the choices of MSMEs may not necessarily be consistent with the choices made by larger firms whose objective is to optimise. While a low debt to equity ratio for a large firm may indicate a low access to finance, this may not necessarily be true for MSMEs with similar levels of leverage which may settle on a low leverage by choice rather than constraints. Thus, policy to facilitate the development of large firms may not be suitable as policy for the development of MSMEs.

Part of the problem of a single framework for MSMEs is the wide variation in the forms of MSMEs across countries. The most widely used classification of firms as MSME is by the number of their employees. For instance, USA classifies MSMEs on this basis. Most other countries employ a combination of number of employees as well as some measure of size by way of net-worth or turnover, from the countries of the EU to those in the Far-East Asian regions. The thresholds based on which an enterprise is micro, small and medium can vary across countries, but the underlying features remain the same.

India is an exception to this rule in that MSMEs are identified and classified based on the quantum of a firm's investment in plant and machinery. Thresholds of the quantum of investment is specified to classify firms as micro, small or medium. These thresholds differentiate between manufacturing and services firms as well. Thus, until the first quarter of 2020, a manufacturing firm that invested anything less than Rs. 2.5 million in plant and machinery was a micro manufacturing enterprise. A manufacturing firm that invested between Rs. 50 million and Rs. 100 million was classified as a medium manufacturing enterprise. In between these two were small enterprises. These thresholds were lower by 2.5 times for defining MSME services firms. These firms are registered by the Ministry of Micro, Small and Medium Enterprises set up under the Micro, Small and Medium Enterprises Act (2006) (MSME Act). The ministry designs and implements policy to help the development and growth of MSMEs, including implementing credit support schemes specifically for these enterprises.

In 2018-2019, there were 63.3 million firms that were classified as MSME with 63 million classified as micro enterprises, 30 thousand as small and 5 thousand as medium enterprises[4]. These firms were estimated to account for 29 per cent of the GDP in the country that year. Further, they account for around 110 million employees with 108 million estimated to be employed in the micro enterprises.

In addition to firms registered under the MSME Act, firms that are registered as limited liability companies with the Ministry of Corporate Affairs (MCA) under Companies Act, 2013 may also meet the criteria for the MSME enterprises. As of 2019, there were a total of 1.1 million firms registered with the MCA. There were 110,000 new firms that were registered in 2018-2019 alone, many of which are likely to meet the MSME requirement. Sharma and Sinha (2020)[5] analysed the firms available in the CMIE Prowess database for 2018-2019 to examine if any of these firms satisfied the MSME classification criteria. The data-set had 7689 manufacturing and services firms which were not subsidiaries or firms involved in wholesale or retail trading, or firms that had missing financial observations. Of this subset of firms, 2488 firms could be classified as MSME. This is around 33 per cent of the data. This subset can be used as a benchmark for what we can expect is the number of firms registered by the Registrar of Companies at the MCA as MSMEs. In the first quarter of 2020, the MSME classification was changed to include turnover as part of the MSME definition, along with higher thresholds for the investment in plant and machinery for the three categories of firms. This reduced the number of MSMEs from 2488 to 1444, or to 19 per cent of the MCA firm data.

Lastly, as elsewhere in the world, MSMEs in India proliferate in the form of proprietorship. These are typically registered under the Shops and Establishments Act at the level of each State.

Across all these different entities, there is great variation in the availability of systematically organised data-sets that are available or have been systematically studied other than the firms registered with the MCA. The Ministry of MSME publishes estimates of the number and turnover of their registered MSMEs, along with the number employed as well as the industry sectors where the MSMEs operate[6]. As far as we are able to tell, there is no access to the underlying information about the balance sheet or the annual operations of these entities. Information about proprietorships are collected at the level of each State, and there is no reliable access point in the public domain to obtain or analyse this data. We find that, unlike in jurisdictions such as USA and the UK where there are efforts to collect information on small businesses through regular surveys of these small businesses that are administered in a timely manner (Hurst and Pugsley, 2011; Davis *et al.,* 2016[7]), there are no reliable data sources that are yet available about small business in India. There is some information in an All India Census conducted about the MSMEs at some frequency, but these tend to be outdated and the information collected is limited.[8]

Two relatively recent sources that can potentially help in providing some information about these firms are (a) the MCA-21 database of the MCA and (b) private institutions such as credit rating agencies of the MSMEs and MSME information aggregators like Dun & Bradstreet India or CMIE, and FinTech credit platforms. There is well established research that shows that credit information collected for MSMEs through such platforms improve the access to credit for MSMEs substantially (Kallberg and Udell, 2003[9]). However, this information is not made readily available to the public. In the following section, we present some preliminary work from a project[10] about the financing patterns of MSMEs.

Financing sources

Firms finance their operations and project development from a variety of sources, that can either be thought of as being equity or debt. Debt can be in the form of borrowings and current liabilities, with the distinction that borrowings are funds raised from various financiers with a promise to repay with interest, while current liabilities are payments that the firm owes to their trading partners or to cover expected losses in the form of provisions, and other liabilities such as unpaid dividends or pre-paid income. All firms start with equity as the first source of finance. Through their years of operations, they tend to also have debt in the form of current liabilities and borrowings.

Table: Sources of funds for Large firms and MSMEs, 2014-2017

This table shows source of funding for two sets of firms: **Large firms** is a set of 17,350 firms from the CMIE Prowess database, while the other columns use data for a sample of 4600 firms from the MCA-21 database. The data is for a two-year period 2015-2016 and 2016-2017. Each value reported is calculated as a ratio of the sum of funding from a source across all the firm observations in the sample over the sum of the total liabilities for the same set of firm observations.

(% of Total Liabilities)

	Large firms	MCA-21 small firms			
		Manufacturing	Non-financial Services	Construction	Trade
Borrowing	**29.0**	**38.0**	**24.0**	**36.2**	**23.8**
Current liabilities	**30.1**	**26.2**	**25.1**	**29.9**	**37.8**
Equity	**30.0**	**32.6**	**47.9**	**28.6**	**36.9**
No. of firms	**17,350**	**662**	**1,811**	**1,260**	**868**

Source: CMIE Prowess for the Large firms and the MCA-21 database for the rest

Table above shows the fraction of funding that the average firm in the CMIE Prowess database has across **Borrowing** (which is collected as loans from formal financial sources, short-term and long-term), **Current liabilities** (which is largely supplier's credit, advances and deposits and has a short-term nature) and **Equity** (which includes both externally raised funds as well as retained earnings). This is a conservative picture of financing for small Indian business, since it uses data for a small sample. But this does provide a few interesting features of how MSME finance differs from the larger sample of registered firms. The first is that MSMEs depend more on equity financing compared to the large firms, and the large firms tend to have more Current liabilities funding than the MSME firms. Finally, borrowings from formal financial sources appear to be a higher fraction of funding for Construction and Manufacturing MSMEs which supports the notion that borrowing is more readily available in industries which have physical collateral to offer than those without (such as services and trade).

The MCA-21 sample dataset does not have information about the number of employees. However, we do observe the age of the firms in this sample. A surprising observation that emerges is that the funding patterns described above are agnostic to the age of the firm. We observe that older firms (above 10 years) tend to have more financing through equity than younger firms. This suggests that as firms age while still remaining small, they tend to finance themselves more through retained earnings rather than through formal financial borrowings.

Given the size of the sample, we reiterate that this must be treated as indicative only. Nevertheless, this snapshot does add to the perception that access to credit is a feature of small business in India. But, the presence of a significant fraction of old firms among the firms of the MCA-21 data-set suggests that, like the observation in the study on the small US business, the lower leverage might indicate a deliberate choice to stay small instead.

RETHINKING THE INSOLVENCY OF SMALL ENTERPRISES

Traditionally, there has been no separate legal framework for resolving MSME distress. They are treated as firms in insolvency or bankruptcy, which is resolved under the provisions of companies law. But over the last two decades, there has been an increasing recognition that MSME cannot be treated under the same legal assumptions as larger firms.

One feature is that MSMEs do not have the complexity of credit relationships that large firms have, with loans from multiple financial firms. The decision making is likely to be simpler because the resolution decision is likely to rest with a single financial firm rather than a consensus decision across multiple firms. On the other hand, the concentration of decision making means that the single financial firm is likely to have the balance on power in the negotiation leading to closure of viable enterprises.

Another feature of the MSME that differs from the typical large firm is the lack of clear separation between personal and business assets of the promoter/entrepreneur. Very often, the assets in small firms will be jointly owned by various family members of the entrepreneur. In an environment where lending is dominantly against secured credit, this introduces the challenge of how to protect the small business entrepreneur's property rights against the need to ensure that the secured creditors can protect their interests so that they continue to be incentivised to lend to small businesses.

In these features, resolving MSME insolvency is closer to individual insolvency than to corporate insolvency. However, it is simultaneously clear that there is organisational capital in an MSME which deserves to be preserved if the MSME is a viable, going concern. The challenge is to combine the features of preserving enterprise value for viable enterprises while allowing a fresh start to entrepreneurs who are not viable so that their property rights are protected in bankruptcy.

More broadly, when designing the insolvency and bankruptcy resolution framework for an enterprise, it raises the need to keep in mind the objectives with which the enterprise is created. Insolvency and bankruptcy resolution laws must not be so onerous that these become the dominant consideration in the decision to create and operate the enterprise.

A rich source of work which takes the holistic approach to identify the optimal framework to deal with development of MSMEs as distinct from larger firms is the UNCITRAL Working Group on MSMEs[11] . The development of MSMEs is part of Goal 8 of the United Nations Sustainable Development Goals (SDG) charter[12] and the UNCITRAL Working Group on MSMEs has proposed a new form of enterprise called the UNCITRAL Limited Liability Organisation (UNLLO) that represents a general form of MSMEs which is distinct from companies and individuals. They identify the requirements common to MSMEs, regardless of their form, as follows:

- *Autonomy and flexibility* in the forms under which the enterprise can be setup and operationalised.
- *Simplicity of rules and terms of operations* of the business, so that neither the legal establishment nor the operations is a costly nor a lengthy or time-consuming process.
- *Legally recognisable identity* that can help the entity get visibility and credibility when dealing with other entities, companies and persons. This becomes particularly important in improving access to financial markets or in international trade.
- *Certainty of property rights* which will allow entrepreneurs to control assets in order to access finance but will also allow them to use asset partitioning to protect personal assets from business claims.

- *Control over their business* which will allow them to exercise management control in decisions related to administration and business strategy.

In return for these features, these entities would have to adhere to the discipline of visibility and transparency of operations. The framework therefore makes registration with a business registry a requirement (UNCITRAL, 2019[13]). This enables MSMEs in a jurisdiction to be registered in a manner that information is visible more broadly to the formal economy, both domestic and international. In addition, certain records of information have to be maintained on a regular basis by the entity including: the registration information, rules of the organisation, names of all shareholders, past and present, financial statements, tax returns and records about their activities and operations. This information allows visibility on the MSME with the type of details that facilitates both financing as well as business transactions. It also has the added benefit that, in insolvency, access to such information allows for lower asymmetry of information for all parties which has the potential to reduce both costs of, and time to, insolvency resolution.

The above list of requirements suggests a larger role and participation by the MSME entrepreneur to lead insolvency and bankruptcy resolution processes. Thus, the insolvency process must allow the debtor entrepreneur to trigger insolvency resolution, and if the insolvency application is accepted, it must allow for a debtor-in-possession model during the resolution and for the entrepreneur to propose a resolution plan for the distressed enterprise. In return, the process must have in place elements to ensure that the creditor does not lose trust that their interests will also be taken into account in the resolution. There are stringent requirements of disclosure on the debtor that enterprise assets will not be stripped during the process. It is important to have a third party like a insolvency professional to monitor and verify the disclosure to ensure that the systemic integrity is maintained.

CONCLUSION

The prime focus in the IBC was upon the bankruptcy process of large firms. The trade-offs in institutional design for large firms differ from those of small firms. In order to think about the bankruptcy process of small firms, it is important to carefully look at the stylised facts about small firms and envision how their bankruptcy process could best be organised. In this article, we have shown some principles that can guide such thinking. It is likely that the 'information utilities', that were originally envisaged by the Bankruptcy Legislative Reforms Committee (BLRC), will prove to be an important part of the answer[14]. In the design of the IBC, this industry was visualised and designed in order to capture essential information about both financial and operational credit contracts and the repayment performance of all the persons that can use the IBC as the forum to resolve their insolvency. In order to service the wide range of entities that form the domain of MSMEs in India, there are several advantages to the design adopted for this industry – a private competitive market of information utilities that have to be inter-operable to ensure both access as well as economic efficiency.[15]

NOTES

[1] UNCITRAL Working Group 1 (MSMEs) (2020), “Draft Legislative Guide on an UNCITRAL Limited Liability Organisation”, Technical report, United Nations Commission on International Trade Law.

[2] Hurst E and Pugsley BW (2011), “What do small businesses do?” , Technical report, Brookings Papers on Economic Activity, https://www.brookings.edu/wp-content/uploads/2011/09/2011b_bpea_hurst.pdf.

[3] Hurst and Pugsley (2011) include flexible working hours or not working for a boss as examples of non-pecuniary benefits of starting an enterprise.

[4] Annual Report, Ministry of Micro, Small and Medium Enterprises (2018), Government of India, https://msme.gov.in/sites/default/files/Annualrprt.pdf.

[5] Sharma S. and Sinha P. (2020), “Statistics on MSME firms” ,Technical report, National Institute of Public Finance and Policy.

[6] Ministry of Micro, Small and Medium Enterprises (2019), “Registration of Micro, Small and Medium Enterprises in India (Udyog Aadhaar Memorandum)”, Government of India, http://www.dcmsme.gov.in/uam_publication_2015-2018.pdf.

[7] Davis RB, Madaus S, Mazzoni A, Mevorach I, Mokal R, Romaine B, Sarra JP, Tirado I (2016), “The Modular Approach to Micro, Small, and Medium Enterprise Insolvency”, http://dx.doi.org/10.2139/ssrn.2904858.

[8] For example, the results of the Fourth All India Census on MSME was conducted in 2006-2007, http://www.dcmsme.gov.in/publications/census10.pdf.

[9] Kallberg JG and Udell GF (2003), “The value of private sector business credit information sharing: The US case”, Journal of Banking & Finance, (27), pp. 449–469.

[10] This project was undertaken at the Indira Gandhi Institute of Development Research titled “A cross-sectional study of firm financing patterns using the MCA-21 data-set” using a grant from the MCA under the “Guidelines for Funding Research and Studies, Workshops and Conferences etc. under the Plan Scheme Corporate Data Management (CDM) of the MCA”.

[11] Supra Note 1.

[12] SDG 8 is to “Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all”, with particular attention to the growth of the MSME particularly through a higher access to finance.

[13] UNCITRAL (2019), “UNCITRAL Legislative Guide on Key Principles of a Business Registry”, Technical report, United Nations Commission on International Trade Law, https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/lg_business_registry-e.pdf.

[14] The "Report of the Bankruptcy Law Reforms Committee", (2015), Volume 1: Rationale and Design, Ministry of Finance, Government of India.

[15] Ministry of Corporate Affairs (2017), “Report of the Working Group on Information Utilities”, Government of India, https://ibbi.gov.in/uploads/resources/wg-04report.pdf .