

Madras High Court Landmark Ruling: MSMEs Protected from SARFAESI Action Without Following 2015 Revival Framework

Background of the Case

Four MSME units in Trichy, Tamil Nadu, once thriving suppliers to BHEL (Bharat Heavy Electricals Limited), found themselves in financial distress when the thermal power sector declined due to India's shift toward green energy^[1]. These engineering companies, which had built sophisticated manufacturing capabilities and supplied critical components worth approximately ₹4 lakh tonnes to BHEL, became victims of changing government policies favoring renewable energy over coal-based power generation.

When their accounts were declared Non-Performing Assets (NPAs) between 2016-2020, Canara Bank initiated SARFAESI proceedings without following the mandatory Framework for Revival and Rehabilitation of MSMEs established in 2015^[1]. The companies challenged these actions, arguing that banks must exhaust revival mechanisms before proceeding with asset recovery.

Key Legal Holdings

1. Mandatory Nature of the 2015 MSME Framework

The Madras High Court definitively held that the Framework for Revival and Rehabilitation of MSMEs, issued on May 29, 2015, under Section 9 of the MSMED Act, has **statutory force** and is **binding on all banks**^[1]. This aligns with the Supreme Court's ruling in *Pro Knits v. Board of Directors of Canara Bank* (2024), which established that banks cannot classify MSME accounts as NPAs without first following the revival framework^{[2][3]}.

2. Bank Cannot Claim Ignorance of MSME Status

The Court rejected Canara Bank's argument that petitioners failed to notify their MSME status early enough. The judgment noted that:

- MSME certificates explicitly mention the lending bank's name
- Loan sanction letters clearly classified the units as "SME - Small Enterprise - Manufacturing"

- In the digital era with inter-linked databases, banks cannot claim ignorance of a borrower's MSME status^[1]

3. Banks Must Constitute Mandatory Committees

A critical finding was that Canara Bank had **never formed the committees** required under Clause 2 of the 2015 Framework. The notification mandates that "all banks shall constitute one or more Committees at such locations as may be considered necessary" to provide reasonable access to stressed MSMEs^[1]. Without these committees, MSMEs were denied their statutory right to approach the revival mechanism.

4. Sequence of Statutory Duties

The Court emphasized that banks have **dual statutory obligations**:

- **First:** Follow the 2015 Notification for MSME revival and rehabilitation
- **Second:** Only then proceed under SARFAESI Act if revival efforts fail^[1]

The judgment stated: "without exhausting the statutory duty under Notification 2015, the bank cannot proceed under Sarfaesi Act."

Government Support and Broader Context

The case gained additional significance because the Central Government was actively working on a **Cluster Specific Revival and Rehabilitation Package** for these Trichy engineering units. The Ministry of Finance had confirmed these units' eligibility under various schemes, and the government was promoting defense manufacturing through its **Defense Corridor initiatives**^[1].

The Court noted that four Defense Indigenization Lists had been published (December 2021 to May 2023), containing over 2,100 items worth approximately ₹715 crores for local manufacturing. The petitioner companies were well-positioned to benefit from this defense manufacturing boom, making their premature liquidation economically counterproductive^[1].

Critical Observations on Banking Practices

The High Court made several sharp observations about banking attitudes:

"Shylock - Pound of Flesh" Critique: The Court stated with "heavy heart" that banks cannot act like Shylock, focused solely on debt recovery while killing business units^[1]. It emphasized that banks are the "backbone of India's economy" and have a duty to both recover loans and allow business units to thrive.

Mutual Support System: The judgment highlighted that the 2015 Notification was designed to create a "mutual support system" where banks work with MSMEs for both revival and repayment, rather than pursuing only recovery^[1].

Implications for MSMEs and Banks

For MSME Borrowers:

1. **Statutory Protection:** MSMEs now have clear legal protection against premature SARFAESI action
2. **Right to Committee Access:** Banks must provide access to revival committees before any recovery action
3. **Time for Revival:** Genuine MSMEs get breathing space to explore revival options with government support

For Banks:

1. **Mandatory Compliance:** Banks must establish MSME committees and follow the 2015 Framework as a prerequisite to SARFAESI proceedings
2. **Due Diligence Required:** Banks cannot claim ignorance of borrowers' MSME status given digital integration of databases
3. **Sequential Process:** Revival efforts must precede recovery actions - banks cannot skip directly to SARFAESI

For the MSME Ecosystem:

1. **Policy Alignment:** The judgment aligns judicial interpretation with government policy supporting MSME growth and defense manufacturing
2. **Sectoral Protection:** MSMEs facing stress due to policy changes (like the shift from thermal to renewable energy) get explicit judicial recognition

3. **Rehabilitation Focus:** Emphasis shifts from mere debt recovery to enterprise rehabilitation and job preservation

Practical Takeaways

1. **Document Your MSME Status:** Ensure all loan documents clearly reflect MSME classification
2. **Know Your Rights:** MSMEs can demand committee formation and revival consideration before any SARFAESI action
3. **Act Promptly:** While banks must follow the framework, MSMEs should proactively engage when facing financial stress
4. **Seek Legal Protection:** Courts will intervene to ensure banks follow mandatory statutory procedures
5. **Leverage Government Support:** Explore cluster-specific revival packages and sector-specific opportunities

This landmark judgment represents a significant shift toward protecting MSMEs from aggressive debt recovery practices while ensuring banks fulfill their dual role as financial partners in business growth and loan recovery. It strengthens the legal foundation for MSME protection while promoting a collaborative approach to financial distress resolution.

References:

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3. <https://bridgecounsels.com/the-supreme-courts-judgment-in-m-s-pro-knits-v-the-board-of-directors-of-canara-bank-implications-for-msmes-in-financial-distress/>