

# Works Contracts Unfit for MSME Benefit!



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## Introduction[1]:

MSME sector has been gaining importance in the last few years and the legislature has also implemented various schemes to allay the issues faced by the sector. To address one of the main issues for delayed payments, the Micro, Small and Medium Enterprises Development Act, 2006 (MSMED, Act 2006) was passed with special provisions. These provisions are covered here. [2]

However, these special provisions do not apply to Work Contract. Let's dive deeper into the topic.

## What is Works Contract?

As per Section 2 (119) of Central Goods and Services Tax Act — “Works Contract” means a contract for building, construction, fabrication, completion, erection, installation, fitting out, improvement, modification, repair, maintenance, renovation, alteration

or commissioning of any immovable property wherein transfer of property in goods (whether as goods or in some other form) is involved in the execution of such contract. Thus, a work contract is generally understood to refer to legally binding agreement between parties that outlines the terms and conditions for the performance of specific tasks related to construction, repair, or maintenance work. Under a Works Contract, parties would typically include details such as:

- the scope of work with milestones and minute details and procedures to be adopted;
- timelines and consequences of failure of achieving such timelines like levying liquidated damages or termination as per the arrangement of the parties;
- payment terms;
- responsibilities of each party;
- representations from each side;
- defect liability period (if agreed);
- performance guarantees;
- Site safety;
- procedures for dispute resolution;

[1] The article reflects the general work of the authors and the views expressed are personal. No reader should act on any statement contained herein without seeking detailed professional advice.

[2]<https://www.ynzgroup.co.in/articles/Litigation-ADR/FAQs%20on%20MSME.pdf>





These would be in addition to other general provisions in a contract like force majeure, indemnity, insurance, change requests, termination, confidentiality, etc. Work contracts are commonly used in industries such as construction, engineering, and maintenance services to formalize agreements between contractors, subcontractors, and clients.

### **Understanding the nature of Works Contract**

The works contract is a composite contract which involves both Goods and Services.

The parties under works contract intend to pay consideration not for goods involved in execution but for transfer of physical property involved in execution of the contract.

For example, work contract for construction of flat/ house consideration is not towards Cement Gitti etc., but the constructed house. Under work contract sale/ purchase of goods are not intended by parties but by necessary implication once a house or flat is built, it is transferred to buyer. Therefore, it is not a sale of goods or service or both as when a house is built, physical property is supplied and not the goods or service or both.

Works contract can be traced to be goods or service or both however it is not supply of goods or service or both as once immovable property is built under the contract, what is transferred ceased to be goods.

The determination of whether a contract is a works contract or a sale requires many factors and simply naming a document as works contract would not make the contract a works contract.

The Apex Court while deciding the issue that whether the manufacture, supply, and installation of lifts should be classified as a “sale” or a “work contract” in *M/s Kone Elevator India Pvt. Ltd. Vs. State of Tamil Nadu and others*[3] held that the question whether a particular transaction is a contract of sale, or a works contract depends upon the intention of the parties and the true construction of all the terms and conditions of the document, when there is one. A contract of sale is a contract whose main object is the transfer of the property in, and the delivery of the possession of, a chattel as a chattel to the buyer.

[3] Writ Petition (C) no.232 of 2005



## **Exclusion of Works Contract from the ambit of MSMED Act, 2006**

“Enterprise” is defined in the MSMED Act, 2006[4] as an industrial undertaking or business concern or any other establishment, by whatever name called, engaged in the manufacture or production of goods, in any manner, of any industry or engaged in providing or rendering of any service or services.

MSMED Act, 2006 is applicable to enterprises registered under MSMED Act, 2006 as per the classification provided as micro, small and medium under Section 7 of the MSMED Act, 2006 as amended by notification dated 1st June, 2020[5].

To protect the interest of MSME business, the MSMED Act provides the provision under Section 15 for buyers to make payment within the period of 15 days from the date of receiving good/services or on or before such date as was mutually agreed between the parties.

Under this provision the agreed payment date between the parties shall not exceed 45 days from the date of receiving goods/ services. Section 15 of MSMED Act, 2006 reads as follows:

**Where any supplier supplies any goods or renders any services to any buyer, the buyer shall make payment therefor on or before the date agreed upon between him and the supplier in writing or, where there is no agreement in this behalf, before the appointed day:**

**Provided that in no case the period agreed upon between the supplier and the buyer in writing shall exceed forty-five days from the day of acceptance or the day of deemed acceptance.**

**The term "Appointed day" refers to the day immediately following the expiry of the stipulated period of (15) fifteen days from the day of acceptance[6] or the day of deemed acceptance[7] of goods or services by a buyer from a supplier.**

[4] Section 2 (e) of MSMED Act, 2006

[5] [https://msme.gov.in/sites/default/files/MSME\\_gazette\\_of\\_india.pdf](https://msme.gov.in/sites/default/files/MSME_gazette_of_india.pdf)

[6] The actual day when goods or services were delivered or when the Buyer objects to the acceptance of goods or services in writing within 15 days from the date of delivery and the date on which such objection is removed by the Supplier.

[7] The buyer does not object to the acceptance of goods or services within 15 days from the date of delivery then the actual date of delivery of goods or services.

However, the provision of delayed payment does not become applicable to MSME under work contract due to its indivisibility and composite nature. Additionally, a practical challenge arises in applying the Act to works contracts due to the ambiguity surrounding the determination of the "appointed date" or the "date of acceptance." This determination is crucial for the Facilitation Council when resolving disputes concerning payment and the subsequent awarding of interest.

## Case Studies

1. In *Sterling and Wilson Private Limited and Ors. v. Union of India and Ors.*[8] wherein a dispute arose due to awarding of a tender for design, installation and service of firefighting and detection systems, the Court held that the contract under tender is a composite contract for supply of goods as well as installation of fire water spray system, which is a permanent fixture. The goods supplied under the contract are eventually assembled and installed at site and become part of the permanent fixture. The said contract satisfies fundamental characteristics of work contract and hence, cannot be considered as a contract simplicitor for sale of goods and services. Further, the Court held that the contract under tender not being a contract for sale of goods and predominantly a work contract, the benefits of the MSMED Act, 2006 and the Policy could not be extended to the MSEs registered under the MSMED Act, 2006.
2. In *M/s Rahul Singh v. Union of India & Ors*[9] , the petitioner challenged the decision of the North Central Railway for rejecting the tenders for not depositing the tender cost and earnest money before the Allahabad High Court. The petitioner was MSME registered and contended that under the provisions of Public Procurement Policy, 2012 MSME registered are exempted from depositing the tender cost and earnest money cost.

[8] WRIT PETITION (L) NO. 1261 OF 2017

[9] WRIT - C No. - 2316 of 2016



However, the respondents argued that the tenders were invited for a works contract, which, according to the operating manual of the North Central Railway, did not qualify as a contract for the supply of goods and services. Therefore, the petitioner was deemed ineligible for the benefits of the Public Procurement Policy, 2012. The Allahabad High Court upheld the decision of the respondents and reiterated the view that works contract is excluded from the ambit of MSMED Act, 2006 and held that the MSMED Act, 2006 does not require a court of law to deconstruct the works contract into its elements of supplying goods and providing services.

3. In PL Adke v. Wardha Municipal Council[10], an appeal was filed before the Bombay High Court against the decision of Nasik district court rejecting the injunction petition filed under section 9 of the Arbitration and Conciliation Act, 1996 (“Arbitration Act”) for interim reliefs of restraining the respondent corporation from proceeding with levy of penalty, fine from deducting additional security deposit and invoking the risk and cost clause and also to restrain the respondent from blacklisting the appellant.

The respondent argued that the works contract and work order issued to the appellant for planning, designing, constructing, operating and maintaining water supply under Wardha sewerage scheme excluded arbitration as dispute resolution mechanism. Further the Respondent contended that work under works contract was not for purchase and supply but was for works contract and therefore the provisions for arbitration under MSMED Act will also not apply.

The High Court of Bombay dismissed the appeal and held that the nature of the contract was composite, indivisible and continuous, and hence was a works contract. To such a contract, the provisions of MSMED Act will not apply.

[10] AIRONLINE 2021 BOM 1016



Further the Court held that since the appellant was a contracting party agreed to the exclusion of arbitration, it cannot invoke section 9 of the Arbitration Act.

The judgment rendered by the Honorable High Court of Bombay in PL Adke v. Wardha Municipal Council has been appealed before the Apex Court in SLP (C) No. 4970 of 2021 IX and is presently awaiting consideration.

## **Conclusion**

Although the MSMED Act does not explicitly define "work order" or expressly excludes it from the MSMED Act's purview, the intricate application of MSMED Act provisions has led to the exclusion of work orders from its ambit. Many MSME registered companies are engaged in work contracts that entail both the supply of goods and services. Despite their MSME registration, they are unable to leverage the benefits accorded by the MSMED Act, 2006. Therefore, it's prudent for the legislature to note the rulings of various courts and explicitly clarify within the MSMED Act, 2006 on the applicability to Works Contract. Such clarity would safeguard the interests of all enterprises involved.

Until such clarification, every MSME must exercise caution and diligence in scrutinizing the contracts it engages in. It's imperative to:

- a. Understand and identify the nature of the contract based on its characteristics, i.e. whether the said contract is for the sale of goods or a works contract.
- b. Negotiate contract terms and establish a mutually agreeable dispute resolution mechanism, and if the parties intend to refer to arbitration under the Arbitration Act then a clause to that effect is required to be incorporated.

Thus, comprehending contract constructs, negotiating effectively, and establishing robust dispute resolution mechanisms are vital steps in safeguarding the interests of MSMEs.

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