

SC paves way for tribunal to act against IL&FS auditors

BHAVINI MISHRA
 New Delhi, 3 May

In a setback to BSR & Associates, LLC (BSR) — a KPMG India affiliate — and Deloitte Haskins and Sells (Deloitte), both former auditors of IL&FS Financial Services (IL&FS Financial), the Supreme Court (SC) on Wednesday set aside the Bombay High Court (HC) order to quash all prosecution against the two firms pending before the National Company Law Tribunal (NCLT) and a special court in Mumbai.

Upholding the constitutional validity of Section 140(5) of the Companies Act, 2013, that allows the government to enquire and act against auditors, it allowed the tribunal to proceed with its enquiry and any subsequent action against the former auditors of IL&FS Financial. The Section deals with the removal and resignation of auditors and



imposes a five-year ban on an auditing firm that is proven to have “acted fraudulently”, or to have “abetted or colluded in any fraud”.

“The order (Bombay HC) setting aside the Serious Fraud Investigation Office (SFIO) prosecution is quashed. Section 140(5) is neither discriminatory, arbitrary and/or violative of Articles 14, 19(1)(g) of the Constitution of India, as alleged,” the court observed.

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CASE FILE

▶ **Jun 2019** MCA moves NCLT against former auditors of IL&FS Financial Services

▶ **Aug 2019** NCLT finds merit in the plea

▶ **Apr 2020** Bombay HC quashes the prosecution of both firms — BSR & Associates, LLC and Deloitte Haskins and Sells — ordered by NCLT

▶ **May 2023** SC sets aside the HC order, upholds Section 140(5) of Companies Act, 2013

IL&FS recently told NCLAT that of the ₹61,000 crore that was to be recovered from it, ₹56,943 crore had been paid until Sept '22

IL&FS...

Under the Ministry of Corporate Affairs (MCA), SFIO is a multi-disciplinary organisation that detects and prosecutes or recommends for prosecution white-collar crimes/frauds.

The MCA had sought the removal of both firms as auditors of IL&FS Financial and initiated criminal proceedings against them for their role in the alleged financial irregularities at the now-bankrupt Infrastructure Leasing & Financial Services Group.

The firms, however, argued that they had already resigned as auditors of IL&FS Financial much before the ministry sought their removal. They also challenged the constitutional validity of Section 140(5) of the Companies Act, 2013. The apex court observed that auditors should be independent above all. "When the earlier Companies Act, 2009, was introduced, it was for stricter accountability for the auditors. There were suggestions to make the provisions for audit and auditors stringent," the court said.

It noted that the view taken by the Bombay HC was erroneous.

"The subsequent resignation of the auditor after Section 140(5) has been initiated does not mean that the proceedings against the auditor will end. Therefore, the enquiry/proceedings initiated under the first part of Section 140(5) have to be taken to their logical end. If the HC order is upheld, the

auditors will resign whenever there are proceedings initiated against them. This could not have been the intention of the legislature. There must be a final order passed by the tribunal, irrespective of their resignation, to see if they have colluded or acted fraudulently," the court said.

The court said the intention of the legislature behind Section 145 is very clear.

"Irrespective of any other provisions of the Act of 2013, the NCLT is vested with powers under Section 140(5) of the Act to pass a final order against the auditor on the allegation that such an auditor of the company has, directly or indirectly, acted fraudulently," the court said.

The court exhorted that the Section cannot be called to be an excessive or arbitrary use of power by NCLT to determine offences of a grave nature.

"The NCLT shall have the quasi-judicial power under Section 140(5) and ample opportunity shall be given by the NCLT before passing a final order," the Bench said.

"In light of this ruling by the SC, the auditors will need to lend extra caution in the course of performing their duties and responsibilities, as is evident that the firms will not be absolved of liability in such cases because of having tendered their resignation once the relevant proceedings are initiated. Furthermore, the court also highlighted the fact that sufficient opportunity will be given in such matters to the auditors, before the NCLT," said Ketan Mukhija, partner, Link Legal.

A lookback

The MCA had moved the NCLT in June 2019 against BSR and

some of the then external auditors of IL&FS Financial, alleging professional misconduct. It had also directed the SFIO to initiate a probe and disciplinary action against such audit firms.

The SFIO had subsequently claimed BSR and some other audit firms had acted in breach of auditing standards and that they had failed to detect financial inconsistencies at IL&FS.

BSR, part of KPMG India, and Deloitte had moved the Bombay HC in 2019, challenging the validity of the Centre's plea before the Mumbai Bench of the NCLT, seeking their removal as auditors of IL&FS Financial.