INDIA’S SUPREME COURT RULES ON THE MAINTAINABILITY OF PROCEEDINGS AGAINST AUDITORS AFTER THEIR RESIGNATION

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In a recent ruling, India’s Supreme Court has held that an enquiry or proceeding against an auditor of a company under Section 140(5) of the Companies Act, 2013 (the “**Act**”) does not terminate upon the resignation of the auditor, and the auditor, if found to have acted in a fraudulent manner, will be subject to penal action.

**Background**

Deloitte Haskins and Sells LLP (“**Deloitte**”) and BSR & Associates LLP (“**BSR**”) served as the statutory auditors of IL&FS Financial Services Limited (“**IFIN**”). Deloitte was the statutory auditor of IFIN from 2008 to 2018, and BSR was appointed as the joint statutory auditor in 2017. Between June and September 2018, IFIN and its group companies defaulted on debt repayments aggregating to a sum in excess of INR 900 billion. This debt contagion was caused, *inter alia*, by corporate governance failures, as well as a window dressing of accounts. Both Deloitte and BSR had jointly conducted IFIN’s statutory audit for financial year 2017-18.

Section 140(5) of the Act provides that the National Company Law Tribunal (the “**NCLT**”) may, either *suo motu*, or on an application made to it by the Central Government or any person concerned, if it is satisfied that the auditor of a company has acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, direct the company to change its auditors. In this situation, if the NCLT is satisfied that any change of the auditor is required, it can pass an order removing the auditor, and the Central Government can appoint a new auditor. The second proviso to this section provides that an auditor against whom a final order has been passed by the NCLT will be ineligible to be appointed as an auditor of any company for a period of five (5) years and will also be liable for action under Section 447 of the Act (which pertains to punishment for fraud).

In June 2019, the Serious Fraud Investigation Office (“**SFIO**”) investigated IFIN and prepared a report, on the basis of which proceedings were initiated against Deloitte and BSR, among others, under Section 140(5) of the Act. BSR issued a letter of resignation and contended that Section 140(5) was inapplicable to them, as they were no longer the auditors of IFIN. Similar contentions were made by Deloitte on the grounds that they had resigned as the statutory auditors of IFIN in 2018. The NCLT, however, upheld the maintainability of the petitions. This was challenged before the Bombay High Court (“**BHC**”). The BHC upheld the validity of Section 140(5) of the Act but quashed the proceedings against Deloitte and BSR. The Union of India appealed the BHC decision to the Supreme Court.

**Decision of the Supreme Court**

The Supreme Court held that the subsequent resignation of an auditor does not by itself lead to the termination of proceedings under Section 140(5) of the Act. As the second proviso to Section 140(5) lists out further consequences upon the culmination of an enquiry when an auditor has acted in a fraudulent manner, the enquiry/ proceedings must be completed. If the proceedings stand terminated on the resignation or discontinuance of an auditor, the penal consequences as provided under the second proviso can easily be circumvented by the simple act of resignation.

The Supreme Court laid emphasis on Section 140(5) and state that this is a substantive provision and a consequence of the NCLT finding that the auditor has acted fraudulently. This makes the auditor ineligible to be appointed as auditor for anycompany for a period of five (5) years. Therefore, an auditor cannot be permitted to avoid these consequences merely by resigning as auditor of a company.

**Our comments**

The Supreme Court decision follows a recent trend of stringent corporate governance rulings, ostensibly in the wake of allegations of misconduct against the Adani group. It highlights the importance of the independent role of an auditor and an auditor’s statutory duty to detect and prevent fraud in the companies under audit. By clarifying that penal consequences of fraud cannot be avoided by mere resignation, the Supreme Court has taken a hard stance against auditor misconduct and collusion. This decision will surely act as a deterrent against professional malpractice not just for auditors but other professionals as well.