LIABILITY LIMITATION AGREEMENTS
UNDER THE COMPANIES ACT 2006

OPINION

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1. Chapter 6 of Part 16 of the Companies Act 2006 (Sections 532 – 538) permits a company to enter a Liability Limitation Agreement ("**an LLA**") with its auditor. By section 534(2), an LLA must be authorised by the members of the company in accordance with section 536.

2. Section 535 stipulates the permitted terms of an LLA. As a result of representations made on behalf of the auditing profession when the Companies Bill was being considered by Parliament, it is immaterial how an LLA is framed. This is expressly provided by sub-section 535(4), which further provides that the limit on the amount of the auditor's liability need not be a sum of money, *or a formula*, specified in the agreement. This paves the way for proportionality LLA's, under which the liability of an auditor is limited to (adopting the language of section 2(1) of the Civil Liability (Contribution) Act 1978) such amount as may be found by the Court to be just and equitable having regard to the extent of the auditor's responsibility for the damage in question.

3. I am asked to advise on two issues concerning LLA's which are likely to arise now that this new permissive regime has come into effect. The first issue is whether directors expose themselves to any increased risk of liability if they recommend an LLA to the members of a company. The second issue is the degree of detail in which the basis of any such recommendation should be documented and explained to the company's members.

The liability of directors who recommend an LLA.

4. The relevant hypothetical scenario has two components:

   (1) At the time of recommending an LLA to the members of the company, the company has drawn up, or will be in the course of drawing up, financial statements which contain a material misstatement.

   (2) The auditors who subsequently conduct the audit of those financial statements negligently fail to detect the material misstatement.

5. Within this general hypothetical factual scenario, there are two broad possibilities. The first is that the directors of the company are unaware of the material misstatement. This would be the case if, for example, an employee in the accounts department was misappropriating the company's funds without anyone else being aware of it. In this scenario, it seems to me that the directors do not face any increased risk of liability. If the members refuse to authorise the LLA, then the point falls away. If the members do authorise the LLA, then the directors are protected from liability so long as such authorisation was fully informed in the sense that the directors took reasonable care to lay before the members all the information which they needed to reach an informed decision. The fact that the directors face no liability in such a case is implicit in: (i) the factual premise outlined above which has to exist for an LLA to have any relevance; and (ii) the machinery introduced by the 2006 Act by which the directors must obtain the authorisation of the members before entering into an LLA.

6. The second possible scenario is that one or more of the directors who recommend the LLA are aware that the financial statements contain a material misstatement. This would occur where, for example, a director had himself been guilty of misappropriating the company's assets. In this scenario, there is again no increased risk of liability for the simple reason that the director guilty of the misappropriation is liable to the company in any event, regardless whether the company enters the LLA. The only effect of the LLA is that any claim against the director will be a direct claim by the company itself rather than a contribution claim by the auditor in proceedings brought against the auditor by the company.

The Board's decision and the authorisation of the members.

7. The directors cannot properly recommend that members authorise an LLA unless the directors are bona fide satisfied that the LLA is consistent with their duty under Section 172 of the 2006 Act to promote the success of the company. The mere fact that an LLA works exclusively in favour of the auditor (and therefore against the company) does not in any way preclude the directors from concluding that an LLA is consistent with their statutory duties. It is common place for a company to accept a contractual term which excludes or limits the liability of an opposite contracting party. This is unavoidable because many parties will not contract without an exclusion or limitation of liability on their part.

8. It seems to me that the factors which the directors would ordinarily need to consider include the following.

9. First, there is the objective fairness and reasonableness of the terms of the LLA. There are numerous factors which make it reasonable for an auditor to insist on a limitation of liability, including the expense of insurance cover, the limits on the available level of insurance cover, and the harshness of the operation in an audit context of the principle of

English law that a claimant may recover all its loss against any one of two or more defendants who are liable in respect of that loss.

10. Second, I would expect the directors to consider, at least from time to time, the availability of better terms from auditors of equal standing. This is not to say that every audit engagement has to be preceded by a process of competitive tender, but it does seem to me that directors ought to keep an eye on what alternative LLA terms are available from auditors of similar standing.

11. Third, the directors must bear in mind the general undesirability of changing auditors on a regular basis. This generates unnecessary costs, discontinuity, and loss of the auditor's accrued knowledge of the business being carried on by the company. Furthermore, for those companies who wish to engage the largest audit firms, there is only a limited number of firms from which to choose.

12. The above is not intended in any way to be an exhaustive list, and each company must consider the factors relevant to its own particular position.

13. I am asked whether there are potential problems in a company being a 'first mover' in the sense of entering into the first, or one of the first LLAs at a time when, by definition, there is no general picture of what limitation of liability other companies are prepared to accept. I do not see this as a problem. If there are no comparables LLAs, directors cannot be criticised for not considering them. Someone has to go first.

14. It would be best practice for the relevant factors to be documented and considered in a paper submitted to the directors for consideration at a Board Meeting.

15. As regards the shareholders, it is important that their authorisation of an LLA should be fully informed. The Directors should, in my view,

inform the shareholders of the factors which they have considered and their reasons for seeking authorisation to enter an LLA.

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