

Liability Limitation Agreements

Since the new provisions of the Companies Act 2006 were introduced in April 2008 auditors can for the first time agree contractually with their audit client the limitation of their liability in respect of an audit. This is done by way of a Liability Limitation Agreement (LLA).

■ Section 534 of the Companies Act 2006 defines an LLA as:

"An agreement that purports to limit the amount of a liability owed to a company by its auditor in respect of any negligence, default, breach of duty or breach of trust occurring in the course of an audit of accounts, of which the auditor may be guilty in relation to the company."

The way in which an LLA should be affected is, however, not defined but must have the following features:

- it must be approved by company members and prior to entry into the agreement Shareholders in private companies can resolve to waive need for approval
- it can only apply to a single year's audit
- the limitation cannot be less than an amount that is "fair and reasonable (in all the circumstances of the case) having regard to:
 - a) the auditor's responsibilities
 - b) the nature and purpose of the auditor's contractual obligations to the company, and
 - c) the professional standards expected of him" (s 537).

An LLA which limits liability to what is judged to be less than 'fair and reasonable' will have effect as if limited to that lower amount. In assessing the limitation of liability the court

must not consider circumstances arising after the loss or damage is incurred or the possibility of recovering from others.

fair and reasonable

The Act does not restrict the manner in which liability can be limited beyond being 'fair and reasonable'. And so there are a number of different ways an auditor could attempt to limit liability. These could be by way of proportionate liability, capping and formula limits, a proportion of audit fees, a specified sum or even the professional indemnity insurance limit of the auditor.

The situation could be envisaged where a cap would be beneficial in certain cases encouraging settlement within realistic levels rather than incurring expense through the process of finding out what the courts deem to be fair and reasonable. From discussions with various professional indemnity insurers the reality is that proportionality is likely to be key in determining market practice. While insurers are not currently providing any advice as to a preferred method, the Association of British Insurers favours a proportional cap based on the extent of the auditor's role and responsibility rather than agreeing a fixed financial cap for their auditor's liability.

It was felt initially that LLAs would not make a huge difference as the majority of low to middle value claims would not reach any



LLA cap. Rather it would be those high value claims which would fall to the excess layers of insurance over the primary layers that would have the biggest impact. In this respect the 'Big 4' were expected to lead by example. This has not happened as yet. The subject, it seems, remains in the 'long grass' and it is evident that the focus of attention given the current economic climate has been diverted elsewhere. Lawyers have also advised that they are not seeing the anticipated flurry of engagement letters they would expect to come with the new limitation provisions.

responsibilities of directors

From the standpoint of a directors and officers insurer when considering such agreements it will, however, remain paramount that any board of directors carries out their duties in line with their fiduciary responsibilities. The very fact that it is a permissive regime means that responsibilities and roles should be extensively discussed between advisers and their clients. This represents good risk management and gives comfort to insurers. One insurer remarks that those who enter into such agreements will have a tangible advantage when it comes to insurers assessing the risk. ■

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