

COMPANIES ACT 2006

EXPLANATORY NOTES

COMMENTARY

Part 16: Audit

Chapter 6: Auditors' Liability

816. This Chapter makes it possible for auditors to limit their liability by agreement with a company, but the agreement will be effective only to the extent that it is fair and reasonable.
817. It achieves this by defining a “liability limitation agreement” – a contractual limitation of an auditor’s liability to a company, requiring member agreement – as a new exception to the general prohibition, restated here, on a company indemnifying its auditor. The court will be able to substitute its own limitation if the agreement purports to limit liability to an amount that is not fair and reasonable in all the circumstances.

Section 532: Voidness of provisions protecting auditors from liability

818. This section restates the existing general prohibition, currently in section 310 of the 1985 Act, against a company indemnifying its auditor against claims by the company in the case of negligence or other default. Any such indemnities are void and unenforceable except where permitted by sections 533 to 536.

Section 533: Indemnity for costs of successfully defending proceedings

819. This section contains the current exception from the prohibition in section 532 allowing the company to indemnify the auditor against the costs of successfully defending himself against a claim, though it does not repeat the current exception that allows the company to buy insurance for its auditor.

Section 534: Liability limitation agreements

820. This section defines a “liability limitation agreement” as an agreement that seeks to limit the liability of an auditor to a company whose accounts he audits. The agreement can cover liability for negligence, default, breach of duty or breach of trust by the auditor.
821. *Subsection (2)* provides that such an agreement is excepted from the general voidness of such agreements under section 532, provided that the agreement complies with the rules in section 535, and that it has been authorised by the members of the company in the way specified in section 536. *Subsection (3)* provides that the agreement’s effect is limited by section 537, which contains the test of fairness and reasonableness, and that certain provisions of the Unfair Contracts Terms Act 1977 do not apply.

Section 535: Terms of liability limitation agreement

822. This section contains rules about the terms of a liability limitation agreement. An agreement must relate to the audit of a specified financial year, and the limitation may be expressed in any terms, not necessarily as a fixed financial amount or a formula.
823. *Subsection (2)* confers on the Secretary of State a power to make regulations (subject to negative resolution) prescribing or proscribing specified provisions or descriptions of provisions; and *subsection (3)* provides that the power may be used to prevent adverse effects on competition.

Section 536: Authorisation of agreement by members of the company

824. This section specifies the way in which members of a company are to give their approval to a liability limitation agreement, without which approval the agreement will not be effective. The members of a private company can pass a resolution waiving the need for approval. The members in a private or a public company can pass a resolution before an agreement is signed approving its principal terms, or can approve the agreement after it is signed. The resolution may be an ordinary resolution, unless a higher threshold is set in the company's articles.
825. *Subsection (5)* specifies what the principal terms of a liability limitation agreement are for this purpose, namely the terms that specify, or enable one to determine, (i) the sorts of faults by the auditor that are covered, (ii) the financial year in relation to which those faults are covered, and (iii) the limit on the auditor's liability.
826. *Subsection (6)* provides that members, by passing an ordinary resolution, can withdraw their approval of a liability limitation agreement at any time before the agreement is entered into. If the company has already entered into the agreement, approval can be withdrawn, by ordinary resolution, only before the start of the financial year to which the agreement relates.

Section 537: Effect of liability limitation agreement

827. This section provides that a liability limitation agreement will not be effective to limit an auditor's liability if the limitation would result in the company recovering an amount that was less than what was fair and reasonable, in all the circumstances of the case, having regard in particular to the auditor's responsibilities, the auditor's contractual obligations, and the standards expected of the auditor. If a court decides that a liability limitation agreement would limit the auditor's liability to an excessive degree, the agreement will have effect as if it limited liability to the amount that the court determines is fair and reasonable.
828. *Subsection (3)* provides that in assessing what is fair and reasonable, the court should not take into account circumstances arising after the loss or damage in question has been incurred. Nor should it take into account the chances of the company successfully claiming compensation from any other people responsible for the loss or damage.

Section 538: Disclosure of agreement by company

829. This section requires companies to disclose any liability limitation agreement they have made with their auditor in accordance with any regulations made by the Secretary of State subject to negative resolution. *Subsection (2)* provides that the regulations may require this disclosure to be in a company's annual accounts (or in any other manner in the case of group accounts), or in the directors' report.