FINANCIAL REPORTING COUNCIL

FRC WORKING GROUP ON AUDITOR LIABILITY LIMITATION AGREEMENTS

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FRC GUIDANCE ON
AUDITOR LIABILITY LIMITATION AGREEMENTS

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SECTION 1: INTRODUCTION

Background

1.1. Under sections 532 to 538 of the Companies Act 2006, which will come into force on 6 April 2008, auditors will be able to limit their liability by contract provided that shareholder approval is obtained. The resulting arrangements will be effective only to the extent that they are "fair and reasonable" in the particular circumstances.

1.2. Previously auditors were prohibited from entering into contractual arrangements that would have the effect of reducing or excluding their liability in relation to the statutory audit work performed for a company. In particular, auditors were prohibited from entering into arrangements to limit their liability to the proportion of the losses suffered by a company for which they were directly responsible.

1.3. As companies have become larger and their activities global, and as society has become more litigious, auditors have faced an increasing number of claims, including many that, if they were successful, would be beyond their financial resources.

1.4. That position is exacerbated if other parties (such as directors or other advisers) who are held responsible for the losses suffered by the company are unable to meet any award made against them. In those circumstances, under the principle of 'joint and several' liability, the auditors could be required to meet the full amount of the damages awarded in favour of the company, not just the amount for which they were held to be directly responsible.

The purpose and status of the guidance

*[**Note**: as explained in the consultation document, views are sought on whether the final guidance should indicate which approach or approaches are most likely to be acceptable in certain circumstances in order to reduce the need for extensive negotiation between auditors, companies and shareholders. If that is the outcome this section of the guidance will need to be revised accordingly.]*

1.5. The guidance aims to provide practical assistance to directors, auditors and shareholders on how to apply the new legislation. In particular it aims to:

- explain what is and is not allowed under the 2006 Act (Section 2 and Appendix A);

- set out some of the factors that will be relevant when assessing the case for an agreement (Section 3);
- explain what matters should be covered in an agreement, and provide specimen clauses for inclusion in agreements (Section 4 and Appendices B and C); and
- explain the process to be followed for obtaining shareholder approval, and provide specimen wording for inclusion in resolutions and the notice of the general meeting (Section 5 and Appendix D).

1.6. The law allows a degree of flexibility as to the manner in which liability can be limited and the form that agreements can take. Given the wide variety of circumstances to which the law applies - for example, whether the company is a public or private company and whether its shares are listed or traded - it is unlikely that any one approach will be considered suitable in all cases. The guidance therefore does not currently identify a preferred approach, but simply sets out the available options.

1.7. The guidance does not attempt to determine whether particular arrangements will be considered "fair and reasonable". That is because every arrangement will need to be assessed in the context of the particular circumstances. That would ultimately be for the Courts to decide in the event of a dispute.

1.8. The guidance includes specimen clauses for inclusion in agreements and specimen resolutions to put to the General Meeting (or, for private companies, for agreement by written resolution). These are not intended to be binding and are provided as examples only. Companies and auditors that are considering entering into an agreement may wish to take legal advice to ensure that agreements, the resolutions to approve them and any related documentation is adequate and satisfactory for their purposes.

1.9. Companies, auditors and shareholders should consider other relevant sources of guidance when considering whether to enter into a limitation of liability agreement and, if so, on what terms. [Details of some sources of guidance can be found in Appendix E to this guidance and on the FRC website at http://www.frc.org.uk/about/auditorliability.cfm.]

*[**Note**: this information will be added when the final guidance is published.]*

SECTION 2: WHAT DOES THE LAW ALLOW?

2.1. The provisions relating to auditors' liability are set out in sections 532 to 538 of the Companies Act 2006 (“the Act”), and are described in more detail in Appendix A to this guidance.

What does the Companies Act allow?

2.2. A liability limitation agreement is defined in the Act 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 the audit of accounts, of which the auditor may be guilty in relation to the company.

2.3. The Act states that for a liability limitation agreement to be valid it cannot cover more than one financial year and it must be approved by a resolution of the company's shareholders. For public companies this must be done at a General Meeting, while private companies have the option of using a written resolution, and for group companies this means each company in the group and not just the holding company.

2.4. The Act also states that any arrangements to limit liability will not be effective except to the extent that they are “fair and reasonable” in the particular circumstances. This is the key principle in the legislation, and it means that the Court can override any contractual limits agreed between the company and the auditors if it considers that they are less than “fair and reasonable”. The Court may reach this conclusion notwithstanding the fact that the agreement had been approved by the company’s shareholders. In these circumstances the agreement does not become null and void; instead the liability is amended to a level set by the Court.

2.5. Although the question of what is a "fair and reasonable" limit on the auditor's liability will ultimately be for the Court to decide in each individual case, the Act sets out a number of factors that should be taken into consideration:

- the auditor's responsibilities under Part 16 of the Act (which include provisions relating to the statutory audit and the duties and rights of auditors);

- the nature and purpose of the auditor's contractual obligations to the company; and

- the professional standards expected of the auditor.

2.6. However the Act also states that no account is to be taken of:

- matters arising after the loss or damage in question has been incurred; or

- matters (whenever they arise) affecting the possibility of recovering compensation from other persons liable in respect of the same loss or damage.

What is the effect of these changes?

2.7. At present, under English law, if an auditor negligently audits a company's accounts, the auditor is liable to the company for all the loss it suffers as a result. There may be others, such as company employees and other advisers, who are also liable to the company for all or part of the same loss - for example, if a company employee has been fraudulent or another adviser has negligently advised the company in connection with the accounts. The company can recover all its loss from the auditor, even though others are also liable to it. This is known as "joint and several liability".

2.8. Under the Civil Liability (Contribution) Act 1978, the auditor may be able to claim a contribution from the others who are liable. A court can order such a person to pay such amount as is "just and equitable having regard to the extent of the person's responsibility for the damage in question." For example, a court could find that the employee was 70% to blame, the other adviser was 10% to blame and the auditor was 20% to blame. However, if the other parties were insolvent or had fled the country, the auditor will not be able to recover any money from them and must therefore pay the full amount of the loss.

2.9. This will continue to apply even after the Companies Act provisions come into effect on 6 April 2008 in those cases where the company and its auditors have not agreed a liability limitation agreement.

2.10. Where an agreement is in place, the Act does not restrict the manner in which liability can be limited (except as set out in paragraph 2.4). This means that, in principle, the contractual limits could be set in a number of different ways, for example:

- a limit based on the auditor's proportionate share of the responsibility for any loss (under this approach, the company would agree that if there is someone other than the auditor who is also liable to the company for all or part of the same loss, the auditor's liability would be limited to the extent to which the auditor was responsible for that loss. The company would not be able to look to the auditor for any loss attributable to the acts of any other party);

- purely by reference to the "fair and reasonable" test;

- a cap on liability, expressed either as a monetary amount or calculated on the basis of an agreed formula; or

- a combination of some or all of the above.

2.11. It is not possible at this stage to predict how the "fair and reasonable" test will be applied by the court and the extent to which the court will look beyond matters relating purely to the auditor's proportional share of the blame.

2.12. The Act does not specify the test to be applied to determine what is fair and reasonable, and in particular does not specify that what is fair and reasonable will depend solely on the auditor's share of the responsibility. The court can take into account all the surrounding circumstances subject only to the provisions described in paragraph 2.6. Whilst it seems likely that a court may decide that it is fair and reasonable to limit the auditor's liability to an amount which reflects his percentage responsibility for the loss, this may not always be the case.

SECTION 3: WHAT ISSUES SHOULD BE CONSIDERED?

*[**Note**: as explained in the consultation document, views are sought on whether the final guidance should indicate which approach or approaches are most likely to be acceptable in certain circumstances in order to reduce the need for extensive negotiation between auditors, companies and shareholders. If that is the outcome this section of the guidance will need to be revised accordingly.]*

3.1. This section considers some of the factors that may be relevant to a decision by directors and shareholders as to whether a company should enter into a liability limitation agreement.

3.2. There are three important factors to have in mind when considering whether a company should enter into a liability limitation agreement. It will be important to appreciate that:

- Parliament has replaced legislation prohibiting an agreement that has the effect of limiting an auditor's liability to the company it audits with legislation prescribing the procedures to be followed if such an agreement is to be enforceable. Therefore there is no legal or regulatory prohibition on companies entering into liability limitation agreements provided the provisions of sections 532 to 538 of the Companies Act 2006 are complied with.

- The existence of a liability limitation agreement would not reduce or otherwise affect the legal and professional obligations imposed on auditors in respect of the quality of the audit.

- Shareholder approval is required before any agreement can take effect.

3.3. Directors will wish to ensure that they have a full understanding of the legal and regulatory environment in which they will make their decision. This will include being familiar with:

- their general duties as directors as set out in sections 171 to 177 of the Companies Act 2006;

- their responsibilities for the production of financial statements for the company that comply with the legislative and regulatory requirements applicable to the company; and

- the responsibilities of the auditors under the Companies Act 2006 including their duty to report whether the accounts give a true and fair view, whether they have been properly prepared in accordance with the relevant financial reporting framework, and whether they have been prepared in accordance with the requirements of the Act.

3.4. Directors will wish to establish that it is in the company's interest to enter into a liability limitation agreement. This will involve obtaining a clear understanding of the nature of the proposed agreement and its practical implications.

3.5. Examples of reasons why a director might conclude that it is appropriate to enter into a liability limitation agreement include:

- The proposed agreement would give effect to the objective of enabling auditors to ensure that their potential liability in the event of a financial reporting failure is appropriately matched to their degree of responsibility for that financial reporting failure and their available resources (as referred to in Section 1 of the guidance).

- The proposed agreement is an essential element of the arrangements under which the company is able to secure the appointment of auditors which, for example, it believes are particularly well suited to audit its affairs by virtue of their specialist industry expertise or geographic coverage.

3.6. Other matters that the directors may need to consider include:

- If the company is subject only to the laws and regulations of the United Kingdom or whether it is subject to other laws and regulations that preclude entry into liability limitation agreements.

- Whether the method by or extent to which the auditor's liability is to be limited would be appropriate to achieve the stated rationale for the proposed agreement.

- Whether there is any potential interaction between the proposed liability limitation agreement and the future plans for the company. For example, if the company is currently privately owned and there are plans to take the company public in the foreseeable future, the directors may be advised that difficulties might be encountered if they entered into a liability limitation agreement in a form that is not approved by particular prospective shareholders.

- Whether by limiting the auditors' liability, a situation may arise where the company is unable to recover part of the loss suffered from the auditor or any third party.

3.7. Having decided that a liability limitation agreement is appropriate in the particular circumstances, the directors will need to consider the manner in which they communicate that decision and any reasons for it to the shareholders of the company and seek their approval of the proposed agreement. Their approach will differ depending upon whether the company is public or private and on the identity of its shareholders.

3.8. They will also need to consider the form of any resolution to be put before the shareholders and any disclosure to be made in the financial statements of the company (see Section 5 of this guidance).

3.9. Examples of matters that directors should have regard to include:

- Whether any of their shareholders have particular policies in relation to proposals involving auditor liability limitation agreements and, if so, whether those policies are likely to result in opposition to any particular proposal.

- The fact that institutional shareholders are likely to welcome early dialogue with companies that are developing auditor liability limitation agreements.

- If the company is privately owned, the relationship between (a) the directors and management of the company and (b) those shareholders who have no such involvement.

3.10. Where the company is a public listed company, the directors may consider it appropriate to seek the views of institutional shareholders and governance bodies such as the Association of British Insurers, the National Association of Pension Funds, and others. The ABI and NAPF have indicated that, in the case of listed or publicly traded companies, their members should only support limitation agreements that provide for proportionate liability unless there are compelling reasons why that is not appropriate.

*[**Note**: links to policy statements produced by investor and other representative bodies will be included in Appendix E in the final guidance.]*

SECTION 4: WHAT SHOULD BE COVERED IN ANY AGREEMENT?

4.1. Under the Companies Act 2006 a company has the option of seeking shareholder approval either before or after entering into an agreement with its auditors. If the company is seeking approval having already entered into an agreement, the shareholders must approve the whole agreement; if seeking approval first, the shareholders must approve what the Act calls the "principal terms". These are the terms which specify:

- the kind of acts or omissions covered by the agreement;
- the year the agreement relates to; and
- the limit of the auditor's liability, however expressed.

4.2. Appendix B to this guidance contains specimen "principal terms", being the operative terms for a liability limitation agreement. These have been drafted so that they can be included in the resolution that is put to shareholders, and then incorporated into the agreement without the need for further drafting. They are provided as examples only.

4.3. Appendix C to this guidance contains specimen clauses that can be added to the principal terms to form a liability limitation agreement. The exact form and content of an agreement will be a matter for discussion between the company and the auditors.

Issues for consideration

4.4. Companies and auditors will need to consider how any agreement inter-relates to the audit engagement letter. One option is for the principal terms to be part of the audit engagement letter. This might particularly be appropriate if that letter includes an "all agreement" clause (that is, a clause confirming that the letter alone records the agreement to audit). Another option is to have a separate agreement which just deals with the limitation of the auditor's liability, and which cross refers to the audit engagement letter.

4.5. Timing will also need careful consideration in deciding whether to incorporate a liability limitation agreement into the audit engagement letter (see paragraph 5.6 onwards).

4.6. Companies and auditors will also need to consider whether there are any provisions in the audit engagement letter that would have the effect of limiting the auditor's liability in other ways, for example a limit of the period in which claims can be brought.

4.7. Where the company is a member of a group of companies, auditors will typically have a single audit engagement letter that is addressed to the parent but structured to capture all group members. In such cases the company and the auditor will wish to consider the relationship between the limit for each company in the group and the total amount payable in respect of the group as a whole.

SECTION 5: WHAT PROCESS MUST BE FOLLOWED TO IMPLEMENT THE AGREEMENT?

5.1. The process that must be followed to obtain shareholder approval for a liability limitation agreement varies, depending on whether the company is a private company or a public company (whether or not its shares are listed or traded). In both cases, approval must be given by ordinary resolution.

5.2. Private companies can ask for shareholder approval by written resolution or at a shareholders meeting. If a private company has not yet entered into the agreement, it can seek a resolution waiving the need for approval or approving the principal terms of the agreement. If the agreement has been entered into, the resolution must approve the agreement (not just the principal terms).

5.3. Public companies must hold a General Meeting of shareholders to pass a resolution. If a public company has not yet entered into the agreement, the resolution must approve the principal terms of the agreement. If it has already entered into the agreement, the resolution must approve the full agreement (not just the principal terms). In addition listed companies will need to consider the relevant Listing Rule requirements for circulars sent to shareholders.

5.4. Where a company is part of a group, every company in the group which enters into a liability limitation agreement must obtain authorisation from its shareholders. Although the Act does not require such a subsidiary to obtain the approval of the shareholders of any holding company, the directors may wish to consider whether the agreement should be conditional on obtaining the authorisation of the company's ultimate parent as well as authorisation from its own shareholders (see paragraph 5.15 onwards for further points to consider where a company is part of a group).

5.5. Appendix D contains specimen resolutions and notices. These are provided as examples only.

Timing of authorisation

5.6. The Act does not require authorisation to be given before the beginning of the financial year to which the liability limitation agreement relates. The agreement can be entered into before, during or after the financial year to which it relates, although because of the disclosure requirements (see paragraph 5.20 below) it must have been entered into before the accounts for the year to which the agreement relates are approved[1].

5.7. Companies and auditors will need to consider the timing for shareholder approval of a liability limitation agreement. In particular they will need to consider how it fits in with the timing of the financial year to which the agreement relates, the timing for signing the auditor's engagement letter for that financial year and the timing for holding the annual general meeting.

5.8. The Act contains requirements relating to the appointment of auditors and their remuneration. Companies may therefore wish to seek authorisation for a liability limitation agreement at the same time as proposing a resolution to appoint the auditors and a resolution to fix their remuneration. This may not be possible in all cases in the first year in which companies can enter into liability limitation agreements.

5.9. In the case of a private company or a public company with only a small number of shareholders, it should be relatively straightforward to arrange for the liability limitation agreement (or principal terms) to be approved by the shareholders at the same time as the company settles the auditor's engagement letter for the financial year to which the agreement relates. This is because it should be possible for the company to arrange for a written resolution to be circulated to shareholders, or a general meeting to be held, at the appropriate time. However directors and auditors will need to consider whether this will require them to make any changes to the existing arrangements for agreeing the engagement letter.

5.10. In the case of companies whose shares are publicly traded – including listed companies and those whose shares are traded on the AIM and PLUS markets - and any other companies that have a large shareholder base, the timing issues may be more complicated.

[1] This is subject to regulations on the disclosure requirements to be issued by BERR. The draft Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations can be found on the Company Law pages of the BERR website: http://www.berr.gov.uk

5.11. These companies will in normal circumstances wish to propose the resolution to approve the liability limitation agreement (or principal terms) at their annual general meeting (AGM) each year, rather than call an extraordinary general meeting solely to deal with this issue.

5.12. The AGM is normally held towards the end of the first half of each financial year, and will include resolutions to approve the audited accounts from the previous financial year and to reappoint the auditors for the current financial year. This is a different timetable to that involving the audit engagement letter. The practice to date has been for the letter to be signed in the final quarter of the financial year to which it relates. To be effective it must in any event be signed before the audit report for the financial year in question has been signed off.

5.13. This may give rise to difficulties as to the timing of shareholder approval for a liability limitation agreement. Given that the terms of an agreement are likely to be closely linked to the terms of the engagement letter, the company and auditor will want to look at both aspects together.

5.14. Normally, it seems likely that shareholders will be asked to approve the liability limitation agreement (or the principal terms of the agreement if it has not yet been entered into) at the AGM held during the financial year to which it relates. So, for example, a liability limitation agreement for the financial year ending 31 December 2009 would be approved at the AGM earlier in 2009. If this approach is adopted companies and auditors may wish to consider a process whereby the negotiation of the audit engagement terms is brought forward to a point in time early in the relevant financial year so that agreement on those issues is reached before the liability limitation agreement is put to shareholders. The timing of this may be different in the first year of agreeing a liability limitation agreement.

Groups of companies

5.15. For companies that are subsidiaries, the timing for approval of a liability limitation agreement will flow from the timing for approval of the holding company agreement. Obtaining shareholder approval via a written resolution or shareholder meeting should be a straightforward process to put in place across the group at the appropriate time. Companies will need to consider whether to arrange for the subsidiary company approval to be put in place before or after the holding company approval; and if it is before, whether it should be conditional on the approval by the holding company's shareholders of the agreement relating to the holding company.

5.16. If the holding company does not own all the shares in a subsidiary, or if the company is a joint venture, the timetable will need to make allowance for any extra time needed to obtain shareholder approval.

5.17. If any UK companies are audited by a different firm from the firm which audits the group accounts, the timetable will need to make provision for discussions with that auditor too. Where there are non-UK companies in the group, the provisions of the Companies Act 2006 will not apply to those non-UK companies. However, there may be other relevant provisions which apply, for example under the local law where these companies are incorporated.

5.18. Where liability limitation agreements are to be entered into by different members of a group, the companies and the auditor will want to consider any inter-relationship between the limit of the auditor's liability to any one company and the total amount payable by the auditor to the group as a whole. Where a holding company is seeking shareholder approval for a limitation liability agreement, although the Act only requires it to seek approval for the limitation of liability which applies to that particular company, shareholders are likely to wish to understand how that limitation of liability fits with any limitation of liability agreed by other group members. It is recommended that holding companies should explain this in seeking shareholder approval.

Withdrawal of authorisation

5.19. Authorisation may be withdrawn at any time before the company enters into the agreement. If the company has already entered into the agreement, it can be withdrawn before the beginning of the financial year to which the agreement relates (even if the agreement provides otherwise). Authorisation is withdrawn by the company passing an ordinary resolution to that effect.

Disclosure of the agreement by the company:

*[**Note**: this section is based on the draft regulations issued by BERR and will be updated if necessary to reflect any changes in the final regulations. The draft Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations can be found on the Company Law pages of the BERR website: http://www.berr.gov.uk]*

5.20. A company which has entered into a liability limitation agreement must disclose the principal terms of the agreement in a note to the company's annual accounts for the financial year to which the agreement relates. It must also disclose the date of the resolution approving the agreement or the agreement's principal terms or, if the company is a private company, the date of the resolution waiving the need for such approval.

APPENDIX A: SUMMARY OF THE COMPANIES ACT PROVISIONS

This appendix sets out a summary of the provisions in the Companies Act 2006 ("the Act") relating to auditors' liability.

The provisions relating to auditors' liability are set out in sections 532 to 538 (Chapter 6 of Part 16) of the Act.

Starting point - provisions limiting liability or providing indemnities are void

The starting point in section 532 of the Act is that provisions limiting auditor liability and provisions giving indemnities to auditors are void under the Act. These are defined as any provision for exempting an auditor or indemnifying an auditor from any liability for "any negligence, default, breach of duty or breach of trust in relation to the company" which occurs "in the course of the audit of accounts".

Section 532 also makes it clear that, for this purpose, it does not matter where the provision is set out, for example it may be in a company's articles or any contract with the company or otherwise, it is still covered by the restrictions.

The Act then allows certain liability limitation agreements and indemnities, as an exception from this absolute restriction, provided they meet the requirements set out in the Act.

Permitted indemnities for costs of defending proceedings

Section 533 of the Act provides an exception for indemnities for costs of defending proceedings. It restates section 310 of the Companies Act 1985 which allows a company to indemnify an auditor against any liability in defending both civil and criminal proceedings in which judgement is given in his favour or he is acquitted. Section 533 is more restrictive than section 310 in one respect, which is that it no longer permits a company to purchase insurance for an auditor.

Permitted liability limitation agreements

Sections 534 to 536 set out the details of the liability limitation agreements that are permitted as an exception to the general prohibition in section 532. It is these provisions that are new – section 310 of the 1985 Act just contains an absolute bar on exempting an auditor from liability.

There are three requirements for a valid liability limitation agreement:

- an agreement cannot limit an auditor's liability to less than such an amount as is fair and reasonable (and if it does so it instead takes effect as if it limited the auditor's liability to such an amount);
- the agreement must be approved by a resolution of the company's shareholders; and
- the agreement cannot cover more than one financial year.

Permitted terms

Section 535(4) expressly states that it is immaterial how the actual limitation is framed and that in particular it need not be a sum of money, or a formula, specified in the agreement.

Fair and reasonable test

Section 537 limits the effect of liability limitation agreements. Section 537(1) provides that a liability limitation agreement is not effective to limit the auditor's liability to "less than such amount as is fair and reasonable in all the circumstances of the case having regard (in particular) to

(a) the auditor's responsibilities under this Part;

(b) the nature and purpose of the auditor's contractual obligations to the company, and

(c) the professional standards expected of him".

Furthermore, the Act specifically states (in section 537(3)) that no account is to be taken of:

(a) "matters arising after the loss of damage in question has been incurred; or

(b) matters (whenever arising) affecting the possibility of recovering compensation from other persons liable in respect the same loss or damage".

The Act also provides in section 534(3) that a liability limitation agreement is not subject to section 2(2) or 3(2a) of the Unfair Contract Terms Act 1977 (UCTA) (or in Scotland, sections 16(1)(b) or 17(1)(a) of that Act). These are the provisions in UCTA which prevent a contract from excluding liability for negligence except to the extent it is reasonable to do so and which prevent a consumer contract from excluding or restricting liability from breach of contract. This means that the provisions in the Act regarding the requirement for the limitation to be fair and reasonable take effect in place of these UCTA provisions.

Effect of agreement limiting liability to more than is fair and reasonable

If a limitation liability agreement purports to limit the auditor's liability to less than an amount which is fair and reasonable, then the agreement is treated as if it limited the auditor's liability to an amount that is fair and reasonable (section 537(2)). This acts to preserve any agreement which goes beyond what is permitted, by reducing the limitation by reference to the fair and reasonable test, rather than making the agreement completely void.

Duration

Liability limitation agreements cannot apply in respect of acts or omissions occurring in the course of the audit of the accounts for more than one financial year (section 535). An agreement therefore needs to be limited in duration to one financial year and must also state the financial year for which it applies.

Approval of shareholders

Each new liability limitation agreement must be approved by an ordinary resolution of the members of the company that has agreed to it (section 536). For group companies this means each company in the group, and not just the holding company.

Shareholder approval can be given before or after the agreement is entered into. If it is before the agreement is entered into, then the resolution must approve the agreement's principal terms (see section 4 of the guidance).

This approval can be withdrawn by a subsequent shareholder resolution but if the agreement has already been entered into by the company the withdrawal of approval can only be effective if it is done before the beginning of the financial year to which the agreement relates (section 536(5)).

Disclosure

Section 538 requires disclosure of the liability limitation agreement by the company in a note to the accounts or in the directors' report. The details to be disclosed will be set out in Regulations to be issued by BERR.

*[**Note**: The draft Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations can be found on the Company Law pages of the BERR website: http://www.berr.gov.uk . This section will be updated to reflect the final regulations.]*

Power to make regulations

Section 535(2) gives the Secretary of State power to make Regulations, both to require liability limitation agreements to contain specified provisions and to prohibit them from containing specified provisions. Specifically there is a power to do so if the Government believes that there has been an adverse effect on competition. The Government has indicated that this power will only be used if problems emerge in practice from the use or misuse of the liability limitation provisions.

APPENDIX B: SPECIMEN PRINCIPAL TERMS

The specimen wording provided in Appendices B to D is for guidance only. It is the responsibility of companies, auditors and their own legal advisers to ensure that the principal terms, liability limitation agreements, the resolutions to approve them and any related documentation which they issue is adequate and satisfactory for their purposes. Neither the Financial Reporting Council, nor any member of the working group which has prepared this guidance, takes any responsibility for or in respect of the specimen wording.

The specimen clauses in Appendix B cover the principal terms to which companies are required, as a minimum, to get shareholder agreement under Section 536 of the Companies Act. The Appendix covers three examples of different types of limitation which companies and auditors can agree to adopt. These are:

B(i) *proportionality – where the auditor's liability is limited to his share of the company's loss, taking account of the liability of others who may also be liable for some or all of that loss;*

B(ii) *a fair and reasonable amount – where the auditor's liability is limited to such amount as is fair and reasonable in accordance with section 537 of the Act; and*

B(iii) *a monetary cap – where the auditor's liability is limited to a particular amount, which is either stated or calculated in some way e.g. as a multiple of the audit fees.*

These options are not exhaustive. Companies and auditors may, for example, want to consider a combination of two of the options.

In each example specimen clause C sets out the type of limitation being agreed, and is different in each option. Clauses A and B describe the scope of, and period covered by, the limitation. They are the same under all options and they (or something similar) will need to be included in all agreements. It is recommended that clause D is also included where options (i) or (iii) are chosen to make it clear that, whatever wording is chosen, the Act will substitute a fair and reasonable amount if the limit is less than a fair and reasonable amount.

In each example the specimen clauses are shown in the left hand column, with commentary in the right hand column.

APPENDIX B (i)

PRINCIPAL TERMS: PROPORTIONALITY

This Appendix contains two different sets of principal terms for an agreement based on proportionate liability. Both versions provide that the Auditor's liability is to be limited to such amount as is just and equitable having regard to the extent to which the Auditor and others are liable or responsible for the Company's loss or damage or have caused or contributed to it. This does not limit the assessment to an arithmetical calculation but allows the Court discretion, which is more consistent with the requirement that the limit should be fair and reasonable.

Version 1 deals expressly with a case where the Company cannot recover its loss from either an employee or someone else for whom no-one is vicariously liable. Where such a person is involved, the Auditor's liability is reduced by such amount as is fair and reasonable (which may differ from the extent to which that employee or other person is responsible or liable for the loss or may have caused or contributed to it). It sets out the factors to be considered and ignored in deciding this. Version 2 does not deal with this expressly, leaving it instead to the Court's discretion.

Views are invited on whether it would be helpful to include both sets of principal terms in the final guidance. If you feel it would be better only to include one version, please indicate which one you prefer.

PRINCIPAL TERMS: PROPORTIONALITY (VERSION 1)

Agreement	Commentary
	It is envisaged that the Liability Limitation Agreement will form part of the Engagement Letter, probably as a Schedule or Appendix. The main body of the letter should refer to the Liability Limitation Agreement. If the Liability Limitation Agreement is to be separate from the Engagement Letter, it will be necessary to consider how the two interrelate and, if the Liability Limitation Agreement is entered into after the Engagement Letter, it will be necessary to ensure that it is either entered into as a Deed or is for valuable consideration, in order to be enforceable.
A: This Agreement limits the amount of any liability owed to the Company by the Auditor in respect of any negligence, default, breach of duty, or breach of trust, occurring in the course of the audit of the accounts for the financial year [beginning/ending] [*insert date*] pursuant to [this Letter of Engagement *or* the Letter of Engagement entered into on [date]] of which the Auditor may be guilty in relation to the Company ("The Auditor's Liability").	*A. This wording sets out the scope of the Auditor's liability which is to be limited. It follows section 534(1) of the Act. Companies and Auditors will want to consider if this scope is appropriate. Companies and Auditors may prefer to identify the relevant financial year by reference to the date on which it begins, rather than when it will end, if the period the financial year relates to may be changed.*
B: This Agreement shall not limit the amount of any liability of the Auditor for fraud [*consider whether to include any other carve-outs*] or any other liability that cannot be excluded or restricted by applicable laws or regulations.	*B. Liability based on fraud cannot be excluded. Companies and Auditors may wish to specify any other circumstances in which the limitation of liability should not apply. Their views on this may be affected by the way in which liability is limited, for example proportionately or by a fixed amount.*
C: The Auditor's Liability shall be limited in accordance with the following sub-paragraphs:-	*C: The wording explains that the Auditor's Liability (as defined at A above) is to be limited. Because of the definition of "the Auditor's Liability", it will cover the position both where the Liability Limitation Agreement is part of the Engagement Letter and where it is entered into separately. This version of Clause C limits the*

	Auditor's Liability proportionately, i.e. to that proportion of the loss or damage for which it should be responsible where others are also liable or responsible for the same damage. If the limitation of liability is to be by reference to some other measure, such as a fixed amount, different wording will be required.
(i) where any Person (as defined below) (but excluding a Deliberate Wrongdoer as defined in sub-paragraph C(ii) below) is also liable to the Company, or has otherwise caused or contributed to, all or part of the same loss or damage as the Auditor (a Responsible Person), the Auditor's Liability shall be limited to such amount as is agreed between the Company and the Auditor, or in default of agreement determined by the Court[2] to be just and equitable having regard to the extent to which the Auditor and any other such Responsible Person [***or*** to represent the extent to which the Auditor, as opposed to any other such Responsible Person] is, in each case, liable for, or has otherwise caused or contributed to, such loss or damage. Any limitation exclusion or restriction (however arising) on the liability of any other such Responsible Person and any other matter (whenever arising), including inability to pay or insolvency, affecting the possibility of recovering compensation from any other such Responsible Person shall be ignored in determining:- (1) whether and to what extent that Responsible Person is liable to the Company;	*C(i): This wording deals with the situation where someone other than the Auditor is also liable or responsible to the Company for loss caused by the Auditor's fault or has caused or contributed to that loss. For an explanation as to why liability of a Deliberate Wrongdoer is excluded from this paragraph see C(ii) below. This paragraph provides that the Auditor's Liability is limited by reference to the Auditor's proportionate responsibility for the loss and damage suffered by the Company in the light of the extent of the responsibility of the various other parties involved, other than contributory negligence on the part of the Company itself or the act of a Deliberate Wrongdoer. It also takes account of others, such as regulatory bodies, who have also caused or contributed to the loss. The wording does not limit consideration only to those who have or would if sued have had a legal liability to the Company but also includes those who have in some way caused or contributed to that loss whether or not they could be sued by the Company. This should include those who bear a responsibility for the damage but for policy or other reasons have no legal liability to the Company despite their blameworthiness.* *However, the wording does not limit the assessment to an arithmetical calculation but instead uses wording taken from the Civil Liability (Contribution) Act 1978, with its reference to what is "just and equitable". This allows the Court (in the event of disagreement) a discretion as under the 1978 Act, which is more consistent with a requirement that the limitation should be fair and reasonable as required by section 537 of the Companies Act 2006. In practice, the Court is likely to apply a broadly arithmetical approach. So,*

[2] If the Engagement Letter includes an arbitration clause, reference should be made to the Arbitrator.

(2) the extent of responsibility of that Responsible Person for the loss and/or damage suffered by the Company; (3) the extent to which the Responsible Person caused or contributed to the loss and/or damage suffered by the Company; and (4) the amount to which the Auditor's Liability should be limited. The absence of any other Responsible Person from any proceedings in which the Auditor's Liability is to be determined, whether as a witness or as a party to the proceedings, shall not prevent the Court from making a determination as to the Auditor's Liability on the evidence before such Court, provided that neither the Auditor nor the Company shall unreasonably resist the joinder to the proceedings or the calling as a witness in the proceedings of such other Responsible Person. "Person" means any corporate body, individual or other person, which expression shall for the avoidance of doubt include any company, any director or employee of the Company, persons associated with the Company, persons providing or who have provided finance or services to the Company including other professionals, and any governmental or regulatory authority or body.	*for example, if the Auditor is 30% responsible and a non-fraudulent employee or another professional is 70% responsible or, say, a non-fraudulent employee is 20% responsible and another professional 50% responsible, the Auditor's Liability is likely to be limited to 30% of the loss.* *The use of the words "just and equitable" and "having regard to" provide a mechanism to be taken into consideration and a discretion as to how such factors are to be taken into account, as opposed to a merely arithmetical approach. It would be possible to make the approach much stricter and more arithmetical as in the alternative wording shown in square brackets and italics but this would make it more likely that an application might be made to the Court to apply the overriding test of what is fair and reasonable.* *The wording provides that other facts which affect the Company's ability to recover money from another responsible person are to be ignored. These could include the fact that that person has no money or that the Company has agreed to limit their liability. The wording also provides that the fact that another person is not a party to any court proceedings or a witness in those proceedings is not to prevent a court deciding what the Auditor's Liability is to be, based on the evidence it has before it. Both the Auditor and the Company agree not to resist such a person being called as a witness or joined in any court proceedings, unless it is reasonable to do so.*

(ii) where there is [: (a)] an employee of the Company [; or (b) a natural person for whom no-one is vicariously liable in respect of the relevant acts or omissions;] who is also liable to the Company for all or part of the same loss or damage as the Auditor by reason of fraud or dishonesty ("a Deliberate Wrongdoer") and that person does not or does not appear able to satisfy any Order or Judgment against them, then the Auditor's Liability shall, in addition to any limitation agreed or determined pursuant to clause C(i) above be further reduced by such amount as is fair and reasonable in all the circumstances of the case having regard in particular to the matters referred to in sub-section (1) of section 537 of the Companies Act 2006 and without regard to any of the matters referred to in sub-section (3) of the said section 537, and in addition having regard to the following matters:- (a) the opportunities reasonably available to the Auditor to discover the fraud or dishonesty of the Deliberate Wrongdoer; (b) the opportunities reasonably available to the Company to discover such fraud or dishonesty; (c) any contributory fault on the part of the Company and its directors or employees other than the Deliberate Wrongdoer.	*C(ii): This clause covers two separate but similar situations. First, where an employee of the Company is at fault but has acted honestly, the Company will generally be vicariously liable for their conduct, and it is reasonable to limit the Auditor's Liability proportionately. However, where the employee is fraudulent, the Company will not be treated as vicariously liable for the fraud of that employee, for the purposes of contributory negligence, and it could be regarded as unreasonable to reduce the Auditor's Liability applying the test in C(i) above because it would probably leave the Company with only a very limited recovery against the Auditor and little prospect of recovering against the fraudulent employee.* *Secondly, where fraud is committed by somebody outside the Company, then if that person is a director or an employee of a company or a partner in a firm, the company or firm will generally be vicariously liable and the partners of a professional or the LLP of which the fraudster is an employee or member, will generally have insurance cover which will respond to indemnify the innocent partners or the innocent members of the LLP. There will, however, be cases where a fraud will be perpetrated on the Company by an individual outsider, perhaps working in conjunction with a dishonest employee. In those circumstances, also, a strictly proportionate approach may not give a fair and reasonable result. If it is considered that it is appropriate for special treatment to be given to this category, then the wording relating to "natural person" at sub-paragraph (b) can be added.* *This provision is therefore proposed to deal with those two situations. Where there is such a dishonest or fraudulent person (described here as a "Deliberate Wrongdoer") who either does not meet any Judgment or Order or appears to be unable to pay, the effect of this clause is that the Auditor's Liability is limited to what is fair and reasonable in all the circumstances, taking account of the opportunities the Company and the Auditor each reasonably had to discover the fraud or dishonesty and any fault by the Company, its directors or*

	employees (other than the Deliberate Wrongdoer) which contributed to the loss. This wording, whilst quite complicated, has been included in order to make it more likely that the requirement in the Act that the limitation of liability must be fair and reasonable will be met. It is arguable that, because the wording in paragraph C(i) requires the Auditor's Liability to be limited to what is just and equitable, there is already sufficient discretion to allow these sorts of considerations to be taken into account. The advantage of including this wording is that the parties will have considered and agreed what factors are to be taken into account, rather than leaving it to be agreed or determined by a Court once a dispute has arisen. Where the acts of a Deliberate Wrongdoer and acts or omissions of others apart from the Auditor have contributed to the loss or damage, then the Auditor's Liability is reduced in two separate stages.
(iii) where any loss or damage suffered by the Company as a result of the Auditor's breach of duty has been caused or contributed to by any fault on the part of the Company, its directors or employees other than a Deliberate Wrongdoer (but excluding any contributory fault already taken into account pursuant to sub-paragraph C(ii)(c) above, and any fault on the part of an individual director or employee taken into account under C(i) above) then the Auditor's Liability shall be further reduced by such amount as is just and equitable having regard to:- a. those matters stated to be taken into account and/or to be disregarded under section 537 of the Companies Act 2006;	*C(iii): Sub-paragraph C(ii) requires contributory fault on the part of the Company to be taken into account where there is a Deliberate Wrongdoer, and C(i) also requires the fault of any director or employee to be taken into account where that director or employee is liable to the Company. However, there may also be situations in which the Company is at fault because of systemic failures or weaknesses in procedure, resourcing or other matters which are not the responsibility of any individual who has a liability to the Company for them, but rather are failures for which the Company as an entity or its shareholders, directors or staff collectively, are responsible. This wording provides that where there is any such contributory negligence of this nature, it also is taken into account.*

b. the relative fault of the Auditor and the Company and its said directors and/or employees; c. the extent to which the loss and damage complained of was caused by such fault on the part of the Auditor and the Company (and those for whom it is responsible) respectively.	
D. In accordance with section 537 of the Companies Act 2006, if the effect of paragraph C of this Liability Limitation Agreement would be to limit the Auditor's Liability to less than such amount as is fair and reasonable, as determined in accordance with that section this Liability Limitation Agreement shall have effect as if it limited the Auditor's Liability to such amount as is fair and reasonable, as so determined.	*D: Section 537 of the Companies Act 2006, which substitutes a fair and reasonable amount if a lower amount is agreed, applies whether or not a clause like this is included. However, it is recommended that such provision is included as a reminder of the position under the Act. The limitation is therefore stated to be subject to the statutory fair and reasonable overriding test. This means that, whatever the result after applying the various limitations in clause C, a Court can step back and decide whether that result overall is fair and reasonable in all the circumstances.*
E: This Liability Limitation Agreement has been authorised by the Company's members under section 536 of the Companies Act 2006 and that authorisation has not been withdrawn. Pursuant to that authorisation, the Company has demonstrated agreement to this Liability Limitation Agreement by appending the signature of its duly authorised officer to the Engagement Letter [*or, where the Liability Limitation Agreement is entered into separately*, this Agreement].	*E: This paragraph assumes that the agreement has been authorised in accordance with the Act's requirements when the Engagement Letter is signed. The Act permits subsequent authorisation. For a private company the Act permits (section 536(2)(a)) waiver of the need for approval by the members, which will itself amount to authorisation of the agreement.* *Separate signature of the agreement is not required if it forms part of the Engagement Letter. However, where the Liability Limitation Agreement is entered into separately, then that also should be signed.*

APPENDIX B (i)

PRINCIPAL TERMS: PROPORTIONALITY (VERSION 2)

Agreement	Commentary
	It is envisaged that the Liability Limitation Agreement will form part of the Engagement Letter, probably as a Schedule or Appendix. The main body of the letter should refer to the Liability Limitation Agreement. If the Liability Limitation Agreement is to be separate from the Engagement Letter, it will be necessary to consider how the two interrelate and, if the Liability Limitation Agreement is entered into after the Engagement Letter, it will be necessary to ensure that it is either entered into as a Deed or is for valuable consideration, in order to be enforceable.
A: This Agreement limits the amount of any liability owed to the Company by the Auditor in respect of any negligence, default, breach of duty, or breach of trust, occurring in the course of the audit of the accounts for the financial year [beginning/ending] [*insert date*] pursuant to [this Letter of Engagement *or* the Letter of Engagement entered into on [date]] of which the Auditor may be guilty in relation to the Company ("The Auditor's Liability").	*A. This wording sets out the scope of the Auditor's liability which is to be limited. It follows section 534(1) of the Act. Companies and Auditors will want to consider if this scope is appropriate. Companies and Auditors may prefer to identify the relevant financial year by reference to the date on which it begins, rather than when it will end, if the period the financial year relates to may be changed.*
B: This Agreement shall not limit the amount of any liability of the Auditor for fraud [*consider whether to include any other carve-outs*] or any other liability that cannot be excluded or restricted by applicable laws or regulations.	*B. Liability based on fraud cannot be excluded. Companies and Auditors may wish to specify any other circumstances in which the limitation of liability should not apply. Their views on this may be affected by the way in which liability is limited, for example proportionately or by a fixed amount.*

C: The Auditor's Liability shall be limited in accordance with the following sub-paragraphs:- (i) where any Person (as defined below) is also liable to the Company, or has otherwise caused or contributed to, all or part of the same loss or damage as the Auditor (a Responsible Person), the Auditor's Liability shall be limited to such amount as is agreed between the Company and the Auditor, or in default of agreement determined by the Court[3] to be just and equitable having regard to the extent to which the Auditor and any other such Responsible Person [*or* to represent the extent to which the Auditor, as opposed to any other such Responsible Person] is, in each case, liable for, or has otherwise caused or contributed to, such loss or damage. Any limitation exclusion or restriction (however arising) on the liability of any other such Responsible Person and any other matter (whenever arising), including inability to pay or insolvency, affecting the possibility of recovering compensation from any other such Responsible Person shall be ignored in determining:- (1) whether and to what extent that Responsible Person is liable to the Company; (2) the extent of responsibility of that Responsible Person for the loss and/or damage suffered by the Company;	*C: The wording explains that the Auditor's Liability (as defined at A above) is to be limited. Because of the definition of "the Auditor's Liability", it will cover the position both where the Liability Limitation Agreement is part of the Engagement Letter and where it is entered into separately. This version of Clause C limits the Auditor's Liability proportionately, i.e. to that proportion of the loss or damage for which it should be responsible where others are also liable or responsible for the same damage. If the limitation of liability is to be by reference to some other measure, such as a fixed amount, different wording will be required.* *C(i): This wording deals with the situation where someone other than the Auditor is also liable or responsible to the Company for loss caused by the Auditor's fault or has caused or contributed to that loss. This paragraph provides that the Auditor's Liability is limited by reference to the Auditor's proportionate responsibility for the loss and damage suffered by the Company in the light of the extent of the responsibility of the various other parties involved, other than contributory negligence on the part of the Company itself. It also takes account of others, such as regulatory bodies, who have also caused or contributed to the loss. The wording does not limit consideration only to those who have or would if sued have had a legal liability to the Company but also includes those who have in some way caused or contributed to that loss whether or not they could be sued by the Company. This should include those who bear a responsibility for the damage but for policy or other reasons have no legal liability to the Company despite their blameworthiness.* *However, the wording does not limit the assessment to an arithmetical calculation but instead uses wording taken from the Civil Liability (Contribution) Act 1978, with its reference to what is "just and equitable". This allows the Court (in the event of disagreement) a discretion as under the 1978 Act, which is more consistent with a*

[3] If the Engagement Letter includes an arbitration clause, reference should be made to the Arbitrator.

(3) the extent to which the Responsible Person caused or contributed to the loss and/or damage suffered by the Company; and (4) the amount to which the Auditor's Liability should be limited. The absence of any other Responsible Person from any proceedings in which the Auditor's Liability is to be determined, whether as a witness or as a party to the proceedings, shall not prevent the Court from making a determination as to the Auditor's Liability on the evidence before such Court, provided that neither the Auditor nor the Company shall unreasonably resist the joinder to the proceedings or the calling as a witness in the proceedings of such other Responsible Person. "Person" means any corporate body, individual or other person, which expression shall for the avoidance of doubt include any company, any director or employee of the Company, persons associated with the Company, persons providing or who have provided finance or services to the Company including other professionals, and any governmental or regulatory authority or body.	*requirement that the limitation should be fair and reasonable as required by section 537 of the Companies Act 2006. In practice, the Court is likely to apply a broadly arithmetical approach. So, for example, if the Auditor is 30% responsible and a non-fraudulent employee or another professional is 70% responsible or, say, a non-fraudulent employee is 20% responsible and another professional 50% responsible, the Auditor's Liability is likely to be limited to 30% of the loss.* *The use of the words "just and equitable" and "having regard to" provide a mechanism to be taken into consideration and a discretion as to how such factors are to be taken into account, as opposed to a merely arithmetical approach. It would be possible to make the approach much stricter and more arithmetical as in the alternative wording shown in square brackets and italics but this would make it more likely that an application might be made to the Court to apply the overriding test of what is fair and reasonable.* *The wording provides that other facts which affect the Company's ability to recover money from another responsible person are to be ignored. These could include the fact that that person has no money or that the Company has agreed to limit their liability. The wording also provides that the fact that another person is not a party to any court proceedings or a witness in those proceedings is not to prevent a Court deciding what the Auditor's Liability is to be, based on the evidence it has before it. Both the Auditor and the Company agree not to resist such a person being called as a witness or joined in any court proceedings, unless it is reasonable to do so.* *Unlike the longer version of the proportionate wording set out in Version 1, this wording does not specifically deal with the position where there is a fraudulent employee of the Company or someone outside the Company who has been fraudulent and for whom no-one (including the Company) is vicariously liable. In such cases, the Company may have little prospect of recovering the loss caused by such fraudulent persons. Because the wording in*

	C(i) says the Auditor's Liability is limited to an amount which is just and equitable having regard to the extent to which the Auditor and others are liable for the loss, there is already provision for taking account of any unfairness which arises where the only other person liable is a dishonest employee of the Company. In such circumstances, this alternative wording, which is simpler and more straightforward, will allow a fairer result to be achieved. In certain circumstances, version 1 may be preferred, particularly where it is felt that it would be preferable to spell out the different approach where the only other Responsible Person is a fraudulent employee, or where it is considered better to spell out the particular matters to have regard to in those circumstances, as opposed to leaving it to the just and equitable test.
(ii) where any loss or damage suffered by the Company as a result of the Auditor's breach of duty has been caused or contributed to by any fault on the part of the Company, its directors or employees (but excluding any fault on the part of an individual director or employee taken into account under C(i) above) then the Auditor's Liability shall be further reduced by such amount as is just and equitable having regard to:- (a) those matters stated to be taken into account and/or to be disregarded under section 537 of the Companies Act 2006; (b) the relative fault of the Auditor and the Company and its said directors and/or employees;	*C(ii): Sub-paragraph C(i) requires the fault of any director or employee to be taken into account where that director or employee is liable to the Company. However, there may also be situations in which the Company is at fault because of systemic failures or weaknesses in procedure, resourcing or other matters which are not the responsibility of any individual who has a liability to the Company for them, but rather are failures for which the Company as an entity or its shareholders, directors or staff collectively, are responsible. This wording provides that where there is any such contributory negligence of this nature, it also is taken into account.*

(c) the extent to which the loss and damage complained of was caused by such fault on the part of the Auditor and the Company (and those for whom it is responsible) respectively.	
D. In accordance with section 537 of the Companies Act 2006, if the effect of paragraph C of this Liability Limitation Agreement would be to limit the Auditor's Liability to less than such amount as is fair and reasonable, as determined in accordance with that section this Liability Limitation Agreement shall have effect as if it limited the Auditor's Liability to such amount as is fair and reasonable, as so determined.	*D: Section 537 of the Companies Act 2006, which substitutes a fair and reasonable amount if a lower amount is agreed, applies whether or not a clause like this is included. However, it is recommended that such provision is included as a reminder of the position under the Act. The limitation is therefore stated to be subject to the statutory fair and reasonable overriding test. This means that, whatever the result after applying the various limitations in clause C, a Court can step back and decide whether that result overall is fair and reasonable in all the circumstances.*
E: This Liability Limitation Agreement has been authorised by the Company's members under section 536 of the Companies Act 2006 and that authorisation has not been withdrawn. Pursuant to that authorisation, the Company has demonstrated agreement to this Liability Limitation Agreement by appending the signature of its duly authorised officer to the Engagement Letter [*or, where the Liability Limitation Agreement is entered into separately*, this Agreement].	*E: This paragraph assumes that the agreement has been authorised in accordance with the Act's requirements when the Engagement Letter is signed. The Act permits subsequent authorisation. For a private company the Act permits (section 536(2)(a)) waiver of the need for approval by the members, which will itself amount to authorisation of the agreement.* *Separate signature of the agreement is not required if it forms part of the Engagement Letter. However, where the Liability Limitation Agreement is entered into separately, then that also should be signed.*

APPENDIX B (ii)

PRINCIPAL TERMS: FAIR AND REASONABLE TEST ONLY

Agreement	**Commentary**
	It is envisaged that the Liability Limitation Agreement will form part of the Engagement Letter, probably as a Schedule or Appendix. The main body of the letter should refer to the Liability Limitation Agreement. If the Liability Limitation Agreement is to be separate from the Engagement Letter, it will be necessary to consider how the two interrelate and, if the Liability Limitation Agreement is entered into after the Engagement Letter, it will be necessary to ensure that it is either entered into as a Deed or is for valuable consideration, in order to be enforceable.
A: This Agreement limits the amount of any liability owed to the Company by the Auditor in respect of any negligence, default, breach of duty, or breach of trust, occurring in the course of the audit of the accounts for the financial year [beginning/ending] [*insert date*] pursuant to [this Letter of Engagement *or* the Letter of Engagement entered into on [date]] of which the Auditor may be guilty in relation to the Company ("The Auditor's Liability").	*A. This wording sets out the scope of the Auditor's liability which is to be limited. It follows section 534(1) of the Act. Companies and Auditors will want to consider if this scope is appropriate. Companies and Auditors may prefer to identify the relevant financial year by reference to the date on which it begins, rather than when it will end, if the period the financial year relates to may be changed.*
B: This Agreement shall not limit the amount of any liability of the Auditor for fraud [*consider whether to include any other carve-outs*] or any other liability that cannot be excluded or restricted by applicable laws or regulations.	*B. Liability based on fraud cannot be excluded. Companies and Auditors may wish to specify any other circumstances in which the limitation of liability should not apply. Their views on this may be affected by the way in which liability is limited, for example proportionately or by a fixed amount.*

C. The Auditor's Liability shall (so far as is permitted by law be limited to such amount as is fair and reasonable in all the circumstances of the case having regard (in particular) to: (a) the Auditor's responsibilities under Part 16 of the Companies Act 2006; (b) the nature and purpose of the Auditor's contractual obligations to the Company; and (c) the professional standards expected of the Auditor. In determining what is fair and reasonable in all the circumstances of the case: (a) no account is to be taken of: (i) matters arising after the loss or damage in question has been incurred; or (ii) matters (whenever arising) affecting the possibility of recovering compensation from other persons liable in respect of the same loss or damage.	*C: This wording tracks the wording of section 537 of the Companies Act 2006*
This Liability Limitation Agreement has been authorised by the Company's members under section 536 of the Companies Act 2006 and that authorisation has not been withdrawn. Pursuant to that authorisation, the Company has demonstrated agreement to this Liability Limitation Agreement by appending the signature of its duly authorised officer to the Engagement Letter [*or, where the Liability Limitation Agreement is entered into separately*, this Agreement].	*This paragraph assumes that the agreement has been authorised in accordance with the Act's requirements when the Engagement Letter is signed. The Act permits subsequent authorisation. For a private company the Act permits (section 536(2)(a)) waiver of the need for approval by the members, which will itself amount to authorisation of the agreement.* *Separate signature of the agreement is not required if it forms part of the Engagement Letter. However, where the Liability Limitation Agreement is entered into separately, then that also should be signed.*

APPENDIX B (iii)

PRINCIPAL TERMS: FIXED CAP

Agreement	Commentary
	It is envisaged that the Liability Limitation Agreement will form part of the Engagement Letter, probably as a Schedule or Appendix. The main body of the letter should refer to the Liability Limitation Agreement. If the Liability Limitation Agreement is to be separate from the Engagement Letter, it will be necessary to consider how the two interrelate and, if the Liability Limitation Agreement is entered into after the Engagement Letter, it will be necessary to ensure that it is either entered into as a Deed or is for valuable consideration, in order to be enforceable.
A: This Agreement limits the amount of any liability owed to the Company by the Auditor in respect of any negligence, default, breach of duty, or breach of trust, occurring in the course of the audit of the accounts for the financial year [beginning/ending] [*insert date*] pursuant to [this Letter of Engagement *or* the Letter of Engagement entered into on [date]] of which the Auditor may be guilty in relation to the Company ("The Auditor's Liability").	*A. This wording sets out the scope of the Auditor's liability which is to be limited. It follows section 534(1) of the Act. Companies and Auditors will want to consider if this scope is appropriate. Companies and Auditors may prefer to identify the relevant financial year by reference to the date on which it begins, rather than when it will end, if the period the financial year relates to may be changed.*
B: This Agreement shall not limit the amount of any liability of the Auditor for fraud [*consider whether to include any other carve-outs*] or any other liability that cannot be excluded or restricted by applicable laws or regulations.	*B. Liability based on fraud cannot be excluded. Companies and Auditors may wish to specify any other circumstances in which the limitation of liability should not apply. Their views on this may be affected by the way in which liability is limited, for example proportionately or by a fixed amount.*

C: The maximum aggregate amount of the Auditor's Liability to the Company shall not exceed (1) the sum of £[ ] times the fees payable (excluding expenses and Value Added Tax) under the Engagement Letter referable to the financial year in question, or (2) £[ ], whichever is the lesser amount.	*C: This example assumes the Company and Auditor will agree to limit the Auditor's Liability to whichever is the lower of two amounts. However, Companies and Auditors may wish only to agree a fixed stated amount or an amount calculated by way of formula.* *The Company and Auditor may agree to limit liability to a multiple of the audit fees payable. If this is the approach adopted, it will be important to identify these precisely.*
[*For groups of companies:*] This limit shall apply to the Company and collectively to any and all other companies to which the Engagement Letter applies so that the Auditor's aggregate liability to all such companies including the Company shall not exceed the amount stated above. The apportionment of the total amount payable by the Auditor between the Company and such other companies shall be made by agreement between the Company and all other such companies without reference to the Auditor.	*Where the Company is a member of a group of companies, the Company and Auditor may wish to agree a limit for the group as a whole which can be shared between different companies in the group. For this reason the limit is expressed as a maximum aggregate so that it captures multiple acts of negligence and applies to all companies in a group. If the limit is a fixed sum it will need to be apportioned between the group companies, so that the total of all amounts paid to any group company do not, in aggregate exceed the agreed amount. This is consistent with the common practice for audits of groups to have an audit engagement letter addressed to the parent, to which all other group companies agree separately, in line with ISA (UK&I) 210, Terms of Audit Engagements.* *Parties who want the limit to be apportioned between different companies in the group should consider how to achieve this and whether there should be a fall back mechanism to be applied if the relevant companies cannot agree on apportionment.* *Reference to the fees payable under the Engagement Letter will, assuming a "group" letter as described, capture all fees payable by all companies, although it will be important to make sure the drafting fits appropriately with the drafting of the Engagement Letter.*

D. In accordance with section 537 of the Companies Act 2006, if the effect of paragraph C of this Liability Limitation Agreement would be to limit the Auditor's Liability to less than such amount as is fair and reasonable, as determined in accordance with that section this Liability Limitation Agreement shall have effect as if it limited the Auditor's Liability to such amount as is fair and reasonable, as so determined.	*D: Section 537 of the Companies Act 2006, which substitutes a fair and reasonable amount if a lower amount is agreed, applies whether or not a clause like this is included. However, it is recommended that such provision is included as a reminder of the position under the Act. The limitation is therefore stated to be subject to the statutory fair and reasonable overriding test. This means that, whatever the result after applying the various limitations in clause C, a Court can step back and decide whether that result overall is fair and reasonable in all the circumstances.*
E: This Liability Limitation Agreement has been authorised by the Company's members under section 536 of the Companies Act 2006 and that authorisation has not been withdrawn. Pursuant to that authorisation, the Company has demonstrated agreement to this Liability Limitation Agreement by appending the signature of its duly authorised officer to the Engagement Letter [*or, where the Liability Limitation Agreement is entered into separately*, this Agreement].	*E: This paragraph assumes that the agreement has been authorised in accordance with the Act's requirements when the Engagement Letter is signed. The Act permits subsequent authorisation. For a private company the Act permits (section 536(2)(a)) waiver of the need for approval by the members, which will itself amount to authorisation of the agreement.* *Separate signature of the agreement is not required if it forms part of the Engagement Letter. However, where the Liability Limitation Agreement is entered into separately, then that also should be signed.*

APPENDIX C: SPECIMEN PROVISIONS FOR AGREEMENTS

Note: *This Appendix contains specimen clauses that can be added to the principal terms to form a liability limitation agreement. They are provided as examples only. The exact form and content of an agreement will be a matter for discussion between the company and the auditors.*

This Agreement is made between [*name and address*] (the ***Company***) and [*name and address*] (the ***Auditor***) on [*date*] 200[ ].

This Agreement accompanies an engagement letter [issued/to be issued] by the Auditor relating to the delivery of audit services to the Company under the Companies Act 2006.[4]

In consideration of [ ][5], the Company agrees to limit the Auditor's liability to the Company on the terms and conditions set out in this Agreement.

[Insert principal terms as in Appendix B]

This Agreement shall not be affected by any amendment to or expiry or termination of the Engagement Letter. Any amendment to this Agreement must be in writing.

If and to the extent that any provision of this Agreement is held to be illegal, void or unenforceable, such provision shall be given no effect and shall be deemed not to be included in this Agreement but without invalidating any of the remaining provisions of this Agreement. [The parties shall meet to negotiate in good faith to agree a valid, binding and enforceable substitute provision or provisions (if necessary with reconsideration of the other terms of this Agreement not so affected) so as to re-establish an appropriate balance of the commercial interests of the parties.]

This Agreement is governed by and shall be interpreted in accordance with English law.

A person who is not a party to this Agreement shall have no right under the Contracts (Rights of Third Party) Act 1999 to enforce of any of its terms.

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[4] Where the liability limitation agreement is a separate agreement from the audit engagement letter, it will usually be helpful to cross refer to the audit engagement letter.

[5] For a liability limitation agreement to be a valid agreement, there must either be consideration provided by the Auditor (which can be nominal) or the agreement could instead be executed by the Company as a deed (in which case, the attestation provisions should be those for a deed).

This Agreement sets out the entire agreement between the Company and the Auditor in respect of the limitation of the Auditor's liability to the Company in connection with the audit of the accounts for the financial year [beginning/ending] [*date*]. Neither party has relied on any representation, warranty or undertaking not set out in this Agreement and neither party has a claim or remedy for any misrepresentation or untrue statement made by or on behalf of the other. This does not exclude any liability for, or remedy in respect of, fraudulent misrepresentation.[6]

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[6] The Company and the Auditor will usually want to include a provision like this (known as an "entire agreement clause") to make sure neither party has relied on something said or done by the other which is not reflected in the agreement. Liability for fraudulent misrepresentations cannot be excluded. Both parties should consider carefully how this agreement fits with the audit engagement letter and any entire agreement clause in that letter.

APPENDIX D: SPECIMEN RESOLUTIONS AND NOTICES

Note*: these resolutions and notices are provided as examples only.*

Private Companies

Resolutions by a private company waiving the need for approval before entering into the agreement

It is resolved that the requirements of the Companies Act 2006 as to approval of any liability limitation agreement (as defined in section 534 Companies Act 2006) for the financial year [beginning/ending] [*date*] be and are hereby waived.

Resolution by a private company – approving the principal terms of a liability limitation agreement before the company enters into the agreement

It is resolved that the principal terms (as defined in section 536(4) Companies Act 2006) [attached to this written resolution/produced to the meeting and initialled by the chairman of the meeting for the purpose of identification][7] of a liability limitation agreement (as defined in section 534 Companies Act 2006) for the financial year [beginning/ending] [*date*] proposed to be entered into by the company and [*name of auditor*] be and are hereby approved.

Resolution by a private company – approving a liability limitation agreement after the company has entered into it

It is resolved that the liability limitation agreement [attached to this written resolution/produced to the meeting and initialled by the chairman of the meeting for the purpose of identification][8] [for the financial year [beginning/ending] [*date*] between the company and [*name of auditor*]] be and is hereby approved.

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[7] If the resolution is to be passed as a written resolution, the principal terms should be attached to the written resolution sent to shareholders. If the resolution is to be passed at a general meeting, the principal terms should either be sent with the notice of the meeting or reproduced in a letter or circular being sent to shareholders with the notice of the meeting. It is also recommended that they are available for inspection at the company's registered office and at the meeting.

[8] If the resolution is to be passed as a written resolution, the liability limitation agreement should be attached to the written resolution sent to shareholders. If the resolution is to be passed at a general meeting, a copy of the liability limitation agreement could be sent with the notice of the meeting or be reproduced in a letter or circular being sent to shareholders with the notice of the meeting. If this is not done, at least the principal terms of the agreement and any other terms of the agreement which the directors think the shareholders should be told in order to make an informed decision on how to vote on the resolution should be described in the letter or circular sent with the notice of meeting. It is also recommended that the liability limitation agreement be available for inspection at the company's registered office during the notice period and at the meeting.

Resolution by a private company withdrawing authorisation

It is resolved that the authorisation given under section 536 Companies Act 2006 by ordinary resolution passed on [*date*] approving [the principal terms of a liability limitation agreement/the liability limitation agreement] between the company and [*name of auditor*] dated [ ] be and is hereby withdrawn.

Public Companies

Resolution by a public company – approving the principal terms of a liability limitation agreement before the company enters into the agreement

It is resolved that the principal terms (as defined in section 536(4) Companies Act 2006) produced to the meeting and initialled by the chairman of the meeting for the purpose of identification[9] of a liability limitation agreement (as defined in section 534 Companies Act 2006) for the financial year [beginning/ending] [*date*] proposed to be entered into by the company and [*name of auditor*] be and are hereby approved.

Resolution by a public company – approving a liability limitation agreement after the company has entered into it

It is resolved that the liability limitation agreement produced to the meeting and initialled by the chairman of the meeting for the purpose of identification[10] [for the financial year [beginning/ending] [*date*] between the company and [*name of auditor*]] be and is hereby approved.

Resolution by a public company withdrawing authorisation

It is resolved that the authorisation given under section 536 Companies Act 2006 by ordinary resolution passed on [*date*] approving [the principal terms of a liability limitation agreement/the liability limitation agreement] between the company and [*name of auditor*] dated [ ] be and is hereby withdrawn.

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[9] The principal terms should either be sent with the notice of the meeting or reproduced in a letter or circular being sent to shareholders with the notice of the meeting. It is also recommended that they are available for inspection at the company's registered office and at the meeting.

[10] A copy of the liability limitation agreement could be sent with the notice of the meeting or be reproduced in a letter or circular being sent to shareholders with the notice of the meeting. If this is not done, at least the principal terms of the agreement and any other terms of the agreement which the directors think the shareholders should be told in order to make an informed decision on how to vote on the resolution should be described in the letter or circular sent with the notice of meeting. It is also recommended that the liability limitation agreement be available for inspection at the company's registered office during the notice period and at the meeting.

APPENDIX E: OTHER SOURCES OF GUIDANCE

[Note: this section will be added in the final guidance.]

[Consultees may wish to be aware that the NAPF issued a voting policy statement on auditor liability limitation agreements in November 2007, which states that "investors should consider voting against resolutions which propose any form of liability limitation other than proportional liability unless there are compelling reasons why that is not appropriate, and why the directors feel that another form of liability limitation would survive a court's judgement of what is fair and reasonable in all the circumstances". The NAPF Corporate Governance and Voting Guidelines are available at: http://www.napf.co.uk/Policy/governance.cfm]

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