THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

22 August 2008

Mr Arthur Levitt Jr
Mr Donald Nicolaisen
Co Chairman
Advisory Committee on the Auditing Profession

Dear Messrs Levitt and Nicolaisen

AUDITOR LIABILITY LIMITATION

The Institute of Chartered Accountants of England and Wales (ICAEW) operates under a Royal Charter, working in the public interest. As a world leading professional accountancy body, the ICAEW provides leadership and practical support to more than 130,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

The importance of the US within the global markets means that what happens in the US inevitably has a significant impact elsewhere. So while we do not think it appropriate to submit direct proposals in respect of an auditor liability limitation regime for the US, we hope that you will be interested in our own experience in Europe.

The ICAEW has long held reasonable liability limitation to be in the best interests of efficient markets, shareholders and companies, as well as of auditors. This has been agreed by the UK government and the European Commission and we hope, therefore, that you will be interested in:

- submissions made to both these authorities as at an early stage in the process, explaining why we believe limitation to be in the public interest; and

- a briefing on the ensuring legal developments

We would be very happy to discuss the matter further if you would find this helpful.

Yours sincerely

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A PROPOSAL TO ALLOW AUDITORS AND COMPANIES TO AGREE TO LIMIT LIABILITY THROUGH PROPORTIONALITY BY CONTRACT

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Foreword

Unlimited liability places auditors in a unique and precarious position. Professional advisers other than auditors are contractually able to agree limits on their liabilities with their clients. Auditors are prevented from limiting their liability by Section 310 of the Companies Act 1985. Auditors are therefore subject to the law of joint and several liability which results in a level of economic risk which is disproportionate and potentially threatens their ability to continue auditing UK companies. This is a matter which impinges not only on the UK auditing profession but also on the continued successful operation of the UK capital markets.

The Department of Trade and Industry rightly realised the danger of this situation when it conducted a consultation in December 2003 which examined options to reform the current liability regime. Responses to the consultation process showed a high level of support for reform of auditor liability, although respondents differed on their preferred solution. The December 2003 consultation excluded the option of proportionate liability although many respondents, including the ICAEW, as well as a number of business leaders and representatives of the investment community, indicated their clear preference for such a system.

This report is the result of a task force which, at the invitation of the DTI, has put together a proposal for a system of proportionate liability established by contract, which would command a broad consensus of support across the audit profession, business and the investment community as well as other users of accounts. We were asked to determine whether such a scheme is practicable in law (appendix), whether it would enhance competition and improve quality (section 3.4) and how it would be administered and overseen (section 4.4). I believe we have satisfied all of these objectives and have also set out proposals for a mechanism to take forward audit quality and assurance reporting issues.

UK shareholders deserve and expect further and continued improvements in financial reporting. The auditors of Britain's major companies are keen to take on a role in relation to matters that are relevant to the governance of listed companies, beyond that required by the traditional statutory audit. The Institute is keen to establish a mechanism to take this forward, but believes that without reform of the current unlimited liability placed on auditors these improvements will prove almost impossible to achieve. Proportionate liability reform is necessary to create the right conditions for these improvements in financial and non-financial reporting to happen. I believe auditor liability reform is a matter of public interest, and this remains the prime reason for such reform.

I am immensely grateful to all of the people who have been involved in this process for their time and effort in what has necessarily been a very constrained period of time. It is a testimony to the merit of the proposals that we have been able to build such a broad base of support for the proposition in such a short period of time.

Eric Anstee
Chief Executive, ICAEW

1 Introduction

1.1 Background

At present auditors are held accountable not only for their own actions or failings but, under the law of joint and several liability, for those of other parties who are responsible for, but do not have the resources to meet, claims awarded against them.

This position holds back progress in enhancing assurance and stifles competition in the audit market for larger companies. These aspects are discussed further below, but the reason they are affected by the liability position is that while auditors' potential liability is unlimited, that liability is not and cannot be matched by unlimited resources. The ability of even the largest audit firms to meet massive claims is severely limited by the non-availability of adequate professional indemnity insurance. Instead these firms have to rely on their limited capital resources and own in-house captive insurance vehicles which, by definition, are unable to spread the risk widely and therefore themselves have limited ability to cope with an increasingly litigious environment. Given the scale of the capital available to audit firms relative to the market capitalisation value of the businesses audited, which amounts to trillions of pounds, it is impossible for them to build up sufficient reserves to provide the scale of cover which would be necessary to insure the market capitalisation of even one, let alone all, of our largest companies. A market that expects audit firms to act as insurers of last resort is not a tenable long term proposition.

1.2 The case for reform

Liability reform would create the conditions for improvement in financial reporting that would allow auditors to take on a role in relation to matters that are relevant to the governance of listed companies, beyond that required by the traditional statutory audit. The Institute proposes to establish a forum to explore, with stakeholders, more innovation in auditor and assurance reporting and additional transparency to assist shareholder decisions on audit appointments. These developments, for which a reasonable liability regime must be a pre-requisite, will be of benefit to shareholders and the capital markets and are considered in more detail in section 3.1.

The loss of another major audit firm would have very serious consequences for our capital markets in terms of auditor choice and indeed availability. Many leading mid-tier accountancy firms in the UK have already confirmed that in these circumstances they would not be prepared to move into the Big Four's current audit market. The remaining largest firms would be constrained both by conflict-of-interest issues and their appetite for audit risk in the aftermath of the loss of one of the Big Four. The possibility in this situation that some companies would not be able to find an auditor is as real as it is serious for the markets.

It is our view that permitting proportionate liability by contract for company audits would positively enhance competition in the audit market for larger companies, at least below the FTSE 100, by removing an important barrier to entry.

These issues of competition and choice are considered further in sections 3.4 and 3.5.

There is a growing international trend towards the limitation of auditor liability. Canada and Australia have both recently enacted laws designed to introduce systems of proportionate liability for auditors. Nearly half the EU Member states either permit limitation or provide for it on a statutory basis. These countries have all recognised that liability limitation offers advantages to their economies in terms of audit market competition and/or scope for development of audit reporting. The UK economy is being put at risk of being left behind some of our major economic competitors.

Proportionality by contract would not amount to preferential treatment for auditors. The proposals amount to no more than the opportunity to agree the same kind of liability limitation which is currently available to other professions and businesses. Proportionality by contract is used by many leading firms of lawyers and is already the basis of service agreements (other than in audit) registered with the Office of Fair Trading for reports prepared under an agreement of the Big Four with the British Venture Capitalists Association ('BVCA'). Accordingly such a reform would not represent adoption "solely in respect of the audit industry" nor would it require a "major reform of the law of negligence", being reasons cited for its exclusion from the December 2003 consultation.

These proposals are designed to deal with civil law. Auditors would still be held accountable and financially responsible for their share of any loss, which could still amount to significant sums of money. They would rightly offer no relief for potential criminal activity.

Some have argued that reputational threat is a greater threat to audit firms' continued existence than catastrophic litigation and that liability reform is therefore pointless. This argument fails to recognise that the audit firms themselves should, and indeed already do, take action to protect their reputation. However, they cannot control the risks imposed by joint and several liabilities as these arise from the acts of others. Removing the perverse threat posed by joint and several liability will significantly reduce the chances of an audit firm collapsing as a result of the actions of others.

Proportionate liability by contract would give auditors full responsibility for managing their own risk and would not absolve the audit firm from financial and reputational responsibility for its own actions. It would also help innovation in new forms of auditor reporting which would help make the UK capital markets stronger and more efficient and reduce further the possibility of financial scandal.

1.3 A sound regulatory environment

The reforms proposed are not being suggested as a substitute for sound quality control of audits.

The UK is widely recognised as having a world class auditing profession which operates within a robust and independent regulatory environment.

In January 2003 Government published the findings of a thorough review of the regulatory regime for the UK auditing and accountancy profession. This review concluded that the UK had a fundamentally sound regime which did not suffer from some of the systemic problems which had been evident in other countries.

This is supported by the facts. Every year in the UK auditors conduct audit processes and sign audit opinions in over two thousand listed companies as well as tens of thousands of private companies. Failures are rare.

The Government review did suggest a series of incremental reforms to further improve the transparency and independence of regulatory oversight of the UK accountancy profession. These measures were welcomed by the UK profession and in the period since then, a number of reforms have been voluntarily introduced ahead of the statutory measures being considered in the Companies (Audit, Investigation and Community Enterprise) Bill currently passing through Parliament.

The key aspects of the new regulatory environment are:

- enhanced responsibilities for the Financial Reporting Council, including the FRC taking on responsibility for the functions previously undertaken by the Accountancy Foundation to create a unified, independent oversight body;
- the establishment of an independent Professional Oversight Board for Accountancy responsible for the independent monitoring of all auditors of listed and other public interest entities;
- the establishment of a new Accountancy Investigation and Discipline Board with clear responsibility for the independent investigation and, where appropriate, discipline of both firms and individuals in public interest cases;
- an independent Auditing Practices Board, responsible for both audit standards and ethical standards for auditors;
- a more proactive system for the review of financial reports by the Financial Reporting Review Panel.

In addition the largest audit firms volunteered to publish annual reports and accounts to increase the level of transparency and understanding of the firms responsible for auditing many of the UK's largest companies. The first full set of these reports are now being published and are being regarded as an important contribution towards establishing a better understanding of the scale, operations and management of our largest audit firms.

2 Proportionality by contract

2.1 Overview

We propose a system which would be fair, transparent and consistent with liability limitation in other areas of business. It would allow auditors and the company to agree the application of proportionate liability in the event of an audit failure. In such a system auditors are held responsible and financially accountable to the companies they audit only for the losses which they are determined to have caused and having regard to the extent of responsibility for damage in question.

The scale of these losses and the consequential liability would thus be limited to the proportion of the damage claimed that the court considers just and equitable having regard to the auditors' responsibility.

This approach is already standard practice for other professions and businesses, including accountancy firms in their non-audit business activities and many leading firms of solicitors when agreeing the terms of their client retainers. For example, standard proportionality clauses have been used by the larger accountancy firms for a long period of time in contracts for due diligence and investigative engagements for private equity/debt finance transactions as a result of the BVCA agreement referred to above. This is now accepted market practice on such engagements.

2.2 Why was proportionality previously excluded from reform options?

A system of proportionate liability has long been the preferred option of the audit profession and many investment and business groups. Submissions to the DTI consultation on liability reform in December 2003 from, inter alia, the leading UK professional accountancy bodies, the Association of British Insurers, the National Association of Pension Funds, Hermes and the Confederation of British Industry stated their support for proportionate liability as the preferred reform option.

The December 2003 DTI consultation document excluded proportionate liability as one of the options for consideration on the basis that the option had been explored previously. However the Law Commission was at that point looking at proportionate liability reform as part of a wider reform of the law. That was a number of years ago. Since then concern has been increasing about the growth of a 'Compensation Culture' and the practice has grown of other business and professional firms inserting clauses in contracts which limit liability on a proportionate basis.

A change to the general law of tort remains our preferred option. Proportionality by contract would not involve such a change and it would not affect third party actions. However, proportionate liability by contract would provide a simple and quick solution by repealing the current prohibition on auditors and ensuring full transparency for shareholders.

3 Benefits for shareholders

3.1 What is in it for shareholders?

From the perspective of business, the loss of a major audit firm in the Big Four and Group A categories would result in serious issues of conflict of interest, of lack of choice and even of lack of availability. That risk would be diminished by the removal of the current unlimited liability and replacing this position with one where the auditors effectively take on liability only for their share of responsibility for any failure.

The business community, investors and Government are all looking to the audit profession to help develop and deliver new types of financial and non-financial reporting, such as the Operating and Financial Review. Proportionality by contract would help create an environment whereby auditors can take on a more meaningful role in relation to providing assurance on such matters relevant to the governance of listed companies. This is because the litigation risks faced by auditors are a major impediment to the development of new financial reporting and auditing standards and the development of governance and reporting more generally.

On the basis of genuine progress to liability reform based on proportionality by contract, the Institute would invite representatives of key stakeholders to participate in a regular Forum for the Development of Governance and Financial Reporting in the UK. This would involve exploring together:

- more innovation in auditor reporting;
- the development of better information for capital markets (an existing Institute project);
- creating a new form of assurance on ‘shareholder voting pipelines’ thereby addressing an important recommendation made by Paul Myners;
- new style assurance on matters that are objectively verifiable, for example assurance reports on pension trustees’ procedures(which would assist in meeting principles recommended by Paul Myners in this area) ;
- disclosure by firms in their websites of their quality control processes to assist shareholder decisions on audit appointments.

Taking forward new areas of reporting based on the International Standard on Assurance Engagements could put the UK at the lead globally in the provision of assurance by auditors and assist shareholders.

3.2 High quality people deliver high quality audits

With liability reform the UK audit profession will continue to be able to attract some of our brightest and most talented young people to join, train and remain in a profession which is able to offer them a reasonably secure future. The quality of audit is dependent in large part on the ability of audit firms to maintain the quality of new professional recruits, and having trained them, keeping these skilled and highly employable professionals within the audit sector. Demand for talented young people from the other professions, commerce and the public sector is and will continue to be very strong.

Proportionate liability by contract would address a major uncertainty in the audit profession and thus represent a major step forward in this respect.

3.3 Shareholder transparency

Shareholder transparency and buy-in is vital. Any contract clauses creating proportionate liability would at least be reported to shareholders and other interested parties as part of the annual report and accounts for the audit client. Shareholders should also be given the opportunity to review any contract clause creating proportionate liability in respect of audit work at the General Meeting at which auditors are appointed or reappointed. This transparent approach would mirror the government's proposals for the disclosure of directors' qualifying third party indemnity provisions as set out in draft Section 309C which was published within the Notices of Amendments to the Companies (Audit, investigations and Community Enterprise) Bill on 8 September.

Such transparency would enable shareholders as a body to object by voting against the appointment or re-appointment of the auditors under the existing provisions of Section 385 of the Companies Act 1985, if that is what they wish.

3.4 Enhanced competition

We are aware that there have been arguments that liability reform will not positively enhance competition within the audit market. However, while there are a number of factors influencing the competitive environment, we disagree that there would be no effect as a result of liability reform. First, a significant number of firms just below the Big Four wrote to the DTI at the time of the original consultation indicating that they wished to audit larger public companies but were reluctant to do so - either because they could not get insurance or because the potential exposure was just too great. Second, whilst there are a range of possible causes of different levels of competition in the audit field, including structural and economic issues, it is instructive to consider audit concentration elsewhere in Europe. In Germany there is currently a cap of €4m and 67 of the top 300 quoted companies are audited outside the Big Four. In Austria, where the liability of all possible defendants who did not act intentionally is limited to €363,364 per audit, 10 out of the top 50 companies are audited outside the Big Four. In Greece, where the cap is set at five times the salary of the President of the Supreme Court, 27 of the top 60 companies are audited outside the Big Four. This compares with, as noted above, all but 2 of the FTSE 250 companies in the UK being audited by the Big Four. As noted above, there may be a number of reasons for the degrees of concentration in these other countries, but it is noticeable that concentration is reduced where less unfavourable liability regimes prevail.

Over the longer term, we believe that proportionality by contract is likely to have a positive effect on competition within the audit market. A number of mid tier audit firms have said that proportionality by contract would remove one of the structural barriers to entry and growth facing smaller audit firms. The OFT report, which did not consider proportionality, suggested that some forms of capping could be anti-competitive. In contrast this proposal is pro-competitive because the exposure that an audit firm accepts in respect of an audit engagement is linked to the scale of the client activities and the nature of the industrial section it operates in. This will encourage firms not currently active in the public company audit market to participate in the lower end of that market in the manner which enables them to actively manage their risk. Thus, whilst reform is unlikely to be the immediate catalyst to enable a mid tier firm to take on a very large FTSE 100 audit, it would create more competition for audits outside the FTSE 100 and, over time, afford mid tier firms the opportunity to grow in all sectors.

3.5 Reduced risk of audit market concentration

An argument has been advanced that the conversion of most large and medium audit firms to Limited Liability Partnership (LLP) status has removed the likelihood of those firms collapsing. This misunderstands the way in which LLP status operates. Operating as an LLP protects the individual members (partners), other than those directly involved in the audit in question, from losing their personal assets (other than those invested in the firm) in the event of a large successful claim being made against the firm, in the same way that limited liability status protects individual shareholders. However, it does not protect the firm itself, just as limited company status does not prevent companies becoming bankrupt.

The need to safeguard against loss of firms in an already concentrated market, as the result of meeting other parties' liabilities therefore remains.

Proportionate liability limitation through contract would significantly reduce the increasingly real risk that one of our larger audit firms could collapse as a result of a catastrophic claim, for which the audit firm concerned might in equity have a very small share of the responsibility. Such a collapse would have very significant adverse effects on competition in this area.

3.6 No creation of moral hazard

Audit is and would remain a highly regulated activity, as described in 1.3 above. This regime includes inspection, investigation and discipline with unlimited fines, possible exclusion and de-registration of firms.

Auditors would still be responsible for the reputational and legal consequences of their own actions. The courts would award damages against a negligent auditor for a fair proportion of the company's loss to reflect the extent of the auditor's responsibility for the damage suffered. Proportionality by contract would mean only that the auditor would not have to pick up the bill for the acts of others who are also responsible. It cannot be economically efficient or equitable, for a market to operate on the expectation that all financial deficiencies will be compensated by the auditors. Proportionality by contract provides an equitable result and should accordingly enjoy a good measure of support.

If there is a moral hazard it is in the current situation, that auditors having unlimited liability removes the pressures on others to fulfil their stewardship responsibilities to the highest standard.

4 Legislative reform

4.1 Amendment to Section 310 of the Companies Act 1985

Proportionality by contract for auditors could be effected simply by inserting a new sub-section to Section 310(3) of the Companies Act 1985 along the following lines:

"(c) from entering contractual terms that recognise that any liability of any such auditor for damage suffered by the company shall be limited to such an amount as is finally determined to be just and equitable having regard to the extent of responsibility of any such auditor for the damage in question."

At the very least, we believe an enabling clause should be included in the forthcoming Companies Bill, to allow this to be implemented without further parliamentary legislation.

4.2 Legal assessment

Legal opinion has been obtained showing that proportionality by contract is workable under English law and including a model contractual clause. This is included as the appendix to this document.

4.3 Model Clause

A full model clause is attached as an annexe to the appendix. It would establish that where:

- the audit firm is liable (except through its own fraud) to the client in connection with the audit engagement for any damage); and
- one or more other persons are also liable or potentially liable to the client in respect of the same damage,

the liability of the audit firm would be limited to its proportionate share of the damage having regard to the contribution to the loss made by the audit firm and other parties.

Joint and several liability creates a position where any defendant, even if only responsible for a small proportion of the blame for a claimant's loss, can be liable for the full amount of the loss. Section 310 of the Companies Act 1985 prohibits any form of contractual limitation in respect of statutory audits.

We contend that the "same damage" aspect of joint and several liability is unreasonable in a commercial (as opposed to consumer) transaction where the liable parties have been appointed independently by the claimant for different purposes, and are not working together.

We are not seeking to avoid liability on behalf of auditors for the consequences of their own negligence, or that of their partners/employees acting on their behalf. The proposed proportionality clause would leave that unchanged. What it does seek to change is the situation where not only the auditors but also others acting independently of the auditors (such as other professional advisers, or even the company's own directors) contributed to the same damage. In a commercial context, a claimant who has appointed parties independently of each other should also bear (or insure) the risk of non-recovery from them.

What we now propose is a position whereby auditors continue to accept liability for the damage caused in the context of an audit, but only to the extent a court considers just and equitable having regard to the auditors' responsibility for that damage.

The draft model clause in the annexe to appendix B assumes that Section 310 of the Companies Act 1985 has been amended to permit auditors' liability to be limited in proportion to their degree of responsibility, but leaves it to companies and auditors to agree the detail of the arrangement. The draft clause provides for third party liability for damage to be taken into account in the assessment of an auditor's responsibility for damage, whether or not that third party is made a party to any claim and whether or not the liability of such third party is limited, unrecoverable, time barred or excluded in any way.

Relevant to this is experience in Australia. The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 now provides expressly for the main types of claim against auditors to be treated as "apportionable claims". Awards of damages against auditors are to be "limited to an amount reflecting that proportion of the damage or loss claimed that the court considers just having regard to the extent of the [auditor's] responsibility for the damage or loss".

4.4 How the system would be overseen

We envisage that the Secretary of State would ask the FRC to accept responsibility for overseeing the effectiveness of both the contract used to establish proportionality and the transparency to shareholders of the arrangements.

4.5 Overview of impact on plaintiffs

The risk profile of different types of investment varies. By the nature of their investment, shareholders take some risk in holding equity within a company. They therefore need to recognise that audited accounts are there to empower shareholders to participate in the governance of the companies in which they invest rather than to be a total guarantee of the worth of companies. Nevertheless, there are occasions when shareholders can legitimately look to recover loss from others.

The principal criticism often levied against the concept of proportional liability is that in such circumstances, plaintiffs do not recover all the losses suffered. However, this is an over simplistic view for a number of reasons:

- Plaintiffs cannot assume full recovery at present. The current joint and several system is only as good as the ability of defendants to pay. Given the sheer scale of the amounts associated with the financial affairs of companies, this is not limitless.
  In the context of corporate failure, plaintiffs can sue others who may be more directly involved in establishing arrangements to deceive investors or in providing reports on

which decisions were taken. Unlike auditors however these other advisers can already make use of proportionality by contract.

- We understand there is scope in the insurance market for significantly increased levels of Director and Officer (D&O) insurance. As it is often the individuals who would be covered by such insurance, that are unable to pay their share of attributable damages, increased D&O insurance by companies would reduce the likelihood of non-recovery.
- Financial reporting and governance will improve, and the risk of corporate scandal will diminish, if shareholders have the benefit of better financial information and more innovative and meaningful auditor reporting. These developments are being constrained by joint and several liability and the inability of companies and auditors to contract for proportionate liability.

The US experience of proportionality shows that in many cases auditors may still have to pay out very large amounts, but even though there is a relatively high incidence of claims in that country, the firms have been able to survive because joint and several liability does not apply (Andersen failed for obstructing the course of justice and because of reputational loss). It is also noticeable that claims have reduced since proportionate liability was introduced there. Lawyers are able to identify other parties with funds, notably those involved in M&A transactions and in promoting and facilitating off balance sheet schemes. In addition, directors are becoming more risk averse and keener to obtain insurance. Also more attention is being directed towards the right tone at the top and effective systems of internal control. Auditors are not seen as total guarantors. Others are now seen as having to play their full part in the governance of companies.

A number of worked examples of the impact of proportionality by contract are included in the appendix.

APPENDIX

Legal opinion from leading Counsel:

LIMITING AUDITOR'S LIABILITY ON A PROPORTIONATE BASIS, VIA CONTRACT

ADVICE

1. We are asked to advise in relation to a proposed amendment to s. 310 of the Companies Act 1985 so as to allow auditors to limit their liability contractually, on the basis of proportionality.

2. In summary, we believe that the proposed reform is both feasible and workable as a matter of English law. An example of such a contractual clause can be found at the Annexe.

The general principles

3. Under English law, the starting point is that liability for losses caused by two or more defendants who are each to blame is joint and several; that is to say that in a case where the claimant's loss is contributed to by each of two defendants whose share of the blame is equal, each is liable to the claimant for 100% of the loss, and not 50% of the loss. In this respect the liability of each defendant is not proportionate to his or her share of blame.

4. The obvious injustice of this position is however potentially ameliorated by two pieces of legislation: (i) the Law Reform (Contributory Negligence) Act 1945 ("the Contributory Negligence Act"); and (ii) the Civil Liability (Contribution Act) 1978 ("the Contribution Act"). In theory both introduce an element of proportionality where the loss is due partly to the fault of the defendant, but also partly due to the fault of someone else. Thus:-

   (1) The Contributory Negligence Act applies where the loss is partly due to the fault of the defendant and partly due to the fault of the <u>claimant</u>, or someone whom the law identifies with the claimant for these purposes. It reduces the damages that the claimant may recover from the defendant "…to such extent as the Court thinks just and equitable having regard to the claimant's share in the responsibility for the damage…". [1]

   (2) The Contribution Act applies where the loss is partly due to the fault of the defendant and partly due to the fault of <u>a third party</u>, i.e. someone whom the law does not identify with the claimant for these purposes. It provides the defendant with a right to recover a contribution from the third party; and the amount of the contribution recoverable from the third party "…shall be such as may be found by

[1] See s1(1) of the Contributory Negligence Act.

the Court to be just and equitable having regard to the extent of that person's responsibility for the damage in question". [2]

5. However, in practice the Acts do not always operate so as to alleviate the 100% liability imposed on a defendant who may be only partly to blame for the claimant's loss: and this is particularly so in cases brought by companies against their auditor's for professional negligence. In particular:

(1) For reasons that are considered further below, the Contributory Negligence Act may not apply to negligent auditors who fail to detect the fraud of a company's director or employee.

(2) In those circumstances, the auditor will only be left with recourse to the Contribution Act and a right to recover a contribution from the fraudulent company director or employee. However, the Contribution Act will not provide a satisfactory remedy when the damages claimed by a company against the auditor are substantial, but the fraudster is either out of pocket or out of the jurisdiction (as will often prove to be the case). In these circumstances, the theoretical right of recovery which an auditor has against the fraudster is of little comfort, particularly when the claim by the company may run to millions of pounds.

The Contributory Negligence Act, and its application to auditor's liability

6. Until recently, the orthodox view was that the doctrine of contributory negligence provided little if any scope for reduction in an auditor's liability. It was only if some independent fault on the part of innocent management was identified that a reduction could be made; and no reduction was permissible to take into account the misconduct of the fraudulent company director or employee himself, despite the fact that the fraudster was the individual primarily to blame for the company's losses. [3]

7. Two rationales were put forward for suggesting that the Contributory Negligence Act did not apply in these circumstances:

(1) First it was said that the acts of a director or employee acting in fraud of the company could not be attributed to the claimant company, since his conduct was deliberately hostile to the interests of his corporate employer. The result was that, as a matter of law, the acts of the fraudulent director or employee would be treated as the acts of a third party, and not attributed to the corporate claimant so as to reduce the claimant's ability to claim damages.

(2) Secondly it was said that as between the company and the auditor it was not just and equitable to make any reduction in damages in such a case because the auditor's role as a watchdog rendered it wholly responsible for shortcomings which it failed to detect or report on.

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[2] See s2(1) of the Contribution Act.
[3] There was little English authority on the point. See however *Simonius Vischer & Co v Holt* (1979) 2 NSWLR 322 at 329; *Dairy Containers v NZI Bank* (1995) NZLR 30, 77-78; and *AWA v Daniels* (1995) 37 NSWLR 438, 565.

8. The orthodox view was, however, not followed by Evans-Lombe J in the recent High Court decision of Barings Plc v Coopers & Lybrand [2003] EWHC 1319 (Ch). He held that the acts of a fraudulent director or employee could be attributed to the company, provided that the acts of the fraudster were "so closely connected with his employment that it would be fair and just to hold the employers vicariously liable"; and that it was no bar to the defence that the auditor's breach of duty was to protect against the fraud. He said:

> "…there is nothing special about the auditors which requires of them a special standard of skill and judgment in their investigation of the audit client's affairs over other professional men, and in particular, over the directors and officers of the commercial companies they audit. As I have remarked, it is upon such directors and officers that the primary duty to protect the company from loss occasioned by fraud rests…The authorities establish that the auditor's duty is to report to the shareholders, in particular, on the conduct of the company's management. But the shareholders can not escape responsibility for the conduct of those directors and officers whom they have been instrumental in appointing, directly or indirectly."

9. We believe that the decision reached by Evans-Lombe J in the Barings case was right. The orthodox view is anomalous in treating contributory negligence as unavailable where the employee's conduct is fraudulent, but available where the conduct is merely negligent. In other words, the orthodox view treats the claimant's exposure to a reduction in damages as inversely proportional to the culpability of the behaviour of his employee. Yet the duty of auditors is no more to detect fraud than to detect negligence.

10. However, it remains the instinctive reaction of many judges that fraud is a thing apart, and that there can not be anything just and equitable about penalising the company for the very acts of a fraudulent director or employee which the auditor is engaged to guard against, in the absence of some culpable failings by innocent management. The Barings decision remains a first instance decision (we understand the appeal was settled out of Court); and the facts of that case were extreme in terms of the innocent management failings. The judgment does not make clear how much of the contributory negligence deduction was attributable to Mr. Leeson's conduct, as opposed to that of Barings innocent management. In our view, there therefore remains a substantial risk that the orthodox view may yet survive.

11. Furthermore, even if the decision in Barings stands, the Contributory Negligence Act may not apply in a number of situations. Thus:-

    (1) It will remain a question of fact in each case whether the fraudulent conduct in issue is "so closely connected with [the fraudster's] employment that it would be fair and just to hold the employers vicariously liable".

    (2) In the context of audits of large and complex group structures, different entities may be treated as different juridical persons: with the result that if the fraudster is employed by one company within the group, but the defrauds another company within the group, the fraudster will be treated as a "third party", with the result that

the Contributory Negligence Act would not apply and the auditors would be thrown back onto the Contribution Act.

(3) Different considerations may apply if the fraudster is not an employee, but an agent of the company. In that case, the Contributory Negligence Act may not bite, since the agent's acts may not be attributed to the company. [4]

Reform of s. 310 of the Companies Act 1985

12. It follows that the Contributory Negligence Act may often not apply in circumstances where an auditor is faced with a claim by a company that has been defrauded by a director or senior employee. In those circumstances, as noted above, the Contribution Act will in practical terms be of little value to the auditor – since the fraudster may be insolvent or overseas. The result is that the auditor will be faced by a claim for 100% of the losses suffered by the company, even though the auditor's responsibility for the loss (in terms of culpability and causation) may be minor and technical.

13. These difficulties are also compounded by the fact that, rightly or wrongly, auditors are perceived to be "deep-pocket" defendants: and are therefore an obvious target for litigation by companies who have found themselves to have been defrauded. In many cases, a company will seek to recover 100% of its loss from the auditors, even though the primary culprit (in terms of both culpability and causation) will be a corporate director or senior company employee to whom the company chose to delegate responsibility in the first place.

14. The obvious solution to these practical difficulties would be to allow auditors to stipulate contractually for a limitation to their liability: and to allow them to limit their liability by reference to the extent to which the auditor is responsible for the damage in respect of which the claim is made. In this way, an auditor would be entitled contractually to achieve the same equitable and just result that the legislature set out to achieve by the Contributory Negligence Act and Contribution Act. This solution is however, currently precluded by s. 310 of the Companies Act 1985.

15. If s. 310 were repealed or amended so as to allow auditor's to exclude their liability on a proportionate basis, we see no reason why the law would not give effect to such a clause (provided it complied with the test of reasonableness under the Unfair Contract Terms Act 1977). An example of such a clause is appended at the Annexe to this Advice.

16. Any amendment to s. 310 of the Companies Act 1985 could impose a requirement that the terms of the auditors' appointment, and in particular the proportionality clause be disclosed to shareholders at the AGM. This would ensure that shareholders were given due notice of any proposed proportionality clause, as a pre-condition to its enforceability.

Examples of how the clause would operate in practice

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[4] This was the view of Cresswell J in *Henderson v Merrett* [1996] 1 PNLR 32. It is not clear whether this decision would still stand in the light of the *Barings* case, but at the moment there is certainly a risk that it might.

17. We have been asked to demonstrate how the proportionality clause would work in practice, by reference to some worked examples. These are set out below:

(1) A company ("C") is defrauded by a senior executive director ("F"), in a way that is closely connected with F's employment (eg F is the Financial Director, and draws down and makes off with a large number of unauthorised loans to C). C's auditors ("A") negligently fail to detect the fraud; and innocent management ("M") also negligently fail to detect the fraud. Both A and M's responsibility for failing to detect the losses is assessed as being equal. The lion's share of responsibility for the loss of course falls on F. Let us assume that the responsibility may be apportioned 50% F, 25% M and 25% A. Result:

(a). If the orthodox view prevails, and there was no proportionate liability clause, C would be entitled to recover 100% of its loss from A. A would be left trying to recover a contribution from M and F. F is unlikely to have any funds or be insured (due to fraud exclusions from D&O policies); but A might recover 25% of the loss from M, or from M's D&O insurers.

(b). If the Barings view prevailed, and there was no proportionate liability clause C's claim would be reduced by 40% (25% for M's contributory negligence and say a further 15% for F's contributory negligence (but not a full further 50%)). The result would be that A would be liable for 60%: C would be left trying to recover the balance of 40% of its losses from M (or M's D&O insurers) and F; and A might also seek a contribution from F, although F is unlikely to have any funds.

(c). Regardless of whether Barings or the orthodox view prevails, if there was a proportionate liability clause C would recover 25% of its losses from A. C would then have to recover the balance of 75% from M and F. C is unlikely to recover from F; but C might recover 25% of the loss from M, or from M's D&O insurers.

(2) C is defrauded by F, but in a way that is not closely connected with F's employment (eg F is a senior marketing executive, but happens also to have extremely good IT skills; he hacks into the company computer and uses it to make large payments into a private offshore bank account). Once again, both M and A are each 25% to blame for C's losses, due to their failure to detect the fraud. Result: Barings does not apply, because the fraud is not sufficiently connected to the scope of F's employment. In this scenario:

(a). If there is no proportionate liability clause, C would be entitled to recover 75% of its loss from A (A still being allowed to invoke the Contributory Negligence Act in respect of M's negligence, to reduce C's claim to 75%). A would be left trying to recover a contribution from F, who is unlikely to have the funds.

(b). If there is a proportionate liability clause, C would recover 25% of its loss from A. C would then have to recover the balance of 75% from M and F. C is unlikely to recover from F; but might recover 25% of the loss from M or from M's D&O insurers.

(3) C is the head company within the group, and D its subsidiary. C employs F as its Financial Director, and (as in example (1) above) F absconds with the proceeds of unauthorised loans to D. D therefore suffers the loss. A is the group auditor, auditing both C and D, and is 25% responsible for the loss in failing to detect the fraud. M is senior management of C, and is 25% responsible for the loss in failing to detect the fraud. Result: Barings does not apply, because F's acts are not attributable to D. In this scenario:

(a). If there is no proportionate liability clause, D would be entitled to recover 100% of its loss from A (A is not even able to invoke the Contributory Negligence Act against M, because their negligence is not attributable to D). A would be left trying to recover a contribution from M and F; and is unlikely to recover from F, but might recover 25% from M or M's D&O insurers.

(b). If there is a proportionate liability clause, D would recover 25% of its loss from A. D would then have to recover the balance of 75% from M and F. D is unlikely to recover from F; but might recover 25% of the loss from M or from M's D&O insurers.

(4) C is defrauded by X, a firm of independent contractors (eg IT consultants, who hack into C's systems and divert assets away from C). A and M are both 25% responsible for failing to detect the fraud. Result: Barings does not apply, because X's acts are not attributable to C. In this scenario:

(a). If there is no proportionate liability clause, C would be entitled to recover 75% of its loss from A (since A can invoke the Contributory Negligence Act in respect of M's negligence). A would be left trying to recover a contribution from X.

(b). If there is a proportionate liability clause, C would recover 25% of its loss from A. C would then have to recover the balance of 75% from X and M; and is unlikely to recover from X, but might recover 25% from M or M's D&O insurers.

Additional points

18. We have also been asked to consider the impact (if any) of the proportionate liability clause in a situation where everyone (including the fraudster) was before the Court, and everyone was solvent: and whether in those circumstances the effect of the proportionate liability clause would be that a fraudulent director who had received 100% of the proceeds of his dishonest dealings would not be liable for the full 100%, because the auditor might be required to make a proportionate contribution (say of 25%). We do not think that this would be case. The fraudster would not be entitled to

make a windfall from his crime, since he would then be unjustly enriched at the auditor's expense. In those circumstances, the auditor would clearly have a claim for a contribution from the fraudster under the Contribution Act – and in taking into account what was "just and equitable" the Court would not allow the wrongdoer to retain any profit from his crime.

19. Indeed, this very scenario was considered (albeit hypothetically) by Ferris J in *K v P (J third part*y) [1993] Ch 140. In that case the claimant had brought proceedings against a defendant alleging conspiracy and fraud; and the defendant had sought a third party contribution from the negligent auditor. Ferris J was asked to strike out the defendants' notice claiming contribution, and refused to do so on the facts of that case. However, he made the following observation:[5]

> "In so far as the [claimants] are seeking to recover from the third defendant money which he has obtained for his own benefit or for the benefit of companies which are, in effect, his alter ego, I can see that the third party would have an overwhelming argument that it cannot be just and equitable to require him to contribute to whatever the third defendant is ordered to pay to the plaintiffs. Contribution, if ordered, would enable the third defendant or his fellow conspirators to retain part of the proceeds of their conspiracy or fraud."

20. For these reasons, we do not think that, by allowing auditors to limit their liability to a proportionate amount, Parliament would be allowing fraudsters to retain the proceeds of their crime. In these circumstances, the auditors would have an unanswerable claim in contribution against the fraudsters under the Contribution Act: and as Ferris J makes clear, the Courts would be astute (as part of their just and equitable discretion) to ensure that the fraudster did not profit from his crime.

21. We have also been asked if, taking the same example of a fraudster who is 100% solvent and before the Court, there is anything wrong in principle in holding the fraudster 100% to account, whilst the negligent auditor is not obliged to make any contribution to the company's claim for damages. As to this:

    (1) We do not see anything inherently wrong with this result. If the fraudster is insolvent or out of the jurisdiction so that a full recovery cannot be made from him, then the auditor's negligence has caused the company to suffer loss – and plainly the auditor is liable. On the other hand, if the fraudster is solvent and before the Court, so that the company can and does recover all of its money from the fraudster, then it will have suffered no loss as a result of the auditor's negligence. In those circumstances, there is no reason why the auditor should also be liable to the company in damages.

    (2) Furthermore, we should also note that this scenario is very unlikely to arise in practice. In virtually every case a full recovery will not be made from the fraudster, and the auditors will therefore find themselves liable to account. The only question is how much should they have to account: a disproportionate, or a proportionate

[5] At p. 149.

amount? For the reasons we have set out above, we think that system that allows auditors to limit their liability to a proportionate amount is more just and equitable than the present law.

(3) Finally, we should also note that the introduction of proportionate liability would not alter the above result in any way. At present if the fraudster repays the moneys in full, the company cannot also claim over against the negligent auditor: that would be to allow the company to make a double recovery, which the present law already prevents. The introduction of the proportionate liability clause would not therefore affect the outcome in this (extremely hypothetical) scenario.

22. Finally, we have also been asked to comment briefly on the protection already afforded to auditors under s. 727 of the Companies Act 1985, which bestows a discretion on the Court to reduce the level of damages awarded against a negligent auditor in certain circumstances.

23. We are not aware of any case in which s. 727 of the Companies Act 1985 has been successfully invoked as a defence by an auditor. The efficacy of the provision is severely impaired by the inherent paradox in its wording. As Evans-Lombe J noted in the *Barings* case:[6]

> "As has been frequently remarked, there is an obvious paradox in the wording of section 727. It allows a defendant who has been found liable for negligence to be excused wholly or partially on the grounds that he acted 'honestly and reasonably' and, in the light of all the circumstances of the case, 'ought fairly to be excused'. A number of judges have had to consider how a negligent defendant can be found to have acted reasonably."

24. In practical terms, the Courts have therefore reduced the scope of the s. 727 to a very limited range of circumstances. Indeed, in *Barings* its scope was confined to a scenario where the auditor's negligence could be described as "technical or minor in character", rather than "pervasive and compelling".[7] In reality, this means that s. 727 will very rarely be available as a means of protection for an auditor who has been found to have behaved in a professionally negligent manner, and one that has caused the claimant company to suffer substantial loss.

1st October 2004
Brick Court Chambers
7 – 8 Essex Street
London WC2R 3LD

ANDREW POPPLEWELL QC
ROGER MASEFIELD

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6 At para 1128.
7 See para 1133.

Annexe to Appendix

Model Clause

This provision applies where there is or was any other person responsible and/or liable to you in respect of loss or damage suffered by you.

Our liability to you arising out of or in connection with this engagement, whether for breach of contract or breach of duty or fault or negligence or otherwise howsoever arising, shall be limited to a proportion of the loss or damage (including interest and costs). Such proportion shall be calculated as our proportionate share of responsibility, by reference to culpability and/or causative potency, having regard to:

(a). the contribution to the loss and damage in question by any other person who is or was responsible and/or liable to you for such loss and damage; and

(b). our contribution to the loss and damage in question.

For the purpose of assessing the contribution to the loss and damage in question by any other person pursuant to the preceding paragraph, it is agreed that no account shall be taken of any limit imposed or agreed on the amount of liability of such person by agreement (including any settlement agreement) made before or after the loss or damage in question occurred.

This provision shall have no application to any liability for death or personal injury nor to any liability arising as a result of fraud on our part (or for which we are vicariously liable) nor to any liability which cannot lawfully be excluded or limited.

15 March 2007

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European Commission
DG Internal Market and Services
Unit-F4 – Auditing/Liability
B-1049 Brussels
Belgium

Submitted by email to:
Markt-f4@ec.europa.ec

Dear Sir

EUROPEAN AUDITOR LIABILITY REFORM

The Institute of Chartered Accountants in England and Wales ('the Institute') is writing in response to the European Commission's Staff Working Paper: '*Consultation on Auditors' liability and its impact on the European capital markets'*.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

We set out below our comments on the overall case for reform and then a number of observations on the four potential ways forward suggested in the European Commission Staff. Working Paper.

If you require further information, please do not hesitate to contact Martin Manuzi, Director of the ICAEW European Office, Tony Bromell, Head of Accountancy Markets and Ethics, or myself.

Yours faithfully

Michael Izza

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Overall case for reform

The Institute welcomes the consultation and indeed the work that has been carried out leading up to it, as it has consistently argued that auditor liability reform will enhance audit choice and audit quality. Reform across the European Union is important because of the globalising of capital markets, the increasing litigation culture, increased international perspective to audit work and it is also in the interests of the Single Market. Consequently, the Institute strongly encourages the European Commission to publish, as referred to in the Statutory Audit Directive (2006/43), a Recommendation to Members States on the need for auditor liability reform in all EU jurisdictions.

At present the joint and several liability regime in operation in many Member States means that auditors not only have to bear the consequences of their own actions but those of others who are also responsible but do not have funds. It cannot be economically efficient or equitable, for a market to operate on the expectation that all financial deficiencies will be compensated by the auditors.

We note that the London Economics study published by the Commission in Autumn 2006 was also supportive of liability reform as, inter alia, it reduced the risk of the failure of a major audit firm with potential consequences for the wider international audit network. We note particularly the following key points made in the study:

- The international market for statutory audits of large and very large companies is highly concentrated, largely as a result of market forces, and there is a limited likelihood of new entrants into this market in the coming years.
- The level of auditor liability insurance available for higher limits has fallen sharply in recent years and there are limited other funds available to meet claims. Accordingly, large claims put at risk firms and potentially an entire network.
- The failure of a network could lead to difficult consequences for the wider economy like a significant reduction in large company statutory audit capacity possibly creating serious problems for companies whose financial statements need to be audited.

Our own analysis of the position in the United Kingdom is that the level of concentration does present issues of lack of choice, particularly for large specialised businesses. A further concentration as a result of a failure of one of the large networks would significantly exacerbate this. The remaining largest networks would be constrained both by conflict-of-interest issues and their appetite for audit risk in the aftermath of the loss of one of the Big Four. The possibility in this situation that some companies would not be able to find an auditor is as real as it is serious for the markets.

Another key point in favour of liability reform is the impact on audit quality. Contrary to a common perception, there is no evidence that liability reform has a negative impact on quality. On the contrary, maintaining unlimited liability in an increasingly litigious environment would encourage defensive auditing. There are also longer-term quality issues which need to be considered in relation to human resources. With liability reform the audit profession will be better positioned to continue to attract many of our brightest and most talented young people to join, train and remain in a profession that is not at a comparative disadvantage to other sectors in terms of economic stability and security and personal risk. The quality of audit is dependent in large part on the ability of audit firms to maintain the quality of new professional recruits and, having trained them, keeping these skilled and highly employable professionals within the audit sector. Demand for talented young people from the other professions, commerce and the public sector is and will continue to be very strong. While today the profession remains attractive to graduates, there is some evidence that a long term career as an auditor is becoming less attractive. We must act now before a serious problem develops, by which time significant long term damage will have been done.

Introductory comment on specific options being consulted on:

As noted above, we believe that liability reform in all European Union jurisdictions is vital in view of the increased international perspective to audit work and is advantageous in terms of the potential benefits of the single European market. It is also important in relation to the operation of audit networks which, as noted in the European Commission's Staff Working Paper, is a subject requiring further clarification. However, in agreement with the conclusions in the London Economics study, we recognise that the differing legal regimes across Europe mean that different solutions are likely to be most appropriate in each country, at least for the time being. We therefore do not comment specifically on what might or might not be appropriate in different countries but set out below some issues for consideration in respect of the four proposals set out in the consultation document.

Single monetary cap at European Union level
Question 1: Do you agree with the analysis of the option of fixing a single monetary cap at EU level?

We do not believe that a single monetary cap at European Union level, which we interpret to mean a fixed monetary cap to be applied across all EU jurisdictions, is a practicable proposition at least for the time being given the variable size and composition of European capital markets..

We have not favoured a fixed monetary cap that is unrelated to the size of the entity being audited in the UK, as the level of such a cap is difficult to set: if set too low, they would allow auditors unreasonably to escape the consequences of their own actions and, if set too high, they will benefit only those carrying out large audits and have no beneficial effect on competition just below that level (where firms that could ultimately compete at the highest level might be expected to operate). We note that such limits exist at a national level in a number of other member states, which have clearly found them to be an appropriate means of limitation.

Cap based on market capitalisation of audited company
Question 2: Would a cap based on the size of the listed company, as measured by its market capitalisation be appropriate?

The concept of a market cap linked in some manner to the size of the entity being audited does remove the difficulties noted above and, if given a basis in statute and set at appropriate levels, addresses the problem of a 'catastrophe claim'. It also has the advantages that it does not distinguish between sizes of audit firm and applies equally across all sizes of audit market,

However, we believe that there are practical problems with seeking to link the cap to market capitalisation:
- such a formulation could not be applied to the audits of unlisted companies or of public interest entities that are other types of organisation, as there is no clear indicator of market capitalisation;
- even where there is a readily available market capitalisation, this can vary over short spaces of time as a result of a whole set of market and external economic factors, resulting in any cap varying similarly.

There are other measures of size, though, which could be applied if this option is to be taken forward, which overcome the above difficulties. An example is the option considered in the next section.

Cap based on a multiple of audit fees
Question 3: Would a cap based on the audit fees charged to the company be appropriate?

A cap based on a multiple of audit fees would be a reasonable proxy for the size and risk profile of the entity being audited. It also does not suffer from the practical problems referred to above in relation to market capitalisation as there will always be an audit fee to base it on and more closely relates to the risk profile of the company than a limit set by reference to the size of the audited entity. We are aware that in some member states there is no disclosure of audit fees but we strongly believe that there would need to be transparency in any form of liability limitation and there would therefore need to be disclosure of the limitation in some form (possibly in the audited financial report).

Proportionate liability
Question 4: Do you agree with the analysis of the option of introduction of the principle of proportionate liability? What are your views on the two ways in which proportionate liability might be introduced?

The Institute supported proportionate liability reform in the UK as we believe it to give the most equitable result: auditors continue to be responsible for the consequences of their own actions, but not those of others.

However, the effectiveness of proportionality does depend on relatively robust legal protection against liability to third parties, particularly if implemented by the relatively straightforward means of contractual agreement. This is available in the UK but not available in all countries in the EU. In addition, though a clear and helpful move in the right direction, the effectiveness of proportionality is confined in that it does not directly address the issue of a ‘catastrophe claim’., While we would therefore like to see proportionate liability form part of the reform package where possible at EU Member State level, proportionality on its own is not a complete solution to the risk of a catastrophic claim.

AUDITOR LIABILITY:
Overview of legal developments within the United Kingdom and European Union

United Kingdom

The ICAEW has long held reasonable liability limitation to be in the best interests of efficient markets, shareholders and companies, as well as auditors: the principle of joint and several liability entrenched in UK law meant that auditors and their fees were being used as a compensation resource of first resort, regardless of the actual degree of blame. Liability limitation is n ot about removing liability from auditors, or enabling them to escape the consequences of their own actions. However, they should not be held liable for the consequences of other people's actions, with the ensuing undesirable effects on audit market stability and choice.

The United Kingdom government has agreed that action is needed and the UK Companies Act 2006 introduces legislation permitting limitation of auditor liability by contract. Properly approved agreements are valid as from 6 April 2008.
The government's stated intention behind the Act's provisions was to permit proportionate liability by contract (a position advocated by the ICAEW). However the limitation is, according to the Act, permissible by any means (eg a monetary cap, multiple of fees, proportionality) but the terms are subject to shareholder approval and they must be 'fair and reasonable'.

Neither the law, nor guidance produced by the independent Financial reporting Council (FRC) specify what might be considered to be fair and reasonable. This ultimately is subject to challenge in the courts and if the courts consider the terms not to be 'fair and reasonable in all the circumstances of the case', they can substitute alternative terms.

The FRC guidance[1]seeks to address a number of issues by:

1. summarising what the law now permits and requires in respect of LLAs;
2. explaining what matters an LLA should cover;
3. providing specimen clauses for various types of LLA (including, inter alia, proportionality and a monetary cap);
4. noting the views of a number of institutional shareholders, who have indicated that they would be likely to oppose types of LLA other than proportionality;
5. explaining the process to be followed for obtaining shareholder approval, including specimen wording for resolutions and the notice of the general meeting; and
6. setting out some of the factors that will be relevant when assessing the case for an LLA.

In addition the ICAEW has made available a legal opinion[2] that directors recommending LLAs to shareholders will not be in breach of their duty to act in the interests of the shareholders.

European Union

The EC issued, on 6 June 2008, a Recommendation on auditor liability[3]. Primarily on competition grounds, it recommends limiting liability. Because of the wide variety of legal regimes in the European Union, one method would not work everywhere, so three methods are recommended.

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[1] Available from: www.frc.org.uk
[2] Available at www.icaew.com (under 'Technical and Business Topics', 'Audit and Assurance')
[3] Available at http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2008:162:SOM:EN:HTML

a) establishment of a maximum financial amount or of a formula allowing for the calculation of such an amount.

b) establishment of a set of principles by virtue of which a statutory auditor or an audit firm is not liable beyond its actual contribution to the loss suffered by a claimant and is accordingly not jointly and severally liable with other wrongdoers. (i.e. proportionate liability, as favoured by the ICAEW)

(c) provisions allowing any company to be audited and the statutory auditor or audit firm to determine a limitation of liability in an agreement (i.e. contractual liability, as enacted in the UK).

AMB 8/08