LIMITATION OF LIABILITY BY ACCOUNTANTS

Introduction

1. Traditionally, a central plank of an accountant's corporate work has been carrying out the audit. However, over the years the profession's role has expanded to include more diverse work. One issue of particular concern for accountants may be how far the prohibition on excluding liability for breach of their duties as an auditor invalidates limitations of liability for these other types of work. Answering this question involves very careful consideration about the nature and scope of the prohibition. This is not an easy issue.

The role of the auditor

2. A company's statutory reports and accounts are the responsibility of the directors. However, our system of company law, like most others, recognises that those reports and accounts ought to be subject to verification by an independent third party. Traditionally, it is the function of the audit to provide such third party verification.

3. The statutory framework of the audit is contained in the Companies Act 2006 ("the 2006 Act"). The key task of the auditor is to provide a report to the members of the company which gives the auditor's opinion on whether:

   (1) the annual accounts give a true and fair view of the financial position of the company (or the group as the case may be);[1]

   (2) the directors' report is consistent with the accounts;[2] and

   (3) in relation to a quoted company, the auditable part of the directors' remuneration report has been properly prepared in accordance with the 2006 Act.[3]

4. The auditor's report must be 'qualified' or 'unqualified'. A qualified report is one where the auditor is unable to give positive opinions on all the above matters and an

[1] Companies 2006 Act 2006, s. 495(3)
[2] Companies 2006 Act 2006, s. 496
[3] Companies 2006 Act 2006, s. 497

unqualified report is one where he can. The auditor must also refer to any matters to which he wishes to draw attention by way of emphasis without qualifying the report.[4] In preparing his report the auditor is under a duty to carry out such investigations as will enable him to form an opinion as to:[5]

(1) whether adequate accounting records have been kept by the company and returns adequate for their audit have been received from branches not visited by him,

(2) whether the company's individual accounts are in agreement with the accounting records and returns, and

(3) in the case of a quoted company, whether the auditable part of the company's directors' remuneration report is in agreement with the accounting records and returns.

5. If the auditor reaches a negative opinion on any of the above matters he must state that fact in his report.[6]

6. Furthermore:

(1) If the directors have prepared the accounts and reports in accordance with the small companies regime and in the auditor's opinion they were not entitled to do so, the auditor must state that fact in his report.[7]

(2) If the auditor finds that the statutory provisions on the disclosure of directors' remuneration have not been complied with, the auditor must, so far as he is reasonably able, provide the particulars which should have been given in the directors' report or (for a quoted company) the directors' remuneration report.[8]

[4] Companies 2006 Act 2006, s. 495(4)
[5] Companies 2006 Act 2006, s. 498(1)
[6] Companies 2006 Act 2006, s. 498(2)
[7] Companies 2006 Act 2006, s. 498(5)
[8] Companies 2006 Act 2006, s. 498(4)

Determining the scope of limitation of liability restrictions

7. Under the 2006 Act, as under previous companies legislation, the extent to which auditors are permitted to limit their liability for breach of duty is substantially restricted and the scope of these restrictions is considered below. However, before examining this issue in detail it is worth making the point that, in any case of alleged breach of duty by an accountant, it is crucial to ascertain first the precise scope of the accountant's duties in respect of the work which forms the subject matter of the complaint.

8. The reason for this should be obvious: any question about the limitation of liability (including whether or not the limitation offends statute) only arises once it has been determined the accountant owes a *prima facie* duty to the claimant. Where no duty exists, no limitation of liability issue arises and the proposed action will fail *in limine*. Although this paper is not intended to revisit, in great detail, the notoriously complex principles for quantifying accountants' duties in respect of their work as auditors, it is nevertheless convenient to begin by summarising law on this topic.

Duties of care owed by the accountant

(a) The general duty of the auditor – duty to the company and body of shareholders

9. The auditor performs his duties pursuant to a contractual relationship with the client and, where his work fails to comply with terms of his engagement, including any express or implied term that he will carry out his work with reasonable care and skill, then the auditor will be liable to the company for breach of contract. Further, in so far as the auditor has acted carelessly in the conduct of his work, he may be liable to the company for negligence.[9] The duties of the auditor were discussed in detail in *Re Kingston Cotton Mill Co (No. 2)* [1895] 2 Ch 673, where Lopes LJ said:

> It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in

[9] It should not be overlooked that the auditor will generally owe fiduciary duties to his client, the company.

> believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.

10. Aside from the auditor's duties to the client, it is also settled that a duty is owed to the shareholders. This was established in the leading case of *Caparo Industries Plc v Dickman* [1990] 2 AC 605. The claimant brought a claim against a company's auditor. The claimant alleged that it had begun purchasing shares in the company a few days before the annual accounts had been published to shareholders; and that in reliance upon those accounts it then made further purchases of shares so as to take over the company. The claimant further alleged that the auditors owed both shareholders and potential investors a duty of care in respect of the certification of those accounts and should have known that, as the company's profits were not as high as projected and its share price had fallen significantly, it was susceptible to a takeover bid and that reliance upon the accuracy of those accounts would be placed by any potential bidder, such as the claimant.

11. The House of Lords declined to uphold any such duty of care. Central to the court's reasoning was what the House identified as being the statutory function of the audit. Lord Oliver said:

> It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.

12. Speaking of the statutory provision regarding audit, Lord Bridge said:

> No doubt these provisions establish a relationship between the auditors and the shareholders of a company on which the shareholder is entitled to rely for the protection of his interest. But the crucial question concerns the extent of the shareholder's interest which the auditor has a duty to protect. The shareholders of a company have a collective interest in the company's proper management and in so far as a negligent failure of the auditor to report accurately on the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book and to ensure that errors in management are corrected, the shareholders ought to be entitled to a remedy. But in practice no problem arises in this regard since the interest of the shareholders in the proper

> management of the company's affairs is indistinguishable from the interest of the company itself and any loss suffered by the shareholders, e.g. by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of the company, will be recouped by a claim against the auditors in the name of the company, not by individual shareholders.

13. The duty of care owed by an auditor to the shareholders is not owed to them as individuals but as a body and has as its object the protection of their interest in the proper management of the company. The damage from which the auditors must take care to protect the shareholders is a diminution in the value of their interest in the company. However, as Lord Bridge explained, this interest of the shareholders is indistinguishable from the interest of the company. Any loss falling within the scope of the duty may therefore be claimed from the auditor's in the name of the company. *Caparo* established that the auditor's duty does not extend to protecting individual shareholders, or potential investors, from the consequences of their investment decisions.

(b) Special duties owed to third parties

14. Although the general, ordinary duty of the auditor in respect of his work is somewhat limited, the law nevertheless accepts that in some circumstances a special duty may arise between the auditor and a third party, under which the auditor is under a duty to protect the third party against the particular type of loss suffered. The latter point about the type of damage involved is important. As Lord Bridge said in *Caparo*:

> "It is never sufficient to ask simply whether A owes B a duty of care. It is always necessary to determine the scope of the duty by reference to the kind of damage from which A must take care to save B harmless."

15. Similarly, Lord Oliver said:

> "It is not a duty to take care in the abstract but a duty to avoid causing to the particular plaintiff damage of the particular kind which he has in fact sustained."

16. The cases have established that a number of factors may be relevant in establishing whether a special duty of care exists. Among these are: (1) the purpose for which the statement was made; (2) the purpose for which the statement was communicated; (3) the relationship between the advisee and any relevant third party; (4) the size of any class to which the advisee belongs; (5) the state of knowledge of the adviser; and (6) reliance by the advisee.

Exclusion of liability: the statutory prohibition

(a) The statutory prohibition and limitation of liability agreements

17. Once it is established the auditor owes a duty of care to the claimant in respect of the type of loss suffered, questions about the limitation of liability arise. The looming issue for the accountancy profession is the statutory prohibition on limitations and indemnities contained in section 532 of the 2006 Act (originating in previous companies legislation). This provides:

> **532 Voidness of provisions protecting auditors from liability**
>
> (1) This section applies to any provision—
>
> (a) for exempting an auditor of a company (to any extent) from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company occurring in the course of the audit of accounts, or
>
> (b) by which a company directly or indirectly provides an indemnity (to any extent) for an auditor of the company, or of an associated company, against any liability attaching to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company of which he is auditor occurring in the course of the audit of accounts.
>
> (2) Any such provision is void, except as permitted by—
>
> (a) section 533 (indemnity for costs of successfully defending proceedings), or
>
> (b) sections 534 to 536 (liability limitation agreements).
>
> (3) This section applies to any provision, whether contained in a company's articles or in any contract with the company or otherwise.
>
> (4) For the purposes of this section companies are associated if one is a subsidiary of the other or both are subsidiaries of the same body corporate.

18. The general prohibition on limitations of liability and indemnities is similar to position under section 310 of the Companies Act 1985 ("the 1985 Act"). In particular, it was always open to a company to indemnify an auditor against any liability incurred by him (1) in defending civil or criminal proceeding in which judgment is given in his favour or he is acquitted; and (2) in respect of which he is granted relief by the court based on his honest and reasonable conduct.

19. However, the major innovation is that the further exception to the prohibition for 'liability limitation agreements' under the 2006 Act. The provisions relating to these agreements are contained in section 534 to 538. By section 534(1), a liability limitation agreement is:

> "an agreement that purports to limit the amount of 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."

20. The agreement will be effective to limit the auditor's liability only to the amount that is fair and reasonable in the circumstances, having regard, amongst other things to (1) the auditor's responsibilities under the 2006 Act; (2) the nature and purpose of the auditor's contractual obligations to the company; and (3) the professional standards expected of the auditor.[10] In determining what is fair and reasonable the court must not take into account (1) matters arising after the damage has been suffered or (2) the possibility of recovering compensation from elsewhere.[11] If the agreement goes beyond this limit, then it only operates so as to limit liability to that level.[12]

(b) Issue of construction – trigger of prohibition and of possible exception

21. It is important to appreciate that both the general prohibition on limitations of liability, and the definition of liability limitation agreements, makes use of the phrase "*occurring in the course of the audit of accounts*". Thus, the prohibition, and its potential derogation, only applies to limitations in respect of liability arising out of the performance of 'audit' work properly so called. As far as the scope of the prohibition is concerned, this raises two very tricky issues on which there does not seem to be any authority:

    (1) First, how is the phrase "*occurring in the course of audit work"* to be defined? Obviously, it covers work carried out by an accountant in performing his statutory functions as auditor. But what of the situation where the auditor, by the terms of his contract with the company, undertakes additional work above and beyond these statutory functions, such as advisory work? The line between audit work and non-audit work may be a hard one to draw.

    (2) Second, where a limitation in an auditor's contract is apt to cover both audit work and non-audit work because, for instance, the auditor has undertaken additional work which is not part of the 'audit' proper, will section 532

[10] Companies 2006 Act 2006, s. 537(1)
[11] Companies 2006 Act 2006, s. 537(3)
[12] Companies 2006 Act 2006, s.537(2)

invalidate the whole clause or merely invalidate it in so far as it purports to limit liability for breaches occurring in the course of the audit.

(c) Claims by the company

22. Where a claim is brought against an auditor for breach of duty and the auditor's contract contains a putative limitation of liability, the correct approach may be as follows:

(1) The court must first determine the nature and scope of auditor's liability aside from the alleged limitation. This will depend primarily upon the terms of the auditor's retainer. The claim may be based upon the auditor's general duty of care to the company or the shareholders as a whole or some special enhanced duty or upon breach of the auditor's fiduciary obligations.

(2) The putative limitation of liability must be considered. First of all, the court will need to decide whether the statutory prohibition applies to the limitation of liability. If the court concludes that the claim is <u>not</u> for a breach of duty "*occurring in the course of audit work*", it is strongly arguable that the clause is not void.[13]

(3) Assuming that the statutory prohibition applies to the type of claim at hand, the court will then need to consider whether the limitation in question falls with the definition of a 'liability exclusion agreement' under section 534(1). This will involve making sure that the agreement (a) complies with section 535 (relating to the terms of the agreement);[14]and (b) is authroised by the members of company in accordance with section 536.

(4) Finally, the court will need to decide what is a fair and reasonable limit to the auditor's liability. As noted above, if the limitation seeks to cap the auditor's liability below this level, the court will effectively substitute a fair and reasonable alternative limit and apply the agreement subject to this revised limit.

[13] A point can be made that other way to the effect that, if the clause is apt to cover audit breaches and non-audit breaches alike, it is still void.
[14] Summarise

(d) Claims by third parties

23. These claims throw up a further difficult issue, namely the extent to which the statutory prohibition against limitations of liability and indemnities applies in the context of claims by parties other than the company.

24. Take, for example, a claim by a third party investor for an investment decision taken on the basis of a company's statutory accounts; assume that the investor is able to establish (by reference to special circumstances) that the auditor owed him a duty to prevent him from suffering the type of loss that he did, in fact, suffer in relying upon those accounts.

25. The first point to note is that same difficulty of construing meaning of the words "*occurring in the course of audit work*" applies in this type of case as in the case of a claim by the company. By definition this type of claim will involve an allegation that the auditor has breached a special duty to the third party. However, in order for the statutory prohibition against limitations to apply it seems that the alleged breach of this duty must be one occasioned by the accountant whilst carrying out audit work. If the breach lies in some other failure, it would seem that the statutory prohibition on limitations is not engaged.

26. Assuming that the claim is in respect of audit work proper, further questions arise about the scope of the statutory prohibition. Conceivably, the auditor may wish to rely upon one of the following types of immunity:

    (1) An exclusion or limitation taking effect between the claimant and the auditor.

    (2) An indemnity given by the company to the auditor in respect of the auditor liability to the claimant.

27. There is precious little authority on the ambit of the old statutory prohibition against limitation clauses in section 310 of the 1985 Act, which applied to all company officers, and nothing on section 532 of the 2006, which replaced it (in relation to auditors). However, there is come useful dicta by Neuberger J in *Burgoine v Waltham Forest* [1997] 2 BCLC 812, at 625-627.

28. The case concerned the position of two officers of the council who had acted (pursuant to their nomination by the council) as directors of a joint venture company that had become insolvent. The directors had been given an indemnity by the council which covered them "*in or about the pursuit of their duties on behalf of the council while acting within the scope of their authority*". One of several arguments advanced against their claim to enforce the indemnity (in respect of liability for wrongful trading) was that it was void as a result of section 310 of the 1985 Act. The directors argued that section 310 did not apply to indemnities that were not given by the company itself. Neuberger J held that the indemnity did not cover the relevant liabilties as a matter of construction so the argument about the scope of section 310 fell away. However, he made some helpful comments on the point:

> "have reached the conclusion that the plaintiffs' contention on this point is correct, and that s 310 only applies to indemnities given by the company concerned (ie, in this case, the company). First, s 310(1) appears primarily to be concerned with a 'provision . . . exempting any officer': **given that the sort of claims contemplated by s 310 are claims brought by the company**, it could only be the company which granted any such exemption. In those circumstances, I consider it would require clearer words before a provision relating to indemnification applied to persons other than the company. **Secondly, the phrase 'whether contained in a company's articles or in any contract with the company or otherwise', while somewhat cumbersome, seems to me to be directing attention to an arrangement with the company, and not with anyone else**..." (Emphasis added).

29. These comments suggest that the statutory prohibition in section 310 (and by analogy section 532 of the 2006 Act) only applies to indemnities and limitations in a contract between the company and the auditor. These remarks are given further support by certain observations emanating from the Court of Session (IH). In *Royal Bank of Scotland v Bannerman Johnston Maclay* [2006] BCC 148 the Lord Justice Clerk, Lord Gill said:

> Counsel for the defenders referred us to section 310 of the 1985 Act, which provides, in effect, that a disclaimer made by an auditor is void. The Lord Ordinary was not referred to this section. In my view, it is irrelevant to this case. It applies to claims against the auditors by the company (*Burgoine v Waltham Forest LBC*, [1997] BCC 347). **There is nothing in that provision to prevent an auditor from disclaiming liability to third parties, and I see no reason why a disclaimer that would be void in a question with the company should not be valid in a question with a third party,** nor why a failure to disclaim against a third party should not in appropriate circumstances be a factor pointing to an assumption of responsibility or to the creation of a relationship of proximity. (Emphasis added).

30. It might reasonably be suggested, then, that any exclusion or limitation taking effect between the auditor and the third party claimant will be outside the scope of the statutory prohibition in section 532 of the 2006 Act.

31. As far as indemnities are concerned, the position is more complex. Neuberger J's comment that "*the sort of claims contemplated by section 310 are claims by the company*" might suggest that, where the indemnity relates to claims by a third party against the auditor then, again, section 532 of the 2006 Act is arguable not engaged.

32. However, a limitation between the third party and the auditor is arguable in a different category from an indemnity given by the company in respect of third party liability for at least one reason. Where a company has given an indemnity to the auditor, it will incur liability if the third party successfully brings a claim against the auditor or the company; and, in so far as it is the company that is sued, the indemnity compromises any right that the company would otherwise have against the auditor to recover a contribution. These considerations do not apply to an exclusion clause. Just because the auditor has excluded liability to the third party there seems no reason why, if the third party brings a claim against the company, the company might not then bring a claim against the auditor. This distinction might lead a court to conclude that an indemnity in respect of third party liabilities is, in principle, within the scope of the prohibition.

33. In summary, the tentative view might be advanced that:

    (1) An exclusion or limitation of liability between a third party claimant and the auditor is outside the scope of the statutory prohibition on limitations in section 532 of the Act.

    (2) As to an indemnity given by the company to the auditor in respect of the auditor's liabilities to third parties:

        (a) such a promise may well be covered by the prohibition; but

        (b) the prohibition probably applies only where the breach of duty has occurred "*in the course of audit work*" (whatever that means).

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