

**Bills Committee on
Legal Practitioners (Amendment) Bill 2010 (“Bill”)**

**An Explanatory Paper on the Operation of
the Proposed Section 7AI**

Background

The proposed section 7AI of the Bill provides, in its subsections (1) and (2), as follows –

- “(1) If a limited liability partnership makes a distribution of any of its partnership property to a partner, or to an assignee of a partner’s share in the partnership, as a consequence of which—
- (a) the partnership would be unable to pay its partnership obligations as they become due; or
 - (b) the value of the remaining partnership property would be less than the partnership obligations,
- then the partner or assignee is liable as provided in subsection (2).
- (2) The partner or assignee who receives the distribution is liable to the partnership for—
- (a) the value of the property received by the partner or assignee as a result of the distribution; or
 - (b) the amount necessary to discharge the partnership obligations at the time of the distribution,
- whichever is the lesser.”

2. At the 5th Bills Committee (“BC”) meeting held on 27 January 2011, the members of the BC (“**Members**”) asked the Administration to provide a paper to explain the following:

- (a) the relationship between the liability for clawing back distributions and the LLP’s negligence; and
- (b) how the clawback provisions of the proposed section 7AI (assuming that they have already come into effect) would operate in practice by reference to the following example provided by a Member at the meeting (“**Example**”)-
 - (i) an LLP was negligent in handling a client’s case on 1 January 2010;

- (ii) the client issued a letter before action to the LLP threatening to sue the firm on 1 January 2011;
- (iii) the client issues a writ against the LLP on 1 January 2012; and
- (iv) the client obtains judgement against the LLP on his negligence claim on 1 January 2018.

Specifically, the Members asked the Administration to explain and identify which distributions made during the period would be liable to be clawed back under the proposed section 7AI.

Relationship between the liability for clawing back distributions and the LLP's negligence

3. In simple terms, the proposed section 7AI provides that if an LLP makes a distribution to its partners and as a consequence of which either –

- (a) the LLP is not able to pay its partnership obligations when due (i.e. fails the test in the proposed section 7AI(1)(a) (“**liquidity test**”)); or
- (b) the value of its remaining property is less than its obligations (i.e. fails the test in the proposed section 7AI(1)(b) (“**asset test**”)),

then the partner receiving the distribution, or assignee of that partner's share in the partnership, is liable to pay back the whole or part of the distribution to the LLP.

4. Thus, it is clear that the trigger for clawback liability under the proposed section 7AI is the LLP's failure to meet the liquidity test or the asset test as a consequence of the distribution. In the absence of the failure to meet either of such tests, a distribution is not liable to be clawed back under the proposed section 7AI. In other words, a *necessary condition* for clawing back a distribution is that the LLP must have failed to meet the liquidity test or the asset test as a consequence of the distribution.

5. Specifically, it should be noted that an LLP's negligence in a specific case is not a trigger for clawback liability *on its own*. It is only when the LLP

fails to meet the liquidity or asset test after taking into account the partnership obligation arising from the negligence case that the clawback provision under the proposed section 7AI would come into play. Without failing the liquidity or asset test, the fact that an LLP is negligent before or after a distribution does *not* render that particular distribution liable to be clawed back.

Operation of the proposed section 7AI

6. For clarity and simplicity purposes, we have represented the Example in a diagram in **Appendix 1** attached and shall refer to it in explaining the operations of the proposed section 7AI below as requested. For simplicity, the diagram only focuses on the period between 1 January 2010 (when the LLP committed negligence) and 1 January 2018 (when the client obtains judgement against the LLP).

7. In the diagram, we assume the following-

- (a) that the LLP makes two distributions in each year, denoted by a “D” and a “D(2)” respectively in the diagram. For example, in 2009 (i.e. during 1 January 2009 to 31 December 2009), there were two distributions, namely D1 and D1(2) respectively. Similarly, there were two distributions in 2010, namely D2 and D2(2) respectively, and so on for each succeeding year;
- (b) that in respect of each year, the LLP is able to meet the liquidity test and the asset test immediately after the first distribution (“D”), but fails to meet either or both of the tests as a consequence of the second distribution (“D(2)”). In other words, we assume that the LLP is profitable such that by the time it makes the first distribution in the succeeding year, the LLP is able to meet the tests again. For example, we assume during 2010, when D2 was made, the LLP was able to meet both tests but had failed to meet those tests as a consequence of D2(2). We also assume that during the period between D2(2) and the first distribution in the succeeding year of 2011, i.e. D3, the LLP shall be profitable such that it would be able to meet the tests immediately after D3 is made. In the discussion that follows, we assume the same pattern repeats itself for each succeeding year.

8. Based on the assumptions in paragraph 7 above, each of D1, D2, D3, D4, D5, D6, D7, D8, D9 and D10 is not liable to be clawed back on the basis that the LLP is able to meet the tests immediately after the distribution.

Conversely, each of D1(2), D2(2), D3(2), D4(2), D5(2), D6(2), D7(2), D8(2), D9(2) and D10(2) is liable to be clawed back on the basis that the LLP is not able to meet either or both of the tests as a consequence of each of those distributions.

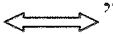
Effect of occurrence of negligence and institution of legal action on distributions

9. Hence, whether or not a distribution is liable to be clawed back is not determined by whether or when the LLP has been negligent, whether or when a letter before action and/or writ is issued. For example, in the diagram, both D2 and D2(2) were made after the LLP had committed negligence, yet D2 is not liable to be clawed back but D2(2) is. Likewise, both D3 and D3(2) would be made after the letter before action is issued by the client, yet D3 would not be liable to be clawed back but D3(2) would be. As stated in paragraph 4 above, a *necessary condition* for clawing back a distribution is that the LLP must have failed either the liquidity test or the asset test as a consequence of the distribution.

10. However, it should be noted that under the proposed section 7AI(3), proceedings to claw back a distribution may be brought by (a) the LLP itself; (b) any partner of the LLP; and (c) any person to whom the LLP “owes a partnership obligation at the time of the distribution”. Insofar as the client in the Example is concerned, he can only commence a clawback action in respect of the distributions made after 1 January 2010. He cannot claw back distributions made before that date because he is not a person to whom the LLP owes an obligation at the time when those earlier distributions were made as stipulated under the proposed section 7AI(3)(c). Therefore, as shown in the diagram in Appendix 1, D1 and D1(2) are not liable to be clawed back by the client.

Limitation period for clawback actions

11. In paragraph 10 of our paper, “The Administration’s Policy Position on (a) the constructive knowledge element of the proposed section 7AC(3)(a), and (b) the limitation period for clawback actions under the proposed section 7AI” issued in January 2011, LC Paper No. CB(2)888/10-11(01), we mentioned that the Administration would like to impose a limitation period of 6 years from distribution such that no action for clawback is permitted after that period. Accordingly, once it is ascertained that (a) the LLP is unable to pass the

liquidity or asset test as a consequence of a distribution and (b) it owes a partnership obligation toward the client at the time of the distribution (i.e. in our diagram, each of D2(2), D3(2), D4(2), D5(2), D6(2), D7(2), D8(2), D9(2) and D10(2)), the distribution shall be liable to be clawed back by the client provided that the clawback action is commenced within 6 years from the distribution. For illustration in **Appendix 2**, the limitation period for clawback actions for each of D2(2), D3(2), D4(2), D5(2), D6(2), D7(2), D8(2), D9(2) and D10(2) is shown by a “double arrowed bar”, i.e. “”.

Conclusion

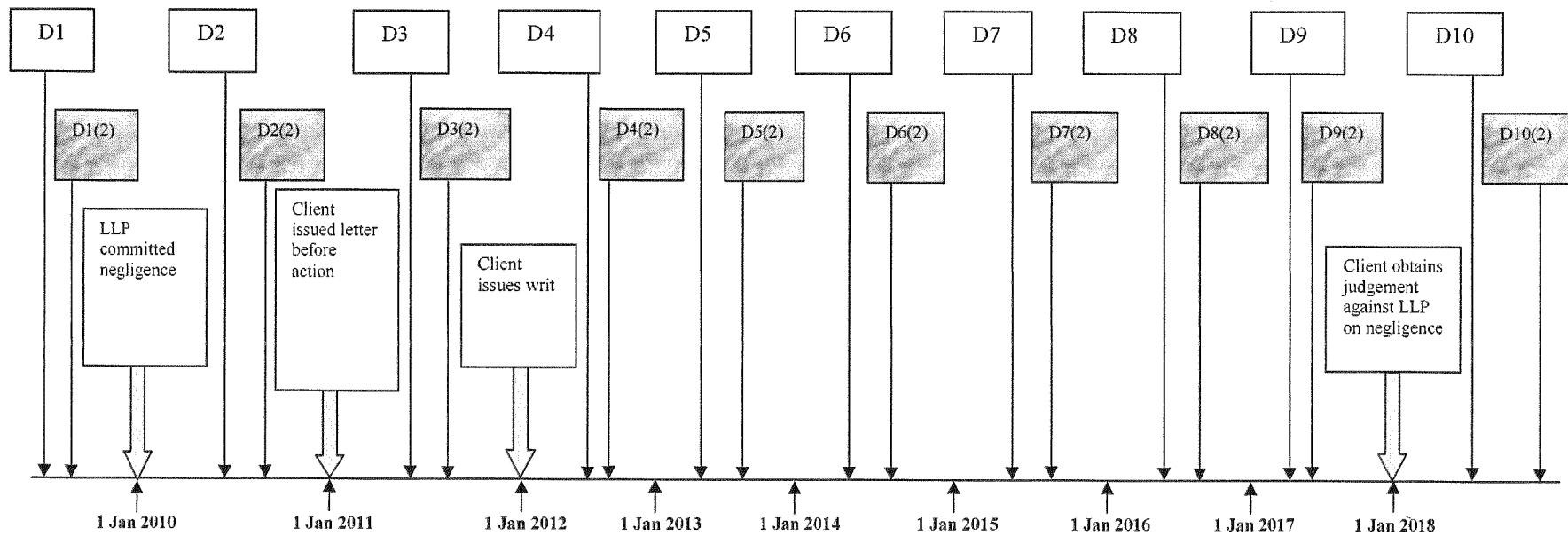
12. In conclusion, to ascertain whether a distribution is liable to be clawed back by a client under the proposed section 7AI, it is necessary to consider the following-

- (a) whether the LLP has failed the liquidity or asset test in the proposed section 7AI(1)(a) and (b) as a consequence of the distribution - if so, the distribution is liable to be clawed back;
- (b) whether the LLP owes an obligation to the client at the time when the distribution is made - if not, that distribution is not liable to be clawed back by the client; and
- (c) assuming that the proposed section 7AI is amended in accordance with the proposal mentioned in paragraph 11, whether the distribution is made more than 6 years before the commencement of the clawback action - if so, a clawback action for that distribution is time-barred.

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Appendix 1

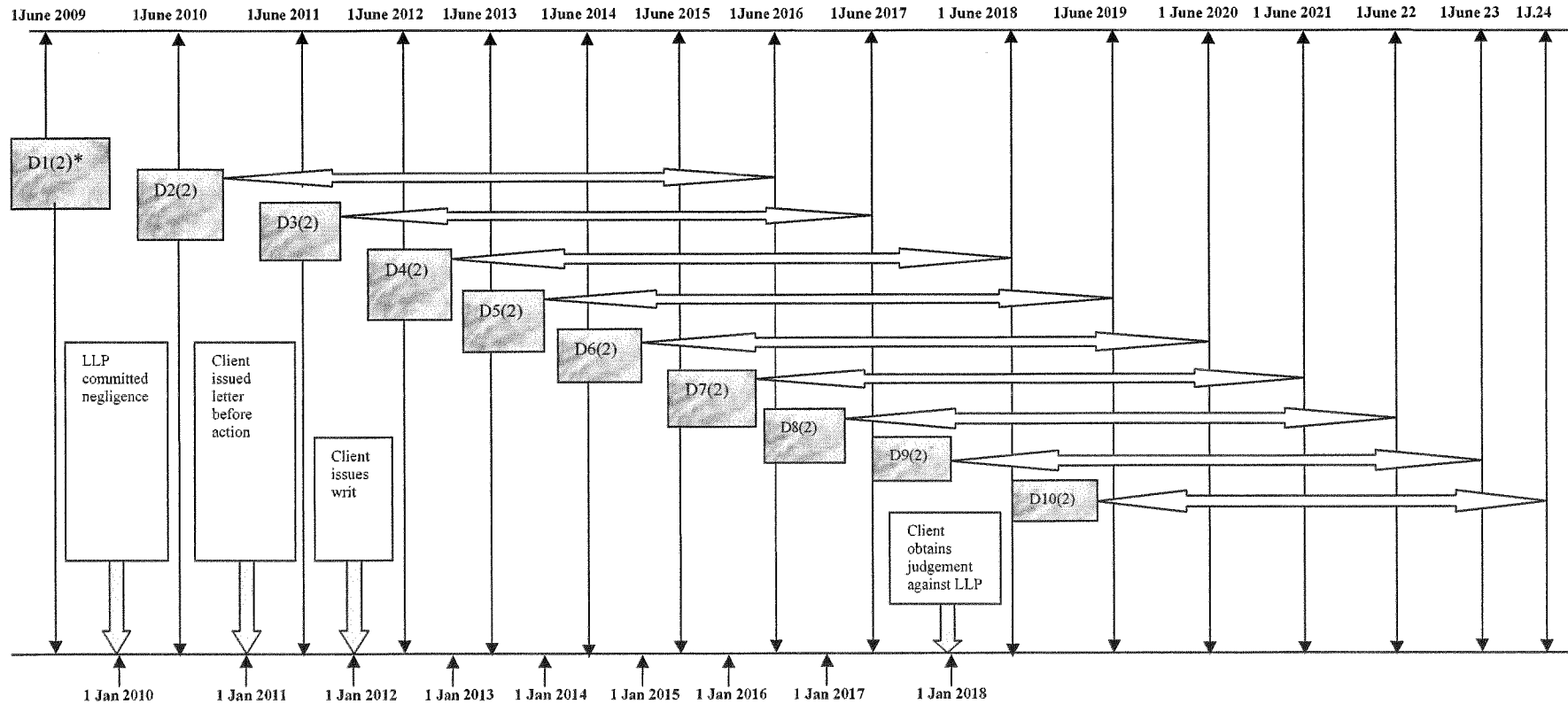


Legends:

D : a distribution, after which the LLP can still meet both the liquidity and asset tests

D(2) : a distribution, as a consequence of which the LLP cannot meet either or both of the liquidity and asset tests

Appendix 2



Legends:

* : no clawback action is allowed as the LLP has not yet incurred a partnership obligation toward the client

↔ : limitation period for clawback actions in relation to a distribution