

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

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**

Background

The proposed sections 7AC(3), 7AI(1) and (2) of the Bill provide respectively as follows –

The proposed section 7AC(3)

“Subsection (1) does not protect a partner from liability if the partner –

- (a) knew or ought reasonably to have known of the default at the time of its occurrence; and
- (b) failed to exercise reasonable diligence to prevent its occurrence.”

The proposed sections 7AI(1) and (2)

- “(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 4th Bills Committee meeting held on 25 November 2010, the Administration reported that we had met with the Law Society to discuss the following¹:-

- (a) the Law Society’s request for removing the words “or ought reasonably to have known of” (**“Constructive Knowledge Element”**) from the proposed section 7AC(3)(a), and the proposal (**“Proposal”**) to replace the Constructive Knowledge Element with a requirement for an LLP to serve a written notification confirming the identities of its responsible handling solicitor and supervising partner for a matter before the firm accepts instructions in respect of the matter from a client (**“Notification Requirement”**)²; and
- (b) the Law Society’s concern that “Section 7AI is unlimited in time”³.

3. At the 4th Bills Committee meeting, the Bills Committee requested the Administration to further discuss with the Law Society and submit a paper to the Bills Committee on the Administration’s policy position on each of the issues as mentioned in paragraph 2 above before the 5th Bills Committee meeting scheduled on 27 January 2011.

4. Since the 4th Bills Committee meeting, the Administration has held two further meetings with the Law Society to discuss the issues respectively on 14 December 2010 and 13 January 2011. As requested, the following sets out and explains the Administration’s current policy position on each issue.

¹ The Administration had two meetings with the Law Society on 16th and 24th of November 2010 respectively.

² For the background of the discussion of the Proposal with the Law Society, please see paras 7 and 8 of the Administration’s previous paper submitted to the Bills Committee in November 2010 (LC Paper No. CB(2)344/10-11(01)).

³ Para 18(a) of the Law Society’s “Submission to the Bills Committee on LLPs” dated 29 September 2010 (LC Paper No. CB(2)2328/09-10(01)).

The Constructive Knowledge Element in the proposed section 7AC(3)(a)

Consequence of breach of the Notification Requirement

5. A key issue and focus of our recent discussions with the Law Society about the Proposal is to determine the appropriate sanction against an LLP which fails to comply with the Notification Requirement. On this issue, the Administration's current policy stance is that all partners of an LLP should be barred from relying on the proposed section 7AC(1) for protection in the particular case where the LLP had failed to comply with the Notification Requirement ("**Loss of LLP Protection**"). The following sets out the principal reasons for our position:

- (a) the Notification Requirement is a simple procedural step to comply with, and it would not be unduly burdensome, in our view, for the management of an LLP to put in place a system to ensure the compliance with the Notification Requirement, e.g. a checklist system; and
- (b) a principal objective of the Notification Requirement is to provide certainty to a client by informing him of the name of the responsible LLP partner(s) for his case before there is default on the part of the LLP. This will help eliminate the uncertainty in establishing whether an LLP partner has constructive knowledge of the default after its occurrence. In order to achieve the above objective, it is necessary to provide an effective deterrent to prevent an LLP from breaching the Notification Requirement. In our view, the Loss of LLP Protection sanction would provide a powerful deterrent to prevent LLPs from breaching the Notification Requirement.

6. In addition, taking into account practical considerations for the implementation of the Notification Requirement, we would propose to provide an exception to the Loss of LLP Protection sanction as described in paragraph 5 above. In the event that an LLP can prove that a client has **actual** knowledge of the identity of the responsible partner(s)(a) prior to the occurrence of the default and (b) within 30 days from the firm's acceptance of instructions in respect of his matter, all other partners of the LLP should continue to be allowed to rely on the proposed s 7AC(1) for protection in the particular case concerned even if the Notification

Requirement was not observed by the LLP. This is justified as the aggrieved consumer in that case knows the responsible partner(s) for his matter. As such, it would be inappropriate to hold all other LLP partners liable in such a case.

Proposed requirements in respect of the notice

7. In terms of the form and contents of the notice to clients, the Administration proposes that the notice must:

- (a) be in writing;
- (b) name the responsible partner(s) for the matter;
- (c) be signed by the responsible partner(s) on behalf of the LLP;
- (d) be given as soon as practicable, and in any event not later than 30 days after the LLP accepts instructions in respect of the matter; and
- (e) contain an undertaking by the LLP to inform the client of any subsequent changes of the responsible partner(s).

Time Limit for Clawback Actions under the proposed section 7AI

8. We mentioned in paragraph 14(a) of our paper entitled "Response to Law Society's Submission" issued in November 2010, LC Paper No CB(2)344/10-11(01) that the Administration would propose a limitation period of two years from the date the claimant discovered the distribution made or could with reasonable diligence have discovered it for the proceedings under the proposed section 7AI(3) in response to the Law Society's concern that "*Section 7AI is unlimited in time*".

9. The Law Society did not agree with the above proposal on the basis that the effective limitation period for clawback actions would be uncertain. The limitation period would not end until two years from the date the claimant finds out or could reasonably have found out that the distribution was in contravention of the liquidity test and/or solvency test in the proposed section 7AI(1).

10. Having taken into account the Law Society's views, the Administration would propose that the limitation period shall be six years from the date of distribution. The following are our reasons:

- (a) section 4(1) of the Limitation Ordinance (Cap. 347) provides, inter alia, that "actions to recover any sum recoverable by virtue of any Ordinance....., other than a penalty or forfeiture or sum by way of penalty or forfeiture" shall not be brought after the expiration of six years from the date on which the cause of action accrued. We intend to set out this rule in the Bill; and
- (b) a six years' limitation period from distribution would provide a longer period than the two years' limitation period proposed by the Law Society and therefore better protection to the consumers. We object to the Law Society's proposal of two years' limitation period for two reasons: (a) clients are not privy to information about distribution of profits and assets by an LLP to its partners; and (b) it usually takes more than two years for a client to obtain a first instance judgment on his claim for negligence against a law firm before he is in a position to enforce the judgment debt.

11. In sum, we consider that, as compared with the proposal by the Law Society, a six years' limitation period from distribution would strike a better balance between protecting consumer interest and the interest of LLP partners regarding clawback actions under the proposed section 7AI.

**Department of Justice
January 2011**

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