

Bills Committee Meeting on LLPs

The Law Society awaits the revised draft Bill with respect to the replacement of the designated partner provisions. This submission thus focuses solely on the proposed clawback provisions.

Sufficient compensation

1. The Law Society understands the concerns that consumers will be exposed to the risk of not being sufficiently compensated in a claim as a result of the exclusion of the personal assets of the innocent partners of an LLP.
2. Nevertheless, in the particular Hong Kong context, it is not a concern because there are statistical evidence to show that the statutory professional indemnity limit of HK\$10 million is generally sufficient for indemnity protection of individual consumers.
3. From the claims statistics, from 1994/95 indemnity year to 2 July 2009:
 - (i) Only 1.6% of the total claims (including notifications) (i.e. 53 claims out of 3,321 claims) have sought HK\$10 million or more; and
 - (ii) Out of those 53 claims, there was only one claim which was brought by an individual and for which the Fund paid HK\$10 million (including defence cost but less the indemnified's deductible).
4. Further, any increase to the statutory indemnity limit of HK\$10 million per claim will inevitably lead to an increase in insurance premium. The extra cost will in turn be passed onto the consumers who will have to pay more to get higher indemnity cover which is unnecessary based on claims statistics.

Sufficient transparency to enable the making of an informed choice

5. The Law Society is fully conscious of the importance of consumer protection. It takes the view that the existing safeguards in the proposed LLP framework ensuring transparency are sufficient to ensure that the public can make an informed choice as to whether to engage the services of an LLP:
 - (a) The name of an LLP must include the words "Limited Liability Partnerships" or abbreviation "LLP" or "L.L.P." so that the public know that the firm operates with limited liability;
 - (b) The name must be displayed visibly and legibly at or outside its offices and on its office documents;
 - (c) An LLP must notify its existing clients in writing within 30 days of the fact that it has become an LLP;

- (d) The written notice to its existing clients by an LLP, the form of which is to be specified by the Law Society, must include a statement stating how liabilities of partners of a law firm are affected by the law firm becoming an LLP;
- (e) An LLP must give 7-day advance notice of its particulars to the Law Society;
- (f) The Law Society must keep a list of LLPs for public inspection free of charge.

Sufficient protection against dissipation of firm assets

- 6. On the premises that consumers will not be disadvantaged, Hong Kong should be in line with most other jurisdictions in designing its LLP legislation so that it can truly achieve the objective of enhancing Hong Kong's competitiveness through a modernization of its legal infrastructure that is comparable to other jurisdictions.
- 7. Consumers will not be disadvantaged without clawback because:
 - (a) the mandatory Professional Indemnity Scheme has proven to be sufficient protection based on past claims experience;
 - (b) the Bankruptcy Ordinance will apply to assets that should not have been transferred out in the event that the firm becomes insolvent;
 - (c) the general remedy of Mareva injunction will apply should there be any risk of dissipation of firm's assets.

Higher level of consumer protection than other professions

- 8. A number of other professions (accountants, architects, surveyors dentists etc.) in Hong Kong are permitted to conduct their businesses through limited liability entities. That method of operation is not perceived to create concerns in terms of consumer protection for the users of those services. Consequently, there should not be any similar concern if law firms operate through limited liability partnerships. From the standpoint of consumer protection, permitting law firms to operate as LLPs will simply treat law firms in a manner similar to these other professions. Consumers would actually be well protected vis-à-vis LLPs compared to these other professions since there is a statutory professional indemnity scheme for solicitors and further, a negligent partner of an LLP would remain liable for all of the liabilities of the law firm arising out of that negligence (since the liability shield would not apply).

Section 7AI is practically unworkable

- 9. The current claw back section (section 7AI) effectively allows a claimant to commence proceedings to enforce a partner's liability to return a distribution to the partnership even before the claimant has obtained judgment on his negligence claim as long as the partnership property is less than the partnership obligations taking into account his claim (which is a contingent partnership obligation).

10. The issue is where judgment has not been obtained for the claim, how much of the claim should be allowed for the purpose of determining if the value of partnership obligation is more than that of partnership property. It poses problems for the following reasons:
- (a) the amount of the claim may be over-inflated;
 - (b) an assessment of quantum at the early stage of the claim proceedings is extremely difficult.

Proposed improvement

11. The Administration claims that it has adopted a pragmatic approach to allow flexibility and autonomy to an LLP to decide for itself whether or not it should make a distribution. However, this approach becomes an irresponsible approach if the legislation does not make it clear how a decision can be made in compliance with the law.
12. If a comparison is made with the few Canadian jurisdictions that have provisions regulating distribution of partnership property in LLPs, it is noted that they do expressly provide for the bases to determine whether a distribution should have been made, namely,
- “(a) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances;*
 - (b) on a fair valuation;*
 - (c) on another method that is reasonable in the circumstances.”¹*

If it is the view of the Bills Committee that a clawback provision must be provided in the legislation, the inclusion of such objective bases will add certainty and predictability to the existing section 7AI so that at the very least, an LLP will know how to ensure compliance with the provision. There is no use imposing a requirement if no one knows how to comply with it.

13. The Administration does not consider setting out the criteria in the legislation appropriate because the courts should be allowed to make a ruling based on all relevant circumstances of the specific case concerned. Nevertheless, in the improvement suggested, the court is entitled to consider other methods that are reasonable in a specific case and it is certainly not restricted to take into account only those methods specified in the provision.

Appeal to have a fair limitation period consistent with world trend

14. There are two reasons given by the Administration for proposing 6 years instead of 2 years as the limitation period for claw back actions :
- (a) clients do not know when a distribution has been made; and

¹ Based on section 85(5) Manitoba Partnership Act and Section 83(5) Saskatchewan Partnership Act

- (b) it takes more than 2 years for a client to obtain a first instance judgment on his negligence claim before he is in a position to enforce the judgment debt.
15. On the client's knowledge of distribution, a comparison can be made with the bankruptcy scenario where similarly the claimant would not have knowledge of any unfair transfer of assets, the restoration period is still legislated as 2 years. The Law Society does not see any justification for LLPs to depart from the policy of existing legislation.
 16. For the second reason on the need of more than 2 years to obtain a first instance judgment, section 7AI provides that the claimant can take out a clawback action even before he obtains judgment. This is thus not a valid reason.
 17. In a bankruptcy scenario, the relevant period for restoration is 2 years before presentation of bankruptcy petition where unfair preferences were given to associates of debtors and a person is an associate with whom he is in partnership under sections 50, 51 and 51B of the Bankruptcy Ordinance (Cap 6). The spirit of the proposed clawback is the same as that of the restoration of assets in a bankruptcy situation and the period should be consistent.
 18. Further, comparing with the few Canadian jurisdictions² that have provisions regulating the distribution of property for LLPs, the period of limitation to enforce a liability under all of those provisions is 2 years.
 19. The Administration comments that some overseas jurisdictions provides for a prohibition of distributions. The current section 7AI is thus said to be already more liberal. However, the practical effect of section 7AI, because of its uncertainty, is no different from a strict prohibition of distribution of partnership property because an LLP would likely not distribute in any event. The more liberal approach adopted in section 7AI is only illusory.
 20. The Law Society submits that no separate clawback is needed at all since LLPs would be covered by bankruptcy law. Bearing in mind that the LLP model now proposed by the Administration would only offer partial shield, it is all the more important to ensure equality of treatment for all unsecured creditors on a pari-passu basis in accordance with the existing bankruptcy framework. As is common with a trade creditor (who may also have obtained a successful judgment against an LLP), a successful claimant who has established his claim for negligence against an LLP is likewise regarded as an unsecured creditor. The existing bankruptcy law has already provided a statutory framework based on public policy for balancing the competing interests of all unsecured creditors on an equal footing. However, if the Bills Committee considers a clawback provision must be provided in the legislation, the limitation for a person to enforce a liability under such a provision should be 2 years in line with the existing bankruptcy regime and other overseas LLP legislation, e.g. British Columbia, Manitoba and Nova Scotia (relevant extracts attached). Any proposal to impose a 6 year clawback period may actually create conflicting bankruptcy rules in dealing with successful trade creditors (with 2 years clawback) as against successful claimants (with 6 years clawback as proposed by the Administration). Indeed, such a proposal for 6 year clawback in favour of a successful claimant would be inconsistent with the existing bankruptcy law and would cause

² British Columbia, Manitoba, Nova Scotia

prejudice to the interests of other successful trade creditors. Public policy demands that all unsecured creditors should be treated on a pari-passu basis and no individual unsecured creditors should be given preferential treatment to the detriment of the others.

21. As a matter of fact, under the existing PIS, a successful claimant is entitled to receive compensation for professional negligence from the PIS Fund of up to HK\$10 million per claim as well as top-up cover (if any). Only the excess amount over and above the professional indemnity cover would be claimed by a successful claimant as an unsecured creditor against an LLP for that excess amount. In contrast, a successful trade creditor would not be entitled to receive any payment from the PIS Fund. It clearly demonstrates that a successful claimant is already well protected and favoured by the professional indemnity cover, as against a successful trade creditor who will have no protection at all apart from being treated as an unsecured creditor under the existing bankruptcy regime. If so, why should a successful claimant be granted an additional advantage to recover the excess amount (with a far more generous 6 year clawback as now proposed by the Administration) than a successful trade creditor (with a 2 year clawback under the existing bankruptcy law)? In conclusion, a proper balance has to be struck between all unsecured creditors on a pari-passu basis in accordance with the existing bankruptcy law.

The Working Party on LLPs
The Law Society of Hong Kong
7 March 2012

112 (1) A limited liability partnership

(a) must not make a distribution in connection with winding up its affairs or after it has ceased to carry on business unless all partnership obligations have been paid or satisfactory provision for their payment has been made, and

(b) in circumstances other than in connection with winding up its affairs, must not make a distribution if the limited liability partnership would, after the distribution, be unable to pay its partnership obligations as they come due in the ordinary course of business.

(2) Despite subsection (1) (a), if a partner has expended money for the benefit of a limited liability partnership or has made a loan to the partnership, other than for or in relation to an acquisition by the partner of an interest in the partnership, the partner is entitled to receive a prorated payment with all other creditors of the same class of the limited liability partnership.

(3) Subsection (1) does not prohibit a payment made as reasonable compensation for current services provided by a partner to the limited liability partnership.

Recovery of prohibited distributions

113 (1) A partner in a limited liability partnership who receives a distribution contrary to section 112 (1) is liable to the limited liability partnership for the positive difference between

(a) the lesser of

(i) the value of the partnership property received by the partner, and

(ii) the amount necessary to discharge partnership obligations that existed at the time of the distribution, and

(b) the amount the partner is entitled to receive under section 112 (2) or (3), as the case may be.

(2) Partners in a limited liability partnership who authorize a distribution contrary to section 112 (1) are jointly and severally liable to the limited liability partnership for any amount for which the partner who received the distribution is liable under subsection (1) of this section, to the extent that the amount is not recovered from that partner.

(3) Proceedings to enforce a liability under this section may be brought by the limited liability partnership, any partner in the limited liability partnership or any person to whom the limited liability partnership was obligated at the time of the distribution to which the liability relates.

✓ (4) Proceedings to enforce a liability under this section must be commenced no later than 2 years after the date of the distribution to which the liability relates.

Division 5 — Extraprovincial Limited Liability Partnerships

Non-registered status

114 Whether or not a foreign partnership has, in a jurisdiction other than British Columbia, the status of, or a status equivalent to that of, a limited liability partnership, the liability attributable to the foreign partnership and its partners while the foreign partnership is carrying on business in British Columbia is the same as the liability that is attributable to a general partnership and its partners unless that foreign partnership is registered as an extraprovincial limited liability partnership.

Registration of extraprovincial limited liability partnership

115 (1) Subject to section 116, a foreign partnership that wishes to register as an extraprovincial limited liability partnership may apply to register the foreign partnership as an extraprovincial limited liability partnership if the foreign partnership has the

Service

83(1) A notice or document required or permitted to be sent to or served on an extra-provincial limited liability partnership may be

- (a) delivered to its registered office, as shown in the Director's records;
- (b) personally served on the partner who is designated as its representative, as shown in the Director's records;
- (c) sent by registered mail to
 - (i) its registered office, as shown in the Director's records,
 - (ii) the partner who is designated as its representative, as shown in the Director's records, or
 - (iii) the separate post office box designated as its address for service by mail, as shown in the Director's records; or
- (d) delivered or sent by any other manner that may be provided for in the regulations.

Deemed time of receipt

83(2) A notice or document sent by registered mail to an extra-provincial limited liability partnership in accordance with clause (1)(c) is deemed to be received on the fifth business day after mailing, unless there are reasonable grounds for believing that the partnership did not receive the notice or document at that time or at all.

S.M. 2002, c. 30, s. 5.

Law of governing jurisdiction applies

84(1) Except as provided in another Act or in subsections (2) to (4), the law of the governing jurisdiction of an extra-provincial limited liability partnership applies

- (a) to the organization and internal affairs of the partnership; and
- (b) to the liability of the partners for debts, obligations and liabilities of or chargeable to the partnership.

Manitoba partner's own acts and omissions

84(2) A Manitoba partner of an extra-provincial limited liability partnership has the same individual liability as a partner of a Manitoba limited liability partnership does for debts, obligations or liabilities arising from his or her own negligence, wrongful act or omission, malpractice or misconduct.

Extent of Manitoba partner's liability

84(3) A Manitoba partner of an extra-provincial limited liability partnership has no greater protection against individual liability for debts, obligations or liabilities of the partnership or another partner described in subsection (4) than a partner of a Manitoba limited liability partnership would have against individual liability for similar debts, obligations or liabilities of the Manitoba partnership or another partner.

Debts to which subsection (3) applies

- 84(4) The debts, obligations or liabilities referred to in subsection (3) are those arising
- (a) from the negligence, wrongful act or omission, malpractice or misconduct of another partner or an employee, agent or representative of the partnership about which the partner knew at the time of its commission and in respect of which he or she failed to take reasonable steps to prevent its commission; or
 - (b) from the negligence, wrongful act or omission, malpractice or misconduct of an employee, agent or representative of the partnership for whom the partner was directly responsible in a supervisory role.

S.M. 2002, c. 30, s. 5.

Restrictions on distribution of partnership property

85(1) A Manitoba limited liability partnership must not make a distribution of partnership property in connection with the winding up of its affairs unless all partnership obligations have been paid or satisfactory provision for their payment has been made.

Distribution other than in winding up

85(2) In circumstances other than in connection with the winding up of its affairs, a Manitoba limited liability partnership must not make a distribution of partnership property if there are reasonable grounds to believe that after the distribution

- (a) the partnership would be unable to pay its partnership obligations as they come due; or
- (b) the value of the partnership property would be less than the partnership obligations.

Exception re subsection (1)

85(3) Subsection (1) does not prohibit a payment on account of a partnership obligation if a partner receives a prorated payment with all other creditors of the partnership of the same class.

Exception for current services

85(4) Subsections (1) and (2) do not prohibit a payment made as reasonable compensation for current services provided by a partner to the partnership, to the extent that the payment would be reasonable if paid to an employee who was not a partner as compensation for similar services.

Determination of prohibited distribution

✓ 85(5) A Manitoba limited liability partnership may base its determination of whether a distribution is prohibited by subsection (2)

- (a) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances;
- (b) on a fair valuation; or
- (c) on another method that is reasonable in the circumstances.

S.M. 2002, c. 30, s. 5.

Recovery of prohibited distributions

86(1) A partner in a Manitoba limited liability partnership who receives a distribution in contravention of section 85 is liable to the partnership for the lesser of

- (a) the value of the property received by the partner; and
- (b) the amount necessary to discharge the partnership obligations that existed at the time of the distribution.

Authorizing partner jointly and severally liable

86(2) A partner in a Manitoba limited liability partnership who authorizes a distribution in contravention of section 85 is jointly and severally liable to the partnership for any amount for which a recipient is liable under subsection (1), to the extent that the amount is not recovered from the recipient.

Parties who may institute recovery proceedings

86(3) Proceedings to enforce a liability under this section may be brought by the Manitoba limited liability partnership, any partner in the partnership or any person to whom the partnership was obligated at the time of the distribution to which the liability relates.

Limitation period

✓ 86(4) No proceedings to enforce a liability under this section shall be commenced later than two years after the date of the distribution to which the liability relates.

S.M. 2002, c. 30, s. 5.

Dissolution of partnership

87(1) After the dissolution of a Manitoba limited liability partnership, the partnership maintains its status as a Manitoba limited liability partnership while its affairs are being wound up.

Deemed dissolution and winding up

87(2) For the purposes of this section and subsection 85(1), a Manitoba limited liability partnership is deemed to have dissolved and to be winding up its affairs if

- (a) it ceases to carry on business; or
- (b) it is dissolved under any of sections 35 to 38.

Application to court for supervision order

Nova Scotia

(a) the negligence, wrongful act or omission, malpractice or misconduct of another partner or an employee, agent or representative of the partnership about which the partner knew at the time of its commission and in respect of which the partner failed to take reasonable steps to prevent its commission; or

(b) the negligence, wrongful act or omission, malpractice or misconduct of another partner or an employee, agent or representative of the partnership for whom the partner was responsible in a supervisory role.

(5) For the purpose of this Section, the governing jurisdiction for an extra-provincial LLP is the jurisdiction under the laws of which the partnership was formed. *2002, c. 37, s. 2.*

Distribution of property of Nova Scotia LLP

67 (1) A Nova Scotia LLP shall not make a distribution of partnership property in connection with the winding up of its affairs unless all partnership obligations have been paid or satisfactory provision for their payment has been made.

(2) In circumstances other than in connection with the winding up of its affairs, a Nova Scotia LLP shall not make a distribution of partnership property if there are reasonable grounds to believe that after the distribution

(a) the partnership would be unable to pay its partnership obligations as they come due; or

(b) the value of the partnership property would be less than the partnership obligations.

(3) Subsections (1) and (2) do not prohibit a payment made as reasonable compensation for current services provided by a partner to the Nova Scotia LLP, to the extent that the payment would be reasonable if paid to an employee who was not a partner as compensation for similar services.

✓ (4) A Nova Scotia LLP may base its determination of whether a distribution is prohibited by subsection (2)

(a) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances;

(b) on a fair valuation; or

(c) on another method that is reasonable in the circumstances. *2002, c. 37, s. 2.*

Liability respecting contravention of Section 67

68 (1) A partner in a Nova Scotia LLP who receives a distribution contrary to Section 67 is liable to the partnership for

(a) the value of the property received by the partner; or

(b) the amount necessary to discharge partnership obligations that existed at the time of the distribution,

whichever is less.

(2) Any partners in a Nova Scotia LLP who authorize a distribution contrary to Section 67 are jointly and severally liable to the partnership for any amount for which a recipient is liable under subsection

(1), to the extent that the amount is not recovered from the recipient.

(3) Proceedings to enforce a liability under this Section may be brought by the Nova Scotia LLP, any partner in the partnership or any person to whom the partnership was obligated at the time of the distribution to which the liability relates.

✓ (4) No proceedings to enforce a liability under this Section may be commenced later than two years after the date of the distribution to which the liability relates. *2002, c. 37, s. 2.*

Successor partnership

69 (1) For the purpose of this Part, a new partnership is the successor partnership of an original partnership where

(a) at a particular time, the original partnership is registered as a Nova Scotia LLP;

(b) immediately after that time, a new partnership with different partners is carrying on the business of the original partnership;

(c) one or more of the partners in the original partnership are members of the new partnership; and

(d) there is an express or implied agreement between the partners in the original partnership and new partnership that the new partnership will assume all partnership obligations of the original partnership.

(2) A successor partnership is deemed to be the same partnership as the original partnership for the purpose of this Part and, without limiting the generality of the foregoing, is subject to all the partnership obligations of the original partnership. *2002, c. 37, s. 2.*

Dissolution of Nova Scotia LLP

70 (1) When a Nova Scotia LLP dissolves and its affairs are to be wound up, the partnership maintains its status as a Nova Scotia LLP while its affairs are being wound up.

(2) A Nova Scotia LLP is deemed, for the purpose of this Section and subsection 67(1), to have dissolved and to be winding up its affairs if

(a) the partnership ceases to carry on business; or

(b) there is any change in the membership of the partnership and there is not a successor partnership within the meaning of Section 69.

(3) When a Nova Scotia LLP has dissolved and its affairs are being wound up, the Supreme Court of Nova Scotia may, on the application of any interested person, make any order with respect to the partnership that could be made with respect to a corporation under Section 43 of the Companies Winding Up Act. *2002, c. 37, s. 2.*

Regulations

71 (1) The Governor in Council may make regulations

(a) authorizing a profession that meets the requirements of clauses 51(1)(a) and (c) to be practised in limited liability partnerships;