

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

Section 7AI(1) of the Bill

Purpose

This paper seeks to further explain, at the request of the Chairman of the Bills Committee, how section 7AI(1)(a) of the Bill incorporating the draft CSAs at Annex A of our BC Paper, LC Paper No. CB(2)2045/11-12(01) (“**Last Amended Bill**”) operates by reference to a situation where an LLP has defaulted in its professional duties toward a client and:

- a) at the time when a distribution was made by the LLP, both the client and the LLP were unaware of the default had occurred, and despite the fact that the LLP had exercised reasonable diligence in accordance with the requirements of s7AI(1A), the default was not identified (“**Senario A**”); and
- b) at the time when a distribution was made by the LLP, the client was aware of the default and had already demanded compensation from the LLP but liability of the partnership obligation was not yet established (i.e. whether by the LLP’s own admission, an agreement between the parties or as a result of judgment obtained against the LLP) (“**Scenario B**”).

In particular, the Chairman would like the Administration to clarify, in each Scenario A and Scenario B mentioned above, whether the partnership obligations owed by the LLP by reason of the default have “become due” for the purposes of s7AI(1)(a).

2. For ease of reference, we would set out section 7AI(1) of the Last Amended Bill below. For simplicity, references to a section in this Paper are to a section of the Last Amended Bill.

- “(1) If a limited liability partnership makes a distribution of any of its partnership property to one or more persons (each being a partner or an assignee of a partner’s share in the partnership), and immediately after the distribution –
- (a) the partnership is unable to pay its partnership obligations as they become due; or
 - (b) the value of the remaining partnership property is less than the partnership obligations, then each of the persons is liable to the partnership to the extent specified in subsection (2).”

Our Analysis

s7AI(1)(a)

Scenario A

3. The partnership obligation had arisen from the date of the default. However, since both the LLP and the client were unaware of the default, there was no proof of the partnership obligation (whether by the LLP's own admission, an agreement between the parties or as a result of judgement obtained against the LLP) when the distribution was made. As a corollary, there was no proof that the partnership obligation was due when the distribution was made. In our view, a partnership obligation cannot be regarded as due unless it is established. Until it is established, the partnership obligation is only a potential liability, yet to be discovered and established.

Scenario B

4. In this scenario, notwithstanding the LLP and the client were aware of the partnership obligation, there was no proof that the partnership obligation was due when the distribution was made. The partnership obligation remained a contingent liability, yet to be established at the time of distribution.

s7AI(1)(b)

5. The above partly explains why it is necessary for s7AI(1) to have two separate limbs, namely s7AI(1)(a) which focuses on the liquidity position of the LLP at the time of the distribution, and s7AI(1)(b) which focuses on the asset position of the LLP at the time of the distribution.

6. Under s7AI(1)(a), a debt owed but not due at the time of distribution is irrelevant. The principal focus of this limb is to ascertain whether an LLP can meet its liquidity requirement immediately after the distribution, not in the future. Thus, the default of the LLP in each Scenario A and Scenario B above is irrelevant for the purposes of s7AI(1)(a).

7. Under s7AI(1)(b), an LLP should not make a distribution, if immediately afterwards its net asset value will be negative. Given "partnership obligation" is defined in s7AI(4) to include a contingent liability, demands made by client for compensation before judgement is relevant for ascertaining the net asset value of the LLP for the purposes of s7AI(1)(b). To complete our analysis above, we also set out below the application of s7AI(1)(b) in each of Scenario A and Scenario B above.

Scenario A

8. The partnership obligation had arisen from the date of the default. However, since both the LLP and the client were unaware of the default, and the due diligence exercise by the LLP in accordance with s7AI(1A) did not reveal the default, the LLP was not in a position to make contingent liability provisions for the partnership obligation when the distribution was made. In other words, the default will not be taken into account by the LLP in ascertaining whether the net asset test could be met under s7AI(1)(b) immediately after the distribution.

Scenario B

9. In this scenario, given the LLP was aware of the partnership obligation it could make suitable contingent liability provisions for it in its financial statements¹. Hence, the default is relevant in ascertaining whether the LLP could meet the net asset test under s7AI(1)(b) immediately after the distribution.

10. It should be noted that the conjunction between paragraph (a) and paragraph (b) of s7AI(1) is “or”, which means that a distribution made by an LLP, subject to the reasonable assessment defence in s7AI(1A), will be liable to be clawed back if the distribution fails to meet either the liquidity test under paragraph (a) or the asset test under paragraph (b).

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¹ For example, Hong Kong Accounting Standard 37 defines contingent liabilities as to include “*a present obligation that arises from past events but is not recognised because...the amount of the obligation cannot be measured with sufficient reliability.*”