

Submission to the Bills Committee on LLPs

Constructive knowledge

1. In its submission to the Bills Committee dated 6 August 2010, the Law Society set out its views on the provision of constructive knowledge in section 7AC(3) of the Legal Practitioners (Amendment) Bill 2010.
2. It proposed to replace 7AC(3) with the following provision:
“(3) Subsection (1) does not operate to protect a partner from liability
 - (a) where the partner knew of the default at the time it was committed and failed to take reasonable steps to prevent its commission, or*
 - (b) where*
 - (i) the default was committed by an employee, agent or representative of the partnership for whom the partner was directly responsible in a supervisory role, and*
 - (ii) the partner failed to provide such adequate and competent supervision as would normally be expected of a partner in those circumstances.”*
3. At the Bills Committee meeting held on 17 September 2010, it was noted that there was still some concern on whether the revised provision would offer sufficient consumer protection in cases where partners deliberately avoided personal liability by not getting involved in the supervision at all.
4. Under Principle 5.17 of the Hong Kong Solicitors’ Guide to Professional Conduct, Volume 1 (“Conduct Guide”), a solicitor is under a duty to keep his client properly informed and to comply with reasonable requests from the client for information concerning his affairs.
5. Commentaries 1 and 2 under Principle 5.17 provide:
 - “1. A client should be told the name and the status of the person responsible for the conduct of the matter on a day-to-day basis and the partner responsible for the overall supervision of the matter.*
 - 2. If the responsibility for the conduct or the overall supervision of the whole or part of a client’s matter is transferred to another person in the firm the client should be informed.”*
6. To address any concern that partners may try to avoid personal liability by not supervising the practice, the Law Society would agree to amend the Conduct

Guide to make the obligations in Commentaries 1 and 2 under Principle 5.17 mandatory for solicitors operating as LLPs.

7. LLPs will be expressly required to inform their clients of:
 - (a) the name and status of the person responsible for the conduct of the matter on a day-to-day basis;
 - (b) the partner responsible for the overall supervision of the matter; and
 - (c) any subsequent changes to any of the above.

Under Commentary 1, Principle 4.10 of the Conduct Guide, a bill must be signed by a partner.

8. This express requirement, coupled with the revised section 7AC(3) set out in paragraph 2 above, is clear and certain to both clients and solicitors and offers a practical solution to the concern raised.
 - (a) To a client, he will have the comfort that:
 - (i) there will be a partner designated to supervise his case;
 - (ii) the partner will not be able to claim innocence and enjoy LLP protection by staying away from the case because as the designated supervising partner, he is responsible for providing adequate and competent supervision.
 - (b) To a solicitor in an LLP,
 - (i) the requirement is sufficiently clear to enable him to ensure compliance and to have a clear understanding of his liability exposure;
 - (ii) the risk of being dragged into negligence claims by clients taking a catch-all approach irrespective of merits and engaging in excessive litigation will be minimised.

9. In addition, there are existing requirements governing solicitors' conduct upon acceptance of instructions to protect consumer interest. They include:

- (a) Competence to act

Principle 5.03 of the Conduct Guide provides that "*A solicitor must not act or continue to act in circumstances where he cannot represent the client with competence or diligence.*"

- (b) Diligence, care and skill

Principle 5.12 of the Conduct Guide provides that *“A solicitor who has accepted instructions on behalf of a client is bound to carry out those instructions with diligence and must exercise reasonable care and skill.”*

- (c) Communicating with client

Commentaries 3 and 5 of Principle 5.12 of the Conduct Guide state:

“3. A client should be told in simple language at the outset of a matter or as soon as possible thereafter the issues raised and how they will be dealt with and in particular, the immediate steps to be taken...”

“5. A solicitor should keep his client informed of the progress of the matter, any significant development in the matter and of the reason for any serious delay which occurs.”

- (d) Information on work

Commentary 1 of Principle 4.01 of the Conduct Guide provides that *“A solicitor should ensure that his client or prospective client is given an explanation by a person with appropriate competence of the work which is likely to be involved in carrying out his instructions and the time which may be taken.”*

- (e) Information on costs

Principle 4.03 of the Conduct Guide provides that *“If no fee has been agreed or estimate given, a solicitor should tell his client how the fee will be calculated, for example, whether on the basis of an hourly rate plus any mark-up, a percentage of the value of the transaction or a combination of both, or any other proposed basis. The solicitor should tell his client what other reasonably foreseeable payments he may have to make either to his solicitor or to a third party and the stages at which they are likely to be required.”*

- 10. Furthermore, safeguards to ensure transparency of the LLP status of a law firm are included in the Bill to ensure that the public can make an informed choice when engaging the services of a law firm. These safeguards include:

- (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 (section 7AE of the Bill);
- (b) The name must be displayed visibly and legibly at or outside its offices and on its office documents (section 7AF of the Bill);

- (c) An LLP must notify its existing clients in writing within 30 days of the fact that it has become an LLP (section 7AG(1) of the Bill);
 - (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 (section 7AG(4) and (5) of the Bill);
 - (e) An LLP must give 7-day advance notice of its particulars to the Law Society (section 7AD of the Bill);
 - (f) The Law Society keeps a list of LLPs for public inspection free of charge (section 7AJ of the Bill).
11. Pursuant to section 7AG(4) of the Bill, the Law Society will specify the form of the written notice that an LLP sends to its existing clients. It has reviewed some samples from overseas jurisdictions, for example, the one used in Ontario, Canada, which is **attached**. It is likely that the Law Society specified form will adopt a similar approach but tailored appropriately to the standard of liability applicable to Hong Kong.
12. On top of the above requirements, consumers are effectively protected with a statutory professional indemnity scheme which provides indemnity cover of a limit of HK\$10 million per claim as well as any top up indemnity insurance taken up by individual law firms.
13. The Law Society is of the strong view that all these safeguards have balanced the need to give adequate protection to consumers and to allow the modernisation of the legal infrastructure which has been moving at a snail pace to proceed at the speed it deserves to catch up with the global trend.

Distribution of partnership property

14. In its submission dated 6 August 2010, the Law Society has raised its concerns of section 7AI which regulates the distribution of partnership property.
15. At the Bills Committee meeting held on 17 September 2010, the Law Society was requested to elaborate in practical terms how the section will deter practitioners from setting up LLPs.
16. It is submitted that the section is unclear, unreasonably burdensome, and redundant without serving any useful purpose.
17. Section 7AI is unclear for the following reasons:
- (a) Section 7AI(4) provides that “partnership obligation” includes both actual and contingent obligations.

- (b) The meaning of “contingent” is not defined. Practitioners are left to their own judgment in figuring out when an obligation is to be included or excluded in the computation of “partnership obligation” for the purpose of section 7AI.
- (c) There is so much uncertainty surrounding it that practitioners will not be able to know whether they have safely complied with the section or not:
 - (i) How remote an obligation has to be for it to be excluded as a “partnership obligation”?
 - (ii) Will all demands and claims, no matter how frivolous and vexatious they are, have to be taken into account as “partnership obligations” as soon as they are issued?
 - (iii) Once a demand or a claim is made, does the entire amount demanded or claimed have to be counted as partnership obligation even though the amount is out of proportion to the anticipated liability?

18. Section 7AI is unreasonably burdensome for the following reasons:

- (a) Section 7AI is unlimited in time. It creates the prospect of a claim against individual partners in perpetuity, which is not only an unreasonably excessive burden but also an unworkable requirement from the practical perspective of enforcement.
- (b) In reality, meritorious claims will be settled under the Professional Indemnity Scheme. Rarely does a consumer claimant have to resort to the personal assets of the culpable partner, let alone the partnership property because the statutory indemnity limit of HK\$10 million per claim is already sufficient to settle the claim amount.
- (c) However, in valuing “partnership obligation” for the purpose of section 7AI, an LLP is required to artificially include claims which may in fact be covered by the Professional Indemnity Scheme and the firm’s own top up insurance. This unreasonably distorts the amount of surplus available for distribution to partners.
- (d) In a general partnership, there is no regulation on distribution of partnership property. It is claimed by the Administration that section 7AI is included to address the concern of depletion of partnership property in an LLP.
- (e) On the basis of this rationale, the “partnership obligation” in section 7AI should only cover those protected by an LLP. As currently drafted, “partnership obligation” in section 7AI unreasonably includes all obligations, even those for which every partner still personally shoulders unlimited liability.

19. Section 7AI is redundant because, as mentioned in previous submissions, in the event that the firm becomes insolvent and the partners are bankrupt, the Bankruptcy Ordinance will apply. It serves the same purpose of restoring assets that should not have been distributed out.
20. 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).
21. The above drawbacks in connection with the current section 7AI will deter practitioners from considering LLPs because it is not worth subjecting themselves to uncertain and unfair risks of:
 - (a) taking on something with which they have no idea of how to ensure compliance;
 - (b) having to freeze partnership surplus from distribution for no reasonable cause;
 - (c) shouldering in perpetuity the liability of having to return the distributions received.

Definition of “partnership obligation”

22. At its meeting on 17 September 2010, the Bills Committee requested for the views of the Law Society on the definition of “partnership obligation” in the Bill:

““partnership obligation”, in relation to a partnership, means any debt, obligation, liability of the partnership, other than debts, obligations or liabilities of the partners as between themselves, or as between themselves and the partnership;”
23. The definition mainly serves to distinguish between “external” partnership obligations (i.e. those between the partnership and third parties) and “internal” partnership obligations (i.e. those between the firm and the partners and those among partners) and make it clear that LLP protection does not extend to “internal” obligations.
24. The Law Society has no comment on the legislative intent of the definition although from the drafting perspective, it looks superfluous to repeat the term being defined (which is “obligation”) within the definition itself.

25. A possible solution is to amend the definition as follows:

“partnership obligation”, in relation to a partnership, means any debt, obligation **(whether contractual or otherwise)** or liability of the partnership; **owed to any third party by the partnership** other than ~~debts, obligations or liabilities of the partners as between~~ **those arising between the partners** themselves; or as between themselves and the partnership;”

26. Alternatively, as suggested by Mr Paul Tse, the definition can be deleted in its entirety and the term “partnership obligation” be replaced with “partnership liability” whenever it appears in the Bill.

The Law Society of Hong Kong
29 September 2010

DISCLOSURE

By-law 7 contemplates that an existing general partnership may wish to continue as a limited liability partnership. In such case, section 2(1) of By-law 7 requires that the partnership disclose to each person who was a client immediately before the continuance and who remains a client after the continuance the liability of the partners of the limited liability partnership under the *Partnerships Act*.

Firms may choose to publish a notice in a local newspaper as provided in subsection 2(2) of By-law 7. Such notices should be complete and clear enough for clients to understand the nature of the limitation on the liability of the firm. **If the partnership chooses to send a written notice to clients, they are encouraged to design their own communications respecting the disclosure requirement and customize them as they see fit for their particular clients. To the extent that lawyers may find it useful, a sample letter, appearing below, may be considered an example of a communication on disclosure.**

Sample Disclosure Letter for LLPs

Dear (Client):

Effective (date), the firm of ---- has become a limited liability partnership, as permitted by the *Partnerships Act* and the *Law Society Act*. The firm is now known as ----- LLP.

As the name suggests, the partnership carries on the practice of law with a degree of limited liability. The partners in a limited liability partnership are not personally liable for the negligent acts of another partner or an employee who is directly supervised by another partner. Each partner is personally liable for his or her own actions and for the actions of those he or she directly supervises and controls. The partnership continues to be liable for the negligence of its partners, associates and employees, and accordingly there is no reduction or limitation on the liability of the partnership. All of the firm's assets remain at risk.

Liability insurance protection for the lawyers of the partnership continues, and minimum insurance requirements, as required by the *Partnerships Act*, have been established for LLPs by the Law Society. The Law Society has determined that the liability insurance coverage for an LLP is that maintained individually by the partners.

The limitation on liability is the only change to the partnership resulting from the legislative amendments and this change will not affect our firm's relationship with you as a client. We would be happy to answer any questions you have about our limited liability partnership.