Response to Law Society's Submission

At the third Bills Committee meeting of 5 October 2010 ("**BC Meeting**"), the Bills Committee requested the Administration to provide a written response to the Law Society's "Submission to the Bills Committee on LLPs" dated 29 September 2010 ("**Submission**"). Accordingly, we are writing to respond to the various issues highlighted in the Submission below.

Constructive knowledge

2. The proposed section 7AC(3) of the Bill provides as follows –

> "Subsection (1) does not protect a partner from liability if the partner –
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> (a) knew or ought reasonably to have known of the default at the time of its occurrence; and
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> (b) failed to exercise reasonable diligence to prevent its occurrence."

3. The Administration has explained in paragraphs 16 to 18 of our Paper, LC Paper No. CB(2)2233/09-10(02), our concerns over the Law Society's proposal to replace the proposed section 7AC(3) of the Bill with the following ("**Revised section 7AC(3)**") –

> "Subsection (1) does not operate to protect a partner from liability
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> (a) where the partner knew of the default at the time it was committed and failed to take responsible steps to prevent its commission; or
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> (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
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>   (ii) the partner failed to provide such adequate and competent supervision as would normally be expected of a partner in those circumstances."

4. In the Submission, the Law Society stated its view that the Revised section 7AC(3) coupled with the following would be sufficient to address the Administration's concerns –

(a) The following current principles in the Hong Kong Solicitors' Guide to Professional Conduct, Volume 1 ("**Conduct Guide**"):
   i. Commentaries 1 and 2 under Principle 5.17[1] ;
   ii. Commentary 1, Principle 4.10[2] ;
   iii. Principle 5.03[3] ;
   iv. Principle 5.12[4] ;
   v. Commentaries 3 and 5 of Principle 5.12[5] ;
   vi. Commentary 1 of Principle 4.01[6];
   vii. Principle 4.03[7] .

(b) The requirements in the proposed sections 7AE, 7AF, 7AG(1), 7AG(4) and (5), 7AD, and 7AJ of the Bill.[8]

(c) The current statutory professional indemnity scheme which provides indemnity cover up to HK$ 10 million per claim and any top up insurance taken out by an individual firm.[9]

5. A key policy intent of the Bill is to strike a suitable balance between protecting innocent LLP partners on the one hand and consumers of legal services on the other hand. The proposal for the Revised section 7AC(3) will deny consumers the right to pursue against LLP partners who are not "innocent" in the sense that they ought reasonably to have known of a default by other members of his firm but failed to exercise reasonable diligence to prevent its occurrence. As such, the Revised section 7AC(3) should be considered carefully based on the policy intent as outlined above.

6. The principles of the Conduct Guide as mentioned in paragraph 4(a) above (with the exception of the Law Society's latest proposal to make Commentaries 1 and 2 under Principle 5.17 mandatory) [10] and the statutory professional indemnity scheme as mentioned in paragraph 4(c) above are existing requirements for

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[1] see paragraphs 4 to 6 of the Submission for details. It should be noted that the Law Society is also proposing to make the requirements in these commentaries mandatory for solicitors operating as LLPs.

[2] see paragraph 7 of the Submission.

[3] see paragraph 9(a) of the Submission.

[4] see paragraph 9(b) of the Submission.

[5] see paragraph 9(c) of the Submission.

[6] see paragraph 9(d) of the Submission.

[7] see paragraph 9(e) of the Submission.

[8] see paragraph 10 of the Submission.

[9] see paragraph 12 of the Submission.

[10] see paragraph 7 below.

solicitors. They are not additional measures targeted for consumer protection in relation to LLPs. The proposed sections of the Bill as mentioned in paragraph 4(b) above are existing provisions in the Bill (principally to ensure that a consumer is aware that the firm he engages is an LLP) in its current form. In other words, all the provisions as mentioned in paragraph 4 are not additional safeguards for consumer protection to justify removing the constructive knowledge element from the proposed section 7AC(3)(a) of the Bill.

7. That said, the Administration welcomes the Law Society's latest proposal to make the obligations in Commentaries 1 and 2 under Principle 5.17 of the Conduct Guide (as referred to in paragraph 4(a)(i) above) mandatory for solicitor firms operating as LLPs. That will help avoid the possibility that no partner can be identified as being responsible for a case. However, as we indicated at the third BC Meeting, we would like to clarify and discuss with the Law Society on a number of issues before we can reach any specific conclusion on its proposal. In particular, we would like to discuss with the Law Society about the possibility of developing its proposal regarding Commentaries 1 and 2 under Principle 5.17 of the Conduct Guide into more concrete measures, such as requiring an LLP to provide a prior written notification confirming the identities of its responsible handling solicitor and supervising partner before it accepts instructions from a client.

8. In this respect, we have met with the Law Society to discuss, among others, about the issues mentioned in paragraph 7 above on 16 November 2010. At the meeting, the Law Society was receptive to the proposal of an LLP providing a written notification to its client confirming the identity of its responsible supervising partner in respect of each matter/case the firm handles. The Administration and the Law Society would require more time to discuss on certain related issues on the proposal, including in particular, the consequences of failing to issue the notice. The Administration will continue to keep the Bills Committee informed of any further progress on this issue.

Distribution of Partnership Property

9. In the Submission, the Law Society expressed the views that "*Section 7AI is "unclear"*" [11] by reason that "*[t]he meaning of "contingent" is not defined*" in the Bill, and that "*Practitioners are left to their own judgment in figuring out when an obligation is to be included*

[11] paragraph 17 of the Submission.

or excluded in the computation of "partnership obligation" for the purpose of section 7AI".[12]

10. In connection with the above, we have set out our comments in paragraphs 10 to 15 of our Paper, "Policy intent on distribution of partnership property under the proposed section 7AI".

11. In the Submission, the Law Society also raised the following questions which, according to the Law Society, would hinder practitioners from knowing whether they have safely complied with the proposed section 7AI –

> "(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?"[13]

12. In connection with the above, we have explained in paragraph 5 of our Paper, "Policy intent on distribution of partnership property under the proposed section 7AI" that the proposed section 7AI does not prohibit a distribution from being made, and that it is entirely the LLP's decision and judgment whether or not it should make a distribution to its partners where it has (i) a remote obligation; (ii) a frivolous and vexatious claim against it; and/or (iii) a claim, the amount that is out of proportion to the anticipated liability. Proposed section 7AI is more lenient than various Canadian precedents in that, under the Canadian precedents, a partner who authorises a distribution of partnership assets while the LLP is insolvent will be liable for the assets distributed if they cannot be recovered from the partner who receives the assets.[14]

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12 paragraph 17(b) of the Submission.

13 paragraph 17(c) of the Submission.

14 Relevant sections in the Partnership Acts of the jurisdictions concerned are as follows -
British Columbia, s.113(2)
Manitoba, s.86(2)
Nova Scotia, s.68(2)
Newfoundland & Labrador, s.53(2)
Saskatchewan, s.84(2)

13. In the Submission, the Law Society also expressed the view that *"Section 7AI is unreasonably burdensome"* [15] based on the following reasons –

(a) *"Section 7AI is unlimited in time"*[16].

(b) *"statutory indemnity limit of HK$ 10 million per claim is already sufficient to settle the claim amount"*[17].

(c) *"This [requirement of Section 7AI] unreasonably distorts the amount of surplus available for distribution to partners"*[18].

(d) *"In a general partnership, there is no regulation on distribution of partnership property"*[19].

14. We would like to respond to the Law Society's comments in paragraph 13 above in the following –

(a) In response to the request made by the Law Society on this issue, the Administration would propose a limitation period of 2 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). The Administration considers this proposal apt to balance the conflicting needs of protecting innocent LLP partners and consumers.

(b) Whether or not the existing statutory professional insurance indemnity of HK$ 10 million per claim is appropriate for LLPs is still being examined by the Bills Committee. Furthermore, as acknowledged at the AJLS meeting of 25 May 2009, professional insurance scheme is a complicated issue which should be considered in a separate context.[20]

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15 paragraph 18 of the Submission.

16 paragraph 18(a) of the Submission.

17 paragraph 18(b) of the Submission.

18 paragraph 18(c) of the Submission

19 paragraph 18(d) of the Submission

20 paragraph 12 (c) of the minutes of meeting of the Panel on Administration of Justice and Legal Services of 25 May 2009. For Members' background information –

(a) In Canada, the Rules of the Law Society of Alberta, in Rule 159.4, and Manitoba Law Society Rules, in Rule 3-48, contain special requirements for LLPs.

(b) Under the (UK) Solicitors' Indemnity Insurance Rules 2009 and the Minimum Terms and Conditions, LLPs (as recognised bodies) are required to obtain cover complying with the

(c) As explained in paragraph 5 of our Paper, "Policy intent on distribution of partnership property under the proposed section 7AI", there is no restriction in the proposed section 7AI of the Bill against distributions by an LLP.

(d) We have pointed out in paragraph 20 of our Paper, "Policy intent on distribution of partnership property under the proposed section 7AI" that since all partners of a general partnership are personally liable for all debts and obligations of the firm under section 11 of the Partnership Ordinance (Cap. 38), there is no need to put in place a regulation on distribution of partnership property for general partnerships.

15. In the Submission, the Law Society expressed the view that *"Section 7AI is redundant because .. 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"*[21]. It also mentioned that *"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)."*[22]

16. The Bankruptcy Ordinance (Cap. 6) ("**BO**") provides the following –

(a) that in respect of a transaction which is at an undervalue entered into by a debtor[23] (who is later adjudged bankrupt) within 5 years before presentation of the bankruptcy petition against him[24], the court can make an order to restore the position to what it would have been without the transaction[25].

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minimum terms and conditions and with a sum insured of £3 million, rather than £2 million for other Firms.

(c) In Singapore, the insurance cover required for a solicitor in an LLP firm is twice the amount of that practising in general partnership. In addition, the LLP firm needs to take out insurance for itself. (s.4(1)(ba) & (d) of the Legal Profession (Professional Indemnity Insurance) Rules (Singapore))

[21] paragraph 19 of the Submission.
[22] paragraph 20 of the Submission.
[23] section 49(1) of the Bankruptcy Ordinance.
[24] section 51(a) of the Bankruptcy Ordinance.
[25] section 49(2) of the Bankruptcy Ordinance.

(b) that where a debtor (who is later adjudged bankrupt), has within 2 years before presentation of the bankruptcy petition against him[26] given an unfair preference (which is not a transaction at an undervalue) to a person who is an associate of the debtor[27], the court can make an order to restore the position to what it would have been had the debtor not given the unfair preference[28].

17. Subject to the Law Society's further clarification, the Administration does not agree that the provisions against unfair preferences or transactions at an undervalue in the BO can achieve the objective of the proposed section 7AI for the following reasons –

(a) Under section 50(3) of the BO[29], a bankrupt debtor gives an unfair preference to a person if that person is one of the **debtor's creditors** or a **surety** or **guarantor** for any of his debts or other liabilities. It is clear that a partner having received property from an LLP is not a "person" that would trigger the operation of section 50(3).

(b) Under section 49(3) of the BO[30], a "transaction at an undervalue" involves passing of property by a bankrupt debtor to another person for no or undervalued consideration. Distributing partnership assets and profits to partners does not fall within sub-paragraphs (a), (b) or (c) of section 49(3) and thus is not a "transaction at an undervalue".

18. By reasons as explained in paragraph 17 above, we do not consider the proposed section 7AI redundant. Instead, given the

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26 section 51(1)(b) of the Bankruptcy Ordinance.

27 section 51(1)(b) of the Bankruptcy Ordinance.

28 sections 50(1) and (2) of the Bankruptcy Ordinance.

29 Under section 50(3) of the BO, a debtor gives an unfair preference to a person if (a) that person is one of the debtor's creditors or a surety or guarantor for any of his debts or other liabilities; and (b) the debtor does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the debtor's bankruptcy, will be better than the position he would have been in if that thing had not been done.

30 Section 49(3) of the BO provides:
"For the purposes of this section and sections 51 and 51A, a debtor enters into a transaction with a person at an undervalue if –
(a) he makes a gift to that person or he otherwise enters into a transaction with that person on terms that provide for him to receive no consideration;
(b) he enters into a transaction with that person in consideration of marriage; or
(c) he enters into a transaction with that person for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the debtor."

inadequacy of the BO provisions for such purpose, we consider the proposed section 7AI necessary for consumer protection.

Partnership Obligation

19. Paragraph 26 of the Submission suggests the definition of "partnership obligation" can be deleted. The Administration does not agree for the following reasons –

(a) We have explained in the Administration's Response on "partnership obligation" and "debts, obligations and liabilities" (LC Paper No. CB(2)2233/09-10(01)) that the proposed Part IIAAA operates against the background of the Partnership Ordinance (Cap. 38) and that the existing sections 11 to 14 of the Partnership Ordinance use those three terms. If the proposed Part IIAAA only protects an innocent partner from "partnership obligations" without defining that term to mean not just "obligations" but also "debts" and "liabilities", doubts will arise as to whether the protection given to an "innocent" partner cover "debts" and "liabilities".

(b) As noted by the Law Society (paragraph 23 of the Submission), the definition of "partnership obligation" in the Bill serves to distinguish debts, obligations and liabilities that are *external* from those that are *internal*, and makes it clear that a reference to "partnership obligation" does not extend to the internal debts, obligations and liabilities. If the definition were deleted, problems of interpretation may arise. For example, there may be disputes as to whether *internal* debts, obligations and liabilities are relevant in assessing a partnership's solvency under the proposed section 7AI.

20. Paragraph 24 of the Submission states that it looks superfluous to repeat "obligation" within the definition itself. The Administration considers it necessary to repeat "obligation" in the definition. The reasons are as follows –

(a) The definition of "partnership obligation" in our Bill is the same as that in the *Model Limited Liability Partnership Act* adopted and recommended by the Uniform Law Conference

of Canada[31]. Some Canadian jurisdictions have adopted the same definition.[32]

(b) If the defined term were "obligation" alone, the reference to "obligation" may be omitted and the definition may read – "obligation" includes debt and liability.

(c) However, in the Bill, the term defined is "partnership obligation", *not* "obligation" alone. The definition is to make it clear that "partnership obligation" does *not* cover obligations, debts or liabilities that are *internal*. In order to achieve this purpose, the definition says what "partnership obligation" means, instead of saying what "partnership obligation" includes. Given that the word "means" is used, it would be wrong to omit the reference to "obligation" from the definition. The policy intent is that "partnership obligation" means debt, obligation or liability that is external.[33]

21. Paragraph 25 of the Submission proposes an alternative definition as a "solution" to the alleged "problem" –

> "partnership obligation" (合夥義務), 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~~ those arising between the partners ~~of the partners as between~~ themselves, or as between themselves and the partnership;

22. The Administration has the following observations on the alternative definition –

(a) It is not clear how the alternative definition is a "solution" to the alleged "problem". Still, the alternative definition includes "obligation".

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31 The work of the Uniform Law Conference of Canada is done by delegates appointed by member governments (i.e. the various provincial and territorial governments of Canada). The ULCC considers areas in which provincial and territorial laws would benefit from harmonization and adopts or recommends model laws for the member governments.

32 For example, section 94 of the *Partnership Act of British Columbia*, Canada and section 102.1 of the *Partnership Act of the Northwest Territories*, Canada.

33 For a discussion on the function of definitions, see G.C. Thornton, Legislative Drafting (4th Edition), pages 145 - 147.

(b) It is not clear why "(whether contractual or otherwise)" is added. Since the bracketed phrase is added after "obligation", it is not clear whether the bracketed phrase is intended not to apply to "liability".

(c) Introducing the term "third party" seems to be an attempt to shorten the definition, but the meaning of "third party" is not clear –

(i) It seems that the reference to "third party" is intended to convey the idea of *external* debts, obligations and liabilities.

(ii) However, as if the drafter is unsure that "third party" conveys clearly the "external" sense, the drafter retains "other than those arising between the partners themselves or as between themselves and the partnership".

(iii) But if "third party" means a party that is neither "the partners" nor the partnership, the passage beginning with "other than" is superfluous.

(iv) With the passage beginning with "other than" retained, the reader may be puzzled as to what is meant by "third party" and what the alternative definition as a whole means.

Department of Justice
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