

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

**Policy intent on distribution of partnership property
under the proposed section 7AI**

On 29 September 2010, the Law Society submitted a paper to the Bills Committee (LC Paper No. CB(2)2328/09-10(01)) incorporating, among others, its comments on the proposed section 7AI of the Bill (“**Submission**”).

2. At the Bills Committee meeting held on 5 October 2010, the Administration has, in response to the relevant comments of the Law Society in its Submission, explained the policy intent of the proposed section 7AI. This paper recapitulates (and where appropriate, elaborates on) our explanations on the policy intent of the proposed section 7AI at the meeting and to discuss the practical implications of the proposed section on solicitors’ practice.

Pragmatic Approach of the Bill on Distributions to LLP Partners

3. A key feature of the Bill is its pragmatic approach in balancing the practical needs of an LLP to make distributions to its partners in proper circumstances on the one hand and consumer protection on the other.

4. With regard to distributions by an LLP in similar circumstances as described in the proposed section 7AI, it is noted that many overseas jurisdictions have adopted a more restrictive approach and prohibit an LLP from making any distribution under similar circumstances (please refer to the **Annex** attached to this paper for the relevant provisions in such overseas jurisdictions). In this regard, we do not consider it conducive to the development of LLPs in Hong Kong to adopt such a restrictive approach on all LLPs generally and understand the practical needs of LLPs to make distributions to their partners in proper circumstances. The Administration has therefore adopted a pragmatic approach by providing flexibility and autonomy for each individual LLP to decide for itself whether or not it should make a distribution to its partners and not to seek a general prohibition against distributions by LLPs in the circumstances prescribed in the proposed section 7AI(1)(a) and (b) of the Bill.

5. Hence, contrary to the suggestion made by the Law Society in its Submission that the proposed section 7AI would “freeze partnership surplus from distribution for no reasonable cause”¹, the Bill does not prohibit distributions by LLPs in general. It remains for an LLP itself to judge whether, in a given circumstance, it would like to make a distribution to its partners after taking into account all relevant considerations including those set out in paragraphs 17(c)² and 18(c)³ of the Law Society’s Submission. It should be noted that the proposed section 7AI does not prohibit a distribution from being made. It is entirely an 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. Similarly, if there is a well-founded claim against an LLP, it would be entitled to decide and judge for itself whether or not it should make a distribution by reference to its insurance coverage under the Professional Indemnity Scheme and any additional top up insurance it may have at the time.

6. In providing LLPs with the autonomy as described above, however, it is also necessary to provide appropriate checks and balances against irresponsible distributions for consumer protection purposes. Accordingly, the proposed sections 7AI(1) and (2) provide as follows:

- “(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).

¹ Paragraph 21(b) of the Submission.

² Namely:
“(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 anticipated liability?”

³ Namely:
“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.”

- (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.”

7. In sum, the proposed section 7AI provides that if the liquidity test under sub-section 7AI(1)(a) or the solvency test under sub-section 7AI(1)(b) is not met after an LLP has distributed its property to a partner or an assignee, the partner or assignee is liable to return an amount equivalent to the whole or part of the value of the property received in accordance with the rules set out in the proposed section 7AI(2).

8. It should further be noted that, as provided in sub-section (5), the proposed section 7AI does not affect a payment made as reasonable compensation for current services provided by a partner to the LLP, to the extent that the payment would be reasonable if paid to a person who is an employee, but not a partner in, the LLP as compensation for similar services.

9. For reasons as explained above, we consider the policy of the Bill regarding distributions to LLP partners pragmatic and less restrictive than many other overseas jurisdictions, and we do not agree with the Law Society’s submission that the proposed section 7AI is “unreasonably burdensome”⁴ for LLPs.

Contingent Obligation under the Proposed Section 7AI(4)

10. The proposed section 7AI(4) of the Bill provides:

“In this section, a reference to partnership obligation is a reference to partnership obligation⁵ (whether actual or contingent).” [emphasis added.]

⁴ Para 16 of the Submission.

⁵ Under the proposed section 7AA of the Bill, “partnership obligation” is defined as “in relation to a partnership, ...any debt, obligation or liability of the partnership, other than debts, obligations or liabilities of the partners as between themselves, or as between themselves and the partnership”.

11. In this respect, the Law Society has commented in its Submission that the proposed “*section 7AI is unclear*”⁶ by reason that “[t]he meaning of “contingent” is not defined” in the Bill, and that “[p]ractitioners 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.”⁷

12. The Administration does not share the view of the Law Society and considers that the word “contingent” is commonly found in our legislation and its meaning is sufficiently clear to legal practitioners. For example, in the *Black’s Law Dictionary*⁸, “contingent liability” is defined as:

“A liability that will occur only if a specific event happens; a liability that depends on the occurrence of a future and uncertain event. In financial statements, contingent liabilities are usu. stated in footnotes.”⁹

13. A test similar to that in the proposed section 7AI is also found in section 123 of the *Insolvency Act 1986 (UK)* which also contains the term “contingent liabilities”. Section 123 of the *Insolvency Act 1986 (UK)* is extracted below -

“123. Definition of inability to pay debts.

— (1) A company is deemed unable to pay its debts—

..

(e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.

(2) A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company’s assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.”

14. Furthermore, there are other Ordinances in Hong Kong containing references to similar terms, such as “contingent liabilities” or “contingent liability” without providing specific definitions for them and there does not appear to have caused any difficulties in practice. For

⁶ Para 17 of the Submission.

⁷ Para. 17(b) of the Submission.

⁸ Ninth Edition, West (Thomson Reuters), 2009.

⁹ *Ibid*, at 997.

example, in the Third Schedule of the *Insurance Companies Ordinance* (Cap. 41), the term “provision” is defined as follows and the term “contingent liabilities” therein is not defined in Cap. 41:

“ ... any amount written off or retained by way of providing for depreciation, amortization, renewals or diminution in value of assets or retained by way of providing for any known liability, including liabilities in respect of expenditure contracted for and all disputed or contingent liabilities, the amount of which cannot be determined with substantial accuracy”. [Emphasis added.]

15. In fact, the term “contingent” is also used in the proposed section 7AK(1)¹⁰ of the Bill without any apparent difficulty.

Implications of the introduction of LLP and the proposed section 7AI on Solicitors’ Practice – liability of partners (general partnerships vs. LLPs)

16. Innocent partners of an LLP are not, solely by reason of being a partner, liable for the default of other members of the LLP¹¹. This provides significant protection for innocent partners when comparing to present solicitor practices where all partners are jointly and severally liable for all partnership obligations. However, from the perspective of a client, it means that the personal assets of innocent partners of an LLP would be ring-fenced against claims made against the firm and its other members by clients. Thus, it is necessary to balance the needs to protect innocent LLP partners on the one hand and consumers on the other hand, and the exercise is a delicate one. The proposed section 7AI aims to provide the correct balance. It provides autonomy for an LLP to make its own decision whether or not to make a distribution in

¹⁰ The proposed section 7AK(1) provides, among others, as follow:

“The fact that a partnership becomes, or ceases to be, a limited liability partnership-

....

(b) does not affect any of the rights and liabilities (whether actual or contingent) of the partnership, or of any person as a partner, that have been acquired, accrued or incurred before the partnership becomes, or ceases to be, a limited liability partnership.” [Emphasis added.]

¹¹ The proposed section 7AC(1) provides:

“..., a partner in a limited liability partnership is not, solely by reason of being a partner, jointly or severally liable for any partnership obligation (whether founded on tort, contract or otherwise) that arises from a default of any other partner in the partnership, or of an employee, agent or representative of the partnership, in the course of the business of the partnership as a limited liability partnership.”

any given circumstance while preserving the LLP's assets against irresponsible distributions to frustrate client's claim by requiring such distributions be clawed back to the firm's asset pool under certain circumstances¹².

17. The following example, which compares a general partnership with an LLP in meeting partnership liabilities arising from a default, explains how the proposed section 7AI would apply in practice.

Liability of partners in a general partnership solicitors' firm

18. Currently if a claim against the default of a partner in the course of the business of a general partnership solicitors' firm is substantiated, the claim amount will first be settled under the Professional Indemnity Scheme ("PIS"), which currently has a statutory indemnity limit of \$10 million in respect of any one claim.¹³ The liability of any remaining claim amount not covered by the PIS will be borne by the solicitors' firm and all partners in the partnership.

19. The above indemnity arrangement may be illustrated by using a general partnership solicitors' firm with, say, 5 partners as an example. If the default of one of its partners resulted in an actual liability, e.g., a judgment debt of \$20 million against all partners trading as the firm, the first \$10 million would be covered by the PIS. If there is money in the account of the firm, say, \$5 million, that amount of money would also be used to satisfy the claim. The burden of discharging the remaining judgment debt of \$5 million would fall on the 5 partners as they are jointly and severally liable for the judgment debt obtained against the firm.

20. In para 18(d) of its Submission, the Law Society argues that the proposed section 7AI is "*unreasonably burdensome*" because "*[i]n a general partnership, there is no regulation on distribution of partnership property.*" Paragraphs 18 and 19 above explain why regulation on distribution of partnership property is not necessary for a general partnership, as all partners of which are personally liable for all debts and

¹² See the proposed section 7AI (1) and (2) of the Bill.

¹³ See paragraph 2(1) of Schedule 3 of the *Solicitors (Professional Indemnity) Rules* (Cap. 159, sub. leg. M).

obligations of the firm under section 11 of the Partnership Ordinance (Cap. 38).

Liability of partners in an LLP solicitors' firm

21. If the solicitors' firm in the above example is an LLP, the judgment debt of \$20 million would be imposed against the LLP and the defaulting partner. The first \$10 million of the judgment debt would still be covered by the PIS, followed by \$5 million from the account of the LLP. The defaulting LLP partner would be the only person personally liable to discharge the remaining \$5 million due to the claimant, and the 4 innocent partners would not be personally liable for the judgment debt.¹⁴

22. However, if the LLP is unable to pay its partnership obligations as they become due (or the value of the remaining partnership property would be less than the partnership obligations) as a consequence of a distribution to the 4 innocent partners (who are given LLP protection), the distribution made to them shall be liable to be clawed back in the circumstances stated in the proposed section 7AI(1) and (2).

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¹⁴ See the proposed section 7AC(1) in n11 above.

**Extracts of overseas LLP statutes containing provisions
prohibiting distribution of partnership property from an LLP**

1. United States – California - California Corporations Code

Section 16957(a)

“*No distribution shall be made* by a registered limited liability partnership if, after giving effect to the distribution:

- (1) The registered limited liability partnership would not be able to pay its debts as they become due in the usual course of business.
- (2) The registered limited liability partnership's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the registered limited liability partnership were to be dissolved at the time of the distribution, to satisfy the preferential rights of other partners upon dissolution that are superior to the rights of the partners receiving the distribution.”

[Emphasis added]

Section 16957(c)

“A distribution for purposes of this section means the transfer of money or property by a registered limited liability partnership to its partners without consideration.”

2. Canada – British Columbia – *British Columbia Partnership Act*

Section 94

“In this Part: ...

“**distribution**” means a transfer by a partnership of some or all of the partnership property to a partner or to an assignee of a partner's share in the partnership;

...”

Section 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.”

[Emphasis added]

Section 112(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.”

Section 112(3)

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

Section 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.”

Section 113(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.”

Section 113(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.”

3. Canada – Manitoba – Manitoba Partnership Act

Section 67

“In this Part,

"distribution", in relation to partnership property, means a transfer of money or other partnership property by a partnership to a partner or an assignee of a partner's share in the partnership, whether as a share of profits, return of contributions to capital, repayment of advances or otherwise; ...”

Section 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.” [Emphasis added]

Section 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.”[Emphasis added]

Section 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.”

Section 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.”

Section 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.”

Section 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.”

Section 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.”

Section 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.”

4. Canada –Saskatchewan – Saskatchewan Partnership Act

Section 78

“In this Part:

- (a) “**distribution**” means, in relation to the partnership property, a transfer of money or other partnership property by a partnership to a partner or an assignee of a partner’s share in the partnership, whether as a share of profits, return of contributions to capital, repayment of advances or otherwise; ...”

Section 83(1)

“A limited liability partnership *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.” [Emphasis added]

Section 83(2)

“In circumstances other than in connection with the winding up of its affairs, a limited liability partnership *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.”[Emphasis added]

Section 83(3)

“Subsection (1) does not prohibit a payment on account of any partnership obligation where a partner receives a prorated payment with all other creditors of the same class of the limited liability partnership.”

Section 83(4)

“Subsections (1) and (2) do not prohibit a payment made as reasonable compensation for current services provided by a partner to the limited liability 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.”

Section 83(5)

“A 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.”

Section 84(1)

“A partner in a limited liability partnership who receives a distribution contrary to section 83 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 partnership obligations that existed at the time of the distribution.”

Section 84(2)

“Any partners in a limited liability partnership who authorize a distribution contrary to section 83 are jointly and severally liable to the partnership for any amount for which a recipient is liable pursuant to subsection (1), to the extent that the amount is not recovered from the recipient.”

Section 84(3)

“Proceedings to enforce a liability pursuant to this section may be brought by the 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.”