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**Report of the Bills Committee on
Legal Practitioners (Amendment) Bill 2010**

Purpose

This paper reports on the deliberations of the Bills Committee on Legal Practitioners (Amendment) Bill 2010 ("the Bill").

Background

2. Under the Partnership Ordinance (Cap. 38), every partner in a solicitor firm is liable jointly and severally with other partners for all debts, liabilities and obligations of the firm incurred while he is a partner, including those arising from any wrongful act or omission of other partners of the firm. Since 2004, The Law Society of Hong Kong ("LS") has called for an early introduction of limited liability partnership ("LLP"). An LLP is an alternative form of business model which confers limited liability on the innocent partners so as to save their personal assets from claims arising from the default of other partners of the LLP in the course of its business.

The Bill

3. The Bill seeks to add a new Part, i.e. Part IIAAA, to the Legal Practitioners Ordinance (Cap. 159) ("the Ordinance") to introduce LLP for solicitors' practices in Hong Kong. The main provisions of the Bill are as follows:

- (a) proposed section 7AB sets out the meaning of an LLP;
- (b) proposed section 7AC varies the rule for law firms which are LLPs. A partner of an LLP will not, solely by reason of being a partner, be jointly or severally liable for any partnership obligation, whether founded on tort, contract or other areas of the law, arising from a default of any other

partner, employee, agent or representative of the LLP in the course of its business. The protection afforded to a partner of LLP is subject to conditions. First, the partner did not have actual or constructive knowledge of the default giving rise to the liability at the time of its occurrence. If the partner had actual or constructive knowledge of the default at the time of its occurrence, he must have exercised reasonable diligence to prevent its occurrence. Second, the cause of action must have accrued when the partnership was an LLP and the client had actual or constructive knowledge of the fact that the partnership was an LLP at that time;

- (c) proposed sections 7AD to 7AH set out the procedural requirements for establishing LLP. LS must be notified in writing at least seven days before the establishment of an LLP. Existing clients must be notified within 30 days in writing in a form to be specified by LS. The name of an LLP must contain the words "有限責任合夥" if it is in Chinese, and the words "Limited Liability Partnership" or the abbreviation "LLP" or "L.L.P." if it is in English. That name must be displayed at every place of business of the partnership and stated in its correspondences, notices, publications, invoices and bills of costs, and on its websites;
- (d) proposed section 7AI provides that distribution of partnership property of an LLP to a partner or an assignee of a partner's share will make that partner or assignee liable to the LLP in the manner and extent as specified in section 7AI(2) if, as a result of the distribution, the LLP would be unable to pay its obligations as they become due, or the value of the remaining partnership property would be less than its obligations;
- (e) proposed section 7AJ requires that the Council of LS must keep a list of LLPs and to make the relevant information available for public inspection;
- (f) proposed section 7AK states that a partnership's existence as a partnership (subject to any contrary agreement between partners), and the pre-existing rights and liabilities of the partnership and of its partners, will not be affected by the fact that it becomes, or ceases to be an LLP;

- (g) proposed section 7AL further states that the new Part IIAAA prevails over inconsistent provisions in the partnership agreement; and
 - (h) proposed section 7AM stipulates that any relevant laws applicable to a general partnership, except in so far as it is inconsistent with the new Part IIAAA, remains applicable to an LLP. The rules at common law, e.g. vicarious liability, agency and the tort of negligence, are not changed.
4. The Bill also seeks to:
- (a) amend section 73 of the Ordinance to empower the Council of LS to make rules respecting the practice of LLPs for giving full effect to the new Part IIAAA; and
 - (b) make a consequential amendment to the Summary Disposal of Complaints (Solicitors) Rules (Cap. 159 sub. leg. AD) so that a complaint against a breach of any requirement in the proposed sections 7AD to 7AF and sections 7AG(1) and (2) may be submitted to the Tribunal Convenor of the Solicitors Disciplinary Tribunal Panel for disposal under the summary procedure provided by those Rules.
5. If enacted, the Bill is to come into operation on a date to be appointed by the Secretary for Justice by notice published in the Gazette.

The Bills Committee

6. At the House Committee meeting held on 2 July 2010, Members agreed to form a Bills Committee to study the Bill. Under the chairmanship of Dr Hon Margaret NG, the Bills Committee has held 16 meetings. The membership list of the Bills Committee is in **Appendix I**. The Bills Committee has also invited views from the Hong Kong Bar Association, LS, the American Chamber of Commerce in Hong Kong and the Consumer Council.

Deliberations of the Bills Committee

Proposed section 7AA - Definitions

7. The definition of "partnership obligation" ("合夥義務"), provided under the proposed section 7AA(1), stipulates that "in relation to a partnership, means 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". Hon Audrey EU has raised concern about including the term "obligation" ("義務") in the definition of "partnership obligation" as this would have the connotation of including obligations other than debts and legal liabilities of the partnership.

8. The Administration has explained that the term "obligation" ("義務") refers to in the definition of "partnership obligation" under the proposed section 7AA(1) means things which a person is legally bound to do rather than things which a person is morally obliged to do. The Administration has pointed out that the object of LLP is to protect innocent partners from personal liability arising from default of another partner of the firm and that liability of partners is provided for in the Partnership Ordinance. Therefore, the definition of "partnership obligation" in the proposed section 7AA(1) is drafted, bearing in mind the wording of the Partnership Ordinance. Section 11 of the Partnership Ordinance provides that "Every partner in a firm is liable jointly with the other partners for all debts and obligations of the firm incurred while he is a partner;.....". As the term "obligation" ("義務") is referred to in section 11 of the Partnership Ordinance, it is necessary to include that term in the definition of "partnership obligation" accordingly.

9. The Administration has further pointed out that the use of "義務" as the Chinese rendition for "obligation" under the Bill is for consistency across the statute book. "Obligation" is rendered as "義務" in the Partnership Ordinance, Limited Partnerships Ordinance (Cap. 37), and in numerous other Ordinances and subsidiary legislation. Section 11 of the Partnership Ordinance, containing "義務" as the Chinese rendition, was quoted in judgements of the Court of Appeal, High Court and District Court and thus is familiar to the courts. The use of "義務" as meaning what is legally binding is also supported by the dictionary. Such usage has also been adopted in legislation on partnership in the People's Republic of China and national laws that apply to Hong Kong.

10. Members note that as the Administration will move Committee Stage amendments ("CSAs") to replace "in the course of the business of the partnership as" referred to in the proposed section 7AC(1) with "from the provision of professional service" to make clear that an innocent partner will be protected against personal liability for the default of other members of the firm from the provision of professional service and not from other ordinary trading debts such as rent and employees' salaries arising in the course of the business of the partnership, the Administration will move CSA to delete the definition of "business" (業務) from the proposed section 7AA(1), so as to better reflect the Administration's policy intent that the Bill offers partial liability shield.

11. LS does not agree to the deletion of the definition of "business" under the proposed section 7AA(1) and the replacement of "business" with "professional service" under the proposed new section 7AC(1), as "professional service" has a narrower meaning than "business". LS has pointed out that in their previous discussion with the Administration during the formulation of the Bill two or three years ago, it was agreed that protection to an innocent partner against personal liability for the default of other members of the firm in the course of business of the partnership should be adopted to avoid any doubt that if a partner was not negligent, protection should be afforded to that partner.

12. According to Dr Hon Margaret NG's understanding of the policy intent of the Administration, the LLP protection shall protect innocent partners for other members' professional default but they remain to be jointly and severally liable for the firm's ordinary business obligations such as staff's salaries and rent of firm. Dr NG is of the view that the policy intent is clear and the Bills Committee has raised no objection to it.

13. Members note that the Administration will also move CSAs to:

- (a) delete the definition of "client" (客戶), provided under the proposed section 7AA(1), as members consider applicable the definition of "client" (當事人) in section 2 of the Ordinance and the definition of "existing client" (現有當事人) is provided under the proposed amended section 7AG(6);
- (b) add a definition of "distribution" (分發) under the proposed section 7AA(1) to mean, in relation to partnership property, a transfer of money or other partnership property by a partnership to a partner, whether as a share of profits, return of contributions to capital, repayment of advances or

otherwise;

- (c) amend the definition of "limited liability partnership" (有限責任合夥) in the proposed section 7AA to exclude that definition from applying to the reference to LLP in a foreign jurisdiction in the proposed section 7AG(3). The reason for this amendment is to tally with the proposed amendments to section 7AG(3), at LS' request, to substitute "partnership with limited liabilities" with "limited liability partnership"; and
- (d) amend the Chinese rendition of the definition of "limited liability partnership" from "有限責任合夥" to "有限法律責任合夥".

Proposed section 7AC - Effect on liabilities of partners in limited liability partnership

Full or partial liability shield under LLPs

14. Members note the concern raised by LS and the American Chamber of Commerce in Hong Kong that the liability shield under the Bill should be broadened to cover ordinary commercial debts of LLPs, i.e. full liability, as in the case of many overseas jurisdictions including the United Kingdom ("UK"), India, Singapore and the New York State of the United States ("US"). LS has pointed out that as it is common for law firms to use service companies to carry out administrative functions such as employment of staff, the introduction of LLPs is a convenient opportunity to simplify the artificial structure of routing the engagement of administrative services through service companies. LS also considers that as legislation had already been enacted in 1997 to permit solicitors' firms to operate with full limited liability by means of solicitor corporations, the same level of liability protection should also be provided to solicitor partners under the LLP model.

15. The Administration maintains its views that LLP partners should continue to be held liable for ordinary debts of their business, i.e. partial liability shield, such as rent and salaries as they are not unforeseeable debts over which LLP partners have no control as in the case of claims incurred by negligence of other partners. The Administration is also of the view that as law firms are free to choose between the different types of business vehicles, solicitors who wish to enjoy full shield from general liabilities of the firm may opt to practise in the form of a solicitor corporation. To reinforce this, the Administration will propose a CSA

to amend section 7AC(1) to specify that LLP protection for innocent partners under the Bill will only extend to cover partnership obligations that arise from the provision of professional service by the partnership as a result of the default of the other members of the partnership.

The proposed section 7AC(3)

16. Under the proposed section 7AC(3), a partner will not be protected from the liability arising from a claim made by a client if the partner (a) knew or ought reasonably to have known of the default of other members of the firm at the time of its occurrence and (b) failed to exercise reasonable diligence to prevent its occurrence.

17. Members note that each of the LLP legislation in the provinces of Alberta, Ontario, British Columbia and Manitoba of Canada and the State of Texas of US has a stipulation that removes LLP protection for a partner who has actual knowledge of the default but failed to exercise reasonable diligence to remove it, whereas each of the LLP legislation of the province of Ontario of Canada and the State of Texas of US also has a stipulation to remove LLP protection for a partner who ought reasonably to have known of the default but failed to exercise reasonable diligence to prevent it.

18. Hon Paul TSE shares the concern expressed by LS that the constructive knowledge element in the proposed section 7AC(3)(a), i.e. "ought reasonably to have known of", may lead to "excessive litigation". Mr TSE has pointed out that the removal of the constructive knowledge element in the proposed section 7AC(3)(a) would not change a partner's liability at common law with respect to the general principles of negligence. Hon Albert HO has also pointed out that the provision of a constructive knowledge element in the proposed section 7AC(3)(a) would provide lesser safeguard to consumers, as senior members of a law firm might refrain from providing guidance to their junior members for fear of being held personally liable to the defaults of the junior members for their negligence or wrongful acts to clients.

19. Dr Hon Margaret NG opines that the proposed section 7AC(3) must be workable in order to encourage the formation of LLPs in Hong Kong. Dr NG shares the concern that Hong Kong is lagging behind other jurisdictions in implementing professional liability reform, which has significant implications on Hong Kong's competitiveness as a leading international financial centre in the Asia-Pacific region.

20. In its submission to the Bills Committee in August 2010, LS proposed to replace the proposed section 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."

21. The Administration does not consider it appropriate to adopt LS' proposed revised section 7AC(3) for the following reasons:

- (a) in general, a partner is liable at common law for the negligence or wrongful act of a person under his direct supervision. In other words, the proposed provision does not provide any additional safeguards for consumer protection that are not already provided by common law;
- (b) by singling out a partner's liability arising from his direct supervisory role, the proposed provision may impliedly negate a partner's potential liability for the firm's collective failure to establish a proper system of staff supervision, thus deviating from the policy intent. The Bill is not intended to change the common law position with respect to the general principles of negligence. A partner in an LLP may still be held responsible under the common law for vicarious liability arising from the default of an employee, agent or representative who is under the supervision of the partner. Also, a failure to establish a proper system of staff supervision by the partners can be the basis for a claim that all partners of an LLP are personally liable for the default of an employee, agent or representative;

- (c) by confining an LLP partner's liability to matters that he knows or under his direct supervision may provide disincentive for LLP partners to monitor the activities of the firm for the benefit of the firm and its clients; and
- (d) consumers will be denied 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.

22. Concern has also been raised by Hon Ronny TONG that LS' proposed revised section 7AC(3) may cause an LLP to deliberately not to assign any partner to supervise an employee in order to protect partners from personal liability. Whilst noting that the systemic failure of an LLP to establish a proper system of supervision may be the basis of a claim that all partners of the LLP could be held liable for negligence, Mr TONG has pointed out that the proposed amendments may force a client to change his cause of action, i.e. instead of founding his claim on the employee's negligence or wrongful act, the client needs to found his claim on the LLP's failure to establish a proper system of supervision, which may not be in the best interests of consumers.

23. To address the concern that partners may try to avoid personal liability by not supervising the practice, LS has proposed to amend the Hong Kong Solicitors' Guide to Professional Conduct ("Conduct Guide") to make the following obligations in Commentaries 1 and 2 under Principle 5.17 mandatory for law firms operating as LLPs:

- "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."

24. Hon Paul TSE and Hon Albert HO consider LS' proposal to amend the Conduct Guide to make the obligations in Commentaries 1 and 2 under Principle 5.17 mandatory for solicitor firms operating as LLPs sufficient to provide adequate protection for the consumers, as all solicitor firms in Hong Kong would have a partner supervising each and every case regardless of the amount involved.

25. The Administration has advised that if the constructive knowledge element is to be removed from the Bill, it is necessary to spell out in the Bill that all partners in an LLP would be held liable for failing to comply with Commentaries 1 and 2 under Principle 5.17.

26. Dr Hon Margaret NG is of the view that actual knowledge is preferable to constructive knowledge in providing protection to consumers, as this would obviate the need for consumers to identify the responsible partner to claim damages for negligence.

The proposed replacement of the constructive knowledge element by the notification requirement and the regulation of liability of the designated partners

27. On the basis that LS would strengthen its Conduct Guide for LLPs, the Administration proposed in January 2011 to replace the constructive knowledge element in the proposed section 7AC(3)(a) with a requirement for an LLP to serve a written notification for each matter on its client informing him of the identity of the LLP partner(s) responsible for handling his case before the LLP accepts instruction in respect of the matter from the client (hereinafter called "the notification requirement"). The partner(s) named in the notice (hereinafter called "the designated partner" ("DP")) shall not be protected from liability under the proposed section 7AC(1) which provides that a partner of LLP will not, solely by reason of being a partner, be jointly or severally liable for any partnership obligation, whether founded on tort, contract or other areas of the law, arising from a default of any other partner, employee, agent or representative of LLP.

28. As regards the consequence of breach of the notification requirement, members note that all partners of an LLP shall not be entitled to LLP protection in the particular case where the LLP has failed to comply with the notification requirement, such as failing to give notice to the client within 30 days after the LLP accepts instructions in respect of the matter or after it becomes an LLP, whichever is the latter. However, if an LLP and/or innocent partners can prove that a client has actual knowledge of the identity of the responsible partner(s) prior to the occurrence of the default and within 30 days from the firm's acceptance of instructions in respect of his matter, all other partners of the LLP would continue to be allowed to rely on the proposed section 7AC(1) for protection in the particular case concerned even if the notice requirement was not observed by the LLP.

29. LS objected to the loss of LLP protection sanction for failing to comply with the notification requirement. In LS' view, any breach of

the notification requirement should be dealt with through disciplinary action by LS. LS also indicated that the denial of LLP protection for the partner(s) named in the notice even if he was not negligent personally in respect of the matter in the notice was unacceptable, and demanded that the DP provisions be removed from the draft CSAs to the Bill. LS said that it would not render its support for the Bill in such form.

30. Members then requested the Administration to further discuss with LS to iron out their differences regarding the notification requirement and the regulation of liability of DPs as well as the issue regarding the distribution of partnership property and how a balance could be struck between protecting innocent LLP partners and consumers of legal services.

The proposed replacement of the DP provisions by the requirements on supervising partners

31. Members note that the Administration met with LS on several occasions from August 2011 to February 2012 to further discuss their differences. In March 2012, the Administration informed members that it would replace the proposed DP provisions by the following requirements ("requirements on supervising partners") to the Bill:

- (a) each client matter of an LLP must be supervised by a partner;
- (b) an LLP shall keep the client informed of the identity of at least one partner who is responsible for the overall supervision of a client matter ("the supervising partner");
- (c) failure of an LLP to keep the client informed under (b) above will result in loss of LLP protection for all partners in respect of that particular client matter; and
- (d) the supervising partner shall, within a specified timeframe, at the request of the client, provide the client with a list of partners who, to the best knowledge of the supervising partner, are or were (as appropriate) responsible for the supervision of the whole or a particular part of the client's matter.

32. At the Bills Committee meetings held between March and May 2012, the Administration advised that the requirements on supervising partner(s) could achieve its policy intent that at least one LLP partner would be held responsible for the LLP's default for the following reasons:

- (a) the four elements of the requirements on supervising partners mentioned in paragraph 31 above would help clients to identify the partner(s) who is/are responsible for supervision of his matter effectively;
- (b) from the policy perspective, the only principal difference between the DP provisions and the requirements on supervising partners is that the former imposes joint and several liability on the DP (after the client has established that there is default on the part of the LLP) while the latter requires the client to prove liability at common law and/or breach of the requirements of other relevant sections in the Bill on the part of the supervising partner for him to be liable to the client personally. In practice, the difference is unlikely to be of significant importance and that the latest proposal should be sufficient in rendering culpable supervising partners liable to their clients for the reasons below:
 - (i) in general, a partner is liable at common law for the negligence or wrongful act of a person under his supervision;
 - (ii) a proposed new section 7ACC(1) under CSAs will be added to stipulate that a partner is not protected from liability of partners in LLP if the partner knew of the default at the time of its occurrence and failed to exercise reasonable care to prevent its occurrence;
 - (iii) a proposed new section 7ACC(2) under CSAs will be added to more clearly state the policy intent that there shall not be LLP protection for a partner if the default is the partner's default or a default of an employee, agent or representative of the LLP firm under the partner's direct supervision; and
 - (iv) from the policy perspective, if a partner does not fall within any of the categories as described in sub-paragraphs (i) to (iii) above, he should not be denied LLP protection under the Bill.

The Administration has further advised that in formulating the requirements on supervising partners, due consideration has been given to the facts that the legal profession is highly disciplined and that LS would

strengthen its Conduct Guide for LLPs.

33. Members note that the Administration will move CSAs to add the proposed new section 7ACB on "Requirements relating to overall supervising partners", the salient features of which are as follows:

- (a) an LLP must have at least one overall supervising partner ("OSP") throughout the time it handles a matter for a client on the matter;
- (b) an LLP must inform the client of the identity of at least one OSP within 21 days after accepting instruction on a matter;
- (c) an LLP must keep the client informed of the identity of at least one OSP throughout the time that the matter is handled by the partnership;
- (d) a client is allowed to make request to:
 - (i) the OSP as last informed to the client by the partnership; or
 - (ii) the partnership if the aforesaid OSP is no longer a partner in the partnershipto provide him with the names of other OSP(s) on the matter, if any, and other partners responsible for supervising any particular parts of the matter; and
- (e) the person who received a request by the client under (d) above is required to provide, to the best of the person's knowledge, the information to the client within 21 days.

34. Members further note that the Administration will move CSAs to amend the proposed section 7AC(3) to provide that LLP protection applies only if the following conditions are met at the time of the default:

- (a) the partnership was an LLP;
- (b) the client knew or ought reasonably to have known that the partnership was an LLP;
- (c) the partnership had complied with the proposed new section 7ACA on "Top up insurance requirements for LLP" (see paragraphs 65 to 67 below); and

- (d) the partnership had complied with the requirements in the proposed new section 7ACB(2) that an LLP must not later than 21 days after it accepts instructions on the matter inform the client of the identity of at least one OSP and must keep the client informed of the identity of at least one OSP throughout the time it handles a matter for a client on the matter.

Proposed new section 7ACC - Limitations on section 7AC(1) protection

35. Arising from the deletion of the constructive knowledge element from the Bill and the introduction of the OSP requirements, members note that the Administration will move CSAs to preserve the actual knowledge element in the original section 7AC(3) of the Bill by adding the proposed new section 7ACC to provide that an LLP partner is not protected from liability if the partner (i) knew of the default at the time of its occurrence; and (ii) failed to exercise reasonable care to prevent its occurrence. An LLP partner is also not protected from liability arising from a default in respect of a matter handled by the partnership if the default is (i) the partner's default or (ii) a default of an employee, agent or representative of the partnership who was under the direct supervision of the partner in respect of the matter at the time of the default. The proposed new section 7ACC also makes it clear that the proposed section 7AC(1) does not protect any interest of an LLP partner in the partnership property from claims against the LLP.

Proposed new section 7ACD - Indemnification under partnership agreement not affected

36. Members note that the Administration will move CSAs to add the proposed new section 7ACD to make clear that the new Part IIAAA does not affect any right of a partner in an LLP to be indemnified by another partner, or any obligation of a partner to indemnify another partner, under a written agreement made between the partners.

Proposed new section 7ACE - Effect of section 7AC(1) on proceedings

37. Members note that the Administration will move CSAs to add the proposed section 7ACE on effect of section 7AC(1) on proceedings to replace the proposed section 7AC(6) under the Bill. The proposed section 7AC(6) provides that if a partner is protected from liability by section 7AC(1), (a) the partner is not a proper party to any proceedings

brought by or against the partnership for the purpose of recovering damages or claiming other relief in respect of the liability; and (b) the proceedings may, if they could apart from this section be brought by or against the partnership, continue to be so brought. Members further note that under the proposed new section 7ACE, if a partner is protected from liability by section 7AC(1), (a) the partner is not, separately, a proper party to any proceedings brought against the partnership for the purpose of recovering damages or claiming other relief in respect of the liability; and (b) the proceedings may, if they could apart from this section be brought against the partnership, continue to be so brought.

38. The Administration has explained that the policy intent of the proposed new section 7ACE is to prevent innocent partner from being sued in his own name, but that does not mean that he cannot be a party to any proceedings against the partnership. In fact, the latter should be allowed on the basis that he is a co-owner of the partnership property and a client is allowed to take enforcement actions against the partnership property. In addition, the Administration seeks to make clear that it is not its policy intent to restrict innocent partners from being a proper party to proceedings brought by the partnership. As such, the Administration has also sought to remove the reference "by or" in the proposed new section 7ACE.

39. LS has raised objection to the proposed new section 7ACE as the new provision may create problem for an LLP to counterclaim a client for matters such as non-payment of legal fees or a third party such as an outside counsel for giving wrong or negligent legal advice. The Administration has explained that the proposed deletion of "by or" means that the Bill does not seek to prevent innocent partners from being a proper party to proceedings brought by the partnership in the two examples cited by LS.

40. Hon Ronny TONG and Hon Audrey EU are of the view that the drafting of the proposed new section 7ACE(a) could be improved to make clearer that an innocent LLP partner should not be jointly or severally liable to any proceedings brought against the partnership for the purpose of recovering damages or claiming other relief in respect of the liability.

41. Dr Hon Margaret NG questioned the necessity of introducing the proposed new section 7ACE. In her view, a client will in most instances sue the LLP and the culpable partner(s) if he could identify that partner(s). Dr NG also agrees to the need for innocent partners to be a party to proceedings against the partnership in order that the client can take enforcement proceedings against the partnership property after obtaining

judgement.

Proposed section 7AD - Advance notice to Society in respect of limited liability partnership

42. Under the proposed section 7AD, a law firm must ensure that a written notice of its relevant particulars is given to LS at least seven days before it becomes, or ceases to be, an LLP. In order to ensure consistent treatment among Hong Kong firms and foreign firms in this regard, the Administration will propose a CSA to remove the proposed section 7AD(3) which provides that a foreign firm constituted as an LLP when it commences business in Hong Kong is not required to give a separate notice under the proposed section 7AD(1).

43. Members note that the Administration will move CSAs to the proposed section 7AD(1)(c) and (d) to stipulate the particulars that a Hong Kong firm and a foreign firm must provide in their respective written notice to LS.

Proposed section 7AI - Provisions regulating distribution of partnership property

44. The proposed section 7AI regulates the distribution of an LLP's property in circumstances where, as a result of the distribution, the partnership would be unable to pay its obligations as they become due, or where the value of the remaining partnership property would be less than its obligations.

45. According to the Administration, the proposed section 7AI does not prohibit distributions by LLPs in general. It is entirely an LLP's decision and judgement 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. In providing LLPs with the autonomy to distribute partnership property to their partners, it is necessary to provide appropriate checks and balances against irresponsible distributions to frustrate client's claim by requiring such distributions be clawed back to the firm's asset pool under certain circumstances. Accordingly, the proposed section 7AI(1) and (2) provide as follows:

"(1) If a limited liability partnership makes 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).

(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 less."

In sum, the proposed section 7AI provides that if the liquidity test under subsection 7AI(1)(a) or the asset test under subsection 7AI(1)(b) is not met after an LLP has distributed its property to a partner or an assignee, the partner or the 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). It should be further noted that, as provided under subsection (5), the proposed section 7AI does not affect a payment made as reasonable compensation for current services provided by a partner to an 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.

46. LS has expressed the views that the proposed section 7AI is unclear by reason that the meaning of "contingent" referred to in subsection (4) is not defined and that LLPs are left to their own judgement in figuring out when an obligation is to be included or excluded in the computation of partnership obligation for the purpose of the proposed section 7AI.

47. The Administration disagrees with the views of LS that solicitors are left to their own judgement in figuring out when an obligation is to be included or excluded in the computation of partnership obligation for the purpose of the proposed section 7AI as the meaning of "contingent", referred to in the proposed section 7AI(4), is not defined. In the Administration's view, "contingent" is a basic legal concept which should be clearly understood by legal practitioners. The reason for not defining

contingent obligation in the Bill is that whether something constituted a contingent obligation or not would depend on the particular facts of each case.

Time limit on clawback action

48. To address LS' concern that the proposed section 7AI is unreasonably burdensome by reason that the provision is unlimited in time, the Administration proposed in November 2010 a limitation period of two 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).

49. LS did not agree with the Administration's proposal mentioned in paragraph 48 above on the basis that the effective limitation period for clawback action would be uncertain. The limitation period would not end until two years from the date the claimant finds out or could reasonably have found out that the distribution was in contravention of the liquidity test and/or asset test in the proposed section 7AI(1).

50. Having taken into account LS' views in paragraph 49 above, the Administration proposed in January 2011 a clawback period of six years from the date of distribution. In so doing, reference has been made to the six years' limitation period that would otherwise be imposed by the Limitation Ordinance (Cap. 347).

51. LS maintained its view that the clawback provision was redundant on the basis that if an LLP became insolvent and its partners were bankrupt, the Bankruptcy Ordinance (Cap. 6) would apply. LS has explained that consumers would not be disadvantaged without the clawback provision in the Bill for the following reasons:

- (a) the mandatory Professional Indemnity Scheme ("PIS") has proven to be sufficient protection based on past claims experience. From 1994-1995 indemnity year up to the 2010-2011 indemnity year, only 1.8% of the total claims have sought HK\$10 million or more, and the average claim size ranges from HK\$0.6 million to HK\$2.7 million which is well below the statutory indemnity limit of HK\$10 million per claim;
- (b) in the event an LLP became insolvent and the partners were bankrupt, the Bankruptcy Ordinance would apply. The Bankruptcy Ordinance serves the same purpose of clawback of restoring assets that should not have been distributed out

from the LLP; and

- (c) the general remedy of Mareva injunction would apply should there be any risk of dissipation of a firm's assets.

52. LS has pointed out that to introduce a six years' clawback period would be inconsistent with the Bankruptcy Ordinance and would cause prejudice to the interests of other creditors, as successful claimants could enforce a liability against a partner(s) in an LLP within six years after the date of the distribution to which the liability relates under the proposed section 7AI, whereas the relevant period for restoration of assets is two years before presentation of the bankruptcy petition where unfair preferences are given to associates of the bankrupt debtors under section 51(b) of the Bankruptcy Ordinance and a person is an associate with whom he is in partnership under sections 50, 51 and 51B of the Bankruptcy Ordinance. As the Bill only proposes partial shield to LLPs, it is all the more important to ensure equality of treatment for all unsecured creditors on a pari-passu or "equal footing" basis in accordance with the existing bankruptcy framework. If the Administration insists on providing a clawback in the Bill, the period should be two years from the date of distribution in order to align with the existing bankruptcy law and keep in step with the world trend on LLP legislation.

53. LS has further pointed out that many overseas LLP legislation only rely on the general insolvency law to protect creditors. Among these jurisdictions, the LLP legislation of the provinces of British Columbia, Manitoba and Nova Scotia of Canada stipulate that proceedings to enforce a liability has to be commenced no later than two years after the date of the distribution to which the liability relates. In the Malaysian LLP Act which has just been gazetted, the partner who received a distribution when the LLP was insolvent is liable to return the distribution if the distribution was received two years before the commencement of winding up of LLP. Major financial centres, such as London, Singapore and the State of New York of US, also rely only on the general company law on insolvency to protect creditors. Hong Kong should be in line with most other jurisdictions in designing its LLP legislation in order to achieve the target of enhancing Hong Kong's competitiveness as a key centre of providing legal services.

54. The Administration objected to LS' proposal of two years' limitation period for two reasons. First, clients are not privy to information about distribution of profits and assets by an LLP to its partners. Second, it usually takes more than two years for a client to obtain a first instance judgement on his claim for negligence against a law firm before he is in a position to enforce the judgement debt.

55. The Administration has further explained that it is not possible to use the Bankruptcy Ordinance to replace the clawback provision in the proposed section 7AI, as the LLP model used in the Bill is a partnership model proposed by LS. The reason why bankruptcy or winding up law is used to enforce liability against a partner(s) of an LLP in jurisdictions such as UK and Singapore is because these places adopted a corporate model for their LLPs. The corporate model of LLPs is one which is grafted on legislation on companies and has a legal personality which means that these LLPs could be sued by creditors under the bankruptcy or winding up law. On the other hand, LLPs operating on a partnership model is grafted on partnership legislation and does not have a legal personality which means that successful claimants could not use the Bankruptcy Ordinance to enforce judgement debt on the LLPs as the LLPs are not a legal person which could be sued for bankruptcy under section 50(3) of the Bankruptcy Ordinance to recover the debt. Moreover, under the partial shield of the LLP model under the Bill, innocent partners of LLPs are protected against claims incurred by the negligence of other partners. As a corollary, a client will not be allowed to take bankruptcy proceedings against them in respect of the partnership's default. Accordingly, it is necessary to provide a clawback mechanism in the Bill to enable consumers to enforce liability on the partnership's default. It is noted that some Canadian provinces which adopted a partnership model also have clawback provision in their LLP legislation.

56. Hon Audrey EU notes that in the LLP legislation of the province of Manitoba of Canada, the clawback period is two years and the LLP model is a partnership one. As the Bill also adopts the partnership LLP model, Ms EU has asked the Administration about the rationale for setting the clawback period in the Bill at six years.

57. The Administration has explained that although the clawback period in the LLP legislation of the province of Manitoba is two years from the date of distribution, it should be noted that under section 86(2) of the Manitoba Partnership Act, a partner of an LLP who authorized a distribution in contravention of the liquidity or asset test is jointly and severally liable to the partnership for any amount for which a recipient is liable, to the extent that the amount is not recovered from the recipient. In other words, all innocent partners who authorized a distribution from the partnership property will be liable to repay the partnership if one of the recipients of the distribution fails to repay the partnership.

58. Hon Paul TSE supports a two years' clawback period, as he could not see why clients of LLPs should get preferential treatment over other creditors in enforcing liability on an LLP and why clients of LLPs need

higher level of consumer protection than other professions such as accountants and building surveyors who conducted their business through limited liability entities. In his views, partners of an LLP would strive to ensure that they would not be at fault in dealing with their clients to avoid having unlimited personal liability for the occurrence of the fault, whereas this might not be the case for other professions which operated as a limited liability entity where the liability of their partners/owners is limited.

59. The Administration disagrees that a successful claimant under the proposed section 7AI is granted an additional advantage over trade creditors in recovering money from an LLP, as firstly, the assets clawed back under a clawback action will be provided to the LLP and not the client directly; and secondly, since the Bill only offers a partial liability shield, all partners in an LLP are still jointly and severally liable for all ordinary trade debts and obligations, such as staff salaries and rent. There is no need for trade creditors to rely on the clawback provision since each and every partner of an LLP is personally liable for the partnership obligations owed to them.

60. Noting that a great majority of LS' members who participated in LS' members' survey do not support the six years' clawback period, members has suggested to the Administration on considering shortening the clawback period to, say, three or four years. In response, the Administration proposed in March 2012 to reduce the clawback period from six years to four years.

61. LS did not accept the four years' clawback period proposed by the Administration. According to LS, the majority of members of LS insist on a two years' clawback period in the Bill because most of the overseas jurisdictions, such as the State of New York of US, UK, Singapore and many provinces in Canada, either use bankruptcy law to enforce liability against a partner(s) of an LLP or use a two years' clawback period in their LLP legislation. Further, no LLP legislation elsewhere use a six years' clawback period, and only the State of California in US use a four years' clawback period in its LLP legislation.

62. In response to Hon Miriam LAU's enquiry on why the Administration would not accept a two years' clawback period, the Administration has explained that unlike many overseas jurisdictions such as the province of Manitoba, the Bill does not prohibit an LLP from making a distribution to its partners. Further, the Administration does not insist on increasing the statutory professional indemnity limit per claim for an LLP. For instance, in Singapore, the professional indemnity insurance requirement is SG\$4 million per claim for an LLP and

SG\$1 million per claim for a general partnership. In UK, the professional indemnity insurance requirement is £3 million per claim for an LLP and £2 million per claim for a general partnership. Under these circumstances and having regard to the fact that confining personal liability to the partner(s) at fault is a new partnership model for doing business in Hong Kong, it is necessary for the Administration to be prudent at the outset by laying down a longer clawback period to better protect consumer interests. The clawback provisions in the Bill would also have a precedent setting effect if LLPs are to be introduced for other professional practices.

Top up insurance requirements

63. Members have suggested to the Administration and LS to consider whether requiring LLP law firms to take out top up insurance, as practised in some overseas jurisdictions such as Singapore and UK, could be a viable option for shortening the clawback period to two years without compromising consumer interests.

64. The Administration has responded that it would consider shortening the clawback period to two years if LLPs are required to take out top up insurance against losses in addition to PIS under section 3 of the Solicitors (Professional Indemnity) Rules (Cap. 159 sub. leg. M). Members note that LS has subsequently consulted its members on the top up insurance proposal and has received no strong objection to the proposal.

65. Members further note that the Administration will move CSAs to add the proposed new section 7ACA to require LLPs to take out top up insurance against losses in addition to the indemnity provided to partnerships under PIS in exchange for shortening the clawback period to two years. The proposed salient features of the top up insurance requirements are as follows:

- (a) compensation should be paid out of the primary professional insurance maintained by Hong Kong LLPs under the Solicitors (Professional Indemnity) Rules or by foreign LLPs under the Foreign Lawyer Registration Rules (Cap. 159 sub. leg. S) (hereinafter called "the primary insurance") before it is paid out of the top up insurance. Subject to the foregoing, the top up Insurance should:

- (i) cover all matters handled by an LLP;

- (ii) indemnify the partnership against any loss arising from any claim in respect of any default; and
 - (iii) provide a minimum indemnity coverage of HK\$10 million in respect of any one claim (hereinafter called "the minimum indemnity amount");
- (b) its requirements should be similar and consistent as between Hong Kong LLPs and foreign LLPs;
 - (c) it should not alter or amend the requirements of the primary insurance;
 - (d) it should not be subject to any limit as to the amount of liability for claims in the aggregate or as to the number of claims made against the partnership in any particular period; and
 - (e) the minimum indemnity amount may be substituted by an amount that is not less than HK\$10 million.

66. Members have asked about the safeguards which would be put in place to ensure compliance with the top up insurance requirements by LLPs.

67. The Administration has advised that it will move CSAs to stipulate that if an LLP fails to comply with the top up insurance requirements at the time of default, its partners shall not be entitled to LLP protection (paragraph 34(c) above refers), albeit the firms can continue to operate in the form of a general partnership. In addition, the Administration will move CSAs to introduce the following consequential amendments to the subsidiary legislation under the Ordinance so as to enable LS to monitor compliance with the top up insurance requirements by LLPs:

Hong Kong LLPs - Rule 5 of the Solicitors' Practice Rules
(Cap. 159 sub. leg. H)

- (a) a new rule 5(1B) will be added to provide that when the firm commences business, a principal in the firm shall, within 14 days of commencement, provide LS with evidence of compliance with the top up insurance requirements;
- (b) a new rule 5(2A) will be added such that if at any time the firm does not have in existence the requisite top up

insurance, a principal in the firm must notify LS in writing within 14 days of such occurrence;

Foreign LLPs - Rule 9 of the Foreign Lawyers Practice Rules (Cap. 159 sub. leg. R)

- (c) a new rule 9(1B) will be added to provide that a principal of the firm shall, within 14 days after the establishment of a place of business by the firm, provide LS with evidence of compliance with the top up insurance requirements; and
- (d) a new rule 9(2A) will be added to provide that if at any time the firm does not have in existence the requisite top up insurance, a principal of the firm must notify LS in writing within 14 days of such occurrence.

68. The Administration has further advised that it will move CSAs to amend section 6(3) and section 7(d) of the Ordinance to make clear that a person's qualification to practise as a solicitor or his right to be issued a practising certificate should not be prejudiced by his firm's failure to comply with the indemnity rules to be made by the Council of LS in respect of the top up insurance requirements.

69. Dr Hon Margaret NG has asked LS about the measures that it would take to ensure compliance by both Hong Kong and foreign LLPs to take out top up insurance.

70. LS has advised that it will maintain a database to track the expiry dates of the top up insurance policies as notified by LLPs and send out reminders to them.

Defence for distribution made under the proposed section 7AI

71. Members note that the Administration will move CSAs to add a new subsection (1A) to the proposed section 7AI to provide a defence for the LLP partner or assignee in subsection (1A)(a) to establish that, after exercising reasonable distribution and based on the information for the purpose of the distribution, it is reasonable to conclude that the LLP will be able to meet the liquidity test and the asset test under the proposed section 7AI (1) immediately after the distribution.

72. Hon LAU Kong-wah has expressed concern that the provision of a defence to the partners may create another hurdle for clients to claim damages for negligence from the culpable partner(s). Hon Albert HO is also of the view that the tests of "reasonable assessment" and "reasonable

diligence" proposed in the defence are too low a threshold and has suggested that these tests be changed to "due diligence".

73. The Administration has advised that while the literal meaning of "due diligence" appears to impose a higher threshold for the defence, what constitutes "due diligence" and "reasonable diligence" would have to depend on the facts of each case.

74. LS has suggested that specific bases on which LLPs could be used to distribute partnership property should be provided in the Bill as a defence for partners, as adopted in the Manitoba Partnership Act.

75. The Administration is of the view that while the criteria proposed by LS may be relevant in justifying a distribution, there may be other factors which are also relevant to the question as to whether the LLP had acted reasonably in making a distribution. In the Administration's view, the courts should be allowed to make a ruling based on all relevant circumstances of the specific case concerned. The Administration will however move CSAs to introduce a new subsection (1B) to the proposed section 7AI to provide that in determining whether the partnership made a reasonable assessment in making the distribution, a court may have regard to all the circumstances of the case including, without limitation, whether the assessment was based on (i) financial statements prepared on the basis of accounting practices and principles that were reasonable in the circumstances; (ii) a fair valuation; or (iii) any other method that was reasonable in the circumstances.

Committee Stage amendments

76. The Bills Committee agreed to the CSAs to be moved by the Administration.

Consultation with the House Committee

77. The Bills Committee reported its deliberations to the House Committee on 1 June 2012 and obtained its support for the resumption of the Second Reading debate on the Bill at the Council meeting of 13 June 2012.

Bills Committee on Legal Practitioners (Amendment) Bill 2010

Membership list

Chairman Dr Hon Margaret NG

Members Hon Albert HO Chun-yan
Hon LAU Kong-wah, JP
Hon Miriam LAU Kin-ye, GBS, JP
Hon Audrey EU Yuet-mee, SC, JP
Hon Ronny TONG Ka-wah, SC
Hon Paul TSE Wai-chun

(Total : 7 Members)

Clerk Miss Mary SO

Legal Adviser Miss Winnie LO

Date 14 July 2010