Hong Kong Institute of Certified Public Accountants
香港會計師公會

“A Case for Professional Liability Reform in Hong Kong”

Three Important Proposals from the Hong Kong Institute of Certified Public Accountants for Liability Reform That Will Safeguard Hong Kong’s Position as a Global Financial Centre

Hong Kong
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EXECUTIVE SUMMARY

1. The work of the Hong Kong Institute of Certified Public Accountants (Institute) (formerly the Hong Kong Society of Accountants) in relation to Professional Liability Reform in Hong Kong includes the introduction of corporate practices for CPAs (which became effective since 2 August 1996) and advocating the introduction of proportionate liability, the repeal of section 165 of the Companies Ordinance and the introduction of Limited Liability Partnerships (LLPs).

2. **<u>The case for Proportionate Liability and Repeal of section 165 of the Companies Ordinance</u>**

   a. The Institute made a submission "Proposal for an Equitable System of Liability" to the Government on 16 April 2002 **<u>(Annex I)</u>** which advocates a system of proportionate liability to address concerns over the joint & several liability framework. The principles behind joint & several liability framework and proportionate liability framework can be briefly explained as follows:

      (i) <u>Joint & several liability framework</u>
      The effect of the principle of the joint and several liability is that where two or more parties are negligent in performing their role in a transaction which causes loss to a plaintiff, the plaintiff can recover his loss in full from any one defendant without reference to the actual share of the fault of each defendant.

      (ii) <u>Proportionate liability framework</u>
      Under a system of proportionate liability, the liability of a defendant is limited to that proportion of the damages suffered by a plaintiff which is directly referable to that person's degree of fault. Courts would then decide on the respective responsibility of various defendants with just and fair regard to all the relevant circumstances.

b. A follow-up submission was made by the Institute on 17 October 2003 **(Annex II)** in response to the Government's Standing Committee on Company Law Reform's (SCCLR) Consultation Paper of its Corporate Governance Review on "Auditors' Liability". The SCCLR has considered the Institute's submission and concluded that the issue of proportionate liability had wide implications which were beyond its remit. The SCCLR therefore stated in its twentieth annual report that the matter should be referred to the Law Reform Commission for further study and consideration in the context of civil liability reform. The Institute has recently written to the Secretary for Justice and the Chief Justice requesting them to make an "official" referral to the Law Reform Commission to undertake a study on proportionate liability.

c. Furthermore, indications are strong in the United Kingdom that proportionate liability by contract will appear in a companies bill, hinging on the profession providing certain guarantees.

d. The key aspects of the two Institute's submissions are:

The case for Proportionate Liability

(i) Joint and several liability is no longer appropriate in the recent and current commercial and business environment, as it results in liability wholly disproportionate to the contribution of any particular defendant to the overall loss, although it is still appropriate where a defendant seeking to restrict liability has been found by the Court to have caused the damage or loss as a result of fraud, dishonesty or wilful default and for personal injury actions.

(ii) The consequence of joint and several liability is that a plaintiff will target defendants with "deep pockets" rather than pursue those primarily to blame for the loss suffered.

- Professionals should take responsibility for their breaches of duty. The concern is to avoid the unfairness of professionals having to pay more than their fair share of loss suffered when they only have partial responsibility for that loss.

- Professionals will be accountable for their conduct and will be responsible for the financial consequences. They should not, however, bear the financial consequences of others' shortcomings.

(iii) For auditors in particular, the amount of damages claimed against them in some cases is so huge that neither the professionals nor their insurers could cover them.

(iv) The profession needs talented people at a time when the financial complexity of business is increasing. Experienced qualified accountants must be encouraged to stay in the profession to make a career. They should not be scared away by the potential catastrophic claims against their employers or own practices.

<u>The case for a repeal of section 165 of the Companies Ordinance</u>

(i) To implement liability reform to repeal that part of section 165 of the Companies Ordinance which prohibits auditors from contractually limiting liability with clients in respect of audit work.

(ii) This is already standard practice for a number of other professions and businesses, including accountancy firms in their non-audit business activities.

(iii) The position of the company and its shareholders will not be prejudiced as a result provided that it is a condition that the limit on liability is approved by the company at its Annual General Meeting.

(iv) The repeal of the relevant part of section 165 of the Companies Ordinance will be beneficial but cannot be the total answer as it will not address an auditor's liability in respect of claims by third parties.

3. <u>The case for Limited Liability Partnerships (LLPs)</u>

a. The Institute also made a submission to the Government on 25 November 2004 **(Annex III)** advocating the introduction of LLPs in Hong Kong, in addition to incorporation, to address the issue of joint and several liability faced by general partnerships. The Institute has worked closely with the Law Society of Hong Kong in this regard and the Institute's submission is intended to supplement the Law Society Working Party Report on LLPs submitted to the Registrar of Companies and the Solicitor General in August 2004.

b. Furthermore, it should be noted that in Singapore, after extensive public consultation, the Government has decided to accept the private sector-led Company Legislative and Regulatory Framework Committee's recommendation to introduce LLPs in Singapore.

c. The key aspects of the Institute's submission are:

(i) LLPs remove the risk for the innocent partners but leave the claimant with a remedy against the LLP and the individual partner or partners responsible for the alleged breach of duty.

(ii) This results in a fairer distribution of the risks inherent in the current business climate.

(iii) Professionals play a vital role in the operation of capital markets and in helping to promote confidence in good corporate governance generally in Hong Kong. It is not in the interests of anyone involved in the capital markets for professionals to conduct their duties in a defensive way.

(iv) The introduction of LLPs will at least reduce some concerns of the bigger accounting firms which consider that incorporation is not appropriate for them.

(v) If Hong Kong is to maintain its position as a global financial centre, it needs to have a sufficient pool of high quality professionals including, auditors. It is not in the public interest where the risk stakes are disproportionately high which will discourage “the best and the brightest” from entering and remaining in the accounting profession.

(vi) The world has also grown more litigious. Whilst Hong Kong may consider itself lucky to date, there is no room for any complacency.

(vii) Over the past 10 years, Hong Kong accounting firms have been taking on an increasing amount of work which has an extraterritorial element to it, such as cross border listings of companies on the Hong Kong Stock Exchange as well as the stock exchanges in US, UK or Singapore. Such work carries additional risks, such as class action law suits by shareholders in the US.

(viii) Litigation as a common way for plaintiffs to obtain redress reflects the growing sophistication of the community and is becoming an acceptable part of how business is conducted in many jurisdictions.

(ix) Auditors, as an important part of the business fabric of Hong Kong, have to accept this new business reality, but seek the alternative business structure of a LLP so that they can participate on a level playing field compared with other jurisdictions. LLPs exist in many jurisdictions, including those in which major financial centres are situated.

4. **Developments in major overseas jurisdictions**

Other jurisdictions have made or are making considerable progress on liability reform while Hong Kong stands still.

a. Australia

Based on our findings, Australia has:

- Proportionate liability
- Ability to limit liability contractually
- Corporate practices
- Statutory liability cap

b. Canada

Based on our findings, Canada has:

- Proportionate liability
- LLPs

c. UK

Based on our findings, UK has/will have:

- Proportionate liability by contract
- LLPs
- Corporate practices

d. Other European Union countries

Based on our findings, a number of the European Union countries have:

- Proportionate liability
- Ability to limit liability contractually
- LLPs
- Corporate practices
- Statutory liability cap

e. USA

Based on our findings, the USA has:

- Proportionate liability
- Ability to limit liability contractually
- LLPs

In contrast, Hong Kong currently only allows corporate practices.

5. **Consumer interests**

The Institute has considered whether its liability reform proposals are in the interests of consumers.

a. The Institute's proposal for proportionate liability does not entail the wholesale displacement or exclusion of the principle of joint and several liability. To protect consumer interests, the Institute is proposing that proportionate liability should be introduced with exceptions. These exceptions would recognize that there are areas in which the principle of joint and several liability should continue to operate with normal consequences such as:
   - Where the defendant seeking to restrict liability has been found by the Court to have caused the damage or loss as a result of his fraud, dishonesty or wilful default; and
   - Personal injury actions.

b. The repeal of that part of section 165 of the Companies Ordinance which prohibits auditors from contractually limiting liability in respect of audit work would allow auditors to agree with the company on contractual limits for the auditor's liability to it. To protect investors' interests, such reform should have a condition such that the limit on liability should be approved by the company at its Annual General Meeting and disclosed in the company's annual report and accounts.

c. In relation to the introduction of LLPs, the fact that accounting firms are allowed to practise through corporate practices suggests that Hong Kong has satisfied itself that a limitation on liability of auditors via LLPs is not inconsistent with consumer interests.

6. **<u>The Public Interest</u>**

The Institute is Hong Kong's only statutory licensing body for accountants. It has more than 24,000 members and close to 10,000 registered students. The Institute operates under the Professional Accountants Ordinance and in the public interest. It has wide ranging responsibilities that include maintenance of the quality of entry to the profession through its postgraduate Qualification Programme, promulgation of first class financial reporting, auditing and ethical standards in Hong Kong and development of the accounting and auditing professions. It has responsibility for regulating and promoting high quality and efficient accounting practices to safeguard Hong Kong's role as a global financial centre.

However, the Institute adamantly believes that Hong Kong's liability framework has not evolved in step with developments in the economic, financial and litigious environment in which its members are currently practising and is no longer appropriate to the nature of work performed by professionals in Hong Kong. The imperatives which have driven the need for change are:

- Hong Kong has transformed itself over the last ten years from a local financial centre to a global financial centre.
- Globalization results in the need for an appropriate liability framework for the business and other risks arising from cross border transactions.
- The increased internationalization of commerce has resulted in the development of an increasingly litigious environment while Hong Kong does not provide the legal protections available in other similar jurisdictions.
- Hong Kong is the focus of fund raising for mainland enterprises, creating an increase in the volume and scale of assurance work whilst the liability framework remains unchanged.

- Adequate insurance cover is becoming increasingly scarce and the collapse of one or more of the major accounting firms, which Enron/Andersen graphically demonstrated can happen, would have an extremely damaging effect on everyone with an interest in a healthy financial market.
- Most sophisticated jurisdictions have or are introducing liability reforms. If Hong Kong is left behind, Hong Kong will be less attractive to talented individuals which will inevitably reduce its competitiveness as a global financial centre.
- Uncertainties regarding the future of the profession will make recruitment and retention of the best people more difficult.

PROFESSIONAL LIABILITY REFORM IS NOW VITAL FOR HONG KONG

1 Introduction

1.1 Background

It is quite right that professionals should be accountable for their actions and should bear losses which they cause to others through their own negligence. The accounting profession globally and in Hong Kong is making a significant contribution to reduce the risk of losses arising through the actions of its members by supporting various initiatives to improve audit quality and financial reporting. However, the Institute believes that Hong Kong's liability framework has not evolved in step with developments in the economic, financial and litigious environment in which its members are currently practising and is no longer appropriate to the nature of work performed by professionals in Hong Kong.

The work of the Institute in relation to liability reform in Hong Kong includes having introduced corporate practices for accounting firms, advocating that the Government introduce proportionate liability for professionals, proposing the repeal of that part of section 165 of the Companies Ordinance which prohibits auditors from contractually limiting liability with clients in respect of audit work and supporting the introduction of LLPs for practising professionals.

The Institute has previously made the following submissions on liability reform to the Government:

1. Submission dated 16 April 2002 on Proportionate Liability **(Annex I)**.
2. Submission dated 17 October 2003 on Proportionate Liability and repeal of section 165 of the Companies Ordinance **(Annex II)**.
3. Submission dated 25 November 2004 on the Introduction of Limited Liability Partnerships in Hong Kong **(Annex III)**.

This document, entitled "A Case for Professional Liability Reform in Hong Kong", sets out a comprehensive summary of why the Institute's three liability reform proposals should be introduced in Hong Kong to safeguard its position as a global financial centre. In short, the proposals, which are necessary to ensure a level playing field with our international counterparts, are:

1. Introduction of Proportionate Liability in Hong Kong
2. Repeal of that part of section 165 of the Companies Ordinance which prohibits auditors from contractually limiting liability with clients in respect of audit work
3. Introduction of LLPs in Hong Kong for professionals

For ease of explanation, the rest of this document refers specifically to the accounting profession, although the arguments set forth may equally apply to other professions. In addition, the Institute would like to emphasize at the outset that it is its belief that accountants in Hong Kong are willing to and do take responsibility for their actions or breaches of duty.

The existing liability framework, however, potentially places an unfair burden on firms where they are only partially responsible for a loss which could, in certain circumstances have dire consequences for a firm, resulting in significant adverse consequences on the stability of the financial markets, the interest of the public at large and Hong Kong's position as a global financial centre. It is important to be clear that what is being proposed does not amount to preferential treatment for professionals. The Institute's three proposals are already available elsewhere in other major financial centres.

1.2 Steps being taken to improve quality of auditing

The Institute is already working with the Government to introduce a bill to the LegCo in the current session to establish the Financial Reporting Council, the umbrella for the Audit Investigation Board (AIB) and the Financial Reporting Review Panel (FRRP). The AIB and FRRP will take on the regulatory role now carried out by the Institute in relation to the accounts of listed entities and their audits. The Institute supports the view that the AIB will strengthen the regulatory oversight of auditors and the quality of auditing and the FRRP will strengthen the quality of financial reporting. The Institute and its members will be providing significant financial support for these initiatives. Furthermore, the Institute is currently reviewing its practice review programme to enhance the methodology and approach, including the setting up of a new Practice Review Steering Board. Together, these initiatives will enhance Hong Kong's reputation as a global financial centre. In this connection, the Institute now feels that it is also the right time for professional liability reform to be introduced to support this framework of enhanced standards and increased regulation.

2 Case for reform

2.1 Transformation of Hong Kong from a regional financial centre to a global financial centre

Hong Kong has transformed itself over the last ten years from a regional financial centre to a global financial centre. It was the world's third largest market in terms of funds raised last year and this trend is continuing. Accounting firms have been taking on an increasing amount of work with extraterritorial elements, such as cross border listings of Mainland companies on the Hong Kong Stock Exchange, as well as the Stock Exchanges in the US, UK and Singapore. In addition, an increased level of risk arises from assurance work such as:

- the audits of subsidiaries of US SEC registrants;
- compliance evaluations in relation to internal controls brought about by the US Sarbanes-Oxley Act;
- compliance evaluations in relation to internal controls requested by directors of Hong Kong listed companies due to new Corporate Governance requirements;
- requests to reporting accountants by sponsors of listing companies to produce "Long Form" reports due to changes in Listing Rules; and
- assisting in the extraction of financial information for publication in the public interest.

Such work carries a high risk, not only through the increase in scale of the potential risks (both in terms of volume and financial amounts involved) but through exposures of a different nature such as class action suits by shareholders in the US. Furthermore, in jurisdictions such as the US where the legal system allows lawyers to act on a contingency fee basis, there may be a greater incentive for plaintiffs to initiate lawsuits even for frivolous claims. The absence of costs awards means that there are no downside risks for initiating such claims. Furthermore, with joint and several liability still in place, there may be an incentive under the contingency fee system to initiate claims and inflate the damages being claimed resulting in defendants to these claims, however frivolous they may be, having to incur substantial sums in legal costs just to defend themselves.

Liability reforms have not been introduced in Hong Kong in tandem with its growth in status as a global financial centre despite the increasing growth of a “compensation culture” around the world and are therefore long overdue. In this connection, it should also be noted that the US Securities Act of 1933 provides greater clarity as to the responsibilities of participants in the capital market. Hong Kong does not have a similar Securities Act clarifying the rights and obligations of the participants in the capital market and therefore liability reforms are all the more crucial.

2.2 Availability of adequate insurance

Hong Kong has a strong accounting profession where failures are rare but it is vital that this is not allowed to disguise the threat inherent in a failure to introduce liability reforms before it is too late.

At present under the law of joint and several liability, auditors are accountable not only for their own actions or failings, but also for those of other parties who as a result of their actions are responsible for, but do not have the money to, meet claims awarded against them. Auditors’ potential liability is unlimited even for events which are not necessarily under their control, but that liability is not capable of being matched by appropriate financial resources. The ability of even the largest accounting firms to meet catastrophic claims is severely limited by the lack of adequate professional indemnity insurance. As in the UK, there is no market for insurance which transfers this risk and none is likely to arise. Unlike auditors in other jurisdictions the liability of Hong Kong auditors is not subject to proportionate liability nor do auditors have the ability to limit liability contractually in respect of audit work. Instead, firms have to rely on their limited capital resources and in-house captive insurance vehicles which are unable to spread the risk. Given the scale of capital available to accounting firms relative to the market capitalization of the businesses audited, in particular Mainland state-owned enterprises, it will not be possible for accounting firms to build up sufficient reserves to provide the scale of cover which would be necessary to match the market capitalization of one, let alone all, of the largest companies. It is wholly unrealistic, and was not the intention when statutory auditing requirements were introduced to expect accounting firms to act as insurers of last resort.

The dangers of relying on insurance cover were clearly demonstrated recently in Australia where there was a serious market failure in the professional indemnity insurance market, after the collapse of HIH Casualty & General Insurance Company. This resulted in a significant risk that services would be carried out by uninsured persons or, as happened in practice, certain suppliers refusing to provide services for fear of the sheer scale of the legal damages that could follow a claim against them. This was the catalyst that triggered Australia to introduce reforms and explains why Australia is now ahead of a number of jurisdictions in liability reform.

2.3 A level playing field with major jurisdictions

The following sets out the position in other jurisdictions on liability reform which shows that Hong Kong is indeed falling very much behind:

(i) Australia

- The Australian Federal and State governments have taken major steps to advance liability reform through implementation of measures for proportionate liability; a nationally consistent regime of Professional Standards Legislation providing a statutory liability cap, while not prohibiting limiting liability by contract; incorporation of auditors; and reforms to the Federal Trade Practices Act (to give complete effect to proportionate liability and the ability for auditors to limit liability contractually).
- Legislation has been passed at the Federal level in Australia, permitting incorporation of audit practices, introducing proportionate liability between concurrent wrongdoers, and extending the operation of State professional standards schemes to cover liability arising from breach of specified Federal laws.
- Five States and/or Territories have introduced proportionate liability bills – the remaining three (Northern Territory, Southern Australia and Tasmania) have stated publicly their intention to do so (Southern Australia), released draft legislation (Northern Territory) or introduced a Bill to Parliament (Tasmania).
- Professional standards legislation has been enacted now in seven of the eight States or Territories. The remaining State has publicly committed to do so and has released a draft of its legislation for public consultation.

- In summary , Australia has:
  - Proportionate liability
  - Ability to limit liability contractually
  - Corporate practices
  - Statutory liability cap

(ii) Canada

- At the Federal level, a modified proportionate liability regime came into force under the Canada Business Corporations Act and the Canada Cooperatives Act on 24 November 2001.
- LLPs are now available in British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick and Nova Scotia.
- In summary, Canada has:
  - Proportionate liability
  - LLPs

(iii) UK

- The Department of Trade and Industry indicated that the UK Government remains committed to improving the operation of the capital market and will consider any proposals, including the possibility of limiting liability on a proportionate basis by contract, which can be demonstrated to significantly enhance competition and to improve quality in the audit market.
- In summary, if the proposals become law, UK has/will have:
  - Proportionate liability by contract
  - LLPs
  - Corporate practices
- It is also worth noting that one of the larger accounting firms incorporated as a corporate practice when it had the opportunity to do so and has now left the corporate practice more or less dormant by transferring the business to an LLP once LLPs became available in 2000. Clearly, this shows that LLP is a better operating vehicle for a large accounting firm than incorporation for the reasons mentioned in the Institute's Paper on LLPs.

(iv) Other European Union (EU) countries

- The 8th Directive of the EU provides that all member states should introduce liability reform provisions in their member states.
- Ten member states permit some form of limitation of an auditor's liability (e.g. Germany has a cap of four million Euros). This can be by way of a limitation imposed by law (e.g. Austria, Germany, Greece and Slovenia), permitting auditors to limit their liability on a contractual basis (e.g. Denmark, Latvia, Lithuania and Poland) or having a liability regime that assesses an auditor's responsibility on a proportionate basis (e.g. France and Malta). In addition Finland and the Netherlands have liability regimes which involve an element of proportionality, and limiting liability is common in the Dutch audit market for unlisted companies.
- Belgium and Italy have been or are currently considering a legal limit on auditors' liability based on a multiple of audit fees. In Italy, a limit based on a multiple of ten times fees has been included in a draft law, whilst in Belgium (where the corporate sector is smaller than in Italy) a multiple of fifty times fees is being discussed. In Portugal, there is a proposed draft law that would introduce liability reform if enacted as drafted.
- In summary, the major countries in the EU have/will have:
  - Proportionate liability
  - Ability to limit liability contractually
  - LLPs
  - Corporate practices
  - Statutory liability cap

(v) USA

- There has been no significant liability reform in the USA since the profession led legislation in 1995, which introduced proportionate liability protection in certain circumstances.
- LLPs were introduced in the USA in 1991.
- In summary, some states in the USA have:
  - Proportionate liability
  - Ability to limit liability contractually
  - LLPs

In contrast, Hong Kong currently only allows corporate practices.

Graphically, this can be illustrated as follows:

	Australia	**Canada**	**UK**	**Other EU Countries**	**USA**	**Hong Kong**
Proportionate Liability	✓	✓	✓ *(Proposal)*	✓	✓	
Ability to limit liability contractually	✓			✓	✓	
Limited Liability Partnerships		✓	✓	✓	✓	
Corporate practices	✓		✓	✓		✓
Statutory liability cap	✓			✓		

2.4 Concept of joint and several liability requires modification in the current business environment

Joint and several liability came into being many years ago when businesses were fairly small and straightforward. The current business environment is completely different. There are many participants in the current business environment all of whom knowingly participate with their "eyes open" being fully aware of the risks involve. In this context having one person bearing all the consequences without reference to the actual share of the fault of each defendant is unfair and unreasonable.

3 Benefits of reform

3.1 Sustaining Hong Kong's role as a global financial centre

With appropriate liability reforms in line with other major jurisdictions, the Hong Kong audit profession will continue to attract some of our brightest and most talented young people to join, train and remain in a profession able to offer an excellent career. The quality of assurance work and therefore the ability of the investing public to have confidence in the financial statements is dependent on the ability of accounting firms to maintain the quality of new professional recruits, and having trained them, to keep these skilled and highly employable professionals within the audit sector.

An environment where the risks are disproportionately high will discourage the best and the brightest from entering and remaining in the audit profession. There is already evidence overseas suggesting that liability risks are deterring some from remaining within the audit profession. Our proposals will help to overcome this threat.

In addition, the increasing demand for trained Hong Kong accountants from Mainland enterprises is a strong incentive for graduates to enter the profession and will improve the financial reporting of Mainland enterprises, many of which will go on to raise capital in Hong Kong and other capital markets. This is clearly important for the credibility of the enterprises concerned and for that of Hong Kong itself. Therefore, the territory needs a sufficient pool of high quality professionals to ensure that Hong Kong maintains its position as a major global financial centre and the best place to raise funds for Mainland companies. Furthermore, the need to have a sufficient pool of high quality professionals is exacerbated by new regulatory changes such as provisions in International Financial Reporting Standards, the US Sarbanes-Oxley Act and the new Basel Capital Accord, as well as anti-money laundering and privacy-protection laws. Accordingly more high quality professionals are needed to provide services in these areas in an increasingly sophisticated and competitive environment.

3.2 Improvement in financial reporting to meet market demands

It is the view of the Institute that liability reforms would facilitate improvements in financial information reporting and the assurance thereon, through auditors taking on a more meaningful role in relation to the governance and financial reporting of listed companies, in line with international trends. Auditors would be more willing to take on the demand for additional assurance services outside that of the statutory audit. All international developments in these areas, for which the Institute believes appropriate liability reforms must be a pre-requisite, will benefit shareholders and support the growth of capital markets. Examples in this regard are:

- the recent changes in Listing Rules governing sponsors such that sponsors are now requesting reporting accountants to give comfort in the form of “Long Form” reports on listing companies;
- reporting on internal controls to regulators and shareholders;
- reporting on directors’ remuneration schedules; and
- assisting in the extraction of financial information for publication in the public interest.

3.3 Proportionate liability provides a more equitable result

Under proportionate liability, auditors would still be responsible for the consequences of their actions. The courts would award damages against a negligent auditor for that proportion of the company’s loss that reflects the extent of the auditor’s responsibility for the damage suffered. The proposals would mean only that the auditor would not have to pay for the actions of others who are responsible for, but do not have the resources to meet damages awarded against them. It is not economically efficient or equitable for a market to operate on the expectation that all financial deficiencies will be compensated by one party (in this case, the auditors who may have performed only a limited role). Proportionate liability provides an equitable result.

4 Recommendations

4.1 The Institute's three proposals

The Institute recommends that all three proposals be considered now. This is because each of the three liability reform proposals is designed to meet a different risk.

1. The introduction of proportionate liability protects the market by significantly reducing the increasingly real risk that one of the larger audit firms could collapse as a result of a catastrophic claim, for which the audit firm might have a relatively small share of the responsibility.

2. Repeal of that part of section 165 of the Companies Ordinance, which prohibits auditors from contractually limiting liability with clients in respect of audit work, would allow auditors to agree on contractual limits for the auditors' liability to clients. Such reform would not be against the public interest particularly if it is a condition that the limit on liability should be approved by the company at its Annual General Meeting and disclosed in the company's annual report and accounts.

   Contractually limiting liability with clients is already standard practice for other professions and businesses, including accountancy firms in their non-audit business activities. However, it should be noted that the repeal of the relevant part of section 165 of the Companies Ordinance will be beneficial, but cannot be the total answer as it will not address an auditor's liability in respect of claims by third parties.

3. The introduction of LLPs would protect innocent individual partners, other than those directly involved in the audit in question, from losing their personal assets (other than those invested in the firm) in the event of a large damages award against the firm. Accordingly, limited liability status protects individual partners. However, LLPs do not protect the firms themselves, just as limited company status does not prevent companies becoming bankrupt.

4.2 Where does Hong Kong stand in comparison with other capital markets?

Hong Kong is a global player in the international capital markets for fund raising. Hong Kong's Accounting Standards, Auditing Standards, Ethical Standards and others are largely in line with those adopted internationally. Client engagement letters of the International accounting firms necessarily follow international trends which are generally established within a liability framework in major jurisdictions that already have liability reform measures in place. Regulatory authorities now have zero tolerance for errors. The Institute understands that this is part of the business environment in which auditors operate save that when it comes to catastrophic claims, global international firms operating in other jurisdictions are doing business under a reformed liability regime. That does not apply to firms operating in Hong Kong. Hong Kong will fail its capital markets and as a consequence, the public interest, in the absence of appropriate liability reform as proposed by the Institute.

Hong Kong accounting firms are already registered with the US Public Company Accounting Oversight Board which was set up to monitor the auditors of SEC listed companies after the accounting scandals in the US. Liability reforms have been introduced elsewhere which do not apply in Hong Kong, which makes it imperative for Hong Kong to adopt liability reforms similar to those adopted elsewhere.

5 Threats if no reform

5.1 Probable life threatening scenario for Hong Kong

Let us imagine the impact on the Hong Kong capital markets if one of the large Hong Kong based accounting firms were forced to exit from the Hong Kong market due to a catastrophic claim because of the delay in liability reform in Hong Kong. The Institute believes that the impact on the Hong Kong capital markets would be enormous affecting the livelihoods of many in Hong Kong.

Apart from the loss of jobs from a firm's failure and the direct effect on their families, the timetables of audits in progress for listed and other companies would be disrupted, initial public offerings of local and Mainland enterprises would be delayed or cancelled and other tax and consultancy projects would be seriously affected. The disruption to the daily activities of corporate and government bodies cannot be over-estimated. This is in addition to the damage Hong Kong would sustain to its reputation and credibility.

In the aftermath of another firm's failure, the entire accounting profession would suffer. The profession would lose its ability to attract and retain the best recruits and professionals because of the risk attached to the profession. Since a respected accounting profession is the backbone of any important financial centre, if the accounting profession suffers, Hong Kong's hard-earned status will suffer.

The Institute is therefore urging the Government and the LegCo to address the issue responsibly now. Otherwise, the Government and the LegCo might be forced to introduce changes hastily in response to a crisis, which is what happened in Australia. The Institute believes that the lack of liability reform has now reached a potentially life threatening stage which will not only affect the accounting profession in Hong Kong but all stakeholders with an interest in a healthy capital market and Hong Kong's entire economic environment.

Some have argued that reputation threat is a greater threat to accounting firms' continued existence than catastrophic claim litigation, and that liability reform is therefore pointless. This argument fails to recognize that accounting firms can take action to protect their reputation. However, these firms cannot control the risks imposed by joint and several liability where exposure can arise or be greatly increased by the acts of others. Removing the threat posed by joint and several liability will significantly reduce the chances of an accounting firm collapsing as a result of the actions of others, with damages to Hong Kong.

5.2 Consequences of one large firm failing in Hong Kong

If one of the large accounting firms were to fail, choice will be greatly limited, especially in areas where specialized skills are required, such as mergers and acquisitions. Limiting choice in this way is not in the public interest and would be detrimental to the Hong Kong capital markets. Many leading mid-tier accountancy firms may be reluctant to move into the large firms' current market. Under this plausible scenario, it is conceivable that some companies would not be able to find an independent auditor.

5.3 Limited Liability Partnerships to be introduced in Singapore

The Government in Singapore, after extensive public consultation, has decided to accept the private-sector led Company Legislative and Regulatory Framework Committee's recommendation to introduce LLPs in Singapore. Hong Kong should not be left behind.

6 Conclusion

The Institute adamantly believes that Hong Kong's current liability framework no longer fits the nature of the work expected of professionals in Hong Kong, the scale of the funds involved and the cross border responsibilities and liabilities now being faced. Hong Kong desperately needs the liability reforms outlined in this paper to stay alive as a major global financial centre.

PROFESSIONAL LIABILITY REFORM IS NOW VITAL FOR HONG KONG

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Annex I

BY HAND

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18 Harcourt Road,
Hong Kong.

Dear Sir,

Review of Professional Liability

The Hong Kong Society of Accountants (HKSA) wrote to the Financial Secretary on 27 September 2001 expressing concerns about the liability of professionals particularly arising from application of the principle of joint and several liability, and requested an opportunity to present recommendations for a more equitable system of liability. The HKSA was advised by the Financial Secretary's Office, in its interim reply dated 22 October 2001 to the aforesaid letter, to submit the HKSA's specific proposal to you.

In this connection, please find attached the HKSA's submission entitled "Proposal for an Equitable System of Liability" (the "Submission"), which examines in more detail the way in which the principle of joint and several liability applies. It looks at the problems that arise in practice particularly for professionals, discusses the advantages and disadvantages of various mechanisms to alleviate the problems and sets out the HKSA's proposal in more detail, together with the justification for its introduction.

Representatives of the HKSA would be pleased to attend a meeting with you to discuss the Submission if considered necessary. Please contact Ms. Winnie Cheung, our Senior Director, Professional and Technical Development at telephone number 2287 7037 to arrange a mutually convenient time for such a meeting. If you have any questions in relation to the Submission, please contact Mr. Stephen Chan, our Deputy Director (Assurance), in the first instance.

We look forward to hearing from you.

Yours faithfully,

LEE KAI-FAT
REGISTRAR & SECRETARY-GENERAL
HONG KONG SOCIETY OF ACCOUNTANTS

KFL/SSLC/jc
Encl.

HONG KONG SOCIETY OF ACCOUNTANTS

Proposal for an Equitable System of Liability

On 27 September 2001, the President of the Hong Kong Society of Accountants ("HKSA") wrote to the Financial Secretary expressing concerns about the liability of professionals particularly arising from application of the principle of joint and several liability. The HKSA has been given an opportunity to present recommendations for a more equitable system of liability. This paper examines in more detail the way in which the principle of joint and several liability applies. It looks at the problems that arise in practice particularly for professionals, discusses the advantages and disadvantages of various mechanisms to alleviate the problems and finally sets out the HKSA's proposal in more detail, together with the justification for its introduction.

Joint and Several Liability

Liability may be several, joint, or joint and several. Several liability arises where the fault of a person for loss or damage is distinct from that of anyone else. Accordingly the person severally liable is responsible independently for loss or damage caused to another. Joint liability arises where two or more persons are responsible for a single tort, giving rise to loss or damage to another, and share liability to compensate that loss or damage. The obligation is indivisible and performance by one discharges the obligation of the other. Joint and several liability arises where two or more persons act independently so as to cause the same indivisible loss or damage to another. Where liability is joint, the plaintiff must usually proceed against all who share liability in the same action, whereas if liability is joint and several, the plaintiff may elect to proceed against defendants separately or decide which defendant to pursue.

The effect of the principle of joint and several liability is that where two or more parties are negligent in performing their role in a transaction which causes loss to a plaintiff, the plaintiff can recover his loss in full from any one defendant without reference to the actual share of fault of each defendant. The plaintiff can choose whether to sue one, some or all of the potential defendants. Any defendant who actually pays the plaintiff's loss is left to pursue the other parties for their contribution reflecting their share of responsibility for the loss suffered. Whilst the defendant has this right, it is in practice only likely to be exercised where there are realistic prospects of making a successful recovery.

The principal justification for joint and several liability is generally that the innocent plaintiff should be compensated in full for loss suffered and that the risk of any one defendant's impecuniosity or unavailability should be borne by the defendants as a group rather than by the plaintiff. The HKSA recognises that this consideration is still important in certain cases, most particularly personal injury actions. In the commercial and business environment, however, the HKSA believes that a rule which frequently results in liability wholly disproportionate to the contribution of any particular defendant to the overall loss cannot be justified. The inevitable consequence of the rule is that a plaintiff will target defendants with 'deep pockets' rather than pursue those primarily to blame for the loss suffered.

At the time when the principle of joint and several liability first developed, any contributory negligence on the part of a plaintiff was a complete bar to recovery of damages from a defendant. Further, before 1963, a plaintiff had no cause of action in tort to recover economic loss based on negligent misrepresentation. The decision of the House of Lords in *Hedley Byrne v Heller* paved the way for a new breed of negligence claims against professionals. Since 1963, the basis for imposing liability in tort has broadened, damage awards have increased in magnitude and an increasing compensation culture has led to a surge in the number of claims.

An example of the application of joint and several liability in practice might arise in the case of a plaintiff who has claims against two defendants (A and B) who are 20% and 80% at fault respectively. The plaintiff can recover all of the damages suffered from either of the defendants jointly and severally liable to him. If B is insolvent or has disappeared, however, the risk of such an event has fallen entirely upon A and not upon the plaintiff. As a result, A will effectively provide the plaintiff with insurance against the fact of B being judgment proof. It may be, however, that it was the plaintiff who decided to engage B and had the chance to check on his financial standing where A had not. Alternatively, B may have had no connection with A and, as far as A is concerned, the fact of their concurrent wrongdoing was pure chance.

Changes brought about in some common law jurisdictions by legislation which provides for apportionment between the plaintiff and defendant (contributory negligence) and between co-defendants (claims for contribution) have removed one of the main arguments for joint and several liability. This argument was that the courts were not qualified to apportion fault and liability for that fault between parties. It is now more common for a plaintiff in a professional negligence claim to be found to have been contributorily negligent and to have his recovery reduced in proportion to his degree of fault. Having established this principle, there is no justification for a defendant to have to make good any shortfall caused by the inability of a co-defendant to pay his share.

Existing legislation in some common law countries not only recognises the principle of apportionment of damage according to the degree of fault as between a plaintiff and a single defendant or as between defendants but also entrusts the courts with the application of the principle in practice. This acknowledges that the courts can fairly make such an apportionment in accordance with the justice of the case. The courts have years of experience in making apportionments which are just and equitable in all the circumstances of any particular case. The courts would clearly be well able to do the same thing in the context of a claim by a plaintiff against multiple defendants if they were not prevented from doing so by reason of the principle of joint and several liability.

<u>Availability and Cost of Insurance</u>

The current economic climate both in Hong Kong and globally brings the need for a review of the principle of joint and several liability into sharp focus. Whilst the motivation for a plaintiff commencing proceedings against a professional is the availability of insurance, recent events are likely to have a significant impact both on the amount of cover available and how much it costs.

Accountants and other professionals are widely regarded as being well insured when in reality the claims experience has made comprehensive cover difficult to obtain, at least at reasonable prices. The cover of the largest accounting practices, for instance, has been restricted to excess layers or what might be referred to as catastrophe cover and then only at substantial premiums. The practices would be self-insured for the smaller claims.

Although the market for professional indemnity insurance had stabilised for a few years, last year alone two major insurance companies providing professional indemnity cover collapsed with insufficient assets available to meet claims that are likely to arise. The first was HIH Casualty & General Insurance Company, an Australian insurance group which went into provisional liquidation in March 2001. HIH wrote professional indemnity insurance for professionals in many jurisdictions including Hong Kong. Australian insolvency rules favour Australian policyholders when the time comes to distribute assets recovered. Subsequently in June 2001 the Independent Insurance Company, a UK insurer which also underwrote professional indemnity risks for insureds in Hong Kong and elsewhere, went into provisional liquidation. Both collapses have created uncertainty for Hong Kong professionals as to the extent to which they may be effectively covered by their policies.

The September 11 terrorist attacks on the US have already had a significant impact on the global insurance market and, in particular, the availability and cost of insurance. There have been reports of insurers going out of business or ceasing to write new business as a result of their exposure, whether direct or indirect, to the enormous insurance losses incurred as a result of the terrorist attacks. The inevitable consequence of the tragedy and its impact on global insurance markets is that insurance premiums will increase substantially across the board. This trend had been apparent before September 11 and has accelerated since.

The Litigious Environment

The recent collapse of Enron Corporation has brought into sharp focus the role of auditors in the context of significant corporate collapses. Soon after Enron had filed for Chapter 11 protection in early December 2001, New York lawyers had advertised in the South China Morning Post on 13 December 2001 announcing the filing of a lawsuit against Enron and its auditors on behalf of all persons who purchased or otherwise acquired the common stock of Enron Corporation between 19 October 1998 and 30 November 2001. The purpose of the advertisement was to encourage investors interested in participating in the action and/or serving as a leading plaintiff to contact the law firm concerned.

One of the factors which it is suggested led to the true financial position of Enron being obscured for so long was the existence of various off-balance sheet partnerships that hid

Enron's huge liabilities. Whilst there has been constant press attention given to the role of Enron's auditors, this should be contrasted with the subdued attention paid to the other professional advisers responsible for advising on and establishing the partnerships.

Clearly investigations into the collapse of Enron Corporation are still at a relatively early stage and it is not possible to reach any conclusions as to what those investigations might reveal and how the advertised lawsuit and any other lawsuits, including those not yet commenced, might be resolved. The response to the collapse, however, is instructive in relation to the business climate in which all professionals operate. Those who suffer loss need to find a scapegoat on whom to attach blame and a source of funds from which to make a recovery. That is perhaps natural and justifiable to an extent but only if liability lies fairly with those responsible according to their respective degree of fault.

The same attitudes can be seen from the events surrounding the collapses of both HIH and Independent last year. Both collapses happened with great speed and little warning. Press reports in both cases indicated that attention was being paid to how the auditors had come to express clean opinions on the financial statements for the last complete period before each collapse. UK press reports have specifically reported that a firm of solicitors is investigating potential class action claims against the auditors of the Independent and seeking new members to join the action group.

Businesses in Hong Kong are currently suffering from recessionary pressures. The current economic climate may lead to further insolvencies and, perhaps, the collapse of one or more high profile companies. In that unhappy event, the role and activities of the auditors and other professional advisers will no doubt come under the spotlight in the same way as has been the case with Enron and numerous previous examples.

It is important to make it clear that the HKSA accepts that professionals should take responsibility for their breaches of duty. The concern is to avoid the unfairness of professionals having to pay more than their fair share of loss suffered when they only have partial responsibility for that loss. It is inappropriate to be held responsible for the mistakes of co-defendants who are either unavailable or unable to pay their share of any loss especially if the consequence is that the financial viability of the professional might be threatened.

Professionals will be accountable for their conduct and will be responsible for the financial consequences. They should not, however, bear the financial consequences of others' shortcomings.

Much is made of the in-built protection for plaintiffs to be able to recover their loss in full when two or more defendants have been negligent but one is unavailable or insolvent. There is no such protection, however, when a plaintiff suffers loss as a result of the actions of a single defendant. If that party is insolvent or unavailable, the plaintiff must bear the entirety of the loss himself. The HKSA believes therefore that there is nothing inherently wrong in transferring at least some of the risk of a defendant's insolvency or unavailability from a 'deep pocket' defendant to the plaintiff. What is important is to balance carefully the interests of a plaintiff who has suffered loss as a result of the shortcomings of others and the interests of negligent professionals who may have caused or contributed to that loss.

Proportionate Liability

Under a system of proportionate liability, the liability of a defendant is limited to that proportion of the damages suffered by a plaintiff which is directly referable to that person's degree of fault. Loss or damage suffered by a plaintiff may arise from failures on the part of a number of different defendants but the degree of fault on their part may vary. They may each be in breach of some duty which is a direct cause of the loss but one may be fraudulent or dishonest, another negligent and the third in technical breach of some statutory duty. Provided that the plaintiff can show that the loss was caused by each of the defendants, the degree of fault is irrelevant under the concept of joint and several liability. Using proportionate liability, however, Courts decide on the respective responsibility of various defendants justly and fairly having regard to all the relevant circumstances.

CANADA

The need to re-evaluate the application of joint and several liability has been recognised in a number of other jurisdictions. For instance legislation was introduced in Canada in June 2001 implementing a modified proportionate liability regime in respect of claims for economic loss arising from errors in financial statements. The new legislation limits a defendant's liability to a portion of the loss by reference to his relative degree of fault. Two exceptions were introduced, the first relating to claims by certain types of plaintiffs considered to be more vulnerable than others and the second to cases where fraud or dishonesty on the part of the defendant is involved.

USA

A number of the States in the USA have also modified the principle of joint and several liability in favour of some form of proportionate liability. Whilst some have abolished the principle of joint and several liability entirely, most of them have chosen to modify it. A form of proportionate liability was adopted at Federal level with the passage of the Private Securities Litigation Reform Act of 1995. This legislation radically altered the rules governing actions brought by investors for fraud in connection with the purchase and sale of securities, one of the principal kinds of legal claim brought against accounting firms. The effect of the legislation is that accountants who did not knowingly engage in fraud will only be liable for damages proportionate to their degree of responsibility. Where a plaintiff cannot collect the share of an insolvent defendant, each of the remaining defendants is also liable for their proportion of the uncollected share provided that it is not more than 50% of his or her proportionate share. Proportionate liability does not apply, however, to claims by small investors. Further the legislation does not apply to claims by the companies themselves.

IRELAND

In Ireland, proportionate liability applies where a plaintiff is contributorily negligent whereas joint and several liability applies where no negligence is attributable to the plaintiff. Ireland's version of proportionate liability provides that the portion of the total loss attributable to an insolvent or unavailable defendant is shared rateably among the solvent defendants and the plaintiff.

BERMUDA

Bermuda has amended its Companies Act to adopt proportionate liability for auditors and corporate officers in situations where they are found to be liable for damages arising out of the performance of any function contemplated by the legislation. Joint and several liability, however, continues to apply where there has been fraud or dishonesty.

UK

A wide ranging review of company law in the UK has recently been undertaken by a Steering Group appointed by the Department of Trade and Industry which presented its final report to the Secretary of State on 26 July 2001. The recommendations in the final report recognise the difficulties faced by accountants particularly in relation to an auditor's liability. Although proposals for proportionate liability have been rejected in the UK, the report recommends that section 310 of the Companies Act 1985 should be repealed.

Section 310 prevents the auditor of a company from limiting his liability to his client by any agreement to exempt or indemnify him from liability for any breach of duty in relation to the company. Under section 310, any such agreement is void. This provision is similar to that in section 165 of the Hong Kong Companies Ordinance. The recommendations made by the Steering Group went on to suggest that any agreement between the auditor and company to limit liability would need to satisfy the test of reasonableness set out in the Unfair Contract Terms Act 1977 and would also need to be disclosed to and approved by the shareholders in general meeting. The Department of Trade and Industry has yet to set out its plans for company law reform in response to the Steering Group's final report.

Other Protection

In Germany, there is a statutory cap on the amount of damages recoverable from auditors in the event of a negligent audit. The monetary amount of the cap is necessarily arbitrary and represents a significant move away from the principle that a plaintiff should be compensated in full for any loss or compensated by reference to the loss actually suffered as a direct result of the negligence or breach of duty. As such, this enactment is inherently unfair to a plaintiff and, perhaps, also to other defendants who might continue to be exposed to full liability. Further, if the cap is set too low, it might diminish the deterrent effect of full liability and reduce any incentive to settle litigation through negotiation.

It has been suggested that mandatory directors' and officers' liability insurance might alleviate concerns on the part of accountants that it is unfair for them to be jointly and severally liable for the full amount of any loss suffered when such loss was directly caused by negligence or fraud on the part of the corporation's directors and officers.

In Hong Kong, section 165 of the Companies Ordinance renders void any provision by a company in a contract exempting or indemnifying any officer of the company from liability in respect of negligence, default, breach of duty or breach of trust. This provision is understood to make void any insurance purchased by the company on behalf of its officers since this effectively provides them with an indemnity against their liabilities. Traditionally this difficulty has been resolved by issuing an insurance policy in two parts, the first being a company reimbursement policy and the second being cover for the directors and officers themselves. It is essential that the officers actually pay for their policy otherwise section 165 may render the policy void. This uncertainty will fall away, however, if the proposed amendments to section 165 of the Companies Ordinance in the recently gazetted Companies (Amendment) Bill 2002 are passed into law.

Whilst the requirement for wider insurance cover is superficially attractive, exclusions in the policy might deny cover for the loss when there has been dishonesty or fraud on the part of the directors or officers of the company thereby invalidating the requirement for mandatory cover and placing the onus back on to the accountants or other professional advisers. Concerns have also been expressed that mandatory insurance cover might impose too heavy a cost burden on the company.

Auditors and other officers in Bermuda may be entitled under the bye-laws of the company to an indemnity out of company funds even where they have been negligent in the performance of their duties. Any provision which provides indemnity for wilful negligence, wilful default, fraud or dishonesty, however, will be void under the Bermudan Companies Act. Whilst superficially attractive, the effect is likely to be that plaintiffs will actively look out ways and means to allege wilful negligence, wilful default, fraud or dishonesty in order to get an action off the ground. In those circumstances, the protection may only be of limited assistance especially where the loss suffered is particularly high.

In common law jurisdictions there has been a general trend towards defining auditors' liability for damages more precisely. This has primarily been achieved by a better definition of the class of persons to whom a duty of care is owed and therefore those entitled to sue. The recent authorities have brought into focus the purpose for which the advice (including, in the case of auditors, the audit report) was given. It appears from the decisions that the relevant policy considerations are:

- Tortious liability should not be owed 'in an indeterminate amount for an indeterminate time to an indeterminate class';

- Liability of professional people to others should address the transaction which the plaintiff had in contemplation; the purpose of the advice given or statement made; whether the defendant knew that the advice would be communicated to the plaintiff as an individual or a member of an identified class and would be relied on by him for the transaction concerned; and whether there was a sufficient relationship of proximity for a duty of care to arise;

- Where functions performed are prescribed by statute, the purpose for which those functions are prescribed must be examined to determine to whom a duty of care should be owed and to what extent.

The law has also used the issue of causation to restrict professionals' liability for damages. Cases have distinguished between failures which give rise to the opportunity for loss to be suffered and failures which can be shown to be the direct cause of the loss claimed.

The need for a plaintiff to establish a causal connection between the breach of duty and loss will not prevent professionals from being exposed to an amount of liability which is disproportionate to the extent of their involvement. The most striking example of what is meant can be seen from the case of *ADT v BDO Binder Hamlyn* in which the judge at first instance awarded damages to ADT for an amount well in excess of BDO's available insurance cover. BDO's liability arose in that case from a comment made to representatives of ADT at a short meeting by the audit partner of a company which ADT was considering acquiring. The partner knew of the planned acquisition but had not previously been involved in it and had not been provided with any agenda or other detailed briefing in advance of the meeting. The audit partner told the representatives of ADT that he stood by the audit opinion on the most recent audited financial statements and was not aware of any change in the company's financial position since the year end.

Specific Issues for Auditors

Justice requires that compensation should be commensurate with responsibility. Exposing professionals to damages which are disproportionate to their degree of fault increases the cost of professional services due to the need to fund the costs of defence and high insurance premiums. Such costs are inevitably passed on to the client and by the client to its customers.

The amount of damages claimed in some cases is so huge that neither the professionals nor their insurers could cover them. The effect of joint and several liability is to force even innocent defendants in such cases to settle in order to avoid the possibility of draconian liability.

Where a plaintiff company is insolvent, as is often the case with claims against auditors, the insolvency is frequently the consequence of acts or omissions on the part of the directors or management. In the absence of fraud on the company itself, the conduct of the directors and management is treated as the conduct of the company itself. Where the liability of the directors or management to the company cannot be satisfied, it is neither just nor commercial sense to impose the consequences on the auditors who do not share in the profits of the business if it is successful and are not at liberty to restrict their liability. The shareholders appoint the directors and should bear the consequences of that choice rather than receive full protection against the consequences of their choice.

There is a clear and important distinction between the situation of an individual plaintiff who suffers physical injury as a result of the negligence of a number of defendants and the position of a corporate body that has suffered loss. Shareholders and other investors are not innocent victims but conscious risk takers. They should bear some risk in respect of the choices they have made rather than being entitled to obtain full recovery by virtue of the principle of joint and several liability.

Specific Issues for Hong Kong

There is no doubt that professionals play a vital role in the operation of the capital markets and in helping to promote confidence in good corporate governance generally. The audit process is particularly important. It is important that high risk companies that are most in need of top quality service should be able to obtain that service. It is not in the interests of anyone involved in the capital markets for the professionals to engage in defensive practice because they are forever looking over their shoulders and worrying how best to limit their potential liability.

Professional costs need to remain competitive and be reasonable in relation to the overall cost of doing business. Further, the professions need talented people at a time when the financial complexity of business is increasing. Bright graduates must be encouraged to apply to join the professions and there must be a clear career structure and good prospects for those who do join.

The risks for professionals are increasing as Hong Kong becomes a more sophisticated financial centre. The growing amount of cross border business and listings of companies with limited track records on the GEM means that the risk exposure is multiplying. The role of professionals in these areas will be crucial.

The perception of the role of auditors is also key. There is still a widening expectation gap as to how investigative auditors should be in performing their functions. Courts have held that auditors are required to be watchdogs not bloodhounds – the reality is that there is a limit to what can be expected from auditors in unearthing financial fraud and error especially where deliberate efforts have been made to conceal such matters from the professional advisers and shareholders. Increasingly, however, auditors are expected to be all-seeing in uncovering and reporting irregularities and duties have been imposed on them to report suspicions of wrongdoing in certain circumstances overriding their professional duty of client confidentiality.

The HKSA's Proposal

The above analysis shows clearly why the principle of joint and several liability is no longer apposite in the current business and economic climate. The HKSA believes that it is important to introduce a revised system of liability that is fair and balances injustice to a plaintiff who has lost money and injustice to a defendant whose breach of duty has contributed only partially to that loss. The proposal set out below represents the HKSA's views as to the best way of redressing the balance, specifically tailored to the particular circumstances of Hong Kong, following a careful analysis of the way that the problem has been addressed in other jurisdictions.

The proposal does not entail the wholesale displacement or exclusion of the principle of joint and several liability. The principle can co-exist with that of proportionate liability. This can be achieved, for instance, by limiting the operation of proportionate liability to specific cases or classes of cases or by conferring on the Court a discretion. The proposal involves the following main elements:

(i) ESSENTIAL IDEA – Proportionate liability should be introduced with exceptions. These exceptions would recognise that there are cases in which the principle of joint and several liability should continue to operate with normal consequences. For instance, joint and several liability should still apply where the defendant seeking to restrict liability has been found by the Court to have caused the damage or loss as a result of his fraud, dishonesty or wilful default.

(ii) THE SCHEDULE OF EXCEPTIONS – The use of the schedule would help facilitate the inclusion of exceptions designed to restrict the application of proportionate liability for policy reasons. The schedule could be shortened or extended and certain types of actions can be excluded altogether. As has been made clear above, the focus of the proposal is on claims by plaintiffs seeking pure economic loss from defendant professionals. The HKSA does not suggest that proportionate liability should apply in other areas such as personal injury actions.

(iii) A SEPARATE AWARD – No award would be made in favour of the plaintiff against any defendant unless the case falls outside the exceptions and any other conditions are satisfied. The Court would apportion as between the defendants the damages assessed against them in such proportion as may be just and equitable having regard to the degree in which each wrongdoer was at fault before making any separate award against the defendant in favour of the plaintiff. Under such a separate award calculated by reference to proportionate liability, the wrongdoer would be liable to pay the plaintiff only that sum which corresponds to his apportioned liability.

The HKSA recognises that there may be public concern about the ability of plaintiffs to recover full compensation for loss suffered if proportionate liability is introduced. The proposal may need further revision or refinement in order to address any public concern which arises. This could be addressed, for instance, by ensuring that the reasons for change are fully explained and publicised at the time or by including specific provisions in the legislation to safeguard the interests of plaintiffs.

The Public Interest

Hong Kong's sustainability as a world-class financial market in the 21st century is an established policy and a paramount objective which the HKSAR has committed itself to pursue. If Hong Kong is to preserve its status as a major world financial centre and keep pace with developments in the global market place in areas such as corporate governance and international regulation, it must be able to attract and retain professionals of the highest calibre. This is particularly important now that China has joined the World Trade Organisation.

Joint and several liability appears to have a negative impact on the accounting and other professions which could have adverse implications for the financial reporting system and capital markets. It also encourages plaintiffs to target 'deep pocket' defendants such as professionals who are known or perceived to be insured or solvent. In the business environment there is less justification for the law to protect plaintiffs who suffer financial loss in the same way as plaintiffs who suffer personal injury. The business environment is rapidly evolving and it is important that the legal principles applied by the Courts should reflect current conditions. Changes to the system of liability proposed by the HKSA are unlikely to reduce the deterrence factor associated with legal liability either significantly or at all.

September 11 has taught us all to expect the unexpected. Whilst the HKSA acknowledges that there have been relatively few high profile claims for enormous sums against professionals in Hong Kong in the last 10 years or so, that has not been the case elsewhere in the world. With the increase in global trade comes the increased influence of trends from our trading partners such as an increased litigation culture. It is important that steps should be taken now to address issues such as the unjust effect of the principle of joint and several liability on claims against professionals before problems strike in Hong Kong with damaging effects on confidence in our capital markets, Hong Kong as a whole and the financial viability of the professionals on whose skills they are so dependent.

16 April 2002

香港會計師公會
HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

Annex II

Our Ref.: C/CGC, M22865

17 October 2003

Mr. Edward Lau,
Secretary, Standing Committee on
Company Law Reform,
Companies Registry,
Queensway Government Offices (High Block),
15th floor, 66 Queensway,
Hong Kong.

Dear Mr. Lau,

Corporate Governance Review by the
Standing Committee on Company Law Reform
A Consultation Paper on Proposals made in Phase II of the Review

The Hong Kong Society of Accountants ("the Society") is pleased to provide its comments, attached at Annexes A and B, on the consultation paper issued by the Standing Committee on Company Law Reform ("SCCLR") in relation to Phase II of its Corporate Governance Review.

We deal with the issues relating to corporate reporting, which have auditing and accounting implications, in Part A of Annex A and other issues in Part B. The separate paper at Annex B relates to the specific issue of auditors' liability (Chapter 5, paragraphs 22.44 – 22.52 of the consultation paper). We have no strong view on those matters not addressed in either of the annexes.

Alignment of Companies Ordinance and Listing Rules or Statutory Backing for the Listing Rules

As regards the general approach to the issues covered in the consultation paper, while we have indicated support in principle for a number of the proposals in the consultation paper that are based on Listing Rule requirements, this is subject to our overall view that it would be preferable to give broader statutory backing to the Listing Rules, rather than incorporating corresponding provisions in the Companies Ordinance ("CO") in a more piecemeal way. If there were to be widely-held support for statutory backing, then, in our view it would be more appropriate to adopt this position as the starting point and consider how statutory backing could best be implemented – for example, which elements, if any, should be incorporated into primary legislation, which in subsidiary, which should be reflected in rules, etc. We note that this subject is touched on in the "Consultation Paper on Proposals to Enhance the Regulation of Listing" issued recently by the Financial Services and the Treasury Bureau. In the course of considering implementation, thought would also need to be given to the question of unlisted public companies and how some of the more fundamental requirements could also be applied to such companies.

Among the reasons for our favouring the approach of statutory backing are the following:

(a) as a matter of principle, we believe that it is better to reserve the CO, as far as possible, for matters that are applicable to all companies, rather than adding to the number of provisions that are applicable only to listed/public companies or only to private companies;

(b) we believe that legislating on specific provisions could result in the CO becoming out of step with the Listing Rules within a relatively short space of time, given that the Rules are generally more amenable to change and may, in practice, need to be changed in response to developments in the market, both locally and internationally; and

(c) we are also not clear as to how a set of expanded provisions on corporate governance matters, in the main body of CO, which would be applicable primarily to listed and public companies, would be enforced – whether, for example, there would be more than one enforcement agency and overlapping responsibilities.

Proportionate Liability

The Society remains very concerned about the considerable unfairness to professionals in Hong Kong generally, which often arises as a result of application of the current system of joint and several liability. It believes that a good case has been made for the introduction of a form of proportionate liability to address these concerns. We would suggest that the focus on auditors' liability in the consultation paper is overly narrow and runs the risk of clouding the more fundamental issue, which applies to all professionals. A number of significant jurisdictions have already introduced or are now committed to the introduction of a system of proportionate liability, most notably Australia. We note that the Australian Government published on 8 October 2003 the CLERP (Audit Reform and Corporate Disclosure) Bill 2003, which will amend the relevant legislation to ensure that proportionate liability applies to damages for economic loss for misleading or deceptive conduct. It is the Society's view that the Government of the HKSAR should take steps to introduce a well-thought-out system of proportionate liability to avert the possibility of a very damaging professional crisis, which would not be in the public interest and would be damaging to Hong Kong's position as a major regional financial centre.

We hope that you find our comments to be useful and constructive. If you have any questions on them, please contact Peter Tisman, Deputy Director (Business and Practice) at the Society in the first instance.

Yours sincerely,

WINNIE C.W. CHEUNG
SENIOR DIRECTOR
PROFESSIONAL & TECHNICAL DEVELOPMENT
HONG KONG SOCIETY OF ACCOUNTANTS

WCC/PMT/cy
Enc.

ANNEX A

Comments from the Hong Kong Society of Accountants in response to the Standing Committee on Company Law Reform's Consultation Paper in Phase II of its Corporate Governance Review

Part A – Issues with accounting and/or auditing implications (other than the issue of auditors' liability)

CHAPTER 5 - CORPORATE REPORTING

Section 22 - The Responsibilities, Liabilities and Independence of External Auditors

We agree with the Standing Committee on Company Law Reform (SCCLR)'s proposals with respect to the following areas:

- Auditors' Function and Auditing Standards (paragraphs 22.06 – 22.13)
- Auditors' Remuneration (paragraphs 22.14 – 22.15)
- Outgoing Auditors (paragraphs 22.19 – 22.20)
- Auditors' Independence (paragraphs 22.21 – 22.29)
- Rotation of Audit Firms (paragraphs 22.30 – 22.33)
- Auditors' Duties (paragraphs 22.36 – 22.43)

Auditors' Access to Information (paragraphs 22.16 – 22.18)

We agree with the proposal that the present requirement under section 141(5) of the Companies Ordinance ("CO") on directors and officers of the company to provide such information and explanations as the auditors think necessary and the corresponding criminal sanctions should be extended to bring employees of the company within its scope.

Nevertheless, we have concern about the proposal to introduce a wider duty on (a) directors as well as (b) directors or auditors of a subsidiary undertaking of a company to volunteer information to the auditors of the company [holding company] where the normal standards of directors' or auditors' care and skill would require them to recognise that such information is needed; and that criminal sanctions should be applied to breaches of this wider duty only where the director or auditor knows that the information concerned is material to the audit [of the holding company].

Auditors of a subsidiary undertaking

We do not support the proposal to impose a duty on the auditors of a subsidiary undertaking to volunteer information to the auditors of the holding company for the following reasons:

(i) The rationale and justification for such a proposal for Hong Kong have not been fully discussed in the Phase II Corporate Governance Review consultation paper other than the understanding that there is a similar proposal in the United Kingdom ("UK").

(ii) The proposal has been drafted in such a way that it contains elements of uncertainty and ambiguity which may cause practical difficulties for the auditors of a subsidiary undertaking to comply. It is unclear as to the intended threshold of the criteria of *"where the normal standards of auditors' care and skill require them to recognise that such information is needed"* and *"information material to the audit [of the holding company]"*.

(iii) In performing an audit of the subsidiary undertaking, the auditors would consider materiality at the subsidiary undertaking level, and not the holding company or the group level. Such materiality level may not be appropriate for the audit of the holding company or group accounts and therefore it would be impossible for the auditors of a subsidiary undertaking to determine what is considered material to the audit of the holding company or the group.

(iv) In a large group of companies with different levels of holding companies, an auditor of a subsidiary undertaking may in practice have difficulty in establishing all the holding companies and their auditors.

(v) The proposal shifts the onus of disclosure from the current reactive obligation on auditors of a subsidiary undertaking to respond to auditors of the holding company enquiries to a pro-active one to volunteer information. This may result in an extension of the scope of the audit carried out by auditors of the subsidiary undertaking with cost implications. We suggest that the proposal should be subject to a further "cost and benefit" analysis.

(vi) We consider that the auditors of the holding company at present already have an effective channel to receive material information on a subsidiary undertaking through any qualifications/modifications in the audit report of the subsidiary undertaking; and the extant HKSA Statement of Auditing Standards (SAS) 510 "Principal Auditors and Other Auditors" already requires co-operation between auditors.

Paragraph 19 of SAS 510 already sets out the basic principles and essential procedures such that the subsidiary auditors, knowing the context in which the principal auditors will use their work, should co-operate, subject to the necessary consent of the client, with the principal auditors. In principle, the subsidiary auditors would therefore be prepared to co-operate with the principal auditors and make available such information as the principal auditors may require in order to discharge their duties as auditors of the financial statements audited by them. In addition, paragraph 25 of SAS 510 provides guidance such that if in carrying out their audit procedures the subsidiary auditors identify matters which they consider likely to be relevant to the principal auditors' work, they would normally consider the most appropriate means of bringing the matter to the attention of the principal auditors. This may be achieved through the subsidiary auditors' direct communication with the principal auditors, providing consent is granted by the subsidiary's management.

In view of the above, we therefore consider that the current requirements are adequate and recommend that further research should be carried out before reaching a conclusion on the proposal to widen the duty of the auditors of a subsidiary undertaking. We believe that it would be more appropriate, if considered necessary, to expand the guidance in the HKSA's Professional Standards instead of introducing legislation to widen the duty of the auditors of a subsidiary undertaking.

Directors of a company

We support the concept to widen the duty of the directors of a company to volunteer information to the auditors of the company subject to clarification of certain ambiguities, such as the meaning of "*where the normal standards of directors' care and skill require them to recognise that such information is needed*". In respect of the definition of "normal standards of care and skill", clarification is required as to whether it would mean that a single standard would apply to all directors of the company, or a different standard for each individual director with reference to his/her education and training background, working experience, professional qualifications, etc. If the latter, it would mean too much a pressure on the professionally trained directors as the normal standards of care and skill expected of them may be higher.

Directors of a subsidiary undertaking

We question the rationale and justification of requiring directors of a subsidiary undertaking to volunteer information to the auditors of the holding company, given that such directors would also be facing the same problem as auditors of a subsidiary undertaking in determining the materiality level of the holding company or the group level in order to carry out a meaningful reporting.

Rotation of Audit Partners (paragraphs 22.34 – 22.35)

We note that it is not clear in the Phase II Corporate Governance Review consultation paper as to whether the proposal with respect to rotation of audit partners is applicable to only listed entities or to all companies in general. We are of the view that extending the requirement to require rotation of audit partners in the audit of private companies would be going too far, since there is no public interest involved and the issues of perception surrounding independence also centres on listed companies. In addition, given the fact that the international references quoted in the consultation paper, i.e. the Sarbanes-Oxley Act (2002) and the IFAC (International Federation of Accountants) Code of Ethics for Professional Accountants are directed at the audit of listed companies, we would take it that the SCCLR's proposal on rotation of audit partners is also intended to be applicable only to the audit of listed entities.

With respect to the proposal itself, we have the following comments:

(i) We recognise that the use of the same lead engagement partner on an audit over a prolonged period may create a familiarity threat. Under the IFAC Code of Ethics for Professional Accountants (paragraph 8.151), auditors of listed entities are required to apply the evaluation process and implement safeguards to reduce the threat to their independence to an acceptable level. The suggested safeguards are:

- rotation of the lead engagement partner after a predefined period (no longer than 7 years);
- a partner rotating after a predefined period should not resume the lead engagement partner role until a further period of time has elapsed (not less than 2 years).

(ii) Although rotation of the lead engagement partner may, on the one hand, help to reduce any perceived threat to independence, there could, on the other hand, be adverse consequences. The efficiency and effectiveness of the audit may be affected, particularly in the case of complex corporations, where the acquisition of specialist knowledge may be beneficial in understanding and reporting on the business. Under the circumstances, we would suggest that the current requirements under the IFAC Code of Ethics may be a more appropriate starting point for Hong Kong (i.e. a rotation period of no more than 7 years). The situation could be subject to review in 2 - 3 years' time to see if it is necessary to shorten the maximum period to 5 years or some other duration.

(iii) The proposed "time-out" period of five years is considered too long. A shorter period is considered to be more appropriate given that a period of five years could prove challenging, not only for small and medium-sized firms, but also for larger firms in the case of audits of specialised industries. Accordingly, we recommend that a "time-out" period of not less than two years, as recommended in the IFAC Code of Ethics for Professional Accountants, should be adopted.

(iv) We support the SCCLR's recommendation of a detailed review of the final rules of the Sarbanes-Oxley model with regard to other partners to determine their relevance and applicability in Hong Kong.

Auditors' Liability (paragraphs 22.44 - 22.52)

Our views on the issue of auditors' liability are contained in Annex B of this submission.

Part B – Comments on non-accounting/auditing issues

CHAPTER 3 – DIRECTORS

Section 7 – Directors' Duties

We would like to reiterate our view with respect to a similar proposal made in Phase I of the SCCLR's Corporate Governance Review. We believe that Hong Kong should aim to underline and entrench its position as one of the world's centres of finance and commerce and, as such, it should be seen to be maintaining a high benchmark in terms of corporate governance standards. We consider that this purpose would be better served by including in the CO a broad statement of general principles in relation to directors' duties and standard of care and skill in the performance of their functions and exercise of their powers, rather than adopting non-statutory guidelines as proposed.

We consider that a statutory enactment would serve the following purposes:

- create more certainty as to the basic expectations in relation to directors' duties;
- give more weight to the principles;
- remind directors of the existence of the legal requirement to exercise fiduciary duties and an appropriate standard of skill and care;
- facilitate monitoring and enforcement by minority shareholders.

We accept that it would not be possible for all directors' duties to be encapsulated in the statute and that any codified statement of directors' duties would not be exhaustive, nevertheless an express provision to this effect could be added in the CO. Furthermore, it would seem to us that the statutory and non-statutory approaches need not be mutually exclusive, and that any statutory statement of the basic duties could be supplemented by a more extensive set of non-statutory principles.

Section 8 – Voting by Directors in relation to Directors' Self-dealing

We support the proposed legislative amendments in relation to improving the general legal position on self-dealing by directors, as set out in paragraph 8.06 of the Phase II Corporate Governance Review consultation paper ("consultation paper"), which should be applicable to all listed and unlisted public companies in Hong Kong.

Section 9 – Shareholders' Approval for Connected Transactions of Significance involving Directors

We support the proposed legislative amendments with respect to shareholders' approval for significant transactions involving directors, as set out in paragraphs 9.09 – 9.11 of the consultation paper, which should apply to listed and unlisted public companies in Hong Kong.

As regards the de minimus thresholds for connected transactions to be incorporated into law, we are of the view that these thresholds should be consistent with those in the Listing Rules in order to avoid confusion. As regards the specifics, in our submission to the Stock Exchange's *Consultation Paper on Proposed Amendments to the Listing Rules relating to Corporate Governance Issues* (January 2002), we expressed reservations about the way in which the proposed "total assets" test and "turnover" test would work in practice. We were of the view that the existing thresholds for notifiable transactions and connected party transactions should be retained. (See Appendix A.)

Section 10 - Transactions between Directors or Connected Parties with an Associated Company

We agree with the extension of the Listing Rules requirements relating to connected party transactions to an associated company, as well as the proposed legislative amendments with respect to transactions between directors or connected parties with an associated company, as set out in paragraphs 10.22 of the consultation paper, which should apply to listed and unlisted public companies in Hong Kong.

As regards the definition of "associated company", in order to avoid confusion, we consider that there should be one definition in the context of both the Companies Ordinance and the accounting standard.

In our submission on the proposals made in Phase I of the Corporate Governance Review, we drew attention to paragraph 2 of Statement of Standard Accounting Practice (SSAP) 10 "Accounting for investments in associates", which defines an "associate" as an enterprise in which the investor has significant influence and which is neither a subsidiary or a joint venture of the investor. "Significant influence" is the power to participate in the financial and operating policy decisions of the investee but is not control over those policies.

Due to difference in the nature of "subsidiary" and "associate", we consider that it is not appropriate to adopt the UK Companies Act definition of "subsidiary", for the purpose of consolidating accounts, which uses the "dominant influence" test of control, and apply it to associates in the context of connected transactions. The concept of "significant influence" used in SSAP 10 to define associate is considered to be more appropriate. In addition, as SSAP 10 is in conformity with the relevant International Accounting Standard, the SSAP definition of "associate" is therefore already accepted internationally.

Section 11 – The Roles and Functions of the Chairman and Chief Executive Officer

We agree that it is sufficient to recommend separation of the roles and functions of the chairman and chief executive as a best practice. We also agree that this is an issue relevant only to listed companies and, therefore, that it would be sufficient to introduce appropriate provisions in the Listing Rules and the Code of Best Practice.

Section 12 - Board Procedures

We note that a number of the proposals in relation to strengthening board procedures set out in this section are in line with recommendations made by the Society in our corporate governance publications. We support the suggestion that the various proposals be incorporated into the Code of Best Practice of the Listing Rules and, in addition, consider that further guidance should be provided on the following matters:

a. *Access to the Company Secretary* (paragraph 12.19)

   "*The company secretary should work closely with the chairman in advising directors of their duties and responsibilities under applicable rules and regulations*"

   Noting that there is also a recommendation for separation of the roles and functions of the chairman and CEO in section 11, paragraph 11.04, we think that it would be helpful to the implementation of the proposal if guidance were to be provided on the chairman's role.

b. *Relationship of Board to Management* (paragraphs 12.22 and 12.23)

   "*There should be guidelines on the relationship between the company's board of directors and the company's management*"

While the fundamental relationship between the board and management may be clear, in practice, it is sometimes difficult to clearly distinguish the roles of the two. It would be helpful, therefore, if some sample/model guidelines could be provided for reference.

Section 13 - Audit, Nomination and Remuneration Committees

We support most of the proposals in relation to audit, nomination and remuneration committees set out in paragraph 13.46, except that we believe item (c), i.e. that "a retired partner of the firm auditing the company's accounts should be prohibited absolutely from acting as the chairman or member of an audit committee", to be overly restrictive.

A retired partner of the relevant audit firm could be in a position to make a very positive contribution to the work of the company's audit committee, provided his independence is not open to question. In order to address the question of independence, we consider that a "sanitisation" period of say, 2 – 3 years, will be sufficient in most cases. So as to further strengthen the perception of independence, a further pre-condition could be added, requiring any retired partner sitting on the audit committee to have no financial interest in the audit firm.

Section 14 - The Structure of the Board and the Role of Non-executive Directors

We support the proposals with respect to the structure of the board and the role of non-executive directors, as set out in paragraphs 14.44 & 14.45 of the consultation paper.

Section 15 - Directors' Qualifications and Training

Whilst we agree that it is not practical or desirable to make directors' training and qualifications mandatory at this stage, we consider that it should be a medium-term goal to make directors more professional in their approach and that the situation should be reviewed in a few years' time. It is important, for example, that directors keep up with changes in company law.

Section 16 - Directors' Remuneration

We support the proposal to require listed companies to disclose individual director's remuneration packages by name in their annual financial statements, including full details of all elements. We would also propose that such details should be further analysed into performance and non-performance based.

Although we do not see a great demand for extending the above proposal to private companies, we would have no strong objection to such an extension. We would however suggest that the minimum threshold for shareholders to be able to direct disclosure should be raised from not less than 5% to not less than 10% of the nominal issued share capital of the company (paragraph 16.23(b) of the consultation paper).

We consider that there should also be specific disclosures on key aspects of a company's remuneration policy. Otherwise, disclosure of individual director's package would not be meaningful. With regard to the key issues to be covered in a general policy statement on directors' remuneration, we suggest that reference could be made to the UK Greenbury Report on "Directors' Remuneration" published in July 1995. The Greenbury recommendation of key issues to be covered in a general policy statement on directors' remuneration have been set out in the HKSA guide on recommendations for enhanced transparency and accountability of directors' remuneration, published in 1999 (extract at Appendix B).

We support the proposals with respect to the disclosure of directors' share options (paragraph 16.23(d) of the consultation paper).

If companies are required to disclose key aspects of their remuneration policy, then we would go along with the introduction in Hong Kong of requirements along the lines of the UK's Directors' Remuneration Regulations 2002 (paragraph 16.25 of the consultation paper). However, if there is no requirement to disclose information about remuneration policy, then the question of shareholders' approval of remuneration reports should be revisited at a later time.

CHAPTER 4 - SHAREHOLDERS

Section 17 - Self-dealing by Controlling Shareholders

We support the proposal set out in paragraph 17.11 of the consultation paper to incorporate the following changes into the law:

(i) connected transactions must be disclosed and subject to a disinterested shareholders' vote;

(ii) the definition of a "connected person" in relation to controlling shareholder; and

(iii) the rule should be subject to certain exceptions and other de minimis exceptions, along the lines of those adopted in respect of director-related transactions. As regards the appropriate thresholds for the de minimis exceptions and the assets thresholds for a disinterested shareholders' vote to be incorporated into law, we are of the view that these thresholds should be consistent with those in the Listing Rules in order to avoid confusion. We suggest incorporating them in rules or subsidiary legislation, which would be easier to amend, rather than primary legislation.

We also support the proposal that voting on connected transactions must take place on a poll (paragraph 17.13 of the consultation paper).

Although the Listing Rules have not set out the criteria for the Stock Exchange to grant a waiver to connected party transaction requirements, we note that the Stock Exchange would usually exercise its discretion to grant such a waiver for expediency or for a series of continuous transactions. We consider that the waiver is a useful tool. If the other requirements relating to connected party transactions are incorporated in the CO but the waiver is omitted, this would appear to have the effect that the Stock Exchange would not be able to exercise a discretion in the case of Hong Kong-incorporated listed companies, which would be anomalous. This highlights one of the problems of trying to incorporate specific aspects of the Listing Rules into law. The Listing Rules are able to provide for a degree of flexibility that it is difficult, and probably not desirable, to replicate in the law. This is one reason for our holding the view, stated in the covering letter and elsewhere in this submission, that it would be preferable in principle to give some form of statutory backing to the Listing Rules rather than seeking to incorporate particular elements of the Rules into the CO.

Notwithstanding the above views, we consider that the criteria for granting a waiver, whether the waiver is to be introduced into the law or to be remained part of the Listing Rules, should be more clearly spelt out.

To digress briefly from the issues raised in the consultation paper, we are of the view that one of the fundamental problems with the existing system of corporate governance checks and balances is that independent non-executive directors (INEDs) are beholden to controlling shareholders for their position on the board. This makes it inherently more difficult for them to be completely disinterested in relation, for example, to connected transactions. We would suggest therefore that the position of INEDs, including measures that could be taken, through the law or otherwise, to further support and protect their function, as well as related issues, such as their remuneration, should also be examined.

Section 18 - Substantial Transactions

It is noted that in certain other jurisdictions, requirements to obtain prior shareholders' approval or to disclose before certain (non-connected) transactions are permitted apply to e.g. undertakings, property or assets generally, rather than being restricted to fixed assets as in the CO; and that the specification of the quantitative thresholds in most jurisdictions are found in listing rules. It is also noted that the term "fixed asset" is not defined in section 155A of the CO.

We consider that the Listing Rules' requirements in relation to "major transactions", i.e. any acquisition/realisation of assets (not limited to fixed assets) by a listed issuer or any of its subsidiaries, the value of which is in excess of the specified quantitative thresholds, are relatively onerous and should not be incorporated into law by bringing section 155A into line with it; similarly to e.g. UK and Australia, it is sufficient for listed companies to be bound by relevant requirements under the Listing Rules.

Section 155A may be seen as a basic minimum requirement and, therefore, it would be reasonable to transfer this provision, modified as may be necessary (e.g. to remove any obvious anomalies) from the main body of the CO into Table A in the First Schedule of the CO, to become applicable to all local companies unless specifically excluded.

Section 19 - Variation of Class Rights

We would agree with the SCCLR's proposal not to recommend legislative changes in this area of the law.

Section 20 - The Suitability of Judicial Control, Multiplicity of Provisions and Class Votes

(a) <u>On class composition</u> (paragraphs 20.08 - 20.17, paragraph 20.36(a)) -

We consider that the question concerning minority rights is complex and that a balance has to be struck between the ability of minority shareholders to exercise their rights and the ability of directors to conduct the business free from undue interference from minority shareholders. Minority shareholders should only be able to exercise their rights where e.g. the affairs of the company are conducted in a manner unfairly prejudicial to the interests of shareholders generally or some part thereof.

We consider that it is not necessary for the definition of class to be defined so as to allow minority shareholders to have a greater say in a proposed scheme of arrangement, for instance, by having separate class meetings for minority shareholders on the basis of their interest rather than legal rights. In any case, the court could order a separate meeting if it considered that the interests of minority shareholders were so dissimilar to those of the controlling shareholder.

(b) <u>On the multiplicity of provisions</u> (paragraphs 20.18 - 20.34, paragraph 20.36(b)) -

We note that there are areas of possible overlap between section 166 of the CO, which provides for schemes of arrangement; section 58, which provides for a statutory scheme for companies to reduce share capital with court and shareholder approval; and section 168, which allows a company that has acceptance amounting to 90% in value of the shares for which an offer is received, to compulsorily acquire the shares of dissenting minorities in an amalgamation or a merger. Nevertheless, we consider that these provisions serve different purposes and that the flexibility currently available under the provisions should be preserved as far as possible.

(c) On the suitability of judicial control (paragraphs 20.35 & 20.36(c)) -

We consider that judicial control, which is based on the common law system of precedents, generally provides a reasonable degree of certainty and predictability. Alternatives by way of e.g. administrative control by regulators would not necessarily offer more certainty, and arbitration would not necessarily reduce costs. Whilst the judicial system would be improved by e.g. simplifying the procedures and reducing the costs involved, there is no substitute for judicial control in terms of the impartiality and independence that it offers and is perceived to offer.

Section 21 - Company General Meetings

Our comments on the proposals in relation to company general meetings are as follows:

Contents of Notice (paragraphs 21.28 - 21.33)

We note that at common law, the information contained in or with the notice must be sufficient to allow a member to determine whether or not to attend the meeting. If the material facts are not disclosed in the notice calling the meeting, any resolution passed will be invalidated at the instance of a member who did not attend.

We have no objection to the basic principle of requiring minimum information to be given in the meeting notices regarding the proposed resolutions, provided the information required to be given is reasonable, such as the examples given in paragraph 21.28, i.e. the text of the resolution, a brief explanation of the reasons behind any proposed resolution, including relevant biographical details of a director proposed for (re-)election, material interests of directors or major shareholders, etc.

Agenda of Annual General Meeting (AGM) (paragraphs 21.34 - 21.38)

We consider that relevant part of section 141(2) of the CO, which requires the auditor's report to be read before the company in general meeting, should be retained unless the members present dispense with that requirement. Not only is the requirement to read out the auditor's report at the meeting useful in ensuring that the auditors attend general meetings, but it also helps to focus shareholders/investors' attention on the report, which is especially important in the case of qualified reports.

It is noted that at present, Regulation 54 of Table A indicates certain general business of an AGM (paragraph 21.35 of the consultation paper). We consider that it is sufficient to include relevant provisions in Table A and that this practice should continue.

Members' Resolution (paragraphs 21.39 – 21.48)

We agree with the SCCLR that shareholders' resolutions and related information should be circulated at the expense of the company if they meet certain criteria, e.g. timing, length, minimum threshold requirements. We do not support the concept of deposit system as an alternative approach to dealing with members' resolutions, as it appears to be over-complex.

As regards the right of shareholders to nominate directors for election at general meetings, we consider that there should not be any limit on the number of such nominations, and that criteria for nomination should be set out in order to prevent abuses, e.g. a shareholder might bombard the meeting with nominations in order to obstruct the proceedings. As regards the percentage of shareholding requirement for such nominations, we consider that it would need to be sufficiently low to encourage genuine nominations, and high enough to prevent abuse.

Voting on a Show of Hands (paragraphs 21.60 - 21.64)

We consider that voting on connected party transactions and contentious issues should be conducted by a poll, whereas uncontroversial resolutions or non-contentious matters could be dealt with more expeditiously by show of hands. Rather than to rule out voting by a show of hands, a better approach may be to consider lowering the existing criteria (e.g. the threshold requirement) for shareholders to demand a poll and also to issue guidance to the chairman as to situations in which a poll should normally be conducted.

Absentee and Electronic Voting (paragraphs 21.65 - 21.72)

We support, in principle, absentee voting and electronic voting. Nevertheless, there would need to be an effective monitoring and verification process to ensure security and authenticity in relation to such votes.

One proxy for each shareholding (paragraphs 21.73 - 21.79)

We support, in principle, the idea of multiple proxies on the basis that owners should be enfranchised, provided that there is some mechanism in place to prevent abuse.

Proxies to vote on a show of hands (paragraphs 21.80 - 21.83)

We agree with permitting proxies to vote on a show of hands.

Proxy Solicitation (paragraphs 21.84 - 21.87)

We consider that proxy solicitation should be regulated to deter abuse.

Delivery of Proxy by Electronic Means (paragraphs 21.88 - 21.94)

We support, in principle, the inclusion of specific provision for the delivery of proxies by electronic means. Nevertheless, as with electronic voting, there would need to be a strong monitoring process to address the security and authenticity concerns.

A Proxy to Vote on Poll according to their Terms (paragraphs 21.95 - 21.98)

Our initial view is that, in principle, we would support the introduction of such a requirement. However, it appears that not much information is available about the background to this suggestion and therefore some further consideration may need to be given to, for example, possible exceptional circumstances.

Disclosure of Proxy Voting Information (paragraphs 21.99 - 21.103)

Purely from the perspective of greater transparency, the chairman of the meeting should disclose to the meeting before the voting, the number of proxies held by the company and the voting instructions (if any) thereunder. On the other hand, there is a risk that prior disclosure of such information may influence the vote. As such, we would suggest making prior disclosure a best practice in normal circumstances rather than a mandatory requirement.

Inspection of Proxy Document (paragraphs 21.104 - 21.107)

We support the proposal that shareholders should be able to inspect votes, but the inspection should be made after the meeting so as not to disrupt the proceedings.

CHAPTER 6 - CORPORATE REGULATION

Statutory backing for the Listing Rules

It is noted that many of the SCCLR's proposals in the Phase II Corporate Governance Review consultation paper appear to be aimed at aligning the CO with the Listing Rules. For various reasons, referred to in the covering letter to this submission, we consider that, in principle, a better approach would be to give statutory backing to, and strengthen enforcement of, the Listing Rules, rather than to try to align various requirements in the CO with the Listing Rules on a more ad hoc basis.

Generally, we are not in favour of expanding the category of provision in the CO that are applicable to only certain types of companies, this will make it more complex when one of the main aims of the 1997 consultancy was to simplify the legislation. As far as possible, the CO should be used to establish minimum requirements applicable to all companies.

Secondly, as the Listing Rules are more amenable to change, notwithstanding the need for proper consultation, it is more efficient to respond to changes in market situation both locally and internationally through the Listing Rules. If requirements based on the Listing Rules are incorporated in the CO, either the legislation could quickly become out of step again, particularly where thresholds, asset tests, etc. are concerned, or necessary changes to the Rules may need to be delayed pending the introduction of related legislative changes. Furthermore the fundamental differences in the nature of the approval processes for the Rules and the legislation mean that, in practice, it may not always be possible to keep the two in alignment in future.

Thirdly, we are also not clear as to how an expanded set of provisions in the CO on corporate governance issues, applicable primarily to listed and public companies, would be enforced – whether, for example, there would be more than one regulatory and overlapping responsibilities.

Under the circumstances, giving some form of statutory backing and strengthening of the enforcement of the Listing Rules is considered to be a more appropriate approach. We appreciate, however, that even this approach will not be without its difficulties and will require careful thought to be given to the mechanics and the detailed implementation of such an arrangement, including the possible application of similar requirements to unlisted public companies in some cases.

The regulation of unlisted companies

We have no strong view on the question of whether the regulation of unlisted companies should be improved at the present time. To a large extent this is a question of public perception and whether there is a public demand for a more proactive enforcement, or at least a stronger capacity to respond to complaints. It is noted that in relation to specific areas of the law, in particular filing defaults, the Companies Registry is already adopting a more rigorous approach. Given the need to find a source of funding to strengthen the enforcement capability and the lack of clear-cut evidence of major problems in this area, it might be better to review this subject one or two years down the road. For the present time, we believe that, as long as there are adequate legislative provisions to protect the interest of minority shareholders, enabling them to raise concerns and, where necessary, take legal action and seek remedies, this is sufficient.

ANNEX B

Comments on issues of professional liability in response to paragraph 22.52 of the SCCLR's Consultation Paper in Phase II of its Corporate Governance Review

This paper supplements the submission made on behalf of the Hong Kong Society of Accountants ("HKSA") dated 16 April 2002 entitled "Proposal for an equitable system of liability". That submission recommended amendments to the existing system of joint and several liability in Hong Kong by the introduction of a modified system of proportionate liability in certain cases. The submission was sent in the first instance to the Financial Services Branch of the Government of the Hong Kong SAR ("FSB"). In May 2003, the HKSA was informed by the FSB that the Standing Committee on Company Law Reform ("SCCLR") had agreed to study the issue of auditor's liabilities.

In June 2003, the SCCLR issued a consultation paper on proposals made in phase II of the review entitled "Corporate Governance Review". At paragraphs 22.44 to 22.52, the SCCLR considered a number of issues arising under the heading "Auditor's Liabilities". The SCCLR was unable to reach a conclusion on this issue and invited comments on the overall issue of auditor's liability with particular reference to the desirability or otherwise of proportionate liability and proposals made by the Company Law Reform Steering Group ("CLRSG") in the United Kingdom. This paper is submitted in response to the SCCLR's invitation.

Introduction

It is important to bear in mind that the HKSA's original submission was not intended to be limited to the position of auditors, let alone accountants. The HKSA believes that the issue is of much wider importance to professionals generally. For the reasons set out in the original submission, the HKSA believes that the current system of joint and several liability can give rise to considerable unfairness particularly where plaintiffs in claims for economic loss arising from negligent misrepresentation target defendants with "deep pockets" rather than those primarily to blame for the loss suffered. Whilst the HKSA welcomes consideration of the issue of auditor's liability in its widest sense by the SCCLR, it maintains that a broader debate is still necessary in relation to the fundamental fairness of joint and several liability particularly in respect of actions in tort to recover economic loss based on negligent misrepresentation.

This paper will start with an update on the various issues raised in the HKSA's original submission by reference to recent important developments around the world particularly in relation to auditor's liabilities although the issues impact all professionals, especially those known to carry professional indemnity insurance. It will then address the arguments raised in paragraph 22.50 of the SCCLR's paper against the question of both proportionate liability and the ability of an auditor to cap its liability in respect of claims. The paper will then set out the HKSA's arguments in support of repeal of section 165 of the Companies Ordinance in as far as it prohibits an auditor from limiting liability in respect of audit work. Finally the paper will summarize the HKSA's views as to why it remains appropriate to amend the current system of joint and several liability.

Recent developments

Perhaps the most startling development since the HKSA's submission was originally sent to the FSB has been the collapse worldwide of the firm of Arthur Andersen & Co ("AA") largely as the result of its ill-fated involvement with Enron. AA was previously one of the so-called "Big 5" global accounting firms. Whilst it is not appropriate for the HKSA to comment on the reasons for the demise of AA, the fact that a leading global brand disappeared from the worldwide business community so swiftly is a clear indication of the risks which all professionals face.

The SCCLR paper refers in paragraph 22.02 to the recent Scottish decision in the case of *Royal Bank of Scotland v Bannerman Johnstone Maclay and others*. Although the case was decided on assumed facts on an application by the defendant auditor to strike out the claims for failing to disclose a reasonable cause of action, the impact of the decision is that an auditor might owe duties of care to third parties if it knew, or ought to have known, that they would rely on the audited accounts and the auditor did not disclaim liability to such third party. In that case it was held that a duty might be owed even though no allegation had been made that there had been direct contact between the auditor and the plaintiff bank. The suggestion by the court that the auditor could have disclaimed liability in such circumstances may therefore have been impractical.

As the SCCLR paper comments, the potential exposure of an auditor is now very great. It is precisely this type of unexpected decision which causes the greatest concern to all professionals. Whilst it is at least possible to adopt appropriate risk management techniques to reduce or avoid potential liability as far as possible, that process is thrown into disarray when decisions are made which effectively extend the duties of care owed to a completely new category of persons.

Another good example of the potential exposure faced by auditors is the recent English Court of Appeal decision in the case of *Equitable Life Assurance Society v Ernst & Young*. In that case, Equitable claimed damages of some £2.6 billion from E&Y for negligence in their conduct of the audit of its statutory accounts for the financial years ended 31 December 1997, 1998 and 1999. The judge at first instance had struck out the majority of Equitable's claims on a summary judgment application on the basis that they had no reasonable prospect of success particularly in respect of the losses claimed. The Court of Appeal substantially allowed Equitable's appeals. Whilst it expressed sympathy for E&Y's complaint that the sheer size of Equitable's claims represented an unwarranted burden for a litigant to have to bear in the circumstances, it did not see that it could reach a decision on the material available that particular heads of claim could not succeed for more than a given amount. The Court indicated that there might be other procedural opportunities for E&Y to capitalize on their scepticism about the size of Equitable's claims but it was not appropriate to adopt the course which the judge at first instance took.

It appears that the Court of Appeal was reluctant to decide on a summary basis claims involving developing areas of the law (which effectively includes most significant professional indemnity claims) nor did it consider it appropriate to decide summarily a case where there were some disputes of fact without giving the parties an opportunity to test the evidence on cross-examination. Accordingly, it appears that E&Y will be put to the considerable cost and uncertainty of having to defend a very significant litigation. This again epitomises the significant difficulties which professionals face in defending claims, particularly where the basis or amount of the claim is potentially dubious.

The HKSA, however, has noted the judgment of Mr. Justice Evans-Lombe in the first part of the litigation commenced by Barings against their former auditors. The judgment primarily related to the claim of Baring Futures (Singapore) Limited ("BFSL") against Deloitte & Touche (Singapore) ("D&T") for failing to detect the losses arising from Nick Leeson's trading. The claim against D&T was for some £150 million. Whilst the judge found that D&T had been negligent, he made a number of findings going to reduce their liability to the Plaintiff.

The *Barings* decision appears to stand on its own facts predominantly as a result of the very high levels of fault by Barings management and staff found by the trial judge and attributed to BFSL. The trial judge applied the significant findings of fault to hold that any damages should be significantly reduced by reason of BFSL's contributory negligence and to say that D&T should bear no liability for all losses incurred after a certain date when head office management inexplicably started to fund trades entered into by Nick Leeson without seeking an explanation of what the money was for.

In assessing contributory negligence, the trial judge held that there were a number of distinct periods between the date on which D&T's liability commenced and the date on which management's failings were so serious that they eclipsed the causative effect of any breach of duty on the part of D&T so as to become the effective cause of the losses suffered thereafter. For the first period, the judge held that management's failings should reduce any damages by 50%. For the second period, the reduction was 60% and for the third period it was 80%. The judge went on to apply reductions in respect of the final period in case he was wrong in finding that management's failings had from that date become the effective cause of the losses suffered. For this final period, the judge applied reductions of 90% and 95%.

The judge also considered the power of the court to grant relief pursuant to the Singapore equivalent of section 358 of the Companies Ordinance. That provision allows a court hearing an action for negligence, default, breach of duty or breach of trust against a company's auditor or officer to grant relief either wholly or partly from liability where it appears that the defendant acted honestly and reasonably and that he should fairly be excused for the negligence, default, breach of duty or breach of trust having regard to all the circumstances of the case. The judge found that an auditor, even though negligent, may have acted reasonably for the purposes of the relevant statutory provision provided it acted in good faith and the negligence was technical or minor in character. D&T only invoked the section in relation to two issues on the quantification of damage. The judge found that if the other arguments in relation to those particular items of damage were not sufficient to relieve D&T of liability for them, they should be relieved under the statutory provision. The judge's approach may suggest that the courts could use the statutory provision to try to soften the effect of the rules on causation and loss having regard to the overall economic outcome for the interested parties. This development could be significant given the frequent disproportion between the damages that may flow from an error and the size of the fee in respect of the work concerned.

The most significant recent developments are perhaps to be found in Australia where there has been serious market failure in the professional indemnity insurance market leading to a significant risk that services will be carried out by uninsured persons such that there will be no one to sue for damages in the event of negligence causing economic loss. The crisis has arisen as a result of a significant contraction in the number of insurers offering professional indemnity insurance, vast premium increases and significant reductions in the extent of cover provided as a result of additional policy exclusions and increases in applicable conditions and self-insured retentions. The difficulties in obtaining insurance, at least at affordable levels, are said to result in consumers being denied access to appropriate professional services, losing the ability to obtain compensation where appropriate and perhaps being unaware that services might be provided by professionals who are not accredited or insured and not subject to professional standards. On 6 August 2003 one of a series of joint ministerial meetings was held to discuss the issues arising from the crisis and consider ways in which it might be resolved. At that meeting, Commonwealth, State and Territory ministers endorsed a national scheme for Professional Standards Legislation ("PSL") for economic loss in conjunction with a commitment to implement proportionate liability across Australia.

PSL is intended to protect consumers by making it mandatory for professionals to carry professional indemnity insurance and to partake in risk management schemes but permitting safety ceilings or caps on claims. The representative association of a group or profession will prepare and submit a scheme for the scrutiny and approval of the Professional Standards Council ("PSC"). The scheme must include a range of risk management and other obligations on the members of the group or profession in exchange for a cap on the civil liability of those members which is set out in the scheme. Once approved by the PSC, the scheme is submitted to the relevant minister for final approval. Once final approval is granted, it will apply to all members of the group or profession represented by the association with only limited exceptions. The cap on liability will be set high enough to cover all consumer claims and most corporate claims for economic loss but should eliminate the risk of catastrophic claims. The intention is that once nationally consistent legislation is in place for PSL, professional indemnity insurance will become more widely available at affordable prices again.

The ministers also endorsed a national model for proportionate liability so that the courts, in considering the liability of a defendant, will also have regard to the responsibility of any potential defendant not a party to the proceedings. The model will require defendants to notify a plaintiff in writing of the identity and alleged role of any other potential defendants of whom they are aware. Defendants who fail to comply with this provision will be at risk of being ordered to pay costs. Proportionate liability has already been introduced in certain states within Australia such as New

South Wales and Victoria and the impetus now appears to be on achieving consistency across Australia. The important thing to recognize is that both of the major elements of the proposal are being pursued together rather than separately or as alternatives.

The Australian Government published on 8 October 2003 the CLERP (Audit Reform and Corporate Disclosure) Bill 2003 <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=700> which will amend the relevant legislation to ensure that proportionate liability applies to damages for economic loss for misleading or deceptive conduct.

The conclusion to be drawn from these recent developments is that all professionals, including auditors, remain exposed to significant potential liability which is all too often exacerbated by the effect of the principle of joint and several liability. Whilst the decision in the *Barings* litigation suggests the position may not be as bad as some suggest, it remains a decision at first instance decided on its own particular facts. It is not known whether the decision will be subject to appeal. The fact specific nature of the decision can be tested against the fact that previously it had generally been accepted that the maximum reduction that might be ordered in respect of contributory negligence would be of the order of 30%. Further the relief granted under the Singapore equivalent of section 358 of the Companies Ordinance has generally been believed to be of no application since it was considered very difficult for a court to find an auditor's actions to be reasonable if the court had already held that he was negligent or otherwise in breach of duty and therefore had not exercised reasonable skill and care.

The HKSA welcomes the initiatives taken by the Australian government to address the problem by the introduction of PSL which involves caps on liability together with, rather than as an alternative to, a system of proportionate liability. Whilst the catalyst for the changes in Australia is unfortunate, the fact that they have become necessary shows that complacency should be avoided and brave action should be taken sooner rather than later.

HKSA's comments on the arguments against proportionate liability and capping

Set out below are the HKSA's comments on the different arguments identified in paragraph 22.50 of the SCCLR paper.

1. **The first argument identified is that it would be difficult to limit a defendant's liability to a particular percentage of the damages without having all involved persons before the court. This argument is premised on the basis that each tortfeasor will be liable for the whole loss suffered.** It is this premise which the HKSA believes should be challenged. Whilst the HKSA accepts that this is the law as it stands, its primary contention is that the effect of this law, particularly in claims for economic loss, is unfair and inequitable. This is particularly the case where the "deep pocket" defendant is only peripherally responsible for the loss claimed. In any event, courts frequently find themselves in situations where findings of fact have to be made or inferences have to be drawn on the basis of incomplete information. Where for instance a claim is brought against a defendant auditor by a company in liquidation, invariably a number of relevant witnesses will not be called by the liquidators whether as a result of their own choice or as a result of circumstance. The HKSA contends that the situation would be little different were the court to be called upon to decide on proportionate liability in the absence of other potentially responsible parties. In any event, the difficulty could be reduced by introduction of a requirement on the defendant to notify a plaintiff in writing the identity and alleged role of any other potential defendants of whom they are aware at an early stage of proceedings or even before proceedings are commenced.

2. **The second argument raised is that an auditor should be able to limit its liability either contractually or by incorporation as a limited liability company.** The HKSA certainly welcomes the recommendations of the CLRSG to the effect that the UK equivalent of section 165 of the Companies Ordinance should be amended to enable an auditor to limit its liability contractually with the company and in tort with third parties. To date, no amendment to the UK company legislation has been enacted and, unless and until section 165 were to be amended,

this argument should be given little weight. In any event, the HKSA believes that the ability to cap liability should go hand in hand with proportionate liability as has been proposed in Australia.

An audit firm is already allowed to incorporate as a limited liability company in Hong Kong. To date, not many practices have taken up this opportunity. In any event, the HKSA does not believe that the ability to incorporate has any bearing on the issue of joint and several liability and the significant potential exposures arising therefrom. The size and number of claims made will not be affected by the way in which audit firms choose to structure themselves.

3. **The third argument raised is that the directors would be responsible for the balance of the damages awarded in respect of such liability if an auditor were able to limit its contractual liability.** This argument is not fully understood. The reality is that the day-to-day management of a company's affairs is the responsibility of its directors and officers. A number of the recommendations in the SCCLR paper quite appropriately address the duties that directors owe in the exercise of their functions and how such directors should be educated as to their responsibilities. The directors and officers know far more about the company and its affairs given their role in management than can be expected of an auditor whose function is to report the financial position as at a certain date. It seems entirely appropriate that the directors and officers should be liable for losses which the company might have suffered as a result of their negligently made management decisions. The HKSA believes that the apportionment of liability through the system of proportionate liability is fair and equitable in this respect. Further, management can purchase directors' and officers' liability insurance in order to protect themselves against any increased risk of liability.

4. **The fourth argument is that the ability to limit liability for negligence should apply to all professions, including directors. The argument goes on that an auditor should not be given favourable treatment.** The HKSA entirely agrees with this point which is why it has been pressing for a wider review of the system of joint and several liability. That said, the HKSA submits that an auditor is in fact in a different position, given its regulatory role, which is not akin to the roles of other professionals. This has been recognized in paragraph 22.51. Consideration of the position of an auditor alone, however, is potentially misleading and may give rise to potentially irrelevant arguments and other considerations. As mentioned in the introduction to this paper, the main focus of the HKSA's submission is the review of the appropriate system of liability for the benefit of all professionals. The Australian government response has been to address the issue in a far broader context by application to all professions and other groups. The HKSA urges the HKSAR government to follow suit.

5. **The fifth argument is that proportionate liability is not the same as contributory negligence since in the former case the court may be required to rule in the absence of some relevant party whereas in the latter case the court has the benefit of hearing the arguments of the opposing parties.** The HKSA recognizes that a court will hear evidence from the plaintiff before deciding whether it has been contributorily negligent and, if so, to what extent. A court, however, is frequently required to reach decisions at a trial without having access to all potential witnesses and all the best evidence. This is the reality of all litigation, especially particularly significant and complex litigation. If it were not the case, the litigation process would in all probability become unworkable in practice. It is the HKSA's view therefore that this concern is far greater in theory than it would be in practice especially if a defendant were required as part of its defence to identify the alleged role of any other potential defendants of whom it is aware.

6. **The last argument raised is that it may not be a practical or realistic proposition for a plaintiff to pursue all other parties under a proportionate liability scheme. The example is given of a company which has gone into liquidation.** The HKSA recognizes that this may present a practical problem for a plaintiff in certain circumstances but it is no different to the situation where a plaintiff suffers loss as a result of breach of duty by a single defendant which is insolvent by the time that litigation is commenced. When a plaintiff is harmed by joint

tortfeasors, however, he receives an advantage, the logic of which is difficult to justify at least in the context of the type of claims which form the focus of this paper. The justification for imposing an inequitable financial burden on a defendant whose contribution to the loss suffered may have been relatively slight is unclear and in the HKSA's view not made out. In cases of economic loss, which often involve commercial entities used to taking risks, there does not appear to be a justification for relieving the plaintiff of a financial burden at the expense of a defendant. The equitable solution is for the contribution of each of the parties to be assessed according to their relative blameworthiness. This may mean that a plaintiff does not recover in full in certain circumstances but at least it will be able to make some recovery. At least the solvent defendant will not have had to bear an unfair share of the total loss suffered.

Section 165 of the Companies Ordinance

The HKSA would welcome the repeal of section 165 of the Companies Ordinance to the extent that it prohibits an auditor from limiting his liability in respect of audit work. The recommendations of the CLRSG in this respect are particularly helpful. The position of the company and its shareholders will not be prejudiced as a result provided that it is a condition that the limit on liability should be approved by the company at the AGM.

The HKSA believes that the position in respect of third parties is more difficult. As there is no privity of contract between an auditor and third party, the effectiveness of any cap on liability as far as claims by third parties are concerned must remain open to doubt.

The decision in *Bannerman* highlights a problem. In that case there was no direct contact between the auditor and the plaintiff bank but the court still found it arguable that the auditor might owe the bank a duty of care. The HKSA has issued a Professional Risk Management Bulletin providing guidance to auditors on appropriate action which they may wish to take to help protect themselves against exposure to third party claims to assist them in managing the risk of inadvertently assuming a duty of care to third parties in relation to their audit reports. The Institute of Chartered Accountants in England & Wales ("ICAEW") has also issued a Technical Release following the *Bannerman* decision with guidance on the same subject. The effectiveness of what has been recommended by the HKSA and the ICAEW, however, has not yet been tested by the courts.

The repeal of the relevant part of section 165 of the Companies Ordinance will therefore be beneficial but in the HKSA's view cannot be the total answer by reason of the continuing uncertainties for an auditor's liability that exist particularly in respect of claims by third parties.

The case for proportionate liability

The HKSA is encouraged by the consultation process being undertaken by the SCCLR but suggests that the breadth of the issues on which comments have been invited is too narrow. The HKSA firmly believes that there is a danger in seeking to review issues on a piecemeal basis in a restricted context since this can give rise to further unfairness and inequalities between different groups or professions. This is borne out by the arguments against capping liability and proportionate liability set out in paragraph 22.50 of the SCCLR paper. The HKSA maintains that the case has been made out that the system of joint and several liability operates unfairly, particularly in the professional indemnity arena, and that a case has been made out for the introduction of a system of proportionate liability. The real issue is where the boundaries of such a system should lie.

The HKSA is encouraged to note the wide-ranging reforms proposed by the Australian government in order to address the professional indemnity crisis there. The proposals extend to all professionals and have been taken in the name of consumer protection which the HKSA recognizes is essential. The proposals call into question the perceived wisdom that the principle of joint and several liability should be sacred in order to protect a plaintiff's position. That requirement no longer appears justified particularly in respect of claims by commercial entities for economic loss against a negligent professional.

Neither the Australian government nor the HKSA is suggesting that the principle of joint and several liability should be abolished in its entirety. What is more important is to establish an equitable system of liability particularly in respect of claims for economic loss where the potential damages can be so significant. The claim by *Equitable* is a case in point.

It is far better to address the issue responsibly now rather than be forced to introduce changes hastily in response to a similar crisis to that faced in Australia. A number of jurisdictions such as Canada, certain States in the USA, Ireland, Bermuda and now Australia have "bitten the bullet" as far as proportionate liability is concerned and the HKSA believes that it is appropriate for the HKSAR Government to do so too for the reasons outlined in this paper and its earlier submission.

Hong Kong Society of Accountants
October 2003

CPA
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Annex III

BY HAND

Our Ref.: C/PRMC

25 November 2004

The Hon. Henry Tang,
Financial Secretary,
Government of the HKSAR,
Central Government Offices,
Lower Albert Road,
Hong Kong.

Dear Mr Tang,

Proposal for the introduction of
Limited Liability Partnerships ("LLPs") in Hong Kong

The Law Society of Hong Kong (LSHK) submitted a report prepared by its Working Party on Limited Liability Partnership to Mr. Gordon Jones, Registrar of Companies and Mr. Bob Allcock, Solicitor General, Legal Policy Division of the Department of Justice in August 2004. The report made proposals to introduce the concept of LLPs as part of partnership law in the Hong Kong SAR. The Hong Kong Institute of Certified Public Accountants (HKICPA) firmly supports the LSHK in this initiative.

There is a justifiable concern amongst professionals generally of the increasing risks they face as a result of the changing business world in which they operate. Globalisation also results in many multinational companies getting bigger and engaging in transactions involving ever increasing sums of money.

The very existence of professional firms is often at risk where allegations of professional negligence are made against the firm concerned. As the law stands, all the partners in the firm face being held liable in the event of a finding of negligence or breach of duty whether or not they had any direct involvement in the matters complained of. If the firm's insurance cover and other assets are insufficient to meet the claim, the personal assets of all the partners will be at risk. The increasing professional risk and exposure has a deterrent effect to entry to the profession.

The Professional Risk Management Committee ("PRMC") of the HKICPA has been looking into ways in which to achieve a more equitable system of liability in Hong Kong. Proposals made by the HKICPA for the introduction of proportionate liability have been referred to the Law Reform Commission for consideration, and the capping of auditors' liability by repealing section 165 of the Companies Ordinance is currently being considered by the Standing Committee on Company Law Reform. Whilst the HKICPA urges the Government of the Hong Kong SAR to adopt those proposals, it also believes that the Government of the Hong Kong SAR should now be taking steps to introduce LLPs in Hong Kong. LLPs were introduced in the United States in 1991, in the Isle of Jersey in 1997, in Canada in 1998 and in the United Kingdom in 2000.

LLPs remove the risk for the innocent partners but leave the claimant with a remedy against the LLP and the individual partner or partners responsible for the alleged negligence or breach of duty. The HKICPA believes that this results in a fairer distribution of the risks inherent in the current business climate.

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The HKICPA has been advised by the LSHK that the LSHK had a meeting with the Registrar of Companies and the Solicitor General on 2 September 2004 to discuss the report prepared by its Working Party on LLP. The HKICPA has been supplied with a copy of the LSHK Working Party report and supports its conclusions particularly as to the type of LLP model that is suitable for Hong Kong. Notably the HKICPA believes that LLPs should be introduced as part of partnership law rather than company law. This will also have the benefit of simplifying the legislative amendments required.

We are pleased to enclose for your consideration the HKICPA's Paper in support of the introduction of LLPs in Hong Kong. This Paper is intended to supplement the LSHK Working Party report rather than to go over again the grounds it covered. The HKICPA believes that the matter requires urgent attention in order to ensure that the Hong Kong SAR retains its competitiveness in the region and maintains its position as a major financial centre.

The HKICPA hopes that you will feel able to support the introduction of LLPs in Hong Kong and to urge your colleagues to secure the introduction of the necessary legislative amendments for consideration by the Legislative Council as quickly as possible.

The HKICPA would welcome an opportunity to meet with you once you have had an opportunity to consider the matters raised in the enclosed Paper. We will be pleased to further discuss and clarify any questions you may have on our proposals. If you have any questions, please contact Mr. Stephen Chan, the Institute's Technical Director (Ethics & Assurance) in the first instance at 2287 7026 or schan@hkicpa.org.hk .

We look forward to hearing from you.

Yours sincerely,

WINNIE C.W. CHEUNG
CHIEF EXECUTIVE & REGISTRAR
HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

WCC/SSLC/jc
Encl.

c.c. The Hon. Elsie Leung, Secretary for Justice, HKSAR Government
The Hon. Frederick Ma, Secretary for Financial Services and the Treasury, HKSAR Government
The Hon. Mandy Tam, Member of the LegCo for the Accountancy Functional Constituency
The Law Society of Hong Kong

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

PAPER DATED 25 NOVEMBER 2004
SUBMITTED TO THE HKSAR GOVERNMENT
ON THE INTRODUCTION OF
LIMITED LIABILITY PARTNERSHIPS IN HONG KONG

1. INTRODUCTION AND BACKGROUND

1.1 The Hong Kong Institute of Certified Public Accountants (HKICPA) is the statutory licensing body of accountants in Hong Kong responsible for the accounting profession. The Professional Risk Management Committee (PRMC) was established by the Council of the HKICPA in March 1996. One of the responsibilities of the PRMC is to study the feasibility of introducing a proposal for an equitable system of liability in Hong Kong.

1.2 The work of the PRMC in relation to the advocacy for an equitable system of liability, over the past eight years, has included reviewing tort reforms in overseas jurisdictions, seeking legal advice from Counsel and considering the various alternatives, including modified proportionate liability, limitation by contract, statutory capping, limited liability partnerships and others. This resulted in two submissions to Government dated 16 April 2002 and 17 October 2003.

1.3 The HKICPA's first submission dated 16 April 2002 to the Secretary for Financial Services entitled "Proposal for an equitable system of liability" was a comprehensive document which examined in detail the way in which the principle of joint and several liability applies. It looked at the problems that joint and several liability gives rise to particularly for professionals (not only auditors), discussed the advantages and disadvantages of various mechanisms to alleviate the problems and set out the HKICPA's proposal in more detail, together with the justification for

the introduction of a modified system of proportionate liability in certain areas. The submission is available at the HKICPA's website:
http://www.hkicpa.org.hk/professionaltechnical/submissions/docs/proposal-4th.pdf.

1.4 The HKICPA's second submission dated 17 October 2003 was a response to the Standing Committee on Company Law Reform's Consultation Paper in Phase II of its Corporate Governance Review and supplemented the first submission. The HKICPA stressed that given that a number of key jurisdictions had already introduced or were committed to the introduction of a system of proportionate liability, most notably Australia, the Government of the HKSAR should take steps now to introduce a well thought–out system of proportionate liability to avert the possibility of a damaging professional crisis, which would not be in the public interest and would be damaging to Hong Kong's position as a major regional financial centre. The HKICPA expressed the desire to work with the Government on the above proposals and looks forward to doing so as soon as possible. The submission is available at the HKICPA's website:
http://www.hkicpa.org.hk/professionaltechnical/corporategov/SCCLR_II.pdf.

In this regard we note that the UK Government has recently announced that it is not going to allow the adoption of contractual limits on auditors' liability, but it is going to look more closely at the possible introduction of proportionate liability by contract. The HKICPA is not in a position to comment on this pending an opportunity to review any proposals put forward. It does appear, however, that it will not be as wide ranging as the HKICPA has advocated.

1.5 In July 1995 the Professional Accountants (Amendment) Ordinance 1995 and the Companies (Amendment) (No.2) Ordinance 1995 were passed to enable Certified Public Accountants (CPA) practices in Hong Kong to practise as corporations as well as partnerships. These laws became effective on 2 August 1996. Before the introduction of the legislative changes, CPAs had to practise as sole practitioners or in partnerships and their liability was unlimited and was joint and several. Accordingly where a firm is sued for negligence, all the partners face the threat of full liability for all damages, regardless of fault. A negligence claim therefore not only affects the partner who is responsible for the work in question, but also those partners who are not personally involved.

1.6 The enactment of the legislation mentioned in paragraph 1.5 enabled CPAs to practise as corporations so that the personal assets, other than their interest in the corporation, of directors who are not negligent will be protected from negligence claims against the corporation. However it should be recognized that incorporation may not limit the liability of a director arising from his own negligence. Personal liability may be incurred if the negligent individual, in the circumstances of the case, has assumed a personal duty of care.

1.7 While incorporation has solved part of the problem for smaller firms, the large accounting firms and growing medium-sized accounting firms in Hong Kong have not incorporated since incorporation does not fully meet their requirements. As reflected in the statistics set out in Annex A, no firms in Hong Kong with more than 10 partners have incorporated as at 30 September 2004. A business vehicle known as a Limited Liability Partnership (LLP) would be more appropriate. A LLP offers all its members limited liability while allowing them to retain the flexibility of operating the LLP as a “traditional partnership”. A LLP partner is not personally liable for the negligence of other partners in the firm. However, he will be personally liable for his own negligence and misconduct. Further specific arguments in favour of LLPs are set out in section 3 of this Paper.

1.8 As part of the HKICPA's advocacy for an equitable system of liability in Hong Kong, the HKICPA would like to see the introduction of LLPs in Hong Kong. LLPs have proved to be popular and attractive for certain types of businesses and would also be suitable for accounting firms and others. Accordingly, the HKICPA requests the Government of the HKSAR to expedite the introduction of LLPs in Hong Kong. In some jurisdictions, LLPs have been introduced for professional firms only, while in others the LLP business vehicle is available for all types of business. Where adopted for all businesses, this is to ensure that a level playing field is maintained for all parties carrying on a trade or a business. Based on information made available to us, the great majority of the 5,000 LLPs registered in the UK are for trading activities such as marketing, joint ventures, property development and agricultural cooperatives.

1.9 This Paper sets out the HKICPA's arguments as to why the LLP business vehicle needs to be introduced in Hong Kong. Whilst this Paper will not go into the HKICPA's previous proposals for the introduction of proportionate liability in Hong Kong and the capping of auditors' liability in Hong Kong through the repeal of section 165 of the Companies Ordinance, the HKICPA still strongly believes these measures to be totally necessary and should be implemented as well.

2. WHY IS THE HKICPA URGING THE GOVERNMENT OF THE HKSAR TO INTRODUCE LLP IN HONG KONG?

2.1 The HKICPA wishes to draw to the attention of the Government that the LLP is a relatively recent vehicle for businesses in a number of major jurisdictions and therefore Hong Kong should not be left without such a vehicle for business for too long.

2.2 LLPs were introduced in the United States in 1991, in the Isle of Jersey in 1997, in Canada in 1998 and in the United Kingdom in 2000. Consultation Papers proposing the introduction of LLPs were issued in Singapore in the middle of 2003 and in Malaysia in late 2003. The HKICPA strongly supports the view that Hong Kong should maintain its strong position as a leading financial and trading centre in Asia by making available a wider choice of business structures. If not, there may be a serious risk of business going to other regional jurisdictions which provide such a vehicle. This was the same threat that faced the UK when Jersey introduced the LLP as a vehicle for business in 1997.

2.3 There is no doubt that professionals play a vital role in the operation of capital markets and in helping to promote confidence in good governance generally in Hong Kong. The audit process is particularly important. It is important that high risk companies that are most in need of top quality service should be able to obtain that service. It is not in the interests of anyone involved in the capital markets for professionals to engage in defensive practices because they are forever looking over their shoulders and worrying how best to limit their potential liability. With this in mind, the introduction of LLPs will at least reduce some concerns of the bigger accounting firms which consider that incorporation is not appropriate for them. Furthermore, if Hong Kong is to maintain its position as a major financial centre, we need to have a sufficient pool of high quality professionals including, in this specific case, auditors. An environment where the risk stakes are disproportionately high will discourage “the best and the brightest” from entering and remaining in the accounting profession. This is not in the public interest.

2.4 The risks for professionals are increasing as Hong Kong becomes a more sophisticated financial centre. The growing amount of cross border business and listings of companies with operations overseas on the Hong Kong Stock Markets means that the risk exposure is multiplying.

2.5 The world has grown more litigious. Whilst Hong Kong may consider itself lucky to date, there is no room for any complacency. Over the last 10 years, Hong Kong accounting firms have been taking on new work outside their normal jurisdiction, in particular to audit companies incorporated in the Mainland China, some of which are listed in Hong Kong or other jurisdictions, such as the US and Singapore. Such work carries additional risks, such as class action suits by shareholders as in the US. Litigation as a common way for plaintiffs to obtain redress reflects the growing sophistication of the community and is becoming an acceptable part of how business is conducted in many jurisdictions. Auditors, as part of the business fabric of Hong Kong, have to accept this new business reality, but seek the alternative business structure of a LLP so that they are able to participate on a level playing field compared with other jurisdictions.

2.6 The HKICPA therefore urges the Government to consider the matter urgently. The proposal is consistent with Hong Kong's position as a vibrant place to do business, a world class city and, in particular, as a leading financial and trading centre in Asia.

3. SPECIFIC ARGUMENTS IN FAVOUR OF LLP

3.1 For accountants in public practice, a LLP goes part of the way towards redressing some of the unreasonably high risks that operating in a traditional partnership structure brings. The traditional partnership structure is incompatible with today's dynamic business environment. The LLP business structure would help a large number of accountants in public practice without diluting public interest and improves the profession's ability to attract the best candidates.

3.2 LLPs combine the organizational flexibility and tax status of a partnership but with limited liability for its members. The structure perpetuates many elements of the partnership culture, such as:

- the trust that comes from partners' duty of good faith towards each other
- willingness to share clients and resources
- common investment in developing the firm's business and its people
- sharing financial rewards.

Clients benefit from the bonds and business ethics that come from a firm with a strong partnership culture.

3.3 Professional partnerships that desire limited liability will find LLPs attractive. As the services provided by professional practices become more complex requiring practices to grow in size, concerns over the possibility of unlimited liability will in time become a limiting factor to the growth of that professional practice because of:

- A general increase in the incidence and size of claims for professional negligence.
- The growth in the size of partnerships since in a very large partnership, partners will be less aware of, and have less influence over, how other partners are running their parts of the business.
- The increase in specialization among partners and the coming together of different professions within a partnership.
- The risk to a partner's personal assets when a claim exceeds the sum of the assets and insurance cover of the partnership.

Although these concerns arise most acutely in very large professional partnerships, they are relevant to partnerships generally.

3.4 LLPs go some way towards addressing the above concerns. Members of LLPs benefit from limited liability. The LLP, and not its members, will be liable to third parties. However, a negligent member's personal assets will still be at risk. By way of example, under general law, a professional person owes a duty of care to his client. Negligent advice given in breach of that duty by a member of an LLP will, in general, give rise to a potential liability on the part of that member as well as the LLP. Professionals are attracted to the LLP structure to shield them from liability for the negligence of their partners, not from the consequences of their own negligence.

3.5 As regards the management of the internal affairs of the LLP there is a parallel with the system that operates for partnerships. Members will not be obliged to enter into a formal agreement among themselves, although there are advantages to doing so, and there will be no obligation to publish any agreement which is entered into.

3.6 If a LLP is structured as an extension of current partnership law and, assuming no change in the taxation laws, there will be no difference in the basis of taxation of a LLP compared with a partnership.

3.7 A change in the membership of an LLP will have the same effect as a change in the membership of a partnership.

3.8 LLPs avoid the legislative burden of incorporation for professional partnerships and the financial reporting obligations associated with companies.

3.9 LLPs address the inequity of unlimited personal liability for the actions of one's fellow partners. Furthermore, it will not substantially affect the rights of the claimant, as limited liability of the partners does not prevent recovery against the firm and the wrongdoing partner. It merely prevents access to the personal assets of the innocent partners, other than their interest in the LLP.

4. HKICPA COMMENTS ON CERTAIN COMMON ARGUMENTS AGAINST LLP

Argument

4.1 There is an argument that the benefits of LLPs are limited as the LLP structure will not protect against catastrophic losses, which would still wipe out the firm and have a grave effect on its partners, other parties and, indeed, the capital market in which the firm operates. Furthermore, it only limits rather than resolves the problems of unfairness arising from joint and several liability. As a result, it will not provide much help in overcoming the limited availability of professional indemnity insurance for the accounting profession.

Rebuttal

The HKICPA accepts that there is some truth in the above and it is for that reason that, in 2002 it advocated the introduction of an equitable system of proportionate liability. The HKICPA does, however, consider that the LLP structure provides an additional safeguard for the continuation of a strong and credible profession if introduced separately to, or ideally, alongside, proportionate liability.

Argument

4.2 Another argument against the LLP is that, for most of the professions, incorporation is already an option, and that structure provides the same level of protection as an LLP.

Rebuttal

As explained in paragraph 3.1 of this Paper, incorporation is not an attractive option for the larger accounting firms or for larger firms in other professions.

Argument

4.3 It has been suggested that innocent, unsophisticated clients and the investors of public companies that LLPs advise or audit will be adversely affected by the limitation of joint and several liability.

Rebuttal

In response to this suggestion, it should be noted that at present, solicitors and accounting firms are already allowed to practise as incorporated entities. This suggests that Hong Kong has satisfied itself that a limitation of the liability of solicitors and CPAs is not inconsistent with consumer interests. Furthermore, professional people will be no less motivated to meet the standards their clients require of them if they practise through a LLP. A partner's negligence could result in the ruin of the firm and all the partners in that firm losing their capital and goodwill in the firm. The negligent partner could be bankrupted by a personal suit and therefore unable to practise. We do not consider that it serves the public interest that innocent partners who are highly qualified professionals should be ruined and unable to provide their services to the business community and practise their profession because of being jointly and severally liable with a negligent partner. If a large firm were to be eliminated in this way, an unacceptably high proportion of partner level professionals in Hong Kong would be prevented from practising here, damaging Hong Kong's capital market credibility.

Argument

4.4 There is an argument that a special relationship exists between professionals and their clients, as well as between the professionals themselves and it is therefore inappropriate for professionals to be able to escape the liabilities and responsibilities of their professions.

Rebuttal

As discussed elsewhere in this Paper, with LLPs, a partner is not personally liable for the malpractice of other partners in the firm. However, he and his partners still need to maintain the special relationships as the firm, its reputation and goodwill are still at risk and he will still be personally liable for his own negligence and misconduct.

5. THE LAW SOCIETY WORKING PARTY REPORT ON LLP

5.1 The Law Society of Hong Kong have provided the HKICPA with a copy of their recent Working Party Report on LLP which explains in detail the various types of models of LLP, the arguments for and against having a legal personality for a LLP, a partnership model of LLP versus a corporate model of LLP, the different taxation implications of a partnership model of LLP versus a corporate model of LLP, the impact on consumer interests of LLP and the effect of a liquidation of a LLP. The Law Society of Hong Kong submitted their Working Party Report on LLP to Mr. Gordon Jones, Registrar of Companies and Mr. Bob Allcock, Solicitor General, Legal Policy Division of the Department of Justice in August 2004. Accordingly, this paper does not endeavour to discuss these same issues again. A copy of the Law Society's paper is attached as Annex B for ease of reference.

5.2 The HKICPA has read the Law Society's paper and fully supports the broad principles therein in relation to the introduction of LLPs in Hong Kong. The HKICPA in particular endorses the following:

- A partnership model of LLP for Hong Kong (with full liability shield) and not a corporate model of LLP. The partnership model of LLP preserves the existing partnership and partner relationships and requires no changes to the firm's operation. In addition, it should be noted LLP legislation in the United States and Canada is based on the partnership model and no common law jurisdiction other than the UK has adopted the corporate model of LLP.
- The partnership model of LLP should not change partners' tax treatment.
- It is in the public interest that the LLP legislation based on the partnership model be as simple as is consistent with public interest.

- The Partnership Ordinance should be changed to allow a new form of practice: LLP.

6. CONCLUSION

6.1 The HKICPA strongly urges the Government to introduce LLP as a new form of business entity as soon as possible. Furthermore, the HKICPA is willing to work closely with the Government to finalize the details of the suitable type of LLP for Hong Kong. The key points of our proposals are:

- LLP should be made available to professional firms.
- It is necessary for the Government to act fast in this respect given that other jurisdictions have introduced, or are in the process of legislating for, LLPs. Hong Kong should not be left behind in the introduction of LLPs if it is to retain its status as Asia's leading financial and trading centre and to prevent the risk of business going to other regional jurisdictions.

6.2 The HKICPA is aware that this is a relatively short paper. This is intentional as the Law Society of Hong Kong and various other parties have already carried out detailed studies. The HKICPA's aim is not to repeat the work of these studies but to encourage taking the public debate about introducing LLP in Hong Kong to the next level by working closely with the Government. In this regard, the HKICPA looks forward to receiving an early response to this paper from the Government and to meeting with the Financial Secretary to discuss its implementation.

Annex A

Corporate Practice Statistics as at 30 September 2004

No. of practising directors	No. of corporate practices	Percentage of total
1	26	16.3%
2	76	47.8%
3	40	25.2%
4	11	6.9%
5	3	1.9%
6 to 10	3	1.9%
11 or over	0	0.0%
TOTAL	**159**	**100.0%**

Annex B

LIMITED LIABILITY PARTNERSHIP

Report of the Working Party on Limited Liability Partnership (the "Working Party")

of the Law Society

TERMS OF REFERENCE OF THE WORKING PARTY:

(1) to consider the desirability and feasibility of permitting Hong Kong solicitors to practise as limited liability partnerships;

(2) to consider the relevance of the Limited Partnerships Ordinance (Cap 37 of the Laws of Hong Kong) to the mode of operation of solicitors' practice in Hong Kong;

(3) if appropriate, to formulate in draft for approval of the Council, new rules and/or amendments to existing legislation to provide a framework for the operation of limited liability partnerships.

1. INTRODUCTION

1.1 A limited liability partnership offers an attractive form of business organisation for businesses that thrive as partnerships but which are concerned about the risk of partners having unlimited liability for the consequences of another partner's negligence.

1.2 This report considers the case for legislation that would allow Hong Kong solicitors and others to practise through LLPs. The report examines the issues relevant to the formulation of legislation and appraises different models of LLP. We believe that the case for LLPs is met and suggest the legislation that we consider appropriate for Hong Kong.

2. WHY HONG KONG SHOULD CONSIDER LLPS

2.1 Partnerships: a successful business model

The partnership has offered professional firms a mode of practice uniquely suited to the requirements of clients and the partners.

2.2 LLPs can perpetuate partnership culture

LLPs allow different forms of partnership models to exist without affecting other forms of partnership models. The expression partnership culture lauds the benefits of a successful partnership:

- the trust that comes from partners' duty of good faith towards each other
- willingness to share clients and resources
- common investment in developing the firm's business and its people
- sharing financial rewards.

Clients benefit from the bonds that come from a firm with strong partnership culture. LLPs can perpetuate partnership culture.

2.3 Consumer interests

One should not advocate the abrogation of partners' joint and several liability without thorough consideration of whether this is in the interests of consumers. We consider consumer protection in paragraph 5.

Numerous other jurisdictions have adopted legislation that allows LLPs, notably most states of the United States of America, Great Britain and Germany.

The LLPs in these jurisdictions take widely different forms. The common denominator of LLP legislation is that a lawyer who practises as a partner in an LLP is not personally liable for the consequences of the negligence of a fellow partner although he remains fully liable for his own negligence. As some other jurisdictions have already adopted this common denominator, Hong Kong is not unique in adopting it. Later we consider the extent to which it is reasonable and consistent with consumers' interests for the Hong Kong LLP to confer a broader shield against liability. We also offer views on whether it is reasonable and consistent with consumer interests for any business - professional or non-professional - to be able to operate through a Hong Kong LLP.

2.4 Competitive threat

For more than a decade Hong Kong law firms produced in excess of HK$6 billion of GDP per annum (Annex 1). It is in Hong Kong's economic interests to keep professional partnerships on-shore and, if consumers' interests are adequately protected, facilitate their practice through LLPs. Professionals who can practise free of personal liability for the negligence of their partners are more likely to invest in the development and expansion of their businesses.

The Jersey LLP provides a cautionary tale. In the 1990s British accountants lobbied hard for LLPs, alarmed at their increasing exposure to negligence claims against auditors. The British government was slow to respond so the accountants offered Jersey the proposition that they might move their headquarters to Jersey if Jersey enacted LLP legislation. Jersey duly did so in 1996, seeing the LLP as a way of attracting offshore professionals to the island and enhancing its reputation as a financial centre[1].

Jersey's initiative prompted the British government to act. In its deliberations on the LLP bill, the House of Commons Select Committee on Trade and Industry commented on the presence of LLP legislation in other jurisdictions: "By mid-1996, it was plain that the option of registration as a Jersey LLP was being seriously considered by a number of the very large professional partnerships. It was this prospect, combined with the perceived possibility that a successful mega-claim could in due course precipitate the failure of a major firm, that led to the November 1996 decision … to bring forward LLP legislation in the UK. Whether Parliament and Ministers like it or not, what is in no doubt is the real possibility of British firms registering offshore; if Jersey statute proves unattractive there may well be other offshore options on offer"[2]. In 2000, Parliament enacted the Limited Liability Partnerships Act (LLPA 2000).

The Singapore government proposes to legislate to allow LLPs, which may not be unconnected with its plan to make Singapore a tax haven for international law firms. See Annex 2. Malaysia is considering the adoption of LLP legislation.

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[1] The UK Inland Revenue frustrated the accountants' plans. The Jersey LLP, like the UK LLP, has legal personality. The Jersey legislation, like the UK legislation, provides that the LLP will nonetheless be treated as a partnership for tax purposes. It remains open to foreign tax authorities to treat an LLP with legal personality as a company for tax purposes, with the adverse consequence of double taxation. The UK Inland Revenue's determination that it would treat the Jersey LLP like a company ended the accountants' thoughts of relocating their headquarters. The Big 4 accountants now operate their UK businesses through English LLPs.

[2] As reported in Geoffrey Morse, Paul Davies, Ian F. Fletcher, David Milman, Richard Morris, David A Bennett Palmer's Limited Liability Partnership Law (London Sweet & Maxwell 2002) at 7.

It is important that Hong Kong react to these competitive threats. If Hong Kong-based international firms move their transactional practices to other financial centres in Asia, Hong Kong will cease to be the region's leading provider of legal services.

2.5 **Demand**

The Enron collapse and the ensuing Arthur Andersen debacle have made partners more conscious of their business risks. The world has grown more litigious. Professional people are no longer content to be personally liable for claims against their firms that emanate from others' negligence. Hong Kong should modernise its law to allow LLPs.

3. WHY HONG KONG SOLICITORS NEED LLPs IN ADDITION TO SOLICITOR CORPORATIONS

3.1 **General**

It is true that solicitor corporations offer limitation on professionals' liability. However, the Solicitor Corporations Rules do not offer the right solution for Hong Kong law firms.

In England, law firms and audit firms were able to operate through limited companies before the LLPA 2000: law firms from 1988 and audit firms from 1991. However, few did so. It was generally agreed that the disadvantages of practising through a company outweighed the goal of limited liability. Not many Hong Kong audit firms have chosen to incorporate

As professional partnerships are owner-managed businesses, the partnership structure has - but for the liability exposure - been ideal for them. The partnership has no legal personality of its own: it is the relationship that subsists between the owner-managers who carry on the business with a view to profit. The corporate structure, by contrast, is ideal for investors who do not run the business. The company has a legal personality of its own, with rights and obligations distinct from those of its investors (whether they are shareholders or creditors) and its directors.

These fundamental differences are at the root of the disadvantages of a corporation for professional firms.

3.2 **Legislative burden on companies**

The relationship between a company and other parties is regulated by extensive legislation intended to uphold the appropriate balance between their interests. By contrast, the law on partnerships is simple and allows partners a great deal of flexibility. The legislative burden of incorporation would be unattractive to professional partnerships.

3.3 **Companies' financial reporting obligations**

A company is a vehicle designed for an infinite number of shareholders[3] who are free to sell their investment to others and are not expected to be intimate with the company's business. A company is also able to undertake liability without recourse to its shareholders. It follows that its shareholders and the public have statutory rights to certain information about the company, notably its accounts. Many professional partnerships would find the loss of privacy too high a price to pay for limiting their liability.

3.4 **Companies do not engender a partnership culture**

While a company has extensive obligations to other parties, the shareholders' common interest in the company does not impose fiduciary duties among them nor require them to act in good faith towards each other[4]. Professional firms, whatever their size, value the ethos that is reinforced by partners' mutual duty of good faith. Partners who share knowledge, collaborate

[3] Section 29 of the Companies Ordinance provides that a company must be "public" if it has more than 50 shareholders.

[4] Subject to common law concerning the behaviour of a majority of shareholders.

on client work and pool their resulting profits feel that clients benefit from the partnership ethos. Professional partnerships would be deterred from incorporating for fear that they would lose the partnership culture inherent in partners' mutual duty of good faith.

Because of this partnership culture, it is important for a professional firm to be able to remove a partner with unsatisfactory performance from the legal firm. However, in case of a corporation, it is more difficult to remove a shareholder and director without his agreement.

Partners want to be "partners", not directors or employees, both in the sense of how they define their relationship with each other and so as to encourage a relationship of trust with their clients.

It has been argued that practising through a company offers protection to all lawyers, even the negligent lawyer. The English case law in this area[5] shows that a director of a company can be personally liable to a third party if he or she "assumes responsibility" towards the third party and the third party relied on the director's assumption of liability and was reasonable in doing so. The House of Lords said that these principles applied to determine the personal liability in tort of any agent acting on behalf of a principal with a separate legal identity, so they do not only apply to directors[6]. It may be that if these principles applied in Hong Kong, a lawyer practising as a partner of an LLP without separate legal identity might be more readily found to have assumed personal responsibility towards a client than a lawyer practising as a director or employee of a company[7].

We suggest that such a conclusion would not cause a law firm to prefer a corporate structure to conversion to an LLP. Lawyers are accustomed to taking personal responsibility for their advice. The personal touch is an important element of the relationship of trust that they seek to establish with their clients. Lawyers are attracted to LLPs to shield them from liability for the negligence of their partners, not from the consequences of their own negligence.

3.5 Company: no continuity

The "conversion" of a law firm to a corporate structure requires a transfer of its assets and liabilities to a new company, typically newly incorporated by the partners. The transfer requires the assignment of leases, the negotiation of new bank facilities, the novation of other contracts and a time-consuming process. The new company would need a memorandum and articles of association instead of a partnership agreement. Partners would generally want the company's constitution to reflect the partnership agreement but because the company is a fundamentally different vehicle, a match will be impossible. The transfer would typically require partners to transfer their capital and current accounts to the company and be followed by the dissolution of the law firm.

By contrast, it would be a straightforward matter for a law firm to "convert" into the model of LLP that we recommend. Conversion would be effected by agreement among the partners. The law firm would preserve its continuity in every respect.

3.6 Company: extra taxation

It makes little difference to the tax treatment of domestic professional firms with no outside participation and which operate exclusively in Hong Kong if they practise through a company rather than an LLP. There is, however, a slightly higher rate of corporation tax than the corresponding income tax rate.

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[5] *Williams v. Natural Life Health Foods Ltd.* [1998] 1 WLR 280.

[6] The *Williams* case was cited in and applied by Deputy High Court Judge Muttrie in *Yazhou Travel Investment Co. Ltd v. David Geofrey Allan Bateson and Others* [2004] HKCU LEXIS 60; [2004] 103 HKCU 1.

[7] The discussion paper of the Standing Committee on Company Law Reform (document 174-1) suggests that a Hong Kong company offers total protection to a negligent lawyer: this is doubted.

If the company has shareholders (formally partners) resident outside Hong Kong this will generally be disadvantageous. Those partners will be subject to their own country's income tax liability on any undistributed profits, as well as suffering the economic cost of the Hong Kong profits tax paid by the company. They will be effectively subject to double taxation on the company's income[8]. The partnership's "conversion" into a company could trigger capital gains tax on the transfer of the foreign partners' interests in the partnership into shares in the company. The company could be liable to foreign corporation tax on its branch profits. Only Hong Kong resident partners, on becoming shareholders, would be largely unaffected: there is no Hong Kong capital gains tax charge, and any dividend they receive from a company paying Hong Kong profits tax is not chargeable to Hong Kong tax in the hands of the shareholders.

3.7 LLP v. company: conclusion

Solicitor corporations have a number of features which will lead law firms to eschew them as, in the UK, law firms eschewed limited companies. Solicitor corporations are therefore unlikely to assuage lawyers' interest in LLPs. Lawyers will seek a model of LLP that preserves the simplicity, flexibility and privacy of partnerships and with which professional firms, their clients and their creditors are familiar.

4. MODELS OF LLP

4.1 Criteria for the perfect LLP

4.1.1 From a partner's point of view, the perfect LLP is one which:

- protects him from personal liability for the acts and omissions of other partners everywhere the firm operates
- is familiar, in the sense that the firm's partnership culture flourishes and the firm's legal structure, management structure and partnership agreement are not significantly disturbed
- preserves the privacy of a partnership
- is treated like a partnership for tax purposes everywhere the firm operates, with no tax costs on conversion
- makes conversion easy, not requiring the transfer of the partnership's business (and therefore its contracts) to a new entity.

Applying these criteria, there is no such thing as the perfect LLP.

4.1.2 From a law-maker's perspective, the ideal LLP is one which:

- without jeopardising consumer interests, enables businesses that are important to the economic life of the jurisdiction to practise through an on-shore vehicle that meets their needs; and
- is simple to legislate for.

4.1.3 Most law-makers have chosen a partnership model of LLP. We too advocate the partnership model of LLP for reasons stated later.

4.2 Partnership model of LLP

The partnership model of LLP is one which grafts on to existing partnership law. Partnership law in common law jurisdictions is generally codified on legislation based on the English

[8] This is not just an "international law firm" issue: many Hong Kong firms have branches in the PRC, Bangkok, etc.

Partnership Act 1890. Legislation that creates a partnership model of LLP does so by amending the existing partnership legislation. The amending legislation covers:

- who may form an LLP
- how to form an LLP
- the requirement for public registration of an LLP
- the scope of a partner's liability shield.

The legislation may but need not include:

- the domestic legitimacy and registration of foreign LLPs
- the requirement that the LLP buy a certain level of insurance.

The relevant legislation can be concise (as in Ontario) or, despite the straightforwardness of the matters covered, wordy (as in New York).

LLP legislation in the United States and Canada is based on the partnership model[9]. Some of New York's major law firms have been slow to convert but most of them are now LLPs. Most of Ontario's law firms have become LLPs, including all the large firms.

4.3 **Corporate model of LLP**

The corporate model of LLP is one which is grafted on to legislation on companies.

The English LLP is a body corporate established by the LLPA 2000. With only 25 pages the LLPA 2000 is easily read. This is because it relies on extensive statutory instruments. Most of the regulations are in Statutory Instrument 2001 No. 1090: the Limited Liability Partnership Regulations 2001 (LLPR 2001) http://www.legislation.hmso.gov.uk/si/si2001/2011090.htm. These regulations run to 118 pages.

The LLPR 2001 applies provisions of the Companies Act 1985, the Company Directors Disqualification Act 1986, the Insolvency Act 1986, and the Financial Services and Markets Act 2000 to LLPs with modifications specified in schedules. The regulations also make detailed amendments to 187 statutes so that they apply to LLPs, from the Bills of Sale Act (1877) Amendment Act 1882 to the Contracts (Rights of Third Parties) Act 1999.

The effect of the regulations' application of this legislation to LLPs cannot be understood without cross-reference to the legislation itself. Tolleys has published a book which, in 600 pages, shows how the Companies Act 1985, the Company Directors Disqualification Act 1986 and the Insolvency Act 1986 apply to LLPs[10].

Additionally, the regulations apply to LLPs 24 statutory instruments made under the Companies Act 1985, the Insolvency Act 1986 and other legislation.

Other statutory instruments have been published since the LLPR 2001[11].

[9] The Jersey LLP, which has legal personality, derives from discrete legislation, the Limited Liability Partnerships (Jersey Law) 1997. Jersey does not have legislation equivalent to the Partnerships Act 1890. The Jersey legislation draws on the customary law concerning contrats de sociétés. For this reason, we do not regard it as a helpful model for Hong Kong. Nor do we believe that civil law countries' LLPs, such as the German LLP, provide a helpful model.

[10] Tolley's Limited Liability Partnerships, The New Legislation by Douglas Armour, published by Tolley in 2001

[11] An uncontroversial fees order, SI2002 No. 503, and an order to apply to LLPs some 2002 company legislation allowing members of an LLP to apply to the Secretary of State for their residential address to be removed from the public register. The Secretary of State will only grant the application if satisfied that residents would otherwise be subject to violence or intimidation http://www.hmso.gov.uk/si/si2002/20020913.htm

Subsequent regulations on LLPs will arise on any amendment to the Companies Act 1985 and the Insolvency Act 1986 framework on which they depend.

The regulations are incomplete. There will, for instance, be further regulations on overseas LLPs.

No other common law jurisdiction has adopted the corporate model of LLP.

Only about 90, mostly smaller, UK law firms have become LLPs[12]. The other UK law firms have been deterred from conversion by the extensive requirements of the legislation as well as the features that make the English LLP so different from a partnership.

4.4 **Legal personality?**

4.4.1 A corporate model of LLP has legal personality. It does not follow that a partnership model of LLP does not have legal personality. Some partnership models of LLP have aspects of legal personality.

4.4.2 The question of whether an LLP has legal personality may not matter domestically where there will be law about how to sue a partnership, who is liable for the firm's negligence and who pays tax on partnership profits. However the question of whether an LLP has legal personality can be important to a court or tax authority from another jurisdiction. For example:

- a foreign court considering whether a claim against a New York LLP under the foreign law is properly made against the LLP or its partners might disregard the New York law limitation on the partners' liability if it concludes that the New York LLP is not an entity

- a foreign tax authority considering how to characterise the profits of a branch within its jurisdiction might treat them like company profits potentially giving rise to double tax (a risk for an English LLP because it is a body corporate).

4.4.3 We considered whether, if Hong Kong were to adopt a partnership-style LLP, there was a case for providing that the Hong Kong LLP have legal personality.

This might have the advantage of persuading a court considering a foreign law claim against the LLP that the LLP, having legal personality, is contractually responsible for the claim to the exclusion of its partners.

It might have the disadvantage that the LLP, having legal personality, would be taxed on its profits (like a company) as well as its partners (like shareholders). The Hong Kong legislature could provide that domestically the LLP is treated like a partnership for tax purposes (i.e. the partnership is taxed through its partners, so that the partners' income is taxed only once) but such legislation might be disregarded by a tax authority in a foreign jurisdiction where the LLP has a branch. In that case the LLP and its partners could be subject to all the tax disadvantages of a corporate structure as were mentioned in paragraph 3.6.

A further disadvantage of conferring legal personality on an LLP is that the legislation for LLPs would be much more complicated.

4.4.4 In coming to our conclusions we drew on the recently published report of the English and Scottish Law Commissions on the law on general partnerships[13]. The extensive report - it runs to 500 pages - included a bill comprehensively to replace the English Partnership Act 1890 and the Limited Partnership Act 1907. It should be noted that the report did not deal with the English LLP which, by virtue of the LLPA 2000, has legal personality.

[12] Limited Liability: A Question of Protection by Bob Sherwood in the Financial Times, 26 April 2004.

[13] Law Com No. 283 and Scot Law Com No. 192

One of the Law Commissions' most far-reaching proposals was that the English partnership have legal personality, as the Scottish partnership does. The Law Commissions thought this proposal would helpfully modernise partnership law. For example a partnership's legal personality would give legislators the chance to assert a partnership's continuity of existence on a change of partner[14]. Such a change would also enable a partnership to hold property and enter contracts.

The Law Commissions took the view that a partnership's legal personality was incompatible with each partner being the agent of each other, so their bill makes each partner an agent of the firm instead[15]. They said that a partnership's legal personality was consistent, however, with partners continuing to have joint and several liability for the partnership's debts and obligations, as they do in Scotland.

4.4.5 While it was tempting to suggest that the Hong Kong LLP have legal personality to help partners defend claims under foreign law, we concluded not to make such a recommendation for the following reasons.

- The Hong Kong legislature might want to consider such a proposal only in the context of a review of the law on general partnerships enshrined in the Partnership Ordinance.
- The Hong Kong legislature would note that the changes to the Partnership Act 1890 that the Law Commissions recommend are far-reaching (not least because of the proposal that the general partnership have legal personality) and may never be enacted.
- Amendments to the Partnership Ordinance to provide for an LLP with legal personality would be much more complicated.
- A Hong Kong LLP that might be taxed like a company on its foreign profits would be unattractive to Hong Kong businesses with significant branches outside the jurisdiction.

4.5 Partnership model v. corporate model

We recommend a partnership model of LLP for Hong Kong. Here we draw our reasoning together by measuring each of the partnership model and the corporate model against our criteria for the perfect LLP.

4.5.1 *First criterion: protection of partners from personal liability for the acts and omissions of other partners.*

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[14] There is some doubt about the continuity of a Scottish partnership on a change of partner, despite it having legal personality. In England, partnership, seen as a relationship between individuals or as a contract between individuals, ceases when the identity of the partners changes. The same is true in Hong Kong. Even an agreement in advance that partners will continue to practise in partnership on the retirement of one of their number does not prevent the partnership which practises the day after retirement from being a different partnership from that in business on the previous day: *Hadlee v. Commissioners of Inland Revenue* [1989] 2 NZLR 447, 455 per Eichelbaum J.

[15] The UK Inland Revenue suggested that the partners' mutual agency was the justification for taxing partners on their partnership income and to the exclusion of taxing the partnership. The Law Commissions therefore accepted the UK Inland Revenue's offer to support the introduction of tax legislation to provide that a general partnership with legal personality be treated for tax purposes in the same way as English and Scottish partnerships are currently treated. The LLPA 2000 similarly provides that an English LLP, despite being a body corporate, is treated for tax purposes like an English general partnership. The Law Commissions' report indirectly recognised that such legislation could not determine a foreign tax authority's treatment of an English partnership with legal personality. As mentioned, one of the problems with the English LLP is that foreign tax authorities may tax it as if it were a company.

Hong Kong law

A Hong Kong LLP based on the partnership model and without legal personality would, through an amendment to the Partnership Ordinance, shield a partner from personal liability for the consequences of another partner's negligence. A Hong Kong LLP based on the corporate model would mean that the LLP, as a legal person, was contractually responsible for its negligence to the exclusion of the partners. The law might leave the claimant able to establish that the negligent partner is liable for his negligence in tort[16].

Under Hong Kong law, the non-negligent partner would be free of personal liability whether or not the LLP follows the partnership or corporate model. This might not be so if the law governing the LLP's breach of contract is foreign.

Foreign law

If an LLP faces a claim under foreign law, the liability of the LLP and its partners will be determined by reference to the foreign law's doctrines on conflicts and these vary from jurisdiction to jurisdiction. In some jurisdictions the court will never have considered the liability of an LLP established elsewhere. Accordingly there may be uncertainty about the doctrine that the court would apply to a Hong Kong LLP sued under foreign law.

- Some jurisdictions that have adopted the partnership model of LLP - New York and Ontario for example - provide in their statutes that under certain conditions, the local court will apply the law of the jurisdiction in which the LLP was established to determine whether one of its partners should be liable to the claimant.

- Some jurisdictions will take the same approach on the basis of their own doctrines on conflicts of law, rather than because of statutory provision on foreign LLPs.

- Some jurisdictions will determine the question by assimilating the Hong Kong LLP to a local entity.

- Other jurisdictions, as mentioned in paragraph 4.4, might disregard Hong Kong law's limitation on partners' liability if the court determines that the Hong Kong LLP is not an entity under Hong Kong law. In that case the foreign law governing the LLP's contract with the client would attach responsibility for the breach to all the partners, whether they were negligent or not.

Overall, the corporate model of LLP is a surer shield for non-negligent Hong Kong partners facing claims under foreign law.

There remains a question, though, of whether the Hong Kong court would enforce a foreign court's judgment that the non-negligent partners are liable for the Hong Kong LLP's breach of contract.

4.5.2 *Second criterion: familiarity*

Our second criterion for the perfect LLP was whether it would allow the partnership culture to flourish; and would the LLP be a familiar form of business, in the sense that conversion would not significantly disturb the firm's legal structure, management structure or partnership agreement? Partnerships are a successful business model. It is better for Hong Kong if the chosen model of LLP preserves the ingredients of their success.

The corporate model of LLP is very different from a Hong Kong general partnership, not least because the Hong Kong LLP would be a new legal person defined by legislation based on company legislation. We have argued that companies, subject to sophisticated legislation, are ideal for investors who do not run the business in question. Company legislation would appear unduly demanding and complicated for an owner-managed partnership. Bob

[16] See paragraph 3.4 for a discussion of the relevant law.

Sherwood, writing about the English LLP in the Financial Times recently, said: "Many solicitors have been wary that becoming a corporate-style LLP as the legislation demands, would mean a fundamental shift in the ethos of partnership that is central to law firms. Martin Ellis, director of Alexander Forbes, the professional indemnity insurer, believes many law firms are afraid the switch would damage the "family approach" of law firms where all partners are "in it together". Senior managers at law firms may also be wary that they will inherit a fiduciary duty similar to that of a corporate executive"[17].

The corporate model of LLP creates a legal person with rights and obligations of its own in relation to third parties and partners. Partners would become agents of the LLP and not of each other, undermining the collegiality that flows from the partners' mutual fiduciary duties. The partnership agreement would have to accommodate the existence of the LLP and acknowledge the new legal relationships that it establishes.

The partnership model of LLP preserves the existing partnership and partner relationships and requires no changes to the firm's operation.

4.5.3 ***Third criterion: privacy***

Partnerships value the fact that they can keep the firm's affairs confidential. Law-makers would want to ensure that consumers know what they are dealing with by at least requiring the LLP to demonstrate to third parties that the partners' liability is limited. Law-makers will tend to have different requirements for a partnership model of LLP compared with a corporate model.

Laws constituting partnership models of LLP require the LLP to demonstrate that partners' liability is limited by using the suffix "limited liability partnership" or "LLP" with the firm name and through some form of registration.

The corporate model of LLP is subject to the same requirements but also to onerous filing obligations based on the law of companies. Commentators have suggested that one of the reasons UK firms have been slow to take up limited liability is because the legislation on the UK LLP - a body corporate - requires the LLP and its partners to file the partners' names and addresses and annual accounts, including the total remuneration paid to the partners and the remuneration of the highest paid partner.

4.5.4 ***Fourth criterion: tax treatment***

Partners will want the LLP to be treated like a partnership for tax purposes.

The partnership model of LLP should not change partners' tax treatment.

The corporate model of Hong Kong LLP would create an entity which, but for specific legislation, would prima facie be taxable in its own right with partners being liable to tax on their profits as well. We assume that the Hong Kong legislature would follow the precedent set by the UK and say that notwithstanding the LLP's structure as a body corporate, its partners are to be taxed as if the body corporate were a partnership. This would mean the corporate model of Hong Kong LLP would not change partners' Hong Kong tax treatment.

The tax treatment of an LLP in a foreign jurisdiction depends upon the rules in that foreign jurisdiction, but foreign tax authorities are more likely to treat an LLP which is a body corporate as a company in contrast to a partnership model, with all the possible adverse consequences for partners resident outside Hong Kong as were discussed in paragraph 3.6:

- double tax
- capital gains tax on conversion

[17] Limited Liability: A Question of Protection, Financial Times of 26 April 2004

- foreign corporation tax on branch profits.

The corporate model of LLP is therefore unlikely to be attractive to partnerships with operations outside Hong Kong.

4.5.5 ***Fifth criterion: easy conversion***

The partnership model of LLP perpetuates the partnership. The partnership achieves limited liability simply by agreement amongst the partners or registering as an LLP. The regulators of law firms would typically require the firm to tell clients that the firm has become an LLP. Conversion is therefore straightforward.

If the LLP is a body corporate, conversion requires partners to establish the new LLP, transfer the partnership business, assets and liabilities to the new LLP and wind up the operations conducted through the former partnership. The process will be time consuming and require a careful examination of the firm's contracts to see whether they may be assigned and whether novation should be sought.

4.5.6 ***Sixth criterion: simple legislation***

It is in the public interest that the LLP legislation be as simple as is consistent with public interest.

In paragraphs 4.2 and 4.3 we describe the legislation that creates partnership and corporate models of LLP, using the English LLP as our example of the latter. The partnership model of LLP is simple to legislate for; the corporate model of LLP requires complex legislation.

Also, it is simplier to adopt a LLP model as compared to a limited liability corporate model.

4.5.7 ***Seventh criterion: preservation of consumer interests***

Law-makers will want to create a form of LLP that, without jeopardising consumer interests, enables businesses that are important to the economic life of Hong Kong to practise in a Hong Kong-based vehicle that meets their needs.

If the legislators are satisfied that consumer interests are appropriately addressed by either model of LLP, they are likely to sponsor a model that enjoys the most support from partnerships that would like to limit the liability of non-negligent partners.

We consider that, balancing the judgments on the criteria for a perfect LLP, partnerships will be more likely to support the partnership model than the corporate model.

All criteria

Judged by these criteria, the partnership model of LLP is the better model for Hong Kong. It prevails over the corporate model in all but one (i.e. the first) of the seven criteria.

4.6 **Full or partial liability shield?**

The earlier statutes creating common law partnership models of LLP in the US generally only protect partners from liability for claims arising from other partners' negligence or other malpractice. All partners remain jointly and severally liable for other partnership debts, obligations and liabilities. The Ontario LLP follows this model.

More recent common law partnership models of US LLP protect partners from all personal liability, subject to the proviso that a partner is responsible for his or her own negligence or other malpractice or that of a person under his or her direct supervision and control. The New York LLP follows this model.

The corporate model of LLP offers a full liability shield but may leave a partner exposed to personal liability for his own negligence.

We suggest that the justification of a full or partial liability shield be tested by reference to whether consumers retain adequate remedies against the firm.

4.7 **Different models of LLP**

We conclude this analysis of different models of LLP with a reference to Annex 3. Annex 3 summarises the differences among two forms of partnership model - Ontario and New York - and the English corporate model, indicating with a plus and minus sign the pros and cons of each. Later we discuss fine-tuning a partnership model of LLP for Hong Kong by reference to New York and Ontario legislation.

5. **CONSUMER INTERESTS**

5.1 **Balancing the interests**

Those who want to undertake business with joint and several liability for the acts and omissions of their partners cannot be allowed to limit their liability unless the interests of those with whom they do business are adequately protected.

Hitherto Hong Kong has required certain professionals to carry on business with unlimited liability.

New rules allowing solicitors to practise through solicitor corporations suggest that Hong Kong has satisfied itself that a limitation on liability of solicitors is consistent with consumer interests.

In this section, we state why we believe allowing professionals to practise through LLPs can give adequate protection to the interests of those with whom they do business. We then touch on whether non-professionals should be allowed to practise through LLPs.

5.2 **Motivation**

Professional people will be no less motivated to meet the standards their clients require of them if they practise through an LLP. A partner's negligence could result in the ruin of the firm and all partners losing their capital and goodwill in the firm. The negligent partner could be bankrupted by a personal suit and therefore unable to practise.

A partnership model of LLP would leave the negligent partner with contractual and tortious liability for his own negligence. Not only does it protect the clients but the innocent partners. A corporate model would protect the negligent partner from contractual liability but leave him exposed to a claim in tort.

5.3 **Insurance and capital**

A firm will therefore be no less motivated to sustain its business as a going concern and buy appropriate levels of insurance if it becomes an LLP.

Professional regulators may set their own requirements for a firm's professional indemnity insurance and there is no reason why such requirements should be any different for an LLP.

- Some of the earlier LLP statutes enacted in the United States required an LLP to have insurance or an escrow account to cover liabilities as to which partners do not have personal responsibility. More recent US LLP statutes typically do not mandate insurance, but instead leave insurance issues to the statutes governing the relevant practitioners[18].

- The Ontario legislation on LLPs says the professional body governing the relevant LLP must establish minimum insurance requirements. The Law Society of Upper

[18] Limited Liability Partnerships and Limited Liability Limited Partnerships by J. William Callison Esq.

Canada does not require a lawyer practising through an LLP to have more than the CAN$1million cover that is the minimum for all lawyers.

- Jersey requires that its LLPs maintain £5million in escrow to meet debts arising on its dissolution.
- The English LLPA does not require an LLP to buy insurance, leaving such matters to those who regulate the partners of the LLP.

Caron Wishart of the Lawyers' Professional Indemnity Company in Ontario confirms that the company's claims portfolio has not changed since the introduction of LLPs, nor have LLPs had an impact on the types or size of claims.

It seems unnecessary for Hong Kong legislation on LLPs to require a certain level of asset backing, either through specifying levels of insurance cover or capital contributions from partners. Those who deal with an LLP - or a partnership - are at liberty to make enquiries about the adequacy of the firm's assets and, if they are not satisfied, to deal with competitors or require greater protection. An LLP could respond by buying more insurance or agreeing that partners will be personally responsible for a particular transaction, for example by guaranteeing the firm's bank borrowings.

5.4 **Professional regulation**

Professional regulators would retain responsibility for setting standards of conduct, investigating allegations of misconduct and applying penalties for breach of their rules.

Professional regulators are likely to have to adapt their rules to accommodate LLPs. The Law Society of England and Wales has made detailed rules for this purpose, drawing from its rules for incorporated practice. The new rules are therefore somewhat complicated but do not change the substance of the regulations governing solicitors in general partnership. The Law Society of Upper Canada has made simple changes to its by-laws to accommodate Ontario's partnership model of LLPs. These are shown in Annex 4.

5.5 **Disclosure**

Those who deal with the LLP will know that partners' liability is limited because of the LLP suffix to the firm's name.

Good business practice would lead a firm to publicise its conversion among those with whom it does business. Professional regulators may require that the firm inform its clients of its conversion[19].

5.6 **Pre-conversion liability**

A firm's conversion to an LLP will not affect partners' responsibility for the acts and omissions of the firm and its partners before conversion.

5.7 **Liquidation**

A Hong Kong partnership model of LLP would be dissolved under the Partnership Ordinance (as appropriately amended). The current legislation gives third parties priority over partners' claims to the firm's assets. Partners may therefore have to forfeit their undistributed profits and capital if the firm's assets are insufficient to pay the firm's creditors[20].

The UK's corporate model of LLP enables partners to claim amounts that the firm owes them alongside third parties' claims to be paid. The UK LLP is not subject to rules on maintenance of capital of the kind that applies to a company but partners can be subject to rules which

[19] As in Ontario. See Annex 4 for the Law Society of Upper Canada's sample disclosure letter.

[20] Section 46 of the Partnership Ordinance

allow the liquidator to claw back property, including partnership profits, which a partner has withdrawn from the LLP in the two years before an insolvent liquidation. These powers are additional to those that arise from UK company legislation relating to "wrongful trading", which are absent from Hong Kong company legislation.

5.8 Negotiated protection

Banks, landlords and other suppliers of an LLP are free to insist that partners concede individual liability to them by contract.

The extent to which suppliers do so will depend on the model of LLP. Some partnership models of LLP only shield partners from liability for the negligence of other partners, so partners would remain jointly and severally liable to their suppliers.

Suppliers to LLPs which confer a broader shield may seek recourse against individual partners in the form of guarantees of specific obligations.

The legislation on New York LLPs allows partners by at least a majority to agree that their liability shield will not apply to a specific obligation.

5.9 Conclusions: professional LLPs

Anecdotal evidence from law firms that have become LLPs suggest that their standards remain as high, clients have not objected and the firms remain robust. For the reasons set out above, we suggest that allowing professional LLPs in Hong Kong - either partnership model or the corporate model - is not inconsistent with consumer interests.

5.10 Should LLPs be for professionals only?

Some states only allow professionals to practise through LLPs. The United States are divided on the issue with more recent LLP statutes tending to allow any business to practise through an LLP.

Canadian LLPs are only available to professionals.

The UK LLP is available to any trade, profession or occupation. We suggest that if Hong Kong agrees to adopt LLPs, there is no reason why this should only be available to professionals but this is a public policy matter for government. The LLP could offer a useful model of practice for all businesses and entrepreneurs. In the UK the great majority of the 5,000 LLPs registered are for trading activities such as marketing, joint ventures, property development and agricultural cooperatives, rather than for professional partnerships[21].

We see no reason to reserve the LLP to professionals. The public is accustomed to dealing with businesses with limited liability. Hong Kong law would give customers of non-professional LLPs remedies against the LLP in contract and against a partner culpable of negligence or otherwise. Regulators and trade associations might require and enforce special standards of conduct through, for example, industry regulation of an LLP that is an insurance broker or trade regulation of an LLP that fits gas appliances.

6. A NEW LLP FOR HONG KONG: THE ONTARIO CUM NEW YORK MODEL

We believe that the model of LLP that would best suit Hong Kong would be the Ontario model with the full liability shield conferred by the New York model. We call this the Ontario cum New York model.

The Ontario cum New York model would fulfil our criteria in the following ways.

[21] Per Legal Week, 11 December 2003.

6.1 **First criterion: protection of partners from personal liability for the acts and omissions of other partners**

The Ontario cum New York model would protect partners from all personal liability, subject to the proviso that a partner is responsible for his or her own negligence.

Some US jurisdictions, including New York, add a proviso that a partner is responsible for the negligence or other malpractice of the person under his or her direct supervision and control. The statutes do not define "direct supervision and control" and the expression creates uncertainty[22]. We do not believe this second proviso is necessary. Common law would generally attach fault to a partner with ostensible responsibility for negligent advice whether the partner actually gave the negligent advice or not, subject to the usual conditions that establish whether the partner is liable in tort.

The "cum New York" feature of the model we propose is that, subject to the proviso that a partner is responsible for his or her own negligence, partners are protected from all personal liability. This contrasts with the Ontario model, which only protects partners from the consequences of other partners' negligence.

The imperfection of the partnership model is that partners might be vulnerable to claims against their assets under non-Hong Kong law, as described in paragraph 4.5.1. In paragraph 4.4 we discussed whether we should propose a Hong Kong partnership model of LLP that would have legal personality in order to help partners resist such claims. We concluded that we should resist this temptation for the reasons set out in paragraph 4.4.5. The vulnerability of a Hong Kong partner's assets in these circumstances depends on whether the Hong Kong court would enforce the foreign court's judgment that he or she is liable in damages. We believe that, for most Hong Kong law firms, this shortcoming is worth living with.

- It is not a concern for law firms that advise only under Hong Kong law and the law of jurisdictions which would respect Hong Kong law's limitation on partners' liability.
- While the corporate model of LLP should provide a surer shield against claims under non-Hong Kong law, its disadvantages outweigh this advantage. As judged by the remaining criteria, the Ontario cum New York model is superior.

6.2 **Second criterion: familiarity**

The Ontario Partnerships Act is a close descendent of the English Partnership Act 1890 and therefore closely resembles the Partnership Ordinance.

An LLP based on the Ontario cum New York model would offer a familiar entity that would allow the partnership culture to flourish and need not significantly disturb the firm's legal structure, management structure or partnership agreement.

A converting firm would want to review its partnership agreement and, in the light of the partners' limited liability, amend provisions relating to:

- partners' liability for losses: it should follow from the LLP status that partners do not expect their liability to exceed their share of partnership assets, including capital
- a negligent partner's right to indemnity
- the obligation of other partners to contribute if a partner has a right to indemnity.

[22] As discussed, for example, in Limited Liability Partnerships & Limited Liability Limited Partnership by J. William Callison.

6.3 **Third criterion: privacy**

The Ontario cum New York LLP would have to register under the Business Registration Ordinance. The firm would be able to keep its affairs confidential.

6.4 **Fourth criterion: tax treatment**

The Ontario cum New York model of LLP should be treated like a partnership for tax purposes wherever the firm operates.

6.5 **Fifth criterion: straightforward conversion**

The Ontario cum New York model of LLP would achieve conversion by agreement among the partners.

6.6 **Sixth criterion: simple legislation**

The legislation for the Ontario cum New York model of LLP would require simple amendments to the Partnership Ordinance[23]. We suggest the amendments in Annex 5. The Law society might wish to make minor amendments to the rules of the Law Society[24].

6.7 **Seventh criterion: preservation of consumer interests**

We suggest that the framework within which the Ontario cum New York model of LLP would operate in Hong Kong appropriately addresses consumer interests.

7. **CONCLUSIONS**

We conclude that it is in Hong Kong's interests to change the Partnership Ordinance to allow a new form of practice: the limited liability partnership.

We believe that the LLP should be available to all but leave government to judge whether only professionals should be able to practise through LLPs.

Having surveyed different legislative frameworks for the Hong Kong LLP, we recommend a framework which requires few changes to the existing law and leaves professional regulators able to set their own standards of conduct.

Members of the Working Party on Limited Liability Partnership:

Denis Brock (Chairman)
David Hirsch
Andrew Jeffries
Allan Leung
Joseph Li
Janice Chan (Secretary) (Assistant Director, Regulation and Guidance)

This paper is not legal advice. It may therefore not be construed as legal advice of any member of the working party or of the firms they come from.

[23] The changes would be much less extensive than those required to allow solicitor corporations because the latter have to accommodate practice through a new type of entity with its own legal personality (as would those relating to a corporate model LLP).

[24] E.g. confirm that solicitors may practise through LLPs and to cover notification of LLP status to clients.

LIMITED LIABILITY PARTNERSHIP

Report of the Working Party on Limited Liability Partnership

List of Annexures

1. Contribution to Hong Kong's GDP by Solicitors' Firms and Barristers Chambers
2. Singapore's plans to attract international professional services firms
3. Comparison of Ontario, New York and English LLPs
4. Law Society of Upper Canada: by-law for Ontario LLPs
5. Limited Liability Partnerships Ordinance (Draft) for Hong Kong
6. Ontario cum New York model: additional questions for legislature

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7. Partnerships Act, R.S.O. 1990 (marked up with amended provisions on LLP)
8. Bill 6 1998 (Ontario)
9. Section 26, Article 3, New York State Consolidated Laws on Partnership
10. Article 8-B, Registered Limited Liability Partnerships, New York State Consolidated Laws on Partnership
11. Section 12, Partnership Act, Alberta
12. Partnership Ordinance in Hong Kong (Cap. 38)
13. Limited Partnerships Ordinance (Cap. 37)

* *Remarks: Annexures 7 to 13 are available on request*

Annexure 1

Annexure 1

Value added contribution by establishments* engaged in the provision of legal services in Hong Kong

	Value added (HK$ Mn)	% change over a year earlier	% contribution to GDP
1990	4,754	4.3	0.8
1991	5,887	23.8	0.9
1992	5,914	0.5	0.8
1993	6,301	6.5	0.7
1994	8,361	32.7	0.9
1995	6,507	-22.2	0.6
1996	8,015	23.2	0.7
1997	9,583	19.6	0.8
1998	7,286	-24.0	0.6
1999	6,446	-11.5	0.5
2000	6,978	8.3	0.6
2001	6,597	-5.5	0.5
2002	6,522	-1.1	0.5

Notes : (*) Establishments include solicitors and barristers firms in Hong Kong.

Source : GDP by economic activity

Annexure 2

Annexure 2

In the News

Launch of Expansion Incentive for Partnership tax incentive scheme and refinements to Regional Headquarters Award to boost Singapore's attractiveness as a regional business location

DATE 31 Mar 2004

Seven new International Headquarters Award recipients from manufacturing to emerging sectors such as food services and non-profit sectors attest to vibrancy of HQ environment in Singapore

1. Seven companies from a variety of sectors were presented with the International Headquarters (IHQ) award by the Singapore Economic Development Board (EDB) today. Minister of State for Trade & Industry and National Development, Dr Vivian Balakrishnan presented the IHQ award at a combined HQ ceremony to the recipients. The seven companies were BreadTalk Pte Ltd, Cuno Filtration Asia Pte Ltd, Emerson Process Management Asia Pacific Pte Ltd, Helen Keller International Asia Pacific, Informatics Holdings Ltd, Integra Holdings Private Limited and Mercury Marine Singapore Pte Ltd (see Annex B for company details). Together, these companies will generate an additional total business spending of $140 million annually and employ some 1,200 skilled and professional workers when their business projects are fully implemented.

2. A strong base of professional services companies is also needed to complement the business activities of a vibrant and growing community of HQs. As part of EDB's concerted efforts to develop this industry, a new Expansion Incentive for Partnerships (EIP) programme for audit, accounting and law firms has been launched. This programme allows such firms, typically constituted as partnerships, to enjoy a 50% tax exemption on the qualifying overseas income above a pre-determined base. Previously, tax incentives were only available to manufacturing and services corporations. The EIP programme aims to encourage audit, accounting and law firms to use Singapore as their central business hub to develop their business and proficiencies locally and service the regional market from here.

3. EDB remains committed to developing Singapore as the foremost global business location and has put in place new measures for this. In the recent Budget 2004, it was announced that the Regional Headquarters (RHQ) award programme given out to smaller niche companies will be enhanced. The maximum duration of the RHQ scheme will be extended from a period of 3 to 5 years, allowing companies to enjoy a preferential tax rate of 15% for a longer period. The RHQ award criteria have also been broadened to allow all companies operating in Singapore to be eligible. These changes, together with the IHQ award programme, which is a customised incentive package for companies with substantial level of headquarters activities in Singapore, will allow EDB to cater to the business needs of a wider spectrum of HQs, big and small, local and foreign, from across industries.

4. In highlighting these new initiatives, Dr Vivian Balakrishnan said, "The new EIP Programme and the enhancements to the RHQ programme will strengthen Singapore's position as an international hub for HQ activities. These programmes, together with our excellent global connectivity, strong IP protection, legal and financial infrastructure will enhance our ability to better engage and service the more than 7,000 international companies that are based here. Singapore is the ideal location for companies to base their nerve centres in order to tap into the region?s resources and to interact with other international and local businesses."

5. The diverse nature of these new HQ investments, from traditional areas of manufacturing excellence to new emerging areas such as food and non-profit sectors affirms Singapore's universal appeal as an attractive HQ location across industries. These seven companies join a growing base of companies who have located their global and regional HQs in Singapore and have made Singapore their decision-making centre to manage their businesses in the Asia-Pacific region and beyond. To date, there are over 4,000 multinational corporations with HQ operations in Singapore. Of these, EDB has granted 280 headquarters awards since the programme?s inception in 1986.

www.sedb.com/edbcorp/sg/en_uk/index/in_the_news/press_releases/2004/launch_of_expansion.html

-- END --

For media enquiries, pls call Ms Sharon Ang, Marketing Communications at Tel: 6832 6087 (DID) 9005 4818 (HP) or email: sharon_ang@edb.gov.sg

Annex A - Quotes from Award Recipients

Annex B - Company Profiles of Award Recipients

Annexure 3

Annexure 3

Comparison of Ontario LLP, New York LLP and English LLP

	Ontario LLP	Pro + Con -	New York LLP	Pro + Con -	English LLP	Pro + Con -
Legal personality	No		No, but some aspects of personality		Yes	
Tax	Generally treated like a partnership for tax purposes	+	Generally treated like a partnership for tax purposes	+	Might be taxed like a company outside UK (extra tax)	-
Legislation	Based on partnership law	+	Based on partnership law	+	Based on company legislation (complex)	-
Conversion process	Agreement among partners	+	Registration as LLP (continuity)	+	Partners transfer business to newly incorporated LLP (transfer of assets and liabilities: time-consuming process; taxable transfer outside UK?)	-
Publicity requirements	Registration under Business Names Act 1998 No requirement for personal details or accounts Firm must show it is LLP, not partnership	+	Registration renewable every five years No requirement for personal details or accounts Firm must show it is LLP, not partnership	+	File names and addresses of partners, annual accounts and information about partners' remuneration Firm must show it is LLP, not partnership	-
Liability shield	Narrow and may not be recognised outside jurisdiction Partners only shielded from liability for others' malpractice	-	Broad but may not be recognised outside jurisdiction Negligent partner is responsible for own malpractice Partners can elect to waive liability shield	-	Broad Negligent partner may be liable in tort	+

Comparison of Ontario LLP, New York LLP and English LLP						
Use	For authorised professionals only		For authorised professionals only		For any trade, profession or occupation	

Annexure 4

Annexure 4

http://www.lsuc.on.ca/services/services_liability_en.jsp

Practising in Ontario

Limited Liability Partnerships

The Governance Scheme

Amendments to the *Partnerships Act* in force in July 1998 permit professions to practice in the form of limited liability partnerships. Unlike a general partnership, where the partners are liable for debts and liabilities arising from the negligent acts of all partners, the partners in a limited liability partnership are not personally liable for the negligent acts of another partner or an employee who is directly supervised by another partner. However, the partnership assets continue to be at risk for the negligence of the partners and employees.

The *Partnerships Act* establishes the following requirements for professions wishing to practice as LLPs:
* the act governing the profession must expressly permit practice as an LLP;
* the partnership must register its firm name under the *Business Names Act*; and
* the professional governing body must establish minimum liability insurance requirements for the LLP.

The *Partnerships Statute Law Amendment Act, 1998* (Bill 6) which amends the *Partnerships Act* respecting LLPs may be found at The Legislative Assembly of Ontario website at www.ontla.on.ca.

The *Law Society Act* permits lawyers to practice as limited liability partnerships. The registration of the business name of the firm as "LLP" is a requirement of the *Partnerships Act*. The final requirement of the minimum level of insurance for LLPs is in By-Law 26. By-Law 26 also requires lawyers to disclose to the clients of the LLP the nature of the limitation on the liability of the partners. The text of By-law 26 appears below, with relevant commentary.

BY-LAW 26

LIMITED LIABILITY PARTNERSHIPS

PROFESSIONAL LIABILITY INSURANCE

Insurance requirements

1. A limited liability partnership shall maintain professional liability insurance coverage for each partner in accordance with By-Law 16.

This section of the by-law establishes the minimum insurance required by a law firm practising as an LLP to be the coverage now maintained individually by each member who is a partner of the firm. This is currently in the amount of $1,000,000 per member. Accordingly, the requirements in s. 44.2(b) of the *Partnerships Act* would be met by requiring the LLP to maintain the coverage that members who are partners maintain pursuant to By-Law 16 on Professional Liability Levies. Section 1 of the by-law focuses on the fact that the partners are essentially the partnership and that it is the partnership's obligation, in the language of the *Partnerships Act*, to ensure that the insurance at the member level is maintained for each partner to satisfy the requirement. The reference to By-Law 16, which requires all members practising law to pay the insurance levy for professional liability coverage, effectively links the scheme to the level of insurance currently carried by members individually. This provision, notwithstanding that for LLPs it is the partnership that is required to maintain the coverage for the partners, in no way operates to derogate from the obligation of members individually to comply with the requirements of By-Law 16 to pay the insurance levy.

DISCLOSURE

Partnership continued as limited liability partnership

2. (1) When a partnership is continued as a limited liability partnership, as soon as is reasonably practical after the continuance of the partnership as a limited liability partnership, the limited liability partnership shall disclose to each person who was a client immediately before the continuance and who remains a client after the continuance the liability of the partners of the limited liability partnership under the *Partnerships Act*.

(2) A limited liability partnership satisfies the disclosure requirement under subsection (1) if it publishes in a local newspaper notice of the matters set out in subsection (1).

(3) In subsection (2), "local newspaper" means any newspaper distributed in the area in which the limited liability partnership carries on business.

While disclosure of the fact that a firm is an LLP and the effect of the limitation of partners' liability is not a legislative requirement that must be enacted by a profession, the Law Society believes it is appropriate as a matter of professional responsibility that at a minimum, clients be told of the nature of the limited liability of the partners resulting from the new practice structure. Although *public* notice is effectively accomplished through the registration as an LLP under the *Business Names Act*, clients, within the general public, maintain unique relationships with law firms. Accordingly the by-law obliges lawyers to make the appropriate disclosure to clients at the time a firm continues as a LLP.

If a written form of notice to clients is to be sent, law firms are encouraged to design their own communications respecting the disclosure requirement and customize them as they see fit for their particular clients. To the extent that lawyers may find it useful, a sample letter, appearing below, may be considered an example of a communication on disclosure.

Sample Disclosure Letter for LLPs

Dear Client:

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

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

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

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

Firms may also choose to publish a notice in a local newspaper as provided in subsection 2(2) of the by-law. Such notices should be complete and clear enough for clients to understand the nature of the limitation on the liability of the firm.

Taxation Issues

Law firms should consult with their tax advisors with respect to any tax consequences that may flow from continuance of a general partnership as an LLP, or any other matters that may impact on the firm because of the new practice structure.

Annexure 5

LIMITED LIABILITY PARTNERSHIPS

To establish limited liability partnerships.

[ ]

1. Short title

This Ordinance may be cited as the Limited Liability Partnerships Ordinance.

2. Interpretation

(1) "foreign limited liability partnership" means a limited liability partnership formed under the laws of another jurisdiction.[1]

(2) "limited liability partnership" means a partnership, other than a limited partnership, that is formed or continued as a limited liability partnership under section 8 or 9.[2]

3. Application

This Ordinance shall apply to partnerships carrying on business in Hong Kong.[3]

4. Constitution of limited liability partnerships

Limited liability partnerships may be formed in the manner and subject to the conditions by this Ordinance provided.[4]

[1] See article "Limited Liability Partnerships & Limited Liability Limited Partnerships", J. William Callison, p.3 II(e)
[2] Bill 6 , para.1
[3] s2, Limited Partnerships Ordinance, Hong Kong
[4] s3(1), Limited Partnerships Ordinance

5. Law as to private partnership to apply

Subject to the provisions of this Ordinance, the Partnership Ordinance (Cap. 38), and rules of equity and of common law applicable to partnerships, except so far as they are inconsistent with the express provisions of the Partnership Ordinance, shall apply to limited liability partnerships that are not foreign limited liability partnerships.[5] [6]

6. Liability of partners

(1) Subject to subsection (2), a partner in a limited liability partnership is not liable, by means of indemnification, contribution, assessment or otherwise, for debts, obligations and liabilities of the partnership or any partner,[7] whether arising in tort, contract or otherwise, which are incurred, created or assumed by the partnership or any partner while the partnership is a limited liability partnership solely by reason of being a partner or acting (or omitting to act) in that capacity or rendering professional services or otherwise participating in the conduct of other business or activities of the limited liability partnership.[8]

(2) Subsection (1) does not affect the liability of a partner in a limited liability partnership for the partner's own negligence[9] or any wrongful act or misconduct committed by him or her while rendering professional services on behalf of the limited liability partnership.[10]

(3) A partner in a limited liability partnership is not a proper party to a proceeding by or against the limited liability partnership for the purpose of recovering damages or enforcing obligations[11] arising out of debts, obligations or liabilities for which, because of subsection (1), he is not liable.

(4) The protection from liability given to a partner by subsection (1) shall not be construed as offering any protection from claims against the partner's interest in the partnership property[12].

(5) This section does not apply to a foreign limited liability partnership.

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[5] s.6, Limited Partnerships Ordinance;
[6] s.45, Partnerships Act, RSO 1990, Ontario
[7] Bill 6, para 2(2)
[8] s26(b), Article 3 of New York State Consolidated Laws on Partnership
[9] Bill 6, para 2(2)
[10] s26(c)(i), Article 3 of New York State Consolidated Laws on Partnership
[11] Bill 6, para 2(2)
[12] s.12, Partnership Act, Alberta

7. Rules as to interests and duties of partners[13]

(1) Subject to any agreement, express or implied, between the partners, a partner in a limited liability partnership shall not be liable to pay or contribute toward losses arising from a liability for which the partner is not liable under section 6; and

(2) a partner in a limited liability partnership is not required to indemnify the firm or other partners in respect of debts or obligations of the partnership for which a partner is not liable under section 6.

8. Formation of Limited Liability Partnerships

A limited liability partnership that is not a foreign limited liability partnership is formed when two or more persons enter into a written agreement that,

(a) designates the partnership as a limited liability partnership; and

(b) states that this Ordinance governs the agreement.[14]

9. Continuance of Limited Liability Partnerships

A partnership that is not a foreign limited liability partnership, may be continued as a limited liability partnership if all of the partners,

(a) enter into an agreement that continues the partnership as a limited liability partnership and states that this Ordinance governs the agreement; or

(b) if there is an existing agreement between the partners that forms the partnership, amend the agreement to designate the partnership as a limited liability partnership and to state that this Ordinance governs the agreement.[15]

10. Effect of continuance

Upon the continuance of a partnership as a limited liability partnership under section 9,

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[13] Bill 6, para 4; s24(1) and (2.1) of Partnerships Act, R.S.O. 1990
[14] Bill 6, para.6 , 44.1(1)
[15] Bill 6, para.6 , 44.1(2)

(a) the limited liability partnership possesses all the property, rights and privileges and is subject to all liabilities, including civil and criminal and all contracts, disabilities and debts of the partnership which were in existence immediately before the continuance; and

(b) all persons who were partners immediately before the continuance remain liable for all debts, obligations and liabilities of the partnership that arose before the continuance.[16]

11. Registration of business name

No limited liability partnership formed or continued by an agreement governed by this Ordinance shall carry on business unless it has registered its firm name in accordance with the Business Registration Ordinance (Cap 310).

12. Name of limited liability partnerships

The name of a limited liability partnership mentioned in section 11 shall contain the words "limited liability partnership" or the abbreviations "LLP" or "L.L.P." as the last words or letters of its name.[17]

13. Foreign limited liability partnerships

(1) No foreign limited liability partnership shall carry on business in Hong Kong unless it has registered in accordance with the Business Registration Ordinance.

(2) To amend or cancel a registration of its firm name, a foreign limited liability partnership shall register an amendment or cancellation of a registration in accordance with the Business Registration Ordinance.

(3) The laws of the jurisdiction under which a foreign limited liability partnership is formed shall govern,

(a) its organisation and internal affairs; and

(b) the liability of its partners for debts, obligations and liabilities of or chargeable to the partnership or any of its partners.

[16] Bill 6, para 6, 44.1 (3)
[17] Bill 6, para 6, 44.3 (3)

(4) Subsection (3)(b) shall not limit the liability of a partner in a foreign limited liability partnership for tort under the law of Hong Kong.

(5) Every foreign limited liability partnership shall,

(a) conspicuously exhibit on every place where it carries on business in Hong Kong the name of the foreign limited liability partnership and the country or territory in which it is formed; and

(b) cause the name of the foreign limited liability partnership and the country or territory in which it is formed to be stated in legible letters in all bill-heads and letter paper, and in all notices and other official publications of the foreign limited liability partnership.

(6) A person may serve a notice or document on a foreign limited liability partnership at its Hong Kong place of business, if any, or its address required to be maintained under the laws of the jurisdiction of formation or its principal office address.

(7) The name of a foreign limited liability partnership shall contain the words "limited liability partnership" or the abbreviations "LLP" or "L.L.P." as the last words or letters of its name.

Annexure 6

Annexure 6

LIMITED LIABILITY PARTNERSHIP

Report of the Working Party on Limited Liability Partnership

ONTARIO CUM NEW YORK MODEL: ADDITIONAL QUESTIONS FOR LEGISLATURE

In the previous annex we have proposed simple legislation for a Hong Kong LLP, believing its simplicity is one of its virtues.

In our paper we mention features of partnership models of LLP which, while not essential, might attract the legislature. This annex summaries alternative options.

1. The LLP legislation might allow majority of partners to agree that all or specified partners are liable for all or specified debts of the partnership, as in section 26(d) of the New York State Consolidated Laws on Partnership.

   This provision could give the LLP valuable flexibility insofar as majority of partners could waive partners' protection from liability.

   New York law requires the LLP's registration to state whether all or specified partners are liable as authorised section 26(d).

2. Our legislation follows the Ontario model insofar as it provides that:

   - a foreign LLP must register under the Business Registration Ordinance before it can carry on business in Hong Kong
   - the law of the foreign LLP governs its organization and internal affairs and the liability of its partners for debts, obligations and liabilities of the firm and its partners.

   We though Hong Kong would want foreign LLPs to register, and the recognition of their law is a *quid pro quo*. The legislature my wish to consider whether to reply on the Hong Kong doctrine of conflict of law rather than recognise the foreign law of the LLP. As there is uncertainty about the applicable doctrine, we thought that the clear recognition of the foreign law was helpful.

3. In the light of our conclusion in paragraph 5.10, we have departed from the precedent of Ontario and New York law by not limiting the Hong Kong LLP to professional practice.

4. We have disregarded the Ontario Partnerships Act by not requiring that the Hong Kong LLP have minimum levels of insurance cover. This is consistent with our conclusions that regulators or market forces will ensure the LLP is appropriately insured.