Submission to the Bills Committee on

Legal Practitioners (Amendment) Bill 2010

Purpose

1. This paper sets out the Law Society's comments on the Administration's policy position on the following issues in its submission in January 2011:

   (a) the constructive knowledge element of the proposed section 7AC(3)(a); and

   (b) the limitation period for clawback actions under the proposed section 7AI.

Inclusion of constructive element in section 7AC(3) unnecessary in the first place

2. Section 7AC(3) of the Bill excludes a partner from the liability protection of an LLP under section 7AC(1) if the partner:

   (a) knew or ought reasonably to have known of the default at the time of its occurrence; and

   (b) failed to exercise reasonable diligence to prevent its occurrence.

3. Section 7AC(3) covers two aspects, namely, actual knowledge and constructive knowledge.

4. On actual knowledge, there is no need to include an express provision. If a partner knew of the default and failed to take reasonable action to prevent it, he would have been negligent himself and would not be protected by the LLP status of the firm in any event.

5. On constructive knowledge, the Law Society is given to understand that the Administration believed, based on academic commentaries that it was more likely for partners in an LLP to avoid personal liability by not getting involved in any supervision at all. The Administration therefore concluded that consumers would consequently end up having no "culpable" partner to shoulder liability for any negligence claim.

6. Academic commentary can be useful in evaluating legislative and policy alternatives. However, at the same time, it is necessary to review the commentary carefully to understand the scope of the subject being addressed by the author, the perspective from which the issue is being considered and any limitations on the research underlying the paper and the quality of the scholarship in general.

7. More importantly, any extract from academic commentaries in support of a view needs to be put in context. The following statement from Kraiwec and Baker was quoted in support of the Administration's view on concerns of lost collegiality in an LLP:

"A handful of partners at firms that had become LLPs believed that this fear had been wellfounded at their firm and that certain partners now avoided helping out on other partners' projects, out of a desire to limit their personal exposure."

However, this was not the conclusion of the article. The article goes on to say the following, in the very next sentence:

"Most partners, however, indicated that becoming an LLP had not impacted in any way the relations among partners. As stated by one law firm partner, 'partners who were uncollegial before [the firm became an LLP] are still uncollegial and partners who were collegial before are still just as collegial [after the firm became an LLP].'"

8. The belief and fear of the Administration that LLPs will lead to partners abandoning proper supervision of their legal practice is unrealistic and over exaggerated. The legal profession is a highly disciplined and competitive profession. No partner will risk loosening up on supervision and damaging his hard earned reputation simply because the firm is an LLP.

9. The Department of Justice itself reported in its submission in November 2010 that it has not found any specific case from Alberta, British Columbia and Manitoba (whose LLP legislations do not include any constructive knowledge provisions) that was relevant in illustrating that there was any problem with the lack of an express provision on constructive knowledge.

Constructive knowledge provision does not resolve the concern on supervision

10. There is absolutely no cause for concern that partners in an LLP will abandon proper supervision. Even if there is such a concern, which the Law Society submits is an unnecessary concern, expressly legislating on the attachment of liability to constructive knowledge will not resolve the issue.

11. It will simply invite claimants to adopt a catch-all approach by easily relying on such an express provision to include all partners as defendants on the basis that being partners in the same firm, they all ought to have known of the default. This defeats the purpose of the introduction of limited liability partnerships. Innocent partners will unreasonably be dragged into negligence claims.

Practical solutions to address the remote concern, if any at all, of LLP partners abandoning supervision to avoid liability

12. In its submission dated 29 September 2010, the Law Society proposed that, in addition to the requirements on disclosure of LLP status in the Bill and the existing solicitors' professional conduct requirements on duty of care, the Solicitors' Professional Conduct Guide be amended or a new Practice Direction be issued by the Law Society Council to require LLPs to inform their clients of the name and status of the person responsible for the conduct of the matter on a day-to-day basis; the partner responsible for the overall supervision of the matter and any subsequent changes.

13. The above additional practice requirement serves to directly ensure that all cases are supervised by a designated partner and offers a practical solution to the remote concern of LLP partners abandoning supervision to avoid liability. Any breach of a Practice Direction will subject the solicitor to disciplinary actions.

Consequence of failure to issue notice

14. The Administration has proposed that the practice requirement be modified into a notification requirement in the legislation as follows:

    (a) an LLP will be required to issue a signed written notice to its clients in respect of every matter, within 30 days after acceptance of instructions of the matter, stating the name of the responsible partner for the matter and containing an undertaking by the LLP to inform the client of any subsequent changes of the responsible partner; and

    (b) the loss of LLP protection for the firm in respect of that matter should the LLP fail to issue the written notice, unless the client knew who the responsible partner was prior to the default and within 30 days from the firm's acceptance of instructions in respect of that matter.

15. The Law Society has no objection to the imposition of a notice requirement or the content to be included in the notice as set out in paragraph 14(a) above. However, the Law Society considers the suggested sanction as set out in paragraph 14(b) disproportionate to such a procedural formality.

16. The decision to become an LLP is no casual decision for a firm. The conversion impacts on the firm's overall operation and long term development planning. Once it was set up as an LLP, held out to the public as an LLP and complied with the disclosure requirements in the Bill relating to its LLP status, then the firm should be afforded the certainty that it can operate as an LLP in respect of all matters.

17. Providing for the stripping of a firm's LLP status (albeit only in respect of a particular matter) on the basis of a failure to comply with a mere formality of issuing a written notice renders the LLP status a sham.

18. Very often, work may not actually start for more than 30 days after acceptance of instructions and yet on the basis of the Administration's proposal, if the required notice is issued, say, one day after the expiry of 30 days from the acceptance of instructions, the LLP status will be lost in respect of the matter.

19. The Law Society considers the proposed sanction of the loss of LLP status highly draconian, in particular the requirement relating to the 30-day limit as illustrated by the example given in paragraph 18 above, and hence, does not support it.

20. If the Bills Committee considers otherwise, the Law Society strongly urges the Bills Committee to remove the 30-day limit to the effect that if a client knew who the responsible partner was prior to the occurrence of the default, irrespective of whether it was within or beyond 30 days from the acceptance of instructions, the LLP status of the firm remains intact.

21. Further, to clarify, it is the Law Society's understanding that the sanction of the loss of LLP status in respect of a particular matter will not extend to a breach of undertaking to inform the client of any subsequent changes of the responsible partner for the matter on the basis that the client will not be disadvantaged because:

    (a) the client can still claim from the partner named in the initial notice and join the subsequent partner as a co-defendant when the latter's identity is known;

    (b) alternatively and invariably, to exonerate himself, the partner named in the initial notice will join the subsequent responsible partner as a third party to the proceedings.

Clawback of a distribution of partnership property

22. Looking at LLP provisions around the world, claw back provisions are uncommon.[1]

23. Most other major jurisdictions like UK, Singapore or New York will simply rely on the general insolvency or fraudulent transfers provisions that do not apply only specifically to LLPs.

24. The Law Society has submitted before and it reiterates its position that on the premises that consumers will not be disadvantaged, Hong Kong should be in line with most other jurisdictions in designing its LLP legislation so that it can truly achieve the objective of enhancing Hong Kong's competitiveness through a modernization of its legal infrastructure that is comparable to other jurisdictions. Consumers will not be disadvantaged without clawback because:

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[1] Extracted from paragraph (d) on Effect of LLP Status on Other Partnership Rules on p.187 - p.189 of *Limited Liability Partnerships, The Revised Uniform Partnership Act, and The Uniform Limited Partnership Act (2001), 2010 Edition by Alan R. Bromberg and Larry E. Ribstein*

(a) the mandatory Professional Indemnity Scheme has proven to be sufficient protection based on past claims experience;

(b) the Bankruptcy Ordinance will apply to claw back assets that should not have been transferred out in the event that the firm becomes insolvent and the partners are bankrupt;

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

25. Further, the current section 7AI is practically unworkable.

26. Section 7AI allows any person to whom the partnership owes any partnership obligation at the time of distribution to take out proceedings to enforce a partner's liability to return that distribution to the partnership if the value of the partnership property is less than that of the partnership obligations.

27. Section 7AI(4) specifically provides that "partnership obligations" cover actual and contingent obligations.

28. Accordingly, section 7AI will effectively allow a claimant to commence proceedings to enforce a partner's liability to return a distribution to the partnership even before the claimant has obtained judgment on his negligence claim as long as the partnership property is less than the partnership obligations taking into account his claim (which is a contingent partnership obligation).

29. The issue is where judgment has not been obtained for the claim, how much of the claim should be allowed for the purpose of determining if the value of partnership obligation is more than that of partnership property. It poses problems for the following reasons:

(a) the amount of the claim may be over-inflated;

(b) an assessment of quantum at the early stage of the claim proceedings is extremely difficult.

30. If a comparison is made with the few Canadian jurisdictions that have provisions regulating distribution of partnership property in LLPs, it is noted that they do expressly provide for the bases to determine whether a distribution should have been made, namely,

"(a) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances;

(b) on a fair valuation;

(c) on another method that is reasonable in the circumstances."[2]

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[2] Based on section 85(5) Manitoba Partnership Act and Section 83(5) Saskatchewan Partnership Act

31. If it is the view of the Bills Committee that a clawback provision must be provided in the legislation, the inclusion of such objective bases will add certainty and predictability to the existing section 7AI so that at the very least, an LLP will know how to ensure compliance with the provision. There is no use imposing a requirement if no one knows how to comply with it.

32. In relation to the limitation period of a clawback action, the Administration has proposed a period of 6 years.

33. In a bankruptcy scenario, the relevant period for restoration is 2 years before presentation of bankruptcy petition where unfair preferences were given to associates of debtors and a person is an associate with whom he is in partnership under sections 50, 51 and 51B of the Bankruptcy Ordinance (Cap 6).

34. The spirit of the proposed clawback is the same as that of the restoration of assets in a bankruptcy situation and the period should be consistent.

35. Further, comparing with the few Canadian jurisdictions[3] that have provisions regulating the distribution of property for LLPs, the period of limitation to enforce a liability under all of those provisions is 2 years.

36. There are two reasons given by the Administration for proposing 6 years instead of 2 years as the limitation period:

    (a) clients do not know when a distribution has been made; and

    (b) it takes more than 2 years for a client to obtain a first instance judgment on his negligence claim before he is in a position to enforce the judgment debt.

37. On the client's knowledge of distribution, a comparison can be made with the bankruptcy scenario where similarly the claimant would not have knowledge of any unfair transfer of assets, the restoration period is still legislated as 2 years. The Law Society does not see any justification for LLPs to depart from the policy of existing legislation.

38. For the second reason on the need of more than 2 years to obtain a first instance judgment, as explained in paragraphs 26 to 28 above, section 7AI provides that the claimant can take out a clawback action even before he obtains judgment. This is thus not a valid reason.

39. The Law Society submits that if the Bills Committee considers a clawback provision must be provided in the legislation, the limitation for a person to enforce a liability under such a provision should be 2 years in line with the bankruptcy regime and other overseas LLP legislation, e.g. British Columbia, Manitoba, Nova Scotia and Saskatchewan.

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[3] British Columbia, Manitoba, Saskatchewan, Nova Scotia

Conclusion

40. In summary, the Law Society's position is as follows:

(a) it welcomes the deletion of the constructive knowledge element in section 7AC(3);

(b) it agrees to the content of the notice requirement;

(c) it is willing to issue a Law Society Practice Direction that reflects the notice requirement and any breach of the Practice Direction will subject the culpable solicitor to disciplinary sanctions;

(d) it does not support the proposed sanction of the loss of LLP status in respect of the matter for which the LLP fails to issue the required notice;

(e) in the event that the Bills Committee decides otherwise, it strongly urges the Bills Committee to remove the 30-day limit to the effect that if a client knew who the responsible partner was prior to the occurrence of the default, irrespective of whether it was within or beyond 30 days from the acceptance of instructions, the LLP status of the firm remains intact;

(f) it does not support the inclusion of an express clawback provision in the Ordinance as there is sufficient existing consumer protection without the need for any express clawback;

(g) the existing section 7AI lacks certainty and is practically unworkable;

(h) the grounds on which the Administration based to determine 6 years as the limitation period for a clawback action are invalid;

(i) the Law Society does not support the inclusion of the proposed 6 years clawback provision in the Ordinance;

(j) if the Bills Committee considers otherwise, the Law Society strongly urges the Bills Committee to include some objective bases on which to determine whether a distribution should be made and a limitation period of 2 years for the clawback action in line with other overseas LLP legislation.

The Law Society of Hong Kong
1 February 2011