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Bills Committee on Legal Practitioners (Amendment) Bill 2010

**Background brief prepared by the Legislative Council Secretariat
for the meeting on 9 March 2012**

**Provisions regarding designated partner and
clawback of a distribution of partnership property**

Purpose

This paper gives an account of the deliberations by the Bills Committee on Legal Practitioners (Amendment) Bill 2010 ("the Bills Committee") on issues relating to the provisions regarding designated partner and clawback of a distribution of partnership property.

Background

2. Under the existing law, every partner in a solicitors' firm is liable jointly and severally with other partners for all debts, liabilities and obligations of the firm incurred while he is a partner, including those arising from any wrongful act of other partners of the firm. Limited liability partnership ("LLP") is a model for doing business which confers the privileges of limited liability on innocent partners so as to insulate their personal assets from claims incurred by the negligence of other partners in the course of LLP's business.

The Bill

3. Introduced into the Legislative Council on 30 June 2010, the purpose of the Bill is to amend the Legal Practitioners Ordinance (Cap. 159) to introduce LLP for solicitors' practices in Hong Kong.

Deliberation of the Bills Committee on the provisions regarding designated partner

4. The Bills Committee had discussed in length issues relating to the introduction of the designated partner provisions. The concerns of members are summarised in the following paragraphs.

Constructive knowledge element in the proposed section 7AC(3)

5. Under the proposed section 7AC(3) of the Bill, a partner in an LLP will not be protected from the liability arising from a claim made by a client if the partner knew or ought reasonably to have known of the default of other members of the firm at the time of its occurrence, and failed to exercise reasonable diligence to prevent its occurrence. The Law Society of Hong Kong ("the Law Society") expressed concern that the constructive element in the proposed section 7AC(3) might be exploited by claimants to cast their net unnecessarily wide leading to excessive litigation by including all partners as defendants on the basis that being partners in the same firm, they all ought to have known of the default.

6. Hon Paul TSE shared the Law Society's concern and urged the Administration to remove the constructive knowledge element in the proposed section 7AC(3). Hon Ronny TONG considered that providing for only the actual knowledge element in the relevant provision might provide lesser safeguard to consumers as partners might deliberately avoid personal liability by not getting involved in the supervision at all. Whilst the failure of an LLP to establish a proper system of staff supervision could be the basis for a claim that all partners of the LLP were jointly liable for negligence, a client needed to found his claim on the LLP's failure to establish a proper system of supervision rather than on an employee's negligence or wrongful act. This might not be in the best interest of consumers. Hon Albert HO and Hon Paul TSE pointed out that all solicitor firms in Hong Kong would have a partner supervising each and every case. Dr Hon Margaret NG considered that actual knowledge was preferable to constructive knowledge in providing protection to consumers, as this would obviate the need for the consumers to identify the responsible partner to claim damages for negligence.

7. To address the concern that partners might deliberately avoid personal liability by not getting involved in the supervision at all, the Law Society proposed that LLPs be required in The Hong Kong Solicitors' Guide to Professional Conduct 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.

8. Having regard to members' views and the Law Society's concern, the Administration proposed to remove the constructive knowledge element in the proposed section 7AC(3) and add the new section 7AGA to the Bill requiring a solicitor firm operating as an LLP to appoint at least one partner of the partnership to act as designated partner for each and every matter it handled for a client throughout the course of the matter. The notice had to be given as soon as practicable, and in any event not later than 30 days after the LLP accepted instructions in respect of the matter. The consequence of breaching this notification requirement would be that all partners of an LLP should be barred from relying on the proposed section 7AC(1) for protection in the particular case where the LLP had failed to comply with this requirement. If an LLP could prove that a client had actual knowledge of the identity of the responsible partner(s) and such actual knowledge was acquired prior to the occurrence of the default and within 30 days from the firm's acceptance of instructions in respect of his matter, all other partners of the LLP would continue to be allowed to rely on the proposed section 7AC(1) for protection in the particular case concerned even if the notification requirement was not observed by the LLP.

9. The Law Society did not agree to the proposed sanction of loss of LLP status against an LLP which failed to comply with the notification requirement. In its view, the LLP concerned should be subject to its disciplinary proceedings. Hon Paul TSE expressed similar views. Dr Hon Margaret NG considered that making all partners collectively liable for negligence caused by a member of the LLP would be disproportionate to the liabilities faced by innocent partners if the failure to notify the clients, say, the transfer of a case to another person in the firm, was made by an employee without the knowledge of his supervising partner.

10. The Administration explained that given that the issuance of notice was a relatively simple step, but crucial to protecting consumers, the consequences of failing to issue the notice should result in the firm losing its LLP status for the case concerned.

Limited liability protection for the designated partner

11. The Administration advised that the notification requirement would obviate the need for the consumers to identify the responsible partner to claim damages for negligence. The Administration further pointed out that given that the designated partner would be the responsible partner in

respect of the matter, it went without saying that the designated partner would not be entitled to the LLP protection provided under the proposed section 7AC(1). To strike a proper balance between protecting consumer interests and allowing flexibility for the LLP to decide who will be the designated partner(s) for a matter, a Committee Stage amendment ("CSA") to the proposed section 7AC(2) was further proposed such that the protection from liability available to a partner who was not a designated partner for the matter would be subject to any written agreement between the partners to the contrary.

12. Members considered it necessary to provide safeguards for consumer protection by providing certainty on the identity of the responsible partner(s) to the clients prior to the occurrence of the default so as to avoid the possibility that a claimant had to drag into legal proceedings to pursue against all partners because no supervising partner could be identified as being responsible for the case. Dr Hon Margaret NG, Hon Albert HO and Hon Paul TSE pointed out that it was justifiable that the fee earners of a matter, who were regarded to have a supervising role in the matter, would lose the limited liability protection in respect of the matter if they were named in the written notice as designated partners.

13. The Law Society considered that the imposition of strict liability on the designated partner had effected a fundamental change to the LLP structure and went against the principle that the introduction of LLP did not intend to change the common law position with respect to the proof of negligence. Under the Administration's proposal, if all partners overseeing different aspects of a matter were named as the designated partners for the matter, all of them had to shoulder personal liability even in aspects where they were not at fault. If only one of these partners was named as the designated partner for the matter, he had to be liable for the default of other partners even though he was innocent. The Law Society proposed that the designated partner should only be responsible to handle client relationship matters and he should be afforded the protection from liability if he was innocent. The designated partner would inform the client who suffered loss as a result of a default of an LLP which partner was responsible for the default. This would obviate the need for the client to identify the responsible partner to claim damages for negligence. The Law Society further opined that the Administration's CSA to the proposed section 7AC(2) which introduced a cross indemnity among partners was just a way of transferring liability by contract but an innocent partner who was named as the designated partner for the matter would remain liable under the legislation.

14. The Administration advised that the policy intent of the Bill was to allow an innocent partner of an LLP to rely on the proposed section 7AC(1) for protection if he did not have actual knowledge of the default at the time it was committed. The proposed section 7AC(1) was not intended to change the common law position with respect to the general principles of negligence and the general law of tort. The designated partner, who should be responsible for the overall supervision of the matter, would not be protected from liability in respect of that matter. In view of the Law Society's concern over matters involving more than one partner overseeing different aspects of that matter, the Administration would study the issue of whether the designated partners named in the written notice, who were responsible for overseeing different aspects of the matter, should only be held liable for defaults arising in their responsible area.

15. Hon Paul TSE pointed out that from the perspective of small law firms, the existing statutory professional indemnity limit of \$10 million per claim which would apply equally to LLPs would be sufficient for indemnity protection of individual consumers, but he considered that the option of increasing the professional indemnity limit for LLPs could be explored. Efforts should also be made to explore whether measures other than excluding the designated partner from limited liability protection could be put in place to safeguard consumer interest on the one hand and allay LS's concern on the other hand. Dr Hon Margaret NG considered that whether the proposed CSAs were objectionable because they were drafted in too great detail could be an issue for consideration.

16. The Bills Committee agreed at its meeting on 27 July 2011 that the Administration and the Law Society should further discuss the issue with a view to forging a consensus on the policy.

Deliberation of the Bills Committee on the provisions regarding clawback of a distribution of partnership property

17. The concerns of members on the time limit for clawback of a distribution of partnership property and the provision of defence in the clawback provision are summarised in the following paragraphs.

Time limit for clawback

18. The proposed section 7AI(1) of the Bill provides that, if the liquidity test in subsection (a) or the asset test in subsection (b) cannot not be met after an LLP distributes its property to a partner or an assignee, the partner or assignee will be liable to return the amount of money received by the

partner or the amount necessary to discharge the partnership obligation at the time of distribution, whichever was the lesser. The Law Society considered that a regulation on the distribution of partnership property which did not exist for general partnership was unnecessary for LLPs and should be deleted. It pointed out that rarely did a claimant have to resort to the personal assets of the culpable partner, let alone the partnership assets because the statutory indemnity limit of HK\$10 million was already sufficient to settle the claim amount of an individual claimant. If it was the view of the Bills Committee that a restrictive provision on the distribution of partnership property had to be remained in addition to the Bankruptcy Ordinance (Cap. 6), the Law Society proposed that there should be a time limit for commencement of proceedings to enforce a liability under the proposed section 7AI.

19. The Administration advised that the main purpose of the proposed section 7AI was to prevent dissipation of partnership assets by partners. The Bill did not prohibit distributions by LLPs in general. It remained for an LLP itself to judge whether, in a given circumstance, it would like to make a distribution to its partners after taking into account all relevant considerations. It was entirely an LLP's decision and judgment whether or not it should make a distribution to its partners where it had a remote obligation; a frivolous and vexatious claim against it; and/or a claim, the amount that was out of proportion to the anticipated liability. Similarly, if there was a well-founded claim against an LLP, it would be entitled to decide and judge for itself whether or not it should make a distribution by reference to its insurance coverage under the Professional Indemnity Scheme and any additional top up insurance it might have at the time. Having taken into account the Law Society's concern, the Administration proposed a limitation period of two years from the date the claimant discovered the distribution made or could with reasonable diligence have discovered it for the proceedings under the proposed section 7AI(3).

20. The Law Society did not agree with the Administration's proposal on the basis that the effective limitation period for clawback actions would be uncertain, as the date when the claimant would discover the distribution made or could with reasonable diligence had discovered it was unknown. The Law Society proposed that if an LLP made a distribution of any of its partnership property to its partners, even at that time the firm's assets were less than the amount of its contingent liabilities arising from the demands or claims made by its clients, the distribution made to the partners should not be liable to be clawed back to the firm's asset pool after the expiration of two years from the date the distribution was made. The proposal was in line with that of the Canadian precedents.

21. Hon Paul TSE pointed out that the proposal put forward by the Law Society to allow a two-year claw back period was sufficient to provide adequate protection for the consumers. Consumers who were concerned about the limitation of restoration of partnership property that had been distributed out were free to choose traditional partnership upon the introduction of the LLP business model for solicitors' practices.

22. The Administration considered the Law Society's proposal unfair to consumers as clients were not privy to information about distribution of profits and assets by an LLP to its partners and it usually took more than two years for a claimant to obtain a first instance judgement on his claim for negligence against a law firm before he/she was in a position to enforce the judgment debt. To balance the needs to protect innocent LLP partners on the one hand and consumers on the other hand, the Administration subsequently put forth a revised proposal that the limitation period on clawback actions under the proposed section 7AI would be six years from the date of the distribution to which the liabilities related, which would be in line with the stipulation in the Limitation Ordinance (Cap. 347). Hon LAU Kwong-wah and Hon Audrey EU agreed with the Administration's proposal of setting the limitation period as six years from the date of the distribution.

23. At the meeting on 27 July 2011, the Law Society maintained its view that it was not common in LLP provisions of other jurisdictions to provide clawback of distributions of partnership property. Most other major jurisdictions, such as New York, simply rely on the general insolvency or fraudulent transfers provisions that apply to all business organisations including LLPs. If the Bills Committee considered a clawback provision had to be provided in the legislation, the limitation for a person to enforce a liability under such a provision should be two years in line with the bankruptcy regime and other overseas LLP legislation such as British Columbia, Manitoba, Nova Scotia and Saskatchewan.

24. The Administration replied that in New York, the clawback period (as provides in the *Debtor and Creditor Law* in relation to fraudulent conveyances and which applied to both bankruptcy and non-bankruptcy situations) was six years from the date of the cause of action accrued or two years from its discovery, whichever was later, while in some jurisdictions, the clawback period varied between two to four years.

Defence for distributions made after financial assessment

25. The Law Society expressed concern about the basis for an LLP to determine whether a distribution of partnership property might be made

without fear of being clawed back. Having taken into account the Law Society's concern, the Administration proposed to provide a defence for a partner in an LLP (or an assignee of a partner's share in the partnership) in the proposed section 7AI to establish that, based on the information at the time of distribution, it was reasonable to conclude that the financial position of the partnership was able to meet the dual liquidity-asset test as described in the proposed sections 7AI(1)(a) and (b) after the distribution. The burden of proof for the defence for distributions made after financial assessment should lie on the defendant but not the client. The Administration added that the proposal might have the effect of providing incentive for LLPs to take out top-up insurance to cover claims for negligence against the firm. The Administration further proposed to replace the expression "as a consequence of which" in the proposed section 7AI(1) with "and immediately after the distribution" to provide more clarity and certainty in the implementation of the liquidity-asset test.

26. The Law Society remained of the view that the Bill should provide specific objective bases for an LLP to determine whether a distribution should have been made, namely, on financial statements prepared on the basis of accounting practices and principles that were reasonable in the circumstances; on a fair valuation; on another method that was reasonable in the circumstances. The Law Society considered that the reasonable assessment test proposed by the Administration was unworkable in the absence of defined criteria. The question of uncertainty and unpredictability also remained unresolved.

27. The Administration did not consider it appropriate to state the specific bases suggested by the Law Society in the Bill. While agreeing that these bases (based on the LLP provisions in some Canadian jurisdictions) might be relevant in justifying a distribution, adopting an exhaustive list of bases in the Bill would imply that the LLP would not need to consider other relevant factors when making a distribution. The Administration further advised that the court should be allowed to make a ruling on whether there would be a reasonable basis for distribution, taking into account all relevant considerations.

28. Dr Hon Margaret NG pointed out that from the perspective of clients, the introduction of a defence would make the clawback actions more comprehensive as it would be for the court to decide whether a defence could be established, hence the question of whether a distribution would be liable to be clawed back. Hon Albert Ho and Hon LAU Kong-wah considered that introducing a defence for distributions was not in the best interest of consumers, as this was a further hurdle that has to be surmounted when a client enforces the judgement debt after obtaining the

first instance judgement on his claim for negligence against an LLP. Hon Audrey EU considered the proposal of the Administration acceptable.

29. Whilst Hon Albert HO considered that the test of "reasonable assessment" in the proposed new section 7AI(1A)(a) was too low a threshold for the defence for distributions made after financial assessment, Hon Paul TSE was of the view that introducing a due diligence defence under the relevant provision may not be conducive to enhancing the legal industry's competitiveness and Hong Kong's status as a legal services centre. He considered it acceptable to use reasonable diligence for the defence of distributions made after financial assessment. Hon Audrey EU had no strong view on whether due diligence or reasonable diligence should be used as the defence for distributions made after financial assessment.

30. The Administration explained that the test of diligence was an objective test. While the literal meaning of due diligence appeared to impose a higher threshold for the defence, what constituted due diligence and reasonable diligence would have to depend on the facts of each case. It was up to the Bills Committee to decide on the diligence requirement for the defence provisions.

31. Hon Paul TSE pointed out that the proposed new section 7AI(1A) had not taken into account circumstances whereby the person who received the distribution might be unable to bear the burden of proof, e.g. the person had died or become mentally incapacitated. Dr Hon Margaret NG pointed out that according to the proposed section 7AI(3), proceedings to enforce any of the liabilities arising under section 7AI as a result of the distribution may be brought by (a) the partnership; (b) any partner in the partnership; or (c) any person to whom the partnership owes any partnership obligation at the time of the distribution. Hence, it would be more appropriate to relocate the defence provisions to follow the proposed section 7AI(3).

32. Dr Hon Margaret NG and Hon Albert HO further suggested that the Law Society should promulgate a Practice Direction on the assessment in respect of whether the financial position of the LLP could meet the liquidity-asset test after the distribution.

33. At the meeting on 15 June 2011, the Administration advised that the informal response of the Law Society was that the present discussion should be focused on the principal issue of the Law Society's objection to imposing liability on designated partners at this stage, and that before the principal issue is resolved, the Law Society would not consider the issue of issuing the Practice Direction.

Recent development

34. The Administration will report on the progress of its discussion with the Law Society on the provisions regarding designated partner and time limit for clawback at the Bills Committee meeting on 9 March 2012.

Council Business Division 2
Legislative Council Secretariat
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