

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

- (a) An Overall Description of the Administration’s Current Proposal on Clawback; and**
- (b) Comparisons of the Defence Provisions against Clawback Actions in the Administration’s Proposal with the Corresponding Provisions in 1) the Manitoba Partnership Act, and 2) the Proposal by the Law Society**

Purpose

At the BC meeting held on 19 March 2012, Members requested the Administration to provide the following:

- (a) an overall description of our current proposal on clawing back distributions made by an LLP to its partners by reference to the following three elements:
 - (i) prohibitions against distributions;
 - (ii) the 6 year clawback period; and
 - (iii) the proposed defence under s 7AI(1A) of the draft CSAs of 19 December 2011 (“CSAs”); and
- (b) comparisons of the defence provisions against clawback actions in the Administration’s proposal with the corresponding provisions in 1) the Manitoba Partnership Act, and 2) the proposal by the Law Society (“LS’ Proposal”).

Administration’s Current Proposal on Clawback

Prohibitions against distributions

2. Unlike many other jurisdictions, such as Manitoba ¹, the Administration has not sought to impose any prohibitions against LLPs in

¹ S 85(2) of the Manitoba Partnership Act provides the following:

making distributions to its partners. As previously explained, the Administration has adopted a pragmatic approach by allowing flexibility and autonomy for an individual LLP to decide for itself in each and every case whether or not it should make a distribution to its partners.²

The 6 year clawback period

3. The Administration has proposed that a distribution made by an LLP in contravention of the solvency tests in s 7AI(1)(a) and (b) of the CSAs (“Solvency Tests”)³ shall be subject to clawback within 6 years after the date of the distribution. As previously explained, the Administration is not convinced that a reduction of the clawback period to 2 years is justified, and that if we were to shorten the clawback period to 2 years, it might become necessary to consider whether other compensatory consumer protection measures should be introduced, such as special professional indemnity insurance requirements for LLPs.⁴

The proposed defence under s7AI(1A) of the CSAs

4. The Administration’s proposed defence in s 7AI(1A) of the CSAs is set out in **Annex 1** attached. In gist, a distribution to a partner of an LLP or, where applicable, an assignee of his partnership share in contravention of the Solvency Tests shall not be subject to clawback if the partner/assignee is able to prove that:-

- (a) immediately before the distribution, the LLP has made a reasonable assessment that the LLP would be able to satisfy the Solvency Tests immediately after the distribution;

“85(2) In circumstances other than in connection with the winding up of its affairs, a Manitoba limited liability partnership must not make a distribution of partnership property if there are reasonable grounds to believe that after the distribution

- (a) the partnership would be unable to pay its partnership obligations as they come due; or
- (b) the value of the partnership property would be less than the partnership obligations.”

² See paragraph 4 of the Administration’s paper for the Bills Committee in November 2010, LC Paper No.CB(2)344/10-11(02).

³ S 7AI(1) of the CSAs provides the following:
“(1) If a limited liability partnership makes a distribution of any of its partnership property to one or more persons (each being a partner or an assignee of a partner’s share in the partnership), and immediately after the distribution—
(a) the partnership is or will be unable to pay its partnership obligations as they become due; or
(b) the value of the remaining partnership property is less than the partnership obligations, then each of the persons is liable as provided in subsection (2).”

⁴ See paragraph 17 of the Administration’s paper for the Bills Committee in February 2012, LC Paper No. CB(2)1182/11-12(01)

- (b) the LLP has arrived at the assessment after exercising reasonable diligence and based on information available at the time, and
- (c) at the time of the distribution the partner and/or assignee did not have any reason to doubt the correctness of that assessment.

An Overall Description of the Administration's Current Proposal on Clawback

5. All in all, as regards the three elements as described in paragraph 1(a) above, the Administration's current proposal is that an LLP should be free to decide whether or not to make a distribution to its partners. This is so even if the LLP would be unable to meet the Solvency Tests immediately after the distribution. In such a case, the principal consequence is that any partner or, where applicable, the assignee of his partnership shares who receives the distribution shall be liable for (a) the value of the partnership property received, or (b) an amount necessary to discharge the partnership obligations at the time of the distribution, whichever is the lesser⁵.

6. In addition, the liability described above is also subject to 3 important qualifications:

- (a) First, each distribution is only subject to a 6 year clawback period. Beyond such period, no clawback proceedings can be commenced against the distribution;
- (b) Second, if in respect of a distribution, the partner/assignee concerned can establish the defence under s 7AI(1A) of the CSAs, the distribution will not be subject to clawback; and
- (c) Third, a payment made as reasonable compensation for current services provided by a partner will not be subject to clawback.⁶

⁵ Per s 7AI(2) of the December 2011 CSAs which provides the following:
“(2) A person who receives the distribution as described in subsection (1) is liable to the partnership for –
(a) the value of the property received by the person as a result of the distribution; or
(b) the amount necessary to discharge the partnership obligations at the time of the distribution, whichever is the lesser.”

⁶ Per S7AI(5) of the Bill which provides the following:
“This section does not affect a payment made as reasonable compensation for current services provided by a partner to the partnership, to the extent that the payment would be reasonable if paid to a person who is an employee of, but not a partner in, the partnership as compensation for similar services.”

Comparisons of the Defence Provisions against Clawback Actions in the Administration’s proposal with the Corresponding Provisions in 1) the Manitoba Partnership Act, and 2) the LS’ Proposal

A Comparison with Manitoba

7. The defence provisions in s 85(5) of the Manitoba Partnership Act are set out in **Annex 2** attached. They should be considered in the light as mentioned in paragraph 2 above that, unlike Manitoba, the Administration has not sought to impose any prohibitions against LLPs in making distributions to its partners. As regards s 85(5) of the Manitoba Partnership Act, each of s 85(5)(a), (b) and (c) of the Act specifies a basis of determination which an LLP may adopt to assess whether “there are reasonable grounds to believe” that a distribution would fall foul of the solvency tests under s 85(2) of the Manitoba Partnership Act⁷. The Administration does not adopt these Manitoba provisions in our CSAs for the following reasons:

(a) S85(5)(a) of the Manitoba Partnership Act

Accounting practices and principles are technical in nature. They are also subject to review and changes by the relevant governing body(ies) from time to time. In the Administration’s view, whilst the financial statements might be relevant for consideration by the courts, they should not be conclusive in determining whether the Solvency Tests are met for clawback purposes in the specific circumstances of each case. Furthermore, there is no requirement in s 85(5)(a) of the Manitoba Partnership Act to have the LLP’s financial statements audited by an independent auditor. In any event, in our view, the court should have the discretion to decide on the defence issue in any individual case based on all relevant factors and its circumstances. The courts’ discretion should not be restricted by information in an LLP’s financial statements prepared by the LLP itself as conclusive evidence.

(b) S 85(5)(b) of the Manitoba Partnership Act

There is no objective definition of “fair valuation”. Who might be qualified to make a fair valuation of a particular asset is also open to argument. Accordingly, in our view, it is not appropriate

⁷ The solvency tests under s 85(2)(a) and (b) of the Manitoba Partnership Act are very similar to the Solvency Tests in s 7AI(1)(a) and (b) of the CSAs. See footnote 1 above for the detailed provisions.

to base the defence merely on fair valuation. Instead, the courts should be allowed to decide whether it is appropriate to take account of a particular valuation obtained by the LLP on its assets on a case by case basis. For example, in each case, the courts should be allowed to consider whether the valuation is conducted by someone who is independent, appropriately qualified to conduct the valuation, and whether the methodology adopted in the valuation is reasonable.

(c) S85(5)(c) of the Manitoba Partnership Act

This is similar to the requirements in our s 7AI(1A)(a) of the CSAs. However, it lacks the additional safeguards we have included in s 7AI(1A)(b) and (c) of the CSAs. In other words, it does not require (i) the LLP to have arrived at the reasonable assessment after exercising reasonable diligence and based on information available at the time of the assessment, and (ii) at the time of the distribution, the relevant partner/assignee did not have any reason to doubt the correctness of that assessment. In our view, it may not be sufficiently effective for protecting consumer interest.

A Comparison with the LS' Proposal

8. The principal defence provisions against clawback actions in the LS' Proposal are as follows:

“s 7AI(1A) But a person who receives the distribution as described in subsection (1) is not liable as provided in subsection (2) if immediately before making the distribution, the limited liability partnership made an assessment that the financial position of the partnership would not be as described in subsection (1) immediately after the distribution on the basis of:

- (a) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances;
- (b) a fair valuation; or
- (c) any other method that is reasonable in the circumstances.”

9. The Administration has not accepted the LS' proposed defence provisions for the following reasons:

(a) The Revised s 7AI(1A)(a) to (c) of the LS' Proposal

The Revised s 7AI(1A) (a) to (c) of the LS' Proposal are similar to s 85(5)(a) to (c) of the Manitoba Partnership Act. Hence, our comments as mentioned in paragraph 7 above apply similarly.

(b) No requirement for reasonable assessment

In addition, unlike s 7AI(1A)(a) of the CSAs, the preamble of the revised s 7AI(1A) of the LS' Proposal does not require an LLP to have made a "reasonable" assessment on its financial position before making a distribution. In the Administration's view, in order to safeguard consumer interest adequately, the assessment should be a reasonable assessment as required by s 7AI(1A)(a) in the Administration's proposed CSAs.

(c) No express provision on burden of proof

Furthermore, unlike s 7AI(1A) of the CSAs, the preamble of the LS' Proposal is unclear as to whether the partner/assignee will have the burden to prove compliance of the requisite defence requirements. In the Administration's view, it is desirable for s 7AI(1A) of the CSAs to specify that the burden of proof is on the partner/assignee so that it would be clear that s 7AI(1A) of the CSAs is a defence provision against clawback actions, not a requisite requirement for taking clawback actions under s 7AI(1) of the CSAs.

Conclusion

10. The Bill aims to lay the foundation for the sustainable operation of LLPs for law firms in Hong Kong over the long term, one that matches our aspiration for Hong Kong to prosper as a major legal services centre in the Asia-Pacific region. The Bill will only command support from the public if it can strike a proper and fair balance between protecting consumers of legal services on the one hand and innocent partners on the other. In the Administration's view, s 7AI(1A) of the CSAs is more apt for safeguarding consumer interest than the corresponding defence provisions in the revised s 7AI(1A) in the LS' Proposal. Hence, in our view, s 7AI(1A) of the CSAs should be preserved as drafted.

Department of Justice
March 2012

Annex 1

s 7AI(1A) of the CSAs as proposed by the Administration

However, a person who receives the distribution as described in subsection (1) is not liable as provided in subsection (2) if the person proves that –

- (a) immediately before making the distribution, the limited liability partnership made a reasonable assessment that the financial position of the partnership would not be as described in subsection (1) immediately after the distribution;
- (b) the partnership arrived at the assessment after exercising reasonable diligence and based on information obtained for the purpose of the assessment or otherwise available at the time of the assessment; and
- (c) at the time of the distribution the person did not have, or (if the person is an assignee of a partner's share in the partnership) neither the person nor that partner had, any reason to doubt the correctness of that assessment.

**Defence provisions against Clawback Actions in
s 85(5) of the Manitoba Partnership Act**

A Manitoba limited liability partnership may base its determination of whether a distribution is prohibited by subsection (2)

- (a) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances;
- (b) on a fair valuation; or
- (c) on another method that is reasonable in the circumstances.