

Bills Committee Meeting on LLPs

The Law Society awaits the revised draft Bill with respect to the replacement of the designated partner provisions. This submission thus focuses solely on the proposed clawback provisions.

Sufficient compensation

1. The Law Society understands the concerns that consumers will be exposed to the risk of not being sufficiently compensated in a claim as a result of the exclusion of the personal assets of the innocent partners of an LLP.
2. Nevertheless, in the particular Hong Kong context, it is not a concern because there are statistical evidence to show that the statutory professional indemnity limit of HK\$10 million is generally sufficient for indemnity protection of individual consumers.
3. From the claims statistics, from 1994/95 indemnity year to 2 July 2009:
 - (i) Only 1.6% of the total claims (including notifications) (i.e. 53 claims out of 3,321 claims) have sought HK\$10 million or more; and
 - (ii) Out of those 53 claims, there was only one claim which was brought by an individual and for which the Fund paid HK\$10 million (including defence cost but less the indemnified's deductible).
4. Further, any increase to the statutory indemnity limit of HK\$10 million per claim will inevitably lead to an increase in insurance premium. The extra cost will in turn be passed onto the consumers who will have to pay more to get higher indemnity cover which is unnecessary based on claims statistics.

Sufficient transparency to enable the making of an informed choice

5. The Law Society is fully conscious of the importance of consumer protection. It takes the view that the existing safeguards in the proposed LLP framework ensuring transparency are sufficient to ensure that the public can make an informed choice as to whether to engage the services of an LLP:
 - (a) The name of an LLP must include the words "Limited Liability Partnerships" or abbreviation "LLP" or "L.L.P." so that the public know that the firm operates with limited liability;
 - (b) The name must be displayed visibly and legibly at or outside its offices and on its office documents;
 - (c) An LLP must notify its existing clients in writing within 30 days of the fact that it has become an LLP;

- (d) The written notice to its existing clients by an LLP, the form of which is to be specified by the Law Society, must include a statement stating how liabilities of partners of a law firm are affected by the law firm becoming an LLP;
- (e) An LLP must give 7-day advance notice of its particulars to the Law Society;
- (f) The Law Society must keep a list of LLPs for public inspection free of charge.

Sufficient protection against dissipation of firm assets

- 6. 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.
- 7. Consumers will not be disadvantaged without clawback because:
 - (a) the mandatory Professional Indemnity Scheme has proven to be sufficient protection based on past claims experience;
 - (b) the Bankruptcy Ordinance will apply to assets that should not have been transferred out in the event that the firm becomes insolvent;
 - (c) the general remedy of Mareva injunction will apply should there be any risk of dissipation of firm's assets.

Higher level of consumer protection than other professions

- 8. A number of other professions (accountants, architects, surveyors dentists etc.) in Hong Kong are permitted to conduct their businesses through limited liability entities. That method of operation is not perceived to create concerns in terms of consumer protection for the users of those services. Consequently, there should not be any similar concern if law firms operate through limited liability partnerships. From the standpoint of consumer protection, permitting law firms to operate as LLPs will simply treat law firms in a manner similar to these other professions. Consumers would actually be well protected vis-à-vis LLPs compared to these other professions since there is a statutory professional indemnity scheme for solicitors and further, a negligent partner of an LLP would remain liable for all of the liabilities of the law firm arising out of that negligence (since the liability shield would not apply).

Section 7AI is practically unworkable

- 9. The current claw back section (section 7AI) effectively allows 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).

10. 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.

Proposed improvement

11. The Administration claims that it has adopted a pragmatic approach to allow flexibility and autonomy to an LLP to decide for itself whether or not it should make a distribution. However, this approach becomes an irresponsible approach if the legislation does not make it clear how a decision can be made in compliance with the law.
12. 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.*”¹

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.

13. The Administration does not consider setting out the criteria in the legislation appropriate because the courts should be allowed to make a ruling based on all relevant circumstances of the specific case concerned. Nevertheless, in the improvement suggested, the court is entitled to consider other methods that are reasonable in a specific case and it is certainly not restricted to take into account only those methods specified in the provision.

Appeal to have a fair limitation period consistent with world trend

14. There are two reasons given by the Administration for proposing 6 years instead of 2 years as the limitation period for claw back actions :
 - (a) clients do not know when a distribution has been made; and

¹ Based on section 85(5) Manitoba Partnership Act and Section 83(5) Saskatchewan Partnership Act

- (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.
15. 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.
16. For the second reason on the need of more than 2 years to obtain a first instance judgment, section 7AI provides that the claimant can take out a clawback action even before he obtains judgment. This is thus not a valid reason.
17. 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). 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.
18. Further, comparing with the few Canadian jurisdictions² 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.
19. The Administration comments that some overseas jurisdictions provides for a prohibition of distributions. The current section 7AI is thus said to be already more liberal. However, the practical effect of section 7AI, because of its uncertainty, is no different from a strict prohibition of distribution of partnership property because an LLP would likely not distribute in any event. The more liberal approach adopted in section 7AI is only illusory.
20. The Law Society submits that no separate clawback is needed at all since LLPs would be covered by bankruptcy law. Bearing in mind that the LLP model now proposed by the Administration would only offer partial shield, it is all the more important to ensure equality of treatment for all unsecured creditors on a pari-passu basis in accordance with the existing bankruptcy framework. As is common with a trade creditor (who may also have obtained a successful judgment against an LLP), a successful claimant who has established his claim for negligence against an LLP is likewise regarded as an unsecured creditor. The existing bankruptcy law has already provided a statutory framework based on public policy for balancing the competing interests of all unsecured creditors on an equal footing. However, 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 existing bankruptcy regime and other overseas LLP legislation, e.g. British Columbia, Manitoba and Nova Scotia (relevant extracts attached). Any proposal to impose a 6 year clawback period may actually create conflicting bankruptcy rules in dealing with successful trade creditors (with 2 years clawback) as against successful claimants (with 6 years clawback as proposed by the Administration). Indeed, such a proposal for 6 year clawback in favour of a successful claimant would be inconsistent with the existing bankruptcy law and would cause

² British Columbia, Manitoba, Nova Scotia

prejudice to the interests of other successful trade creditors. Public policy demands that all unsecured creditors should be treated on a pari-passu basis and no individual unsecured creditors should be given preferential treatment to the detriment of the others.

21. As a matter of fact, under the existing PIS, a successful claimant is entitled to receive compensation for professional negligence from the PIS Fund of up to HK\$10 million per claim as well as top-up cover (if any). Only the excess amount over and above the professional indemnity cover would be claimed by a successful claimant as an unsecured creditor against an LLP for that excess amount. In contrast, a successful trade creditor would not be entitled to receive any payment from the PIS Fund. It clearly demonstrates that a successful claimant is already well protected and favoured by the professional indemnity cover, as against a successful trade creditor who will have no protection at all apart from being treated as an unsecured creditor under the existing bankruptcy regime. If so, why should a successful claimant be granted an additional advantage to recover the excess amount (with a far more generous 6 year clawback as now proposed by the Administration) than a successful trade creditor (with a 2 year clawback under the existing bankruptcy law)? In conclusion, a proper balance has to be struck between all unsecured creditors on a pari-passu basis in accordance with the existing bankruptcy law.

The Working Party on LLPs
The Law Society of Hong Kong
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