

## LIMITED LIABILITY PARTNERSHIPS IN HONG KONG: CHALLENGES AND CONUNDRUMS

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On 18<sup>th</sup> June 2010 the Legal Practitioners (Amendment) Bill was gazetted in the Hong Kong Legislative Council (LegCo).<sup>1</sup> Over two years later, after much to-ing and fro-ing between the Government, the Hong Kong Law Society and LegCo members, the Bill was finally passed as the Legal Practitioners (Amendment) Ordinance (LPAO)<sup>2</sup> the on 12<sup>th</sup> July 2012. These facts may not seem particularly worthy of attention, given the volume of important legislation making its way through the chamber, but it would be unwise to dismiss the LPAO as a mere ‘technical’ or ‘specialist’ provision. Indeed, it may have as much impact on the lives of ordinary citizens as any recent constitutional initiatives.

The LPAO introduces limited liability partnerships (LLPs) for solicitors’ firms, replacing the existing law by which every partner is jointly and severally liable for each and every one of their firm’s contractual and tortious obligations.<sup>3</sup> This, in turn, will alter the relationship between each firm, its individual partners and their clients. When one considers that there are over 6,500 solicitors holding practicing certificates<sup>4</sup> in Hong Kong, who deal with thousands of private individuals, small businesses and multinational corporations on everything from divorces and bail applications to M&As every day, the significance of the LPAO becomes apparent.

This paper examines the reasons for the introduction of LLPs in Hong Kong; how such entities have been introduced and operate in other jurisdictions; the measures in the LPAO and their consequences; and other measures which could be adopted in the future. In essence, the issues can be summed up as -

- *Why?*
- *Elsewhere?*
- *How?* and
- *What next?*

### **Why?**

The impetus for the LPAO seems to be largely commercial in nature. The possible introduction of LLPs was first brought to the attention of the LegCo’s Panel on Administration of Justice and Legal Services (the Panel) by the Hong Kong Law Society in June 2004.<sup>5</sup> The Law Society argued, firstly, that the traditional partnership structure was “no longer appropriate” for the operation of law firms in Hong Kong. The threat of

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<sup>1</sup> See LegCo Bills Committee page - <http://www.legco.gov.hk/yr09-10/english/bc/bc52/general/bc52.htm>

<sup>2</sup> Available at <http://www.legco.gov.hk/yr11-12/english/ord/ord022-12-e.pdf>

<sup>3</sup> Pursuant to section 12 of the Partnership Ordinance (Cap 38). See further below.

<sup>4</sup> Available at

[http://www.hklawsoc.org.hk/pub\\_e/admission/AdmissionasaSolicitor/pdf/Booklet\\_on\\_becoming\\_a\\_solicitor.pdf](http://www.hklawsoc.org.hk/pub_e/admission/AdmissionasaSolicitor/pdf/Booklet_on_becoming_a_solicitor.pdf)

<sup>5</sup> See para 3 of LegCo Background Brief available at <http://www.legco.gov.hk/yr09-10/english/bc/bc52/papers/bc520714cb2-2055-3-e.pdf>

so-called ‘mega-claims’ bankrupting leading firms was alluded to. The great advantage in permitting law firms to operate as LLPs would be:

*“...a wider choice in legal practice structures and allow professionals to practise free of personal liability for the negligence of their partners, thereby increasing their willingness to invest in the development and expansion of their practice, and the attractiveness of Hong Kong as an international legal service centre.”*

The Law Society added that LLPs had, by that time, been introduced or were in the process of being introduced in other common law jurisdictions such as the United States, Canada and the UK. There was, therefore, no risk of Hong Kong adopting an untried or unusual business model. On the contrary, the territory faced the danger of losing major professional practices to other jurisdictions if it did not introduce LLPs.<sup>6</sup>

Moreover, the ‘non-corporate’ form of LLP<sup>7</sup> proposed by the Law Society could, it was suggested, be introduced by “simple amendments” to existing legislation and would not “affect the management structure and culture of a traditional partnership”. Nor would such changes, in the Law Society’s view, undermine the rights of consumers of legal services to take appropriate action against those firms or individual lawyers who may have been negligent or committed some “wrongful act of misconduct”.<sup>8</sup>

The Research and Library Services Division of the LegCo Secretariat (referred to as the “RLSD” in LegCo documentation) subsequently prepared a report entitled “Limited Liability Partnership and Liability Capping Legislation for the Practice of Law in Selected Places”.<sup>9</sup> This report examined LLPs and related issues, as the title suggests, in the UK, the State of New York in the US and New South Wales in Australia. Despite the Panel’s endorsement of the report and ongoing support for the introduction of LLPs in Hong Kong, the Government did not share its point of view. It was not until July 2008 that the Department of Justice indicated that it was prepared to introduce LLPs for law firms. Following further discussions with the Panel, the Law Society and other interested parties, the Bill was gazetted a year later.

It is worth noting, at this juncture, that the Law Society’s relative enthusiasm for LLPs does not appear to be shared by other professions in Hong Kong. In a letter of 24<sup>th</sup> February 2009, the Department of Justice informed the Panel that the Government was “not aware of any requests for limited liability partnership from the medical, engineering and architectural professions”.<sup>10</sup> As for the accountancy profession, it seems to have taken the view that LLPs were an inadequate solution to the problems alluded to by the Law Society. The Hong Kong Institute of Certified Public Accountants (HKICPA) has been campaigning for auditor’s professional liability reform for some time.<sup>11</sup> In its paper

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<sup>6</sup> It should be noted that very little evidence of such ‘mega claims’ or of the loss of professional practices to other jurisdictions was produced by the Law Society.

<sup>7</sup> The two forms of LLP – corporate and non-corporate – are addressed in *(Else)Where?* below

<sup>8</sup> See [Law Society document on LLPs (May 2008)]

<sup>9</sup> Available at <http://www.legco.gov.hk/yr04-05/english/sec/library/0405rp04e.pdf>

<sup>10</sup> Department of Justice letter to Administrative Panel 24<sup>th</sup> February 2009

<sup>11</sup> Available at <http://app1.hkicpa.org.hk/correspondence/2010-05-13/circular.htm>

to the Hong Financial Services and the Treasury Bureau (FSTB) of May 2010, the HKICPA called for, firstly, a statutory cap on auditors' liability and, secondly, the introduction of "a system of proportionate liability". As for LLPs, the HKICPA held that:

*"While incorporation and LLPs can help to protect the assets of innocent partners not directly involved in a negligence claim, operating in either of these modes of practice would not prevent a firm from collapsing under the weight of a massive claim, and would not address the risks of capital market instability."*

Moreover, incorporation or LLP status would, the HKICPA felt, be impractical given the fact that audit firms "may have upwards of 300 partners" of whom only a small minority could expect to become directors of any post-incorporation entity.<sup>12</sup> The HKICPA expressed similar views on LLPs, liability capping and proportionate liability when the Government put the subject of professional liability reform on hold in 2006.<sup>13</sup>

### **Elsewhere?**

It is important to appreciate that there are two basic forms of LLP in other jurisdictions. The original form, pioneered in the US, is the non-corporate or partnership-based LLP and the second, first introduced in the UK, is the corporate entity LLP.<sup>14</sup>

#### *US-Style LLPs*

Legislation for LLPs was first introduced in Texas in 1991, followed by most other US states, in the wake of the "Savings & Loan crisis" of the late 1980s. This crisis led to a US\$150 billion bailout of the Savings & Loan industry (a savings & loan association or 'thrift' is the US equivalent of a UK building society or mutual savings bank) by the US government; the passage of the Financial Institutions Reform Recovery and Enforcement Act (FIRREA), which reorganized the regulation of the industry; and numerous legal claims against accountants and law firms (among others).<sup>15</sup> It was the last of these developments, and the consequential financial pressure upon individual partners in the threatened professional firms, that led to introduction of LLPs.

LLPs in the US are legislated for on a state-by-state basis, not by Congress, albeit many states have adopted the Uniform Partnership Act 1997 (UPA) or, as it is also known, the Revised Uniform Partnership Act (RUPA). This is a model statute, prepared by the National Conference of Commissioners on Uniform State Laws (NCCUSL),<sup>16</sup> which prescribes how partnerships are established and managed, including the relationships

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<sup>12</sup> See the HKICP website at <http://app1.hkicpa.org.hk/correspondence/2010-05-13/liability.pdf>

<sup>13</sup> See HKIPA submission to the Panel 27<sup>th</sup> March 2006.

<sup>14</sup> See Whittaker J. and Machell J. *The Law of Limited Liability Partnerships* (3<sup>rd</sup> Edn, Bloomsbury), Chapter 23

<sup>15</sup> A useful timeline of the Savings & Loan crisis is available on the US Federal Deposit Insurance Corporation website at <http://www.fdic.gov/bank/historical/s&l/>

<sup>16</sup> See the NCCUSL website at [http://www.nccusl.org/Update/Home\\_desktopdefault.aspx](http://www.nccusl.org/Update/Home_desktopdefault.aspx). It produces model legislation for adoption by individual states "in areas where uniformity is desirable and practical".

between individual partners and between partners and the firm itself.<sup>17</sup> Several versions of the UPA have been promulgated by the NCCUSL, the earliest in 1914, and the most recent being the RUPA.<sup>18</sup>

Generally speaking, US LLPs are general partnerships which have chosen to adopt limited liability for their partners. By contrast UK LLPs, as will be discussed in detail below, are corporate entities with their own separate legal personality within the meaning of *Salomon v. A. Salomon & Co. Ltd.*<sup>19</sup> Section 201(a) RUPA does, however, provide that a partnership is a separate legal personality,<sup>20</sup> although it goes on to add that all partners are liable jointly and severally for a partnership's obligations.<sup>21</sup> Thus, there is no fundamental legal distinction between the 'personality' of a US general partnership and LLP under RUPA. The distinction between the two is introduced by section 306(c), which provides:

*An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner.*

As the explanatory notes to the RUPA themselves explain, section 306(c) alters the joint and several liability of individual partners for the obligations of a partnership that becomes a LPP in that they are not personally liable for partnership obligations incurred 'while the partnership liability shield is in place solely because they are partners'. Whilst an individual partner will be personally responsible for the consequences of his own misconduct or negligence (and for that of those individuals under his supervision or control) this provision provides a 'shield' against the traditional joint and several liability of each partner for a firm's debts and obligations.

In some states, individual partners are protected from liability for the misconduct or negligence of others in the firm but not for the firm's general commercial liabilities (i.e. rent and salary payments to employees) whereas in other states individual partners benefit from 'personal immunity' from all partnership liabilities, including general commercial liabilities, which were not incurred as a consequence of their own actions (or omissions).

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<sup>17</sup> The RUPA is available at [https://www.law.upenn.edu/library/archives/ulc/uparta/1997act\\_final.htm](https://www.law.upenn.edu/library/archives/ulc/uparta/1997act_final.htm)

<sup>18</sup> Strictly speaking, all but the original 1914 version of the model legislation should be referred to as the RUPA but, for sake of simplicity, this term shall be used in this paper exclusively for the 1997 version.

<sup>19</sup> (1897) AC 22

<sup>20</sup> This, of course, differs from the position in Hong Kong, where a partnership is not a separate legal entity. The position under RUPA seems to be designed to ensure that a partnership remains intact even if there is a change in its membership i.e. there is no "new" partnership just because someone leaves or someone joins it. The same issue arises under section 34 of the Partnership Ordinance but it permits, as does the UK Partnership Act 1890 upon which it is based, members to agree among themselves that their partnerships would not be dissolved in this fashion.

<sup>21</sup> Section 306(a), albeit subject to the proviso "unless otherwise agreed by the claimant or provided by law".

The former, 'partial shield', states include Michigan and Ohio and the latter, 'full shield' states, include Illinois and New York.

According to the NCCUSL website, over two-thirds of the US states have enacted the RUPA into their own law.<sup>22</sup> The procedures involved in a 'general partnership' becoming a LLP differ from state to state but a majority vote in favour of the change by the partnership's members is generally required;<sup>23</sup> followed by the filing of certain documentation<sup>24</sup> with - and the payment of a fee to - the state authorities; and, in some states, the annual renewal of the LLP status.

Other jurisdictions have followed the US example in introducing non-corporate LLPs. For example, Canadian LLPs are general partnerships and not separate corporate entities, with individual partners being relieved of any liability for any wrongful act or omission which was not carried out (or omitted) by them or those for whom they were responsible. Japan introduced LLPs in 2005, which are general partnerships in the most part albeit an individual partner is only liable for the LLP's obligations to the extent of his capital contribution (with the, common, exception of any losses incurred as a result of his own gross negligence or actual knowledge).<sup>25</sup>

The US RUPA and the New York Partnership Act<sup>26</sup> are of significance to Hong Kong as they influenced the thinking of many, including the Law Society, in the development of the LPAO. This point is returned to below.

### *UK-Style LLPs*

The Partnership Act 1890<sup>27</sup> (upon which the Partnership Ordinance is based) provides the legal basis for the operation of general partnerships within the UK. As has already been observed, such firms are not separate legal entities and every partner is liable jointly, and in Scotland severally also, with his colleagues for all the debts and obligations of his firm incurred during his membership. Similarly, each partner is jointly and severally liable for any loss or damage arising from the negligence or misconduct of any other partner (as well as his own defaults) committed in the ordinary course of the firm's business.

The traditional route for many professional people was to operate as a partnership given that the law and (or) their professional organisations prohibited incorporation. From the mid-1990s, there was growing concern about the continued feasibility of the traditional partnership structure in light of the growth in both the size of firms and the specialisation within them (especially in professional partnerships such as law firms and accountancy practices) together with a perceived increase in both the volume and magnitude of professional negligence claims which, in turn, exceeded the amount of insurance cover

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<sup>22</sup> Available at <http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Partnership%20Act>

<sup>23</sup> Section 1001(b) of the RUPA requires this vote to be unanimous in the absence of an agreement to the contrary.

<sup>24</sup> Detailing the partnership's name, members and principal office address.

<sup>25</sup> Available at <http://www.asianlii.org/jp/legis/laws/lpaan40o2005376/>

<sup>26</sup> Available at <http://law.onecle.com/new-york/partnership/index.html>

<sup>27</sup> Available at <http://www.legislation.gov.uk/ukpga/Vict/53-54/39/contents>

available to such firms and threatened the personal assets of their members.<sup>28</sup> The accountancy profession was particularly vocal in the need for reform to the Partnership Act 1890<sup>29</sup> whilst, at the same time, a number of major UK practices investigated the possibility of relocating to Jersey, which legislated for LLPs in 1997.

In response to the growing disquiet, in 1996 the UK Department for Trade and Industry (DTI) published an investigation into joint and several liability by the Law Commission. This was followed, in February 1997, by a DTI consultation paper entitled 'Limited Liability Partnerships: A New Form of Business Association for Professions'.<sup>30</sup> Unsurprisingly the consultation paper, and the concept of LLPs, was welcomed by the professions. A draft Parliamentary Bill followed (together with draft regulations) followed and, eventually, the Limited Liability Partnerships Act (the 2000 Act) was passed by Parliament and received Royal Assent on 20 July 2000. It is important to note that, despite the fact that the legislation was originally and specifically envisaged for professional firms, any business may opt to become a LLP.

The UK Act creates a very different form of legal entity from traditional general partnerships or US-style LLPs. As section 1(1) to (3) of the UK Act set out:

- (1) There shall be a new form of legal entity to be known as a limited liability partnership.*
- (2) A limited liability partnership is a body corporate (with legal personality separate from that of its members) which is formed by being incorporated under this Act...*
- (3) A limited liability partnership has unlimited capacity.*

Further, by section 1(4) and (5):

- (4) The members of a limited liability partnership have such liability to contribute to its assets in the event of its being wound up as is provided for by virtue of this Act.*
- (5) Accordingly, except as far as otherwise provided by this Act or any other enactment, the law relating to partnerships does not apply to a limited liability partnership.*

The fact that a UK LLP is a separate legal entity makes it more like a company than a general partnership in the way it operates and the legislation (and supporting regulations) recognises that fact.<sup>31</sup> For example, a third party who wishes to do business with a general partnership will enter into a contract with one of the individual partners on behalf

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<sup>28</sup> The most celebrated – or dreaded – case was *ADT Ltd v BDO Binder Hamlyn* [1996] BCC 808. See <http://www.thelawyer.com/reasons-to-be-careful/92609.article>

<sup>29</sup> See Roach, L 'Auditor liability: the case for limitation: Part 1' *Comp. Law*, 2010, 31(5), 136-142 for a discussion of the difficulties faced by accountancy firms from the late 1980s and onwards in obtaining sufficient professional indemnity insurance cover for their activities.

<sup>30</sup> Unfortunately this document is not available on the UK Government websites

<sup>31</sup> In particular, section 15 deals with the application of company law to LLPs subject to any appropriate modifications.

of him and his colleagues, rather than the partnership, as the partnership itself has no separate legal existence. The contracting partner will, by virtue of the law of agency, in general, and sections 5 and 6 of the Partnership Act, in particular, bind his colleagues to that contract. Similarly, by virtue of section 10 of the Partnership Act, partners are vicariously liable for the wrongs (such as negligence) committed by their fellow partners within the firm's 'ordinary course of business'.<sup>32</sup>

By contrast, a LLP can enter into its own agreements although, like a company, it must do so in writing under its common seal or through any someone acting under its authority (express or implied). The 2000 Act adopts the partnership approach towards the role of members/partners as agents of the LLP. Section 6(1) provides that every member/partner of a LLP is the agent of the LLP, much in the same way that section 5 of the Partnership Act establishes that each partner is the agent of his fellow partners. The difference, of course, is that the LLP itself and not the other partners is the principal. It is also possible for the LLP to be the agent of the members/partners.<sup>33</sup>

Consequently, any contractually claim against a LLP will be brought against the LLP itself rather than the individual members/partners. As for liability for negligence and the like, section 6(4) of the 2000 Act states:

*(4) Where a member of a limited liability partnership is liable to any person (other than another member of the limited liability partnership) as a result of a wrongful act or omission of his in the course of the business of the limited liability partnership or with its authority, the limited liability partnership is liable to the same extent as the member.*

Accordingly, vicarious liability for a member/partner's wrongful acts or omissions falls upon the LLP itself and not upon the other members. This provision, together with that in section 1(4), provides the 'limited liability' for individual members/partners of the LLP. As for the 'culpable' member/partner, it has been suggested that his position will be similar to that of a director of a company. In that respect, the decision in *Williams & anor v (1) Natural Life Health Foods Ltd (2) Richard Mistlin*<sup>34</sup> would suggest that whether such a member/partner would be personally liable to a client would depend on whether he had assumed personal responsibility for his allegedly negligent actions or advice; whether the client relied on his assumption of responsibility; and whether this reliance was reasonable in the circumstances.

The remainder of the 2000 Act deals with such matters as the incorporation of a LLP, the management of its internal affairs (which is similar to that for general partnerships), its membership and ex-members/partners, the role of 'designated members' (who perform the administrative and filing duties of LLPs) and the taxation of the LLP. As with

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<sup>32</sup> The equivalent provisions in the partnership Ordinance are sections 7,8 and 12.

<sup>33</sup> In *Jones v St Paul's international Insurance Co Ltd* [2004] EWHC 2209 (Ch) an LLP was held to have the authority to make its members personally liable on an insurance policy required by the Law Society.

<sup>34</sup> [1998] 1 WLR 830.

companies, LLPs must file audited accounts on an annual basis. These sundry matters are also dealt with in more detail by the Limited Liability Partnerships Regulations 2001.<sup>35</sup>

Although the US-style non-corporate LLPs were the pioneers of the move from traditional general partnership structures, the UK-style LLP has gained more popularity in recent years. The Dubai international Financial Centre introduced LLPs in 2004, with the neighbouring Qatar Financial Centre doing so in 2005. Singapore also introduced corporate style LLPs in 2005 and India followed in 2008.

## **How?**

Under the Partnership Ordinance (Cap. 38),<sup>36</sup> every partner in a law firm is liable jointly and severally with his fellow other partners for all the debts, liabilities and obligations of the firm incurred while he is a partner, including those arising from any negligence or misconduct by his colleagues. The LPAO does not amend the Partnership Ordinance but, instead, adds a new Part IIAAA to the Legal Practitioners Ordinance (Cap. 159) (LPO) to introduce LLPs for solicitors in Hong Kong. Other professionals' business arrangements, including those of accountants, are unaffected by the new legislation.

Section 7AR stipulates that any relevant laws applicable to a general partnership, except in so far as they are not inconsistent with the new provisions, continue to apply to a LLP. Further, section 7AM adds that a number of the new provisions are in addition to, and do not affect any other provisions relating to the practice of a law firm. It is therefore necessary to read the LPAO in conjunction with, in particular, the Partnership Ordinance and the LPO

### *What is a LLP?*

Section 3(1) of the Partnership Ordinance states:

*(1) Partnership is the relation which subsists between persons carrying on a business in common with a view of profit.*

There are, therefore, three essential conditions for the existence of a partnership – a business; carried on by two or more persons in common; and with a view to a profit. A fourth condition, being an agreement to share the profit, is not within the statutory definition of a partnership – even though the entitlement to an equal share is provided for in section 26(a) - and has been the subject of debate in the past.<sup>37</sup> Section 3(2) excludes from this definition companies and similar entities that would otherwise come within the broad meaning of section 3(1). Section 4 lays down a number of rules for determining whether a partnership does or does not exist and section 6 adds that individuals who have entered into partnership are called collectively 'a firm'.<sup>38</sup> The term 'firm' is no more than

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<sup>35</sup> Available at <http://www.legislation.gov.uk/ukxi/2001/1090/contents/made>

<sup>36</sup> Available at <http://www.hkllii.hk/eng/hk/legis/ord/38/>

<sup>37</sup> See *Pollock on the Law of Partnership* (15<sup>th</sup> ed) pp 9

<sup>38</sup> It is, sadly, a common error for the media to refer to firms as companies and vice versa.



collective noun and, as with the term ‘partnership’, simply describes the legal relationship of the partners with each other. Neither term creates, or is intended to create, a legal entity separate from the individual partners.

The definition of a LLP is set out in section 7AB of the LPAO as follows:

*For the purposes of this Part, a limited liability partnership is a partnership that is for the time being -*  
*(a) a Hong Kong firm or a foreign firm; and*  
*(b) designated by written agreement between the partners as a partnership to which this Part applies.<sup>39</sup>*

Although this is a rather circuitous definition, it is clear from both it and the rest of the LPAO that Hong Kong LLPs are not a new legal entity along the line of UK LLPs. They are, instead, intended to be general partnerships that have opted to limit the liability of their partners in certain circumstances, as with US-style LLPs. In that respect, sections 3, 4 and 6 of the Partnership Ordinance will apply – in the broadest sense – to LLPs.

Further, it seems unlikely that there will be any great controversy over which firms are or are not LLPs given that sections 7AI to 7AL set out the procedural requirements for establishing their existence. The Law Society and existing clients must be notified in writing in advance of the establishment of a LLP. The firm’s name must also contain the words “Limited Liability Partnership” or the abbreviation “LLP” or “L.L.P.”<sup>40</sup> and the same must be displayed at its offices and on its documentation (i.e. correspondence, publications, invoices and websites). Moreover, pursuant to section 7AO, the Law Society will keep a list of all LLPs.

#### *Limitation of liability- the new rule*

At the heart of the LPAO is the relationship between partners and third parties and the introduction of LLPs is designed to alter that relationship. In that respect, it is worth reminding ourselves that, by the Partnership Ordinance sections 7, 8 and 11:

- each partner is an agent for his firm and has the power to bind firm and his fellow partners (section 7);
- partners are bound by acts on behalf of firm (section 8); and
- every partner in a firm is liable jointly with the other partners for all debts and obligations of the firm (section 11).

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<sup>39</sup> A LLP is also said in section 7AA to have “the meaning given by section 7AB” (except for LLPs constituted in other jurisdictions).

<sup>40</sup> Or “有限責任合夥” if its name is in Chinese

Further, by sections 12, 13 and 14:

- the firm is liable for any partner's wrongful act or omission (section 12);
- the firm must make good the loss where a partner or the firm receives money which is misapplied (section 13); and
- every partner is liable jointly with his co-partners and also severally for everything for which the firm becomes liable (section 14).

The substantive aspect of the LPAO is contained in section 7AC:

*Protection from liability of partners in limited liability partnership*

*(1) A partner in a limited liability partnership is not, solely by reason of being a partner, jointly or severally liable for any partnership obligation (whether founded on tort, contract or otherwise) that arises from the provision of professional services by the partnership as a limited liability partnership as a result of a default of -*

*(a) another partner; or*

*(b) an employee, agent or representative of the partnership.*

*(2) Subsection (1) applies irrespective of whether the liability is in the form of indemnification, contribution or otherwise.*

*(3) Subsection (1) applies only if at the time of the default -*

*(a) the partnership was a limited liability partnership;*

*(b) the client knew or ought reasonably to have known that the partnership was a limited liability partnership;*

*(c) the partnership had complied with section 7AD; and*

*(d) the partnership had complied with section 7AE(2) for the matter in respect of which the default occurred.*

The nature of subsection (1) will be dealt with here, whilst that of subsection (2) will be addressed in the context of partnership indemnities below. Subsections (3)(a) and (b) are self-explanatory and subsections (3)(c) and (d) will be addressed in the context of partnership distributions in due course.

As can be seen section 7AC(1) alters the law applying to general partnerships so that a partner/member of a LLP is not automatically jointly or severally liable for any of the firm's obligations<sup>41</sup> which arise from an error or omission by any other partner/member or employee, agent or representative of the LLP in its "provision of professional services". This is a profound change in that it limits the power of a partner to bind his colleagues under section 7 and it limits the direct obligations owed by individual partners under sections 8, 11 and 14 and their indirect obligations (through the firm) under sections 12 and 13.

It is, however, important to stress that section 7AC(1) only 'limits', rather than 'removes' or 'excludes', the application of these provisions to partners in LLPs. The extent of this limitation is indicated by the use of the term "professional services". Any partnership

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<sup>41</sup> "Partnership obligations" are defined in section 7AA. They will be discussed further in due course.

obligation that arises other than in the provision of its professional services will still be the responsibility of all the partners under whichever of sections 7,8, 11, 12, 13 or 14 of the Partnership Ordinance applies in the circumstances.

Such “professional services” are not explained or defined in the LPAO and it is worth noting that an earlier draft of the legislation referred to “the course of the business” of the LLP rather than the provision of such services. The change, at a late stage of the legislative process, was explained by the Government to reflect that fact that:

*“an innocent partner will be protected against personal liability for the default of other members of the firm from the provision of professional service and not from other ordinary trading debts such as rent and employees' salaries arising in the course of the business of the partnership...so as to better reflect the [Government's] policy intent that the Bill offers partial liability shield”<sup>42</sup>*

Clearly, the use of the term “in the course of business” was interpreted, by the Government, as having the potential (at the least) to create a ‘full shield’ for liability from all partnership obligations. The Government’s view was that those partners who wished to “enjoy [the] full shield from [the] general liabilities of the firm may opt to practise in the form of a solicitor corporation”. Such solicitor corporations will be discussed further in due course.

By comparison, such a full shield is envisaged by section 306(c) RUPA, given that it contains no reference to “professional services” or the like and consists of a simple exclusion of liability for any partnership such “solely by reason of being or so acting as a partner”. Similarly, as was noted in the LegCo’s deliberations, section 26(b) of the New York Partnership Act provides a very comprehensive ‘full shield’ as follows:

*“Except as provided by subdivisions (c) and (d) of this section, no partner of a partnership which is a registered limited liability partnership is liable or accountable, directly or indirectly (including by way of indemnification, contribution or otherwise), for any debts, obligations or liabilities of, or chargeable to, the registered limited liability partnership or each other, whether arising in tort, contract or otherwise, which are incurred, created or assumed by such partnership while such partnership is a registered limited liability partnership, solely by reason of being such a partner or acting (or omitting to act) in such capacity or rendering professional services or otherwise participating (as an employee, consultant, contractor or otherwise) in the conduct of the other business or activities of the registered limited liability partnership.”*

This was not what the Government intended and, consequently, the term “professional services” is used to denote (and restrict) the source of the professional obligations in respect of which the liability shield can be invoked.

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<sup>42</sup> Report of the LegCo Bills Committee on Legal Practitioners (Amendment) Bill 2010, para 10. Available at <http://www.legco.gov.hk/yr09-10/english/bc/bc52/reports/bc520613cb2-2254-e.pdf>

That said, we still do not know what “professional services” are intended to include. Interestingly, Rule 10 of the Hong Kong Law Society’s Solicitors (Professional Indemnity) Rules<sup>43</sup> provide that an insured will be provided with an “indemnity in respect of any description of civil liability whatsoever incurred in connection with the Practice” rather than “professional services” or “business”, albeit “Practice” could be said, with justification, to be an appropriate substitute for the latter term given that Rule 2 states:

*“Practice” means the business of practising as a solicitor, including the acceptance of obligations connected with and incidental to such practice as -*

- (a) trustee;*
- (b) executor;*
- (c) attorney acting under a power of attorney;*
- (d) tax agent;*
- (e) patent agent;*
- (f) trade-mark agent;*
- (g) company secretary;*
- (h) company director; or*
- (i) notary public, provided the solicitor is so qualified, undertaken by the indemnified or his predecessor in business alone or with others, provided always that wherever any fees or other income accrue therefrom they inure to the benefit of that business”*

As can be seen, the list of activities is not exclusive and, accordingly, the meaning of “Practice” may be potentially wider than that of “professional services”. There are, as one would expect, a number of exemptions to the cover provided for under the Indemnity Rules<sup>44</sup> but that does not necessarily detract from the fact that “Practice” may mean more than “professional services”. Alternatively, given that the term “Practice” refers to the business of practicing “as a solicitor”, it could be narrower in scope than the term “professional services”. As Taylor LJ observed in *Balabel v Air-India*<sup>45</sup> solicitors frequently advise clients or act for them on matters beyond ‘the law’:

*“To speak therefore of matters “within the ordinary business of a solicitor” would in practice [in the past] usually have meant the giving of advice and assistance of a specifically legal nature. But the range of assistance given by solicitors to their clients and of activities carried out on their behalf has greatly broadened in recent times and is still developing.”*

Further, in *Super Strategy Investments Ltd v Kao, Lee & Yip*<sup>46</sup> Saunders J observed:

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<sup>43</sup> Available at [http://www.hklawsoc.org.hk/pub\\_e/professionalguide/volume2/default.asp?cap=19](http://www.hklawsoc.org.hk/pub_e/professionalguide/volume2/default.asp?cap=19)

<sup>44</sup> These are set out in Schedule 3 to the Indemnity Rules and include, for example, “a direct or indirect loss by the indemnified of the amount of his fees or profit costs and disbursements”

<sup>45</sup> [1988] Ch 317

<sup>46</sup> [2008] HKEC 1040

*“In the course of the practice of a commercial or conveyancing solicitor, the solicitor inevitably gains knowledge and experience of both the commercial and real estate worlds that extends beyond the knowledge required to provide pure legal services in relation to commercial conveyancing matters ...*

*In Hong Kong, solicitors may give that type of commercial advice, being advice beyond the scope of pure legal advice, in relation to real estate matters”*

The learned judge went on to note that the solicitor in the case accepted that his activities on behalf of his client had not constituted merely “simple legal services” but “property consultancy work” and, in Saunders J’s view, “estate agency work”. Presumably, these activities would fall within the “provision of professional services” by a LPP but whether they would be deemed to be practicing “as a solicitor” is open to question. A solicitor’s professional indemnity insurers would certainly want to know about them. At the very least, the terms “Practice” and “professional services” are inconsistent and ripe with ambiguity, as is the term “arises from”, which is a wider concept than “caused by”.<sup>47</sup>

Finally, it is important to appreciate that only a partner’s personal assets will be protected under section 7AC(1). Section 7AF(3) states quite categorically:

*“Section 7AC(1) does not protect any interest of a partner in the partnership property from claims against the partnership.”*

Partnership property and the interests of the partners therein are dealt with in section 22 of the Partnership Ordinance.<sup>48</sup> The LPAO does not alter the law applicable to the identification and determination of such property or interests, which can be source of bitter disputes within firms. The LPAO does, however, deal with the distribution of partnership property, as is discussed below.

#### *Extent of the liability shield*

As a matter of law, the knowledge of an agent will be treated as that of the principal, albeit the imputation of the former’s knowledge to the latter will depend on the agent’s

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<sup>47</sup> See *Kajima UK Engineering Ltd v Underwater Insurance Co Ltd* [2008] Lloyd’s Rep IR 391; *Beazley Underwriting Ltd v Travelers Companies Inc* [2011] EWHC 1520 (Comm); and *Sutherland Professional Funding Ltd v Bakewells* [2011] EWHC 2658 (Comm) where a firm of solicitors represented several clients in personal injury claims and their costs were funded by loans by the clients which were guaranteed by the solicitors. The claims failed, the clients defaulted and the guarantees were called in. The solicitors sought an indemnity from their insurers on the basis that the loans were a civil liability arising from their failure to perform legal services. The solicitors’ argued that “arising from” included their negligent failure to pursue their clients’ claims, which had led to the loss of those claims, their clients’ default and their own liability under the guarantee. The court, applying a causation test, held that the losses were too remote from any breach of duty in handling claims. The solicitors’ claim also failed as the policy excluded liability for trading debts, for the supply of additional services and under guarantees.

<sup>48</sup> See Halsburys Laws of Hong Kong Online for a discussion of partnership property at <https://www.lexisnexis.com/hk/hkcui/hkol/default.asp?csi=305745&wu=www.lexisnexis.com&dpsb=&hg n=t&pkg=>

authority.<sup>49</sup> This principle is reflected in section 18 of the Partnership Ordinance as follows:

*“Notice to any partner who habitually acts in the partnership business of any matter relating to partnership affairs operates as notice to the firm, except in the case of a fraud on the firm committed by or with the consent of that partner”*

The effect of this section is generally understood to be that if a firm claims the benefit of a transaction entered into by a partner or is otherwise bound by his actions, it cannot use its own ignorance of what that particular partner knew to its own advantage.<sup>50</sup> Similarly, all that is needed to prove that a firm had notice of some fact is to show that notice was given to one of its partners. This is not to say that the firm has notice of everything done by a partner, but only those matters relating to the partnership. The term “partnership affairs” (which also appears in the equivalent section 16 of the Partnership Act) does not include every part of the partnership’s business but only those matters which the partner is under a duty to convey to his colleagues. As Clarke J put it in *Northumberland v Alexander*:<sup>51</sup>

*“Section 16...fixes the partnership with knowledge on matters connected with the partnership, but not its clients’ affairs. Furthermore it is concerned with whether the partnership, and not a single partner, should be regarded as enjoying the knowledge”*

Further, it has been argued that the doctrine of ‘constructive notice’ does not apply to partnerships.<sup>52</sup>

It is the light of section 18 that one should note that in earlier versions of the Bill, the protection afforded to a partner was restricted in two ways. Firstly, he would have no protection from liability if he knew or ought reasonably to have known of his colleague(s)’ default at the time of its occurrence and failed to exercise reasonable diligence to prevent its occurrence. Secondly, the cause of action must have accrued when the partnership was an LLP and the client had actual or constructive knowledge of the fact that the partnership was an LLP.

The second aspect of this provision eventually became section 7AC(3)(a) & (b) but the Law Society was, understandably, unhappy with the first aspect given that it imposed liability upon partners for their ‘constructive knowledge’ of any negligence and breach of duty with their firms.<sup>53</sup> There followed considerable debate between the Government, the

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<sup>49</sup> This issue arises in relation to insurers, insurance brokers and policyholders. See *Blackley v National Mutual Life Association of Australia Ltd* [1972] 1038.

<sup>50</sup> See *Oppenheimer v Frazer & Wyatt* [1907] 2 KB 50

<sup>51</sup> (1984) 8 ACLR 882

<sup>52</sup> See Lindley & Banks on Partnership (18<sup>th</sup> Edition) para 12-29

<sup>53</sup> LLP legislation in the Canadian provinces of Alberta, Ontario, British Columbia and Manitoba of Canada and the US State of Texas removes protection for a partner in a LLP who has actual knowledge of the default but failed to exercise reasonable diligence to deal with it, whilst Ontario and Texas also remove protection for a partner who ought reasonably to have known of the default but failed to address it.

LegCo and the Law Society over the provision. The Law Society expressed the view that the constructive knowledge element would lead to ‘excessive litigation’ whereas LegCo member Albert Ho felt that this proposal would provide a lesser safeguard to consumers, as senior members of a law firm “might refrain from providing guidance to their junior members for fear of being held personally liable to the defaults of the junior members for their negligence or wrongful acts to clients”.

As a consequence of further negotiations between the parties, a compromise was reached in relation to the supervision of junior staff by partners in law firms (the details of which will be dealt with below) On that basis, the Government agreed to remove the ‘constructive knowledge’ element in the Bill. Accordingly, a partners’ “protection from liability” is limited by section 7AF so that a partner will not escape liability only if he knew of the default at the time of its occurrence; and failed to exercise reasonable care to prevent its occurrence. Nor will he be protected from liability “arising from a default in respect of a matter handled by the partnership” if the default in question was his own default or that of “an employee, agent or representative of the partnership who was under the direct supervision of the partner in respect of the matter” at the relevant time.

In short, a partner’s actual knowledge of a default will render him liable and his failure to properly manage his junior colleagues will render him liable if they are in default. In that context, it should also be borne in mind that section 7AR stipulates that any relevant laws applicable to a general partnership, except in so far as they are not inconsistent with the new provisions relating to LLPs, apply to an LLP. Thus the common law rules on vicarious liability are unchanged.

#### *Proceedings against LLPs*

By RHC Order 81 rule 1, partners in may sue, or be sued, in their own name or in the name of the firm. Further, by RHC Order 81 rule 4(1), where persons are sued as partners in the name of their firm, service may only be acknowledged by the partners thereof in their own names.

Section 7AH of the LPAO states that if a partner is protected from liability under section 7AC(1) he or she is not, separately, a “proper party to any proceedings brought against the partnership” in respect of that liability. The proceedings may, if they could apart from section 7AH be brought against the partnership, continue to be so brought. Consequently, such a partner, if he has been served, should acknowledge service on the basis set out in RHC Order 81 rule 4(2):

*“if he denies that he was a partner or liable as such at any material time, [the partner] may acknowledge service of the writ and state in his acknowledgment that he does so as a person served as a partner in the defendant firm but who denies that he was a partner at any material time”*

Where such an acknowledgment has been given in accordance with RHC Order 81 rule 4(2), under rule 4(3) the plaintiff may apply to the Court to set it aside on the ground that

the defendant was liable as such at a material time (or leave it to be determined at a later stage of the proceedings) or the defendant may either apply to set aside the service of the writ on him or serve a defence on the plaintiff denying either his liability as a partner or the liability of the defendant firm or both. The court itself may, alternatively, decide to deal with that matter as a preliminary issue pursuant to rule 4(5).

### *Obligation to supervise*

To address the concern that partners may try to avoid personal liability by not supervising their employees the Law Society proposed to amend the Hong Kong Solicitors' Guide to Professional Conduct ("Conduct Guide") to make the following obligations in Commentaries 1 and 2 under Principle 5.17 mandatory for law firms operating as LLPs:

- "1. A client should be told the name and the status of the person responsible for the conduct of the matter on a day-to-day basis and the partner responsible for the overall supervision of the matter.*
- 2. If the responsibility for the conduct or the overall supervision of the whole or part of a client's matter is transferred to another person in the firm the client should be informed."*

On this basis, the Government agreed to replace the 'constructive knowledge' element in the Bill with a requirement that LLPs should serve written notifications for each matter on each client informing them of the identity of the partner(s) responsible for their affairs before the LLP accepted the client's instructions. Moreover, the partner or partners in question (defined as the "the designated partner") would not be protected from liability under section 7AC(1). Unsurprisingly, the Law Society strenuously objected to the 'designated partner' suggestion, going so far to warn that it would not support the Bill in such a form. In the words of the Law Society President:

*"I do not see how anyone will want to be a designated partner who will not only be the scapegoat but who will have to bear, on behalf of the claimant, the burden of proving who committed the default."*<sup>54</sup>

Further negotiations between the Government and the Law Society eventually resulted in the compromise incorporated in section 7AE of the LPAO dealing with "overall supervising partners". The core of this provision is found in section 7AE(1) which stipulates:

*"For each matter handled by a limited liability partnership for a client there must, throughout the time it is handled, be at least one partner who is responsible for the overall supervision of the matter ("overall supervising partner")"*

Clients must not only be notified of the identity of this 'overall supervising partner' but, upon request, they must be given the names of any other partners who are (or were) overall supervising partners for the whole matter and those who are or were responsible

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<sup>54</sup> See [http://www.hk-lawyer.com/InnerPages\\_features/0/3664/2012/2](http://www.hk-lawyer.com/InnerPages_features/0/3664/2012/2)



for any particular parts of the matter. This provision would appear to address the concern that senior members of a firm would seek to avoid liability for their junior colleagues' actions by 'hiding' from their clients.

### *Indemnification*

Indemnity clauses are fairly common, if not ubiquitous, in partnership agreements. Generally speaking, the partners or (in the case of an LLP) the LLP promises to pay all liabilities of the firm, including those arising from any claim brought directly against a partner. In the absence of an indemnity clause in a partnership agreement, there will be an implied indemnity pursuant to section 26(b) of the Partnership Ordinance:

*“the firm must indemnify every partner in respect of payments made and personal liabilities incurred by him - (i) in the ordinary and proper conduct of the business of the firm; or (ii) in or about anything necessarily done for the preservation of the business or property of the firm”*

This provision is generally understood to reflect an agent's right to reimbursement of expenses incurred whilst acting within his authority on behalf of his principal – in this case, a partner on behalf of his fellow partners - as well as a mechanism for the equal sharing of losses among the partners. For example, the English equivalent of section 26(b)(i) was applied in *Matthews v Ruggles-Brise*<sup>55</sup> where two partners took a 42 year lease from 1879 as trustees on behalf of themselves and eight other partners. The firm was incorporated in 1886 (with Coupe dying the same year) and in 1887 Matthews assigned the lease to the company, before dying in 1891. In 1909 the landlord sued Matthews' estate for arrears of rent and breach of covenant. Matthews' executors settled the claim and sought a contribution from Coupe's estate. The court held that the lease remained a liability of both Coupe and Matthews and was, consequently, a partnership debt. Accordingly, Matthews' estate was entitled to be indemnified by Coupe's estate for a proportion of the sum claimed by the landlord.

There is, however, uncertainty as to the all the circumstances in which partners are entitled to be indemnified by the colleagues or, conversely, are obliged to indemnify them. This is related to the duty of care owed by partners to their colleagues and the partnership and the standard of skill and care which will be expected in the absence of an agreement within the partnership deed. For example, in *Lane v Bushby*<sup>56</sup> the New South Wales Supreme Court held that a statutory provision which is essentially the same as section 26(b)(i) did not apply where there was fraud, illegality, willful default or culpable or gross negligence, although it did cover ordinary negligence in the course of business. Consequently, there was no implied term requiring a negligent partner to indemnify his colleagues for loss caused by his own negligence (and he in turn was entitled to be indemnified by the firm).<sup>57</sup>

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<sup>55</sup> [1911] 1 Ch 194, applying section 24(2) of the Partnership Act 1890.

<sup>56</sup> [2000] NSWSC 1029

<sup>57</sup> The principle that there will be no indemnity for losses due to a partner's own fraud or culpable negligence in the conduct of the partnership affairs was upheld as long ago as in *Thomas v Atherton* (1878)

Section 7AG, which was introduced to the Bill shortly before it was passed into law, states that the new provisions do not affect any right of a partner in an LLP to be indemnified by another partner, or any obligation of a partner to indemnify another partner, under a written agreement made between the partners. Thus, the ability of partners to indemnify each other in their partnership agreements is not automatically prohibited by the introduction of the section 7AC liability shield. A question arises, however, whether or not whether section 26(b) is displaced by section 7AC. Section 7AC(2) states that the section 7AC(1) shield:

*“applies irrespective of whether the liability is in the form of indemnification, contribution or otherwise”*

These words appear to be lifted from section 26(b) of the New York Partnership Act which provides that no partner will be liable:

*“...directly or indirectly (including by way of indemnification, contribution or otherwise), for any debts, obligations or liabilities...”*

These words were inserted in section 26(b) of the New York legislation because the state has its own equivalent of section 26(b) of the Partnership Ordinance. The obligation to indemnify one’s partners raises the possibility that a partner who may otherwise be able to rely on the liability ‘shield’ against a direct claim by a third party will be liable to make indirect payments to his negligent partner to satisfy that same claim. The inclusion of the above words in section 26(b) of the New York Partnership Act are designed to eliminate this danger. It should also be borne in mind that the New York legislation is designed to provide a ‘full shield’, which explains and justifies such language in section 26(b).<sup>58</sup>

At first sight, therefore, section 7AC(2) would seem to similarly negate section 26(b) of the Partnership Ordinance, which would make sense if innocent partners are intended to be free of liability for the consequences of their colleagues’ errors or omissions. Yet, section 7AA defines “partnership obligations” within section 7AC(1) as:

*“any debt, obligation or liability of the partnership, other than debts, obligations or liabilities of the partners **as between themselves, or as between themselves and the partnership**”* [My emphasis]

Given that an implied indemnity under section 26(b) is an obligation upon the firm – the partners - towards each individual partners, it would seem to be outside the scope of section 7AC(1)&(2). If so, the implied indemnity under section 26(b) would seem to remain in place for LLPs and ‘innocent’ partners could be faced with indirect liability for

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10 ChD 185. Indeed, it is accepted that a partner must compensate or indemnify the partnership against such losses, see *Bury v Allen* (1845) 1 Coll 589 and *Robertson v Southgate* (1848) 6 Hare 536.

<sup>58</sup> For a discussion of the New York Partnership Act see *Limited Liability Partnership and Liability Capping Legislation for the Practice of Law in Selected Places* (March 2005) Research and Library Services Division Legislative Council Secretariat

the colleagues' errors or omissions. Although section 7AR stipulates that relevant laws (i.e. the Partnership Ordinance) which are inconsistent with the LPAO will not apply to LLPs, section 26(b) is not in itself inconsistent with the LPAO given that it is consistent with the partial liability shield intended by the Government. The problem is created by the fact that the definition of "partnership obligation" does not include partners' liabilities towards each other, in addition to those to any third party, for default in the provision of professional services.

It is because of such uncertainties that most partnerships should continue to make their own provision for indemnity.<sup>59</sup> The question is, of course, what losses the partners will wish to provide an indemnity and the nature and extent of wrongdoing by a culpable partner that may result in the indemnity being withheld or declined. A partnership agreement may deny indemnity in relation to a partner's own negligence or misconduct, unless they are "insured". Further, even if the liability in question is insured, there will be a limit to that cover (e.g. HK\$10million cover is provided by the Hong Kong SIF for each and every claim against a solicitors firm) and an excess or deductible. Responsibility for claims over the limit of cover and the payment of the excess or deductible would need to be determined by the partners in a LLP just as they would by those in a general partnership.<sup>60</sup>

The precision needed in such indemnity clauses should not be underestimated, as can be seen from the recent English decision of *Rust Consulting Ltd v PB Ltd*<sup>61</sup> in which the court held that the a provision by which one party indemnified another "against all costs, proceedings, claims, demands and expenses which may be incurred... as a result of any act or omission by [the latter party]" did not automatically entitle the latter party to a payment from the former even in the event of there being a consent judgment against the latter. In order to recover under the indemnity clause, the latter party would have to establish that it was liable to a third party for either damages or for the amount of the consent judgment

#### *Distribution of LLP property*

Subject to any contrary agreement between the partners, by section 26(a) of the Partnership Ordinance all of them are entitled to share equally in the capital and profits of the business. Similarly, they must all contribute equally towards the losses, whether of capital or otherwise. Even where one partner does much more work than his colleagues, the principle of equality applies in the absence of any previous arrangement between the partners.<sup>62</sup>

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<sup>59</sup> Under the Civil Liability (Contribution) Ordinance (Cap 377) s 9(3) the right to recover contribution supersedes any right other than an express contractual right to recover such contribution, which would also justify including a provision in any partnership deed.

<sup>60</sup> See <http://www.lawgazette.co.uk/in-business/ten-important-provisions-include-your-partnership-or-llp-agreement>

<sup>61</sup> [2010] EWHC 3243

<sup>62</sup> *Webster v Bray* (1849) 7 Hare 159 at 178, 179; *Robinson v Anderson* (1855) 20 Beav 98

As previously noted, the LPAO is not primarily concerned with partnership property and partners' interests in the same. It is, however, concerned with the distribution of LLP property, with "distribution" in relation to partnership property being defined in section 7AA as:

*"a transfer of money or other partnership property by a partnership to a partner, whether as a share of profits, return of contributions to capital, repayment of advances or otherwise"*

Section 7AN(1) goes on to regulate the distribution of an LLP's property as follows:

*(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 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 to the partnership to the extent specified in subsection (4).*

Section 7AN(4) adds:

*(4) A person who is liable under 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.*

The purpose of this provision is to counter any distributions of partnership property that would, in the Government's words, "frustrate client's claim by requiring such distributions be clawed back to the firm's asset pool under certain circumstances". Under section 7AN(5), proceedings to enforce any liabilities under section 7AN(1) and (4) may be brought by the partnership, any individual partner or any person (presumably a legal 'person') to whom the partnership owes any "partnership obligation at the time of the distribution". The Government originally proposed that such a claw back claim could be brought at any time after the distribution in question. As with other provisions in the original Bill, the Law Society objected to such an open ended liability and – eventually – the Government relented. Section 7AN(8) now prescribes a two year limitation period for such claims, which is consistent with the period for the restoration of assets where unfair preferences have been given to associates of bankrupt debtors as set out in section 51(b) of the Bankruptcy Ordinance.

Further, a defendant to any claim under section 7AN(5) may raise the defence, pursuant to section 7AN(2), that immediately before making the contested distribution, the LLP

made a reasonable assessment that its financial position would not be compromised in the manner set out in section 7AN(1). The defendant would have to demonstrate that such an assessment was reached after “exercising reasonable diligence” and was “based on information obtained for the purpose of the assessment or otherwise available at the time of the assessment”. Section 7AN(3) adds that the court “may have regard to all the circumstances of the case” including (but not limited to) whether it was based:

- on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances;
  - on a fair valuation; or
  - on any other method that is reasonable in the circumstances
- when deciding if the LLP’s assessment was reasonable.

In exchange for the shorter clawback period, the Law Society agreed that LLPs will be required to have in place insurance cover up to an amount of not less than HK\$10 million in respect of any one claim in addition to the statutory indemnity or insurance requirement.<sup>63</sup>

### *Personal liability*

As has already been noted, the LPAO does not alter the nature of the duties owed by a solicitor to his client or third parties. Since the decision in *Henderson v Merrett Syndicates Ltd*<sup>64</sup> it has been accepted that a negligent solicitor is liable to his client in both contract and tort.<sup>65</sup> The nature of his duties, and of any breach, in respect of the former will of course be determined by his retainer. In addition to the contractual duties arising from the retainer and the general duty to exercise reasonable skill and care, a solicitor also owes his client fiduciary duties.<sup>66</sup> Whilst it was traditionally the case that solicitors owed no duty of care who were not their clients for any negligent misstatements relied upon them, that position was changed by *Hedley Byrne & Co. Ltd v Heller & Partners Ltd*.<sup>67</sup> The existence and nature of any duty of care owed by a solicitor to a third party will depend on the circumstances of the case in question albeit the courts have, in recent years, come to make use of the concept of “assumption of responsibility” to justify imposing a duty of care upon solicitors (and others).

It is also important to appreciate that the LPAO does not alter the principles by which a solicitor may be personally liable to a client or third party in tort. Whilst it is reasonable

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<sup>63</sup> Section 7AD

<sup>64</sup> [1995] 2 AC145

<sup>65</sup> This point has been the subject of debate and change over the course of many years. Prior to *Groom v Crocker* [1939] 1 KB 194, it was felt that a negligent solicitor could be sued by his client in contract and/or tort. It was held by the Court of Appeal in that case, however, that a solicitor owed no duty to his client beyond any contractual duties arising from his retainer. This position was challenged in a number of decisions in the 1970s and 1980s, including *Midland Bank v Hett Stubbs & Kemp* [1979] CH 384 and *Forster v Outred & Co* [1982] 1 WLR86 until it was finally resolved in favour of concurrent liability by the House of Lords in *Henderson*.

<sup>66</sup> The relationship between a solicitor and his client was described as “one of the most important fiduciary relations known to our law” by Cozens-Hardy MR in *Re Van Laun* [1907] 2 KB.

<sup>67</sup> [1964] AC 465

to suppose that an ‘overall supervising partner’ will have a contractual relationship with a client, can the same be said of other supervising partners or junior colleagues? If not, any liability will be determined in tort. There is no simple test for determining when a personal duty of care is owed, but a court is likely to consider whether, on all the facts, there was:

- an assumption of personal responsibility by the member to the client or third party so as to create a special relationship;
- reasonable reliance by the client or third party on such an assumption of personal responsibility; and
- reasonable foreseeability of loss.<sup>68</sup>

In *Yazhou Travel Investment Company Ltd v Bateman Starr*<sup>69</sup> the CFI addressed the question of a solicitor’s personal responsibility to his client directly. An investment company sued a solicitors’ firm, the assistant solicitor who handled its matter and the consultant who had overall supervisory responsibility. The allegation was that the firm had been given negligent advice in relation to HK\$67 million property transaction. The claim succeeded at trial. It was held that the firm was vicariously liable for the negligence of the assistant solicitor and consultant and that those two individuals had assumed a personal duty of care towards the plaintiff, which the latter had reasonably relied upon. Accordingly, all three defendants were jointly and severally liable for the plaintiff’s loss.

Saunders J noted that, in order to establish personal responsibility of an employed solicitor to a client, it was necessary to show that they had entered into a ‘special relationship’ and that, consequently, the former had assumed personal responsibility for the professional services he performed, with the client reasonably relying on that personal responsibility in turn. This, the learned judge added, was a question of fact to be decided objectively although, in most cases, the very nature of a solicitor-client relationship would give rise to a ‘special relationship’. This would not, however, be the case where the client dealt with a partner, and the partner delegated the work to junior colleagues with whom a client had no contact. Further, the scope of the duty did not vary as between partners and employed solicitors once it was established that there was such a ‘special relationship’.

Finally, there is the question of professional indemnity insurance. In simple terms, if a third-party claims negligence against a firm, the partners are jointly and severally liable for that claim. If the plaintiff is awarded damages, the insurer is liable for the payment of the sum of the award (with deductions / excesses applied where required) up to the limit of the indemnity. If a firm is a LLP, where the only the culpable partner is liable for the negligence claim and where damages are awarded, the insurer would still be liable for the sum of the award (subject to the terms of the cover).

The first question is who will be liable for the excess/deductible and any sum above the limit of indemnity. Given that, from the 1994-1995 indemnity year to the 2010-2011 indemnity year, only 1.8% of the total claims notified to the SIF have sought HK\$10

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<sup>68</sup> See *Merrett v Babb* [2001] EWCA Civ 214.

<sup>69</sup> [2004] 1 HKLRD 969;

million or more (with the average claim ranging from HK\$0.6 million to HK\$2.7 million), this is unlikely to be a concern in all but the gravest of situations. It does, however, reiterate the importance of a comprehensive and precise indemnity clause with the LLP partnership agreement.

The second question is whether or not the professional indemnity insurers would impose a moral hazard premium based on the characteristic of each partner being covered (i.e. would insurers now place a greater importance on PQE experience as well as previous claims experience and the risks inherent in the type of work undertaken). The ultimate risk is the possible anti-selection of certain partners in a firm.

## **What next?**

### *Solicitor Corporations*

The Legal Services Legislation (Miscellaneous Amendments) Ordinance passed by the LegCo in 1997 amended the LPO to permit the creation and operation of solicitor corporations and foreign lawyer corporations.<sup>70</sup> Under the amended LPO, the Law Society may approve any company which is formed and registered under the Companies Ordinance (Cap 32) to be a solicitor corporation. Solicitor corporations are authorised to do anything that only a solicitor can lawfully do and are required to do anything that a solicitor is required to do by law. Solicitor-client privilege exists between a solicitor corporation and a client of the corporation in the same way as it exists between a solicitor and a client of the solicitor.

Unfortunately, the provisions introduced by the Legal Services Legislation (Miscellaneous Amendments) Ordinance are not yet in operation. Similarly, the Law Society's Solicitor Corporation Rules (SCR) are not yet in operation. Both have been the subject of protracted and extensive wrangling between the Government and the Law Society, which has not been helped by the inconsistencies in the operation of law firms compared to those of 'ordinary' trading companies. For example, the draft SCR prescribe that the control of solicitor corporations must remain with solicitors whereas section 114C(1) of the Companies Ordinance provides:

*“... any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person (whether a member or not) as his proxy to attend and vote instead of him”.*

Consequently, under the Companies Ordinance, a non-solicitor could be appointed as an absent solicitor member's proxy. This particular difficulty (and a number of others) was the subject of the Statute Law (Miscellaneous Provisions) Ordinance passed by the LegCo on 17<sup>th</sup> July 2012. At the moment, the most recent draft of the SCR which is available to the public is the 8<sup>th</sup> draft (of January 2011), which was sent to the LegCo Panel on Administration of Justice and Legal Services by the Law Society on 28<sup>th</sup>

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<sup>70</sup> Section 2 of the Ordinance adds new sections 7B to 7L to the LPO.

January 2011.<sup>71</sup> The author has been informed that the Law Society is still conducting negotiations with the Government on the drafting of the SCR and that the latest draft – the 11<sup>th</sup> such draft – is not a public document and cannot be disclosed to the wider public. Nor is the Law Society advise on when the draft SCR may be finalised as this “will depend on many factors including those which are beyond the control of the Law Society”.

Whatever the final form of the SCR, they will provide for the approval of a solicitor corporation (and its memorandum and articles of association) by the Law Society. Similarly, the written approval of the Law Society is required before a solicitor corporation’s memorandum or articles of association can be amended or its name changed. As with LLPs, the Law Society is required to keep a list of all solicitor corporations. There is also an appeals process, by which anyone who applies to the Law Society for approval of a solicitor corporation (or any subsequent changes relating to the same) and is refused, may appeal to the CFI against the refusal.

Members or employees of solicitor corporations are subject to the same disciplinary procedures as solicitors (or employees of solicitors) in ordinary law firms or LLPs. One specific offence in relation to solicitor corporations, however, is that no one may offer or invite the public to subscribe for or purchase shares in or debentures of a solicitor corporation.<sup>72</sup> Finally, solicitor corporations may be wound up in accordance with the Companies Ordinance or on grounds specified by the Chief Justice in accordance with the LPO. Only the Law Society may make an application to wind up a solicitor corporation on these latter additional grounds.

In the absence of the finalised SCR, it is difficult to predict what all the consequences would be for both solicitors and the clients if practices became solicitor corporations. For example, what distinction, if any, would be made between members and directors? In a small firm it seems probably that all the members would probably also hold directorships but such a practice could, arguably, be unwieldy in a larger firm. Would junior members have fewer shares than senior ones or would there be different classes of share, some with voting rights and others without? Incorporation could also alter the nature of personal liability on the part of director solicitors, the decision in *Williams v Natural Life Health Foods Ltd*<sup>73</sup> would presumably have as much significance for such individuals as that in *Yazhou Travel*. Would director solicitors require D&O insurance cover? What, if any, would be the tax implications of incorporation? These are all matters which would need to be carefully considered by any firm both prior to and after incorporation.

### *Alternative Business Structures*

It should be noted that, whilst Hong Kong has yet to introduce corporate-style structures for law firms (and other professional practices), the UK has moved onto more sophisticated ways in which solicitors may run their affairs. A new entity known as an

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<sup>71</sup> Available at <http://www.legco.gov.hk/yr10-11/english/panels/ajls/agenda/aj20110328.htm>

<sup>72</sup> Section 7F(1). An offender is liable on conviction to a fine at level 5.

<sup>73</sup> [1998] UKHL 17



Alternative Business Structure (ABS) was established under Part 5 of the UK's Legal Services Act 2007.<sup>74</sup> An ABS enables lawyers and non-lawyers to form a partnership or company to provide what are described in the Act as "reserved legal activities".<sup>75</sup> The Act aims create a single regulatory framework for the legal services 'market' and alter the traditional structure of the legal profession. To that end, existing regulators such as the Solicitors Regulatory Authority were entitled to become licensing authorities (as the SRA has done).

An ABS must have at least one "manager" who is authorised to provide "reserved legal activities" and at least one other non-lawyer "manager" or owner.<sup>76</sup> Consequently, an existing law firm that has a non-lawyer manager (which is not uncommon) may need to be licensed as an ABS. In addition, commercial organisations may purchase or create law firms to provide reserved legal activities (in a manner not dissimilar to captive insurers).<sup>77</sup>

The Act also requires an ABS to have a Head of Legal Practice and a Head of Finance and Administration. The former must be a lawyer and is responsible for ensuring compliance with the ABS's license and reporting any non-compliance or suchlike breaches to the licensing authority. The latter (who need not be a lawyer) is responsible for ensuring compliance with any rules relating to the funds held by the ABS and its accounts.<sup>78</sup>

Three types of model 'licenced bodies' have been envisaged by some observers:<sup>79</sup>

- traditional practices with one or more individual non-lawyer managers, without external ownership;
- a subsidiary entity with total or partial external ownership in which the legal services are provided by the same on a 'ring fenced' basis (i.e. like a captive insurer)

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<sup>74</sup> Available at <http://www.legislation.gov.uk/ukpga/2007/29/contents>

<sup>75</sup> Section 12 gives the meaning of "reserved legal activity" and "legal activity" thus - (1)In this Act "reserved legal activity" means - (a)the exercise of a right of audience; (b)the conduct of litigation; (c)reserved instrument activities; (d)probate activities; (e)notarial activities; (f)the administration of oaths. (2)Schedule 2 makes provision about what constitutes each of those activities. (3)In this Act "legal activity" means— (a)an activity which is a reserved legal activity within the meaning of this Act as originally enacted, and (b)any other activity which consists of one or both of the following— (i)the provision of legal advice or assistance in connection with the application of the law or with any form of resolution of legal disputes; (ii)the provision of representation in connection with any matter concerning the application of the law or any form of resolution of legal disputes. (4)But "legal activity" does not include any activity of a judicial or quasi-judicial nature (including acting as a mediator). (5)For the purposes of subsection (3) "legal dispute" includes a dispute as to any matter of fact the resolution of which is relevant to determining the nature of any person's legal rights or liabilities. (6)Section 24 makes provision for adding legal activities to the reserved legal activities.

<sup>76</sup> Section 72

<sup>77</sup> The ownership of 'licenced bodies' is dealt with in Schedule 13 of the Act.

<sup>78</sup> See sections 91 and 92 respectively

<sup>79</sup> See "Alternative Business Structure under new Legal Services Act" available at <http://www.netlawman.co.uk/info/alternative-business-structure-legal-services.php> and "Focus: Alternative business structures - Law and new order" available at <http://www.thelawyer.com/focus-alternative-business-structures-law-and-new-order/1010138.article>

- combinations of different services within one entity - the multidisciplinary practice model.

A number of potential benefits have been identified for both clients and the practices themselves including but not limited to:

- for consumers - greater choice in deciding from where to obtain legal and associated non-legal services and lower fees.
- for practitioners - increased access to finance (i.e. raising of equity and debt finance); increased flexibility (i.e. insurance companies, banks and estate agents may form ABSs and offer integrated services); easier to hire and retain high-quality non-legal and legal staff.<sup>80</sup>

Whether these benefits will be realised remains to be seen. By October 2012, the SRA had granted 29 licences for ABSs,<sup>81</sup> so it is likely that we will know one-way-or-another in the not too distant future. If they are successful, the pressure for further reforms may grow in Hong Kong.<sup>82</sup>

### *Liability capping and proportionate liability*

As noted above, the HKICPA has called for both a statutory cap on auditors' liability and the introduction of "a system of proportionate liability". In the absence of such reforms, the HKICPA regarded the introduction of LLPs as of little practical benefit.<sup>83</sup> Whilst the Companies Ordinance (Cap 32) prohibits the exclusion of auditors' liabilities,<sup>84</sup> and whilst section 59(2) of the LPO renders any exclusion of a solicitors' liability for negligence void, Practice Direction M does allow a solicitor "to limit his liability in business other than contentious business" subject to certain conditions.<sup>85</sup>

At present, Australia is the common law jurisdiction with – arguably - the most advanced regime of proportionate liability and liability capping. New South Wales was the first state to introduce legislation capping professional liability, in the form of its Professional Standards Act 1994,<sup>86</sup> followed by the other states and territories over the next ten years. Professional Standards Councils were also established to "approve and monitor" states' and territories' professional standards schemes (which are known as *Cover of*

<sup>80</sup> See the explanatory notes to part 5 of the Act at

<http://www.legislation.gov.uk/ukpga/2007/29/notes/division/7/5>

<sup>81</sup> See <http://www.guardian.co.uk/law/2012/oct/12/brands-alternative-business-structures>

<sup>82</sup> The Guardian newspaper's website has a section on ABSs available at

<http://www.guardian.co.uk/law/alternative-business-structures>

<sup>83</sup> See the HKICPA paper "A case for Professional Liability Reform in Hong Kong" available at

[http://app1.hkicpa.org.hk/professionaltechnical/liability/liability\\_reform.pdf](http://app1.hkicpa.org.hk/professionaltechnical/liability/liability_reform.pdf)

<sup>84</sup> Section 165(1) reads "(1) Any provision, whether contained in the articles of a company or in any contract with a company or otherwise, for exempting any officer of the company or any person employed by the company as auditor from, or indemnifying him against, any liability to the company or a related company that by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company or related company shall, subject to subsections (2) to (4), be void."

<sup>85</sup> Available at [http://www.hklawsoc.org.hk/pub\\_e/professionalguide/volume2/default.asp?cap=24.14](http://www.hklawsoc.org.hk/pub_e/professionalguide/volume2/default.asp?cap=24.14)

<sup>86</sup> Available at [http://www.austlii.edu.au/au/legis/nsw/consol\\_act/psa1994249/](http://www.austlii.edu.au/au/legis/nsw/consol_act/psa1994249/)

*Excellence*® schemes).<sup>87</sup> In New South Wales, any person who was, at the time of their act or omission giving rise to an “occupational liability”, covered by a Scheme (such as the Law Society of NSW (NSW) Scheme) who is sued for that act or omission will not be liable in damages above a specified amount (not including defence costs). Solicitors in New South Wales practices with 1 to 3 principals maximum liability is capped at AU\$1.5 million.<sup>88</sup>

Proportionate liability legislation was introduced by the Australian states and territories between 2002 and 2004, following the HIH crisis in 2001,<sup>89</sup> for claims involving economic loss and property damage to replace the traditional common law system of joint and several liability. The changes were not without controversy and the Australian Standing Council on Law and Justice (SCLJ),<sup>90</sup> comprising the Attorneys-General of the Commonwealth and States and Territories, the Western Australian Minister for Corrective Services and the Minister of Justice of New Zealand, produced a model law on proportionate liability for public consultation in September 2011.<sup>91</sup> At the time of writing, that consultation process had not been concluded. Given the complexity of the issues involved and the ongoing debates in Australia, where legislation has been in place for almost a decade, it seems unlikely that Hong Kong will set about any similar reforms in the near future.

## Conclusion

Whilst the LPAO may be a welcome development for many solicitors in Hong Kong it is by no means a panacea. Its central provision, section 7AC(1) provides only a ‘partial shield’ protecting the personal assets (but not interests in the partnership property) of partners from claims brought in respect of their colleagues’ errors or omissions in the provision of the firm’s ‘professional services’. Liability for a firm’s ordinary business debts - such as rent, salaries and taxes – remains unchanged. Similarly, partners’ personal liability as solicitors for their own errors or omissions is unchanged – *Merrett v Babb* and *Yazhou Travel Investment Co Ltd v Bateson & Others* remain “good law”.

Any firm which is considering reforming itself into an LLP will need to take a great deal of care when drafting the appropriate documentation, not least in relation to partnership indemnities. Even if the formation of the LLP goes well, the future management of the LLP is not without risk. As noted, partnership distributions may need to be defended against ‘claw back’ claims by disgruntled colleagues, ex-colleagues and clients. The treatment of LLPs by their insurers is also unclear.

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<sup>87</sup> The Professional Standards Councils website is available at [http://www.lawlink.nsw.gov.au/lawlink/psc/ll\\_psc.nsf/pages/psc\\_index](http://www.lawlink.nsw.gov.au/lawlink/psc/ll_psc.nsf/pages/psc_index)

<sup>88</sup> This would be just over HK\$12 million at October 2012 exchange rates. See the Scheme documents available at [http://www.lawlink.nsw.gov.au/lawlink/psc/ll\\_psc.nsf/pages/psc\\_lawsoc\\_nsw](http://www.lawlink.nsw.gov.au/lawlink/psc/ll_psc.nsf/pages/psc_lawsoc_nsw)

<sup>89</sup> See S.S.Cheng & M.W.Seeger “Lessons Learned from Organizational Crisis: Business Ethics and Corporate Communication” *International Journal of Business and Management* Vol. 7, No. 12; June 2012 p74-86.

<sup>90</sup> Website available at [http://www.sclj.gov.au/sclj/standing\\_council\\_index.html](http://www.sclj.gov.au/sclj/standing_council_index.html)

<sup>91</sup> See a discussion of the model law by Allens Linklaters, solicitors at <http://www.allens.com.au/pubs/ldr/fldr21sep11.htm>

In light of these uncertainties, some solicitors may be tempted to keep to what they know and remain as traditional general partnerships. Others may decide to wait until the SCR are finalised and seek incorporation. “Fortune favours the bold” may have been a common phrase among the Romans but it is not often found upon the lips of solicitors.

GM 19.10.12  
(13,272 words)