# Limited liability pa may soon be a rea

## Proposed legislation drafted by the Law Society of Hong Kong with the support of the HKICPA, would, for the first time, allow firms in the territory to form limited liability partnerships

It's a matter of growing urgency. That's the impression one gets from Ken McKelvie, chairman of Deloitte Touche Tohmatsu and of the HKICPA's Professional Risk Management Committee, when the subject of accountant liability crops up.

With major litigation against accountants increasing in the US and other jurisdictions, he believes it's only a matter of time before firms in Hong Kong are faced with the same alarming threat.

Under the system of joint and several liability traditionally in place in many common law jurisdictions, including Hong Kong, all partners in a firm are equally liable if a plaintiff's case succeeds - even if only one was at fault. In describing a sequence of events that would send chills up an accountant's spine, Mr McKelvie outlines what such an eventuality could mean.

'If the auditors are found partially or wholly responsible, the insurance may pay part of the claim. If that is not sufficient, then the firm's assets are seized and, third, after the firm is out of business, the plaintiff has the right to go for all the partners' personal assets jointly and severally, whether or not they were involved in dealing with that client,' he says.

To eliminate the burden on innocent partners and cases in which plaintiffs tend to target defendants with 'deep pockets', the Institute is advocating a new system of structuring professional firms which seeks to assign responsibility for wrongdoing, if any, more fairly than is the case now.

### First steps

Many consider the introduction of limited liability partnerships (LLPs) as the first step on the long road to liability reform. Other measures, such as proportionate liability and contractual liability caps, involve more fundamental changes to the law and are expected to take longer to achieve.

In recent years, a number of countries have been overhauling their liability statutes to reflect accountants' increasing concern about liability risks, particularly in the wake of the Enron and WorldCom scandals and the downfall of Enron's accounting firm Arthur Andersen. Mr McKelvie believes it's time for Hong Kong to do the same.

'Companies are going global and getting much, much bigger. The firms who provide services to the world's largest companies are generally the Big Four which are structured as separate partnerships in most parts of the world. We take on huge risks dealing with those big companies,' he maintains.

'Some of the claims are way above the insurance we can get. The situation has been building since the early 1980s; it accelerated in the 1990s, and this century it is well beyond anything that has happened before.'

Another complicating factor is the impact of the US's Sarbanes-Oxley Act, the post-Enron business reform law that imposed tough conditions on the way auditors, among others, do business.

'It has brought the Big Four into the jurisdictional claws of the US,' he says. 'So that if we here in Hong Kong are doing some audit work for an SEC [Securities and Exchange Commission] registrant in the US or a subsidiary of an SEC registrant, even if our subsidiary has no listing in the US, we are required to register with the Public Company Accounting Oversight Board and make our files available in any investigation they may be conducting either of the company or of our work with the company. It places us right in the most litigious jurisdiction in the world.' Frivolous claims are also multiplying and while less of a worry, he says, they 'have to be dealt with and the costs of having them quashed in court becomes very high'.

The Law Society of Hong Kong has drafted proposed legislation, which is supported by the HKICPA, which would allow firms in the territory to form LLP. Mr McKelvie says he hopes the proposal can be introduced in the Legislative Council next year.

'An LLP is similar in nature to a limited liability company but it is still a partnership. It basically protects the innocent partners from the mistakes of another partner,' he says, explaining that successful litigants could still receive insurance payments, all of the firm's assets and the personal assets of the guilty partner, but not the personal assets of the other partners.

# rtnerships lity

LLPs went into effect in the US in 1991, the Isle of Jersey in 1997, Canada in 1998 and Britain in 2000. Consultation papers proposing their introduction were issued in Singapore and Malaysia last year.

If the legislation is approved here, all professionals – accountants, lawyers, engineers etc – would be able to set up LLPs, which offer the organisational flexibility and tax status of a partnership but with liability limitations.

## HKICPA position paper

The HKICPA's position paper on LLPs, dated 25 November 2004, urges the government to adopt the LLP structure as soon as practicable. 'The HKICPA strongly supports the view that Hong Kong should maintain its strong position as a leading financial and trading centre in Asia by making available a wider choice of business structures,' the paper says. 'If not, there may be a serious risk of business going to other regional jurisdictions which provide such a vehicle. This was the same threat that faced [Britain] when Jersey introduced the LLP as a vehicle for business in 1997.'

For Elizabeth Law, who operates part of her firm as a sole proprietorship and the rest as a limited company, the prospect of a limited liability partnership has a certain appeal. 'If we hadn't already incorporated, we might have chosen the LLP since it is closer to a partnership set-up,' says the partner of Stephen Law Co and director of Law & Partners. The sole proprietorship is a carry-over from the days when her father founded the business. She says she elected to incorporate in order to expand the firm and limit her liability.

While conceding that incorporation is an option for firms, Mr McKelvie says many accountants enjoy the collegial nature of a partnership.

'Limited liability works quite well for small firms. But a partnership presents a different face to the public. A partnership is a group of people who work together, sharing resources, sharing risk, sharing their clients and generally providing a range of services in a professional way,' he says. 'When the public looks at us, they see people who are willing to put their name forward as people taking a risk to do this work.'

Accountancy firms have been allowed to incorporate in Hong Kong since 1996. As of 30 November 2004, a total of 163 accounting firms have incorporated, each with 10 practising directors or fewer. Incorporation offers protection for directors who are not negligent from claims against their personal assets, but may not limit the liability that arises from a director's own negligence.

## Preparing for proportionate liability

If LLPs were introduced, they would be considered an interim measure in preparation for proportionate liability, which Mr McKelvie refers to as the 'crown jewel' of liability reform. Using the term 'equitable system of liability', the HKICPA has advocated a modified system of proportionate liability for the past eight years, issuing position papers on the topic in April 2002 and October 2003.

Proportionate liability is a means of equitably dividing responsibility for a plaintiff's loss by a system of apportionment in which each culpable party pays according to their degree of blame. 'If directors are responsible for 90 per cent of losses they get to pay 90 per cent of the costs. If auditors are responsible for only 10 per cent, then they pay 10 per cent,' Mr McKelvie says, noting that the courts would decide on the percentages.

According to the HKICPA's position paper in 2003, a number of key jurisdictions, including Canada, certain states in the US, and most notably, Australia, already have or were committed to introducing proportionate liability. Britain has rejected it for auditors but plans to look more closely at introducing liability limitation by contract. The Standing Committee on Company Law Reform (SCCLR) examined the HKICPA's proposal last year. However, the SCCLR considered that it was not possible to distinguish auditors from other professionals, so far as professional liability was concerned, there was a suggestion the matter should be referred to the Law Reform Commission for further study and consideration.

'While we were a little disappointed at that, I have to admit that the SCCLR was right. The proposal has much wider implications than company law. The Law Reform Commission is the appropriate forum to consider it and refer its decisions or recommendations to the Government,' Mr McKelvie says. That process could take several years; however the HKICPA is pressing for its adoption as soon as possible.

The HKICPA's modified system of proportionate liability would include certain exceptions where joint and several liability would still apply in full force. One example would be where a defendant was found by the Court to have caused the damage or loss as a result of his fraud, dishonesty or wilful default. Another would be for actions involving personal injury. The Institute also notes that 'no award should be made in favour of the plaintiff against any defendant unless the case falls outside the exceptions and other conditions are satisfied'.

## Accepting the consequences

Mr McKelvie is quick to point out that neither proportionate liability nor LLPs are vehicles for helping accountants avoid the consequences of their actions. 'As professionals, we are perfectly willing to take the blame if we've done something wrong. And that's absolutely the right thing to do. We are there to express an opinion on which people can rely. If that opinion was wrong for whatever reason, whatever is the fair apportionment of blame, we are willing to take that.'

In recommending that the Hong Kong Government take steps to introduce 'a well-thought-out system of proportionate liability', the Institute said doing so would 'avert the possibility of a very damaging professional crisis, which would not be in the public interest and would be damaging to Hong Kong's position as a major regional financial centre'.

Mr McKelvie goes even further. 'The spectre of claims is increasing and that could have a number of effects. One is the collapse of another firm, which would leave only three that have the resources and size to deal with some of the world's largest firms. We have a very credible capital market in Hong Kong and to lose a Big Four firm would [have a negative impact] on that market,' he says.

## Need to retain the best

'Of more concern is that we won't get some of the best people coming into the profession because they won't be prepared to take the risk. If we don't have good people in this profession, then over time the quality of audits may deteriorate and that is a problem. That's a long-term big question mark. It is clearly no good for Hong Kong to have a profession that is undermanned or has a quality problem.'

A third measure favoured by the HKICPA deals with contractual limits on liability. The Institute has called upon the Government to repeal section 165 of the Companies Ordinance, which currently prohibits auditors from limiting their liability in respect of audit work.

'This is another dimension that would limit the claims against us,' he adds.

If the liability risks to accountants were more manageable, Mr McKelvie believes firms might be willing to take on clients they now feel compelled to reject. He cites new listings, especially companies expecting to list in the US market; mergers and acquisitions where accounting firms undertake due diligence on a target company; start-up businesses and some aspects of the gaming industry as assignments that could pose a significant risk.

'At the moment we have to think very hard before we take a risky client. That element may be less of an issue to us in the future because we would be able to see where our risk lies. But for many of them, the financial risk is only part of the picture. Reputational risk is the other part. Do the people we are going to do business with have integrity? Are they obeying the rules in the country in which they do business? Because we are strongly associated with our clients, that sort of reputation can reflect back on us,' he says.

Insurers that provide professional indemnity insurance (PII) might also be more willing to cover firms if they were able to quantify their liabilities. Mr McKelvie says Big Four firms find it nearly impossible to secure professional indemnity insurance in the marketplace. The HKICPA offers professional indemnity insurance coverage to members through its Master PII Policy. A total of 163 corporate practices and 222 firms were covered by the plan as of 30 November 2004. Corporate practices are required to carry professional indemnity insurance.

'One would hope that the insurance market would look at the professions in a slightly different way. If our liability is limited or capped, then theirs is too. If a claim can't go into hundreds of millions of dollars, they won't be hit with that,' he says. 'But whether it would bring our premiums down, I don't know.'

If premiums decrease, he suggests that this could have a knock-on effect on accountancy fees. 'Insurance is a big overhead for firms. If premiums came down substantially, that could well have an impact on the way we price generally. But we would still look at each client and our assessment of the engagement risk when determining our fees,' he says.

## Unanimous endorsement

Many of Mr McKelvie's colleagues in the profession enthusiastically endorse each of the measures outlined above. 'My personal view is that we should have all three and have them straightaway. It's essential that Hong Kong align itself with the rest of the world in terms of limitation of liability. It falls behind woefully now,' declares Paul Winkelmann, partner at PricewaterhouseCoopers in charge of risk and quality for Hong Kong and China.

If nothing is done to improve the situation, Mr McKelvie paints a bleak picture of what Hong Kong's future could be. 'Everybody is looking at this around the world because the independent reporting on what a company is doing is very important to a capital market,' he says. 'If the capital market doesn't have credibility, it very quickly loses its status.'

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