Australian College of Community Association Lawyers

Second Annual Conference
Tuesday 21 August 2007

Implications of the Arrow Asset Management decision

By Gary Bugden OAM

The New South Wales Supreme Court decision in *Community Association DP No. 270180 v Arrow Asset Management Pty Ltd & Ors* [2007] NSWSC 527 was handed down by McDougall J. on 30 May 2007.

The facts of the case

The case involved an attempt by the plaintiff, Community Association DP No. 270180, ("**Association**") to avoid a Site Management Agreement ('**Agreement**') entered into by it on 2 December 1998 when the Association was under the control of the third defendant, Australand Consolidated Investments Pty Ltd (known at the time as Walker Consolidated Investments Pty Ltd) ('**Australand**').

Under the Agreement –

(a) the manager, Arrow Asset Management Pty Ltd ('**Arrow**'), was the first defendant;

(b) Arrow was required to perform certain specified duties in exchange for an annual fee;

(c) the annual fee escalated each year by the higher of CPI or 5%;

(d) the term was 10 years with 2 options of up to 5 years each; and

(e) Arrow had the sole right to enter into an agreement with the Association to conduct a letting service and tenancy management service, as well as to provide ancillary services.

The Association was constituted on 27 November 1998. On 2 December 1998 when Australand owned all the lots in the community scheme, an Inaugural General Meeting of the Association was held at which Australand and its solicitors were the only persons present. At that meeting the Association resolved, inter alia, to enter into the Agreement with Arrow. The Agreement was made on the same day.

On or about 30 June 2000 the Agreement was, by Deed of Assignment, assigned to the second defendant, Bondlake Pty Ltd ('**Bondlake**'). The Association was a consenting party to that deed.

The claim

The Association in its action raised a large number of issues for determination by the Court (32 in total). However, in the event, the most significant issue was whether Australand, when it caused the Association to enter into the Agreement with Arrow, owed the Association a fiduciary duty to not place itself in a position of conflict or to profit from contracts entered into between the Association and Arrow, without proper disclosure. This was put more succinctly by McDougall J. (at paragraph 208 of his reasons) as follows:

> '*In essence, the Association's case was that Australand, as developer of the community scheme, stood in a position vis- à - vis the Association analogist to that of a promoter vis-à-vis the company promoted. It relied on the judgment of Else-Mitchell J. in* Re Steel & Ors and the Conveyancing (Strata Titles) Act 1961 (*(1968) 88 WN(PT1) (NSW) 467, and on an article by Mr David Bugden,* ***Management Rights – Are Developers Promoters?*** *(1996) QLSJ 281.*'

The discussion in this paper is confined to that issue.

The common law position

At common law a person who is involved, as a principal, in the "*birth, formation and floating of the company*" is a promoter of that company.[1] That person remains a promoter until the board of directors of the company is in place and takes control of the company.[2] During the period that a person is a promoter of a company, that person is in a fiduciary relationship with the company and under an obligation to act in good faith towards the company.[3] A promoter must make real and meaningful disclosure to company in respect of related party transactions. This requires disclosure to an independent board of the company, or if such a board is not in place, to the shareholders or prospective shareholders of the company.[4] The onus lies on the promoter to show that full disclosure has been made. Where the company is party to a contract the promoter may not retain any profit out of the transaction unless full disclosure is made. The disclosure must be made before the transaction is completed and must include the fact that there is an interest in the transaction, the nature of the interest and all other material facts.[5]

Available remedies include affirmation of the contract and an account for secret profits,[6] including interest,[7] and rescission of the contract.[8]

Disclosure

On the question of disclosure, the evidence was that –

(a) Clause 42 of the Association's Community Management Statement ('**CMS**') noted that the Association had power to enter into agreements such as the Agreement; and

(b) Clause 43 of the CMS went into considerable detail about the Association's intention to enter the Agreement and the actual terms of the Agreement.

In turn, the CMS was disclosed in the Contracts for Sale of the lots in the community scheme. However, Australand did not disclose in those contracts for sale, or

otherwise to purchasers, an agreement Australand had with Arrow providing for $190,000 to change hands in exchange for Australand procuring the Association to enter into the Agreement with Arrow.

The Court was mindful of the statutory disclosure requirements that applied to the Agreement. McDougall J. said at paragraph 218 –

> *'Clearly, any application in this case of the principles relating to fiduciaries must take account of the way in which the legislature has sought to impose duties of disclosure in certain cases, and to provide for the consequences of non-disclosure. But it does not follow from the legislative scheme that all principles relating to the obligations of fiduciaries have been excluded. In particular, I think, nothing in that scheme excludes the basic principle that a fiduciary should not benefit from its position.'*

Decision

After analysing the various cases on fiduciary duties,[9] the Court held –

1 It is appropriate to regard the developer of a community title scheme as being, vis-à-vis, the community association, in a position analogist to that of a promoter of a company.

2 The relationship between the developer and the community association is a fiduciary relationship.

3 Australand owed the Association a duty not to place itself in a position of conflict or to profit from contracts entered into between the Association and Arrow, without proper disclosure.

4 There was a clear conflict between Australand's interest and its duty. On this point His Honour said (at paragraph 231) –

> *"There was a clear conflict between Australand's interest and its duty. Australand's interest was to extract the maximum price from Arrow. That conflicted, or might conflict, with its duty to the Association: to get the benefit of management services at the most reasonable terms commercially available. Further, to the extent that the management agreement provided for an 'excessive' remuneration (see para [105(4)] above), Australand acted to the detriment of the Association in causing it to enter into the management agreement on the terms contained in that agreement."*

5 If a premium was to be paid for the making of the Agreement, it should have been paid to the Association and not to Australand.

6 Australand garnered a profit for itself, in the form of the premium of $190,000, through its exploitation of its control of the Association.

7 Prima facie, the breach of duty was not cured by adequate disclosure because, although the Agreement was disclosed, the separate agreement between Australand and Arrow under which the $190,000 was paid, was not disclosed.

8 Australand is liable to account to the Association for the profit of $190,000 it made by causing the Association to enter into the Agreement.

The Court also decided a number of other important issues that are not dealt with in this paper. One was to deny the Association equitable compensation, being the difference between the amount payable under the Agreement and an amount payable under an agreement entered into at arms length as at the date of the Agreement. This was based on two things –

(a) failure of the Association to prove its losses (because of evidentiary shortcomings); and

(b) the fact that the Agreement terminated at the end of the First Annual General Meeting pursuant to a 'trigger' in the *Strata Schemes Management Act 1996* (NSW); (this being one of the other points decided by the Court).[10]

Disclosure

The question arises whether disclosure needs to be made to all of the prospective members of the Association (i.e. the purchasers of units or land) or simply to the Association itself. Australand submitted that disclosure could be made to a completely independent board of directors or to the existing and potential members of the Association. This submission relied on a statement of principle in the 6th Edition of Gower, ***Principles of Modern Company Law*** which was accepted by Austin J. in *Aequitas v. A.E.F.C.* (2001) 19 ACLC 1006 at 1069 [293] in the following terms:

> *"The position therefore seems to be that disclosure must be made to the company either by making it to an entirely independent board or to the existing or potential members as a whole. If the first method is employed the promoter will be under no further liability to the company, although the directors will be liable to the subscribers if the information has not been passed on … . If the second method is adopted disclosure must be made in the prospectus, or otherwise, so that those who are all or become members, as a result of the transaction in which the promoter was acting as such, have full information regarding it. A partial or incomplete disclosure will not do; the disclosure must be explicit."*

Clearly, in the current case the executive committee or board was made up by the sole representative of Australand, so there could be no disclosure to a completely independent board of directors.

Alternatively, Australand relied upon the doctrine of unanimous consent. It submitted that there had been full disclosure to the Association's sole member, Austaland, at the time of the impugned conduct. That proposition was rejected by the Court given the intent of the law on these matters to protect future shareholders.

The conclusion is that, in the case of a normal transaction for the sale of management rights by a developer, the required disclosure and informed consent must be made to and obtained from the purchasers of all of the units or land in the community titles scheme being promoted.

Application to Queensland

In New South Wales, section 24 of the *Community Land Management Act 1989* (NSW) applies to certain service agreements with an association or members of an association. Section 24(2) provides for such an agreement entered into during the initial period to terminate at the end of the first annual general meeting unless "its effect" was disclosed in the association's management statement before the transfer of any lots in the scheme, or it is ratified at the meeting. This is the sub-section that triggered the termination of the Agreement in the case under consideration.

In Queensland, section 213 of the *Body Corporate and Community Management Act 1997* (Qld) ("**Act**") effectively requires a developer to disclose in relation to management rights agreements:

- the terms;
- the estimated cost to the body corporate; and
- the proportion of the costs to be borne by the purchaser.

Disclosure usually includes annexing a copy of the agreement to the contract of sale. However, disclosure never involves disclosure of the transaction under which the management rights (including the agreements) are sold.

Apart from this provision there are a number of other provisions that need to be considered:

- Section 112 of the Act imposes obligations on a developer procuring a body corporate to enter into a service contract or letting authorization during an "original owner control period". These obligations are designed to ensure that the contract or authorization is fair and reasonable.
- Section 113 of the Act prohibits the body corporate from receiving a payment or benefit for entering into a service contract or letting authorization.
- Sections 114 and 115 prohibits an engagement or authorization itself having a requirement for a payment or a benefit for entry into the engagement or authorization.

Clearly, these provisions give rise to an argument in Queensland that the legislative scheme intends to prevent a body corporate from profiting from the sale of management rights so as to facilitate such a sale by the developer. In exchange, the body corporate is protected by the provision requiring the developer to ensure that any contract or authorization is fair and reasonable.

Relevant to this argument are the provisions of section 87 of the *Body Corporate and Community Management (Standard Module) Regulation 1997* (and the corresponding provision in section 85 of the *Body Corporate and Community Management (Accommodation Module) Regulation 1997*). That section requires for a service contract or letting authority an ordinary resolution passed by secret ballot, without proxy votes and with voters having the benefit of a range of information about the

documents to be entered into. However, section 87(3) of the Standard Module (section 85(3) of the Accommodation Module) provides that the secret ballot requirement does not apply if all the lots are held by the same person.

The question is whether these provisions displace the common law relating to promoters. If they do not, then a Queensland developer may well be regarded as a common law promoter of membership of a body corporate with the resulting fiduciary relationship requiring full disclosure of any benefit gained out of the sale of the management rights. This would open the remedies of account for profit and equitable compensation. This would need to be supported by the argument that the prohibitions on the body corporate benefiting from a person entering into a service contract or being granted a letting authority do not extend to an award for compensation in favour of the body corporate.

On balance, I am inclined to the view that in Queensland the common law relating to promoters has been displaced by the legislative provisions to which I have referred. However, it should also be remembered that those provisions were only introduced to the Act and modules in March 2003. Therefore, one cannot rule out a claim being made within the next couple of years (being the run-out of any limitation period) based on the former provisions of the Act, which would generally be supportive of the principles decided in the *Arrow Management case*. There is also the prospect of a claim in relation to those bodies corporate still regulated under the *Building Units and Group Titles Act 1980*, as well as those regulated under the *South Bank Corporation Act 1989*.

Other Implications for Developers

Therefore, the direct implications of this decision potentially extend to all Australian jurisdictions and are not confined just to New South Wales. The possible constraints that exist in Queensland may not exist in other Australian jurisdictions. The direct implications are:

- The ‘non unit’ components of management rights (i.e. the management and letting agreements) belong to the body corporate and not to the developer.

- If the developer is to ‘sell’ those rights and profit personally from the sale, it must make ‘full disclosure’ and obtain ‘informed consent’ from those persons purchasing units and proposing to become members of the body corporate.

- Full disclosure would need to include the actual price, plus ‘all relevant information’ about the sale of the management rights. This would extend to information relevant to the reasonableness of the fee having regard to the services to be provided.

- Where this does not occur, the body corporate:

    - will be entitled to receive the profit (i.e. the consideration for the sale); and

    - may be entitled to equitable compensation or an account for profits if the relevant agreement is continuing and the fee under that agreement is

excessive for the services provided or is likely in the future to become excessive.

Perhaps the most serious indirect implication is the real possibility of existing bodies corporate of some years standing suing the developers of their schemes to recover amounts received by the developers on the sale of the 'non unit' components of management rights. Of course, such action would need to be taken within the relevant limitation period.

Also, the implications may not be confined to management rights agreements. Take for example a developer who enters into an agreement with a body corporate manager for advice on structuring issues relating to a new project and/or the set up of the body corporate records for a nominal or concessional fee. If that occurs on the understanding that the developer will procure the grant of an appointment as body corporate manager, there may be further implications for the developer.

The reduced fee on the consultancy arrangement is a benefit to the developer potentially at the expense of the body corporate. This breaches the developer's fiduciary duty and thereby requires full disclosure to and the informed consent of the purchasers. In the absence of those, on the principles in the *Arrow Management case*, the developer must account to the body corporate for the benefit gained.

Again, there is the possibility of historical claims by bodies corporate, subject again to the relevant limitation period.

The decision in the *Arrow Management case* ushers in an entirely new chapter in the Australian management rights industry. This time the spotlight is clearly focussed on the performance of the developers and, as the play unfolds, the on- site managers can safely take a place in the audience for a change. Or can they? What about secret commissions?

---

[1] Whaley Bridge Calico Printing Co v. Green (1879)5 QBD 109, Bowen J at 111.

[2] Twycross v. Grant (1877) 2 CPD 469 (CA), Cockburn CJ at 541.

[3] Twycross v. Grant (supra) and Lagunas Nitrate Co v. Lagunas Syndicate [1899] 2 Ch 392 at 428.

[4] Gluckstein v. Barnes (Official Receiver & Official Liquidator of Olympia Ltd) [1900] AC 240.

[5] Re Darby, ex p Brougham [1911] 1 KB 95; A-G for Canada v. Standard Trust Co of New York [1911] AC 498, PC; Emma Silver mining Co v Grant (1879) 11 ChD 918.

[6] Lydney and Wigpool Iron Ore Co v. Bird (1886) 33 ChD 85 CA.

[7] Gluckstein v. Barnes (supra).

[8] Erlanger v. New Sombrero Phosphate Co (1878) 3 App Cas 1218, HL.

[9] From Para 216 of the judgment: "See (by way of example only) *Tracy and Others v Mandalay Proprietary Limited* (1953) 88 CLR 215. However, to say that one person stands in a fiduciary position vis-à-vis another is to begin, not to end, the enquiry: see the observation of Frankfurter J in *Securities and Exchange Commission v Chenery Corporation* (1943) 318 US 80 at 85, 86, cited with approval by the majority (McHugh, Gummow, Hayne and Callinan JJ) in *Pilmer and Others v Duke Group Limited (In Liquidation) and Others* (2001) 207 CLR 165 at 198-199 [77]. Their Honours earlier at 197-198 [74] had referred with approval to the observation of Gaudron and McHugh JJ in *Breen v Williams* (1996) 186 CLR 71 at 113, that the obligations of a fiduciary are proscriptive - "not to obtain any unauthorised benefit from the relationship and not to be in a position of conflict" - and not positive (or prescriptive): "positive legal duties on the fiduciary to act in the interests of the person to whom the duty is owed.""

[10] Section 24 of the *Community Land Management Act 1989* (NSW) applies to certain service agreements with an association or members of an association. Section 24(2) provides for such an agreement entered into during the initial period to terminate at the end of the first annual general meeting unless "its effect" was disclosed in the association's management statement before the transfer of any lots in the scheme, or it is ratified at the meeting. In *Hudson Property Group Pty Ltd v Community Association DP 270238* [2005] NSWCA 374 the Court of Appeal held that disclosure similar to that in the CMS referred to in this paper did not satisfy the requirements of section 24(2) and therefore the subject agreement terminated at the end of the first annual general meeting. It followed that McDougall J held that the Agreement also terminated at the time of the first annual general meeting of the Association.