Arrow Asset Management Case has Implications for the Whole of Australia

A recent decision of the New South Wales Supreme Court potentially has far reaching repercussions for the residential real estate development industry in Australia.

The 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 case involved an attempt by the 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 was the first defendant, Arrow Asset Management Pty Ltd ('**Arrow**');

(b) the manager 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) the manager 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 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, 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.’*

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.’*

After analysing the various cases on fiduciary duties, 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 article. One was to deny the Association equitable compensation and an account for profits on the Agreement. This was based on two things –

(a) failure of the Association to prove either the profit or 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).

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.

Other Implications for Developers

The direct implications of this decision extend to all Australian jurisdictions and are not confined just to New South Wales. Some of these 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 implication is the real possibility of existing bodies corporate of some years standing suing the developers of their schemes for 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. Where a developer enters into an agreement with a body corporate manager for advise on structuring issues relating to a new project and/or the set up of the body corporate records for a nominal or concessional fee, in consideration of the developer procuring 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?

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