Strata Management Revenue Model – Sustainable?

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The origins of the current strata management revenue model date back to the early days of specialist strata management and has substantially been driven by the cost sensitivity of the market in which strata managers operate.

As early as the mid 1970's when specialist strata management firms began to emerge, the market was extremely sensitive to the headline level of management fees. This lead to a very competitive market as the early firms tried to build their businesses. Another factor at the time, which still exists today, was the tendency of "back yard operators" (i.e. new businesses working from home with very low overheads) to market their services for very low fees.

This trend continued throughout the next 2 decades and has resulted in the current situation where the headline annual fee is still very competitive and the subject of sharp focus by bodies corporate considering which strata manager to appoint to manage their schemes.

The industry response has been to find ways of charging "extras" that are not reflected in the annual management fee, or by providing extra services that are charged to owners and others rather than the body corporate itself. Some managers have been very innovative in the way in which they devise and charge for these extras. This has tended to deflect attention from the annual management fee itself and thus allow the manager to make a reasonable profit from the overall revenue; a profit that would not be achievable if the management fee alone was relied upon.

The underlying problem

There is a problem with this approach – a problem that is not well understood among managers. The problem arises as a consequence of the legal relationship between the manager and the body corporate they manage. In legal terms, this relationship is one between a principal and agent and is known as a "fiduciary relationship". In practical terms, it is a "relationship of good faith". Under this relationship, the agent owes the principal a number of "fiduciary duties". One of these duties is not to profit from the relationship. There are 2 exceptions to this –

- The agent is entitled to any agreed remuneration for services provided within the relationship (i.e. the agreed fees and expenses).
- The agent can benefit from the relationship in other ways if there is full disclosure from the agent to the principal and this is followed by the informed consent of the principal.

The first exception does not usually cause any problems. However, the second exception is riddled with potential problems for the agent. This is because of the meaning the Courts have given to the requirements of full disclosure and informed consent.

Full disclosure

Full disclosure requires something more than a mere disclosure of the existence of the transaction or profit. For example, if a manager is to receive an insurance commission for placing a body

corporate's insurance business, it is not sufficient that the agent discloses the fact the commission is to be received. In order for there to be full disclosure there would need to be –

1. Disclosure before the transaction.

2. Detailed disclosure of the transaction itself (i.e. the parties and terms and any implications for the principal).

3. Disclosure of the actual amount of the profit.

In relation to item 3, if the actual amount is not known at the time the disclosure is made, the law regards it as sufficient if the advance disclosure is as detailed as practicable (e.g. 15% of the premium component of the insurance costs) and is followed by disclosure of the actual dollar amount once that is known. In these circumstances it does not matter that the supplementary disclosure occurred after the benefit accrued.

Informed consent

Informed consent is not the same as consent. Informed consent requires a full understanding of the transaction and the possible implications of that transaction. In many cases informed consent will require a body corporate to receive independent legal advice before the consent is given. In the case of the insurance commission it is arguable that independent legal advice would not normally be required if the relevant officers of the body corporate are experienced business people capable of understanding the nature and implications of the transaction. However, one should not overlook the possibility that, in relation to insurance commissions, independent legal advice may be necessary in a particular case, or in all cases for that matter.

Other transactions have a much higher degree of certainty. Take for example, the situation in Queensland where a body corporate manager provides written information known as a Disclosure Statement to owners selling their units. This information (which is not required to be given by the body corporate) is disclosed in the sale contract and becomes the subject of a statutory warranty. If the warranty is breached (i.e. because the information is inaccurate or incomplete), then there will be a liability for damages. The following will be relevant to that liability –

1. The information provided belonged to the body corporate.

2. It was provided voluntarily.

3. A fee was charged for the information.

4. The person providing the information (i.e. the body corporate manager) was the agent of the body corporate and at least implicitly was acting in that capacity.

5. The act of an agent is the act of the principal.

6. The body corporate was aware, or should have been aware, that its agent was providing the information.

It follows that the liability in most, if not all cases, will fall on the body corporate. Although the body corporate may have recourse against the agent, the fact is that the body corporate will potentially

incur a liability and be subjected to legal proceedings as a consequence of the actions of the agent providing information for a fee that is not required to be provided under the governing legislation. And, of course, it is the manager that profits from the transaction – the consequence being that the manager profits while the body corporate carries substantial risk.

Clearly, for there to be informed consent to this type of transaction the body corporate would need to receive independent legal advice before it gives its consent. A lawyer advising the body corporate may well consider one or more of the following to be necessary –

- Advice that the body corporate should not provide its consent given that it receives no benefit in exchange for exposing itself to potential liability. (Based on normal business risk management principals it makes no sense for a body corporate to consent outright to this type of transaction.)
- Advice that consent should only be given if the agent enters into a formal Deed of Indemnity in favour of the body corporate.
- Advice that the information should be given on the basis that the agent is the person liable and not the body corporate and the recipient of the information agrees to that basis.
- Advice that all or part of the fee should go to the body corporate.

Remedy for breach

The remedy for breach of the fiduciary duty not to profit from the fiduciary relationship is an “account for profits”. In other words, if a body corporate successfully establishes a breach of this duty, then it will be entitled to receive from the manager what the manager originally received from the third party (e.g. the fees earned in providing the unauthorized information, without any allowance for the costs involved in providing that information).

From a business perspective, the risk of future recovery and the impact this could have on the business is not insubstantial.

Secret commissions distinguished

All Australian States, as well as the Commonwealth, have criminal laws dealing with secret commissions. Potentially, any benefit a strata manager receives outside their normal fee structure is a secret commission. To avoid this, the body corporate must consent to the transaction, or in some cases, to at least be aware of it. However, the level of knowledge and consent is much lower than the knowledge and consent required under a fiduciary relationship. To this extent, little is gained by comparing the requirements to avoid a secret commission with the requirements to avoid a breach of fiduciary duty.

Conclusion

Despite the best efforts of legal draftspersons who craft the terms of standard strata management agreements, from a business risk management perspective, strata managers would be well advised to seriously reduce the services used to generate revenue outside the annual fees per unit charge. Inevitably, this will drive a need to increase the annual fees per unit. However, this may well be an

opportunity rather than a treat if it is marketed positively and pampers the current market dissatisfaction with “hidden extras” in strata management agreements. It is also a better revenue model from a straight business perspective.

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* **Gary Bugden** has seen the development of the current strata management revenue model since the early 1970’s. With his mother in Sydney in 1973, he established Residential Unit Management Pty Ltd, Australia’s first specialized strata management business. In its day that business experienced many of the same problems and issues that current strata management businesses are experiencing.