Conflicts of Interest in Strata

What are conflicts of interest and how can they be managed?

STRATA KNOWLEDGE

Background

Over the last decade, legislative provisions have increasingly been embedded in our strata laws to deal with conflicts of interest. Various terms and phrases are used to describe these conflicted interests. However, the main legal mechanism used to limit potential negative impacts is disclosure. Regulators assume that in disclosing the conflict or potential conflict, affected parties can discount any biased or contaminated information and make an appropriate and informed decision.

Numerous studies have shown that disclosure is not an effective panacea to overcome the potential problems associated with conflicts of interest.

But before we get ahead of ourselves, we need to have a better understanding of what conflict of interests are.

Generally, conflicts of interest exist where one party (who owes duties) acts in their own self-interest usually (but not always) to the detriment of another. More specifically:

A conflict of interest exists in any situation in which an individual has difficulty discharging the official duties attaching to a position they hold because:

1. there is an actual or potential conflict between their own personal interests and the interests of the person to whom they owe the duty, or

2. the individual has the desire to promote the interests of a 3rd party and there is an actual or potential conflict between promoting the 3rd parties' interests over the interests of the duty owed.[1]

It is useful to break down this definition to understand who the parties to a conflict of interest might be and in what circumstances the conflict might arise. These elements are important:

1. The **nature of the relationship** – based on reliance and trust. Often arises where one party is a professional or agent of another and the other is a client or more vulnerable party.
2. **Obligation or duty to act** in a certain way – we need to be able to determine the duty or obligation. This requires not only a segregation of competing interests but an elevation of the reliant party's interests ("best interests") or a displacement of the professional's own interest ("fiduciary").
3. The **situation -** that may or does give rise to competing interests and includes an action, decision, advice, or guidance.

Essentially, any professional who has a duty to act in the interests of another, provides advice or guidance, takes action, or makes decisions on behalf of another is susceptible to conflicts of interest.

In strata, owners corporation[2] managers, building managers, developers, lawyers and committees all fall into this group.

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[1] Thomas L Carson, 'Conflicts of Interest' (1994) 13 Journal of Business Ethics 387, 388

[2] The term 'owners corporation' is used generically to refer to any private governing entity created under a strata or community title arrangement (e.g., body corporate, strata company, association).

Research has shown that owners corporation managers and developers are frequently placed in situations where they are confronted with conflicts of interest.

Why?

Conflicts of interest are most prevalent in settings where there is complexity to the services being offered, there is a high reliance on the duty-bound person, or the duty-owed person lacks the knowledge to correctly evaluate the information being provided.

The voluntary nature and apathy of committees in strata schemes married with the regulatory environment, places a high level of reliance and trust in managers to assist in the operation of schemes. Similarly, the governance or other arrangements instituted by developers are often ignored or not sufficiently understood by incoming strata buyers to evaluate the consequences of the decisions made.

As a result, managers and developers are in best place to benefit from another interest without being detected.

Research Findings

The Director of Strata Knowledge has undertaken two specific research projects aimed at exploring situations in strata that give rise to conflicts of interest and how these conflicts are avoided, mitigated, or managed.

The first project focused specifically on developers of strata schemes and the second focused on strata managers.

We found that conflicts of interest can arise from competing roles (e.g. when the developer is also the committee, or when a manager is also a service provider) or due to specific relationships (e.g. with other service providers).

Property developers often have multiple and competing roles when creating a strata scheme. This gives rise to conflicts of interest. Developers are responsible for implementing governance arrangements in order for the scheme to operate upon its inception. Therefore, there are numerous opportunities for developers to act in their own self-interest with little detection. Research has shown that developers often make decisions that are not only conflicted but lead to unfavourable outcomes for the owners corporation. Some arrangements include:

- engagement of a caretaker (where the terms are less favourable to the owners corporation)
- engagement of a strata manager (where developers receive free or low-cost advice in exchange for a non-negotiated management agreement)
- leasing and licensing arrangements where the developer or associate benefit from the arrangement at the expense of the owners corporation
- engagement of supply contracts where the developer receives a benefit (usually in the form of scheme infrastructure in return for a non-negotiated contract)

Some strata managers also have multiple and competing roles that give rise to conflicts of interest. Our research found that managers have taken on competing roles as committee members, insurance brokers and facility managers. They also have relationships with service providers that can lead to situations where the manager receives a benefit from the provider (financial or otherwise). Such arrangements include:

- engagement with developers in exchange for management agreements where the manager receives no payment or little payment for the work undertaken to assist in the structuring of the scheme

- engagement with service providers where sponsorship is provided in exchange for preferred trade lists
- insurance commissions

Lessons and Implications

In an ideal strata world, these types of conflicts of interest would be avoided altogether but that is unlikely and certainly not realistic. Therefore, it is up to each duty-bound party to carefully consider the advice they give, the decisions they make, and the actions they take that may give rise to a conflict of interest. A critical and independent assessment should be made of current practices to ensure the best approach is undertaken to minimise the impacts of any conflicted interest.

Although some governments have become aware (to varying degrees) of the potential harms that can be caused in strata schemes by these types of conflicted arrangements, the common response is to insert a disclosure provision in the legislation that effectively absolves duty-bound parties. These disclosure mechanisms are often perceived as a form of transparency but rarely is transparency achieved. Although duty-bound parties should always abide by their statutory obligations around disclosure, consideration should be given to take additional steps toward transparent disclosure.

Prohibition is rarely used and when it is, usually the parameters don't go far enough to effectively stop the conflicted interest.

Although this paper presents a bleak picture, more strata management companies are taking steps to avoid conflicts of interest or at least mitigate these conflicts. This is done by establishing ethical protocols aimed at enhancing transparency and developing professional norms. This is an issue that should be part of the strata management and property development industries professional development.

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