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Strata and Community Titles

**Conveyancing Due Diligence
on Owners Corporations**

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Conveyancing Due Diligence on Owners Corporations

1. Introduction

- 1.1 Due diligence in relation to strata title owners corporations and community title associations (which I will generally refer to as “owners corporations”) involves the inspection of the books and records of the corporation or association with a view to determining –
- The financial health of the owners corporation and, in particular, any unfunded liabilities
 - The general state of repair of the building and, in particular, whether there are any known building defects
 - The state of harmony within the building
 - The standard of record keeping and relevant information from those records
 - Management irregularities that can adversely impact on a purchaser, such as levies being imposed otherwise than in proportion to unit entitlements
 - Any future risks that the purchaser should be aware of, such as inadequate insurance covers, outstanding notices or orders.
- 1.2 The practice of purchaser’s solicitors carrying out inspections of owners corporation records commenced in the mid-1970’s. This practice gained momentum around 1980 after the New South Wales Law Society publicly expressed the view that a purchaser suffering loss as a result of the failure of their solicitor to carry out an inspection would potentially result in the solicitor being liable in negligence for the loss.
- 1.3 This practice is still common, but is clearly not universal. Furthermore, there is ante dotal evidence to suggest that –
- The importance of owners corporation due diligence is not fully appreciated by solicitors and conveyancers
 - The due diligence reports, when obtained, are not being properly analysed by solicitors and conveyancers
 - The results of the due diligence process and the implications of its outcomes are not being adequately communicated to purchasers.
- 1.4 In this paper I will endeavour to provide guidance in respect of all of those matters.

2. Nature of an owners corporation

- 2.1 While this section deals specifically with owners corporations, the effect of the community titles legislation is substantially the same in relation to the various associations regulated by that legislation. It is therefore appropriate to assume that a purchaser of a community title lot is in substantially the same position as the purchaser of a strata title lot.
- 2.2 An owners corporation is automatically constituted upon registration of a strata plan, vide section 11 of the *Strata Schemes Management Act 1996* (“SSM Act”). It is governed by a voluntary non-professional executive

committee (secs 16-21 SSM Act), whose performance is often unpredictable. Management of the owners corporation is undertaken by either:

- A voluntary secretary (sec 22 SSM Act)
- A strata managing agent (sec 28 SSM Act).

The strata managing agent is usually delegated certain of the functions of the owners corporation (sec 28 SSM Act). This delegation is usually fairly extensive and puts the owners corporation in the position of being bound by the acts of the strata managing agent. The legislation actually provides that the act of a strata managing agent exercising a delegated function is taken to be an act done or suffered by the owners corporation (sec 28(7) SSM Act).

2.3 An owners corporation has fairly extensive powers, including the power:

- To borrow money (sec 110 SSM Act)
- To provide amenities or services to lot owners (sec 111 SSM Act).

Furthermore, an owners corporation can sue and be sued in its corporate name and can commit a crime and be liable to monetary penalty (sec 50(1) *Interpretation Act 1987*). To offset risks associated with these “qualities”, an owners corporation has the power to effect a range of insurances (Ch 3 Pt 4 SSM Act).

2.4 An owners corporation is also given responsibility for the management and control of the common property and the administration of the strata scheme, including the maintenance and repair of the common property (sec 61 SSM Act).

2.5 To fund all these things an owners corporation imposes contributions or levies on lot owners (sec 76 SSM Act). These levies are imposed in proportion to the unit entitlements of the lots and if an owners corporation is short of funds because some owners have not paid their levies, then pending payment, it must re-levy on those owners who are willing or able to pay. The net effect of this is that the burden ultimately falls on the owners who are able to pay the levies. Theoretically, the other owners can be pursued to their bankruptcy.

2.6 It follows that an owners corporation confronted with a large unfunded liability must impose levies on lot owners to raise the funds to discharge that liability. A good (although) extreme example arose in Perth a few years ago when a balcony collapsed and badly injured a group of medical specialists attending a party in the unit. The owners corporation was insured for \$10 million but the claims made against it totalled in excess of \$30 million. When the litigation is finalized the owners corporation will need to fund any amount awarded in excess of the \$10 million by imposing levies on the lot owners. Any lot owner unable to pay may be confronted with bankruptcy.

2.7 This raises the question whether the strata scheme can be terminated and the owners corporation wound up to limit the liability of lot owners. The simple answer is “No”. This is because of the provisions in the SSM Act dealing with termination and winding up. Termination can occur in one of 2 ways:

- Voluntary by all lot owners under sec 51A of the *Strata Schemes (Freehold Development) Act 1973* (“SSFD Act”)
- By order of the Supreme Court under sec 51 of the SSFD Act.

- 2.8 In the case of a voluntary termination former lot owners are liable for the outstanding liabilities of the owners corporation in shares proportional to the unit entitlements of their former lots (sec 51A(8) SSFD Act). In the case of a termination by order of the Court, sec 51(6) SSFD Act requires the order of the Court to include directions with respect to the discharge of the liabilities of the owners corporation. Having regard to:
- (a) the limited options available to the Court;
 - (b) the provisions of sec 51A(8) of the SSFD Act; and
 - (c) the fact that sec 15(2) of the SSM Act provides that after termination of the scheme and pending the winding up of the owners corporation, the owners remain liable for the liabilities of the owners corporation in proportion to their unit entitlements,

it is virtually inevitable that the Court will order the lot owners to discharge the liabilities of the owners corporation in shares proportional to the unit entitlements of their former lots.

- 2.9 This is supported by the decision in *Pritpro Pty Ltd & Ors v. Willoughby Municipal Council* (NSW Supreme Court, 18 March 1986) where Young J said:

“The function of the Court under section 51 is to ensure that no one is prejudiced by the termination of the scheme and the virtual subsuming of the strata lots into one non-strataed lot. Furthermore, there must be protection to creditors both actual and contingent who may have charges on the building or against the body corporate.”

His Honor then went on to adopt a procedure similar to that adopted by the Court when dealing with applications by companies for reduction of capital.

- 2.10 The net affect of all this is that an owners corporation is effectively an unlimited liability company. Therefore, when a purchaser buys a strata lot they are effectively acquiring, in addition to the real estate, an interest in and membership of an unlimited liability company. This should clearly signal to solicitors and conveyancers acting for purchasers a prima facie need to undertake a due diligence exercise in relation to the owners corporation. But first, need has to be tested against any protective mechanisms otherwise available to purchasers.

3. Statutory protection for purchasers

- 3.1 Apart from remedies available under general consumer protection legislation, such as the Trade Practices Act, there are only 2 strata specific provisions designed to protect purchasers of strata properties:

- A certificate from the owners corporation under sec 109 of the SSM Act
- The right to search the owners corporation’s records under sec 108 of the SSM Act.

- 3.2 The certificate under sec 109 deals with the following:

- Current levy information, including amounts outstanding
- Particulars of certain other moneys recoverable from the lot owner
- Names and addresses of executive committee members

- Name and address of any strata managing agent
- Name and address of any caretaker
- Unregistered by-laws
- Particulars of all insurance policies held by the owners corporation.

If the particular strata scheme is also part of a community titles scheme, then certain levy information must be given in relation to the community association.

- 3.3 This certificate is very important to protect the purchaser against becoming liable for unpaid levies. The purchaser, as an incoming owner of the lot, will become jointly and severally liable with the outgoing owner for any outstanding levies (see sec 78(3)). The owners corporation's certificate is conclusive evidence, as at the date of the certificate, of the matters stated in it in favour of a person taking for valuable consideration a relevant interest in the lot the subject of the certificate (sec 109(8)).
- 3.4 However, an examination of the content of the certificate shows that it offers little protection against unfunded owners corporation liabilities, or such things as building defects and information about living conditions within the scheme. Furthermore, there is little scope for the Government to expand the content of the certificate to cover such things because:
- The quality of and accuracy of the information in many certificates is already poor given the current content requirements and increasing the content is likely to further impact adversely on such quality and accuracy.
 - Ultimately, the owners corporation has to stand behind the information in the certificate and it is not a very satisfactory situation for the incoming owner to have to sue the owners corporation (and their new neighbours) to be compensated for any loss.
- 3.5 An inspection under sec 108, which can be requested by the lot owner, or a person authorized by the owner, provides access to virtually all of the available books and records of the owners corporation. The person inspecting may take extracts of documents or make copies of them. This right to inspect is the core of the due diligence processes the subject of this paper.
- 3.6 The position in New South Wales is in direct contrast to the position in Queensland. In that State the *Body Corporate and Community Management Act 1997* contains an entire part of a Chapter (Ch 5 Pt 3) dealing with non-excludable implied warranties in favour of purchasers. Five sections confer extensive and very effective protection on purchasers (including an imputed knowledge provision) using the principle that a vendor must extensively disclose in the contract certain:
- Latent or patent defects in the common property or body corporate assets
 - Actual, contingent or expected liabilities of the body corporate that are not part of normal operating expenses
 - Circumstances regarding the body corporate's affairs that will exist at completion which may materially prejudice the purchaser.

3.7 The principal remedy for breach of the Queensland warranties is cancellation of the contract, although damages are available as an alternative to cancellation.

4. Contractual protection for purchasers

4.1 The approach to strata related purchaser protection in New South Wales has always involved the inclusion of warranties in the standard “*Contract for the sale of land*” issued by The Law Society of New South Wales and The Real Estate Institute of New South Wales (“**Standard Contract**”). All past versions of the Standard Contract have had provisions to protect purchasers against unfunded liabilities of owners corporations.

4.2 In the current edition, clause 23 deals with strata or community title. The provisions of that clause relevant to this paper are (the highlighted words being defined):

“23.5 *The parties must adjust under clause 14.1*

23.5.1 *a regular periodic **contribution**;*

23.5.2 *a **contribution** which is not a regular periodic **contribution** but is disclosed in this contract; and*

23.5.3 *on a unit entitlement basis, any amount paid by the vendor for a **normal expense** of the owners corporation to the extent the owners corporation has not paid the amount to the vendor.*

23.6 *If a **contribution** is not a regular periodic **contribution** and is not disclosed in this contract*

23.6.1 *the vendor is liable for it if it was levied before the contract date, even if it is payable by instalments; and*

23.6.2 *the vendor is also liable for it to the extent it relates to work started by the owners corporation before the contract date.*

23.7 .

23.8 *Normally, the purchaser cannot make a claim or requisition or rescind or terminate in respect of*

23.8.1 *an existing or future actual, contingent or expected expense of the owners corporation;*

23.8.2

23.9 *However, the purchaser can rescind if*

23.9.1 *the **special expenses** of the owners corporation at the later of the contract date and the creation of the owners corporation when calculated on a unit entitlement basis (and, if more than one lot or a higher scheme is involved, added together) are more than 1% of the price;*

23.9.2 ”

4.3 For the purpose of these provisions:

“ **contribution** *includes an amount payable under a by-law;*

normal expenses , *in relation to an owners corporation for a scheme, means normal operating expenses usually paid from the administrative fund of an owners corporation for a scheme of the same kind;*

special expenses, in relation to an owners corporation, means its actual, contingent or expected expenses, except to the extent they are normal expenses, due to fair wear and tear, or disclosed in this contract.”

4.4 The first point to be noted concerns the circumstances in which contributions are adjusted. Under clause 23.6, if a contribution is not a regular periodic contribution (i.e. it is what has commonly been called a “special levy”) and it is not disclosed in the contract then the vendor will be liable for it in one of 2 circumstances:

- If it was levied before the contract date (even if payable by instalments)
- If it relates to work started by the owners corporation before the contract date.

Neither of these circumstances can be ascertained from the sec 109 certificate made available shortly before completion of the contract and, presumably, the vendor will not be too keen to draw these circumstances to the attention of the purchaser (assuming that the vendor understands the intricacies of the Standard Contract provisions). Therefore, the due diligence process will be essential to alert the purchasers solicitor or conveyancer to the need to adjust the so called special levies.

4.5 The next point to be noted is the right of the purchaser to rescind the contract if the special expenses at the later of the contract date and the creation of the owners corporation, calculated on a unit entitlement basis, exceed 1% of the price. The inclusion of the date of creation of the owners corporation is intended to accommodate “off the plan” contracts where the owners corporation is not in existence as at the date of the contract. This avoids the problem highlighted in *Gelski v. Dainford Limited* (1985) NSW Title Cases ¶30-061 where it was held that a purchaser could not rescind because a similar warranty had not been breached as at the date of the contract when the owners corporation was not then in existence.

4.6 This right of rescission is potentially very dangerous for a vendor, particularly if there is a simultaneous sale and purchase involved. First of all, 1% of the price is not a large sum of money (e.g. on a purchase price of \$600,000 it is only \$6,000). Secondly, “special expenses” can be very high in the case of many strata schemes. This is because “special expenses” are actual, contingent or expected expenses except to the extent that they are:

- (a) “normal expenses”;
- (b) due to fair wear and tear; or
- (c) disclosed in the contract.

In turn, “normal expenses” are normal operating expenses usually payable from the administrative fund.

4.7 Building defects, as well as a raft of other expenses, many of them contingent (such as uninsured liabilities), are clearly not covered by the exclusions from the warranty. Yet building defects are probably the most common problem currently confronting owners corporations. Furthermore, building defects are usually expensive to rectify.

4.8 To illustrate by example; in a new 6 lot building there are significant building defect problems. Lot 3 is under contract for \$455,000 and has a unit

entitlement of 25 out of an aggregate of 120. If the cost of fixing the building defects equal or exceed \$21,841, then, in the absence of a disclosure in the contract, the purchaser has a right to rescind. *It is even irrelevant that the owners corporation may have funds in hand of say \$85,000.*

5. Obligations of the purchaser's solicitor

- 5.1 Depending upon the instructions under which the purchaser's solicitor or conveyancer are operating, they must determine whether there is any breach of the vendor's warranties and advise the purchaser of the results so that the purchaser can decide whether to rescind the contract, (possibly) claim damages or decide to waive the breach. If the solicitor or conveyancer fails to do this then, in my opinion, they will be negligent.
- 5.2 The due diligence process (i.e. the inspection of the owners corporation's records) is the means used by the solicitor or conveyancer to determine whether there has been a breach of the vendor's warranty.
- 5.3 That raises the question – Who should carry out the due diligence (inspection)? There are a number of options:
 - The solicitor or conveyancer
 - A clerk or conveyancing secretary of the solicitor
 - The purchaser themselves
 - A professional search agent.
- 5.4 Because of the complexities associated with owners corporation records and current issues with inspection practice (which I will touch on later in this paper) if it is to be done “in house” or if the client is to be involved special training or instructions would be very desirable.

6. Scope of the due diligence process

- 6.1 A thorough due diligence process will involve the following aspects of the administration of the owners corporation:
 - Strata Roll
 - Insurance policies
 - Register of Notices and Orders (including the copies of notices and orders)
 - Accounting records (including bank statements)
 - Maintenance contribution records (including owner's ledger account) – all of which can be either non-existent or very unreliable in the case of self-managed schemes and some professionally managed schemes.
 - By-laws
 - Strata managing agent information (including inspection of licence)
 - Caretaker information
 - Minutes of executive committee and general meetings
 - Income tax returns and assessments
 - Correspondence and documents on various files (mainly related to building defects and disharmony within the scheme)

- Dispute records
- General information (such as recent repairs and maintenance undertaken, number of tenanted units, etc.).

6.2 It is always difficult to determine how far back the due diligence exercise should extend and how thorough it should be (i.e. what records should be skimmed rather than read). Professional searchers will usually search for at least the past 2 years, although some go back 6 years and even further. Minute books in particular should be thoroughly searched over an extended period of time. As a rule of thumb, the average scheme will take around 1½ to 2 hours to complete. However, some schemes have been known to take the best part of a full day to complete.

7. **Alternative to due diligence**

7.1 As an alternative to undertaking a due diligence process, the purchaser can instruct his or her solicitor or conveyancer not to undertake the process at all on the basis that they will accept the risk involved. Those instructions would need to come from “an informed client”. Therefore, before a solicitor or conveyancer relies on such instructions they should advise the client about:

- The nature of their liability as a unit owner
- Why a due diligence process is undertaken
- The risks of proceeding to settlement without undertaking the process.

7.2 If those precautions are observed and the solicitor or conveyancer is reasonably satisfied that their client understood the implications of their instructions and the risks involved, then, in my opinion, the solicitor or conveyancer will not be liable in negligence if the client subsequently suffers a loss because no due diligence exercise was undertaken.

8. **Some current issues**

8.1 For completeness, there are a number of current issues associated with strata inspections that I should mention. They fall under the following headings:

- Timing of the inspection
- Authority for the inspection
- Problems with owners corporation records
- Dealing with the results of the inspection

Timing of the inspection

8.2 Most inspections are undertaken before contracts are exchanged. This is because the inspection report may disclose information that may influence a purchaser in their decision whether or not to proceed with the purchase but which, if discovered after exchange, would not entitle the purchaser to rescind the contract. This has 3 main disadvantages:

- Costs are incurred before the property has been secured
- The maintenance contribution and work-in-progress positions as at the date of contract (which are important from a contribution adjustment point of view) will not be determined (see cl 23.6 of the Standard Contract)

- There is a delay of some 6 to 8 weeks between the inspection and the settlement and the owners corporation's position may have changed within that time.

8.3 Despite those disadvantages, this remains the normal practice. While some professional search agents offer an "update report" just before settlement it is not common for purchasers to go to the expense of this additional report. The best solution is for the solicitor or conveyancer to make the purchaser aware of the pros and cons of the early inspection and let them decide the timing and whether an update report is warranted. Often the pre-exchange report will be a good indicator of the risks involved between the date of the report and settlement.

Authority for the inspection

8.4 Section 108 of the SSM Act allows an owner of a lot, or a person authorized by the owner, to request the owners corporation to allow an inspection of its records. Since amendments that took effect on 7 February 2005 the authority need not be in writing. This change was intended to facilitate e-mail authorizations. If the inspection is to occur before exchange of contracts an authorization will be required from the vendor. However, if the inspection is to occur after exchange, then the necessary authorization is contained in clause 23.17 of the Standard Contract. If the inspection is to be done by a professional search agent or the purchaser's solicitor, then the problem with this authorization is that it is in favour of the purchaser and not a third party search agent or solicitor. An authority directly in favour of the search agent or solicitor will usually be necessary. Alternatively, the purchaser can make application for the inspection and appoint the search agent to do the inspection "as agent" (see sec 108(3) of the SSM Act).

8.5 Once the applicant has the necessary authority (sufficient to satisfy the owners corporation) they can apply to inspect the records. This application must be in writing and accompanied by the prescribed fee. It is usually accompanied by evidence of the owner's authority. The prescribed fee is \$24, plus \$12 for each half hour after the first hour. It is suggested that \$24 be sent with the application and any further fee can be paid at the time of the inspection, if necessary.

8.6 The section then sets out details of the records to be made available and the process to be followed for the inspection. The important thing to note is that the owners corporation can delay the inspection for up to 10 days. While this is not common it is worth keeping in mind when deciding when to actually order an inspection. While professional search agents are often able to provide inspection results within 1 to 3 days, this cannot be relied upon.

Problems with owners corporation s records

8.7 Depending upon the size and nature of the scheme, there are potentially a number of difficulties confronting persons undertaking inspection of owner corporation records for due diligence purposes. In most cases there is no ready solution, but persons undertaking due diligence inspections need to be aware of the difficulties, which include:

- The volume of available records
- Poor filing practices and office procedures
- External storage arrangements

- Split responsibility in self-managed schemes
 - Failure to produce all records
 - Deliberate concealment of records
 - Unreliable accounting information
 - Electronic filing systems.
- 8.8 The sheer volume of records can make it difficult to complete the due diligence within a reasonable time. It also increases the chances that an important document will be missed. Time and care needs to be taken to cover the full collection, or alternatively, an historical time line needs to be arrived at beyond which no consideration is given (i.e. the due diligence is restricted to say the last 3 years).
- 8.9 Whether a scheme is self managed or professionally managed, it is often the case that records are poorly organized. Common problems include:
- No or inadequate categorization of records
 - No separation of various categories of records
 - Correspondence not in date order.
- 8.10 Some strata managing agents keep current records (say one or 2 years) on their premises and send the earlier records for external storage. The earlier records are either not produced or there is a delay in the due diligence process while the earlier records are retrieved. Sometimes, the strata managing agent even seeks (contrary to their legal entitlement) to recover from the applicant the costs of retrieving the records.
- 8.11 Where schemes are self managed the various roles (Chairperson, Secretary and Treasurer) are often shared among unit owners. Records are therefore held by a number of people. This can result in delay to the inspection process while records are collected and made available in a single location, or the inspection has to be carried out in a number of locations.
- 8.12 A particularly worrying problem is an increasing tendency for not all records to be produced. When seeking access to records it is worth reminding the owners corporation or strata managing agent what records must be produced and what are your expectations in this regard. It may also be worth pointing out that the owners corporation may be liable for any loss suffered by the purchaser as a result of failure to make all records available. Unfortunately, failure to produce all records is not always accidental. A strata managing agent in Sydney recently told me that his company took over a strata scheme that had serious building defect problems and not only was there no mention of the problems in the minutes, but the comprehensive engineer's report had a "Post it" note attached with the words "***Not to be produced for purchaser inspections By order Chairman***". Clearly, in that scheme there was a culture of deliberate concealment. In other cases, office procedures are the culprit. Some strata managing agents have a separate folder for matters not dealt with (like an "In Tray"). They produce all the owners corporation records but forget to include this folder.
- 8.13 The accounting information made available during inspections is usually unreliable. This is because of one or more of a number of factors, such as:
- Account books not being up to date

- Computerized print outs not being available and historical print outs being relied upon
 - Cheques awaiting banking
 - Up to date bank statements not being available.
- 8.14 It is becoming increasingly common for strata managing agents to scan owner corporation records into a computerized document management system. The original records are either destroyed or placed in long term storage. This practice is totally unregulated by the SSM Act and a number of problems are starting to emerge, including:
- Poor quality scanning
 - Poor functionality and/or complexity of the document management software used
 - Inadequate, inaccurate or total lack of cataloguing of scanned documents
 - Failure to store documents in date order
 - Inadequate computer facilities for persons undertaking inspections (e.g. slow old computers being provided, no printing facilities, no instructions on the program or the cataloguing).

Dealing with the results of the inspection

- 8.15 Professional inspection reports only present a factual outcome for the solicitor or conveyancer. Rarely do they contain advice or useful commentary on what was discovered. They are like an “x-ray” in medical practice. They need to be interpreted and the results conveyed to the client. This will often involve taking an overall view of the material in the report. For example, if there has been a long history of building problems and there are a number of current problems, it may be appropriate to point out that there is a strong likelihood that these problems will continue to occur into the future. In those circumstances the solicitor or conveyancer should discuss with the purchaser the possibility of a building inspection being carried out to check the current state of the building and quantify the risk of future problems.
- 8.16 Therefore, undertaking the due diligence, or having it undertaken professionally, is not the end of the matter for the solicitor or conveyancer. The purchaser client must be advised of the result and any rights or risks they may have arising from those results. The purchaser must be able to make an informed decision about the exercise or non exercise of those rights. In the case of a professional inspection report, this requires the solicitor or conveyancer to analyse the report, determine what matters should be specifically brought to the attention of the purchaser and advise the purchaser in relation to those matters.

9. Summary

- 9.1 Having regard to the unlimited liability aspect of membership of a strata title owners corporation it is essential that a purchaser’s solicitor or conveyancer either:
- (a) carries out or has carried out the due diligence process in relation to the owners corporation; or

- (b) obtains informed consent from the purchaser not to carry out or have carried out the due diligence process.
- 9.2 The inspection of owner corporation records can be very difficult, depending on a number of factors (including the size and nature of the scheme and its management). Careful consideration therefore needs to be given to who undertakes the due diligence process; the solicitor/conveyancer, one of their staff, a professional search agent or the purchaser personally. If the purchaser is to undertake the process, then some assistance (at least by way of instruction) may be required from the solicitor or conveyancer.
- 9.3 The due diligence is best done before exchange of contracts, but consideration needs to be given to the likely need for an up-date process shortly before settlement. This is usually only necessary where there are particular events occurring within the scheme or there is an issue regarding adjustment of special levies.
- 9.4 When the results of the due diligence process are available, they need to be interpreted and communicated to the purchaser so that the purchaser is able to make an informed decision as to how to proceed.
- 9.5 Finally, having done everything recommended in this paper it is worth reminding the purchaser that, despite every care having been taken, the due diligence process is not foolproof. Issues and expenses can still occur, sometimes within a relatively short period after the process has been concluded, and there is always an element of risk that the purchaser will need to accept when buying into a strata or community scheme.

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