MEMO

April 23, 1999

RE: **LIQUIDATED DAMAGE CLAUSES IN LISTING AGREEMENTS**

Introduction

Last year, the Oregon Court of Appeals upheld a trial court decision denying a broker a commission under a term of a standard exclusive listing agreement promising the commission if the owner withdrew the authority to sell. At first blush, the case is just one of appellate judges getting it "wrong" because they did not understand the context of a contract very well. We believe, however, the reasoning used masked a more systemic problem with the development of Oregon real estate law concerning listing agreements. The purpose of this memo is to identify the systemic problem and suggest ways in which the drafting of listing agreements may be affected.

What's the Problem?

Prestige Home Real Estate Company v. Hanson, 151 Or. App. 756 (1997), involved a standard listing agreement granting a broker an exclusive right to sell. The term of the listing was one year. For reasons not stated in the Court of Appeals' opinion, the seller withdrew the listing after a few months. No sale was pending and no buyer had been procured.

The listing agreement, typical of the industry, contained the following clause:

> The SOLE and EXCLUSIVE RIGHT to sell, exchange, rent or lease the herein described property is hereby granted to the undersigned Real Estate Broker. A full fee as stated above shall be paid to the Broker in the event of a sale by the owner(s) or persons acting on behalf of the owner(s) during the term of this contract. In case owner(s) withdraw(s) the authority hereby given prior to said expiration date, Owner(s) agree(s) to pay Broker the said fee just the same as if a sale had actually been consummated by Broker.

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The broker's suit for a commission was based on the last sentence of the clause. The trial judge, reading the clause in conjunction with other provisions of the listing agreement and accompanying MLS information forms, granted the seller summary judgment ruling that no commission was due under the listing agreement unless there was a sale (made or pending) at the time of the withdrawal.

On appeal to the Oregon Court of Appeals, Prestige Homes argued there were three events that would trigger the right to a commission under the listing agreement. According to Prestige, a commission was due if there was (1) any sale during the listing period; (2) if a ready, willing and able buyer was produced during the period, but Hanson refused to sell; or (3) if Hanson withdrew the exclusive authority to sell during the listing period. Hanson's lawyers countered that the contract, read in context, showed that a commission was due only if the seller withdrew authority after Prestige had already produced a buyer or a sale was otherwise made or pending. The majority of the Court of Appeals Panel agreed with Hanson's interpretation.

No one who has been around real estate more than a week would have any doubt whatever as to the meaning of the contested contract provision. Listing agreement clauses requiring the seller to pay the commission if they cancel the listing during its term have been around for as long as listing agreements have been in use. In fact, contract clauses like those found in Prestige Home's listing agreement are used everywhere real estate is sold in this country. Plainly and simply, such clauses are intended to discourage withdrawal of listings after the broker has expended money and effort in reliance on the listing. Such clauses have historically been treated as liquidated damage clauses.

The Oregon Supreme Court first dealt with a withdrawal-of-authority clause in *Wright v. Schutt Construction Co.*, 262 Or. 619 (1972). In *Wright*, the Oregon Supreme Court treated a listing agreement clause almost identical to that found in *Prestige Homes* as a liquidated damage clause. Consistent with the common understanding of the operation of such clauses, the *Wright* Court undertook the familiar task of deciding whether the clause was a reasonable liquidated damages provision or unenforceable "penalty" clause used as "an attempt to secure performance by a provision for an excessive payment." On the facts of the case, the Court found an unenforceable penalty and denied the broker the commission.

The resolution of the *Wright* case is typical of real estate commission liquidated damage cases. Although the reasoning in such cases has tended to be perfunctory, the gravamen is generally whether payment of a full commission in the circumstance bore any relationship to the actual damages caused by the seller's breach. Arcane issues of pleading and proof were often used to shift the balance to make the cases "come out right." See e.g. *Dean Vincent, Inc. v. Krimm*, 285 Or. 439 (1979).

In withdrawal of authority cases (as opposed to "secret sale cases" where the seller deliberately tries to avoid a commission by going around the broker to make a sale), the battle for the broker under a liquidated damages analysis is often uphill. Indeed, appellate judges have sometimes suggested a boilerplate provision in a standard take-it-or-leave-it listing agreement cannot evidence a "reasonable forecast of just compensation for the harm that is cause by the breach." At any rate, liquidated damages cases have historically not been the model for the best of judicial reasoning.

The general historic confusion regarding liquidated damages in Oregon came to a head in a real estate case involving forfeiture of earnest money in 1984. In *Illingworth v. Bushong*, 297 Or. 675 (1984), the Oregon Supreme Court made a serious effort to clear up what it called "apparent ambiguity, if not confusion, in our pronouncements of the law applicable to this kind of [liquidated damages] case." The fundamental issue in the case was whether forfeiture of $50,000 of earnest money in a half-a-million dollar ranch deal constituted a penalty. The trial court believed it was and gave the money back. The Court of Appeals agreed.

The Supreme Court used the *Illingworth* case to announce that henceforth it would apply the test stated in ORS 72.7180 for contracts for the sale of goods in all liquidated damages cases in Oregon. The UCC standard reads as follows:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

The Court left for another day the issue of whether the *Illingworth* test substantially changed the historic analysis in liquidated damages cases or offered any real guidance.

"Another day" arrived for the Court in 1990. In *Ditommaso Realty, Inc. v. Moak Motorcycles, Inc.* 309 Or. 190 (1990), the Oregon Supreme Court faced the issue of what to do when a seller ignores an exclusive listing and sells the property themselves. Such "secret sale" cases are usually resolved in favor of the broker. See e.g. *Dean Vincent v. Chef Joe's*, 273 Or. 814 (1975). Of course, a broker would also probably win a breach of contract action even if the listing agreement contained no liquidated damages clause. See e.g. *Brady v. East Portland Sheet Metal Works*, 222 Or. 584 (1960). Whatever the theory of recovery, courts are generally sympathetic to brokers when property actually sells during the term of an exclusive listing agreement.

It comes as no surprise then that both the trial court and the Court of Appeals sided with the broker in the *Ditommaso* case notwithstanding the seller's attempt to characterize the commission as a "penalty." Unfortunately, the Court of Appeals' rationale was less than compelling. According to the court, the first part of the *Illingworth* test was met because "it [the liquidated damages amount] was equal to the commission that plaintiff would have earned if the agreement had been honored by the defendant." The Court of Appeals also concluded that "in the absence of a stipulated fee, it would have been difficult to prove the operational expenses attributable to the property and the value of plaintiff's lost opportunity."

The Court Appeals ignored the fact that a straight breach of contract claim would have required nothing more than proof that a sale during the term was more likely than not to gain the promised commission without regard to liquidated damages. That being the case, Ditommaso could easily have calculated and proven the value of the lost opportunity. If that were done, the operational expenses would be irrelevant. In fact, it may actually be so easy to prove damages in a secret sale case that there is serious doubt as to whether damages can ever be liquidated in such cases.

On review, perhaps realizing the Court of Appeals' reasoning might prove difficult to defend (or perhaps seeking to avoid the whole messy question of liquidated damages), the Oregon Supreme Court chose an alternative theory of the case. Noting that the broker plead the case under a recovery of contract debt theory, the Court held that the provision of the listing agreement requiring payment of a fee if the property was sold during the term of the listing "was not for liquidated damages but was an independent, valid contractual promise."[1] According to the Court, the seller did not breach the contract by selling without the broker because the contract recognized that right. The Court concluded that the only breach was the failure to pay the promised commission pursuant to the terms of the contract. Thus, the suit was properly an action on a debt.

The Supreme Court's solution to the difficulties of deciding secret sale commission cases under a liquidated damages theory was, if nothing else, certainly clever. *Ditommaso* explains why it is unusual to find a listing agreement in Oregon that does not recite payment of the commission under all circumstances as a "promise to pay." After *Ditommaso*, it would have been easy to conclude that court battles over real estate commissions promised under the listing agreement would become a thing of the past. And so it might have turned out had it not been for the unfortunate fact that the *Wright* case was also plead as an action on a debt.

In 1972, the *Wright* Court didn't think pleading the cause as an action on a debt made much difference. In fact, the Court dismissed the broker's claim that liquidated damages were no part of the case by simply citing *Corbin* for the proposition that the terms used in drafting a contract are of little significance in determining whether a contract provision is one for liquidated damages or a penalty. Clearly, the Supreme Court in deciding *Ditommaso* could not ignore its prior decision in *Wright*. Therefore, it declared that it had erred in *Wright* by failing "to distinguish between two independent theories of recovery: (1) that an amount is due because the contract has been satisfied, and (2) that liquidated damages are due because a breach has occurred."[2]

Smooth as the majority decision in *Ditommaso* appeared, it pulled a stinging concurrence from then Chief Justice Edwin Peterson. According to the concurring opinion:

> Under the majority opinion, so long as the agreement does not use the words "penalty" or "liquidated damages," and is not written in terms of prohibited conduct, the agreement will be enforced as "an independent, valid contractual promise" if the contract is written to provide that certain conduct gives rise to the

[1] The listing clause at issue read as follows: "For value received, you are hereby employed and given the exclusive right to sell or exchange the above described property at the price and terms stated above ***. In the event that you or other broker cooperating with you find a buyer ready and willing to purchase said property for said sale and terms or such other price and terms as I may accept, or in the event of any sale, contract to sell or exchange or conveyance of said property by me during the life of this contract or any renewal or extension thereof, or that you place me in touch with a buyer whom at any time within ninety days after the termination of this contract or renewal or extension thereof I may sell, contract to sell or exchange or convey said property, or if you are the procuring cause of said sale, exchange or conveyance, I hereby agree to pay you in cash for your services in connection with this contract a fee equal in amount to TEN % of the selling price of the property, but in no case less that $ NA."

[2] The rule was applied very recently in the case of *Kesterson v. Juhl* (CA A97376) (December 9, 1998). In *Kesterson*, the Court of Appeals interpreted a promise to pay a large "loan fee" in the event of untimely repayment of a loan as provision for liquidated damages rejecting an attempt to characterize the clause as a promise to pay. The court cited *Ditommaso* and *Illingworth*.

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> right to payment. Henceforth, lawyers will be well advised not to write a contract using the terms 'liquidated damages,' or in terms of what conduct is prohibited, for such a contract will be subject to the carefully drawn liquidated damages rules of *Illingworth*. So long as the drafter uses language similar to that used in the case at bar, the contract will be enforceable, however unreasonable the damages.

Clearly, the Chief Justice did not believe the majority to have fashioned a very workable rule. In what would prove to be an all too accurate foreshadowing of *Prestige Homes*, Justice Peterson went on to ask:

> ..... what contract obligation has the broker satisfied under the majority opinion? The broker's 'best efforts' in selling the property? Does this include the situation where the seller revokes the broker's authority one day after entering into the agreement? An hour? Must the broker show that he or she made a few phone calls during that hour in his or her best efforts to sell the property? Or do we assume that with the hour following execution of the contract the broker fully performed his or her contract obligation? The rule pronounced today, though workable and clear, does away with much well settled liquidated damages law. Its practical effect will be to entirely do away with our case law concerning liquidated damages and penalties.

It is these questions, raised by Justice Peterson in 1990 that may explain the Oregon Court of Appeals' decision in *Prestige Homes.*

It is hard to imagine the Court of Appeals panel did not understand the intent of the contested clause. Yet, the majority of the *Prestige Homes* panel signed off on the tortured construction of the clause urged by Hanson's lawyers?[3] The reason the panel did so may be found in the following statement of the majority's rationale:

> Under plaintiff's [Prestige Homes] interpretation, the owner would immediately be liable for six percent of the listing price as a penalty for withdrawing the broker's authority irrespective of the reasons for withdrawal -- death of a family member, illness of the owner or change of mind. However, the context of the language relied on by plaintiff does not support that reading. Instead, the requirement that the commission be calculated according to the sale price shows that the provision was intended to apply in situations when a buyer is found but the owner withdraws the listing so as to save a commission.

It appears that, just as Justice Peterson had predicted, the Court of Appeals felt trapped by the Oregon Supreme Court's *Ditommaso* decision.

[3]Dissenting on the contract claim, Judge Warren made the obvious point that whatever the relative merit of the majority's interpretation of the contract and clause, theirs was certainly not the only interpretation as a matter of law. Given that simple fact, and that the matter was before the Court on grant of summary judgment, the judge believed the matter should have been remanded.

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The “withdrawal of authority” clause in the *Prestige Homes* case was, as the Court of Appeals recognized, a “penalty” clause that might well lead to very “bad” results in certain circumstances. True, the clause did appear to be written as a promise to pay, but the court could have distinguished *Ditommasso* as not involving a withdrawal of authority. The Court could have also undertaken to decide whether the clause was in fact a promise to pay, or a liquidated damages provision, as it did recently in the *Kesterson* case. Instead, the Court chose to interpret the listing agreement as requiring a “sale” before a commission could be demanded. Hanson’s lawyers, whether by brilliance or luck, offered the Court of Appeals an easy way out and they took it.

Given *Illingworth*, *Ditommaso* and now *Prestige Homes*, it is hard to see how best to address the issues of secret sales and withdrawal of authority when drafting standard listing agreement forms. *Ditommaso* suggests “promise-to-pay” clauses can be used to avoid the problems created by liquidated damages clauses. Promise-to-pay clauses, however, raise their own questions. The Court of Appeals was clearly willing to go to considerable lengths to avoid having to face the issues raised by Justice Peterson in *Ditommaso.* In doing so, they have, for all intents and purposes, read a sale requirement into Oregon listing agreements. As it now stands, standard withdrawal of authority clauses are probably no longer viable.

It would, of course, be a simple matter to revise listing agreements to avoid the interpretation given the listing agreement in *Prestige Homes*. Since the Court relied on the “context” of the clauses, the opinion rests not on the law, but the contract itself. The parties, not the courts, control their contract. For instance, adding the words, “whether or not any sale has been made or buyer found” to a withdrawal clause would preclude the result reached by the Court of Appeals. It would also be possible to strengthen the “promise-to-pay” language of such clauses by making clear that the seller has the right under the contract to withdraw authority without “breaching” the contract.

Easy as it might be to draft around *Prestige Homes*, the real question is would that be a smart thing to do? At bottom, the issue is one of fairness when a broker sues his client. Our societal notions of fairness are based for the most part on ideas of blame or fault. A broker who has done little or nothing to affect a sale has no real claim to a commission, regardless of what the contract says. At the other end of the spectrum, an owner who takes advantage of a broker’s efforts and then tries to avoid the promised commission by canceling the listing or conducting a secret sale, clearly ought not escape paying the broker. In between lie the cases that have spawned the homely case law we have been examining.

The Supreme Court’s decision in *Ditommaso*, and the Court of Appeals’ decision in *Prestige Homes,* leaves listing agreement drafters with a number of choices. All clauses under which the broker is to receive a commission can be written as valid promise-to-pay clauses that make clear no sale or procurement of a buyer is required. Care would have to be taken to avoid creating any kind of a breach, but it should not be difficult to meet *Ditmommaso*’s requirements and avoid *Prestige Homes*.

Unfortunately, drafting around these cases may well assert more pressure on the courts to find creative ways to avoid the kinds of issues and results Chief Justice Peterson predicted in

Ditommaso. Ultimately, one would have to guess that *Ditommaso* will be distinguished as applying only to secret sale cases. With that in mind, one could draft secret sale clauses as promise-to-pay clauses per *Ditommaso* and leave other penalty clauses, like a withdrawal-of-authority clause, to an express liquidated damage clause that meets the *Illingworth* test. Of course, a liquidated damages clause would require the kind of bargained-for agreement to potential damages that is hard to fashion into a standard form. That suggests that now might be a good time to consider limiting the use of both promise-to-pay and liquidated damage clauses in standard Oregon listing agreements.