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BROKERAGE COMMISSION – EARNED AT EXECUTION OF CONTRACT OR UPON CLOSING?

(PROPER DRAFTING IS IMPERATIVE)

Another recent California Court of Appeal decision underscores the need for careful drafting of real estate contract documents. In *RC Royal Development and Realty Corporation v. Standard Pacific Corporation*, 2009 Cal. App. LEXIS 1606 (September 29, 2009), the buyer (“Standard Pacific”) was held liable for payment of a commission to its broker (“RC Royal”) based upon its agency agreement with its RC Royal notwithstanding that Standard had justifiably terminated the purchase agreement. The court determined that the contract, as drafted, did not condition payment of the brokerage commission upon closing but instead was deemed earned upon execution of the purchase agreement.

Relevant Facts and Circumstances

RC Royal contacted Standard Pacific regarding availability of properties in downtown Los Angeles which RC Royal thought might be appropriate for development by Standard Pacific. Standard Pacific entered into an agency agreement with RC Royal pursuant to which RC Royal would be paid a 1.5 percent brokerage commission should Standard Pacific purchase the property. The agency agreement provided for payment of the commission through escrow at closing.

After its preliminary investigation of the property, Standard Pacific executed a purchase agreement to acquire the property. The purchase contained many of the usual conditions including satisfaction of Standard Pacific’s due diligence review, issuance of certain entitlements and receipt of temporary certificates of occupancy. After waiving its due diligence contingency, entering into sale contracts with prospective condominium purchasers but prior to receipt of temporary certificates of occupancy, Standard Pacific terminated its purchase agreement for the property based upon substantial delays in the seller’s completion of the project and deterioration of the market for condominiums in Los Angeles. In conjunction with its termination of the purchase agreement, Standard Pacific forfeited \$4,000,000 in earnest money and transaction costs. Standard Pacific refused to pay any commission to RC Royal.

RC Royal filed an action for payment of its brokerage commission alleging breach of contract and breach of the implied covenant of good faith and fair dealing. The substance of RC Royal’s complaint was that Standard Pacific failure and refusal to consummate its purchase breached both the agency agreement and the implied covenant. The trial court granted Standard Pacific’s motion for summary judgment finding that under the agency agreement RC Royal’s brokerage commission would only be payable when all contingencies had been removed and escrow actually closed. The trial court also held that Standard Pacific’s decision to terminate the purchase agreement was justified and did not constitute a breach of the implied covenant of good faith and fair dealing.

Legal Analysis

The appellate court viewed the contract and circumstances very differently and read the agency agreement more literally. In reversing the trial court’s determination that no commission was due, the appellate court focused on two specific provisions of the agency agreement. The first specified that the commission would be payable “in the event the Property is purchased...”. The second defined “Purchase” as including any and all acquisitions of “any direct or indirect beneficial interest in the Property, including, without limitation, any lease, option, finance, exchange, stock purchase, joint venture or other transaction...”

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The appellate court found that once Standard Pacific had entered into the purchase agreement it acquired “equitable title” to the property and consequently obtained a “beneficial interest” in the property sufficient to trigger Standard Pacific’s obligation to pay the agreed upon brokerage commission to RC Royal. The court rejected the contention that close of escrow was a condition precedent to payment of the brokerage commission holding that reference to escrow was merely a description of the timing of the payment. Its reasoning was that the contract definition of “Purchase” included several scenarios in which no escrow would exist at all (e.g., lease or stock purchase). The court specifically noted the absence of language indicating that escrow must close before the commission is earned.

The appellate court also reversed the trial court’s finding that Standard Pacific had not breached the implied duty of good faith and fair dealing. The court noted that although Standard Pacific may have acted in a commercially reasonable manner in declining to close under its purchase agreement, doing so may not necessarily constitute good faith towards its broker. The court acknowledged the existence of an implied promise by a buyer to its broker to complete the purchase so that the broker can earn its commission. The case was returned to the trial court to determine whether Standard Pacific breached its duty to RC Royal.

Lessons Learned

In the case at issue, more careful drafting of the agency agreement clauses relating to (i) the definition of “Purchase,” (ii) the relevance of close of escrow, and (iii) disclaimer of duty to the broker, could have avoided the entire disagreement. Had the parties anticipated, and specifically addressed, in the contract the major potential outcomes, there would have been little or no doubt about whether the brokerage commission was payable under the circumstances.

Careful drafting of real estate contracts is essential to realization of the parties’ expectations. Implicit assumptions based upon common practices may be trumped by literal interpretation of contract terms. Similarly, implied legal obligations may not be avoided unless specifically disclaimed. There is no substitute for thorough thinking, thoughtful discussion and clear drafting. The alternative is surprise, litigation and expense.

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