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Subject: Competition and Real Estate Workshop ? Comment, Project No. V50015

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To: Competition and Real Estate Workshop – Comment, Project No. V50015
Department of Justice
Federal Trade Commission

Re: My Comments in the Proceeding on
Competition Policy and the Real Estate Industry

Date: November 28, 2005

I had hoped that by this time I would have completed a reasonably coherent full draft of a law review article that I am writing critical of the rate structure used to calculate the commissions paid to residential real estate brokers. Unfortunately, the article continues to evolve and require substantial work, and I am not comfortable sharing it in its entirety in its current, flawed state.

Nevertheless, given the DOJ and FTC's commendable efforts to address some inherent problems with competition in the residential real estate brokerage industry, I am submitting two excerpts from that draft article, which address two aspects of the dominant, traditional, percentage-of-sale price commission structure, which I believe, have generally been neglected by other researchers:

1. The arrangement whereby those selling homes are the ones who set the fee that will be paid to the agents working with and supposedly serving the interests of home buyers (the cooperating agent fee listed in the MLS).

2. The use of a percentage-of-sale price commission, which bases the fee paid to the agents on the sale price of a home, irrespective of the quantity or quality of service provided.

I recognize that my analysis is incomplete and will require some corrections, clarifications, and further research. Nevertheless, I hope that by identifying and offering a reasonable preliminary discussion of these matters, it will aid policymakers in their effort to identify the steps that may help channel competition in the brokerage industry to better serve the interests of home buyers and home sellers.

I have attached an abridged, edited version of my current introduction as well as the two subsections of a later section, which address the two issues I just mentioned.

I. Introduction

Unaccountably, the percentage-of-sales-price commissions that residential real estate brokers and agents representing buyers and sellers generally receive are unrelated to either the quantity or quality of service they provide. The two brokers involved in the sale of a million dollar home will typically receive equal shares of the total commission ($50,000, assuming a 5% rate). It does not matter that the strong seller's market permitted the seller's agent to obtain an auction-aided high price in one weekend open house after less than ten hours of work, while the agent working with the buyer has spent many months on exhausting house visits, unsuccessful bids, long phone calls, and answering numerous questions.

Conversely, the two agents on either end of the sale of a $200,000 home will generally each receive $6,000 (half of a 6% commission) for their assistance. It does not matter that the buyers found the home on their own, were very experienced in price negotiations, and only desired an agent's assistance with the routine paperwork, while the seller's agent provided expert advice and many hours of assistance "staging" the home to look its best, hosting many open houses, and saved the seller's many hours of inconvenience by pre-screening potential buyers to ensure that they were financially qualified to bid for the home.

Commissions generally do not vary based on whether an agent has accumulated 30 years of knowledge about all aspects of the neighborhoods in a community or whether the agent is one of the hundreds of thousands of novice agents, who have recently passed the state licensing exam after less than 100 hours of study. The commission is based solely on the nominal selling price, irrespective of the incremental benefit that the agent has produced or failed to produce, in terms of a higher selling price or a lower purchase price.

As the Federal Trade Commission (FTC)'s 1983 two volume, multi-year study of the residential real estate brokerage industry observed, "the market for real estate brokerage service does not accord with the customary model of competitively functioning markets."[1] In fact, the strange nature of the fee structure has led the industry and press to state that estimated average commissions have "fallen" from about six percent to 5.1 percent over the last dozen years, although the fees brokers have received have increased over this period, even after adjusting for inflation.[2] (Furthermore, the main reason for the commission "reduction" appears to be the willingness of agents to accept slightly lower percentage rates for selling homes that are priced two or three times more than average homes.)

Separate and apart from the level of commissions in the industry, which totaled approximately $60 billion in 2004,[3] is the question of why the traditional fee structure continues to treat brokers

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[1] FEDERAL TRADE COMMISSION STAFF REPORT, THE RESIDENTIAL REAL ESTATE BROKERAGE INDUSTRY (1983) Vol. I (hereinafter FTC 83 Report), at 11.

[2] *See* John C. Weicher, The Price of Residential Real Estate Brokerage Services: A Review of the Evidence, Such as it is, presented at AAI, Washington, D.C., Nov. 8, 2005, at 2-4, questioning whether the 5.1% figure may be too low. Then again, that data does not appear to take into account rate reductions in the form of commission rebates, closing cost assistance, and other in-kind rebates, like free moving truck services. *See* Lawrence Yun, Real Estate Brokerage Industry: Structure-Conduct-Performance, Oct. 25, 2005, at 11, http://www.ftc.gov/opp/workshops/comprealestate/yun.pdf (Yun NAR report). It would also likely omit rebates that agents prefer to hide.

[3] This is the figure used in the GOVERNMENT ACCOUNTABILITY OFFICE, REAL ESTATE BROKERAGE: FACTORS THAT

more like equity investors than outside experts. Why are agents involved on either end with the sale of a million dollar home make three, four, or even five times as much as those involved in the sale of a $200,000 home when the time and effort involved appears to be comparable and may even be less. And why does the pricing structure for compensating buyer's brokers punish them for negotiating a lower purchase price for a buyer.

The industry's traditional one-dimensional fee structure is very similar to the illogical and inefficient formula previously used by travel agents and stock brokers through the early 1970s – setting the fee to vary directly with the size of a sale (whether in dollars or shares of stock). Stock broker commissions, however, began to be priced competitively in 1975, when the Securities and Exchange Commission ended its protection of fixed commissions and permitted order processing to be unbundled from research. Customers increasingly opted for the dramatically lower prices offered for "no frills" service.[4]

The more recent transformation in travel agent commissions is probably more suggestive of the future for real estate agents because the former was also significantly triggered by easier customer access to the information in databases (via the Internet). Through the mid-1990s, airlines generally paid travel agencies ten percent commission on the airline tickets they sold. As the airlines found they could cut costs significantly by permitting travelers to purchase electronic tickets via the Internet, they gradually eliminated the commissions previously paid to travel agents. As a result, today most travel agents are forced to bill separately and explicitly for the research and ticketing services they provide,[5] leading to a dramatic decrease in travelers' use of travel agents.

This comment contends that the current dominant, traditional residential real estate broker rate structure – particularly the one-dimensional percentage basis – serves the interests of brokers, but has at least a half dozen significant harmful effects on home buyers and sellers.

The analysis on which it is based finds that buyers are hurt because their agents often steer them toward homes represented by traditional brokers, while omitting those represented by non-traditional brokers, particularly those offering less than the going rate commission for cooperating agents. The traditional rate structure also leads most buyers to view their agent as a free service with no need to negotiate their fees. Sellers are harmed by their broker's use of a price-of-purchase based fee rather than the cost-based fee that competition generally yields. The

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MAY AFFECT PRICE COMPETITION 6 (2005) (hereinafter GAO 2005 Rep.) and by Robert W. Hahn, et al, Paying Less for Real Estate Brokerage: What Can Make it Happen? 1 n.3 (2005) http://www.aei-brookings.org/admin/authorpdfs/page.php?id=1159: data from Real Trends yields an estimate of $61 billion in 2004, the figure commonly referenced in the press, *see, e.g.,* James R. Hagerty, *Discount Real-Estate Brokers Spark a War Over Commissions,* WALL ST. J., Oct. 12, 2005, at A1. The Bureau of Economic Analysis, National Income and Product Accounts, Table 5.4.5BU. Private Fixed Investment in Structures by Type, http://www.bea.gov/bea/dn/nipaweb/nipa_underlying/TableView.asp?SelectedTable=35&FirstYear=2004&LastYear=2005&Freq=Qtr (line 43) estimates that brokers' commission on residential sales totaled about $100 billion in 2004, but this calculation assumes commission rates are fixed at specified levels. One 2003 study estimated the total *excess* charges to home buyers for brokerage mortgage, and related services at $39 billion annually, about $14 billion for real estate agents services. *See* Shane Ham & Robert D. Atkinson, Modernizing Home Buying: How IT Can Empower Individuals, Slash Costs, and Transform the Real Estate Industry, Mar. 2003, PPI, at 2, *available at* http://www.ppionline.org/documents/Real_Estate_0303.pdf

[4] *See* Lawrence J. White, The Residential Real Estate Brokerage Industry: What Would More Vigorous Competition Look Like?, presented at AAI, Washington, D.C., Nov. 8, 2005, [sec. III on the Brokerage Industry].

[5] *See* Martha Brannigan & Jesse Drucker, *Travel Agents Change Fee Structure,* WALL ST. J., Apr. 10, 2002, at D5.

single bundle package contract also permits seller agents to limit the dissemination of the listing, enabling them to use it as bait to attract new customers, despite the harm to sellers. Some listing brokers also deter visits from some potential buyers by reducing the fees offered to non-traditional buyer brokers. The traditional rate structure also denies both buyers and sellers the option of obtaining significantly lower prices by handling more of the standard real estate services themselves.

The analysis on which it is based then examines the six rate elements of the dominant, traditional broker rate structure, which cause these harms: 1) the fee is set as a percentage-of-sales price, 2) the seller's broker sets the fee paid to the selling broker working with the buyer (usually half of the commission the listing broker receives), 3) the single fee for a bundle of services is not subject to reduction for customers desiring substantially reduced service, 4) the fee generally does not vary among the different agents working for the broker, 5) the fee charged by traditional brokers in a region are generally uniform, and 6) laws and rulings in many states against rebates effectively prohibit buyer brokers from charging buyers less than the standard fee. While the analysis reviews how these elements can be efficient and yield socially beneficial results in some contexts, it finds that they are not socially beneficial in the real estate brokerage market.

The analysis on which it is based next contends that competitive pressures should lead real estate agents to set fees based on the level of their skills, generally flat fees or hourly, i.e., cost-based, rates. It explains how a transformation of industry structure – one that appears to be inevitable, in the long run – can provide consumers with superior residential real estate services at substantially lower prices. This is not to say that the best agents would not be able to demand large fees for superior service in a number of areas. Those with a detailed knowledge of particular local real estate markets, the latest information about market trends, and/or a deep understanding of buyer and seller needs and desires might be able to obtain fees of $500 per hour or a standard fee of $1,000 or more dollars for a few specific services. A few may even be able to negotiate for fees based on a percentage of the price of the home or of the difference between an expected and the actual sale price. Many agents are undoubtedly able to pay for themselves in terms of either a higher selling price or a more suitable purchase at a lower price, even without considering the time and effort they save a consumer.[6] On the other hand, most real estate agents, offering merely routine services, will likely be forced to replace their percentage commissions with much lower standard fees or hourly rates, and many, less-qualified agents, would likely to exit the field completely.

The American real estate brokerage industry appears to bear some striking similarities to the American funeral industry, expertly exposed by Jessica Mitford in her original and revised versions of *The American Way of Death*.[7] In both, consumer ignorance appears to result in tens of billions of dollars annually in unnecessary expenses to consumers.

The analysis on which it is based suggests three disclosure efforts that might educate home

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[6] *See, e.g.,* Snider v. Oklahoma Real Estate Comm'n, 987 P.2d 1204, 1206 ¶5 (Okla 1999) (finding savings to buyers). *But see* Norm Miller, The US Residential Real Estate Brokerage Industry's Resistance to Commission Rate Competition with some Speculating on the Future of the Industry, presentation to the AAI, Washington, D.C., Nov. 8, 2005, at slide 12 (stating that there is no solid academic evidence that has shown that agents can secure higher prices than FSBOs, except on their own homes).

[7] The original version was published in 1963. *See* JESSICA MITFORD, THE AMERICAN WAY OF DEATH REVISITED (1998). *See also* Bill Davidson, *The High Cost of Dying*, COLLIER'S, May 1951 ("Even this honest majority [of undertakers] is guilty of accepting a mysterious, nation-wide fixing and raising of prices") cited id. at 237-38.

buyers and sellers in a manner apt to the adoption of a more efficient, rational price structure, which should then stimulate vigorous price competition. It would attempt to ensure that buyers would, before engaging an agent, learn the size of the commission the agent expected to receive as well as whether the agent would be showing them all of the homes meeting their criteria, or would likely omit many represented by non-traditional brokers. Sellers would learn that 30% of purchasers have no agents so that they could decide how to address that case before they signed their listing contract.

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IV. Justifications for and Historical Basis of the Elements of the Current Fee Structure

A. Seller Pays for Buyer Assistance

1. General Economic Justification

In almost all stores, the people who assist consumers in selecting which product to purchase are employees of, and paid by, the retailer.[8] Most consumers understand that the costs of such service are included in the prices of products and that the salespeople are generally more loyal to the store than the customer. The "honest broker" Macy's Santa Claus in the classic film *The Miracle on Thirty-Fourth Street* is the exception that proves the rule.

Since consumers already pay indirectly for such biased assistance, one might expect them to be willing to pay directly for unbiased assistance, for personalized selection assistance that might be provided by a *Consumer Reports*–like entity. Yet there are a number of reasons why this model has been rare, (although the Internet may well spawn its emergence.[9])

Most importantly, given the small size of the likely fees, it does not appear to be economically practical for retailers to try to bill consumers for very small amounts of assistance. To begin with, there is the matter of what increment to bill by: by the minute, the question, or the visit. All are problematic. There would also be the matter of the qualifications of most sales help to provided advice for a fee, requiring additional training and monitoring. In addition, there is the matter of the administrative cost of billing for the service, which, for short inquiries, e.g., 30 seconds, that did not lead to a purchase, could even exceed the price of the service.

Even if new technologies solve all of these issues, many consumers have grown accustomed to the illusion of free service and will likely initially resist efforts to charge for what formerly appeared free. This is illustrated by the current consumer resistance to paying for information on the Internet. Because Internet securities investors in the 1990s were willing to finance free services to attract an audience, individuals quickly became accustomed to paying nothing for valuable content. This start-up strategy, by setting unrealistic consumer expectations, has hampered the emergence of a more rational marketplace where consumers pay for valuable information.[10]

In a number of markets, however, unbiased experts have long been paid directly by consumers. For example, consumers pay doctors directly[11] for their expert opinions of what drugs they should try and that advice is supposed to be unbiased.[12] Many wealthy shoppers have long paid

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[8] In some cases, for example, for cosmetics sales in department stores, the manufacturer may pay to staff its counters, but in that case the manufacturer is also playing the role of retailer.

[9] *See* Mark S. Nadel, *The Consumer Product Selection Process in an Internet Age: Obstacles to Maximum Effectiveness and Policy Options,* 14 HARV. J. L. & TECH. 183, 212-13 (2000) *revised version available at* www.ssrn.com/abstract=247818; PHILIP EVANS & THOMAS S. WURSTER, BLOWN TO BITS: HOW THE NEW ECONOMICS OF INFORMATION TRANSFORMS STRATEGY (1999).

[10] *See* Nadel, *supra* note 9, at 202-04; Michael E. Porter, *Strategy and the Internet,* HARV. BUS. REV., Mar. 2001, at 63, 76-77.

[11] Consumers and their health insurance companies.

[12] There is some concern, however, that some doctors are unreasonably influenced by gifts and attention they receive from drug companies or their own partial ownership of some medical equipment. *See* Abigail Zuger, *How Tightly Do Ties Between Doctor and Drug Company Bind?*, N.Y. TIMES, July 27, 2004, at F5.

personal shopping consultants to provide them with advice.[13] Meanwhile, the Internet is probably most responsible for the shift in the pay structure for travel agents from an approximately 10 percent commission paid by airlines to travel agents, hidden from customers, to the fees that agents now charge explicitly to travelers for "ticketing" or research services."[14]

The key appears to be whether the value of the expertise that a consumer desires, and is willing to pay for is sufficient to cover the costs of providing such services, given the state of technology. Where both the value of the service and consumer's willingness to pay is relatively high, one would expect an market for service providers to emerge.

2. Justification for Use by Real Estate Brokers

Given the multi-thousand dollar fees that the agents working with home buyers now obtain, even from buyers who fully appreciate that they are footing the bill, this analysis would suggest that buyers should prefer to employ an agent paid by them and loyal to them. There seem to be a number of weak reasons why that has not occurred.

First, there is the history. Prior to the 1950 Supreme Court decision in *U.S. v. Nat'l Assn of Real Estate Boards,*[15] price fixing was the norm, rather than considered illegal. Therefore, if a fixed fee was to be collected for a transaction, it would make economic sense for agents to contract to receive it from the buyer or the seller, but avoid the need for twice as many contracts. In any case, until the 1990s agents working with buyers were generally recognized by the law as sub-agents of the listing agent, that is, they worked for the seller. In many, if not almost all, jurisdictions the listing agent used the MLS to make a blanket offer of subagency to any agent who could find a buyer, making the latter "cooperating" or "selling" agent a subagent of the seller.

Conflicts over who the agent working with the buyer actually represented eventually led to the emergence of buyer brokers who were not sub-agents of the listing agent, but rather technically owed their fiduciary duties to buyers. In theory, this reform should have included the practice that buyers negotiate with their brokers and set the commission that they are willing to pay and agree to add that to the price of the house, net any amount already allocated to the buyer's agent.[16] The original concept of buyer brokers, conceived by Bill Broadbent in the late 1970s, recognized that he who pays the piper calls the tune,[17] yet this element did not catch on.[18]

One reason why and why the model did not otherwise arise is that buyer's were ignorant about the payment mechanism and the size of the fees involved. Many still believe the myth that the

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[13] Anne Faircloth, *One-on-One Shopping*, FORTUNE, July 7, 1997, at 235

[14] Confirm and get reference.

[15] 339 U.S. 485 (1950).

[16] Courts, however, have not found it improper for an agent to have clear duties to serve the buyer, but be paid by the seller's agent. *See* Brean v. North Campbell Professional Building, 548 P.2d 1193 (Az. 1976)[ck]; Duffy v. Setchell, 347 N.E.2d 218, 221 (Ill. App. 1976); RAY WILSON, BOUGHT, NOT SOLD: SINGLE AGENCY, BUYERS' BROKERS, FLAT FEES, AND THE CONSUMER REVOLUTION IN REAL ESTATE 89-95 (1998).

[17] *See* id., at 9-10, 79, 89-95 (1998).

[18] The FTC's circa 1980 survey found that non-traditional brokers typically charged a percentage-of-sale-price commission rate, although about a quarter charged a flat fee. (This figures include both buyer and seller brokers). *See* FTC 1983 Report, *supra* note 1, at 154.

service is actually free.

Another reason why the model may not have emerged is that buyers enjoy the right to avoid paying a fee when there is no sale, i.e., the contingent nature of the commission. Yet this should not be an obstacle to buyers hiring buyer's agents directly, for one would expect agents now representing buyers to willingly agree to defer payment of their fee until the buyer closed on a home. After all, that is the arrangement that agents representing buyers currently embrace.

Furthermore, the danger of free riding would not seem likely to increase from the level now accepted by buyer agents. That is, a buyer can now work with an agent for many hours, identifying the neighborhoods and types of homes of most interest, milking the agent for all their expertise, but then avoid a fee by terminating or simply not renewing the broker agreement, before seeking to purchase the next suitable new home on the market. Agents working with buyers now rely on buyers' sense of fairness, time pressures, or the fact that the having already worked with the buyer has allowed them to know the buyer well and thus likely to be helpful. There is no reason to expect that free riding would significantly rise in a buyer-pays-agent environment.

The buyer pays model may also have been deterred by agents' fear that buyers would find the hourly or flat fees they needed to charge to be much too high. Yet this would not likely last if and when buyers discovered the size of the fee they were indirectly paying already. After all, a direct fee might well be dramatically less than the standard, hidden fee.

Finally, agents willing to work for buyers at a fee negotiated with buyers are deterred by the prohibitions against rebates in many states, since sellers typically have already committed to a three percent fee for the cooperating broker.

B. Using a Percentage-of-Sale-Price, i.e., Equity-Based Element

Where a worker's performance is easily measurable in terms of a commodity output, it is generally efficient to pay the worker based on that output, e.g. on a piece-work basis. In most cases, however, it is difficult to quantify an individual's output. Therefore, individuals are often paid based on their input in terms of a rate per hour, day, week, or year, with the level of their pay dependent on their relative skills and experience and the supply and demand for their expertise.

Professionals, including lawyers, plumbers, and car mechanics usually state their hourly fees for labor at an initial meeting with a customer. While most would like to charge based on the value they can provide to customers in terms of additional profits, cost savings, or quality of result (i,e, capture almost all of the surplus value they create), competition generally pressures their prices down from that maximum to one based more on their costs in terms of the amount of time they must spend on a task and what hourly rate equalizes the supply and demand for their services. If tasks are relatively routine, professionals may charge a fixed price based on the average time required to accomplish them out of administrative convenience and buyer preference for certainty. Those with unique skills or expertise in a particular area may, however, be able to command a monopoly rent, and others may also be able to justify a fee resembling an equity share of an item for sale or purchase.

1. General Economic Justifications

a. Creator/Co-creator of Surplus Demands an Equity Stake

Some individuals have special talents, knowledge, experience, or skills that enable them to add substantial surplus value to a venture. While they could demand very high hourly or flat fees to try to reflect their contributions, its value may depend greatly on how successful a venture is and be terribly hard to predict. They may prefer to receive an equity share in the enterprise (possibly in addition to other fees) and their bargaining power may permit them to obtain this.

This group includes many executives who investment banks approach about leveraged buyouts (LBOs) due to their strong, longstanding, trusting relationships with other workers, customers, and suppliers. It also includes those lawyers and agents for top sports or entertainment talents able to obtain features in a contract that no one else can secure as well as higher payouts. They can demand and obtain a substantial portion, i.e., equity share, of the incremental benefit their involvement in the venture produced or they may insist that they will only work with someone who treats them like a co-venturer (equity owner or family) all the way.

b. Employer Unable to Secure Reasonably-Priced Debt Financing

In some cases, one entity will have an apparent opportunity to earn a substantial payout due to a patent, business model, copyright, talent, or status as victim of an accident. To collect their payout, however, they not only need help developing the project, but they need substantial amounts of capital they can simply contract to pay the latter a reasonable fee and proceed. The first entity lacks either the ability or willingness to finance the entire venture.

They may seek a loan to finance the project, but if there is a very high risk of failure (loss of the entire loan amount), the only willing lenders may be those who demand exorbitant rates of interest, making loans uneconomical. Instead, the entity with the idea or lawsuit generally secures an equity partner: one who will agree to provide a significant portion of the financing – in dollars and labor – in return for a share of the potential returns. The share set will depend primarily on how much funding is needed, how great the risk of failure, and the payoff from success.

One category of these situations is high risk tort litigation, where there is great uncertainty about whether anything will be collected. The personal injury cases portrayed in the John Travolta film "A Civil Action," the Julia Roberts film “Erin Brokovich,” and the initial cigarette company lawsuits are good examples of these cases. Given the amount of highly risky investments attorneys must make with their time and working capital, there is good reason to believe that they often deserve a substantial portion of the settlement, even one-third or more, or at least of the first large chunk of the settlement.[19]

A second category is new ventures with little working capital, like the Internet start-up companies of the late 1990s. In many cases, firms wanted to attract new employees with large salaries, but they simply did not have the funds or debt capacity to finance them and there was a

[19] These cases are very different from personal injury cases where a significant payoff is highly likely, but the level of the payoff is in question. In those cases, an hourly fee, payable at settlement, and a bonus share of the incremental value provided, i.e., the amount obtained above the settlement offer or some other estimate of the suit value might be appropriate.

chance that they never would. Therefore, in return for taking the risk that they would not get paid what they were worth, desired employees were offered substantial amounts of stock options, if not straight stock. When these firms later needed additional working capital to grow and still were unable to secure reasonably priced loans, they generally sold an equity stake to a venture capital firm.

A third category of these ventures include entertainment projects like new films, Broadway shows, musical groups, etc. In each of these cases, significant financing is required to develop these projects, including marketing costs and there is a large risk of a complete failure. Those willing to finance these projects, including Hollywood studios and record companies, insist on a large share of the revenues so that one big success can compensate them for losses on many other projects. They demand some equity ownership of the projects.

c. Motivate Better Performance, When Other Bonuses Are Insufficient

In most cases one can motivate individuals to exceed their normal performance standards with the opportunity for bonuses, promotions, and salary increases. Bonuses can be awarded subjectively or for meeting one or more targets. Yet in some cases, some top individuals may find such inducements insufficient because they believe that they are being treated unfairly compared to their peers, who have secured equity arrangements. That is behavioral economists have shown that many individuals will veto a payout scheme – even at the cost of denying themselves any payout – if they view it as unfairly enriching someone else at their expense.[20]

Thus, when LBO firms sought to employ top executives in their LBOs they showed those executives that the LBO firm viewed them as peers by recognizing that they were deserving of comparable equity participation, rather than as hired, albeit, highly paid hands.[21] Stock options, however, frequently grant enormous rewards to executives, due to general industry or economy-wide trends, even when the executive's performance was clearly sub-par. More traditional rewards, including bonuses and increased salaries would often seem more appropriate.[22]

Some might view the standard sales commissions that manufacturers or retailers pay to salespeople to encourage them to sell greater quantities of their products as an example of equity participation, but it is more accurate to view this form of compensation as piecework payments. For each item sold, the salesperson receives a portion of the price earmarked for marketing.

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[20] *See* Ernst Fehr & Klaus M. Schmidt, Theories of Fairness and Reciprocity – Evidence and Economic Applications, http://www.ssrn.com/abtract=255223[ck]; Robert Slonim & Alvin E. Roth, *Learning in High Stakes Ultimatum Games: An Experiment in the Slovak Republic*, 66 ECONOMETRICA, 569 (1998).[ck]

[21] Unfortunately, it appears that Wall Street extrapolated from this that either 1) to show appropriate "respect" all top executives need pay packages with substantial stock options or 2) that as a general matter, it is smart to stimulate corporate CEOs and other top executives to achieve more by tying payments to them to the fortunes of shareholders by using stock options. Unfortunately, this approach has encouraged executives to alter the timing of financially significant actions to produce short-term increases in stock prices, which maximize their compensation, even at the long term cost to the corporation.

[22] Some might argue that providing stock options (equity) widely within a firm is desirable for the purposes of morale, because then everyone has a stake in the success of the venture as a whole. Again, however, the use of stock options for this purpose suffers from the same flaws just mentioned, and there is a significantly less flawed alternative: profit sharing. Profit-sharing is a form of equity ownership, in that participants own the rights to a share of the profits, but it has the advantage that it is likely to be less affected by extraneous market conditions?

d. Proxy for Value of the Service

Some might justify setting compensation rates as a percentage-of-sales based on the precedents of tipping restaurant servers, taxi cab drivers, and others like that. Social norms appear to pressure consumers into adding an approximately fifteen percent surcharge to their dinner bills to reward the waiter or waitress.[23] This practice is honored by about ninety percent of consumers even though it leads two neighboring tables requiring the same level of service to leave very different tips simply because one ordered much more expensive entrees or wine than the other. Yet the critical element of this arrangement is that the payment is voluntary. Thus, customers are generally not compelled to pay such amounts and so they can comfortably pay less if they get relatively little service. In addition, when relatively big spenders tip they often desire to share their pleasure from a meal with others in a manner comparable to the way they donate to charity.

Although using the sales price as a proxy for total value provided is certainly imperfect, some may justify it as an alternative to the incremental value provided due to the difficulty of establishing the incremental value produced. The problem, as with granting bonuses or stock options, is what benchmarks to use to measure work that is satisfactory, excellent, or outstanding. If there is no way to estimate what result to expect from a lawsuit or a contract negotiation given mere adequate service, it is impossible to set a provider's fee on the incremental value provided.

e. Avoiding Some Harmful Effects of Hourly Rates

Basing compensation on a percentage-of-sales-price also avoids some drawbacks of paying fees based on hours of input, particularly that the latter creates an incentive for employees to cautiously spend more time than necessary on a project and to overstate the time spent. The approach can also favor the slow over the fast, although fast workers can advertise their speed and demand higher hourly rates based on it. Hourly rates may also deter customers from communicating freely because they feel that they are "on the meter." Many may be reluctant to fully explain an important matter out of a false belief that it is not important and they do not want to pay a lot to air it.

Whatever the disadvantage of hourly rates, however, it is important to recognize that they can be avoided by employing any one of multiple alternatives, including flat fees for particular discrete tasks. In fact, this article suggests such fees for services where there is the greatest danger of the abuses just mentioned and where flat fees appear to be relatively efficient.

A few of the services provided by agents, however, would seem to vary greatly from sale to sale and be hard to predict in many cases. Flat fees might be less efficient for these, particularly if average pricing leads to adverse selection. Yet the services where the agent is together with the client in discussions on the phone, taking buyers on home visits or managing an open house seem to be relatively easy to monitor and hard for agents to cheat on clients. Furthermore, clients would have the option of extending or contracting these time periods.

[23] *See* Mark S. Nadel, *How Current Copyright Law Discourages Creative Output: The Overlooked Impact of Marketing,* 19 BERKELEY TECH. L.J. 785, 839-41 (2004).

f. Contingent Nature of Fee: Insurance

An equity-based fee also may appeal to consumers because it is contingent upon a transaction, i.e., no fee if there is no sale. Still, as noted above, fees can be made contingent on a transaction without being made equity-based; one can simply supplement the fee with a surcharge priced to cover insurance against the failure of the transaction to occur. Many consumers might gladly pay such a surcharge to option such protection against facing a bill for an agent's services even without a purchase or sale. Others, however, might prefer to avoid the fee by committing to pay the base charge whether or not the transaction takes place.

This situation is similar to what arose with regard to airline tickets in the not too distant past. Prior to about 1990?, airlines were willing to refund the purchase price to ticket buyers if they did not use their tickets. Thus, ticket buyers were effectively purchasing both a ticket and insurance against cancellation. Yet when price competition led some airlines to begin to offer lower prices for non-refundable tickets??, most leisure customers chose them and generally only business travelers, who frequently had to cancel, paid the higher price to purchase the insurance component.

2. Justification for Use by Real Estate Brokers

Some argue that using a percentage-of-sale-price fee ensures that listing agents are motivated to secure the highest price for the seller,[24] but as noted in the analysis above, other bonuses would seem to be sufficient and more targeted to this goal. Meanwhile there are two major problems with this justification. First, it argues against the use of the pricing element in the buyer broker's rate structure, since it gives buyers' agents an incentive to encourage buyers to offer a higher price.[25] Second, there does not appear to be any scholarly research that supports the assertion that the pricing structure motivates agents to obtain higher prices.[26]

With respect to motivating agents, they will presumably give greater attention to those projects where they stand to earn the greatest payoffs,[27] that is, generally higher priced homes. To truly motivate and reward them to serve the interests of the client their compensation might be based on a measure of the *incremental benefit* they provide. Rather than basing it on the nominal selling price of the home, they should be rewarded based on their ability to help a buyer secure a price below the asking price or a seller with a price above the price of comparable homes sold immediately before and after it. Using the selling price rather than the incremental value added

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[24] *See* Michael A. Arnold, *The Principal-Agent Relationship in Real Estate Brokerage Services,* 20 J. AREUEA 89 (1992); G.D. Jud & J. Frew, *Real Estate Brokers, Housing Prices, and the Demand for Housing,* 23 URB. STUD. __ (1986).[ck]

[25] *Cf* Vogel v. American Society of Appraisers, 744 F.2d 598, 602 (7th Cir. 1984) (upholding an appraisal industry rule against using a fee of 1% of the appraised value of item(s) as likely a praiseworthy effort at self-regulation).

[26] *See* note 6, *supra*; Steven D. Levitt & Chad Syverson, Market Distortions When Agents are Better Informed: The Value of Information in Real Estate Transactions, NBER Working Paper #11053, Jan. 2005, *available at* http://www.nber.org/papers/w11053; Thomas S. Zorn & James E. Larsen, *The Incentive Effects of Flat-Fee and Percentage Commissions for Real Estate Brokers*, 14 AREUEA J. 24 (1986) (finding that a flat fee and percentage fee provide equivalent incentives); Henry J. Munneke & Abdullah Yavas, *Incentives and Performance in Real Estate Brokerage,* 22 J. REAL EST. FIN. & ECON. 5 (2001) (finding that effectively doubling agents net percentage commissions did not seem to have any effect on agent performance).

[27] *See* W. Carroll, *Fixed-Percentage Commissions and Moral Hazard in Real Estate Brokerage,* 2 J. REAL EST. FIN. & ECON. 349 (1989).[ck]

is comparable to granting executives stock options with a strike price of zero. That is, in addition to some flat fee or other combination of fees for service, agents might be offered bonuses of a substantial percentage, e.g., 30 or even 50 percent or more, of the difference between the target price and the more desirable price they secured.[28] Given the importance of time to many sellers, bonuses based on obtaining a sale quickly would also appear to make a lot of sense, and here, flat amounts would seem to do the trick.[29]

One commentator says that a three percent commission looks right for the typical amount of hours that an agent spends on a transaction,[30] and another estimates that that fee is probably right for low to mid-sized homes.[31] Another academic study used a model to calculate the theoretically socially optimal rate: about three percent.[32] Yet it is difficult to understand how one can simultaneously defend a fee of X for selling a home priced at $200,000 and 4X for selling an identical home in a much more popular location for $800,000 home. Savvy or lucky investors may deserve their differing profits, yet one's real estate agent would seem to have no greater claim to a share of the profit than one's tax accountant.

More expensive homes are more likely to include more special features than less expensive homes, but it does not follow that it would take agents longer to sell such homes, since lower-income purchasers might well be more concerned about basic details than wealthier buyers are about special features. It is hard to generalize and certainly there is no support for a presumption that it requires four times the effort to sell an $800,000 home as to sell a $200,000 home. That seems similar to paying tax preparers four times the fee for preparing a tax return reporting four times the gross income when the difference between the returns is solely a single large stock sale or paying a doctor four times the fee for prescribing pills priced at four times the dollar value of another's pills when that is because the first patient's pills' retail price is four times higher.

Despite this analysis and the emergence of unbundled real estate service providers and buyers agents, the NAR reports that about 90% of agents are still compensated based on the sale price of a home,[33] and this includes most buyer agents. Moreover, non-traditional, relatively new entrants eRealty, zipRealty, and Foxton's all entered the residential real estate brokerage industry by offering percentage-of-sale-price commissions.[34]

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[28] *See* Chang-Tai Hsieh & Enrico Moretti, *Can Free Entry be Inefficient? Fixed Commissions and Social Waste in the Real Estate Industry,* 111 J. POL. ECON. 1076, 1087 n.17 (2003). In fact, in the extreme case of this arrangement, called a "net listing," a seller states a net price desired and permits an agent to keep 100 percent of what the home sells for above that amount as a fee. *See* ROBERT IRWIN, TIPS AND TRAPS WHEN SELLING A HOME 60 (3rd ed. 2004)[ck].

[29] *But see* D. Geltner, B. Kluger & N. G. Miller, *Incentive Commissions in Residential Real Estate Brokerage,* 2 J. HOUSING ECON. 139 (1992) (finding that time incentive contracts are not superior to fixed percentage commissions).[ck]

[30] *See* WILSON, *supra* note 16, at 99-100.

[31] *See* KIPLINGER STAFF, KIPLINGER'S GUIDE TO BUYING & SELLING A HOME 95 (1996)..

[32] *See* Paul Anglin & Richard Arnott, *Are Broker Commission Rates on Home Sales Too High? A Conceptual Analysis,* 27 REAL EST. ECON. 719, 736 (1999) (2.8 percent).

[33] NAT'L ASSOC. OF REALTORS, THE FUTURE OF REAL ESTATE BROKERAGE 6 (2003).

[34] The former two both began at 4.5%, but in 2003, both raised their rates. eRealty stopped promising 4.5% commission to sellers and a 1% rebate to buyers, moving to an individually negotiated levels. After dropping its guarantee earlier in the year zipRealty claims that its commission average about 4.75%. *See* David Wessel, *Web May Soon Work Magic in Real Estate,* WALL ST. J. , Oct. 31, 2002, at A2; James R. Hagerty, *Real-Estate Sites Raise*

Commissions, Dec. 24, 2003, at D1.