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Putting the Brakes on Private Transfer Fee Covenants

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PUTTING THE BRAKES ON PRIVATE TRANSFER FEE COVENANTS

By R. Wilson Freyermuth

Real estate developers are increasingly imposing private transfer fee covenants on real estate under development. A covenant of this type purports to allow a developer to collect a fee on each future resale of the affected land during the term of the covenant. But is a private transfer fee covenant valid and enforceable?

Three years ago in this magazine, Marjorie Bardwell and Jim Durham first highlighted the use of private transfer fee covenants in their article, *Transfer Fee Rights: Is the Lure of Sharing in Future Appreciation a Flawed Concept?*, Prob. & Prop. 24, May/June 2007. That article raised substantial questions about the validity of such covenants. Since that article, however, the imposition of these covenants has continued to grow exponentially. Companies now market private transfer fee covenant documentation to developers. Nevertheless, the legal basis for the enforcement of such covenants remains dubious and private transfer fee covenants are increasingly commanding the attention of state legislatures.

This article will discuss private transfer fee covenants, using one popular model as an example. After explaining how a private transfer fee covenant operates, the article will review the background legal principles relevant to its enforceability. As this article will argue, sound policy does not justify the enforcement of private transfer fee covenants. The article concludes with a discussion of recent state legislative efforts to invalidate private transfer fee covenants and highlights a new model statute that, if adopted, would declare such covenants void as contrary to public policy.

The Private Transfer Fee Covenant

Assume that ABC Land Co. is developing a 500-lot residential subdivision, known as Shady Acres, and wants to impose a transfer fee covenant on each lot. As in any typical development, ABC Land Co. records a declaration within the chain of title for each lot in Shady Acres. The declaration imposes a transfer fee covenant that purports to run with each lot and bind subsequent owners for a 99-year period. This covenant does not impose a fee on the first sale, so when ABC Land Co. sells a home to the initial homebuyer (whom we will call Jones), Jones pays no transfer fee. The covenant, however, provides that if Jones resells the home during the 99-year term of the covenant, Jones must pay a fee equal to 1% of the purchase price. As a result, if Jones resells the lot four years later for a price of $200,000, Jones must pay a $2,000 transfer fee to a trustee identified in the declaration. If Jones does not pay the fee, the declaration provides that the trustee has a lien on the land to secure the unpaid transfer fees and can foreclose that lien (including by nonjudicial process, to the extent permitted by other state law) to satisfy the fee payment obligation.

On collecting a transfer fee, the trustee divides the fee among the following persons:

- the developer (which typically retains at least 50% of the transfer fee right);
- the trustee (which retains a portion of the fee as compensation for tracking ownership of the transfer fee rights and handling transfer fee payments);
- the company that developed the private transfer fee documentation (which retains a portion of the fee as compensation for "licensing" the developer to use its documentation);
- in some cases, agents, brokers, and other professionals associated with the sale transaction; and
- in some cases, a community nonprofit organization identified by the developer (according to one source, such nonprofits may receive as much as 5% of the transfer fee right).

Most importantly, however, this declaration does not simply impose the transfer fee covenant only on the first resale by Jones. Instead, the declaration also imposes a 1% fee on the seller at the time of *each subsequent resale* of the parcel during the 99-year term. Thus, if the parcel is sold 11 times during the 99-year term (or every nine years, on average), the trustee could collect a 1% fee from each seller in each of the 11 sale transactions.

A developer could choose to retain its transfer fee rights and collect from the trustee its allocated share of the fee on each future resale during the term of the covenant. Alternatively, the developer could instead choose to sell its transfer fee right immediately. One company assists developers wishing to sell their transfer fee rights by pooling those rights and seeking secondary market buyers. Freehold Capital Partners, *Learn How Reconveyance Fee Instruments Can Help You*, at 11–12 [hereinafter Freehold Brochure], available at www.freeholdcapitalpartners.com/forms/freehold_brochure.pdf (last visited Apr. 19, 2010).

The "Touch and Concern" Standard

A substantial question, however, is whether a private transfer fee covenant based on this model actually creates an enforceable legal right. Under traditional common law rules, the burden of a covenant did not run to bind a successor to the original covenantor unless *both the benefit and the burden* of the covenant "touched and concerned" land. Although the precise meaning of "touch and concern" has never been transparent, the standard was understood to protect against the creation and enforcement of covenants that could unreasonably restrain the alienability of land.

Historically, American courts struggled in applying this test to evaluate affirmative covenants to pay money. Both the benefit and the burden of an affirmative covenant to pay money can "touch and concern" land. *Neponsit Property Owners' Ass'n v. Emigrant Indus. Sav. Bank*, 15 N.E.2d 793 (N.Y. 1938). The best example is the typical owners' association assessment covenant, which imposes an assessment on each lot payable to an owners' association to fund the operation of the association and the maintenance of common facilities. These

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assessments benefit community residents directly (for example, by providing access to pools or parks) or indirectly (such as by preserving/raising property values because of the presence of valued amenities). Ever since the landmark *Neponsit* case, courts have held that both the burden and benefit of a lot assessment covenant "touch and concern" land and bind successor owners of that land. This result makes good sense doctrinally. Although the covenant does indirectly restrain alienation of the affected land, its practical effect on alienability is negligible. Because many buyers value the common facilities and amenities enough to accept the assessments needed to preserve them, the assessment covenant constitutes a reasonable and enforceable restraint.

By contrast, a private transfer fee covenant is payable only to private persons, not to an owners' association. By the time the developer collects a future transfer fee, the developer likely will have completed the sale of all affected lots and will have no legal interest (other than the transfer fee rights) in the community. As a result, the benefit of a private transfer fee covenant is personal to the developer; in the language of the common law, the benefit of the covenant is "in gross." Under the weight of common law authority, if the benefit of a covenant is in gross, the burden of that covenant does not run to bind successors to the original covenantor. See, e.g., *Garland v. Rosenshein*, 649 N.E.2d 756, 758 (Mass. 1995); *Bremmeyer Excavating, Inc. v. McKenna*, 721 P.2d 567 (Wash. Ct. App. 1986); *Caullett v. Stanley Stilwell & Sons, Inc.*, 170 A.2d 52, 56 (N.J. Super. Ct. App. Div. 1961).

The "touch and concern" standard essentially established a prophylactic rule against the running of covenants that created purely personal benefits. In other words, it did not matter whether the enforcement of a covenant in gross *actually* constituted an unreasonable restraint on alienation. Instead, courts viewed the *potential* burden on alienability posed by covenants in gross as warranting a per se rule prohibiting their enforcement against successors, regardless of actual harm. Under this traditional view, a developer could not enforce a private transfer fee covenant against subsequent owners of the affected land.

The Restatement of Servitudes

The status of the "touch and concern" standard has been called into some question by virtue of the new Restatement on Servitudes. The Restatement purports to abandon the "touch and concern" standard, instead substituting standards under which a covenant is enforceable against successors unless the covenant is "arbitrary, spiteful, capricious," imposes an "unreasonable restraint on alienation," imposes

The argument that a private transfer fee covenant is a reasonable restraint depends on a dubious assumption.

an "unreasonable restraint on trade or competition," or is "unconscionable." Restatement (Third) of Property—Servitudes, § 3.1(1), (3)-(5) (2000). If a covenant imposes only an indirect restraint on alienation, the Restatement suggests that the covenant does not unreasonably restrain alienation unless it "lacks a rational justification." Id. § 3.5(2).

Under the common law's prophylactic "if the benefit is in gross, the burden won't run" rule, a developer had little incentive to impose a private transfer fee covenant. By purporting to reject this prophylactic rule in favor of a "reasonableness" standard, however, the Restatement has encouraged the proliferation of private transfer fee covenants. In fact, companies marketing private transfer fee covenants characterize such covenants as "reasonable" restraints, and their promotional materials point to the Restatement for support. Transfer fee covenant advocates argue that:

- A 1% private transfer fee covenant has no practical burden on the alienability of land, but only slightly reduces the price at which a transfer will take place Because the covenant is recorded, a buyer of an affected lot will reduce its offer price to account for the transfer fee obligation that the buyer will incur on resale. Thus, the covenant does not create an unreasonable restraint on alienation and should be enforceable as long as it has a rational justification.
- A 1% private transfer fee covenant has a rational justification because it benefits both the developer and the initial buyer. The covenant benefits the developer by allowing it to retain the transfer fee rights, thus assisting the developer's marketing efforts (that is, permitting the developer to sell its lots at a discounted price as compared to unrestricted land). In turn, the covenan benefits the buyer, who obtains the land at a discounted price as compared to unrestricted land. By lowering the buyer's acquisition costs, the covenant in turn reduces the buyer's transaction and carrying costs (that is, by lowering the value of the land, the covenant mar ginally reduces the buyer's borrowing costs, annual ad valorem tax obligation and ultimately the buyer's brokerage commission on resale).

Certainly, some of the strong freedom-of-contract rhetoric in the Restatement's commentary offers some support for advocates o private transfer fee covenants:

> Many economic arrangements for spreading the purchase price of property over time and for allocating risk and sharing profit from property developmen can be attacked as indirect restraints on alienation. If such arrangements are not unconscionable and do not otherwise violate public policy, there is usually no reason to deny the parties freedom of contract. The parties are usually in a better position than judges to decide the economic trade-offs that will enable a transaction to go forward and enhance their overall value. The fact that the value that may be realized from a parcel of land

> that is part of a larger arrangement has been reduced does not justify legal intervention to nullify part or all of the agreed-on arrangement.

Restatement § 3.5 cmt. a.

Transfer Fees and Land Policy

Notwithstanding the ostensible justifications offered by those marketing this product, the enforcement of private transfer fee covenants constitutes unsound public policy. Courts should refuse to enforce these covenants against successors, for several important reasons.

Buyers Cannot Accurately "Price" the Effect of a Private Transfer Fee Covenant

The argument that a private transfer fee covenant is a reasonable restraint depends on a dubious assumption—that buyers can readily discover the covenant, fully understand and evaluate its implications, and adjust the offer price to account for its effect. Even buyers that know of the covenant cannot "price" its effect with precision, however.

First, because the amount of the buyer's future transfer fee obligation is a function of the land's value at a *future* date, the buyer's ability to "price" the appropriate discount is a function of both the expected future appreciation in the land's value and the appropriate "discount" rate (the rate used to convert the expected future transfer fee obligation into present dollars). There is little empirical evidence to suggest that the typical homebuyer can make an informed or accurate judgment about future rates of appreciation or an appropriate discount rate. Second, buyers lack perfect information about their holding periods. A buyer that expects to resell the house in only two to three years can readily appreciate the need to discount the offer price to account for the transfer fee that will be imposed on this expected transaction. By contrast, a buyer that expects to live in the house for 40 years may tend to disregard the fee, concluding that its effect in present dollars is *de minimis*. Because buyers lack perfect information about their likely holding period, they cannot accurately price the appropriate discount for the transfer fee covenant.

More importantly, in most real estate price negotiations buyers lack a way of evaluating the actual price reduction that results from the transfer fee covenant or its value in carrying cost reductions. It is correct to say that *if* a transfer fee covenant enables Jones to pay $2,500 less to acquire the land today—and thus allows Jones to borrow $2,000 less to finance the purchase—Jones will save $100–$120 in interest costs during the first year (and slightly less during each subsequent year as the principal balance amortizes). Jones, however, cannot be certain that $100–$120 per year will be saved in borrowing costs *unless Jones also knows that the purchase price of the property is $2,500 less because of the presence of the covenant*. Unfortunately, Jones cannot be so confident, unless the developer offers Jones a choice to purchase the land at either a "restricted" price (subject to the covenant) or an "unrestricted" price (not subject to the covenant). If the private transfer fee covenant is imposed on a "take it or leave it" basis, buyers do not have a meaningful "covenant or no covenant" choice. Further, because land is relatively unique, there is likely no identical "unrestricted" parcel with an identifiable price that the buyer can use as a baseline to calculate the incremental "burden" and "benefit" of the covenant.

Buyers who lack the ability to evaluate the financial effect of the covenant accurately are likely to underestimate the covenant's effect, and thus to not discount their offer prices sufficiently. If so, the covenant presents the developer with a profitable arbitrage opportunity, and promotional materials have touted this opportunity to developers. For example, the Freehold Brochure suggests that a 1% transfer fee covenant should reduce the buyer's offer price by approximately 2%. Freehold Brochure, at 3. Yet earlier editions of this brochure estimated the *value* of the transfer fee rights at approximately 5% of the improved value of the property. If buyers were truly informed and sufficiently sophisticated to price the covenant accurately, such a sizable gap would not be present. This may explain why—notwithstanding its freedom-of-contract rhetoric—the Restatement characterizes a private transfer fee covenant as potentially unconscionable. See Restatement § 3.7 cmt. c, illus. 3.

Transfer Fee Covenants Unreasonably Hinder the Alienability of Land

A private transfer fee covenant impedes future land transactions by imposing additional unwarranted transaction costs. Because the developer may have sold the right to collect future transfer fees, the seller may incur additional expense to locate and pay the holder of the transfer fee rights, and the fee may have to be escrowed if that person cannot be found. Although the developer can ameliorate this risk by designating a trustee to collect the fee, nothing prevents the developer from imposing a private transfer fee covenant that requires payment directly to the developer. Also, the seller and the buyer must incur additional costs negotiating responsibility for payment of the fee. The seller can incur additional costs in determining whether disclosure of the covenant is required (and, if so, ensuring that it makes proper disclosure). The buyer may incur additional time and expense negotiating with the title insurer over the form of the exception that the insurer will take for the covenant. Unless the covenant subordinates the developer's lien to the lien of future mortgage loans, the buyer can incur greater expense in obtaining financing if the buyer's mortgage lender insists on obtaining subordination of the transfer fee covenant lien. Finally, if private transfer fee covenants are enforceable, a buyer of the land may try to impose an additional transfer fee covenant (to permit the buyer to recoup the expected cost of having to pay the first transfer fee), thereby triggering multiple transfer fees on later resales. Over time, this "stacking" of transfer fees would create a needless complication and impediment to the transfer of the affected land.

Transfer Fee Covenants Reduce the Tax Base for the Benefit of Private Parties

Finally, and most important, any financial benefit that a private transfer fee covenant creates comes at the expense of the public. The enforcement of a private transfer fee covenant will reduce the value of the affected land, creating an artificial reduction in the community's ad valorem tax base. Incremental sums that would have gone to the local

community to fund public education, infrastructure, and community services will instead be diverted to developers. Sound public policy should not permit private action, taken outside of the community's democratic processes, to create a diversion of the tax base for private benefit.

Recognizing these concerns, in October 2009 the Joint Editorial Board for Uniform Real Property Acts (JEBURPA) unanimously resolved that private transfer fee covenants create an unreasonable restraint on the alienability of land. The JEBURPA is comprised of representatives from the ABA's Real Property, Trust and Estate Law Section, the American College of Real Estate Lawyers, and the Uniform Law Commission, as well as liaison members from the American College of Mortgage Attorneys and the Community Associations Institute. The JEBURPA has issued a position paper expressing the view that state courts should not enforce private transfer fee covenants and that state legislatures should enact statutes declaring such covenants void as contrary to public policy.

Recent Legislative Activity

To date, 11 states have adopted statutory provisions directly addressing the enforceability of private transfer fee covenants. The only state that has explicitly validated private transfer fee covenants is California, which has adopted a "disclosure" model. In California, a transfer fee covenant is enforceable against successors as long as the person imposing the covenant records a document indicating "Payment of Transfer Fee Required" in the chain of title to the real estate. Cal. Civ. Code § 1098.5. This document must contain certain information, including (1) a clear statement of the amount or percentage of the fee; (2) for residential real estate, "actual dollar-cost examples of the fee" for a home priced at $250,000, $500,000, and $750,000; (3) the expiration date of the transfer fee covenant, if any; (4) the purpose for which the funds from the fee will be used; and (5) the name of the entity to which the fee must be paid (along with specific contact information).

By contrast, eight states—Arizona, Florida, Iowa, Kansas, Maryland, Missouri, Oregon, and Utah—have recently enacted statutes explicitly banning private transfer fee covenants. Fla. Stat. Ann. § 689.28 (2007); Mo. Rev. Stat. § 442.558 (2008); Or. Rev. Stat. § 93.269 (2009); Kan. Stat. § 58-3821 (2009); Ariz. Rev. Stat. § 33-442 (2010); Iowa Code § 558.48 (2010); Md. Real Prop. Code Ann. § 10-708 (2010); Utah Code Ann. § 57-1-46 (2010). In these states, private transfer fee covenants imposed after the effective dates of the relevant statutes are deemed contrary to public policy and void.

Likewise, in 2007, Texas adopted a statute that purports to prohibit the enforcement of a covenant imposing a transfer fee on a "transferee of residential real property or the transferee's heirs, successors, or assigns . . . in connection with a future transfer of the property . . . ." Tex. Prop. Code § 5.017(b). Transfer fee advocates may argue that private transfer fee covenants are enforceable under the Texas statute because they obligate the *seller* to pay the fee, not the buyer. This argument is of doubtful validity, however. First, it is inconsistent with a literal reading of the statute; even if a buyer is not liable for the fee that accrues when the land is acquired, the covenant still imposes on the buyer the obligation to pay "a fee in connection with a *future* transfer of the property" (that is, a future resale). Second, if the seller fails to pay the fee, it becomes a lien against the land that prevents the buyer from delivering clear title to a subsequent purchaser. Thus, the better view is that the Texas statute operates as a ban on private transfer fee covenants on residential real property.

Finally, while Louisiana does not have a statute directly addressing private transfer fee covenants, such a covenant would almost certainly be unenforceable under its civil law. The Louisiana Civil Code requires that a predial servitude (which is analogous to an easement appurtenant) provide a benefit to a dominant estate for that servitude to be enforceable. La. Civ. Code art. 647. Further, it allows personal servitudes (servitudes in gross) to be enforced only when they provide an "advantage" (such as an access right) that could be established as a predial servitude. Id. art. 640.

A Model Transfer Fee Covenant Statute

As the use of private transfer fee covenants has accelerated, both the National Association of Realtors (NAR) and the American Land Title Association (ALTA) have adopted comparable policy statements against the use and enforcement of private transfer fee covenants. ALTA's statement provides that "these covenants provide no benefit to consumers or the public, but rather cost consumers money, complicate the safe, efficient and legal transfer of real estate, and depress home prices." American Land Title Ass'n, *Private Transfer Fee Covenants*, www.alta.org/advocacy/docs/PrivateTransferFeeCovenant_OnePager.pdf (last visited Apr. 19, 2010). The NAR's statement argues that "such fees decrease affordability, serve no public purpose, and provide no benefit to property purchasers, or the community in which the property is located." National Ass'n Realtors, *Private Transfer Fees–Issue Summary*, http://realtorbenefits.org/fedistrk.nsf/c2c6e17e27e92119852572f8005cd953/8d538870711f2242852573d400721228?OpenDocument (last visited Mar. 31, 2010).

Consistent with their stated policy, both NAR and ALTA are currently seeking to introduce in state legislatures a model statute banning transfer fee covenants. This model statute appears on page 25. Section 1(b) of the model statute expresses state legislative findings that private transfer fee covenants violate public policy by creating an unreasonable impediment to the alienability of land, regardless of the duration of the covenant or the amount of the transfer fee. Section 1(c) would prospectively invalidate any transfer fee covenant recorded after the statute's effective date—making such a covenant unenforceable against the real property or any subsequent owner of the property. Section 1(c) also would invalidate any lien to the extent that it purports to secure the payment of a transfer fee.

Although the model statute would not apply to private transfer fee covenants recorded before the statute's effective date, section 1(d) does provide that the statute should not be interpreted to validate such covenants. Thus, in any state that adopts

this model statute, a court facing a challenge to a pre-existing transfer fee covenant should evaluate its enforceability against successors based on the common law of covenants and servitudes—and ought to conclude that such a covenant does not run with the land to bind successors.

The model statute does recognize that a covenant might impose a transfer fee that is payable to an owners' association for the purpose of financing association operations and/or maintenance of common amenities. Such covenants (the "flip tax" often imposed by housing cooperatives, for example) would typically have satisfied the common law's "touch and concern" test, and thus section 1(a) of the statute excludes such covenants from the definition of a "transfer fee covenant." Likewise, in master planned communities, some amenities (community centers, recreational facilities, or performing arts centers, for example) may be financed in part by transfer fee covenants on land within the various common interest communities that comprise the larger development. Because such facilities provide an ostensible benefit to these common interest communities and the owners within these communities, covenants that create transfer fees to fund those amenities are likewise excluded from the coverage of the model statute.

Conclusion

Although advocates argue that private transfer fees are reasonable and benefit both developers and buyers, these arguments are unpersuasive. Private transfer fee covenants create an unjustified impediment to the transfer of affected real estate; further, enforcing private transfer fee covenants (and thereby lowering the value of the affected real estate) would permit a developer to divert a portion of the community's ad valorem tax base to the developer's private benefit—all outside the community's democratic processes. Accordingly, courts should refuse to enforce private transfer fee covenants against successors, and states should enact legislation (such as the model statute discussed above) making clear that private transfer fee covenants are void because they are contrary to public policy. ■

Model Private Transfer Fee Covenant Statute

SECTION 1. Prohibition on Transfer Fee Covenants.

(a) As used in this section:

(1) "Association" means a nonprofit, mandatory membership organization comprised of owners of homes, condominiums, cooperatives, manufactured homes, or any interest in real property, created pursuant to a declaration, covenant, or other applicable law.

(2) "Transfer" means the sale, gift, grant, conveyance, assignment, inheritance, or other transfer of an interest in real property located in this State.

(3) "Transfer fee" means a fee or charge imposed by a transfer fee covenant, but shall not include any tax, assessment, fee or charge imposed by a governmental authority pursuant to applicable laws, ordinances, or regulations.

(4) "Transfer fee covenant" means a provision in a document, whether recorded or not and however denominated, which purports to run with the land or bind current owners or successors in title to specified real property located in this State, and which obligates a transferee or transferor of all or part of the property to pay a fee or charge to a third person upon transfer of an interest in all or part of the property, or in consideration for permitting any such transfer. The term "transfer fee covenant" shall not include:

(A) any provision of a purchase contract, option, mortgage, security agreement, real property listing agreement, or other agreement which obligates one party to the agreement to pay the other, as full or partial consideration for the agreement or for a waiver of rights under the agreement, an amount determined by the agreement, if that amount:

(i) is payable on a one-time basis only upon the next transfer of an interest in the specified real property and, once paid, shall not bind successors in title to the property;

(ii) constitutes a loan assumption or similar fee charged by a lender holding a lien on the property; or

(iii) constitutes a fee or commission paid to a licensed real estate broker for brokerage services rendered in connection with the transfer of the property for which the fee or commission is paid;

(B) any provision in a deed, memorandum, or other document recorded for the purpose of providing record notice of an agreement described in subsection (a)(4)(A);

(C) any provision of a document requiring payment of a fee or charge to an association to be used exclusively for purposes authorized in the document, as long as no portion of the fee is required to be passed through to a third party designated or identifiable by description in the document or another document referenced therein; or

(D) any provision of a document requiring payment of a fee or charge to an organization described in Section 501(c)(3) or 501(c)(4) of the Internal Revenue Code, to be used exclusively to support cultural, educational, charitable, recreational, environmental, conservation, or other similar activities benefiting the real property affected by the provision or the community of which the property is a part.

(b) The Legislature makes the following findings:

(1) The public policy of this State favors the transferability of interests in real property free from unreasonable restraints on alienation and covenants or servitudes that do not touch and concern the property.

(2) A transfer fee covenant violates this public policy by impairing the marketability of title to the affected real property and constitutes an unreasonable restraint on alienation, regardless of the duration of the covenant or the amount of the transfer fee set forth in the covenant.

(c) A transfer fee covenant recorded after the effective date of this section, or any lien to the extent that it purports to secure the payment of a transfer fee, is not binding on or enforceable against the affected real property or any subsequent owner, purchaser, or mortgagee of any interest in the property.

(d) Nothing in this section shall imply that a transfer fee covenant recorded prior to the effective date of this section is valid or enforceable.