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October 12, 2010

Alfred M. Pollard, General Counsel
Federal Housing Finance Agency
Fourth Floor, 1700 G Street, NW
Washington, DC 20552

Re: Public Comments “Guidance on Private Transfer Fee Covenants” [No. 2010-N-11]

Dear Mr. Pollard:

On behalf of the Joint Editorial Board for Uniform Real Property Acts (JEBURPA), we are submitting these comments on the FHFA’s proposed guidance No. 2020-N-11 on Private Transfer Fee Covenants.

The JEBURPA is comprised of representatives from the American Bar Association Real Property, Trust and Estate Law Section, the Uniform Law Commission (ULC), and the American College of Real Estate Lawyers, as well as liaisons from the American College of Mortgage Attorneys and the Community Associations Institute. The JEBURPA members — all distinguished real estate practitioners and/or teachers of real estate law — advise the ULC regarding prospective uniform law projects relating to real estate, and seek to promote law reform by encouraging states to adopt existing uniform and model real estate laws. We emphasize, however, that the comments in this letter represent solely the views of the individual members of JEBURPA and have not been considered or approved by the ULC or the other constituent organizations of JEBURPA.

Over the past three years, the JEBURPA has been engaged in detailed study of transfer fee covenants. This study prompted the JEBURPA to prepare a formal position paper, issued in April 2010, which recommended that all state legislatures enact statutes declaring private transfer fee covenants to be unenforceable. A copy of this position paper is attached to these comments as Exhibit A.

In addition, members of the JEBURPA have consulted with representatives of the American Land Title Association (ALTA) and the National Association of Realtors (NAR) in the preparation of a model state statute. Since 2007, these collaborative efforts have produced legislation banning private transfer fees in 17 states, and we expect significant new enactments in the 2010-2011 and 2011-2012 legislative sessions.

The JEBURPA’s position paper, and all of the recent state legislation, is directed at covenants imposing “non-beneficial” or purely ***private*** transfer fees — *i.e.*, transfer fees payable to the developer or other third parties with the recipient(s) having no

ongoing obligation to use or apply the fees for the benefit of the land affected by the covenant or the common interest community in which the land is located. If the FHFA's proposed guidance had been limited ***solely*** to these private transfer fee covenants, JEBURPA would have had no substantial concerns with the proposed guidance. We find no policy justification for purely private transfer fee covenants and little support for them among any interest groups, other than those financially benefitted by such covenants.

Our major concern, however, is that the proposed guidance "does not distinguish between private transfer fee covenants which purport to render a benefit to the affected property and those which accrue value only to unrelated third parties." 75 Fed. Reg. 49932-33. The proposed guidance would direct Fannie Mae and Freddie Mac not to purchase any mortgage loan where the mortgage secures land that is subject to a transfer fee covenant — even if that fee is payable to an owners' association and its use is devoted to purposes which directly benefit the owners of the affected land, such as maintenance of, improvements to, or replacements of community facilities.

In this respect, the proposed guidance is demonstrably overbroad when compared to the existing legal status of covenants imposing transfer fees for the benefit of owners' associations. Existing law is clear — if a covenant imposes a financial obligation on a landowner, but the funds generated by that covenant would provide a benefit to the affected land or other land, the covenant "touches and concerns" the land and thus the covenant is enforceable against the owners of affected land and their successors. *See, e.g., Neponsit Property Owners' Ass'n, Inc. v. Emigrant Indus. Sav. Bank*, 278 N.Y. 248, 15 N.E.2d 793 (1938) (annual lot assessment covenant "touches and concerns" land); *Mayerson v. 3701 Tenants Corp.*, 123 Misc.2d 235, 473 N.Y.S.2d 123 (1984) (upholding covenant imposing 7.5% transfer fee upon resales of cooperative units); *Jamil v. Southridge Co-op. Sec. No. 4 Inc.*, 102 Misc.2d 404, 425 N.Y.S.2d 905 (1979) (upholding covenant imposing flat $2,000 transfer fee upon resales of cooperative units); Restatement (Third) of Property — Servitudes § 3.5.[1]

Likewise, the proposed guidance would direct Fannie Mae and Freddie Mac not to purchase any mortgage loan where the mortgage secures land that is subject to a transfer fee covenant for which the fees support various forms of charitable endeavors such as affordable housing, historic preservation, or environmental protection. Again, the proposed guidance would be overbroad when compared to the existing legal status of such covenants, many of which are enforceable under state law (either because they have been found to "touch and concern" the affected land or because of enabling state legislation).

The JEBURPA members appreciate that the question of whether an association should generate revenues from transfer fees as opposed to periodic lot assessments — or whether endeavors such as affordable housing or environmental protection should be financed using transfer fee covenants — is a political question on which persons hold differing views. In offering these comments, the JEBURPA does not express a position on the relative merits of using transfer fee covenants. Rather, our substantial concerns

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[1] The comments to Restatement § 3.5 explicitly validate a covenant that imposes a transfer fee payable for financing the activities of an owners' association. Illustration 5 states: "The declaration for a condominium development requires payment of a transfer fee to the property-owners association on each transfer of a unit by sale or lease. The amount of the fee is set by the governing board of the association and the funds are used for operating expenses of the association. There is a rational justification for the servitude."

regarding the proposed guidance focus instead on the consequences that homeowners will likely face if the guidance should bar Fannie Mae and Freddie Mac from purchasing any mortgage on real estate that is subject to a transfer fee covenant. In this regard, the JEBURPA has three substantial concerns. First, the retroactive nature of the proposed guidance would have unwarranted negative consequences upon many existing homeowners whose titles are subject to transfer fee covenants. Second, because the proposed guidance includes transfer fee covenants that are enforceable under state law, implementation of the guidance could hinder the recovery of markets for residential real estate development. Finally, the proposed guidance could result in additional compliance costs to mortgage lenders that could result in higher transaction costs for all homeowners seeking mortgage financing. Each concern is addressed briefly below.

The Retroactive Application of the Proposed Guidance. JEBURPA believes that FHFA's proposed guidance, as drafted, will create significant title and financing problems for all homes currently subject to a transfer fee covenant. Under the proposed guidance, any homeowner whose title is now subject to a transfer fee covenant — whether it is a non-beneficial, purely private transfer fee covenant or is instead payable to an owners' association or to an entity for a charitable purpose — will be unable to refinance their existing mortgage. Further, a homeowner whose title is subject to a transfer fee covenant likely will be unable to sell her home, because the proposed guidance would prevent most would-be buyers from obtaining the financing needed to complete the purchase. In effect, the proposed guidance would, if it became effective in its current form, render hundreds of thousands of land titles immediately unmarketable.[2] This would have devastating personal economic consequences for the current owners of those properties — who, of course, had nothing to do with the original decision to impose the transfer fee covenant. Further, the inability of homeowners to sell their affected properties would exacerbate an already wrenching economic downturn in the national housing market.

While the JEBURPA would like to discourage the imposition and enforcement of non-beneficial and purely private transfer fee covenants (*i.e.*, those that do not provide ongoing or future benefit to the affected land), we believe that sound policy requires that the proposed guidance be narrowly tailored to avoid dramatic financial consequences on innocent homeowners. If the FHFA is going to issue any guidance on this subject, JEBURPA believes that such guidance should be issued only on a prospective basis. Regardless of whether any guidance ultimately issued by FHFA applies to transfer fee covenants broadly or only to non-beneficial and purely private ones, FHFA should limit the applicability of the

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[2] In the case of transfer fee covenants on land within common interest communities, some commentators have suggested that residents can solve this marketability problem by having the association's residents vote to amend the covenant regime to remove the transfer fee covenant. Unfortunately, this solution is not feasible in many circumstances. Amendments to a community's declaration of covenants frequently require unanimous consent, unless either the declaration itself or applicable state law provides for modification by majority or supermajority vote. In communities whose documents require unanimous or substantial supermajority consent, obtaining the necessary consent will be practically impossible. In other communities, modification is impossible because of commitments the association will have made to municipalities or to third parties. For example, municipalities have sometimes conditioned development approvals upon the developer's imposition of transfer fee covenants payable to environmental or conservation entities (to be used to mitigate the environmental impacts of the development). Likewise, in some master planned communities, the owners' associations have pledged transfer fee income to lenders to secure the funds needed to build community facilities.

guidance to parcels of land for which a transfer fee covenant is first recorded on the land records after the effective date of the guidance.

The Proposed Guidance Creates a "Mismatch" with Respect to Existing State Laws. As drafted, the proposed guidance would prohibit Fannie Mae and Freddie Mac from purchasing mortgages on land subject to transfer fee covenants that are ***currently enforceable under state real estate law***, and that common interest community developers and municipal planners view as legitimate land planning tools. While this would not inherently justify the purchase of mortgages that are, in the words of the guidance, "adverse to liquidity, affordability and stability in the housing finance market and to financially safe and sound investments," developers and community associations have made longstanding and widespread use of transfer fee covenants to fund the construction, financing, and/or maintenance of community services and facilities — and we are aware of no empirical evidence to suggest that this practice has compromised the operation of the secondary market or threatened the solvency of home mortgage lenders.

The JEBURPA does appreciate that if the FHFA should choose to make its guidance parallel either to existing state statutes — or even to more restrictive statutes that FHFA might itself urge upon the states — the nation's real estate community would enjoy the considerable benefits of a single body of regulatory law on this subject. Stated differently, the nation's real estate community would function with greater efficiency — which we believe to be a public good — if whatever forms of transfer fee covenants were permitted under state law were simultaneously viewed as acceptable under the FHFA guidance. In suggesting this approach, JEBURPA does not intend that FHFA should surrender its regulatory authority in these matters to the states. Indeed, there have been many instances in the history of secondary market underwriting where the underwriting standards of the secondary market imposed significant constraints on state statutes and essentially forced state adoption of secondary market expectations.

Rather, what JEBURPA suggests is that before FHFA acts unilaterally to adopt underwriting standards that may radically affect the nation's housing market, it should first confer with other stakeholders in the national real estate community to identify those aspects of transfer fee covenants that pose the greatest threat to the fiscal soundness of the secondary market (and that simultaneously can most readily be constrained by statute). While development of a broad consensus in these circumstances might well require some delay in the implementation date of FHFA's guidance, it would most likely result in state adoption of more uniform state statutes that would meet with far broader public acceptance and far less disruption of the nation's mortgage industry.

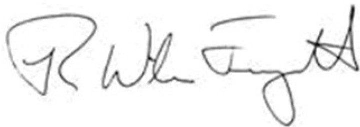
New Guidance Should Not Impose Increased Closing Costs for Borrowers. JEBURPA urges FHFA, as it considers adoption of any new guidance, to take into account whether the costs to mortgage lenders of compliance with the guidance would likely produce higher transaction costs for all borrowers. To satisfy the standards required by the proposed guidance, mortgage lenders will be obliged to make additional representations and warranties to secondary market purchasers. In this case, an originating lender is likely to insist upon a title insurance endorsement affirmatively insuring that the mortgaged real estate is not subject to a subordinate transfer fee covenant — an endorsement not currently being offered by major title insurers. It may be that such an endorsement will be made available and that, as with many endorsements, it will be offered at no additional premium. On the other hand, JEBURPA is concerned that if an additional premium is assessed, that premium will be passed on to the borrower, resulting in increased closing costs for a home purchase. As with any additional costs in this economic environment,

such an outcome will be viewed negatively by the general public and by their elected representatives at both the federal and state levels.

Conclusion. State law has traditionally defined the rights and obligations associated with landownership. State legislatures have begun to address the problems created by non-beneficial private transfer fee covenants, and now 17 states have banned their enforcement, with more enactments anticipated during the next two state legislative sessions. Notably, nearly all of these state statutes carve out an exception for transfer fee covenants that impose a fee payable to an owners' association to fund the provision of services or the maintenance of facilities that benefit the common interest community residents. Many of these statutes also carve out an exception for covenants that fund the provision of affordable housing, historic preservation, environmental protection, or other charitable purposes.

If FHFA is to issue any guidance to Fannie Mae and Freddie Mac regarding the purchase of loans secured by mortgages on land affected by transfer fee covenants, we encourage FHFA to tailor that guidance carefully with this existing state law landscape in mind. Because it does not do so, the proposed guidance risks not only disrupting the financial operations of untold numbers of common interest communities that have traditionally levied transfer fees, but also rendering unmarketable the titles of many innocent owners of single family homes or units in common interest communities whose current chains of title contain a transfer fee covenant of any type.

Respectfully submitted,



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Attachment (JEB Position Paper)

JOINT EDITORIAL BOARD
FOR UNIFORM REAL PROPERTY ACTS

Position Paper on Transfer Fee Covenants
April 2010

Introduction. With increasing frequency, developers are imposing private transfer fee covenants upon real estate. These covenants, which purport to run with title to the land (either perpetually or for a defined term), typically require that a fee be paid to the developer upon each subsequent transfer of the affected land. Under the traditional common law rules governing the enforcement of covenants, a transfer fee covenant payable to the developer would not run with the land to bind successors. However, following the promulgation of the Restatement (Third) of Property — Servitudes (the "Restatement"), developers have begun to impose transfer fee covenants upon land under development on the theory that such covenants do not create unreasonable restraints on alienation.

As this position paper explains, the Joint Editorial Board for Uniform Real Property Acts (JEBURPA) is of the view that transfer fee covenants payable to a developer serve no useful purpose in land development and thus create an unreasonable restraint on the alienability of land. In recognition of this concern, legislatures in eight states have enacted statutory prohibitions on the enforcement of private transfer fee covenants since 2008. The American Land Title Association and the National Association of Realtors have proposed model legislation (a copy appears in the Appendix to this position paper), for which introductions are anticipated during 2010-2011. The JEBURPA recommends that state legislatures enact a statutory prohibition on private transfer fee covenants similar to the model legislation in the Appendix.

What Is a Transfer Fee Covenant? A transfer fee covenant purports to impose a fee that is analogous to a real estate transfer tax but that is payable to a private party (typically, the real estate developer) rather than a governmental entity. For example, suppose that the developer of Sea View (Developer), a proposed common interest development, imposes a recorded covenant upon all lots within the development. This covenant requires that upon any resale of an affected lot within Sea View during the term of the covenant, a fee equal to one percent (1%) of the sale price must be paid to Developer. Upon Developer's initial sale of an affected lot to Buyer #1, no transfer fee arises. However, when Buyer #1 sells the affected lot four years later to Buyer #2 at a price of $250,000, the terms of the covenant (assuming the covenant is enforceable) would entitle Developer to collect a $2,500 transfer fee. Likewise, when Buyer #2 sells the affected lot 10 years later to Buyer #3 for a price of $350,000, Developer could collect a $3,500 transfer fee. Furthermore, the documents creating a transfer fee covenant often provide that any transfer fees that have accrued but remain unpaid constitute a lien against the affected real estate.

Why Would Developer Impose a Transfer Fee Covenant? Economics would predict that a buyer of land affected by a transfer fee covenant will factor that covenant into the price to be paid for the land. For example, suppose Developer is considering imposing a 1% transfer fee covenant on units in Sea View. If the units were unrestricted, a buyer may be willing to pay $400,000 to acquire a unit (assume this is the fair market value of a comparable unrestricted unit). If the units are subject to a 1% transfer fee, however, a buyer might insist upon discounting the price for the unit by at least 1% (to $396,000 or less) to account for the future impact of the 1% transfer fee. After all,

when the buyer goes to resell the unit, the buyer's purchaser will be subject to the 1% transfer fee upon the next resale, and thus should insist upon a comparable discount. Theoretically, then, the burden of the transfer fee covenant — if it runs with the land to bind future owners — should reduce the value of the affected land as compared to comparable unrestricted land.

By imposing a transfer fee covenant, Developer thus forfeits a higher initial lot sale price in exchange for the right to collect a stream of future transfer fee payments. In a perfectly efficient market, the consequences of this trade-off would be irrelevant — the discount on Developer's initial sale would precisely equal the expected value of the future transfer fees. Regardless, however, Developer might still prefer to impose the transfer fee covenant as a marketing device. Because the transfer fee covenant would be expected to lower the sale price of the Developer's inventory, the covenant may assist Developer in marketing its unsold inventory, particularly as contrasted with comparable unrestricted units.

Transfer Fee Covenants and the "Touch and Concern" Test. Under the 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. While 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 have struggled in applying the "touch and concern" 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. A good example is the typical lot assessment covenant in a common interest development. Such a covenant 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 assessments provide for the maintenance of services and amenities that benefit community residents directly (e.g., access to pools, parks, etc., and in some cases even insurance and maintenance of the residents' own dwellings) and/or indirectly (e.g., higher property values due to the presence of valued amenities). Since the landmark case of *Neponsit Property Owners' Ass'n, Inc. v. Emigrant Indus. Sav. Bank*, 278 N.Y. 248, 15 N.E.2d 793 (1938), courts have held that both the burden and benefit of a lot assessment covenant "touch and concern" land such that a lot assessment covenant binds successor owners of that land.

This result makes good sense doctrinally. While a lot assessment covenant theoretically creates an indirect restraint on alienation of the affected land (those unwilling to pay the assessment will not agree to purchase the land), its practical impact on alienability is negligible. Many purchasers sufficiently value the common amenities to the point that they would willingly accept the assessment in exchange for access to and preservation of the common amenities. As a result, the lot assessment covenant constitutes a reasonable (and enforceable) restraint.

The typical transfer fee covenant, however, is payable to the ***developer***, not to an owners' association. By the time the developer attempts to collect a transfer fee (at the time of a future transfer), it is likely that the developer will have completed the sale of all affected lots and will no longer have any legal interest (other than by the transfer fee covenant) in the community. As a result,

the benefit of the transfer fee covenant is personal to the developer; in the language of the common law, the benefit is "in gross." Under the weight of judicial authority, if the benefit of a covenant was in gross, the burden of that covenant did not run to bind successors to the original covenantor. *See, e.g., Garland v. Rosenshein*, 649 N.E.2d 75 (Mass. 1995); *Bremmeyer Excavating, Inc. v. McKenna*, 44 Wash. App. 267, 721 P.2d 567 (1986); *Caullett v. Stanley Stilwell & Sons, Inc.*, 67 N.J. Super. 111, 170 A.2d 52 (1961).

This aspect of 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 the actual harm posed by any particular "personal" covenant. Under this traditional view, a developer would not be able to enforce a transfer fee covenant against subsequent owners of the lot.

The Restatement of Servitudes. Over the past decade, the status of the "touch and concern" standard has been called into question following the American Law Institute's promulgation of the Restatement of Servitudes. The Restatement purports to abandon the "touch and concern" standard, instead substituting standards under which a covenant purporting to affect title to land is enforceable against successors unless the covenant is "arbitrary, spiteful, capricious" [Restatement § 3.1(1)], imposes an "unreasonable restraint on alienation" [§ 3.1(3)], imposes an "unreasonable restraint on trade or competition" [§ 3.1(4)], or is "unconscionable." [§ 3.1(5)] Where a covenant imposes only an indirect restraint on alienation, the Restatement suggests that the covenant does not create an unreasonable restraint on alienation unless it "lacks a rational justification." [§ 3.5(2)] Professor Susan French, the Restatement's Reporter, has argued that application of the Restatement standards should generally produce the same result that courts would have reached under the "touch and concern" test — but with greater transparency, because a court that refused to enforce a covenant would have to articulate the specific concern justifying nonenforcement (rather than masking its conclusion behind the opaque "touch and concern" label).

With respect to most covenants, Professor French may be correct, but this is uncertain with respect to transfer fee covenants. Under the prophylactic "if the benefit is in gross, the burden won't run" rule, a developer had little incentive to attempt to create a covenant imposing a transfer fee payable to the developer (rather than payable to owners' association to finance and/or maintain common amenities). However, the Restatement creates an incentive for developers to impose such covenants, because it purports to permit enforcement of a covenant for which the developer can proffer a "rational justification." The dominant marketer of transfer fee covenants is Austin, TX-based Freehold Capital Partners (formerly known as Freehold Licensing and hereafter referred to as "Freehold"), which markets a comprehensive transfer fee document (the "freehold license") to developers and encourages developers to place it on land under development.[1] Freehold's

[1] As part of its study of transfer fee covenants, the JEBURPA invited Freehold to make a presentation to the board on its transfer fee covenant documentation. A representative of Freehold made such a presentation to the JEBURPA at its December 2008 meeting.

promotional materials (available online at www.freeholdlicensing.com), demonstrate how Freehold uses the language and rhetoric of the Restatement to make a case for the enforcement of a transfer fee covenant. Freehold argues:

- A 1% transfer fee covenant will have no practical effect on the alienability of land — only upon the price at which any transfer will take place — because each buyer of land affected by a transfer fee covenant will reduce its offer price to account for the impact of the covenant upon 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% transfer fee covenant has a rational justification because it creates arguable benefits for both the developer and the initial buyer. It benefits the developer by allowing it to retain the transfer fee rights, which it can either sell immediately or hold to collect as fees come due upon future resales. The value of the transfer fee stream permits the developer to discount the sale price of its lots, thereby facilitating the developer's ability to market the lots (particularly as contrasted with otherwise comparable unrestricted land). In turn, the buyer is benefited because it obtains the land at a discount from the price that the land would have commanded if unrestricted. This discount reduces the buyer's acquisition cost (enabling the buyer to obtain land at a nominally lower investment), and should also reduce the buyer's transaction and carrying costs. For example, if the buyer obtains the land for a lower price, the buyer can borrow less to finance the purchase, thereby reducing its interest costs. Likewise, with a lower acquisition price, the buyer's title insurance premiums would be marginally reduced. Further, the reduction in land's value occasioned by the transfer fee covenant should also marginally reduce the buyer's real estate tax obligations during the period of the buyer's ownership. Finally, when the buyer later resells the land, the cost of a brokerage commission should be slightly reduced (as the transfer fee covenant should produce a discounted sale price vis-a-vis a comparable unrestricted parcel).

Based upon the commentary to Restatement § 3.5, courts may well be reluctant to invalidate a transfer fee covenant as lacking a rational justification, because the freedom-of-contract rhetoric in the Restatement's commentary is sweeping:

> Many economic arrangements for spreading the purchase price of property over time and for allocating risk and sharing profit from property development 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.

In the period following the Restatement's promulgation, the imposition of transfer fee covenants has accelerated. As of December 2009, Freehold has (in conjunction with developers and homebuilders) imposed 99-year transfer fee covenants upon land in 45 states with an estimated total improved value of $488 billion. Further, Freehold's promotional materials argue that the Restatement supports its

view that a transfer fee covenant based upon the Freehold model constitutes a reasonable and enforceable restraint on alienation.

Transfer Fees and Land Policy. For a number of reasons discussed below, the creation and attempted enforcement of transfer fee covenants constitutes unsound public policy and should be discouraged.

Buyers cannot accurately price the impact of a transfer fee covenant. Freehold defends transfer fee covenants by arguing that as long as the covenant is recorded, the buyer can readily discover the transfer fee covenant, fully understand and evaluate its implications, and adjust the offer price accurately to account for the covenant's financial impact. However, even intelligent buyers that know of the transfer fee covenant are unlikely to be able to "price" its effect with precision. There are simply too many variables for the typical buyer to assess.

One such variable is the buyer's holding period (i.e., how long before the buyer will resell the land and incur the transfer fee?). Assume that X is looking to buy a home that is subject to a 1% transfer fee covenant, and that the unrestricted fair market value of a comparable home would be $250,000. If X expects she will sell the house in 2 years, she can readily appreciate the need to discount the offer price to account for the fact that she expects to incur a transfer fee of approximately $2,500 or more in the near future. By contrast, if X thinks she will live in the house for 40 years (e.g., until X retires or dies), she may tend to disregard a future transfer fee, concluding that its effect in present dollars is *de minimis*. Because a buyer typically has imperfect information about the buyer's likely holding period, the buyer may have a difficult time judging how much to discount the offer price.

Second, the amount of the buyer's future transfer fee obligation is a function of the land's value at a ***future*** date. As a result, a buyer's ability to "price" the appropriate discount in present-day dollars is a function of both (a) the expected future appreciation in the land's value and (b) the appropriate "discount" rate (to convert the expected future transfer fee obligation into present dollars). But there is little empirical evidence to suggest that the typical buyer can make an informed or reliable judgment about future rates of appreciation or an appropriate discount rate.

Third, developers market transfer fee covenants as having beneficial effects for buyers (by lowering the buyer's acquisition cost, transaction costs, and carrying costs). But some of the transaction costs savings are sufficiently *de minimis* that buyers are likely to ignore them in the context of a land purchase. For example, in Missouri, the difference in title insurance premium cost for a $250,000 policy versus a $245,000 policy would be only $4. Further, while Freehold argues that buyers will enjoy reduced carrying costs, real estate price negotiations take place in a context in which buyers lack a defined reference point from which they can accurately calculate the appropriate reductions. It is correct to say that ***if*** a transfer fee covenant enables X to pay $2,500 less to acquire the land — and thus allows X to borrow $2,000 less to finance the purchase — X will save approximately $100-120 per year in interest costs during its first year (declining thereafter as the principal balance amortizes). But X cannot be certain that she is saving $100-120 per year in interest costs ***unless she also knows she is paying $2,500 less to acquire the land due to the presence of the covenant***. This determination is not possible in the context of real estate price negotiation,

unless the developer is offering the buyer a choice to purchase the land at either a "restricted" price (subject to the covenant) or an "unrestricted" price (not subject to the covenant). But because developers typically impose transfer fee covenants on a "take it or leave it" basis in the context of common interest development, developers are not presenting buyers with a "covenant or no covenant" choice. Further, because land is relatively unique, there is no identical "unrestricted" parcel that the buyer can use as a baseline to calculate the incremental "burden" and "benefit" of the covenant. Without this baseline, the buyer lacks the ability to evaluate fully the financial impact of the covenant and thus to price the land accurately to account for its presence.

As a result, one would expect buyers to underestimate the impact of the covenant and thus not to discount their offer prices sufficiently to account for the covenant's impact. In fact, Freehold's promotional materials demonstrate that transfer fee covenants present an arbitrage opportunity for developers. Freehold argues that the presence of a 1% transfer fee covenant would typically result in an offer price that is reduced by 1-2% percent. At the same time, Freehold asserts that the present value of the future income stream from transfer fee covenants is at least 4-5% of the final improved value of the property. If buyers were truly informed and sufficiently sophisticated to price the impact of the covenant accurately, no such gap should be present. Essentially, the transfer fee covenant allows a developer to exploit the inability of buyers to price the impact of the covenant with precision.

Enforcing transfer fees could result in "stacking" of transfer fees. Suppose that the initial buyer of land subject to a transfer fee covenant decides to impose an additional transfer fee covenant on the land, payable to the initial buyer on all future transfers. If enforceable, this would permit the initial buyer to collect future fees that would offset the initial buyer's liability for the transfer fee payable to the developer. If a single transfer fee covenant in favor of the developer is enforceable — i.e., if it were reasonable for the developer to effectively finance a portion of the initial buyer's acquisition cost through the imposition of a transfer fee covenant — there would appear to be no reason why the initial buyer could not do the same thing. This could lead to the "stacking" of transfer fees, with each buyer in the chain creating an additional transfer fee covenant. With each additional transfer fee covenant imposed, the market value of the parcel should be further reduced, and the burden upon that parcel's alienability is further magnified.[2]

Transfer fee covenants unreasonably hinder the alienability of land by complicating future land transactions. In addition to creating an additional fee payable at closing, a transfer fee covenant will impede future land transactions by imposing additional transaction costs. Because the developer may have sold the right to collect future transfer fees, the seller may incur additional expense to

[2] Freehold's transfer fee covenant documentation, by its terms, purports to prohibit the stacking of multiple transfer fees on the same property. However, nothing would prevent a developer from creating a transfer fee covenant using a document that did not prohibit the creation of additional transfer fees. Furthermore, there is an implicit contradiction in Freehold's position. If (as Freehold argues) its private transfer fee covenant is reasonable, why would a second (or third) transfer fee covenant be unreasonable, and why wouldn't Freehold's prohibition on "stacking" of transfer fees constitute an unreasonable restraint upon the initial buyer's right to alienate the property on the buyer's terms?

locate and pay the person entitled to payment of the transfer fee,[3] and the fee may have to be escrowed if that person cannot be found. The seller and the buyer will incur additional cost negotiating between themselves regarding responsibility for the payment, and the seller may incur additional costs in determining whether disclosure of the covenant is required in the purchase contract and, if so, ensuring that proper disclosure has been made. The buyer may incur additional time and expense negotiating with the title insurer over the form of the exception which the insurer will undoubtedly take for the transfer fee covenant. Unless the transfer fee covenant by its terms subordinates the developer's lien for transfer fees to the lien of future mortgage loans, the buyer may incur greater expense in obtaining financing if the buyer's mortgage lender insists upon obtaining subordination of the transfer fee covenant lien.

Transfer fee covenants reduce the tax base for the benefit of private parties. Finally, it is important to acknowledge that any financial benefit that a transfer fee covenant accords to a developer comes at the expense of the public as a whole. If a transfer fee covenant is enforceable, its imposition should reduce the value of the affected land, thereby 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 instead are diverted to private parties. Sound public policy should not permit private action (outside the community's democratic processes) to create an artificial diversion of a portion of the tax base for private benefit.

Recent Legislative Activity. In recognition of the negative impacts of transfer fee covenants, ten states have recently enacted legislation that specifically address transfer fee covenants.

Total bans. Legislatures in Florida (2007), Missouri (2008), Kansas (2009), Oregon (2009), Arizona (2010), Iowa (2010), Maryland (2010), and Utah (2010) have enacted statutes that ban the use of transfer fee covenants payable to a developer. Fla. Stat. Ann. § 689.28; Mo. Rev. Stat. § 442.558; 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). Notably, the Florida legislation embraces the traditional view that a covenant creating a purely personal benefit does not run with the land:

> The Legislature finds and declares that the public policy of this state favors the marketability of real property and the transferability of interests in real property free of title defects or unreasonable restraints on alienation. The Legislature further finds and declares that transfer fee covenants violate this public policy by impairing the marketability and transferability of real property and by constituting an unreasonable restraint on alienation regardless of the duration of such covenants or the amount of such transfer fees, and do not run with the title to the property or bind subsequent owners of the property under common law or equitable principles. [Fla. Stat. Ann. § 689.28(1)]

[3] Freehold's transfer fee covenant documentation establishes a "trustee" to whom the transfer fee is payable, with the trustee thereafter remitting paid fees to the person entitled to collect the fees. This model would reduce some of the potential transaction cost, but nothing compels a developer to use the Freehold model to create a private transfer fee covenant.

In these states, transfer fee covenants imposed after the effective dates of the relevant statutes are void. By their terms, these statutes do not apply to transfer fee covenants imposed before their respective effective dates, leaving the enforceability of such covenants an open question.

Texas. In 2007, the Texas legislature adopted a transfer fee statute that applies only to covenants on "residential real property." Texas Property Code § 5.017(b) provides in pertinent part:

> A deed restriction or other covenant running with the land applicable to the conveyance of residential real property that requires a transferee of residential real property or the transferee's heirs, successors, or assigns to pay a declarant or other person imposing the deed restriction or covenant on the property or a third party designated by a transferor of the property a fee in connection with a future transfer of the property is prohibited.

Freehold argues that its transfer fee covenant is enforceable under this statute because the terms of its covenant obligate the ***seller*** to pay the fee, not the buyer. This argument seems dubious for two reasons. First, Freehold's interpretation is inconsistent with a literal reading of the statute. If X contracts to buy from Y land that is subject to a 1% transfer fee covenant, X may not be liable for the 1% fee that accrues upon the Y-to-X transfer, but the covenant does impose upon X the obligation to pay "a fee in connection with a ***future*** transfer of the property" (i.e., X's future resale). Second, if X fails to pay the fee, the unpaid fee would become a lien against the land that would prevent X from delivering clear title to a subsequent purchaser without paying the prior fee. Thus, it seems more plausible to interpret the Texas statute as a prohibition upon transfer fee covenants. Nevertheless, it appears that developers using the Freehold model continue to impose transfer fee covenants upon residential land in Texas.

California. By contrast, the California legislature has chosen to validate transfer fee covenants, subject to explicit disclosure requirements. In California, a transfer fee covenant is enforceable against successors as long as the person imposing the fee 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 mandated information, including: (I) a clear statement of the amount or percentage of the fee; (ii) if the real estate is residential, "actual dollar-cost examples of the fee" for a home priced at $250,000, $500,000, and $750,000; (iii) the expiration date of the transfer fee covenant, if any; (iv) the purpose for which the funds from the fee will be used; and (v) the name of the entity to which the fee must be paid (along with specific contact information).

Conclusion and a Model Statutory Solution. Under the traditional common law approach, a covenant imposing a transfer fee payable to the developer was unenforceable because the benefit of such a covenant did not "touch and concern land." The Restatement of Servitudes purported to reject this prophylactic rule in favor of a more nuanced standard under which a covenant that indirectly restrains alienation is enforceable so long as the restraint has a rational basis and is not unreasonable. Of course, the Restatement does not become the common law of any particular state solely by virtue of its promulgation. Whether courts will actually enforce transfer fee covenants depends upon (a) whether an individual state's courts will adopt the Restatement's purported abolition of the "touch and concern" rule and (b) if so, whether a court concludes that the covenant in question meets the enforceability standards expressed in the Restatement. Developers have exploited this uncertainty

by imposing transfer fee covenants upon new land development with greater frequency, thereby greatly increasing the uncertainty of title to land affected by such covenants. Therefore, to promote clarity in land titles and efficiency in land transfer, the Joint Editorial Board for Uniform Real Property Acts (JEBURPA) is of the unanimous opinion that state legislatures should enact statutes imposing a ban upon the enforcement of transfer fee covenants imposing fees payable to the developer (e.g., a transfer fee covenant based upon the Freehold model).

A suggested model statute appears in the Appendix to this paper. Section 1(b) expresses model state legislative findings that 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. While the model statute would not apply to transfer fee covenants recorded prior to the statute's effective date, Section 1(d) does provide that the statute should not be interpreted to validate such covenants. In a state adopting this model statute, a court facing a challenge to a pre-existing transfer fee covenant should evaluate its enforceability against successors based upon the common law of covenants and servitudes (and, in our view, 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. These covenants (e.g., the "flip tax" that is commonly included in housing cooperative documentation) 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."

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Members of the JEBURPA stand willing to assist state legislative efforts to adopt a statute prohibiting the enforcement of private transfer fee covenants. For further information, please contact any of the following:

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The JEBURPA is comprised of representatives from the American Bar Association'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 advises the Uniform Law Commission as to prospective uniform law projects relating to real estate, and seeks to promote law reform by encouraging states to adopt existing uniform and model real estate laws.

Disclaimer: This Position Paper reflects the views of the members of the JEBURPA. It has not been approved by, and thus does not reflect the official position of, either the Uniform Law Commission or the American College of Real Estate Lawyers.

APPENDIX
PROPOSED MODEL STATE LEGISLATION ON TRANSFER FEE COVENANTS

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, 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 bind successors in title to specified real property located in this State, and which obligates the 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 larger 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) The limitation of paragraph (c) to transfer fee covenants recorded after the effective date of this section does not imply that a transfer fee covenant recorded prior to the effective date of this section is valid.