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Developing Disaster: How Developers Are Using a Covenant to Steal from Homeowners and Why the States Should Stop Them

Amy Kathleen Lewis

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COMMENT

Developing Disaster: How Developers Are Using a Covenant to Steal from Homeowners and Why the States Should Stop Them^{*}

I. Introduction

In the majority of states today, homebuyers may receive an unpleasant surprise when they attempt to sell their home. Included in the huge stack of papers signed at the purchase of the home may have been a private transfer fee covenant. If the developer of the property added such a covenant, every time an owner sells the property for the next ninety-nine years, a full 1% of the purchase price is due to the developer. This means that a couple purchasing their very first home, naïve and unaware of the consequences, may unwittingly sign a document requiring them to pay a large fee just to sell their home. Companies in several states are patenting this idea and selling it to developers as a way to create a significant cash flow for years to come. Homeowners are thus innocently drawn into a covenant they previously knew nothing about, with significant consequences arising down the road.

As an example of how transfer fees work, assume you were to buy a house today. Prior to your purchase, the developer added a transfer fee covenant in the chain of title which would purportedly run with the land for ninety-nine years. You do not pay a transfer fee on your initial home purchase. However, when you decide to sell, possibly years later, you must then pay a transfer fee before clear title may be transferred to the next buyer. Theoretically, you paid a lower purchase price because the developer lowered the price after selling the right to receive future transfer fee covenant payments. But before you may sell your home, you now owe 1% of the purchase price which may be \$2000 or even more.¹

Transfer fee covenants represent a sizeable step away from traditional property and contract law. These covenants may dangerously inhibit alienability of land as well as violate the law of covenants. A transfer fee covenant² is a covenant which binds a purchaser of real property and runs

* I would like to thank Professor Joyce Palomar for her topic suggestion, edits, and advice. Additionally, I would like to thank my parents and baby brother for their life-long encouragement and support without which I would not be who I am today.

1. See generally R. Wilson Freyermuth, *Putting the Brakes on Private Transfer Fee Covenants*, 24 PROB. & PROP. 20, 21 (2010).

2. This comment will use the terms “transfer fee covenant,” “private transfer fee,” and

with the land for up to ninety-nine years.³ It operates by requiring each successive purchaser to pay 1% of the purchase price to the developer of the subdivision.⁴ A basic and historic tenet of the law of real property is freedom of transfer of real property, also known as alienability of land.⁵ Transfer fee covenants represent a limitation on this central tenet of property law.

When used by developers to bind future owners, transfer fee covenants transform a straightforward transfer of property between the original developer and the original buyer into something much more convoluted and difficult. Currently, a minority of states already ban or restrict transfer fee covenants, either in whole or in part,⁶ and the federal government may soon do the same.⁷ This comment argues that, in doing so, this group of states is moving in the correct direction. Restricting these covenants is both historically and legally correct. This comment demonstrates that transfer fee covenants cannot withstand a number of legal challenges and, in failing at least one of these challenges, should not be permitted to bind future owners.

The transfer of property is vital to our society, and it extends at least back to biblical times; in fact, it may extend back much farther. For example, Hammurabi's Code, which was the first written code of laws, mentions the transfer of property.⁸ At the very least, the Book of Ruth provides an example of an early tradition pertaining to the importance of the transfer of property:⁹ the story of the redemption of family property by Boaz.¹⁰ During biblical times in Israel, one party would take off a sandal

“transfer fee” interchangeably; however, the term “transfer fee covenant” will be used primarily for the sake of clarity.

3. Marjorie Ramseyer Bardwell & James Geoffrey Durham, *Transfer Fee Rights: Is the Lure of Sharing in Future Appreciation a Flawed Concept?*, 21 PROB. & PROP. 24, 25 (2007); FREEHOLD CAPITAL PARTNERS, <http://freeholdcapitalpartners.com> (last visited Oct. 8, 2010).

4. Bardwell & Durham, *supra* note 3, at 25; FREEHOLD CAPITAL PARTNERS, *supra* note 3.

5. See ROBERT G. NATELSON, *MODERN LAW OF DEEDS TO REAL PROPERTY* 5 (1992); see also *The Code of Hammurabi, King of Babylon*, 17 HARV. L. REV. 506 (1904) (exploring the earliest recorded exposition of the right to transfer property).

6. Kenneth Harney, *Proposal to Ban Transfer Fees May Carry Pitfalls*, CHARLOTTE OBSERVER, Aug. 21, 2010, available at 2010 WLNR 16645133.

7. Lew Sichelman, *FHFA Moves Ahead on Rule*, NAT'L MORTGAGE NEWS, Feb. 7, 2011, available at 2011 WLNR 2412782.

8. *The Code of Hammurabi, King of Babylon*, *supra* note 5, at 506; Russ VerSteege, *Early Mesopotamian Commercial Law*, 30 U. TOL. L. REV. 183, 196-98 (1999).

9. NATELSON, *supra* note 5, at 5 (citing *Ruth* 4:2, 7-11).

10. “Boaz . . . bought from Naomi all property of Elimelech, Kilion, and Mahlon . . .

and give it to another to make the transfer of property final.¹¹ Transfers of property were public acts: in some areas transfer required the presence of witnesses who were not merely members of the public but instead were “men of standing, representatives of the public power.”¹² To help supplement the public record, ancient Israelites began memorializing the transfer of property with a deed.¹³ The deed was “an instrument that was signed and sealed and that contained all the terms and conditions of the sale.”¹⁴

Transfer of property remains equally, if not more, important in the modern era. The English system of transfer of property is slightly different than the American system given that each country’s modern common law developed under different circumstances.¹⁵ In the English system, Parliament does not allow conveyance of real property without a deed.¹⁶ Conversely, while a writing is also required to convey real property in the American legal system, one cannot convey land itself.¹⁷ Instead, one may only convey an interest in that land.¹⁸ Therefore, in the American legal system, “[t]o state that a person has a particular interest in land is to state that that person enjoys certain rights of control with respect to property.”¹⁹

Part I of this comment outlines the general structure of transfer fee covenants, how they are created, and how they work. It includes a general overview of the legal framework surrounding covenants, how covenants are created, and how specific private transfer fee methods are patented and used by companies to bind future landowners. Part II discusses possible legal challenges to transfer fee covenants and shows that transfer fee covenants cannot withstand those challenges. This part also includes some of the rebuttal arguments in support of transfer fee covenants. Part III shows several possible consequences if a state allows companies like Freehold Capital Partners to patent and use transfer fee covenants to bind a buyer. First, the transfer fee attempts to create a way for the developer to retain a

[and] Ruth the Moabitess, Mahlons’ widow . . . in order to maintain the name of the dead with his property, so that his name will not disappear from among his family or from the town records. Today you are witnesses!” *Ruth* 4:9 (New Int’l Version).

11. NATELSON, *supra* note 5, at 5.

12. *Id.*

13. *Id.*

14. *Id.*

15. *See id.* at 7-8 (tracing the differences between English and American property law).

16. *Id.* at 7.

17. *See id.* at 11.

18. *Id.*

19. *Id.* at 12.

right to the property without having any right to possession. Second, the transfer fee covenant works as an unreasonable restraint on alienation. Third, transfer fee covenants create an unenforceable covenant because the covenant does not meet the essential requirements of the law of covenants: privity and the “touch and concern” element. Finally, in the alternative, transfer fee covenants violate public policy and should not be enforced in order to protect longstanding traditions in property law. Part IV attempts a moderate survey of the states’ treatment of transfer fee covenants, including an analysis of Oklahoma and the majority of states which, like Oklahoma, have not banned transfer fee covenants. Because this comment takes the position that the minority of states have the correct viewpoint, it also sets forward the possibilities for further action that the majority of states should take to limit the negative influence of transfer fee covenants.

II. How Transfer Fee Covenants Are Created; How They Operate; and Why Companies Are Patenting Them

Although people have used transfer fees for many years, the term “transfer fee covenant” has recently become something of a buzzword.²⁰ Covenants imposing obligations to pay homeowners’ association dues are often used when developers sell land which will be governed by a homeowners’ association; however, transfer fee covenants are much different. Although some uses for covenants may in fact benefit the community, transfer fee covenants are collected solely for use by a private party and benefit no one else.

There are not yet any published cases specifically addressing the use of transfer fee covenants, but that may simply be because the idea of a private transfer fee covenant, like the one Freehold Capital Partners is trying to patent, is too novel to have caused problems which people are willing to take to court. Freehold Licensing, more recently known as Freehold Capital Partners,²¹ is the most well-known of those using private transfer fee covenants to collect a fee every time a property is sold.²²

In total, nearly twenty state legislatures have “either restricted or banned the use of private transfer fees” in one form or another.²³ The best-known

20. Bardwell & Durham, *supra* note 3, at 25.

21. Freehold Licensing, the original name, was later changed to Freehold Capital Partners. This comment will use the term “Freehold” to refer to the company as a whole.

22. FREEHOLD CAPITAL PARTNERS, *supra* note 3.

23. Harney, *supra* note 6; ARIZ. REV. STAT. ANN. § 33-442 (2010); CAL. CIV. CODE § 1098 (West 2009); DEL. CODE ANN. tit. 25, § 319 (West 2010); FLA. STAT. ANN. § 689.28 (West 2011); 765 ILL. COMP. STAT. ANN. 155/5 (West 2011); IOWA CODE ANN. § 558.48

form of transfer fee covenant, which is also the most controversial, is the version promoted by Freehold.²⁴ Generally, under Freehold's plan, a developer creates a covenant and then is able to collect 1% of the purchase price every time the property is sold after the original sale. Freehold designates the private transfer fee as a "Capital Recovery Fee."²⁵ The company claims that "[t]he process starts by filing a legal instrument (called a "Declaration of Covenant" or "Private Transfer Fee Covenant") in the real property records . . . [and] [t]he result is a collateralized income stream."²⁶

The Federal Housing Finance Agency (FHFA) has proposed to cut off federal funds or guarantees for mortgages that support private transfer fees, like those patented and sold by Freehold.²⁷ The federal ban would regulate Fannie Mae and Freddie Mac, which account for approximately 95% of all mortgages.²⁸ The proposal would prohibit a federally funded loan from being made on a home with a transfer fee put in place by the developer.²⁹ It would only apply to homes costing greater than the limit for federal insurance and would not apply to businesses.³⁰ The proposal may deter the use of transfer fee covenants even though it does not operate as a true ban on transfer fee covenants.

Additionally, the American Land Title Association (ALTA) issued a press release extolling United States House of Representatives for protecting homeowners from transfer fee covenants by introducing *The Homeowner Equity Protection Act of 2010*, which was sponsored by U.S. Representative Maxine Waters.³¹ The act would prohibit private transfer

(West 2011); KAN. STAT. ANN. § 58-3821 (2009); LA. CIV. CODE ANN. art. 647 (2008); MD. CODE ANN., Real Prop. § 10-708 (West 2010); MINN. STAT. § 513.74 (2011); MO. ANN. STAT. § 442.558 (West 2011); N.C. GEN. STAT. § 39A-3 (2010); OHIO REV. CODE ANN. § 5301.057 (West 2010); TEX. PROP. CODE ANN. § 5.017 (West 2010); UTAH CODE ANN. § 57-1-46 (West 2010).

24. Harney, *supra* note 6.

25. FREEHOLD CAPITAL PARTNERS, *supra* note 3.

26. *Id.*

27. Press Release, Fed. Hous. Fin. Agency, FHFA Proposes Guidance to Restrict GSEs from Investing in Mortgages with Private Transfer Fee Covenants (Aug. 12, 2010), *available at* <http://www.fhfa.gov/webfiles/16480/PrivTransFeeGuidance081210.pdf>; Harney, *supra* note 6.

28. Harney, *supra* note 6.

29. *See Conforming Loan Limit*, FED. HOUS. FIN. AGENCY, <http://www.fhfa.gov/Default.aspx?Page=185> (last visited Feb. 9, 2011).

30. *Id.*

31. Homeowner Equity Protection Act of 2010, H.R. 6260, 111th Cong. (2010); Robert Franco, *U.S. Congress Addresses Transfer Fee Covenants*, SOURCE OF TITLE BLOG (Oct. 1, 2010), http://www.sourceoftitle.com/blog_node.aspx?uniq=689.

fees if the transfer for which the fee is imposed involves a federally related mortgage.³² A second proposal, *The Homebuyer Enhanced Fee Disclosure Act of 2010*, introduced by U.S. Representative Phil Gingrey, would require a notice paper to be filed in the county recorder's office for any private transfer fee placed on land.³³ Importantly, the act does not appear to require notice to a homeowner before the original purchase. The disclosure requirement seems to mirror California's disclosure requirement.³⁴ The Gingrey bill also provides an additional safeguard to protect private transfer fees: if a transfer fee covenant "imposes a transfer fee of not more than 1 percent of the gross sales price for the affected property, effective for a term of not more than 99 years" it is presumed valid.³⁵ A federal law might effectively preempt state laws banning transfer fees.³⁶ Even more problematic, the Gingrey bill would allow only one covenant, which means that traditional housing associations' covenants would likely be preempted by a covenant added to the land by the developer, who often is the first to add a covenant because they make the original sale.³⁷

Many terms describe transfer fee covenants: capital recovery fees, home resale fees, reconveyance fees, recovery fees, resale fees, and private transfer fee covenants; all of these terms refer to the same basic property concept.³⁸ Under any name, the fundamental idea is that a covenant is recorded in the chain of title, the servitude attaches to the land for ninety-nine years, and the burden runs with the land to bind future owners.³⁹ After the agreement or covenant is attached to the land, 1% of any future sale price must go back to the original covenantors or to whomever they sold the

32. Harney, *supra* note 6.

33. Homebuyer Enhanced Fee Disclosure Act of 2010, H.R. 6332, 111th Cong. (2010).

34. CAL. CIV. CODE § 1098.5(a) (West 2008); *see* discussion *infra* Part V.B.

35. Homebuyer Enhanced Fee Disclosure Act of 2010, H.R. 6332, 111th Cong. § 3(c) (2010). This provision safeguards the covenant from being invalid. It does not, however, help the homeowner since a 1% fee on a \$300,000 home is still \$3000.

36. This raises an interesting question of the implications on federalism and the balance of states' power to regulate the property laws for their citizens versus the federal government's power to do so. Questions like this will likely be raised by Congress as they debate the bills proposed; however, that question is beyond the scope of this comment and will not be discussed in depth.

37. H.R. 6332, 111th Cong. § 3(d) (2010).

38. *Field Guide to Private Transfer Fees*, NAT'L ASS'N OF REALTORS, <http://www.realtor.org/field-guides/field-guide-to-private-transfer-fees> (last visited Apr. 25, 2012). However, for the sake of consistency, this comment will generally refer to the concept as a whole as a transfer fee covenant.

39. Bardwell & Durham, *supra* note 3, at 25.

right to receive payment, which generally includes the company that licenses the use of the system and the real estate broker.⁴⁰

A complicated system controls the sale of transfer fee covenants and the licenses required to use them.⁴¹ Before a sale takes place, a broker approaches an initial seller regarding the use of a transfer fee covenant to give a covenantor the future share, or earnings, of the property.⁴² The broker then collects an initial commission and also may get a share in future earnings of the transfer fee covenant: “The licensor pays for this interest with a note for an amount that is estimated to be the value of those future sums generated by the servitude.”⁴³ There is no way to predict, though, how often or for how much the house will be sold.⁴⁴ This allows the covenantor, as Freehold termed it, to “sit back, relax, and wait for the money to flow in.”⁴⁵

Future purchasers of the property may have ways to opt out but opting out is complicated.⁴⁶ Opt outs include three possibilities: payment of the transfer fee, buying out the covenant if more than five years has expired since the covenant was made, and granting an option to the person to whom the transfer fee is owed in lieu of the payment.⁴⁷

In conclusion, transfer fee covenants are created by developers and often patented by companies like Freehold in order to receive profit continuously from a property as well as to reduce the original buy-in price of property. While case law on point is sparse, there is vehement opposition to transfer fee covenants by those intimately acquainted with the field of property law: the Federal Housing Finance Agency, the American Land Title Association, and several House and Senate members from both the Democratic and Republican parties.⁴⁸ Transfer fee covenants operate like many other

40. *Id.*

41. *Id.* at 25-26.

42. *Id.* at 25.

43. *Id.*

44. *Id.* at 26.

45. *Id.*

46. *Id.* at 26-28.

47. *Id.* at 27.

48. *ALTA Supports FHFA Proposal to Ban Private Transfer Fees*, AM. LAND TITLE ASS'N (Oct. 19, 2010), <http://www.alta.org/news/news.cfm?newsID=12355>; see also Jennifer Hiller, *Federal Plan Likely to Curb Transfer Fees on Real Estate Deals*, HOUS. CHRON., Dec. 25, 2010, available at 2010 WLNR 25483861; Jennifer Waters, *Watch for Private Real-Estate Transfer Fees: Some Developers Add a 1% Fee to Cover Infrastructure Costs*, MARKETWATCH (Nov. 1, 2010), <http://www.marketwatch.com/story/watch-for-real-estate-transfer-fees-2010-11-01>.

covenants used for years without opposition. However, there are stark differences between private transfer fee covenants and the less controversial covenants.

III. Possible Legal Challenges to Transfer Fee Covenants

A transfer fee covenant is unlikely to survive any of the legal challenges discussed in this section. However, as already mentioned, the court system has yet to see a case in order to test these proposed challenges.⁴⁹ State legislatures, attempting to address the issue before the courts have a chance to hear a case, have tried to save potential homeowners and buyers from the possible repercussions of transfer fee covenants. Thus, while transfer fee covenants currently remain unchallenged, that will likely change as they become more popular.

At least three possible legal challenges to the use of transfer fee covenants exist. First, transfer fee covenants violate traditional property law principles by allowing a party to have a right to property without any right to possession, either currently or in the future.⁵⁰ Second, transfer fee covenants violate a fundamental tenant of property law by inhibiting the alienability of land.⁵¹ Third, property law has traditionally required a covenant to “touch and concern” the land as well as meet the requirement of privity between the parties in order to run with the land and bind future parties.⁵² However, private transfer fees meet none of these fundamental requirements. Additionally, private transfer fees violate public policy by making the transfer of property so complex that experts are necessary. They should not be enforced for the basic reason of protecting buyers and sellers of property.

A. The Transfer Fee Attempts to Create a Way for the Developer to Retain a Right to the Property Without Having Any Right to Possession

“The *Restatement of Property* defines an estate as involving the present or future right to possession[;]”⁵³ however, private transfer fees “attempt[] to create an interest in the fee simple without any right to possession.”⁵⁴ A brief background on how property law treats estates and a person’s interest in land is helpful here. An “estate” means an interest in land that “is or may

49. See discussion *supra* Part II.

50. Bardwell & Durham, *supra* note 3, at 28.

51. *Id.* at 28-29.

52. *Id.* at 29.

53. *Id.* at 28.

54. *Id.*

become possessory.”⁵⁵ The term applies to all interests which are created by a conveyance and is “defined by how long possession or use may last.”⁵⁶ Special limitations, conditions subsequent, or conditions precedent can limit interests in an estate.⁵⁷ A “conveyance gives its owner either (i) the right to enjoyment of land immediately following the conveyance or (ii) the right to potential enjoyment beginning in the future.”⁵⁸ Additionally, conveyances create either a corporeal interest or an incorporeal interest.⁵⁹ A corporeal interest is a possessory interest, meaning a right to possess the land.⁶⁰ In contrast, an incorporeal interest only gives the owner a right to use instead of a right to full possession of the land.⁶¹ “Although at one time the list of incorporeal interests was quite long, in modern American law there are only three of importance: (1) the profit a pendre, (2) the easement, and (3) the rent.”⁶²

The three major incorporeal interests play different roles in the law of real property. A profit a pendre allows the owner to take products from the land, for example, in an oil and gas “lease.”⁶³ An easement, on the other hand, can be either an affirmative or negative easement.⁶⁴ Affirmative easements entail “the right to use servient land for a purpose other than the removal of its fruits.”⁶⁵ For example, affirmative easements include easements of access and utility easements.⁶⁶ Negative easements are those created by grant, reservation, or by estoppel,⁶⁷ and are limited to light, air, view, support, and the right to receive water.⁶⁸ Because of the limitations placed on the creation of easements, the need for alternate mechanisms arose “for the enforcement of appropriate ‘noneasement’ interests by and

55. RESTATEMENT OF PROPERTY § 9(a) (1936).

56. NATELSON, *supra* note 5, at 13-14.

57. *Id.* at 14.

58. *Id.*

59. *Id.* at 15.

60. *Id.* at 16.

61. *Id.* at 17.

62. *Id.* at 18.

63. *Id.* at 18-19.

64. *Id.* at 19-20.

65. *Id.* at 19.

66. *Id.*

67. *Id.*

68. *Id.* at 19-20.

against remote owners of the properties involved.”⁶⁹ Finally, rents are usually created by term leases.⁷⁰

Given the foregoing summary of estates, it becomes obvious that transfer fee covenants create an interest in land without concurrently creating any of the traditional or otherwise valid property interests described. Proponents of transfer fee covenants, however, argue that a “transfer fee is an encumbrance [-] it is not an ownership interest in the home.”⁷¹ Proponents add that “few if any homes are sold free of encumbrances.”⁷² With most homes, the buyer knows or assumes there will be an “obligation to comply with subdivision restrictions, pay dues and assessments, grant easements to utility companies, etc., all of which are encumbrances against the land.”⁷³ Additionally, proponents argue that “most residential homes do not convey the mineral rights, oil rights, and, when it comes to commercial property, the air rights.”⁷⁴

Notwithstanding, private transfer fee covenants are an attempt to create an invalid property interest. The interest created by these covenants gives someone an interest in land even though that party has no right to either current or future possession of the property. The holder of the right to receive the fee has no actual rights to the property, only the right to receive payment. Additionally, the created covenant quite obviously does not fulfill the requirements of a negative easement. Thus, private transfer fee covenants attempt to create an invalid covenant between parties and should not be enforced by a court.

B. Transfer Fee Covenants Work as an Unreasonable Restraint on Alienation

Private transfer fee covenants violate a fundamental tenet of fee simple property ownership. Owners in fee simple have the ability to convey their land at any point they wish.⁷⁵ The ability to convey a whole or part interest in land is the core of fee simple ownership. A “private transfer fee covenant impedes future land transactions by imposing additional

69. ROGER BERNHART ET AL., PROPERTY CASES AND STATUTES 344 (2d ed. 2009).

70. NATELSON, *supra* note 5, at 20.

71. *Common Myths About Private Transfer Fees*, PLUS NEWS, Aug. 30, 2010, available at 2010 WLNR 17465882.

72. *Id.*

73. *Id.*

74. *Id.*

75. Bardwell & Durham, *supra* note 3, at 28.

unwarranted transaction costs.”⁷⁶ Under property law, a covenant is not allowed to stop or restrict the free alienability of land if land is held in fee simple.⁷⁷ But a transfer fee covenant requires large sums of money, a full 1% of the purchase price, to be paid to the original covenantor by subsequent purchasers, sometimes many years after the original agreement is made.⁷⁸ A seller may also incur additional fees beyond those imposed by the transfer fee covenant because the developer may have sold the right to collect the fee and the seller then has to locate the holder of that right.⁷⁹ Additionally, the transfer fee may have to be escrowed if the holder of the right to collect the fee cannot be found.⁸⁰ Both seller and buyer may incur further costs in negotiating which party ultimately pays the fee associated with the covenant.⁸¹ The buyer may also incur additional expenses negotiating with a title insurer over the form of the insurer’s exception for the covenant and even more expense in obtaining financing if the mortgage lender “insists on obtaining subordination of the transfer covenant lien.”⁸²

Finally, if enforceable, a buyer of land may try to impose further transfer fee covenants to recoup the costs spent in the transfer of the property which, over time, could create additional complications from stacking of multiple transfer fee covenants.⁸³ This is especially troublesome in states with absolutely no law restricting who can add a transfer fee covenant to a deed. A multitude of transfer fee covenants may then encumber the buyer as well as the property for a long period of time.

All of these factors demonstrate that transfer fee covenants impede a seller’s ability fully to convey land and controvert society’s value of free alienability of land. Since a transfer fee covenant may inhibit an owner from freely transferring land, it should be invalidated as a violation of this important value of property law.

76. Freyermuth, *supra* note 1, at 23.

77. AMERICAN LAW OF PROPERTY § 26.1 (1952).

78. Freyermuth, *supra* note 1, at 23. However, Freehold, in their brochure, says that 1% of the purchase price is a “de minimus” fee. FREEHOLD CAPITAL PARTNERS, LEARN HOW CAPITAL RECOVERY FEE INSTRUMENTS CAN HELP YOU (n.d.), available at http://www.freeholdcapitalpartners.com/forms/freehold_brochure.pdf.

79. Freyermuth, *supra* note 1, at 23.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*

C. Transfer Fee Covenants Create an Unenforceable Covenant Because the Covenant Does Not Meet the Essential Requirements: "Touch and Concern" and Privity

Even property experts admit that the law of covenants is a very confused area of law.⁸⁴ Because it mixes traditional contract principles and property law principles it is necessary first to survey the law of covenants.⁸⁵ Once one has a broad understanding of the law, both traditionally and as it seems to be trending today, it becomes obvious that transfer fee covenants lack at least two essential requirements. Therefore, transfer fee covenants cannot run with the land to bind future owners. First, transfer fee covenants do not touch or concern the land, thus, future owners of the property cannot be bound by these covenants. Second, transfer fee covenants cannot create or meet at least one of the privity requirements of the law of covenants. Future owners should not be bound by a covenant created, at least in part, by a private and uninterested third party.

1. Introduction to the Law of Covenants

In American common law, the law of covenants developed because land is different than other property: land is immovable and illiquid and the magnitude of financial investment involved in a land purchase is generally much greater than that invested in other property.⁸⁶ Therefore, although it may seem strange that land can hold a contractual burden from decades earlier, the doctrine of covenants is, and was, designed "to address the heavy and unique losses" that can occur regarding land.⁸⁷

The underlying purpose of the covenant doctrine was to impose criteria required to make covenants run with or "stick" to the land such that the law enforces only those covenants that "(1) protect dominant owners from losses not readily protected by the market and (2) are consistent with the servient owner's ability to avoid nonconsensual obligations."⁸⁸ In other words, the "law enforces covenants if noncompliance costs are high and avoidance costs are low."⁸⁹ Courts tend to be more likely to allow benefits to run with the land than burdens.⁹⁰ Specifically, courts restrict burdens by

84. See W.E. Shipley, Annotation, *Affirmative Covenants as Running with the Land*, 68 A.L.R. 2D 1022 (1959).

85. See generally *id.* (describing the mixed legal nature of covenants).

86. NATELSON, *supra* note 5, at 350-51.

87. *Id.* at 351.

88. *Id.*

89. *Id.*

90. Shipley, *supra* note 83, at 1022.

requiring “property privity between either the original parties or those parties and their successors, or both, and that the promise involved be one which ‘touches and concerns’ the land.”⁹¹ This is especially true when an affirmative covenant is involved whereby the promisor may be subjected to burdensome obligations which are much greater than the land’s value.⁹²

For a covenant to run with the land and bind a subsequent owner the covenant must meet at least three criteria.⁹³ First, the grantor and grantee must intend for it to do so.⁹⁴ Second, the covenant must touch and concern the land.⁹⁵ Third, privity of estate between the original parties, between the original parties and the present litigant, or between the party claiming the benefit of the covenant and the party burdened is required.⁹⁶

In other words, for a covenant to run with the land, the parties need a contract, intent that the burden run, a burdened estate, a covenant which touches or concerns the land, and horizontal benefit.⁹⁷

a) The Requirement of a Contract, Intent, and a Burdened Estate

Generally, a contract must be in writing and signed by the promisor.⁹⁸ A writing is required for the transfer of land because of the statute of frauds, which aims to ensure that evidence is available to a prospective purchaser.⁹⁹ If the covenant is in a deed, even the most restrictive evidentiary requirements of jurisdictions are met.¹⁰⁰

Second, the requirement of intent provides that a covenant, if it is regarding something not *in esse*,¹⁰¹ must contain explicit language regarding the promisor’s assigns, which means they must be explicitly mentioned or they are not bound.¹⁰² However, as a practical matter, “since it is customary to use the technical word ‘assigns’ in instruments containing

91. *Id.*

92. *Id.*

93. *Jeremiah 29:11, Inc. v. Seifert*, 161 P.3d 750, 753 (Kan. 2007); *see also* *Inwood N. Homeowners’ Ass’n v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987); *Neponsit Prop. Owners’ Ass’n v. Emigrant Indus. Sav. Bank*, 15 N.E.2d 793, 795 (N.Y. 1938). Note that these cases impose a range of criteria, but this comment will focus on three.

94. 20 AM. JUR. 2D *Covenants* § 20 (2010).

95. *Id.*

96. *Id.*

97. NATELSON, *supra* note 5, at 353-58.

98. *Id.* at 354.

99. *Id.*

100. *Id.*

101. *In esse* means “in actual existence.” BLACK’S LAW DICTIONARY 846 (9th ed. 2009).

102. *See generally* *Spencer’s Case*, (1583) 77 Eng. Rep. 72 (K.B.) (establishing the explicit language requirement).

covenants, problems as to the application of this *in esse* doctrine are not frequent.”¹⁰³ Some states do not follow the rule from *Spencer’s Case*,¹⁰⁴ meaning explicit language regarding the promisor’s assigns is not necessary, but they do still require intent that the covenant run with the land.¹⁰⁵

Third, to meet the requirement of a burdened estate, the covenant must burden some interest in land.¹⁰⁶ This can be any estate held by the covenantee, but “in a few states . . . a present possessory interest in fee simple absolute granted simultaneously with the execution of the covenant cannot be a burdened estate unless it is also a benefited estate.”¹⁰⁷

b) The Requirement That the Covenant Touch and Concern the Land

Another element is that the covenant must touch and concern the land.¹⁰⁸ There is no real consensus on the definition of the touch and concern element; generally, however, purely financial covenants do not touch and concern the land.¹⁰⁹ A brief survey of the touch and concern element begins with the rule in *Spencer’s Case* which “established the requirement for running of the covenant that it ‘touch or concern’ the land”¹¹⁰ and continues to the *Restatement of Property* where the element is not found.¹¹¹ Under any definition, however, a private transfer fee covenant cannot meet the requirement of “touching and concerning” the land, and, is therefore an invalid covenant which does not bind later parties.

“A covenant touches and concerns the land if it affects the use, value, and enjoyment of the property,”¹¹² that is, for the requirement that the

103. Howard R. Williams, *Restrictions on the Use of Land: Covenants Running with the Land at Law*, 27 TEX. L. REV. 419, 428 (1949).

104. The rule in *Spencer’s Case* is that a covenant can be binding upon a third party if there is intent to bind the party, the covenant touched and concerned the land, and there was privity. *Spencer’s Case*, (1583) 77 Eng. Rep. 72 (K.B.); see also NATELSON, *supra* note 5, at 355. “The resolutions of *Spencer’s Case* requiring that the covenant relate to something *in esse*, or in the alternative, that assigns be specifically mentioned in the instrument containing the covenant, in order that it run with the land, have become of less importance in a number of jurisdictions.” Williams, *supra* note 102, at 423-24.

105. NATELSON, *supra* note 5, at 354-55 (internal citations omitted).

106. *Id.*

107. *Id.* at 355.

108. *Id.* at 353-58.

109. Williams, *supra* note 102, at 429-30; see also NATELSON, *supra* note 5, at 356-58.

110. Williams, *supra* note 102, at 429.

111. NATELSON, *supra* note 5, at 354-55; see also *Spencer’s Case*, (1583) 77 Eng. Rep. 72 (K.B.).

112. *In re Cnty. Treasurer*, 869 N.E.2d 1065, 1078 (Ill. App. Ct. 2007) (quoting U.S. Fid.

covenant must touch and concern the land, the “covenant must limit the use or enjoyment of the servient owner’s *land*.”¹¹³ Originally, the common law utilized this requirement to guard against unreasonable restraints on alienation.¹¹⁴ A “promise touches or concerns both the servient and the dominant land if, by reason of physical locations of the servient and dominant parcels, violation of the promise would cause harm to the dominant owner that substitutionary relief could not cure.”¹¹⁵

Generally, a purely financial covenant cannot touch and concern the land.¹¹⁶ For example, a covenant to pay money for a property owners’ association or to a developer with authority over the property generally does run with the land; however, when the money is not for purposes that relate to the land’s value, the covenant does not touch and concern the land.¹¹⁷ If stated in the affirmative, this seems to mean that if a covenant does relate to the land’s value, then it does touch and concern the land. Proponents of transfer fees have raised a tenuous argument that a private transfer fee covenant touches and concerns the land because it reduces the financial value homeowners may receive for selling their home; however, because the increase or possible decrease in value cannot be calculated with certainty, this is a difficult argument to make. As another example, a covenant just to pay insurance does not run, but if that covenant is coupled with a covenant to invest the insurance proceeds in restoring the damaged premises, then that covenant does run.¹¹⁸ As time has passed, more and more covenants to pay money have been held to “touch or concern,” and this trend shows an attitude or belief that adequate damages cannot be awarded and that courts should grant specific relief instead.¹¹⁹ Also, rent always counts as “touching and concerning” land, but “[b]ecause the payment of rent is not even indirectly connected to the land, this judicial solidarity is somewhat remarkable.”¹²⁰ Additionally, there are exceptions

& Guar. Co. v. Old Orchard Plaza Ltd., 672 N.E.2d 876 (Ill. Ct. App. 2007) (internal citations omitted)).

113. NATELSON, *supra* note 5, at 356.

114. Freyermuth, *supra* note 1, at 21-22.

115. NATELSON, *supra* note 5, at 354-55.

116. *See id.* at 356-57.

117. *Id.* at 357.

118. Masury v. Southworth, 9 Ohio St. 340, 340 (1859).

119. NATELSON, *supra* note 5, at 356-57 (citing ROGER A. CUNNINGHAM ET AL., THE LAW OF PROPERTY, 471-472 (1984); Douglas Laycock, *The Death of the Irreparable Injury Rule*, 103 HARV. L. REV. 687 (1990)).

120. WILLIAM B. STOEBUCK & DALE A. WHITMAN, THE LAW OF PROPERTY 477 (3d ed. 2000).

for homeowners' associations' use of funds to benefit the burdened land and common areas appurtenant to it; however, that is very different from a developer or third party receiving funds for the transfer of property.¹²¹ Thus, while an argument can be made that a purely financial covenant, such as a private transfer fee covenant, does meet the touch and concern element, the argument is a tenuous one. Most courts holding that purely financial covenants "touched and concerned" the land have not discussed a covenant which was solely for the benefit of a private third party.¹²²

The more recent view of the "touch and concern" element shows the trend is moving away from requiring physical touching of the land.¹²³ The so-called Clark-Bigelow test¹²⁴ "relates benefit and burden to the estates instead of to physical land, and [] measures benefit and burden by economic impact."¹²⁵ Seemingly, the *Restatement of Servitudes 3rd* does away completely with the touch or concern standard; however, it ends up being similar to the *Clark-Bigelow* test.¹²⁶ Thus, the most updated *Restatement of Servitudes* adopts the idea that the touch and concern element is centered on intent rather than physical touching.¹²⁷ The majority of courts, however, still require physical touching.¹²⁸ Therefore, for a majority of courts, a purely financial arrangement between a private third party and the original buyer would not be able to bind a later, successive buyer.

c) The Requirement of Privity

The final element, the requirement of privity, is complicated, and often presents the "greatest conflict" in cases regarding covenants and property law.¹²⁹ This element is best split into horizontal and vertical privity. Horizontal privity is the "property relationship between original

121. Freyermuth, *supra* note 1, at 21-22. *See generally* Neponsit Prop. Owners' Ass'n v. Emigrant Indus. Sav. Bank, 15 N.E.2d 793 (N.Y. 1938).

122. *See* discussion *infra* III.C.2 (discussing some relevant cases).

123. *See* STOEBUCK & WHITMAN, *supra* note 119, at 479.

124. Judge Clark seems to have approved of a test formulated by Professor Bigelow, which can be summarized as "a measuring of the legal relations of the parties with and without the covenant." Williams, *supra* note 102, at 429-30. In other words, the benefit or burden touches or concerns the land when the owner's legal interest is rendered more or less valuable by the promise. *Id.*

125. STOEBUCK & WHITMAN, *supra* note 119, at 479.

126. *Id.* at 480 (citing RESTATEMENT, *supra* note 55, § 5.2 (Tentative Draft No. 2, 1991)).

127. *Id.*

128. *Id.*

129. Williams, *supra* note 102, at 440.

covenanting parties at the time of contracting.”¹³⁰ It “is either established once and for all at the time of contracting or it is never established for that covenant.”¹³¹ Vertical privity means that a later owner must be the promisor’s successor.¹³² The question of who is a successor depends on the jurisdiction, but the majority rule is that for a person to be bound at law, he must have succeeded to the identical estate held by the original promisor.¹³³ Jurisdictions differ as to exactly when chain of privity is broken,¹³⁴ and there seems to be little consensus as to whether the chain of privity is broken when a property is transferred by lease, adverse possession, or foreclosure sale.¹³⁵

Professor Williams gives a spectrum of five general views regarding when the requirement of privity is satisfied by the type of relationship the parties have.¹³⁶ The first and most narrow view requires that the “[t]enure relationship [be] between the covenantor and covenantee.”¹³⁷ Second, some jurisdictions require the parties to have “simultaneous mutual interests in the same tract of land . . . which may have been created prior to the covenant or may be created by the instrument creating the covenant.”¹³⁸ This second view is broader than the first because privity will exist when there is a tenure relationship, as in the first, or when one party owns an interest, like an easement.¹³⁹ Third, what may be the majority view according to Professor Williams, privity “means a succession of interest in land between the covenantor and the covenantee.”¹⁴⁰ Generally, a deed in fee simple will suffice in these jurisdictions.¹⁴¹ Fourth is the hybrid position accepted by the *Restatement of Property*.¹⁴² This view requires “a privity of either succession of or simultaneous interests between covenantor and covenantee” as well as “some compensating benefit to other land justifying the running of the burden.”¹⁴³ This differs slightly as to benefits

130. NATELSON, *supra* note 5, at 358 (emphasis removed).

131. *Id.*

132. *Id.* at 358-59.

133. *Id.*

134. *Id.* at 359.

135. *Id.*

136. Williams, *supra* note 102, at 440-45.

137. *Id.* at 440.

138. *Id.* at 441.

139. *Id.*

140. *Id.*

141. *Id.*; see also NATELSON, *supra* note 5, at 358-59.

142. Williams, *supra* note 102, at 442.

143. *Id.*

because it seems that “the only privity required is the mere promise or covenant itself.”¹⁴⁴ Fifth, “the most liberal concept of privity” is the view that privity “merely requires a succession of interest on the part of assignees by or against whom the covenant is sought to be enforced.”¹⁴⁵ Under this view, privity “does not refer to any relationship between the covenantor and covenantee.”¹⁴⁶ Obviously, which view is taken will depend on the particular jurisdiction; however, the law is not always clear even within this system. Professor Williams states that “[m]athematically, there are twenty-five permutations of these five basic meanings of privity.”¹⁴⁷ Additionally, the requirement in each jurisdiction may change depending on whether the covenant at issue is either a benefit or burden.¹⁴⁸

d) The Requirements for a Benefit to Run with the Land

The above discussion summarizes what elements are required for a burden to run with the land. The requirements for a burden are explained in detail because the majority of the arguments regarding transfer fee covenants classify them as a burden on the land. However, there are also elements, which differ slightly from those discussed above, for a benefit to run with the land.¹⁴⁹ For example, a typical covenant used by a homeowners’ association, which can be analogized in many ways to Freehold’s transfer fee covenant, imposes fees on each homeowner to pay for the common areas and maintenance.¹⁵⁰ These fees benefit the owners both directly and indirectly.¹⁵¹ first, by providing things like pools or parks, and second, by “preserving/raising property values because of the presence of valued amenities.”¹⁵² Since the *Neponsit* case, courts have consistently “held that both the burden and benefit of a lot assessment covenant ‘touch and concern’ land and bind successor owners of that land.”¹⁵³ This makes sense because the effect on alienability is negligible while the land is significantly more attractive to buyers because of the added amenities.¹⁵⁴ Thus, while some may classify a transfer fee covenant as a burden on the

144. *Id.*

145. *Id.*

146. *Id.*

147. *Id.* at 443.

148. *Id.*

149. NATELSON, *supra* note 5, at 359-61.

150. *See* Freyermuth, *supra* note 1, at 21-22.

151. *Id.*

152. *Id.*

153. *Id.* at 22.

154. *Id.*

land, it is helpful to understand the requirements of benefits when considering arguments which take a different stance.

If a benefit exists, for that benefit to run with the land it is necessary to have a contract between the original parties, intent, a dominant estate, “touch or concern,” horizontal privity, and vertical privity.¹⁵⁵ Many elements sound the same, but applied in the benefit context, some are slightly different.¹⁵⁶ For a contract, a benefit depends on the same requirements as those for a burden to run with the land.¹⁵⁷ Also, similar to a burden, for the element of intent, if the parties intend that only the original promisee enforce, then the covenant does not run.¹⁵⁸ For the “touch or concern” element, some argue the benefit of the real covenant must be of a kind that enhances the use or enjoyment of particular land, but Robert G. Natelson, in the *Modern Law of Deeds to Real Property*, argues that the “touch or concern” test applies to the dominant and the servient estate simultaneously.¹⁵⁹ “The promise touches or concerns if, by reason of the physical positions of the servient and dominant land, violation of that promise would cause harm to the dominant owner that substitutionary relief could not cure.”¹⁶⁰

Generally for a benefit to run, horizontal privity is required. However, according to the *Restatement of Property 3rd*, horizontal privity is not *necessary* for a benefit to run.¹⁶¹ Some jurisdictions make the law clear in this area, but in jurisdictions where the law is more muddled, it is generally safe to assume privity is necessary.¹⁶² The requirements for vertical privity for benefits are the same as the requirements for burdens except that “tenants and sublessees may enforce promises made for the benefit of estates held by their landlords.”¹⁶³

2. Transfer Fee Covenants Do Not “Touch and Concern” the Land

The “touch and concern” element is the most contentious element of the requirements for a covenant to run with the land. Private transfer fee covenants, such as those used by Freehold, do not “touch and concern” the

155. NATELSON, *supra* note 5, at 359-60.

156. *Id.*

157. *Id.* at 360.

158. *Id.*

159. *Id.*

160. *Id.*

161. RESTATEMENT, *supra* note 54, §§ 534, 542.

162. NATELSON, *supra* note 5, at 360-61.

163. *Id.* at 361.

land. In their most recent brochure, Freehold claims that “the touch and concern doctrine has been largely abandoned in favor of a contract approach,” and that even if a jurisdiction does not follow this modern approach, Freehold’s covenants do meet the “touch and concern” requirement.¹⁶⁴ Under the modern approach, adopted by the *Restatement of Property 3rd*, many covenants have been held to bind subsequent owners in situations similar to the one Freehold claims their covenant creates.¹⁶⁵ However, private transfer fees are a purely financial burden which should not bind future owners even under the modern *Restatement*. Rents and homeowners’ association fees for common areas, as a financial burden, have traditionally been held to touch and concern.¹⁶⁶ Generally, however, courts do not hold that a solely financial burden regarding the land is one which touches and concerns the land, and the narrow circumstances described above are customarily the only time such financial covenants are held to touch and concern.¹⁶⁷

Additionally, the central tenant of the most recent *Restatement of Property* is the intent of the parties.¹⁶⁸ However, the *Restatement* did not utterly abandon the “touch and concern” element. Instead, it seems to have merged that element into the intent of the parties.¹⁶⁹ Courts following the principles of the modern *Restatement* do not specifically look for “touch and concern;” courts look instead to intent, which can have hints of the “touch and concern” element included in the analysis.¹⁷⁰ Although there has been a proliferation of private transfer fee covenants since the *Restatement of Property 3rd* because of the intent-based view, courts should still refuse to hold that a private transfer fee covenant touches and concerns the land because this would be a dangerous and novel approach.¹⁷¹

164. FREEHOLD CAPITAL PARTNERS, *supra* note 77, at 10.

165. RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 3.2 (2000); *see also* Inwood N. Homeowners’ Ass’n v. Harris, 736 S.W.2d 632 (Tex. 1987) (holding a declaration of covenants recorded for an entire subdivision effective to create lien on later purchasers for the homeowners’ association fees). *But see* Garland v. Rosenshein, 649 N.E.2d 756, 758 (Mass. 1995) (holding public policy concerns weighed against enforcing a burdensome covenant restriction since it did not touch or concern the land).

166. *See* Freyermuth, *supra* note 1, at 21-22.

167. *See* STOEBCUK & WHITMAN, *supra* note 119, at 477.

168. RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 2.1.

169. Locke Lake Colony Ass’n v. Town of Barnstead, 489 A.2d 120, 122 (N.H. 1985) (holding that the intent of the parties was the integral element; however, only after all formal requirements were satisfied).

170. *See* discussion *infra* Part III.D.

171. Freyermuth, *supra* note 1, at 22-23.

The common law developed partially to protect people from covenants which unreasonably restrained alienation. The modern *Restatement* has not completely abandoned these principles, and courts should continue to find that covenants which solely benefit an uninterested third party do not run with the land.

In jurisdictions which still adhere to the more traditional definition of the law of covenants, courts look to whether the “touch and concern” element is satisfied.¹⁷² In these jurisdictions, a purely financial arrangement with a third, uninterested party, does not “touch and concern” the land. Private transfer fee covenants are different from financial burdens associated with rent or homeowners’ associations, which are financial burdens that do touch and concern the land. Transfer fee covenants involve a private third party uninterested in the land or home itself: “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.”¹⁷³ Therefore, “the benefit of a private transfer fee is personal to the developer.”¹⁷⁴ In other words, the covenant is “in gross” and cannot, by the vast authority of common law courts, run with the land to bind later purchasers.¹⁷⁵

Therefore, a company adding a transfer fee covenant, like Freehold, is an uninterested third party which cannot create a covenant that “touches and concerns” the land. As such, the covenant does not affect the land and cannot run with the land to bind later purchasers. A developer’s personal interest in receiving a fee, which is often sold to yet another party, should not be held to bind a future purchaser since the developer’s interest is unconnected to any parcel of land. Additionally, if a jurisdiction follows the modern view, focused more specifically on each party’s intent in creating the covenant, courts should still refuse to find that a private transfer fee covenant runs with the land to bind future purchasers. Even these jurisdictions have not completely abandoned the “touch and concern” element and courts should refrain from enforcing covenants which have absolutely no bearing on the land itself and benefit only a private third party.

172. *Neponsit Prop. Owners’ Ass’n v. Emigrant Indus. Sav. Bank*, 15 N.E.2d 793 (N.Y. 1938); *see also Inwood N. Homeowners’ Ass’n v. Harris*, 736 S.W.2d 632 (Tex. 1987).

173. Freyermuth, *supra* note 1, at 22.

174. *Id.*

175. *Id.*; *see Bremmeyer Excavating, Inc. v. McKenna*, 721 P.2d 567, 568-69 (Wash. Ct. App. 1986).

3. *Transfer Fee Covenants Do Not Meet the Requirement of Privity*

Privity is required between the parties to a covenant.¹⁷⁶ Freehold, in their literature about the legality of transfer fee covenants, does not even mention the concept of privity.¹⁷⁷ Given that it must be established at the time of contracting or not at all, one assumes that horizontal privity must be established between the developer and the original purchaser. However, the type of privity necessary is dependent on the jurisdiction, and the modern view, as adopted by the *Restatement of Property 3rd* is that solely vertical privity is required for a benefit or burden to run with the land and bind successors.¹⁷⁸

Private transfer fee covenants, because they are created with a third party unconnected to the land, do not establish vertical privity.¹⁷⁹ Thus, even if a court were to find that the covenant did, in fact, “touch and concern” the land, the court should find that privity was not established and thus the covenant is invalid. Privity is not established primarily because the company holding a right to payment cannot be classified as any of the parties traditionally labeled as a party with privity in creating a covenant.¹⁸⁰ Under the first four of Professor Williams’ five views of privity, there is a colorable argument that Freehold, as a private third party uninterested in the land at issue, does not meet the essential requirement of privity in order to form a valid and binding covenant.¹⁸¹

First, in a jurisdiction requiring a tenure relationship between covenantor and covenantee, companies like Freehold do not hold the traditional positions required by law.¹⁸² In these most stringent jurisdictions, courts would have a very difficult time finding the privity requirement satisfied.

Under Professor Williams’ second view, a jurisdiction should also find the privity requirement unsatisfied. Again, a jurisdiction adopting this view would have to find that the developer and the later buyer had “simultaneous mutual interest in the same tract of land.”¹⁸³ While that interest may have

176. Williams, *supra* note 102, at 440-46.

177. FREEHOLD CAPITAL PARTNERS, *supra* note 77.

178. RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 2.4 cmt. b (2000); *see also* Gallagher v. Bell, 516 A.2d 1028, 1036-37 (Md. Ct. Spec. App. 1986). *Contra* Runyon v. Paley, 416 S.E.2d 177, 184 (N.C. 1992) (holding both vertical and horizontal privity necessary); *see also* RESTATEMENT OF PROPERTY § 534 (1944).

179. *See* discussion *supra* Part III.C.1.

180. NATELSON, *supra* note 5, at 358-59.

181. *See* discussion *supra* Part III.C.1.

182. *See generally* Austerberry v. Corp. of Oldham, 29 Ch. D. 750 (1885).

183. Williams, *supra* note 102, at 441-45.

been created pre-covenant or with the covenant, the mutual interest is not satisfied by private transfer fees. A third party, such as Freehold, never had a mutual interest with the contracting party in the land. Instead, their interest is only in the later transfer of that land and receipt of a fee. In fact, upon the first original transfer, Freehold's covenant does not even come into effect.¹⁸⁴ Instead, the 1% transfer fee is only paid upon the sale to a secondary, further removed, party.¹⁸⁵

Under the third (and majority) view, privity requires "a succession of interest in land between the covenantor and the covenantee, . . . which succession in interest must be at the time the covenant is made."¹⁸⁶ Even under this slightly more liberalized view of the privity requirement, privity is never established between a company like Freehold and the successive purchasers of the interest in land. A company like Freehold never actually owns an interest in land but instead seemingly owns only a right to receive payment upon the transfer of another's interest.¹⁸⁷ Because Freehold would never have a possessory interest in the estate, the company cannot be said to be in privity with later successive purchasers or sellers.

Under the fourth view, a jurisdiction should also find that Freehold has not created a valid covenant because privity does not exist between the parties.¹⁸⁸ This view, adopted by the *Restatement of Property 3rd*, requires "privity of either succession of or simultaneous interests between covenantor and covenantee and further require[s] some compensating benefit to other land justifying the running of the burden."¹⁸⁹ Again, Freehold, even at creation of the private transfer fee covenant, never had privity through either succession of or simultaneous interests with the property owner. Instead, they created a contract with the developer.

Under the fifth and most liberal view, an argument can be made that privity does exist between the holder of the right to receive a fee and the buyer or purchaser of the property.¹⁹⁰ This view "merely requires a succession of interest on the part of assignees by or against whom the covenant is sought to be enforced."¹⁹¹ In jurisdictions adopting this view, privity seems to be more about succession to the title to land as opposed to

184. FREEHOLD CAPITAL PARTNERS, *supra* note 3.

185. *Id.*

186. Williams, *supra* note 102, at 441.

187. See generally Shumaker, *supra* note 37.

188. Williams, *supra* note 102, at 442.

189. *Id.*

190. *Id.*

191. *Id.*

actual interest. In these most liberal jurisdictions, Freehold does have a colorable argument that a court should hold that they have privity with any party who later buys or sells the land affected by the covenant.

D. Transfer Fee Covenants Violate Public Policy and Should Not Be Enforced.

Because some states already ban or restrict the use of transfer fee covenants, it is clear that some legislatures think a transfer fee covenant would be enforceable absent a statutory ban. However, even assuming that all previously discussed legal challenges were to fail, a transfer fee covenant should not be sustained as a function of public policy. This is not a unique view on the doctrine of covenants, being similar to the view espoused in the *Restatement of Property 3rd*.¹⁹² While transferring property, especially in our modern society, can be a complex task, allowing companies like Freehold to patent and then use transfer fee covenants will only make a transfer more complex. At times when buyers and sellers already require professionals for almost every step of the process, transfer fee covenants threaten to make what is already a seemingly impossible task into one that is even harder to accomplish without legal and other professional involvement in the selling or buying of real property.

Additionally, it is unfair as a matter of public policy to burden future homeowners with transfer fee covenants. For all the basic reasons mentioned above, homeowners will be burdened and potentially unable to sell their land if states continue to allow transfer fee covenants to be used by private parties to bind homeowners. This is especially troublesome if “stacking” of transfer fee covenants is allowed. A homeowner might encounter several transfer fees which must be paid to several different private parties. This would undoubtedly reduce the alienability of the land as well as simply make buying and selling the land more difficult for the homeowner. Homeowners tend to be unsophisticated, at least compared to professional title experts, and assuming that a new homeowner will understand a private transfer fee covenant may simply be irrational, even if the covenant is disclosed. This becomes even more true if the covenants are stacked. While a deed generally must detail any covenants, conditions, easements, equitable servitudes, mineral rights, leases, or other encumbrances, a general reference like “subject to all restrictions of record” will often suffice legally but does not give a buyer adequate warning of the consequences of transfer fee covenants, except in those states which have

192. RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 3.1 (2000).

taken a positive step to require actual notice to the buyer.¹⁹³ As a matter of public policy, our society favors the alienability of land and clear title. For the same reasons, public policy should protect homeowners from unexpected and sometimes very large fees, which may keep them from transferring their interest in the land to another party.

Also, as a matter of public policy, states should be concerned that homeowners are not receiving adequate notice of transfer fee covenants. Many other covenants, like those used by homeowners' associations, raise concerns about notice which can be analogized to the problems likely to occur with private transfer fee covenants. Generally, one would assume that private fees placed on the land by a homeowners' association are visible and people tend to know the likely restrictions. However, even when the homeowner can visually see some of the restrictions in place because of the covenant, i.e. cut grass or no signs, notice issues still arise as to other aspects of the covenant.¹⁹⁴

The first major concern with homeowners' association fees is that the "daunting stack of papers presented to the buyer at closing" prevents the buyer from having actual notice of the covenant.¹⁹⁵ This concern quite obviously carries over to other kinds of covenants, especially those even less visible than a homeowners' association, like the private transfer fees advanced by Freehold.

Second, Hannah Wiseman posits that many new home buyers simply look at the covenants as "general" and never really think that they will be enforced.¹⁹⁶ Again, this same issue arises with respect to the use of private transfer fees, like the one proposed by Freehold, because potential homeowners may never thoroughly read or understand an obscure covenant that they are signing along with all of the other paperwork in the large stack of closing paperwork. As mentioned above, while a deed generally must detail any covenants or encumbrances, a general reference like "subject to all restrictions of record" is often used, and this does not give a buyer adequate warning of the possible covenants.¹⁹⁷ Finally, the title insurance commitment will show a private transfer fee as an exception from the

193. Hannah Wiseman, *Public Communities, Private Rules*, 98 GEO. L.J. 697, 742-45 (2004); see also CAL. CIV. CODE § 1098 (West Supp. 2011); Homebuyer Enhanced Fee Disclosure Act of 2010, H.R. 6332, 111th Cong. (2010); discussion *supra* Part II.

194. See Lee Anne Fennell, *Contracting Communities*, 2004 U. ILL. L. REV. 829, 839. See generally Wiseman, *supra* note 192, at 748-49.

195. Wiseman, *supra* note 192, at 747.

196. *Id.*

197. *Id.* at 742-45.

policy, but most people do not know how to read either the title insurance commitment or the documents listed as an exception.

Third, many homeowners are not made aware of the covenants attached to the home while in the buying process.¹⁹⁸ Instead, it is not until much later, and often too late, that the homeowner is told about the transfer fee, or other covenant, on their property.¹⁹⁹ This is worrisome in the context of a private transfer fee, which will require a large sum of money from the buyer later and may even inhibit fully informed buyers from wanting to purchase the property.

Finally, the last major problem asserted by Hannah Wiseman is that the real estate agents, often in haste to make a sale, do not mention or fully explain the covenants even if the covenants are correctly disclosed.²⁰⁰ For example, Wiseman notes that while the common law of covenants developed primarily because of notice concerns, and while state legislation ensures that notice is provided, many homeowners are still completely unaware of the existence of the homeowners' association.²⁰¹ Thus, "[d]espite the several layers of theoretical notice protections in private covenanted communities [] many homeowners indicate that they were unaware of the covenants when they were in the process of purchasing a home within these communities."²⁰² If real estate agents fail to explain a homeowners' association covenant, the likelihood that they will explain a complex document which requires property purchase price configurations seems to be very low.²⁰³

All of the points made by Hannah Wiseman regarding homeowners' association covenants are magnified when applied to private transfer fees used by developers, which are placed on the land for a full ninety-nine years and cloud the title if unpaid.²⁰⁴ If a state adopts a public policy of protecting homeowners at all, the state cannot allow a homeowner to remain unaware of such a threat to their property ownership. While some homeowners may choose the benefits of a private transfer fee, it is unlikely that many who actually do buy a home with a private transfer fee attached are accurately informed of the implications of that covenant.

198. *Id.* at 747-48.

199. *Id.*

200. *Id.* at 748.

201. *Id.* 742-45.

202. *Id.* at 746.

203. *Id.* at 742-48.

204. Freyermuth, *supra* note 1, at 21.

Therefore, courts should hold that a private transfer fee cannot bind future owners as a matter of public policy. Despite possible legal challenges, some jurisdictions may still find that private transfer fees create a valid covenant as a matter of law, but courts should turn to an alternative public policy rationale to find that they nonetheless create an invalid covenant. In a system that already requires professional help for the lay person wishing to purchase a home, it seems unforgivable to require homeowners to look out for yet another hurdle before their next purchase. Additionally, private transfer fee covenants should be void because they violate the basic value of the free alienability of land. Finally, because homeowners often are not given sufficient notice of covenants which run with their land, it is contrary to public policy to ask them to bear the burden of transfer fee covenants.

IV. While There May Be Benefits of Transfer Fee Covenants, the Benefits Do Not Outweigh the Substantial Problems Created by Allowing Transfer Fee Covenants to Be Used in Order to Obtain Private Gain

Proponents of transfer fee covenants argue that the covenants increase the ability to provide affordable housing and promote charitable giving in communities as well as provide funds for community growth and improvements.²⁰⁵ These proponents “argue that private transfer fees are reasonable and benefit both buyers and developers.”²⁰⁶ While some of these arguments do have merit, the benefits that are gained through use of transfer fee covenants are lackluster and the problems with transfer fee covenant use in the private developer context greatly outweigh any of the favorable arguments.

A. Transfer Fee Covenants Do Not Provide for More Affordable Housing

Joseph Alderman, managing partner of Freehold, says that transfer fee covenants are “a means of spreading out costly infrastructure expenses and jump-starting half-finished subdivisions hobbled by the housing crisis.”²⁰⁷ Freehold claims that homes are more affordable after the use of a private transfer fee because the covenant will lower the “price, transactional costs and carrying costs of the home.”²⁰⁸ The upfront buying costs are reduced because the developer has sold the right to be paid the transfer fees and has

205. *Id.* at 25.

206. *Id.*

207. Waters, *supra* note 48.

208. *Id.*

thereby received income from the property.²⁰⁹ Therefore, the developer can afford to sell the home for less.²¹⁰ However, The Coalition to Stop Wall Street Home Resale Fees, which is a group of realtors that backs the Federal Housing Finance Agency's proposal, says that the use of private transfer fees "lower[s] a home's equity, depress[es] home prices and complicate[s] the safe, efficient and legal transfer of real estate."²¹¹

Peter W. Salsich, Jr., an attorney in Irvine, California, suggests that private transfer fees finance affordable housing through private "endowments," which "are essentially transfer fees collected when market rate housing is sold and then resold."²¹² Salsich proposes that "private restrictive covenants . . . be used to provide [a] funding mechanism" for affordable housing²¹³ and that the "[b]eneficiaries [of these endowments or private transfer fees] would be private not-for-profit organizations."²¹⁴ Again, "[this] proposal calls for the foundations to [get] payments and then distribute fees on a pro rata basis to other not-for-profit housing providers, such as Habitat for Humanity."²¹⁵ The argument is that homeownership costs do not increase because the upfront costs of projects and goals are reduced, resulting in a greater availability of affordable housing and more affordable pricing overall.²¹⁶

However, it seems that a clear rebuttal argument on behalf of those opposing the imposition of private transfer fees on future private parties is that these reasons are not enough to justify binding a future private party with a covenant. While the argument of the proponents of transfer fees is noble, opponents have an equally valid argument that transfer fee covenants may result in unaffordable housing and that owners should not be burdened with recurring payments for each sale of the property.

The proponents of transfer covenant fees point to the fact that "N.I.M.B.Y.," or not-in-my-back-yard, attitudes push unwanted and undesirable facilities or land uses to mostly minority or low-income communities.²¹⁷ The argument is that use of transfer fee covenants to

209. See *Common Myths About Private Transfer Fees*, *supra* note 72.

210. *Id.*

211. Waters, *supra* note 47.

212. Peter W. Salsich, Jr., *Affordable Housing: Can Nimbysism Be Transformed Into Okimbyism?*, 19 ST. LOUIS U. PUB. L. REV. 453, 467 (2000).

213. *Id.* at 467-68.

214. *Id.* at 468.

215. *Id.*

216. *Common Myths About Private Transfer Fees*, *supra* note 70.

217. See Orlando E. Delogu et al., *Some Model Amendments to Maine (And Other States') Land Use Control Legislation*, 56 MAINE L. REV. 323, 349 n.61 (2004).

encourage building and funding of communities will help inhibit this from happening.²¹⁸ Again, it hardly seems congruent with sound public policy to require possible future owners to shoulder this burden. Homeowners have many other choices if they wish to support worthy causes and they can exercise their choice in a way that does not require them to pay for it as a third party through a fee upon the sale of their home.

While current owners may pay less up front for their new property, there is no proof, or even a clearly sound economic argument, that the property is actually cheaper or that this increases the availability of affordable housing to anyone—especially those purchasing the home burdened by the transfer fee covenant. Additionally, there is also no proof that those affected by the endowments are able to receive more affordable housing because of the use of private transfer fee covenants on nearby residences.

B. Transfer Fee Covenants Do Not Promote a Sense of Community

Some argue that private transfer fees, in general, add to the sense of community by allowing residents to group themselves.²¹⁹ For example, it is suggested that residents may find ways to use private transfer fees to group themselves by common behaviors or, alternatively, by socio-economic status.²²⁰ When this is done through private transfer fees, especially when the entity using the transfer fee is a homeowners' association, many seem to think that this is a positive aspect of the use of transfer fees.²²¹ The same arguments made in favor of homeowner' association fees can be made for the use of transfer fees by private parties. Proponents of transfer fees who do not share the same view as the N.I.M.B.Y. proponents, may argue that transfer fee covenants should be tolerated because they are similar in kind to the homeowners' association fees.²²²

However, private transfer fees, when used solely by private parties, do not have the same effects as homeowners' association fees.²²³ For example, homeowners' association covenants, which are essentially private covenants, allow a sense of community by giving a resident a choice to live

218. *See id.*

219. *See* Fennell, *supra* note 193 at 842.

220. *See id.*

221. *See* Wiseman, *supra* note 192, at 713-14, 735-36.

222. *See id.* at 735-36 (noting private transfer fees are not solely a N.I.M.B.Y. concern but “special interest-focused decisions but instead largely respond to broad-based consumer preferences”); *see also* Fennell, *supra* note 193, at 831-32 (noting how voluntary rule-based communities has generated much scholarly debate and succinctly summarizing arguments from both pro- and anti-rule-based community scholars).

223. *See* Wiseman, *supra* note 192, at 735-36.

in a community that only allows a certain number of yard signs.²²⁴ This is an entirely different decision and problem than a resident choosing or being forced into paying 1% of the purchase price of their home back to a private company.²²⁵

In conclusion, while the arguments raised by the proponents of private transfer fees seem plausible, the merits do not weigh heavily enough to balance out the consequences which befall both the buyer and the community in which the property is located. At the very least, private homeowners cannot possibly have sufficient notice, in most cases, to make an informed decision about a private transfer fee burdening their property for the following ninety-nine years.

V. A Minority of States Already Restrict the Use of Transfer Fee Covenants, and the Remaining States, as Well as the Federal Government Should Enact Bans to Protect Both Buyers and Sellers

Eighteen states have already restricted, in some form, transfer fee covenants.²²⁶ The federal government also has several transfer fee covenant proposals. One of these proposals would ban transfer covenants in all loans financed by federally funded Fannie Mae or Freddie Mac.²²⁷ As transfer fees become more newsworthy and popular and as more state legislatures begin to recognize the problems transfer fees could pose, more states will likely begin to introduce their own restrictions on the use of transfer fee covenants.

224. See Fennell, *supra* note 193, at 838; see also Wiseman, *supra* note 192, at 735-36.

225. But see Wiseman, *supra* note 192, at 736 (arguing consumers make the choice to live in such a community for a myriad of other benefits despite the downfalls, including a possible transfer fee covenant).

226. Harney, *supra* note 6; ARIZ. REV. STAT. ANN. § 33-442 (2010); CAL. CIV. CODE § 1098 (West 2009); DEL. CODE ANN. tit. 25, § 319 (West 2010); FLA. STAT. ANN. § 689.28 (West 2011); 765 ILL. COMP. STAT. ANN. 155/5 (West 2011); IOWA CODE ANN. § 558.48 (West 2011); KAN. STAT. ANN. § 58-3821 (2009); LA. CIV. CODE ANN. art. 647 (2008); MD. CODE ANN., Real Prop. § 10-708 (West 2010); MINN. STAT. § 513.74 (2011); MO. ANN. STAT. § 442.558 (West 2011); N.C. GEN. STAT. § 39A-3 (2010); OHIO REV. CODE ANN. § 5301.057 (West 2010); TEX. PROP. CODE ANN. § 5.017 (West 2010); UTAH CODE ANN. § 57-1-46 (West 2010).

227. Harney, *supra* note 6.

A. About a Third of the States Already Restrict the Use of Transfer Fee Covenants, and Those States Which Have Not Yet Banned Them Will Likely Soon Follow the Minority

As one critic of transfer fee covenants put it:

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.²²⁸

Eighteen states have adopted statutory provisions directly addressing enforceability of transfer fee covenants.²²⁹ The states with a statute restricting, in some form, transfer fee covenants are: Arizona, California, Delaware, Florida, Hawaii, Illinois, Iowa, Kansas, Louisiana, Maryland, Minnesota, Mississippi, Missouri, North Carolina, Ohio, Oregon, Texas, and Utah.²³⁰ Other states have banned transfer fee covenants outright: Florida, Missouri, Oregon, Kansas, Arizona, Iowa, Maryland, Utah.²³¹ Under these states' bans "private transfer fee covenants imposed after the effective dates of the relevant statutes are deemed contrary to public policy and void."²³²

Texas adopted a statute in 2007 that purported to prohibit enforcement of transfer fee covenants.²³³ However, transfer fee covenants arguably still are

228. Freyermuth, *supra* note 1, at 25.

229. *Id.* at 24.

230. ARIZ. REV. STAT. ANN. § 33-442; CAL. CIV. CODE § 1098; DEL. CODE ANN. tit. 25, § 319; FLA. STAT. ANN. § 689.28; 765 ILL. COMP. STAT. ANN. 155/5; IOWA CODE ANN. § 558.48; KAN. STAT. ANN. § 58-3821; LA. CIV. CODE ANN. art. 647; MD. CODE ANN., Real Prop. § 10-708; MINN. STAT. § 513.74; MO. ANN. STAT. § 442.558; N.C. GEN. STAT. § 39A-3; OHIO REV. CODE ANN. § 5301.057; TEX. PROP. CODE ANN. § 5.017; UTAH CODE ANN. § 57-1-46.

231. Freyermuth, *supra* note 1, at 25.

232. *Id.*

233. *Id.* The statute reads, in part:

(b) 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

enforceable under the Texas statute because it obliges the seller to pay the fee and not the buyer.²³⁴ Additionally, Freehold interprets the Texas statute to allow transfer fee covenants as long as part of the fee goes to charity.²³⁵ However, these arguments are not valid because they are inconsistent with a literal reading of the Texas Restatement.²³⁶ Even if the buyer is not liable for the fee that accrues, the buyer is still bears the burden of “a fee in connection with a future transfer of the property.”²³⁷ Additionally, “if the seller fails to pay the [transfer covenant] fee, it becomes a lien against the land that prevents the buyer from delivering clear title to a subsequent purchaser.”²³⁸ Finally, reading the statute literally makes it obvious that the 501(c)(3) exemption should not be used to totally exempt private transfer fees from the statute.²³⁹ If that were so, it would seemingly negate the statute as a whole because all private transfer fees could then be partially routed to a charitable organization. The wording of the statute itself shows that it was not intended to provide an exception for any and all private

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. A deed restriction or other covenant running with the land that violates this section or a lien purporting to encumber the land to secure a right under a deed restriction or other covenant running with the land that violates this section is void and unenforceable. For purposes of this section, a conveyance of real property includes a conveyance or other transfer of an interest or estate in residential real property.

(c) This section does not apply to a deed restriction or other covenant running with the land that requires a fee associated with the conveyance of property in a subdivision that is payable to:

(1) a property owners' association that manages or regulates the subdivision or the association's managing agent if the subdivision contains more than one platted lot;

(2) an entity organized under Section 501(c)(3), Internal Revenue Code of 1986; or

(3) a governmental entity.

TEX. PROP. CODE ANN. § 5.017.

234. Freyermuth, *supra* note 1, at 23.

235. See Hiller, *supra* note 47 (“In Texas, state law restricts private transfer fees but says some groups can collect them, including charities, property owner associations or governmental entities. Freehold has interpreted this to mean that if 5 percent of the transfer fee goes to charity, the developer and Freehold can collect the rest. Also in Texas, the fees can be written into neighborhood covenants, accepted by home-owners when they purchase”)

236. Freyermuth, *supra* note 1, at 23.

237. *Id.* at 24.

238. *Id.*

239. TEX. PROP. CODE ANN. § 5.017 (West 2008).

transfer fees donated to a charity. The other exception listed with the 501(c)(3) exception is the exception for homeowners' associations.²⁴⁰ It seems that Texas simply wanted to protect already common and accepted uses of transfer fee covenants. Additionally, if read very literally, the Texas statute only exempts transfer fee covenants that give the totality of the fee to a 501(c)(3) charity.²⁴¹ Thus, the Texas statute does in fact act as a ban on private transfer fee covenants on residential property.²⁴²

In contrast, Louisiana does not have a statute directly addressing transfer fee covenants, but transfer fee covenants are probably unenforceable under Louisiana's civil law.²⁴³ 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."²⁴⁴ This allows personal servitudes, or 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.²⁴⁵ Transfer fee covenants, such as those used by Freehold, do not provide such an advantage. Instead, they simply give a right to receive payment to a third party. Therefore, while servitudes in gross may be enforced in Louisiana, a private transfer fee covenant does not meet this description. Although Louisiana has not banned private transfer fee covenants, their law already seems to have accounted for them and made them invalid.

In sum, over one-third of states have already restricted or banned transfer fee covenants. While this is currently a minority of states, state legislatures in the majority of states without a transfer fee covenant ban should enact such a restriction in order to protect homebuyers. Additionally, the federal government should follow these states' leads and protect homeowners by regulating the use of private transfer fee covenants.²⁴⁶

240. *Id.*

241. *Id.*

242. *Id.*

243. *Id.* See generally LA. CIV. CODE ANN. art. 647 (2008).

244. Freyermuth, *supra* note 1, at 24 (citing LA. CIV. CODE ANN. art. 647).

245. *Id.* (citing LA. CIV. CODE ANN. art. 640).

246. An interesting question is raised by the proposals in Congress regarding the extent of Congress's power vis-à-vis private residential laws within states. This question is outside the scope of this comment and the question will be left open here except to suggest that Congress find a balance that allows the federal government to protect homeowners while also strongly encouraging the States to do the same.

B. Although California Has Explicitly Allowed Transfer Fee Covenants, It Has Restricted their Use

Restrictions, like those that require that notice be given to any buyer, allow companies to continue using transfer fee covenants while mitigating some of the negative features. Private transfer covenants are used for many purposes that our society deems good, useful, and normal. Especially with the rise of suburban living, a homeowner may deem any number of land use controls perfectly suitable and useful.²⁴⁷ Additionally, many authors who have discussed the privatization of public property have argued that private transfer fee covenants are helpful and allow people to better control their neighborhood and living space in an increasingly crowded environment and country.²⁴⁸ This may be why some states are wary of a ban on transfer fee covenants and it also may be why some states are willing to consider restrictions on transfer fee covenants but unwilling to ban them entirely.

The only state officially validating transfer fee covenants is California.²⁴⁹ However, even California adopted some protections including a disclosure

247. Fennell, *supra* note 193.

248. *See* Wiseman, *supra* note 192, at 752-58; *see also* Fennell, *supra* note 193.

249. *See* Wiseman, *supra* note 192, at 752-58.

A "transfer fee" is any fee payment requirement imposed within a covenant, restriction, or condition contained in any deed, contract, security instrument, or other document affecting the transfer or sale of, or any interest in, real property that requires a fee be paid upon transfer of the real property. A transfer fee does not include any of the following:

- (a) Fees or taxes imposed by a governmental entity.
- (b) Fees pursuant to mechanics' liens.
- (c) Fees pursuant to court-ordered transfers, payments, or judgments.
- (d) Fees pursuant to property agreements in connection with a legal separation or dissolution of marriage.
- (e) Fees, charges, or payments in connection with the administration of estates or trusts pursuant to Division 7 . . . Division 8 . . . or Division 9 . . . of the Probate Code.
- (f) Fees, charges, or payments imposed by lenders or purchasers of loans, as these entities are described in subdivision (c) of Section 10232 of the Business and Professions Code.
- (g) Assessments, charges, penalties, or fees authorized by the Davis-Stirling Common Interest Development Act (Title 6 (commencing with section 1350) of Part (4).
- (h) Fees, charges or payments for failing to comply with, or for transferring the real property prior to satisfying, an obligation to construct residential improvements on real property.
- (i) Any fee reflected in a document recorded against the property on or before December 31, 2007, that is separate from any covenants, conditions, and restrictions, and that substantially complies with subdivision (a) of Section

requirement.²⁵⁰ In California, transfer fee covenants are 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.²⁵¹ This is very similar to one of the federal proposals, which would require full disclosure.²⁵² Thus, at least several legislators believe that a disclosure requirement would be helpful in protecting homebuyers from the detrimental effects of private transfer fees.²⁵³ While limitations, like requiring notice to homeowners, in these states might not solve all the negative implications of private transfer fees, they lessen some of the harmful impacts on homeowners and buyers.

C. Remaining States Should Adopt Either a Ban or Restriction on the Use of Transfer Fee Covenants

While the majority of states have yet to restrict or ban transfer fee covenants, this is unsurprising as transfer fee covenants have not been used as they currently are by Freehold, for many years. However, as use of this new legal strategy spreads, state legislatures should provide assistance to homeowners. First, states should consider the fact that homeowners are rarely provided adequate or sufficient notice of a transfer fee covenant. This should be the first issue a state addresses regarding transfer fee covenants. Second, states should consider banning transfer fee covenants, as used by private buyers and developers, in whole or in part because of their deleterious effects.

1. States Should Immediately Be Concerned With Providing Notice

As discussed above, a major concern with transfer fee covenants is inadequate notice for homeowners. This is especially significant given that the “common law of covenants evolved in large part in response to notice concerns.”²⁵⁴ Because of this, states which have yet to enact notice

1098.5 by providing a prospective transferee notice of the following:

- (1) Payment of a transfer fee required.
- (2) The amount or method of calculation of the fee.
- (3) The date or circumstances under which the transfer fee payment requirement expires, if any.
- (4) The entity to which the fee will be paid.
- (5) The general purposes for which the fee will be used.

CAL. CIV. CODE § 1098 (West 2008).

250. Freyermuth, *supra* note 1, at 24; *see also* CAL. CIV. CODE § 1098 (West 2008).

251. Freyermuth, *supra* note 1, at 24.

252. Homebuyer Enhanced Fee Disclosure Act of 2010, H.R. 6332, 111th Cong. (2010).

253. *Id.*

254. *Id.*

requirements may want to first consider this intermediary step before deciding whether to ban or restrict transfer fees altogether.

Private transfer fees have many uses and the idea of a private transfer fee covenant has been used for many years in property law.²⁵⁵ However, prior uses of transfer fees, like those involved with a homeowners' association, are much different than the private transfer fee used and patented by Freehold and other similar companies. For example, when a resident moves into a new home or new area, the existence of a homeowners' association and what flows from membership is seemingly known or at least knowable.²⁵⁶ Even if new homeowners are unaware of a specific fee, they presumably have an idea of what homeowners' associations are, that they exist, and that their land may be burdened by payment to a homeowners' association.²⁵⁷ Furthermore, because of this basic knowledge, when homeowners become aware of the fee, they are often unsurprised or find that the fee is so low that their lack of knowledge was not so unbearable as to keep them from buying the property at all.²⁵⁸ For example, in one instance a homeowner found out about the homeowners' association dues much later in the contract signing stage than he would have liked.²⁵⁹ However, upon finding out that the dues were only twenty-one dollars a month, paid twice a year, he decided to go ahead with the purchase anyway.²⁶⁰ This is evidence that homeowners, even without actual notice, tend to have a more ready understanding of covenants used with homeowners' associations.

Additionally, a resident can almost always see, upon arriving in the community or near the home, what requirements may be part of homeowners' association covenants.²⁶¹ While homeowners may not have notice of specific rules, which can sometimes be problematic, they do tend to have a visual of what the homeowners' association requirements and dues might entail.²⁶²

However, the same cannot be said for private transfer covenant fees used by a private developer to place a covenant on the land for the next ninety-nine years. First, most homeowners, especially those without a legal

255. See Fennell, *supra* note 193, at 829-30.

256. See Wiseman, *supra* note 192, at 743-51; see also Fennell, *supra* note 193.

257. See Wiseman, *supra* note 192, at 747-48.

258. See *id.*

259. See *id.*

260. See *id.*

261. See Wiseman, *supra* note 192, at 743-51; see also Fennell, *supra* note 193.

262. See Wiseman, *supra* note 192, 743-51.

background, have probably never heard of a private transfer fee. Second, even with prior knowledge of what a covenant or, more specifically, a private transfer fee covenant is, many homeowners are unlikely to know the details of how such a covenant functions and how it may burden their land for a long period of time.

The obligation to pay the transfer fee may not always be readily apparent and any state which has not already limited transfer fees should follow states like California, which have made disclosure a mandatory condition of any property transfer including a private transfer fee covenant.

2. State Legislatures Should Ban or Restrict Private Transfer Fees

While homeowners should act to protect themselves when purchasing a home by reading all documents and employing the necessary professionals, the government should also step in and ban or restrict the use of private transfer fee covenants. Freehold claims that a multitude of property types can benefit from the use of private transfer fees: “office buildings, mixed-use projects, hotels/motels, apartment complexes, retail centers, warehouse facilities, industrial facilities, condominiums, residential subdivisions”²⁶³ Most potential buyers of these types of properties have the sophistication and legal knowledge to make a full assessment of the benefits of contracting with a company like Freehold. However, most homebuyers lack similar sophistication to understand the implications of a private transfer fee covenant.²⁶⁴ Often, a home is the biggest purchase a person will make in a lifetime and such a purchaser is likely to be much less sophisticated than the developer or company who is attempting to use the covenant. Additionally, the purchaser will not feel the effects of the private transfer fee until required to pay it years later upon the sale of the property.²⁶⁵ All of these factors put homeowners and buyers in a weaker position than that described by those positing that the use of transfer fee covenants will have obvious benefits for everyone.²⁶⁶ Instead, it seems much more likely that the only party benefiting from the use of a private transfer fee covenant is the company and holder of the right to receive payment.

States often step in to protect consumers in similar situations. For example, “lemon laws” in states like Oklahoma protect consumers from

263. FREEHOLD CAPITAL PARTNERS, *supra* note 77.

264. *See* discussion *supra* Part III.D.

265. *See* FREEHOLD CAPITAL PARTNERS, *supra* note 77.

266. *Id.*

faulty new cars.²⁶⁷ These laws attempt to avert surprise when new cars do not conform to the reasonable expectations of purchasers.²⁶⁸ Similarly, consumers who are taken by surprise by a private transfer fee should be protected. Also, a “lemon law” comes into effect to protect consumers when the car defect substantially interferes with the use of the car.²⁶⁹ Likewise, since the private transfer fee imposes such a hefty cost upon the homeowner, the homeowner should be protected from such a surprise at the time it first arises. While states cannot and likely should not protect homeowners from covenants already signed and in place, they should protect future homeowners from falling into the same trap. While some potential buyers may have the ability to protect themselves from the undesired effects of a private transfer fee, homebuyers on the whole do not. States and the federal government should protect homebuyers from sophisticated attempts to make a profit off of consumers’ lack of knowledge.

D. As the Use Of Private Transfer Fees Becomes More Wide-Spread, It Is Likely that More States and the Federal Government Will Follow the Suggestions of This Comment and Ban or Restrict Their Use

Notably, “as 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.”²⁷⁰ The American Land Title Association’s statement says “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.”²⁷¹ The statement released by The National Association of Realtors says “such fees decrease affordability, serve no public purpose, and provide no benefit to property purchasers, or the community in which the property is located.”²⁷² Both the National Association of Realtors and

267. 15 OKLA. STAT. § 901 (2009).

268. *See id.*

269. *See id.*

270. Freyermuth, *supra* note 1, at 24.

271. *Private Transfer Fee Covenant*, AM. LAND TITLE ASS’N (Apr. 19, 2010), http://www.alta.org/advocacy/docs/PrivateTransferFeeCovenant_OnePager.pdf.

272. *Legislative Update*, MISSISSIPPI ASS’N OF REALTORS), <http://www.comvest.net/documents/MARLegislativeUpdateFeb2011.pdf>.

the American Land Title Association are “seeking to introduce in state legislatures a model statute banning transfer fee covenants.”²⁷³

The model statute introduced by the National Association of Realtors and the American Land Title Association would invalidate transfer fee covenants added after the statute’s effective date, but not those before the effective date.²⁷⁴ A court facing a challenge to covenants that precede the statute should evaluate their 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.”²⁷⁵

The Federal Housing Finance Agency’s proposed ban would affect most states because of the influence of Fannie Mae, Freddie Mac, and other government owned lenders. The proposal would prohibit Fannie Mae, Freddie Mac, and the Federal Home Loan Banks from investing in mortgages on properties with private transfer fee covenants.²⁷⁶ Its guidance applies to mortgages and securities purchased by those banks or acquired as collateral for advances and to mortgages and securities purchased by Fannie Mae or Freddie Mac.²⁷⁷ The proposed guidance for government sponsored enterprises was published August 16, 2010.²⁷⁸ The Federal Housing Finance Agency expresses concerns regarding transfer fee covenants, saying that the covenants may increase cost of homeownership, hamper affordability, reduce liquidity in both primary and secondary mortgage markets, limit transfers or render them legally uncertain, and expose lenders, title companies, and secondary market participants to risks from unknown potential liens and title defects.²⁷⁹

Transfer fee covenants may reduce transparency because they often are not disclosed by sellers and are difficult to discover through customary title searches, especially by successive purchasers.²⁸⁰ As these problems become more widely recognized, the number of states banning or restricting the use of transfer fee covenants continues to grow. Just recently, North Dakota Senators Grindberg, Lee, and Robinson and Representatives Gruchalla, Klemin, and Louser introduced a state bill proposing a

273. Freyermuth, *supra* note 1, at 24.

274. *Id.*

275. *See id.* at 24-25.

276. *FHFA Proposes Ban on GSE Investments in Loans on Properties with Private Transfer Fee Covenants*, HDR CURRENT DEVS., Aug. 23, 2010, available at 38 NO. CD-17 HDRCURDEV 19 (Westlaw).

277. *Id.*

278. *Id.*

279. *Id.*

280. *Id.*

prohibition on the use of private transfer fees.²⁸¹ Furthermore, a founder of National Association of Land Title Examiners and Abstractors and SourceofTitle.com, Robert Franco, predicts that another ten states, at least, will follow suit in 2011.²⁸² Mr. Franco has catalogued the private transfer fee covenant evolution on his blog for years.²⁸³ While he may not be correct about the number of states, his prediction has ample basis for support. Even federal legislators have introduced two bills restricting or banning private transfer fees.²⁸⁴ Also, at the beginning of 2010, only six states banned private transfer fees; however, by the end of that year, the number had grown to sixteen.²⁸⁵

Therefore, while only a minority of states ban or restrict the use of private transfer fees, the remaining states and the federal government should follow their lead. First, the majority of the states are likely to at least consider a proposal to ban private transfer fees in the near future. Second, those states which do not ban transfer fee covenants will lack protections for homebuyers and homebuyers will feel the repercussions of legislative inaction for many years. Third, if a state wants to avoid a total ban, states can follow California's lead and adopt disclosure requirements in order to help homeowners best understand the documents they may sign when they purchase their home. For those states considering proposals to ban or restrict private transfer fees, their primary concern should be protecting homeowners. The states can focus on notice or more fully protect homeowners through total bans or partial restrictions.

VI. Transfer Fee Covenants Are a Dangerous and Novel Property Concept Which Threatens to Make Purchasing Property Not Only Less Affordable but Also a Much More Complicated Process That Threatens Alienability of Land and Violates Public Policy Concerns

Transfer fee covenants are a sizeable step away from historical property or contract law. Transfer fee covenants are made when a developer adds a covenant to a deed, generally, which requires payment of a fee. This fee must be paid from the new buyer back to the developer. The fee is

281. S. 2149, 62th Leg. (N.D. 2011).

282. Robert Franco, *My Predictions for 2011*, SOURCE OF TITLE BLOG (Jan. 1, 2011), http://www.sourceoftitle.com/blog_node.aspx?uniq=736.

283. *See generally* Robert Franco, SOURCE OF TITLE BLOG, <http://www.sourceoftitle.com>.

284. Homeowner Equity Protection Act of 2010, H.R. 6260, 111th Cong. (2009-2010).

285. Letter from Mark Winter, President, ALTA, to Alfred M. Pollard, General Counsel, FHFA (Oct. 15, 2010), *available at* http://www.alta.org/press/FHA_101510.pdf.

generally 1% of the sale price, which is re-calculated every time the property is sold to a new buyer for the next ninety-nine years.

Companies like Freehold are selling this device as an easy and continuously lucrative alternative to requiring the first buyer to bear all of the cost. However, this is dangerous as it may inhibit alienability of land. Additionally, it seems to be a covenant which violates the law of covenants. First, it does not touch and concern the land. Second, privity is never established. Third, it seems to allow the developer or holder of the right to obtain payment and to retain a right to the property without having any actual right to possession.

Finally, as a matter of public policy, transfer fee covenants violate the most basic understandings of property law, especially clear title. Transfer fees threaten to cloud title and to make it all too difficult to transfer property. Our society values the alienability of land and clear title, and private transfer fees potentially make it much more difficult for a buyer, and later a seller, to transfer land. Additionally, buyers may be mostly, or even completely, unaware of the fact that a private transfer fee covenant is attached to the land they are purchasing. As with other types of covenants, homeowners typically do not realize or understand what is attached to the land, and this is especially problematic when the covenant requires a large sum to be paid to a private party before the land can be re-sold and attaches to that land for a long period of time: ninety-nine years.

Amy Kathleen Lewis