

October 15, 2010



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

ATTENTION: Public Comments "Guidance on Private Transfer Fee Covenants, (No. 2010-N-11)"

Dear Mr. Pollard:

On behalf of the more than 3,800 member companies of the American Land Title Association (ALTA), we applaud the Federal Housing Finance Agency (FHFA) for its guidance to the enterprises on the growing use of private transfer fee covenants and their effect on Fannie Mae, Freddie Mac and Federal Home Loan Bank mortgage purchases, but especially consumers. Private transfer fee covenants provide no benefit to consumers, real estate or the public, but rather cost consumers' money, complicate the safe, efficient and legal transfer of real estate and depress home prices¹.

ALTA, founded in 1907, is the national trade association and voice of the real estate settlement services, abstract and title insurance industry. With more than 8,000 offices throughout the country, ALTA members operate in every county in the United States to search, review and insure land titles to protect home buyers and mortgage lenders who invest in real estate. ALTA members include title insurance companies, title agents, independent abstracters, title searchers and attorneys, ranging from small, one-county operations, to large national title insurers.

Real property is the greatest source of wealth in the United States, and access to that wealth is only possible because of a strong set of property rights that determine how property is used and owned. By establishing legal rights to property, economies have the surety necessary to use it as collateral in order to create additional capital. American law bundles property rights into a title that describes the asset and its owner. Titles are tracked by a recording system that gives the public notice of who possess what property rights. Private transfer fee covenants directly threaten this property rights system.

There are two hallmarks of our property rights system: liens and lien priority. A lien is a claim against a property for the payment of a debt. A lien gives a creditor the security to know

¹ We use the term "home" and "consumer" in this letter, however, private transfer fee covenants affect all types of real property, including single family and multifamily residential and commercial properties.

that a debt will be satisfied. Lien priority is the legal structure that determines which creditor has the right to be paid in which order when a property must be sold in order to satisfy a debt. This structure assures creditors of their rights when property is used to secure a debt.

What is a Private Transfer Fee Covenant?

A private transfer fee is commonly established when a developer² agrees to add a covenant to the title of each new home in a development, or a homeowner agrees to add a covenant to an existing home, that requires future owners of the property to pay a percentage of the selling price (usually 1%) to a designated trustee for the next 99 years. In the most widely promoted version of this arrangement, the developer obtains licensed documents and advice on creating private transfer fee covenants from the firm Freehold Capital Partners (“Freehold”). Freehold purports to be awaiting a business method patent³ and has indicated that it is attempting to securitize and monetize private transfer fee covenants as well in exchange for a percentage of the transfer fees.

Proceeds from a transfer fee are typically collected by a trustee who retains a portion of the 1% fee for expenses and distributes the remainder to the developer, Freehold, and sometimes other parties, all of whom have no ownership interest in the property. Under one arrangement, the private transfer fee covenant is split between Freehold (30%), Developer (60%) and the trustee (10%) for the first 30 years it is in effect. For the remaining 69 years, the PTF covenant is split between Freehold (90%) and the trustee (10%).

If a consumer does not pay the private transfer fee covenant, a lien is established against their property in the amount of the unpaid fee, plus interest and costs. Before the property can be sold or refinanced, that lien must be satisfied or the property will be unmarketable.

To illustrate this system, consider a new-construction real estate development called Ocean View. The developer of Ocean View records a covenant on each parcel of property in the Ocean View subdivision. The covenant requires that upon resale of each piece of property in the development the consumer pay a private transfer fee of 1% of the sale price.

In some cases, the developer might lower the initial sale price by 2% and exempt the first purchase from the requirements of the covenant⁴. This helps to camouflage the covenant and its requirements by suggesting the covenant is a benefit to the consumer, thus assisting the developer to initially sell the property. When the initial owner sells the property to buyer #2 for \$250,000, the terms of the covenant require that the seller (initial buyer) pay the developer a private transfer fee covenant in the amount of \$2,500. The initial owner may either pay the private transfer fee or challenge its legality in court (thus clouding the property’s title and

² We use the term developer to encompass all possible covenanters. The only commonality between all types of covenanters is that they must have owned the real property when they recorded the private transfer fee covenant in the local public records. Developers are not the only people placing these covenants. Trade organizations representing developers have warned their members about the potential legal risks associated with private transfer fees and advised them to seek advice of counsel. See Attachment 6.

³ See Attachment 4, page 6.

⁴ A Freehold covenant is attached as Attachment 3. This covenant exempts the first sale of the property from the developers to the consumer.

preventing its sale) or buy out the covenant according to the terms of the covenant. Regardless, the owner will be required to pay someone with no ownership interest in *their* property for the ability to sell *their* real property.

This scenario would play out again when owner #2 makes improvements and then sells to buyer #3 for \$350,000, generating a \$3,500 PTF covenant and continue until the covenant expires after 99 years.

Brief History of Private Transfer Fee Covenants

Private transfer fee covenants are a relatively new occurrence originating in California and Texas over the last decade. One of the first reported covenants was created to meet the demands of the Sierra Club and Audubon Society for environmental protections during the development of Fiddymont Farm in Roseville, California, which imposed a 20-year covenant with the proceeds going to preservation of open spaces.

Freehold Capital Partners has been the largest and most public champion of a licensed private transfer fee covenant system. The company entices developers to record these covenants by claiming that they are going to securitize and monetize private transfer fee covenants, to provide capital to developers. According to Freehold over \$600 billion in real estate in 45 states have private transfer fee covenants attached to them⁵.

State Legislative Response

At the beginning of 2010 only six states had banned or restricted private transfer fee covenants (California, Florida, Kansas, Missouri, Oregon and Texas.) However, this year an additional twelve states have banned the covenants: including, Arizona, Delaware, Hawaii, Iowa, Illinois, Louisiana, Maryland, Minnesota, Mississippi, North Carolina, Ohio, and Utah. In 2011 we expect a number of addition states will legislation banning or severely limiting the use of private transfer fee covenants. Only California and Texas (where private transfer fees are more often used) have restricted and regulated the creation and enforcement of the covenants, instead of banning them.

California passed a private transfer fee law in 2007. California Civil Code § 1098.5 struck a balance between those who sought a total ban and the California Building Industry Association and environmental groups who sought to keep these types of covenants legal. The law requires explicit disclosure of the covenant to all concerned parties by the placement of a document in conspicuous font indicating, “Payment of Transfer Fee Required” in the public record. California’s disclosure rule mandates: 1) a clear statement regarding the fee amount, 2) examples of actual cost, 3) the covenants expiration date, 4) the covenants purpose and 5) the name of the entity to be paid. The goal of this law is to provide the homebuyer with information necessary to make an informed purchase. We believe the California law fails to achieve this goal.

⁵ A cursory look at Freehold’s agreement with developers (Attachment 4) shows that Freehold requires its partners to send them the location and legal description of every property encumbered by a private transfer fee covenant. Freehold does not make this information public.

Texas passed a private transfer fee covenant law in 2007. Texas Property Code § 5.017(b) prohibits covenants that require the buyer of real property to pay a private transfer fee. It has been debated whether the Texas law only bans a buyer (but not a seller) from paying the fee and whether all residential private transfer fees are illegal. Most property law experts believe that the Texas law bans all residential private transfer fee, while Freehold takes the position that the seller, rather than the buyer, can be made to pay a fee under the Texas law. We expect that Texas will seek to clarify their law in 2011.

The other states to act on private transfer fee covenants have all banned their creation after the effective dates of the laws, leaving the enforceability of covenants created prior to enactment up to the courts. These states all recognized that private transfer fees stand in opposition to public policy favoring the marketability of real estate. See Ariz. Rev. Stat. § 33-442 (Arizona); Del. Code tit. 25, § 319 (Delaware); Fla. Stat. Ann § 689.28 (Florida); HRS § 501 (Hawaii); 765 ILCS 155/10 (Illinois); Iowa Code § 558.48 (Iowa); K.S.A. § 58-3822 (Kansas); La. Rev. Stat. Ann. § 9:3131 through 3136 (Louisiana); Md. Code, Real Prop. Law § 10-708 (Maryland); Minn. Stat. § 513.73 (Minnesota); Gen. Laws Miss. 2010 Ch. 348 (Mississippi); Mo. Rev. Stat. § 442.558 (Missouri); N.C.G.S. § 39A (North Carolina); Ohio Rev. Code § 5301.057 (Ohio); 2009 Oregon Laws Ch. 298 (Oregon); and Utah Code § 57-1-46 (Utah).

Federal Response

The Federal Housing Administration (FHA) recognizes the growing concern surrounding private transfer fees. In letter dates April 14, 2010, (see Attachment 2), FHA confirmed that it will not insure mortgages with private transfer fee covenants attached to the title because private transfer fees clearly violate HUD's regulations prohibiting legal restrictions on conveyance and requiring lenders to convey clear, marketable title. Federal law prohibits FHA from conducting transactions that limit, "the amount of sales proceeds retainable by the seller⁶." FHA's guidance recognizes that private transfer fees take the home equity and sales proceeds from consumers and gives them to a third party who is not connected to the property or transaction.

House Financial Services, Subcommittee on Housing and Community Opportunity Chairwoman Maxine Waters (D-CA) introduced HR 6260, "The Homeowner Equity Protection Act of 2010" to ban the payment of a private transfer fees in connection with a federally related mortgage under the Real Estate Settlement and Procedures Act (RESPA). Like other provisions of RESPA, state attorneys general and insurance commissioners would have the authority to protect consumers from these fees. Co-Sponsor Congressman Albio Sires (D-NJ) recognizes that "These damaging and often hidden private transfer fees ruin home equity, depress home prices, and undermine homeowners' right to keep all the funds from the sale of their home."

Securitizing Private Transfer Fee Covenants

In an emerging scheme, Freehold is marketing the covenants as an investment vehicle. The company intends to "bundle" private transfer fee covenants so that they can be securitized and resold on the open market in order for developers to more quickly monetize these streams of

⁶ 24 C.F.R. § 203.41(a)(3)(v).

revenue⁷. To do this, the developer pays Freehold a commission in exchange to create a financial security (essentially a collateralized bond) in the amount of the estimated value of the future revenues that are expected to be generated by the private transfer fee covenant of its 99-year existence. In return for creating the covenants underlying the value of the securities, the developer is provided with an upfront, lump-sum payment.

While Freehold has not been successful in securitizing private transfer fee covenants, if this does occur, then the use of private transfer fee covenants will increase exponentially, and the incentive for developers to place these covenants onto properties will likewise increase.

PRIVATE TRANSFER FEES HARM CONSUMERS

Private transfer fee covenants create myriad problems for consumers and lenders alike. When attached to a property, these fees infect every part of a real estate transaction, including the issuance of a mortgage. These problems present serious consumer protection issues and safety and soundness issues for lenders. For the reasons discussed below, they create unnecessary risk in real estate process for consumers, real estate, the land title industry and the public.

Private transfer fees force consumers to pay more for a less secure land transfer system and provide no added benefit to consumers. They harm consumers by stealing equity from their home, increasing the cost of buying or selling real estate and reducing the marketability of their property by making it more difficult to determine the property's value. Even further, they reduce transparency for consumers by exploiting the complexity of real estate transactions.

Private Transfer Fee Covenants Steal Equity from Consumers

Contrary to the assertions of private transfer fee proponents, the covenants do not save consumers money but rather they steal equity from homeowners.

Private transfer fee covenants are typically paid by the seller and compel them to pay a third party for the right to sell their own home. These covenants require that homeowners pay a portion of the equity they built in their home to a third party who has no ownership interest in the property and did nothing to assist in the maintenance or improvement of the property during the time of the consumer's ownership of the property. In essence, private transfer fee covenants are *private taxes* that benefit third parties with no right to the revenue. The net result is that sellers earn *less* money on their most important investment. They are a method for transferring home equity from its rightful owner to a third party.

Some argue that private transfer fee covenants allow the developer to share in the appreciation in property values which is attributable to the developer's role in designing and building the community. They argue that this allows developers to more fairly distribute the costs of building a home to all of those owners that benefit from its construction. The reality is

⁷Freehold sales brochure discusses their attempts to pool the streams of transfer fees together and create a collateralized bond that would be sold to investors. If Freehold is successful in securitizing the fees it will become exponentially harder for consumers and real estate professionals from unwinding these covenants. Attachment 5, page 4.

that private transfer fee covenants are not tied to any increase in property values that can be attributed to the developer or to any specific costs that are incurred by the developer. Consumers are required to pay this fee at the time they sell their property whether the value of their property has appreciated or is underwater.

Private Transfer Fee Covenants Cost Consumers Money

Proponents of private transfer fee covenants claim that the main benefit to consumers is a lower sales price and therefore lower cost of homeownership for consumers. When developers place a covenant on a property, they supposedly lower the initial purchase price of the property by 2%. This purported sale price reduction allegedly results in the buyer having to finance a smaller mortgage thus saving money on the mortgage principal, interest, insurance premiums and other closing costs.

Freehold’s marketing material⁸ claims that, “a buyer will always pay less for property encumbered by a 1% fee than for the same property without the fee. No matter what a buyer pays, he would have paid more without the reconveyance [private transfer] fee.” Despite Freehold’s assurance, there is no guarantee that consumers receive a price reduction. There is no way for consumers to price the effect of the covenant. As discussed below, the private transfer fee covenant scheme exploits the complexity of a real estate transaction and the pro-cyclicality of real estate market. Consumers: 1) are never offered a choice of a property for full price and no fee or the same property at a reduced price with the fee and 2) generally only become aware of the fee at closing when they have less of an incentive to ensure they receive a price reduction from the previous owner.

Private Transfer Fee Covenants Depress Home Prices

We can see the effects of a private transfer fee on a property when we consider a situation where there are two identical properties: one with a covenant attached and one without a covenant attached. Assume an average resale rate of 7 years, and an annual average appreciation rate of 1.7% compounded annually for each property.

	Initial Value	Sale 1 (7years)	Sale 2 (14 years)	Sale 3 (21 years)	Total
Non-Private Transfer Fee Property Sale Price	\$250,000.00	\$281,310.98	\$316,543.46	\$356,188.60	
Private Transfer Fee Property Sale Price	\$245,000.00	\$275,684.76	\$310,212.59	\$349,064.83	
Transfer Fee Paid by Consumer	\$0.00	\$2,756.85	\$3,102.13	\$3,490.65	\$9,349.62
Lost Appreciation	\$0.00	\$626.22	\$704.65	\$792.90	\$2,123.77
Total Cost to the Consumer	\$0.00	\$3,383.07	\$3,806.78	\$4,283.55	\$11,473.39

⁸ Attachment 5, page 3.

When the property with a covenant attached is sold for \$245,000 – the mythical 2% discount – the initial sale price is depressed by \$5,000. However the appreciation in the property's value is also depressed; resulting in consumers purchasing a property with a private transfer fee attached earning lower return on investment in the property than consumers purchasing a property without a covenant. Overall, the first four owners of a property with a private transfer fee covenant lose \$2,124 in value and must pay \$9,350 in fees, resulting in a total cost to those consumers of \$11,473.

Private Transfer Fee Covenants Have No Positive Effect on Consumers' Property Tax Liability

The financial benefit provided to the developer, Freehold and others comes at the expense of the community. If the artificially low sale prices are used for tax assessment purposes, the real property tax base for a community will be unnaturally lowered. Governments will have to either raise taxes or cut spending on crucial public education, infrastructure and community services to account for the property value that is siphoned off to the developer and Freehold.

While a property's sale price is a major measure of a property's value, it is not the only factor used to determine the value. When local governments appraise real property for taxation assessment purposes, they look to a number of factors to determine the tax rate. Tax assessors will compare a property with a covenant attached to a recently-sold comparable property that does not have a covenant attached. Since the properties do not differ other than the presence of the covenant, they will be valued and taxed equally, negating the artificial decrease in the property's value. This will impose a higher tax bill on consumers than the property's sale price would suggest.

Other Forms of Private Transfer Fee Covenants

While the types of private transfer fee covenants promoted by Freehold do not benefit the property's owners, valuation, marketability, or title, a private transfer fee payable to a homeowners or condo association or to a co-op benefit the consumer and do not cause the same problems as the fees described above. The transfer that provide a net tangible benefit to the consumer and community and should be excluded from FHFA's final guidance.

Private transfer fee covenants or portions of the proceeds from these covenants have been used to fund a variety of programs that benefit homeowners, consumers and the community at large. These transfer fees increase the value of the consumers' property by making their home or community a more desirable place to live, and consumers often seek out these added benefits when purchasing a home. In these instances, the buyer pays the fee to homeowners' associations, or community organizations. These organizations then use the fees to fund projects which benefit the burdened property or the surrounding community, either directly or indirectly.

In cases where the covenants are used to help fund homeowners' association activities, the transfer fee support the association's general or reserve fund, much like yearly or monthly association assessments, and are used to fund common improvements benefiting all the properties in the subdivision. The benefits of these fees flow through the association and back to the

consumer in the form of higher property values from community improvements, lower association dues and generally more desirable communities.

Some transfer fees to fund community organizations like community centers, performing arts centers or parks. In these communities, the developer builds the community center and then transfers ownership of the center to a properly established non-profit 501(c)(3) organization. The transfer fees then go to the non-profit 501(c)(3) organization to help fund its mission. These covenants also help provide desirable services to the consumer and community, and makes the consumer's home more valuable because of those services.

In California, private transfer fees have been used as tools to ease environmental concerns posed by groups opposed to new construction development. In these cases, the transfer fee is used to provide a service or fund organizations that are generally recognized as positive influences the community, such as open space preservation, environmental offsets, or clean water mitigation. The services funded through these transfer fees help reduce taxes and other costs while providing beneficial services to the consumer and the community.

As mentioned earlier, one of the first reported private transfer fee covenants was created to meet the demands of the Sierra Club and Audubon Society for environmental protections during the development of Fiddymment Farm in Roseville, California⁹. The Fiddymment Farm development imposed a 20-year PTF covenant with the proceeds going to preservation of open spaces.

Private transfer fee covenants have also been used as tools to ease affordable housing concerns posed by groups opposed to new construction development or for grants to support local affordable housing initiatives. Companies such as Lennar Corporation have placed covenants on some of its properties as a way to fund its charitable foundation, the Lennar Charitable Housing Foundation ("LCHF")¹⁰. LCHF uses the funds to issue grants to local non profits to provide affordable housing throughout the states of Lennar's operations. Although Lennar originally only used private transfer fee covenants in California, the company has started to use them in developments in Arizona and New Mexico as well.¹¹

Unlike Freehold Capital Partner's private transfer covenants, transfer fees flowing to homeowners' associations or other non-profit organizations help fund important services in the community that benefit the consumer. Private transfer covenants that only benefit an individual developer, company or similar third party do not provide any useful services to the community at large or the consumer. Freehold Capital Partner's business model, which indicates that 5% of the transfer fee revenue is forwarded to an unnamed non-profit, does not legitimize the 95% that is pulled out of a consumer's earned equity. Lastly, unlike Freehold's covenants, those that benefit

⁹ See Kelly Quigley, *Front Lines: Private Transfer Taxes*, Realtor Magazine (September 1, 2007). Available at http://www.realtor.org/archives/frontlinesledesep07?presentationtemplate=rmo-design/pt_articlepage_migratedcontent_print&presentationtemplateid=06ad608049e7ba93ab3dab87f8d337ee.

¹⁰ See Carl Larson, *Helping The Homeless Added To Cost Of Homes*, The San Diego Union Tribune (April 14, 2005). Available at http://legacy.signonsandiego.com/uniontrib/20050414/news_1n14lennar.html.

¹¹ See Jeff Collins, *Lennar's Charitable Fund Raising Opposed*, Orange County Register (May 14, 2007). Available at <http://www.ocregister.com/articles/lennar-8458-fee-private.html>.

homeowners' associations or other charitable organizations are legally enforceable according to common law which requires that covenants must "run with the land."

UNINTENDED CONSEQUENCES FOR THE TRANSFER OF REAL PROPERTY

In addition to these serious concerns for consumers, private transfer fee covenants harm economic growth by hindering the legal, secure and efficient transfer of property. Discovery of a covenant during a title search and real estate settlement, especially as covenants remain in place for up to 99 years, add time required to close a transaction and may result in a cloud on a property's title, reducing the efficiency of the real estate transfer system.

Private transfer fee covenants introduce unnecessary risk into the land transfer process. These encumbrances cloud title and make the transfer of real property more costly and less certain. The covenants create risk in the settlement of home sales in five key ways: 1) by reducing transparency and exploiting the complexity of the real estate transaction, 2) by enhancing the pro-cyclicality of real estate markets 3) by creating lien issues for lenders, and 4) by risking the legality of the property transfer itself.

How Real Property is Transferred

The land title industry consists of thousands of title insurance agents and abstracters, underwriters, real estate settlement service providers, and attorneys who work together to ensure that real estate is safely, efficiently and legally transferred by searching, reviewing and insuring land titles to protect home buyers and mortgage lenders who invest in real estate.

Land title professionals assist consumers in the purchase of real property by auditing public records to establish legal ownership of the property being sold, curing any title or public record defects (one third of all transactions reveal a defect), accounting for and transferring all money related to the sale to the proper parties and insuring the transaction against any mistakes, fraud, risk or defect, whether it is known or unknown. The net result is a system that provides consumers and lenders the fastest loan closure and title transfer in the world. The land title system in the United States works so well that most consumers never take the opportunity to learn how or why it works.

This work ensures that buyers are willing to purchase property and lenders are willing to make loans. Unlike other forms of insurance, which accept that risk will occur and focus resources on paying claims, title insurance seeks to protect consumers by identifying and eliminating risk in order to prevent consumers and policy holders from being harmed.

Private Transfer Fee Covenants Reduce Transparency and Exploit the Complexity of Real Estate Transactions

The private transfer fee covenant is opaque and confusing for consumers. Even if the covenants were beneficial to consumers as proponents claim, those benefits are hidden behind a lack of choice and the veil of legal documents. Supposedly, consumers benefit from private transfer fees because in exchange of the future transfer fees, the original developer can sell the

property at a discount. However, consumers are not allowed the choice to decide if they want a property with a covenant attached or not.

Private transfer fee covenants are often buried in a stack of documents in the chain of title called the Covenants, Conditions and Restrictions (CC&R). These covenants are a proverbial twelve page needle¹² in what can be a two hundred page haystack. Consumers are not given the CC&R until at or right before closing and many people do not read, much less comprehend them before closing. The obscurity of the covenant in this dense document could lead consumers to remain unaware of the covenant until they are at the closing table or worse, when they go to sell their home.

Separate conspicuous disclosure of a private transfer fee covenant in the land records would not inform consumers, and disclosing to consumers that someone with no right to the property has a right to a portion of their equity does not legitimize this transfer of wealth.

A title search is routinely performed after the consumer enters into a contract to purchase the home. Discovery of a disclosure would thus not occur until a time in the real estate closing process when a transaction is all but complete, giving a consumer a disincentive to delay the process in order to make an informed decision regarding the effect of the covenant on the property. These extremely complex covenants will have to be explained to the consumer at the closing table, when they have the least incentive to walk away from the deal. Finally, the covenants are not written in plain language, and can often be difficult for even experienced professionals to comprehend, much less explain accurately to consumers.

Simply put, Freehold Capital Partner's private transfer fee covenants are designed to provoke as little resistance as possible. Disclosure would also be ineffective because consumers still cannot shop comparable properties to determine if a private transfer fee is beneficial to them. There is no choice available to select a home with a covenant attached at a slightly lower price or select a home without a covenant attached at market price. The buyer cannot actually calculate and compare any savings. Without the choice, consumers also cannot be certain that the sale price of the property is actually being discounted. The ability to shop and compare is essential for consumers when purchasing a home and an informed decision rests on consumers' ability to compare prices and services.

Home buying is an already a difficult, time consuming and confusing process, and private transfer fee covenants make it more confusing for consumers. The process of buying a home is a rare experience for most consumers, and is often the only time that they come in contact with the terms of real property law. These concepts can be difficult for consumers to grasp and the complexity of the covenants add further, unnecessary confusion.

Private Transfer Fee Covenants Increase Pro-cyclicality of Real Estate Markets

¹² A typical Freehold covenant (Attachment 3) is 11 pages and is written at a Graduate degree grade level on the Flesh-Kincaid scale.

Real estate is a pro-cyclical investment, which means that property values and sales rise and fall with the overall economy. This as a boom and bust market cycle, and it is marked by volatility in prices. Private transfer fee covenants accentuate the pro-cyclicality of the housing market by affecting the incentives for consumers to purchase property during the up and down periods of the market cycle.

During a rising market private transfer fee covenants and their impact on real estate are effectively hidden from consumers. Even if a buyer could readily discover the covenant, evaluate its implications and accurately price its effect, consumers are unable to factor in the cost of the covenant into the price of the property in a rising market. The result is that property sells more quickly and at a higher price than during a down market.

However, during a down market, consumers are forced to lower the price of the property and assume costs of the covenant on behalf of the new buyer. The incentive to lower prices further in a falling market are likely to render many properties unmarketable – an unreasonable restraint on the alienation of the property.

Private Transfer Fee Covenants Create Lien Issues for Lenders

Before a lender will lend money, it must be assured that it can look to the property in the case of a default. To do this, the lender requires that its security interest in the property have priority and be in the first lien position. Private transfer fees threaten a lenders lien priority, making funding mortgages on those properties less safe.

Private transfer fee covenants remove the assurance lenders require that they will have the first right to the real property in the event of default. A consumer's failure to pay a private transfer fee covenant constitutes a lien against the property which must be paid before a new mortgage can be issued on the property. When a prior private transfer fee is unpaid, that puts the fee's beneficiary in the first lien position ahead of the lender¹³. An unpaid covenant creates a gap in the lenders security interest making a mortgage on the property more risky and likely more costly. Lenders will not lend money until any issue created by the unpaid private transfer fee is resolved. This heightened risk to the lenders' security interest affects underwriting and may require the consumer to bring even more out-of-pocket money to the closing.

FHFA recognized this problem in its proposed guidance, which acknowledges that the risks created by these covenants can be so great that the government sponsored entities ("GSE") Fannie Mae, Freddie Mac and the Federal Home Loan Banks should not lend money on a property that has a private transfer fee attached.

Private Transfer Fee Covenants May Not Be Legal

The most fundamental tenet of property law is alienation, or the ability for property to be sold or transferred from one party to another. The ultimate property right is fee simple title, and the hallmark of fee simple title is the ability for an owner to transfer the property at their will, or

¹³ A copy of a Freehold covenant (Attachment 3) shows the lien creating language on page 5.

unrestrained alienation. Although property may be subject to reasonable restraints on alienation, private transfer fee covenants erode fee simple title, and therefore courts are likely to find the covenants are an unreasonable and impermissible restraint on alienation.

As Marjorie Bardwell and James Durham noted in a 2007 article in the American Bar Association's Property & Probate magazine¹⁴, private transfer fee covenants may also be subject to legal challenge as a non-possessory interest. Courts have been generally unwilling to recognize or create new interests in land. The Restatement on Property defines an estate as an interest in land that "is or may become possessory." A private transfer fee covenant contains a lien clause that allows the beneficiary to foreclose and take possession of the property. Traditionally courts are loath to allow landowners to create new estates not recognized in the common law. If a private transfer fee is an attempt to create a new estate, courts would find them to be suspect because the common law does not recognize them. Further, private transfer fee covenant rights are likely to be viewed as an attempt to retain some part of title without having any right to present or future possession, and courts have been hesitant to find that these rights to exist.

In addition, the existence of a private transfer fee covenant could be interpreted as a failure to grant the proper estate as required by the purchase agreement and deed. A seller that promises to grant fee simple title but gives title encumbered by a private transfer fee could be in breach of the purchase agreement and the warranties they provided in the deed. Further, a reservation of a private transfer fee covenant in a deed granting fee simple title may violate the standard instructions from the consumer's lender regarding acceptable exceptions to title.

Legal tests have shown similar restraints on alienation to be illegal. Several state courts found a due-on-sale clause promulgated in the 1970s to be unreasonable and therefore an invalid restraint on alienation, since they had no business purpose except to increase the company's return on investment.

If a private transfer fee is to be a common law covenant, then it may not be enforceable against subsequent owners of the property because it does not touch and concern the land. Covenants are legally enforceable agreements granting the right to use property without possession or the right to preclude a possessory owner from using their property in certain manner. While similar to a contract, a covenant differs because the covenant has the power to bind future owners or "run with the land." Since covenants have a great power to bind future entities not party to the original negotiations, courts have limited the situations in which these covenants can "run" with the land.

Touch and Concern Test

Common law sets out a number of factors for a covenant to bind a successor, but the most important is that the benefit and burden of the covenant must touch and concern the land¹⁵. The touch and concern test, while sometimes hard to define, has been summarized as requiring that

¹⁴ See Attachment 8.

¹⁵ The other elements are 1) the intent of the parties that the servitude bind future owners, 2) a writing sufficient to appease the statute of frauds, and 3) privity of estate

the covenant must affect the owner's physical enjoyment of the land.¹⁶ This standard for touch and concern requires that the benefit and the burden of the covenant not be personal to the parties, but rather be intimately tied to their physical use of their property. This means to burden future owners of land, you must benefit them.

As University of Missouri Law Professor R. Wilson Freyermouth correctly points out in his 2010 article in the American Bar Association's Property & Probate magazine "Putting the Brakes on Private Transfer Fee Covenants"¹⁷, the key to the touch and concern test is the nature of the benefit or burden. Traditionally, when the benefit and burden are payments of money, courts have held that the covenant is personal and does not touch and concern the land. There are extremely limited exceptions to this rule which generally benefit homeowners' associations.

To illustrate this point, consider a covenant requiring all homeowners in a development to only use a certain contractor for home improvements. Under this scenario, the benefit is personal to the contractor since it benefits their business interests and not any property interest. While it burdens the consumer's land, it does not benefit the contractor's use of their land but rather makes their business more profitable. Almost all covenants for the payment of money are personal to the beneficiary and therefore they do not touch and concern the land. The weight of judicial opinion prevents covenants from binding successive owners when the benefit is personal or in gross¹⁸.

Contrast this with the homeowner's association scenario where all home owners covenant to pay a fee to a homeowners association. This covenant would bind future owners of the property in this division because the homeowners association's activities affect the property owner's physical enjoyment of the land. The benefit and the burden of the covenant touch and concern the land because as a badge of land ownership, the homeowners are burdened with the payment but they also benefit from the associations activities and requirements¹⁹. It is widely viewed that homeowners associations increase the value of property, and benefit all the owners by providing common spaces or other valued amenities. Therefore the benefit and the burden are tied to the physical enjoyment of all the homeowners' lands.

Typically private transfer fee covenants are payable to a third party that is not a homeowners' association. The benefit of the fee goes to a third party's business interest, typically funding either a developers or Freehold's business. Further, when the first transfer fee is owed, the developer has usually sold their interest in the development and has no more legal interest in any property in the development (outside the interest in the revenue from the private transfer fee) and Freehold never had any connection to the property outside the transfer fee. Therefore, the benefit of the covenant is personal to the developer and Freehold, since it is not

¹⁶ See *Mercantile-Safe Deposit & Trust Co. v. Mayor & City Council*, 308 Md. 627, 521 A.2d 734 (1987).

¹⁷ See Attachment 7

¹⁸ See, e.g., *Garland v. Rosenshein*, 649 N.E.2d 75 (Mass. 1995); *Bremmeyer Excavating, Inc. v. McKenna*, 44 Wash. App. 267, 721 P.2d 567 (1986); *Caullett v. Stanley Stilwell & Sons, Inc.*, 67 N.J. Super. 111, 170 A.2d 52 (1961).

¹⁹ See the landmark case *Neponsit Property Owners' Ass'n, Inc. v. Emigrant Indus. Sav. Bank*, 278 N.Y. 248, 15 N.E.2d 793 (1938).

intimately tied to their enjoyment of the land in the development but is rather tied to their business interests.

Difficulties in working with an amorphous concept like the touch and concern test has led legal academia to rethink their approach to covenants. The American Law Institute's *Restatement (Third) of Property: Servitudes*²⁰ abandons the touch and concern test for an inquiry into whether the covenant is "arbitrary, spiteful, capricious"²¹ or an "unreasonable restraint on alienation"²² or "unconscionable"²³. Professor Susan French, the Restatement's Reporter, suggested that the most important inquiry is whether the covenant violates public policy²⁴. Further, she suggested the Restatement's goal is to reach the same conclusions as a court using the touch and concern test, but with great transparency of thought.

For the reasons discussed ALTA strongly supports FHFA's clear guidance to the enterprises and the public on private transfer fee covenants and stands ready to assist stakeholders in protecting consumers, the mortgage finance industry, and the smooth and efficient transfer of real property ownership.

Sincerely,

A handwritten signature in black ink that reads "Mark E Winter". The signature is written in a cursive, flowing style.

Mark Winter
President

²⁰ The American Law Institute's restatements are a series of compilation of the generally accepted common laws throughout the country. The ALI further attempts to clarify the common law and occasionally suggests changes to the common law. While the restatements are never formally attempted by state legislatures, they are extremely influential in courts and are cited frequently.

²¹ *Restatement (Third) of Property: Servitudes* § 3.1(1) (2000).

²² *Restatement (Third) of Property: Servitudes* § 3.1(3) (2000).

²³ *Restatement (Third) of Property: Servitudes* § 3.1(5) (2000).

²⁴ *Restatement (Third) of Property: Servitudes* § 3.2 cmt. a (2000)