HAWAII ASSOCIATION OF REALTORS® (HAR)

2009 LEGISLATIVE PRIORITY - PRIVATE TRANSFER FEES

HAR recommends the enactment of legislation which would prohibit the use of deed restrictions as a vehicle to impose private transfer fees. HAR opposes private transfer fees because these fees decrease affordability, serve no public purpose, and provide no benefit to property purchasers or to the community in which the property is located.

Overview:

Private transfer fees are deed restrictions imposed by an owner of real property, which require a fee to be paid to a specified individual or organization every time the property is sold within the defined time period. These fees currently range from .05 percent to 1.75 percent of the purchase price. Since this fee is part of a private transaction, there is no requirement that the proceeds of these fees be used to benefit the individual property or the neighborhood. There is no oversight to validate that these fees are being used for the purpose specified.

Private transfer fees are most common in the state of California but are beginning to crop up in other states. Historically, they began in California as a way for builders to reduce opposition from various interest groups to the development projects that they were seeking approval for from local governments. To appease these groups, some developers agreed to fund the opposition groups' pet projects with future revenue through private transfer fees imposed on properties within the development projects. When private transfer fees are a part of new development, these fees have most frequently come about as a result of negotiations with affordable housing advocates, environmentalists, and other interest groups. Using private transfer fees, builders can thwart opposition groups and more easily obtain permits to build, all the while passing on these costs to unknowing future consumers at closing.

Furthermore, there is no restriction on where or how the proceeds from these private transfer fees can be spent and no accountability or oversight of the recipients of these funds. In addition, there are no limits on how long a private transfer fee may be imposed as well as no limits on the amount of fees that can be imposed on prospective home buyers.

The impact of private transfer fees on new home sales within new housing developments has not been negative, largely because these fees are not assessed on the first sale but in subsequent transactions. In addition, the disclosure and explanation of these fees has been weak. While builders insist that they have the right to negotiate with buyers over the terms and conditions of a property's sale, in fact there has been no disclosure of this fee until the final closing documents when buyers have already signed a binding sales contract and put a substantial amount of cash down.

Private transfer fees have also shown up in other transactions, where the benefit is only to the individual as a source of "substantial passive income".[1] This practice, referred to as Freehold Licensing, is beginning to be promoted in a number of states through a unique "business method patent" called the GenEstate Legacy Covenant. This covenant is designed to run with the land for 99 or more years and is promoted as an asset that can be sold, bequeathed, donated and added to the asset side of an individual's asset sheet with no off-setting liability. While this "business plan" is promoted to individuals as a benefit of ownership and improvement of real property, it is also designed for developers to address "environmental and housing pressures" by enabling developers and other property owners to better align the sale price of their real estate with current economic levels and reserving the right to additional compensation based on the values of those properties in the future.

To date, several states, including California, Texas, and Florida have enacted legislation explicitly addressing private transfer fees. This legislation has prohibited transfer fees, with certain exceptions including those fees paid to the property owners association that manages or regulates the subdivision, the association's managing agent, charitable entities, or governmental entities.

Hawaii law contains no state statutes or regulations specifically addressing the disclosure of private transfer fees, no limitations on the application of private transfer fees, nor any statutory definition of permitted private transfer fees. A real estate licensee's responsibility with respect to private transfer fees is not currently defined either, except for general duties to "deal honestly and in good faith" and to disclose known material facts that are "not apparent or readily ascertainable."

Conclusion

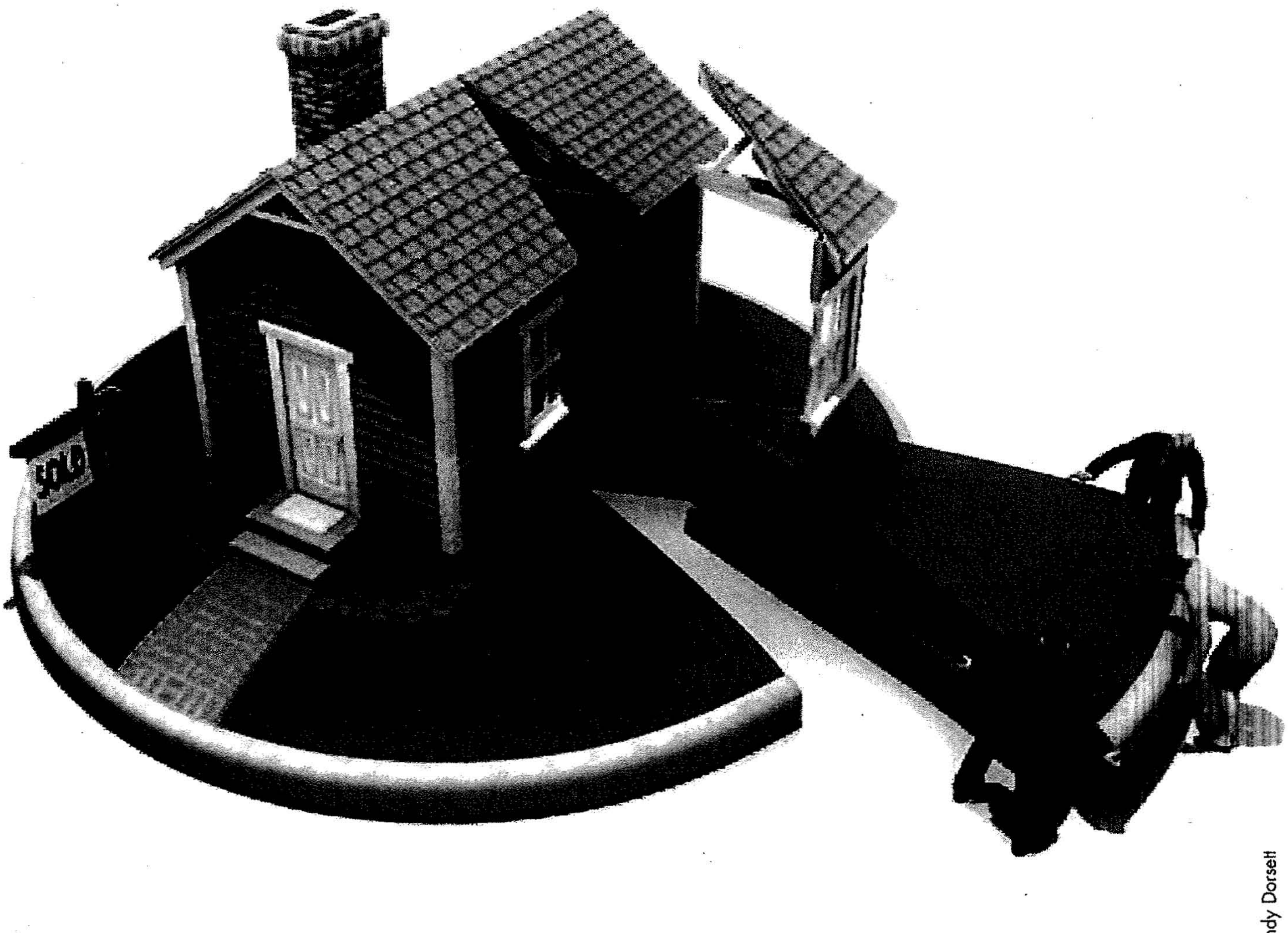
HAR is concerned that, without any oversight, private transfer fees pose risks of excessive and unwarranted fees being charged to unknowing purchasers. HAR is also concerned regarding its licensees' disclosure responsibilities, and that the practice of imposing private transfer fees will become unruly with no regulation. The additional costs that private transfer fees bring at closing may create significant barriers to homeownership. For these reasons, HAR feels that legislation restricting the ability for developers or other to impose such fees is warranted.

[1] Referenced from the Freehold Licensing promotional material at www.FreeholdLicensing.com

Transfer Fee Rights

Is the Lure of Sharing in Future Appreciation a Flawed Concept?

By Marjorie Ramseyer Bardwell and James Geoffrey Durham



Andy Dorsett

"Transfer fee rights," the new buzzwords on the real estate scene, describe a technique for reserving future interests in the appreciation of the value of real property that is being sold. "Sold," however, may be an imprecise term in this instance, especially if compared to its common use, because not all of the "fee simple" interest in the property is being conveyed. This article examines how these "transfer fee rights" to share in the possible future increase in value of the property are being severed from the property before or as part of a sale and then conveyed to others. The article also discusses title implications and why, in the authors' opinion, this new "product" may have considerable difficulty gaining acceptance under real property law.

A note of caution: according to a promoter of the concept, which seeks to purchase these interests, the system of transfer fee rights is covered by a comprehensive business method patent application, so do not try to duplicate it at home (see article on pages 26-27). The authors have noted such an offer by a potential licensor to obtain transfer rights. See the offer available at www.freeholdDevelopment.net. Similar offers may be using this device of which the authors are not aware.

How Transfer Fee Rights Are Supposed to Work

The transfer fee scenario described in the Internet citation mentioned above starts with an agreement that is to be recorded in the chain of title. This agreement purports to be a servitude that attaches to the title to the land and burdens future owners for 99 years. In simple terms, this agreement provides for 1% of any future sale to be divided among the original covenantor, the company that licensed the use of the system, and the real estate broker. But an analysis of the agreement reflects that in fact it is much more complicated. The analysis starts by identifying the parties:

- *Covenantor*: The original seller and the party that places the declaration of covenants, conditions, and restrictions (CCRs) onto the property.
- *Broker*: The original real estate broker, who traditionally represents the covenantor and, in addition, enjoys the future benefit reserved in the covenant.
- *Licensor*: The company that came up with this transfer fee technique, which also shares the future benefit.

In the traditional plain-vanilla real estate transaction, the seller contracts to deliver fee simple title to the buyer, subject to those matters of record that the buyer is willing to accept. These exceptions from the general warranty of title very often include CCRs of record. The CCRs for a subdivision or planned development commonly include limitations on use and enjoyment of the property, access restrictions, or building setback requirements. The transfer fee rights servitude (which will become part of the CCRs for the property) is a completely different animal. It provides that on any future sale (*after* the initial sale from the covenantor) the future parties must pay 1% of the future gross sales price back to the consortium that holds these "transfer fee rights." For the first 30 years, that 1% interest is split among the covenantor (60%), the licensor (30%), and the broker (10%); for the remaining 69 years of the 99-year life span of the covenant, only the licensor (90%) and the broker (10%) share in the proceeds.

To understand this device, it may be helpful to compare it with a profit-sharing tool used more commonly in leasehold transactions. As indicated in a companion article in this issue, leases often include provisions that allow the landlord to share in the profits if the tenant charges a higher rent on sublease or assignment. For a discussion of the issue in the leasehold context, see Sidney G. Saltz, *Landlord Impediments to Subleasing and Assignment: Recapture, Profit Sharing, and Restrictions on the Exercise of Options*, on page 42 in this issue. By using such a provision, the landlord reserves the right to any appreciation in the market value of the leasehold interest if the premises are subleased or assigned. The transfer fee servitude creates a similar result in the transfer of a fee simple interest by allowing a seller to claim the appreciated value in subsequent sales of the property.

How Transfer Fees Get Sold

At some point before the initial sale of the real property, the broker approaches the initial seller (the covenantor) with an offer to use the transfer fee servitude to give the covenantor a share of future appreciation in the property. The broker collects a commission from the covenantor for bringing this offer. In addition, the broker enjoys a share of the future benefit. (Whether this is a conflict of interest will remain to be seen; normally a fiduciary cannot participate in an activity that results in a benefit to itself at the expense of the principal without the understanding and consent of the principal. See *Restatement (Third) of Agency* §§ 8.02, 8.06 (2006).) 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. The amount of this note must

The transfer fee rights servitude provides that on any future sale the future parties must pay 1% of the future gross sales price back to the consortium that holds these "transfer fee rights."

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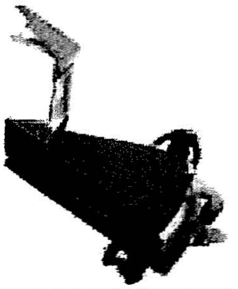

A Primer on Business Method Patents

What You Need to Know for Your Real Estate Practice

By Andrew F. Palmieri and Corinne Marie Pouliquen

Plato instructed that necessity is the mother of invention. Of course, inventions come in varied forms and need not be products, but can also be methods. Moreover, the "necessity" that drives a creative mind to invent often comes from an inspiration for wealth enhancement as much as from a desire to seek a novel or non-obvious solution to a complex problem. As mentioned in the accompanying article, the model for imposing a covenant for "transfer fee rights" on real property is protected by a "business method" patent. What is a business method patent, and how might such patents affect real estate practice?

Business method patents are a class of patents that are defined by the U.S. Patent and Trademark Office (USPTO) as an "apparatus [such as a computer] and corresponding methods for performing data processing operations . . . uniquely designed for or utilized in the practice, administration, or management of an enterprise, or in the processing of financial data" (as distinguished from the more traditional mechanical, electrical, and chemical classes of inventions for purposes of patentability). U.S. Patent Classification System, *Classification Definitions, Class 705* (June 30, 2005), available at www.uspto.gov/web/offices/ac/ido/oeip/taf/def/705.htm. In other words, business method patents protect processes, generally implemented by computers, that are involved in operating a business or that define a product or service provided by a business. Business method patents are seen in industries such as health care, insurance, electronic shopping, inventory management, accounting, finance, and, of course, real estate.

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Consequently, a business method patent may be described as a federally protected invention relating to a novel way of doing business. Before 1998, the USPTO did not recognize business method patents, claiming that such patents did not constitute statutory subject matter. This changed when the U.S. Court of Appeals for the Federal Circuit ruled in *State Street Bank & Trust Co. v. Signature Financial Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998), cert. denied, 525 U.S. 1093 (1999), rejecting the theory that a "method of doing business" was an excluded category of invention and reiterating that a business method patent may be granted on the same basis as any other invention. Subsequently, the USPTO issued guidelines that asserted that a method, including a method of doing business, is patentable if the method produces a useful, concrete, and tangible result. U.S. Patent Office, *Interim Guidelines for Examination of Patent Applications for Patent Subject Matter Eligibility*, available at www.uspto.gov/go/og/2005/week47/patgupa.htm. Since that time, tens of thousands of business method patent applications have been filed with the USPTO, with hundreds of these applications relating to tax strategy, real estate, and business processes that relate to commercial finance.

To qualify for patent protection, a business method must meet four criteria:

1. The method must fall within defined classes of *patentable subject matter*, including processes, machines, articles of manufacture, and compositions of matter. For instance, anything that is created by a human will fall within at least one of these classes, while laws of nature, natural phenomena, and abstract ideas do not. 35 U.S.C. § 101 (2000).
2. The method must be *useful*. Hence, the method must yield some concrete, tangible result. Id.
3. The method must be *novel*, meaning that it does not exist in the prior art, that is, all previous knowledge and inventions. Id. § 102.

float, because there is really no way to determine how often, if at all, the property will get resold. It appears that the covenantor has thus paid a current commission on the opportunity to share in possible future income, in exchange for a note that may or may not have any value (depending on the number of times the property is transferred in the future). The share that goes to the covenantor appears to be the payoff for the note. So what are the character and nature of the consideration tendered? The servitude provides that this obligation to share in the future proceeds shall be a lien on the property. Other marketing material from the licensor in the offer made on the Internet noted earlier in the article assures the covenantor and the broker that this will be collected on their behalf by the title company on all future transactions, so they can sit back, relax, and wait for the money to flow in.

How to Opt Out

The transfer fee servitude provides an exemption for the original sale from the covenantor to the first buyer. This exemption helps camou-

4. The method must be *non-obvious*, meaning that someone with ordinary skill in the relevant technology could not easily think of it in light of the prior art. Id. § 103.

Although applying for and prosecuting a business method patent may be costly and time-consuming, the benefits are significant. The full application process, also called the "patent prosecution" process, may take many years (estimates range from three to 14 years). Once a patent application publishes (approximately 18 months from the priority date), provisional rights are available to the applicant. These rights entitle the applicant to demand reasonable royalty payments from a third party that infringes on a published claim, for the period of time that begins on publication and ends when the patent actually issues, provided that notice is given to the third party and the invention as claimed in the issued patent is "substantially identical" to the invention as claimed in the published application. As a consequence, damages for pre-patent grant infringement are available once a patent actually issues. Moreover, federal law provides for strict penalties, including punitive damages for willful infringement, injunctive relief, and attorney's fees as a further deterrent against violation of a patent, including business method patents. Id. §§ 283–85. It stands to reason that, as a greater number of business method patents are approved by the USPTO, the chances of infringing on a third party's intellectual property rights in a patented business method will grow, including in the area of real estate law. In addition to the method for structuring "transfer fee rights" referenced above, business method patents have issued in connection with

- structuring tenancy-in-common (TIC) transactions as a means to create an investment vehicle for tax-deferred exchanges under Code § 1031 (see U.S. Patent No. 6,292,788),
- systems and methods for facilitating the flow of capital through the housing finance industry (see U.S. Patent No. 6,988,082),
- a method of securitizing and trading real estate brokerage options (see U.S. Patent No. 6,615,187), and
- a system for the creation and collateralization of real estate mortgage investment conduit securities (see U.S. Patent No. 6,070,151).

The proliferation of business method patents relating to tax planning, estate planning, real estate, commercial lending, and other areas of law might suggest that attorneys should attempt to take note of developments in the patent area and monitor published applications that may be of relevance to their specific areas of practice and clients. This issue, however, is so fresh that an industry standard for due care by attorneys against delivering advice to clients in violation of business method patents has yet to be established. Attorneys practicing in firms with intellectual property departments may wish to discuss whether existing firm resources are available to monitor patent applications published by the USPTO to identify business method patents that fall within identified practice areas, and if such resources are not available, one may wish to engage a third-party search firm to periodically research and report on such publications. The costs associated with such a level of care, however, may be prohibitive.

There are also insurance implications to consider. Legal counsel may be exposed to liability if it is alleged to have induced its client to infringe on a patent. Moreover, a client who has been successfully enjoined from infringing a business method patent and has incurred monetary damages may seek retributive action against its legal counsel. Because this is a developing area, there is little guidance on loss prevention measures that may be proactively implemented; however, attorneys may wish to review their firm's professional liability policy, their firm's comprehensive insurance policy, and their personal umbrella coverage policy to ascertain whether they include or exclude from coverage claims for patent infringement.

The American Bar Association also has taken an interest in this subject. The Section of Real Property, Probate and Trust Law has teamed with the Section of Taxation to conduct a series of meetings with the USPTO to discuss the subject of patentable concepts in relation to tax, estates, and real estate law. These efforts, however, will not halt the continued flow of new business method patents in the short term, nor will they immediately alleviate the risks of patent infringement in real estate law practice. ■

flage the purported reservation of a future interest. It will not be collectible until that buyer attempts to resell the property. At that point, the new seller has three choices: pay the transfer fee, buy it out (if five years have expired from the creation of the CCR), or grant an option in lieu of the payment (which may result in termination).

To pay the transfer fee, one needs simply to tender 1% of the gross sales price to the addresses shown in the recorded document. The gross sales price is defined as the total consideration for the property, including cash, any installment notes, trade, or agreement paid by the new buyer. To buy it out, five years must have expired, and the current owner can then give 30-days' notice to the holders of the interests and tender 5% of the gross sales price to them. The holders are then required to cooperate in executing any releases needed for the public record. If the future seller has some time and money to spare, the option route might be a choice. As described in the servitude, the seller, in lieu of payment of the fee, can grant the covenantor the right to buy the property at 90% of the lowest of

- the purchase price (a loss of 10% on the sale right off the top),
- the value of the property shown on the tax roll (depending on the area, this could be substantially less than the current value), or
- the value determined by an appraisal.

The covenantor has 90 days to accept or reject the offer. If not accepted, the seller can give written notice after 60 days declaring the servitude terminated, and file an affidavit to that effect in the public records. The seller then would be free to sell without the lien, albeit probably adding at least five months to the normal transaction time needed to convey complete simple fee title. If the covenantor elects this option to buy the property at the 90% figure, then the seller must provide a survey, a title policy showing only "standard exceptions," and a general warranty deed. If the seller fails to close, then 2% of the *greater* of the three bullet points above is owed to the covenantor, and the servitude remains.

Title Issues

As is often said, timing is everything. In this situation, timing plays a big role in the determination of the effect of the servitude and may leave the covenantor vulnerable to litigation before it has the opportunity to receive any future payments. If the covenantor signs a purchase agreement to sell fee simple title, and then attempts to reserve some of that title before closing, the contract has not been performed. Reliance on the standard language excluding CCRs of record may not protect the original seller because the transfer fee servitude may not be in the record at the time of the contract. Even if the servitude is recorded before the purchase agreement is signed, reliance on the "restrictions of record" language without clear disclosure to the buyer may be misplaced if the recording falls within the "gap" (the period of time that runs from the recording of the document to the actual time it is indexed and discoverable by a search of those records). The "gap" varies by recording jurisdiction but is often more than three weeks and can run in excess of 12 months. The buyer could claim it was misled by the covenantor who did not disclose this attempt to reserve an interest in the property, which, even if excluded by the carveout from the warranties language in the contract, was nevertheless hidden from the buyer because of the gap. The general understanding when one purchases fee simple land is that the buyer is not obligated to share future appreciation without clearly consenting to do so. In addition, if the transfer fee servitude is included with the closing package, it will violate the standard instructions from the lender on what are acceptable exceptions from title, as well as raise the issue of whether it violates the original contract.

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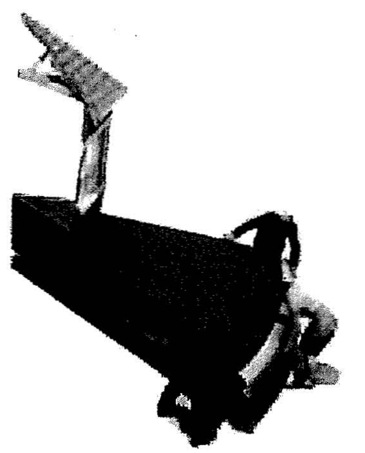
Potential Legal Challenges

The transfer fee device could be attacked on several grounds. Here are four (there may be more), with the first two being based on whether a court views the device as an attempt by the covenantor to retain part of the fee simple and with the second two being based on whether a court views the device as an enforceable servitude:

- As observed at the beginning of this article, the authors view the transfer fee rights device as an attempt by the covenantor to retain part of the fee simple title without having any right of possession presently or in the future. The courts consistently have turned back attempts by landowners to create new estates in land beyond those recognized at common law, and any court that finds this retained interest to be the attempt to create a new estate should void it on that basis alone. See, e.g., *Johnson v. Whiton*, 34 N.E. 542, 542 (Mass. 1893) (Holmes, J.) ("A man cannot create a new kind of inheritance"). The *Restatement of Property* defines an estate as involving the present or future right to possession, and the transfer fee rights device attempts to create an interest in the fee simple without any right to possession. See *Restatement of Property* § 9 (1936) ("estate" means an interest in land that "is or may become possessory").
- If the device is not found to be an invalid attempt to create a new estate in land, many courts may still find it an impermissible restraint on alienation. Courts consistently hold that one of the key incidents of fee simple ownership is the ability to convey. Restraints on alienation are invalid when the restraint is inconsistent with the free alienability of the fee simple estate in property. See generally *American Law of Property* § 26.1 (1952). The device requires payment of a large sum of money (1% to 5% of the value of the fee simple interest) or gives the covenantor the right to buy the fee simple interest for 90% of its value. In the 1970s several state courts held the exercise of a due-on-sale clause by a lender unreasonable (with no business purpose except to increase return on investment) and therefore an invalid restraint on alienation. See, e.g., *Wellenkamp v. Bank of America*, 582 P.2d 970 (Cal. 1978). These cases were preempted by federal law in

section 341 of the Garn-St Germain Depository Institutions Act of 1982. 12 U.S.C. § 1701j-3. In the due-on-sale clause cases, the seller was required to pay off the seller's mortgage loan on the property's sale in exchange for the lender's advancing the funds necessary for the future seller to buy the property. With the transfer fee device, however, the future sellers of the land would be required to pay money on the sale that they arguably agreed to pay but for which they had received no benefit. The argument that the future sellers would have paid less for the land because the servitude was in place makes the point that the existence of the servitude has made the land more difficult to sell, hence the lower price, and thereby is a restraint on alienation. This differs from a landlord's prohibiting a sublease or assignment because the courts view the landlord's right of possession at the end of the lease as giving the landlord an interest in who occupies the premises during the lease, thereby giving a valid basis for the restraint on the alienation of the tenant's interest. See generally *American Law of Property* § 3.58 (1952).

- If a court approaches the device as a servitude under common law doctrines, then it may find the agreement unenforceable because it does not "touch and concern" the land. Typically, under common law principles, a court will enforce a servitude against a future owner of land only when three elements are present: (1) the contract must include the intent for the servitude to run, that is, to bind future owners; (2) the servitude (particularly the burden of the servitude) must "touch and concern" the land; and (3) there must be "privity of estate" (a real covenant running with the land) or notice (equitable servitude). See *Neponsit Prop. Owners' Ass'n, Inc. v. Emigrant Indus. Sav. Bank*, 15 N.E.2d 793 (N.Y. 1938). There is no question that the agreement satisfies the first element (it clearly states that it applies to all future sales), and it likely complies with the third (without going into the details only a law professor could love, there would be privity of estate in most American states, and in all states the recording of the agreement would constitute notice). "Touch



and concern," however, typically means that the agreement affects, or is bound up in, the use of land. The burden of the transfer fee servitude has no effect on the use of the land. Therefore, under the common law view, the agreement should be held not to touch and concern the land and should not be an enforceable servitude.
- The touch-and-concern requirement, however, is not rigidly enforced in many states. As the 20th century progressed, courts more easily found that servitudes touched and concerned land (for example, the burden of the obligation to pay homeowners' association assessments usually is held to touch and concern on the basis that the owner of the land receives the benefit of whatever the association undertakes to do in maintaining common areas or providing services). See generally *Candlewood Lake Ass'n v. Scott*, No. 01AP-631, 2001 WL 1654288 (Dec. 27, 2001). In addition, the *Restatement (Third) of Property: Servitudes* advocates doing away with the touch-and-concern requirement completely. *Restatement (Third) of Property: Servitudes* § 3.2 (2000). The reporter for the *Restatement on Servitudes* suggests that whether an agreement violates public policy is a more relevant inquiry in determining if it should be enforced as a servitude than whether it touches and concerns the land. Id. cmt. a. Although a court may engage in "touch-and-concern lite," or follow the *Restatement* and ignore the touch-and-concern requirement completely, if the court nonetheless examines the effect of the servitude on future owners, it may well find that this attempt to share equity (particularly in the case of a non-investor-owned single-family home) violates the public policy that encourages homeownership and free transferability. Id. §§ 3.2, 3.5, 3.7.

Conclusion

Regardless of what future litigation may find these future interests to be, real estate practitioners should think about a number of issues when presented with the transfer fee concept by a client, whether a covenantor, a broker, or the purchaser of a property burdened by a transfer fee agreement. The lending community is becoming increasingly aware of this issue and may not be willing to loan on properties subject to such agreements. The conflicts raised by the participation of all of the parties, the timing of recording the agreement after signing the contract to sell "fee simple title" and then attempting to reserve rights, the vulnerability to future litigation to determine the consequences of these "rights," and the effect on the marketability of title need to be understood and explained to the client. Finally, anyone relying on the future enforceability of the transfer fee servitude needs to be aware of the legal challenges that may be raised when enforcement is sought. ■

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February 23, 2009

The Honorable Jon Riki Karamatsu, Chair
House Committee on Judiciary
State Capitol, Room 325
Honolulu, Hawaii 96813

RE: H.B 874, H.D. 1 - Relating to Residential Real Property

HEARING DATE: Tuesday, February 24, 2009 at 2:05 p.m.

Aloha Chair Karamatsu and Members of the Committee:

I am Gary Slovin with Goodsill Anderson Quinn & Stifel, here to testify on behalf of the Hawai'i Association of REALTORS® (HAR) and its 9,600 members in Hawai'i. HAR **supports the intent** of H.B. 874 H.D. 1, which prohibits private transfer fees required by a deed restriction or covenant, with certain exceptions.

Private transfer fees are deed restrictions or covenants imposed by an owner of real property, which require a fee to be paid to a specific individual or entity every time the property is sold. These restrictions run with the land and, oftentimes, are not disclosed to subsequent buyers until the closing of a property sale. Sometimes, such fees may be imposed as part of a new housing development upon the buyer and subsequent purchasers of the property. Presently, there is no regulation over the imposition of such fees, no limitation on the application of the fees, and no accountability or oversight of the recipients of the fees.

HAR believes that private transfer fees may create significant barriers to homeownership, particularly because these fees are typically imposed at the closing of a transaction. This puts a burden on the homeowner, at a critical time when money may already be short.

HAR supports H.B. 874 H.D.1, which improves upon the original bill by placing the provisions in Hawaii Revised Statutes Chapters 501 and 502, and by including certain exceptions for customary administrative fees that are collected during property transfer transactions. HAR is continuing to review the bill to see if additional amendments would help to clarify the measure, and looks forward to providing its further comments to the Committee.

Mahalo for the opportunity to testify on this measure.