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Two Pitfalls of Leveraging Developer Influence: Transfer Fee Covenants and Tying Arrangements

BY WILLIAM B. AYCOCK II

During the recent financial downturn, revenues generated by commercial real estate developers shrank by almost half.[1] During those difficult years, a number of tactics emerged, some old, and some new, that held out the promise of improving the business model by shoring up the bottom line. These tactics attempted to take advantage of the influential position held by developers in what will be the fundamental purchase in the lives of many, buying a home. What follows is a brief discussion of two methods by which developers have attempted to expand the influence afforded their role, and how those attempts have fared/may fare under the law.

Transfer Fee Covenants

A transfer fee covenant ("TFC") (also known as a recovery fee, a re-conveyance fee or a resale fee) is a requirement included in a deed or a community or condominium declaration that requires the payment of a fee upon a conveyance of a home or unit.[2] The amount of the fee can be a set amount, or can be based upon a percentage of the sale price.[3] A common example of this kind of fee is a capital contribution paid to a homeowner's association at a closing. Under North Carolina law, for such a covenant to be enforceable, both the benefit and the burden of the covenant must touch and concern the land.[4] The above example satisfies this requirement, as the fee *burdens* the new owner (it is her requirement to pay), and the money *benefits* the homeowners' association, funding common area maintenance, insurance, and other community expenses.

Over the past decade, a new breed of transfer fee covenant has arisen that calls for such payments to be made, not to a seller, or homeowner's association, but to the developer. Further, these fees are not always required to be used for the benefit the development.[5] These covenants are often long-lasting, typically from 20 to 99 years,[6] and in some cases, perpetual.[7] In effect, each time a unit subject to the covenant is sold, the fee must be paid. If the fee is not paid, the developer is usually able to elect one or more remedies to recover the fee, up to and including filing a lien on the applicable unit. With a sales price-based fee and a successful development, these covenants can turn into ever-increasing annuities for developers. Supporters of these practices claim these fees lower acquisition and financing costs (as the purchase price generally must be lowered to accommodate the fee) and provide much-needed streams of capital to developers in what have been financially difficult times.[8] Opponents argue that the fees increase the cost of home ownership, create defects in title, and lessen marketability.[9]

In response to this growing trend, the N.C. General Assembly enacted N.C. Gen. Stat §39A in July 2010.[10] This chapter applies specifically to transfer fee covenants filed after the statute's July 1, 2010 effective date.[11] Chapter 39A reaffirms North Carolina's long-stated public policy supporting the marketability of real property and disfavoring unreasonable restraint on its transfer, and unequivocally states that transfer fee covenants violate this policy.[12] In addition to invalidating transfer fee covenants as covenants that run with the land (i.e. are enforceable against subsequent purchasers of the property), Chapter 39A also invalidates any liens filed to enforce said covenants, and imposes liability for damages and fees on any person who records a covenant or a lien to enforce it.[13]

While Chapter 39A did not expressly make transfer fee covenants enacted prior to 2010 illegal, the language of the legislation left their status in doubt. This past January, in a case of first impression in North Carolina, a Wake County Superior Court Judge struck down a transfer fee covenant, instituted prior to the enactment of Chapter 39A, that was part of a condominium declaration for a continuing care and retirement community in Chapel Hill, NC.[14] The covenant in this particular case required a payment of 10% of the sale price of any condominium unit (dubbed a "Membership Fee" in the condominium declaration) to the declarant in perpetuity.[15] The ruling found that the TFCs were illegal, unconscionable, invalid and unenforceable as a matter of law.[16] The case is currently under appeal.

Tying Arrangements

Another means by which a developer might attempt to leverage its influence is to require buyers to purchase additional goods or services along with their new lot or home. A very common example is a provision in a contract for the purchase of a lot in a new subdivision that the buyers must use a "preferred builder" to construct their new home. Another common example is a requirement that grants an exclusive right to list the new home with a particular realtor, commonly known as a "listback agreement." These requirements may be found as conditions in the contract, but from time to time, like the transfer fee covenant, also take the form of a covenant or servitude in a deed or community declaration. In anti-trust law, these requirements are known as tying arrangements.[17]

A tying arrangement exists where a party, having control in one market, attempts to use that control to obtain an advantage in a second market by tying two products or services together.[18] The intended effect being that a buyer cannot obtain the desired (tying) product without having to acquire the undesired (tied) product as well. In North Carolina, tying arrangements are addressed in N.C. Gen. Stat

§75. More specifically, § 75-1 deals with illegal restraints of trade and §75-1.1 deals with unfair and deceptive trade practices.[19] These sections are largely derived from the federal Sherman Act and Federal Trade Commission Act, respectively.[20]

Under the Sherman Act, a tying arrangement is illegal when the seller has "sufficient market power" in the tying market to effectuate the tie.[21] Historically, the measure of "sufficient market power" established by the Supreme Court was a "not insubstantial" amount of commerce.[22] This low bar reflected the public policy of the day, that tying arrangements "serve hardly any purpose, other than the suppression of competition."[23] As one might imagine, producing sufficient evidence to meet this threshold was not an imposing task.

However, over time, the Court's strong disapproval of tying arrangements has diminished considerably. In the late 1970's and early 1980s, the Supreme Court rejected the previous assumption regarding the uncompetitive nature of tying arrangements and "moved from relying on assumptions, to requiring a showing of market power in the tying product."[24] As a result, the evidentiary burden of establishing sufficient market power to render a tying arrangement illegal has risen significantly.

In the real estate context, the relevant "market" can be identified in a number of different ways. In the broadest sense, the market could be a particular geographic area. Even in the current era of national homebuilders (The nation's 150 largest builders accounted for roughly 33% of all real estate closings in 2013.[25]), dominant shares of the market are rarely seen. In order to establish a tying claim, a complaining purchaser would need to convince a court that the market over which the seller exerts control is more limited to a particular section of a community or even to a particular development. The more narrowly a particular market may be construed, the more likely the seller will possess the requisite amount of control.

An additional factor to consider in the real estate context is the theory of the uniqueness of real property. Buyers have argued that each parcel of real estate represents a market of one, over which a seller has complete control, but courts across the country have not accepted the uniqueness of real property argument in a market power analysis to the same degree they have accepted it in the context of specific performance.[26] Uniqueness arguments, however, have proven successful in distinguishing one development from others in the area, thus narrowing the defined market and magnifying the economic power of the developer.[27] In practice, this means the more a development aims to set itself apart, either by quality of construction, lot size, amenities, proximity to local/regional points of interest, the more a buyer may be able to argue that a single development constitutes a particular market in which the developer has significant control.

In summary, of the two tactics discussed here, barring a contrary ruling on appeal, the use of TFCs has been foreclosed upon in North Carolina. Developers who have instituted TFCs prior to July of 2010 should consult legal counsel prior to filing any liens based on failure to pay amounts owed as a result of TFCs. As to tying arrangements, developers should scrutinize closely their product's position in the relevant market, taking into consideration any feature or amenity that sets it apart, before attempting to tie it to the sale of a second product or service.

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[1] Patrick O'Toole et al.,2014 Housing Giants: Overview and Analysis (May 14, 2014), *available at* http://www.probuilder.com/2014-housing-giants-overview-and-analysis.
[2] Carolyn Clark Snipes, *Private Transfer Fees and Reconveyance Fee Instruments in North Carolina*, NC Bar Association Real Property Newsletter, May, 2010.
[3] Janice E. Carpi, Transfer Fees*: How to Make Money in Real Estate (and Render Your Purchaser's Title Unmarketable) Without Really Trying*, American Bar Association, Law Trends & News Practice Area Newsletter, Vol. 4, No. 3, (Summer 2008).
[4] Christopher D. McEachran, *Sometimes Jumping on the Bandwagon is a Good Thing: An Analysis of North Carolina's Prohibition on Transfer Fee Covenants*, 89 N.C. L. Rev. 2201 (2011).
[5] Capri, *supra* note 3.
[6] *Id.*
[7] *See* Wilner, *infra* note 15.
[8] Capri, *supra* note 3.
[9] *Id*.
[10] *See* Transfer Fee Covenants Prohibited Act of 2010, 2010 N.C. Sess. Laws 245 (codified at N.C. GEN. STAT. §39A (Supp. 2010).
[11] *Id*.
[12] *Id*.
[13] *Id*.
[14] *See* Jonathan Wilner, et al. v. The Cedars of Chapel Hill, LLC, et al. No. 11 CVS 1428 (Sup. N.C. Jan. 7, 2014) (order granting partial summary judgment).
[15] *See* Wilner, *supra* (Plaintiff's Brief and Memorandum of Law in Support of Partial Summary Judgment)
[16] *Id*.
[17] Jefferson Parish Hospital Dist. No. 2 v. Hyde, 466 U.S. 2, 12 (1984).
[18] Illinois Tool Works Inc. et al. v. Independent Ink, Inc., 547 U.S. 28 (2006) (quoting Jefferson Parrish Hospital Dist. No. 2 v. Hyde, 466 U.S. 2 (1984)).
[19] William B. Aycock, *North Carolina AntiTrust Law*, 60 N.C.L. Rev. 205 (1981).
[20] *Id*. at 208, 221.
[21] Independent Ink, *supra* note 18.
[22] *Id*.
[23] Standard Oil Co. of Cal. v. United States, 337 U.S. 293, 305-306 (1949).
[24] *Id*.
[25] Patrick O'Toole et al*., 2014 Housing Giants: Overview and Analysis, available at* http://www.probuilder.com/2014-housing-giants-overview-and-analysis#.
[26] *See* State of Connecticut v. Hossan-Maxwell, Inc., et al., 181 Conn., 436 A.2d 284 (Conn.,1980) (stating that the uniqueness of real property is … sufficient evidence of market power); *But see* Vande Guchte v. Kort, 13 Neb. App. 875 Lexis (2005) (upholding a "preferred builder" provision in a lot purchase agreement based upon failure to present sufficient evidence to demonstrate market power and that the uniqueness of real property is insufficient evidence to do so).
[27] *See, e.g*. Suburban Mobile Homes, Inc. v. AMFAC Communities, Inc., 101 Cal. App. 3d 532 (Call. App. 1 Dist., 1980) (emphasizing that "economic power [over they tying product], may be inferred from the tying product's desirability to consumers or from uniqueness in its attributes" and noting the location, existence of a waiting list, lot sizes, facilities and amenities of the subject development).

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William B. Aycock II is a member of Schell Bray's Real Estate Practice Group and assists and advises clients in a broad range of commercial real estate matters and transactions, including the representation of owners, developers, buyers and sellers.