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The Real Doctrine & Covenants

Chad J. Pomeroy
St. Mary's University School of Law, cpomeroy@stmarytx.edu

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THE REAL DOCTRINE & COVENANTS

*Chad J. Pomeroy**

ABSTRACT

Developers have recently begun creating, and attaching to the property they sell to consumers, what is known as a "recovery fee." These recovery fees are "new" in that most lawyers are not familiar with them and in that they seem to operate in a novel manner and are bottomed on novel claims. In essence, they create and levy a fee on subsequent owners each time the property is transferred, which fee purports to reimburse developers for infrastructure and other development costs. Because they seem new, and because they involve transfers from relatively small and unsophisticated parties to relatively large and more sophisticated parties, they have engendered substantial controversy and opposition.

But they are not really new. They are actually simply a type of covenant, condition, and restriction. Covenants are among the most basic property concepts studied by most first-year property students. These recovery fees are merely a new type of covenant that has recently emerged as a new tool for real property developers to generate additional revenues.

This Article primarily seeks to describe these recovery fees, to place them in their proper context within the extant universe of known encumbrances, and to warn legislators and lawyers against overreacting to them through a flurry of unnecessary and ultimately unhelpful laws. The Article does this by describing recovery fees and the various "solutions" that states have begun promulgating in response thereto. This desire for solutions is understandable, as recovery fees do pose some problems, but, I argue, these problems arise not from the intrinsic nature of these covenants, but from the manner in which our recording system accomplishes its notice function. Though entirely statutory in nature, the recording system effectively relies upon history and custom such that a new variation on even a well-established property interest or encumbrance can undermine notice. Therefore, I ultimately suggest a restrained solution that both ensures notice and avoids the difficulties associated with imprudent laws and prohibitions. I conclude that this restrained solution, by working within the context of existing notice structures, will minimize any confusion associated with recovery fees by maximizing the flow of information and eliminating the need for unwarranted and confusing laws and restrictions.

* Professor of Law, St. Mary's University School of Law.

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I. INTRODUCTION

Assume for a moment that you are a lawyer reviewing a real estate transaction for a client. You might be doing title work, advising on a purchase, helping with due diligence, or performing some combination of these services. In examining the documents recorded against the property, you come across an oddly named instrument called "Financing and Reimbursement of Infrastructure and Improvements." You have never seen anything like that before, and it has language that gives you pause, but you review the preliminary report from the title company and, seeing no corresponding exceptions to title, you move on.[1] This is *not* good lawyering—but it is certainly a scenario one could imagine, given that many lawyers look for common encumbrances and rely on title companies to pinpoint problematic title issues. Unfortunately, a year after the transaction closes, that reliance is shattered when your client calls you and asks why she has started to receive annual invoices from the original developer of the property. The answer is that you have just unknowingly encountered a new sort of encumbrance called a "recovery fee."

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1. A preliminary title report is one of the names for the initial report prepared by a title insurance company that describes title and defines the scope of title insurance the company is willing to issue. *See* 1 C.J.S. *Abstracts of Title* § 2, Westlaw (database updated Dec. 2016). A preliminary title report differs from an abstract of title, upon which one can legally rely, but it is often presented in the same manner, and it is primarily used by title insurance companies to induce stake holders to purchase title insurance. *See id.* §§ 2, 21. An "exception" to title is anything that constitutes a claim against, or encumbrance upon, the status of the title of the property at issue. *See, e.g.*, AM. LAND TITLE ASS'N, OWNER'S POLICY OF TITLE INSURANCE 1 (2006), http://www.waynecountytitle.com/sites/default/files/ALTAOwnersPolicy.pdf.

I say "new" because most lawyers are not familiar with recovery fees and so might run into the problem outlined above. But they are not really new. They seem so because they operate in a novel manner and are bottomed on novel claims, but they are actually a type of encumbrance commonly referred to as "covenants, conditions, and restrictions"—"covenant" in this Article.[2] Covenants are among the most basic property concepts, studied by most first-year property students,[3] and these recovery fees are simply a new type of covenant that has recently emerged as a new tool for real property developers to generate additional revenues. This Article primarily seeks to describe these "recovery fees,"[4] to place them in their proper context within the extant universe of known encumbrances, and to warn legislators and lawyers against overreacting to them through a flurry of unnecessary and ultimately unhelpful laws. Part II describes recovery fees and the various "solutions" that states have begun promulgating in response thereto. Of course, the desire for solutions is understandable, as recovery fees do pose some problems, which Part III acknowledges. These problems arise not from the intrinsic nature of these covenants but from the manner in which our recording system accomplishes its notice function. Though entirely statutory in nature, the recording system effectively relies upon history and custom such that a new variation on even a well-established property interest or encumbrance can undermine notice. As such, Part IV suggests a restrained solution that both ensures notice and avoids the difficulties associated with the imprudent laws and prohibitions counseled

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2. The phrase "covenant, condition, and restriction" is the same with or without an Oxford comma. Often referred to by the acronym "CCR," I prefer the term "covenant" because it is easier to use. I mean by this term, however, to refer to a "real covenant," which is what most people probably mean when they use the term CCR.

3. *See, e.g.*, JESSE DUKEMINIER ET AL., PROPERTY 894 (8th ed. 2014). Note that "equitable servitudes" are closely related cousins of covenants. *See id.* at 892–94. For purposes of this Article, however, I will focus on real covenants, as the requirements thereof are slightly broader than those of equitable servitudes, and I will, as indicated above, generally utilize the phrase "covenants." *See also, e.g.*, *infra* note 35 and accompanying text.

4. These can also be called transfer fee covenants, capital recovery fees, reconveyance fees, or home resale fees. *See, e.g.*, 3 JOYCE PALOMAR, PATTON AND PALOMAR ON LAND TITLES § 609.50 (3d ed.), Westlaw (database updated Nov. 2015). Though there are potential differences between these various terms, which I will discuss in greater length below, see *infra* notes 10, 16, and accompanying text, these terms collectively summarize the type of covenant I wish to discuss herein, with the important proviso that these fees, whatever their designation, are properly described as—and act as—a method of financing improvements to the real property at issue. *See* PALOMAR, *supra*.

against in Part II. The Article concludes that this solution, by working within the context of existing notice structures, will minimize any confusion associated with recovery fees by maximizing the flow of information and eliminating the need for unwarranted and confusing laws and restrictions.

II. THE MORE THINGS CHANGE

"There is nothing new under the sun."[5] Though this sentiment may be a bit strong as a general statement, it nicely sums up the situation regarding recovery fees. While it is true recovery fees are encumbrances that look different from traditional covenants, they are covenants nonetheless.[6] This is so because they serve the same purpose and meet all the elements of traditional covenants.[7] As such, they are legal and permissible.[8] This means laws and customs have grown up around them and they are built into our real property system. And that means attempts to prohibit or avoid recovery fees are likely to prove ineffective or cause more harm than good. This is important because a number of states and commentators—not understanding that recovery fees are a variation of traditional covenants—have passed laws seeking to prohibit or restrict them.[9] These laws are doomed to be mostly ineffective given how widely accepted and utilized covenants are.

A. *The Nature of Recovery Fees and Covenants*

Recovery fees, as mentioned above, may also be called capital recovery fees, reconveyance fees, recovery fees, or home resale fees.[10] Though these terms might feasibly conjure up a variety of different types of fees, they are used interchangeably in this context because they all involve: (1) a covenant-based fee that is triggered by a sale or transfer of real property and (2) money flowing from that fee to the original builder or developer of the real property at issue.[11]

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5. *Ecclesiastes* 1:9.

6. *See* PALOMAR, *supra* note 4.

7. *See id.* (noting transfer fees are covenants).

8. In this Article, my commentary will be directed to the common law, unless a specific state or statute is identified.

9. *Id.*

10. *Id.*

11. *See* Amy Kathleen Lewis, Comment, *Developing Disaster: How Developers Are Using a Covenant to Steal from Homeowners and Why the States Should Stop Them*, 64 OKLA. L. REV. 377, 382 (2012) ("Under any name, the fundamental idea is that a

> A typical transfer fee covenant provides that successive purchasers must pay a percent of any future sale price for the property to the party who originally imposed the covenant, and that said covenant will run with the land . . . . Most often, the party originally imposing the covenant is the developer of a residential subdivision.[12]

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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." (citing Marjorie Ramseyer Bardwell & James Geoffrey Durham, *Transfer Fee Rights: Is the Lure of Sharing in Future Appreciation a Flawed Concept?*, PROB. & PROP., May–June 2007, at 24, 25)).

12. PALOMAR, *supra* note 4. An added element of capitalism is also often present: "Many transfer fee covenants also require payment of a percent of each sale price to the company that 'licensed' the use of its standard form covenants, and another percent to a broker." *Id.* (citing Bardwell & Durham, *supra* note 11); *see also* Lewis, *supra* note 11, at 383 ("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. The broker then collects an initial commission and also may get a share in future earnings of the transfer fee covenant [in much the same manner as the initial seller and the licensor] . . . ." (footnote omitted) (citing Bardwell & Durham, *supra* note 11)). Complicating matters even further, the initial seller (or the licensor or anyone else receiving a stream of future income) can sell his or her rights to anyone else for a lump sum representing the parties' estimate of the net present value of those future payments. Lewis, *supra* note 11, at 383. This is an odd wrinkle for a couple of reasons. One reason is that most people simply do not think of something like a covenant-based fee as intellectual property that is subject to being licensed and generating revenues. *Cf.* Robert King, Comment, *Only in America: Tax Patents and the New Sale of Indulgences*, 60 TAX LAW. 761, 763 (2007) ("As early as 1908, the courts have been reluctant to extend patent protection to methods of doing business."). For most of the history of this country, patenting a business method or process was not generally permitted. *E.g.*, *id.* However, most of us are generally comfortable with the idea of gaining rights or a property interest in a "machine, manufacture, or composition of matter." *See id.* (citing Hotel Sec. Checking Co. v. Lorraine Co., 160 F. 467, 469 (2d Cir. 1908)). But the idea of gaining such rights in a business method or a way of conducting business seems abnormal or even slightly nefarious. *Id.* ("Advice is not patentable." (quoting *Hotel Sec. Checking Co.*, 160 F. at 469)); *see also* Andrew Beckerman-Rodau et al., eBay v. MercExchange *and* Quanta Computer v. LG Electronics, 4 J. BUS. & TECH. L. 5, 29 (2009) (discussing "the suspect validity of business method patents"). Another reason this seems strange is that, as discussed above, this method often involves a property developer selling its rights to the stream of future payments and thus realizing a large and immediate gain. *See* Lewis, *supra* note 11, at 383. Neither of these issues is ultimately of particular import. It is true that some have attempted to patent the concept and application of recovery fees. *See, e.g.*, U.S. Patent Application Pub. No. US 2010/0042528 A1, at [57] (published Feb. 18, 2010) (publishing U.S. Patent Application No. 12/583,122 (filed Aug. 14, 2009)) (describing a patent application for a "method and system for financing and reimbursement of infrastructure and improvements to real property," which "results in

The covenant, then, is the central element in this scheme, and if the fee is not paid, a lien attaches against the land so encumbered.[13]

These fees, then, are recurring and potentially long-lasting.[14] Often left unsaid, however, is the purpose behind them.[15] As the reader may recall, one of the terms used to describe this kind of fee is "capital recovery fee."[16] This is, indeed, a central feature.[17] These kinds of fees are inherently intended to

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the reimbursement of certain costs of infrastructure and improvements made to the land"). Admittedly, this relatively novel business approach shades the entire idea of recovery fees with a patina of "strangeness," which probably makes academics and legislators more suspicious and more willing to criticize or seek to prohibit them. Nevertheless, these kinds of method patents are now a more or less accepted element of intellectual property law. *See* King, *supra*, at 764–65. A third reason is that the transfer or sale of these payments is not relevant insofar as the purpose and intent underlying the transfer and concomitant realization of money is tied to the improvement or development of the real property at issue, which seems an economically justifiable assumption, assuming proper notice is provided. *See infra* notes 42–44 and accompanying text. Ultimately, then, whether the recovery fee scheme at issue is patented, and whether any resultant fee stream is later sold or transferred, is irrelevant. This Article focuses—as the very question of whether recovery fees are permissible should focus—on the nature of the fees and covenants themselves, not on whether they have been patented or sold.

13. PALOMAR, *supra* note 4. The potential for encumbrance is not, in and of itself, dangerous or disruptive. Encumbrances on title are common and even healthy. Almost every commercially originated purchase money loan involves the lender placing a mortgage against the property, and there are all manner of encumbrances that do not disturb "normal" use, including, of course, covenants. *See* PALOMAR, *supra* note 4, §§ 567, 609, Westlaw (database updated Nov. 2016). The danger arises, instead, from an encumbrance that is unanticipated or a surprise. *See, e.g.*, Chad J. Pomeroy, *Ending Surprise Liens on Real Property*, 11 NEV. L.J. 139, 145–48 (2010) [hereinafter Pomeroy, *Ending Surprise Liens*]; *see also* Lewis, *supra* note 11, at 377 (introducing the topic of recovery fees in a scenario that implies home buyers will be unaware of the recovery fees).

14. *See* PALOMAR, *supra* note 4 (noting transfer fee covenants run with the land for 99 years).

15. *See* Lewis, *supra* note 11, at 380–83 (discussing the formation of these fees with the only stated purpose being profits).

16. PALOMAR, *supra* note 4.

17. *See, e.g.*, FREEHOLD CAP. PARTNERS, www.freeholdcapitalpartners.com (last visited Feb. 9, 2017). Freehold Capital Partners is one of the purveyors of the recovery fee approach, approaching developers and attempting to license their particular method. *Id.* A review of their site reveals quite clearly that their fees are meant to be tied directly to the improvement of the property. *See Developers*, FREEHOLD CAP. PARTNERS, http://freeholdcapitalpartners.com/developers/ (last visited Mar. 19, 2017); *see also Freehold Capital Partners Announces $71,910,000.00 Alabama Project*, THESTREET

permit developers to finance the (often substantial) costs associated with real estate development in a manner that spreads the expense over a long period of time.[18]

This is not an entirely new idea. Homeowners' associations routinely assess fees to homeowners to pay for ongoing maintenance.[19] Indeed, much of the purpose behind the modern concept of covenants and owners' associations is to permit neighbors to share in the common expenses of the development.[20] And this is not limited to repairs. Capital improvements and expansion can also be addressed in this manner. It is entirely within acceptable norms, for instance, for a homeowners' association to assess fees (either ongoing or special) and to utilize those funds to build an improvement in the relevant neighborhood.[21] This should sound familiar because it is precisely what a recovery fee does. The only difference is the timing. With recovery fees, the developer is *recouping* fees for development

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(May 25, 2010), https://www.thestreet.com/story/10766366/1/freehold-capital-partners-announces-7191000000-alabama-project.html ("By working with Freehold to structure a one percent Capital Recovery Fee, the project owner can more fairly apportion costs and, in consequence, lower the sales price. Since a portion of the significant capital investment in the project can be recovered over time, current and future buyers will enjoy lower acquisition costs, which means lower closing costs and lower monthly interest payments. In this way a Capital Recovery Fee is distinguishable from a government transfer fee (i.e. a tax that raises property costs for everyone as a means of funding government services) . . . . [B]y creating a Capital Recovery Fee and segregating the income stream out from the project . . . the project owner has the potential to bring additional liquidity to the project. This, in turn, can restart stalled projects, create jobs, pay down bank loans, and create a ripple effect throughout the economy." (emphasis omitted)). This Article is focused on these types of fees: fees that are directly tied to improvements to real property. Of course, it is more than conceivable that these fees could—even if ostensibly tied to improvements—be unduly expanded into a source of extra income or revenue. This would be accomplished simply by imposing them in an amount sufficient to ensure that the future stream of payments exceeds the current cost of improvements. I have little doubt that this could happen, and I rather suspect that the academic and legislative hostility engendered by these fees is due to this suspicion or concern. *See infra* Part II.B. However, this concern is not ultimately troublesome, for the reasons discussed below. *See* discussion *infra* Part II.B. Therefore, we are left focusing on fees that can be accurately described as aimed at "capital recovery." *See supra* note 4.

18. FREEHOLD CAP. PARTNERS, *supra* note 17.

19. *See, e.g.*, Jeffrey E. Stake, *Toward an Economic Understanding of Touch and Concern*, 1988 DUKE L.J. 925, 963 n.146 (noting numerous cases in which covenants to pay fees are explicitly held to run with the land).

20. *Id.* at 962.

21. *Id.*

costs, whereas with traditional homeowner assessments, the association is *pre-funding* development costs.[22]

Given such a provenance, I think the question is the relatively straightforward one of whether these sorts of fees can satisfy the traditional requirements of covenants running with the land. A covenant is a promise that is intended to stick to—or "run with"—the land.[23] This represents a combination of property law and contract law and is not terribly intuitive.[24] The basic idea is that parties to a sale or transfer of land should be able to make a promise that affects land and runs to (and thereby binds) future owners.[25]

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22. Note, however, that even this distinction may break down, if the developer is able to sell its right to future fees. *See, e.g.*, *infra* notes 42–46 and accompanying text. If that occurs, then, in a sense, the homeowners are merely being asked to pay for improvements.

23. Lewis, *supra* note 11.

24. *See* W.E. Shipley, Annotation, *Comment Note.—Affirmative Covenants as Running with the Land*, 68 A.L.R.2d 1022, § 2 (1959), Westlaw.

25. For example, assume that Calvin owns a large farm. He desires to retire, so he puts up most of his property for sale, seeking to keep a small parcel to himself to live on in retirement. Now, Calvin wants to sell the majority of his property, but he still wants to live in a pastoral setting, so he is not willing to sell to just anyone. As such, when Henry makes an offer to buy the marketed property from Calvin, Calvin makes Henry (as part of the purchase agreement) promise not to build something that is not agricultural in nature (like a strip mall or an apartment complex). This promise is a benefit to Calvin (who gets to prevent Henry from building nonagricultural property) and a burden to Henry (who is prevented from building certain types of structures). Of course, assuming Henry receives an adequate discount on the purchase, this arrangement suits both parties just fine. It is, however, a purely contractual arrangement; so Calvin can have little confidence that his pastoral bliss will continue. As soon as Henry sells the property to some third party (let us say someone named Audrey), then Audrey (as a stranger to the contract) would be free to develop the property in whatever way she wanted, thus frustrating Calvin's desire (for which he theoretically paid fair value by way of discounting the price of his farm). Likewise, if Calvin were to sell the retained homestead (let us say to someone named Sophie), then Henry could build anything he wanted without fear of suit because Sophie (as a stranger to the contract) would be unable to enforce the promise. This is obviously problematic, as real property is immovable and the value of the property is the contemplation of its future use and the ability to rely thereon. *See* ROBERT G. NATELSON, MODERN LAW OF DEEDS TO REAL PROPERTY 5, 350 (1992) (noting land is immovable and may be difficult to sell due to actions of neighbors). Because of this, and because of the large financial investment often involved, landowners pushed for the creation of covenants. *See id.* at 5, 350–51; *see also* DUKEMINIER ET AL., *supra* note 3, at 892 ("Thwarted by the law courts' refusal to recognize new types of negative easements, landowners turned—in the early nineteenth century—to the law of contracts. They sought judicial recognition of a contract right

But there a number of specific requirements that must be met for a covenant to run with the land.[26] First, there must be privity of estate.[27] More specifically, U.S. courts have held horizontal and vertical privity are required for the burden of a covenant to run at law to successors, and vertical privity must exist for the benefit of a covenant to so run.[28] If this sounds confusing and complicated, that is only because it is. I think it sufficient for our purposes to indicate broadly that covenants have traditionally satisfied this multifaceted privity requirement when: (1) the original parties to the promise have a grantor–grantee relationship and (2) subsequent landowners succeed to the original parties' (or their successors') estate.[29]

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respecting land use enforceable not only against the promisor landowner, but against his successors in title as well."). These covenants, or promises, run with the land and thereby avoid the problems that might arise, as described above, due the transient nature of both ownership and contractual obligation. *See* NATELSON, *supra*, at 5, 350–51. These covenants are in effect a type of property right, as opposed to a "mere contract right," and their recognition allows "the market to allocate conflicting land uses efficiently." DUKEMINIER ET AL., *supra* note 3, at 893.

26. The requirements set forth herein refer to the traditionally recognized requirements associated with covenants, which arose as covenants evolved from contract rights and duties. DUKEMINIER ET AL., *supra* note 3, at 893–94. This evolution began in the early nineteenth century and is largely reflected in the first *Restatement of Property*. *See id.* at 893, 895–96 (citing RESTATEMENT OF PROP. § 534 (AM. LAW INST. 1944)). This view, since the publication of the Restatement (First), has been criticized as technical and archaic, with the Restatement (Third) repudiating some requirements. *Id.* at 896. Nevertheless, the traditional requirements set forth in the Restatement (First) are what most law students learn, are still widely required, and, as such, will be the focus of this discussion. Note as well, that the requirements of covenants are encompassing of and slightly broader than those of equitable servitudes, serving to further underscore the suitability of generally focusing on covenants. *Id.* at 909.

27. *See id.* at 893. This requirement arose directly out of the English common law exception to the rule of non-assignability of contract rights, which permitted the assignability of landlord–tenant leasehold covenants where there was privity of estate between a landlord and a tenant. *See id.* at 893–94. In other words, the covenants contained in the lease were "enforceable by and against a successor landlord or a successor tenant." *Id.* at 893. This served as the evolutionary jumping-off point for a wider range of covenants to "run with the land." *See* discussion *supra* note 25.

28. *See* DUKEMINIER ET AL., *supra* note 3, at 893–97.

29. *See id.* The concept of horizontal privity grew out of the English focus on the landlord–tenant relationship and so focuses on the connection between the originally promising parties. If they have a grantor–grantee relationship (for example, that of a landlord granting a leasehold interest to a grantee), then the burden (for example, that of a tenant promising to maintain common areas) will run to later grantees (for example, a sublessee). *See id.* at 895. This is not required, however, on the benefit side. This makes sense, perhaps, if one again remembers England's landlord–tenant monomania and

Second, the parties must intend the promise to run.[30] This is a straightforward requirement that requires little elaboration.

Third, a similarly clear-cut requirement is that any subsequent purchaser (to be bound by the covenant) must have actual or constructive notice.[31]

Fourth and finally, a covenant must "touch and concern" the land.[32] This is a fairly imprecise requirement. The general idea is that only "covenants whose content relates to land use or enjoyment" in a direct and specific way should "attach" to the land and thereby bind those who come later.[33] But just what sort of covenants have that sort of relationship to land

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thinks of this in terms of permitting a landlord to assign the rights to a lease easily and with few requirements (likely not upsetting any tenant expectations and furthering the economic benefit associated with the easy marketability of commercial property). As to the benefit side, vertical privity is required because "the burden and the benefit run with *estates* in land, not with the land itself. [As such,] . . . a covenant is enforceable at law by and against remote parties only if those parties have succeeded to the original parties' estates in the land in question." *Id.* at 897. Even this is (perhaps unbelievably) somewhat simplified, as the requirements and definition of vertical privity vary depending on whether the focus is on the burden or the benefit. *Id.* ("On the *burden* side, the covenant is enforceable only against someone who has succeeded to the same estate as that of the original promisor . . . . A more relaxed standard is used for the running of the benefit . . . . [And such a] promise is enforceable by a person who succeeds to the original promisee's estate or a lesser interest carved out of that estate."). Importantly, in the modern context, the privity element *does* exist even when the party seeking to enforce the covenant is a homeowners' association. *See, e.g.*, *id.* at 919 ("Today it is well settled that homeowner associations do have standing to enforce development covenants, both in law and equity, if they have been given enforcement power . . . . The basis for standing is the homeowners' association's status as a third-party beneficiary." (citations omitted)). This means that privity, which would traditionally seem to disqualify homeowners' associations from enforcing a covenant, is not actually a barrier. *See id.*

30. *Id.* at 901.

31. *Id.* In fact, the requirement is a little bit broader than "notice" implies—only a bona fide purchaser (that is, someone who purchases for consideration) will escape the effect of a covenant due to lack of notice. *See id.* at 907. "Notice," in the property context, often (though not always) implies a party who both pays value and has no notice. *See id.* This is because, "A fundamental principle of the recording system is that only subsequent purchasers, and not donees, are protected against prior interests of which they have no notice." *Id.* at 901 n.34.

32. *Id.* at 901.

33. *See id.* at 917. Though maybe not terribly intuitive, this makes sense. Assume that Audrey sells Blackacre to Henry and that Audrey continues to occupy Whiteacre, the neighboring property. Now assume that Henry promises to wash Audrey's car once a month in connection with that sale. That is, of course, wonderful for Audrey. However,

has been subject to much discussion and dispute.[34] Initially, courts often held that only negative covenants qualified.[35] That is no longer the case, though, as affirmative covenants are routinely enforced.[36] As of now, the "touch and concern" requirement is still somewhat vague and has been the object of much debate, but it is fair to say a reasonable working definition is a promise that directly affects the nature or use of the property that is burdened.[37]

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what happens if Henry sells Blackacre to Sophie? Should Sophie thereafter have to wash Audrey's car? The common sense response is that she should not—because that was an agreement between Audrey and Henry, and it has nothing to do with Sophie (regardless of whether Audrey and Henry wanted Henry's successors in interest to be so bound). However, what if Henry, instead of promising to wash Audrey's car, instead promised that he would never install a car wash on Blackacre? The parallel question to the above hypothetical is what happens when Henry sells Blackacre to Sophie: Should Sophie be bound by *this* promise? Here, the common sense response is probably yes—because the promise is inherently focused on the property, not on the performing (or receiving) party because the promise "touches and concerns" the land.

34. *See id.*

35. *Id.* This is likely due to the fact that covenants largely evolved due to the law's limited adoption and promulgation of negative easements. "A negative easement is the right of the dominant owner to stop the servient owner from doing something on the servient land." *Id.* at 887. This is, of course, precisely what a negative covenant does, and negative easements (which are interests owned by the benefited party, or parcel, and so can be said to "run with the land") have been around for much longer than legal covenants. *See id.* (noting negative easements were recognized prior to Queen Victoria's reign). However, negative easements were historically limited to four specific types of prohibitions on neighborly activity: (1) blocking windows, (2) interfering with air flow, (3) removing support of artificial structures, and (4) interfering with water flowing in an artificial stream. *Id.* Because the ability to negatively restrict one's neighbor was limited to these four activities, landowners cast about for additional tools to address other activities—and eventually settled upon negative covenants. *See id.* at 889 ("Restatement (Third) of Property . . . treats negative easements as restrictive covenants.").

36. *Id.* at 917–18. Courts were traditionally hesitant to enforce affirmative covenants because doing so raises the specter of continuing judicial supervision, because such covenants have often been viewed as clogs on title, and because of the potential for significant liability. *Id.* These days, however, most affirmative covenants relate to the payment of dues to an association that has some responsibility for, or relationship with, the property at issue, and courts nearly always enforce these type of obligations. *Id.* at 918.

37. *See, e.g.*, Marcy Allen, Note, *A Touchy Subject: Has the Restatement Replaced the Touch and Concern Doctrine with an Equally Troublesome Test?*, 65 BAYLOR L. REV. 1034, 1036 (2013) ("The touch and concern doctrine is substance-based: there is no one concrete definition, but the inquiry is whether the promise impacts the land itself rather than being solely a personal promise between parties."); *see also, e.g.*, Stake, *supra* note 19 (noting numerous cases in which covenants to pay fees are explicitly held to run with the land).

Recovery fees meet these four elements. The second and third elements are clear: the parties involved intend the promises to run with the land, and notice is provided so long as the recovery fees are properly recorded.[38]

The other two elements (touch and concern, and privity) also exist in connection with recovery fees, though not as clearly. Indeed, these two elements may initially appear fairly problematic because the fee is paid by the homeowner to someone or something other than the developer or a homeowners' association.[39] After all, a payment to a detached third party who is not investing in, or tending to, property certainly seems isolated from the property, and involves an individual who is not in traditional privity with either the benefited or the burdened party. This resuscitated objection is rather easily disposed of though. As discussed above, the concept of paying covenant-based fees to any homeowners' association is conceptually problematic in a traditional sense, and the payment of fees was similarly tricky.[40] However, those concerns have now been laid to rest, as the modern law has put reality over form, and has held both that money paid toward the upkeep of real property does touch and concern that property and that homeowners' associations are legal agents of the true party in privity.[41]

The same logic applies here, albeit in a situation where the parties are a further step removed from each other. As to the touch and concern

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38. There are two ways to be put on notice of another's interest in, or claim to, land: actual notice and constructive notice. 1 PALOMAR, *supra* note 4, § 12, Westlaw (database updated Nov. 2016). Actual notice is just what it sounds like: actual knowledge of the interest (because the relevant party is told, she or he found out directly, or through any other direct reason). *Id.* Constructive notice arises in two ways: through inquiry notice or record notice. *Id.* Inquiry notice describes a situation where a reasonable person in the relevant person's position would have known of the claim or interest. *Id.* A classic example is a home that bears outward signs of being occupied by someone other than the seller; any reasonable buyer, the argument goes, should know (or suspect) that someone else is living in the house and, so, has some claim to it. Record notice is statutory in nature. Every state has a statute providing that everyone (all potentially interested parties) are put on notice of claims or interests that are properly recorded (generally in the appropriate county recorder's office). *See id.* This is, by far, the most important kind of notice and is certainly the way that most third parties would be put on notice of recovery fees; though this Article does suggest a slight addition to the statutory canon in order to make such notice more helpful, with respect to recovery fees. *See infra* Part III.

39. Recall that this payment to a person or entity entirely unknown to the original party is a common circumstance associated with recovery fees. *See supra* note 18.

40. *See supra* notes 11–13 and accompanying text.

41. *See* DUKEMINIER ET AL., *supra* note 3, at 918.

requirement, recovery fees are intrinsically tied to the sums that are expended to develop and care for the real property.[42] It is true the chronology of payment and expenditure is seemingly asynchronous, in that the developer expends the funds early on and receives payments over time.[43] However, this matters not at all. Money is fungible, and the reason the developer is able or willing to spend money is that the developer can count on fees accumulating over time. Indeed, the irrelevancy of this concern—due to the interchangeability of money over time—is heightened when the developer, rather than receiving the fees over time, sells that right to another (either directly or via a licensing arrangement) in exchange for immediate payment, representing the present value of the future stream of payments, which the developer then invests in the real property at issue.[44] In such a situation, it is abundantly clear that the stream of payments is, in fact, directly flowing into the real property in precisely the same way as homeowners' association fees that go toward maintaining improvements, and therefore, the payments touch and concern the land. One possible objection to this line of thinking may be that such an argument suffices so long as the developer does not *overcharge* in fees and thus receive an excess over the investment put into the property.[45] This objection, however, is an inherently patronizing one, taking for granted that the buyers at issue (the burdened parties) are unable to assess value and, as such, their estimation of value—encompassed as it necessarily is in the final contract price—should be discarded.[46] Moreover, any concern in that area should theoretically be resolved by clear information provided to prospective buyers, as is suggested below.[47]

Having concluded that these fees do, indeed, connect to the property—thus, touching and concerning it—the privity issue also resolves. Of course,

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42. *See infra* note 48 and accompanying text.

43. *See* FREEHOLD CAP. PARTNERS, *supra* note 17.

44. *See* Lewis, *supra* note 11, at 383.

45. *See id.* at 404.

46. Assuming that all parties are properly informed, it is difficult to see why the law—either legislatively or judicially—should presume that property purchasers are unable to appropriately value the work that recovery fees are paying for. This is a clear manifestation of basic economics and the concept (albeit not universally adopted or accepted) that well-informed markets reach efficient outcomes. *See, e.g.*, Wentong Zheng, *The Pitfalls of the (Perfect) Market Benchmark: The Case of Countervailing Duty Law*, 19 MINN. J. INT'L L. 1, 52 (2010) ("Markets, it is said, provide a measure of maximum economic efficiency.").

47. *See infra* Part III.

if it is the developer itself that receives the fees, then there is clearly privity (even more so than in the case of an intervening homeowners' association). And even if the recipient of the fees is not the developer, it is, ineluctably, a person who or entity that is receiving them through a direct connection with the developer that imposed them for the benefit of the property and, therefore, the recipient is as much a third-party beneficiary as is the homeowners' association.[48]

Accordingly, recovery fees are merely a new kind of covenant.[49] Thus, there should not be significant worry or concern regarding them and states should not overreact to them. Of course, that fact never stops legislatures.[50]

B. Kicking Against the Pricks

Thinking—mistakenly—that recovery fees are new or scary or some other kind of evil, a number of legislatures have attempted to counteract

48. *See* DUKEMINIER ET AL., *supra* note 3, at 896–97.

49. It is only fair to note that this opinion is not shared by everyone. *See* Lewis, *supra* note 11, at 389–400. Amy Lewis is against recovery fees and believes that they fail almost every conceivable element required of covenants. She argues that they do not touch and concern the land because they are "purely financial" and are not "associated with rent or homeowners' associations." *Id.* at 397. As discussed above, this is certainly an understandable view. Also as discussed above, however, it is a fairly shallow one. To say that recovery fees are purely financial and do not relate to the land is to ignore their explicit tie to the improvements that underlay their existence. Certainly, one could argue that the fees are too high or otherwise unreasonable, *see id.* at 404, but that simply does not divorce them from the improvements they serve to finance (even if the chronology of repayment is not standard). Similarly, Ms. Lewis argues that recovery fees do not satisfy the privity requirement. *See id.* at 398. She walks through four different views of privity and argues that recovery fees generally fail to meet the requirements because the fees are generally paid to a third party. *See id.* at 398–400. Firstly, this argument presumes that the promise necessarily runs to a third party. *Id.* at 398. This presumption is erroneous as recovery fees often flow, under the terms of the underlying covenant, to the original owner (likely, a developer) who may later transfer those rights to a third party. Moreover, even if the fee did run directly to a third party, this would satisfy the modern conception of privity because the ultimate recipient is merely acting as the agent, or some sort of beneficiary, of a promise made between the original parties to the transaction and transfer. *See, e.g.*, *Neponsit Prop. Owners' Ass'n v. Emigrant Indus. Sav. Bank*, 15 N.E.2d 793, 797 (N.Y. 1938) (developing a theory of privity by representation). Lewis then goes on to argue, eloquently, about policy and the balancing of the burdens and benefits of recovery fees (as she sees them). *See* Lewis, *supra* note 11, 400–06. Ultimately, I think these arguments, while interesting, are not persuasive as recovery fees fall within the traditional orbit of covenant law and so should be governed thereby.

50. In 2012, 18 states had restricted transfer fee covenants in some form. Lewis, *supra* note 11, at 406 (citations omitted).

them.[51] Nearly half the states have adopted some sort of provision prohibiting or governing recovery fees.[52]

Unfortunately, these restrictions are unlikely to have their intended effect, given the difficulty of isolating and defining the "undesirable" restrictions and the creativity and ingenuity of those who seek them. Take Utah's statute, for example: it creates two classes of transfer fees.[53] The first class is labeled a "reinvestment fee covenant"; is defined as a restriction that "obligates a future buyer or seller . . . to pay to a common interest association, upon and as a result of a transfer of the real property, a fee that is dedicated to benefitting the burdened property"; and restricts these fees by prohibiting their sale, assignment, or conveyance.[54] The second class is labeled a "transfer fee covenant"; is defined as an obligation "that is imposed on a future buyer or seller of real property, other than a person who is a party to the covenant . . . [which requires said party] to pay a fee upon and as a result of a transfer of the real property"; and is declared "void and unenforceable."[55]

This seems a reasonable and relatively straightforward attempt to restrict recovery fees. However, there are easy ways to avoid these statutory constraints. Rather than directly transferring or selling the reinvestment fee covenant, for example, a recipient could "license" it or direct its income into a jointly held venture with a "partner," or come up with many other methods

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51. Further cementing the Author's belief that the worst phrase in the English language is, "There ought to be a law!"

52. Lewis, *supra* note 11, at 407. The states banning recovery fees include Arizona, Florida, Iowa, Kansas, Maryland, Missouri, Oregon, and Utah. *Id.* (citations omitted). The states otherwise restricting recovery fees include Arizona, California, Delaware, Florida, Hawaii, Illinois, Iowa, Kansas, Louisiana, Maryland, Minnesota, Mississippi, Missouri, North Carolina, Ohio, Oregon, Texas, and Utah. *Id.* (citations omitted). Note, however, that the Texas ban has since been repealed. Act of June 17, 2011, ch. 211, sec. 2, 2011 Tex. Gen. Laws 780, 784 (repealing TEX. PROP. CODE ANN. § 5.017 (West 2010)). Most of these states focused on the public policy of the marketability of real property, indicating that transfer fees directly undercut this policy. *See* Lewis, *supra* note 11, at 407. Indeed, North Carolina went as far as to codify the punishments for those who attempted to attach transfer fees to their developments, stating that those developers would be responsible for all court fees, attorneys' costs, and any other costs caused by litigating the transfer fees. N.C. GEN. STAT. ANN. § 39A-3 (West 2017).

53. *Id.*

54. *Id.* § 57-1-46(1)(i)(ii), (3)(a).

55. *Id.* § 57-1-46(1)(j)(B), (1)(j)(C), (2) (noting that such covenants "recorded on or after March 16, 2010" are "void and unenforceable").

of directing (or "siphoning," if you prefer) the proceeds elsewhere.[56] Similarly, rather than creating a transfer fee covenant that is triggered by a sale or transfer, a developer could build in a recurring fee that is tied to an event other than sale or transfer, for example, a fee that is suspended due to an inactive market in the development area.[57]

Such creativity used to get around restrictive statutes is accessible and plausible because of how mainstream these fees are. Though recovery fees seem new, strange, or even predatory, they are merely a refashioning of a traditional homeowners' covenant meant to protect property values by way of payment. Given that, it is easy to think of many ways in which this concept can be executed.

III. THE DANGER OF RECOVERY FEES[58]

Recovery fees simply are not startlingly dangerous because they are merely a type of covenant, and the general concept of a covenant has been around for so long.[59] This means that people are accustomed to them and can understand and react to them appropriately.[60] This is important because conveying understanding to an interested party is a key element of property, and one which cannot happen with respect to novel or unknown types of interests.[61] So long as interests are understood, the U.S. recording system

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56. *See* Lewis, *supra* note 11, at 383.

57. These are not necessarily the most creative workarounds. There are probably other, better ideas, and it is certainly possible that a Utah court could read the statute broadly enough to restrict these kinds of activities. The broader point stands though, and I maintain that no statute is perfect and likely to entirely restrict fees or a developer's ability to profit from a well-drafted, thoughtful covenant.

58. Much of this Part is drawn from two of the Author's previous articles: Pomeroy, *Ending Surprise Liens*, *supra* note 13, and Chad J. Pomeroy, *The Shape of Property*, 44 SETON HALL L. REV. 797, 807–19 (2014) [hereinafter Pomeroy, *Shape of Property*]. These articles are the primary sources for this Part, both conceptually and through verbatim quotations of text and footnotes found in these articles. Throughout this Part, footnotes located within block quotations are the footnotes originally found in the text quoted in the above articles, with slight changes to comply with current citation requirements. Attribution to the original article source will be found at the end of the quotation.

59. *See* Pomeroy, *Ending Surprise Liens*, *supra* note 13, at 146 (discussing the trend of recording statutes, started in 1640, which provided notice for the public of interests in property).

60. *See id.* at 146 n.43, 147 (discussing the effect of and advantages of recording systems).

61. Pomeroy, *Shape of Property*, *supra* note 58, at 808.

provides adequate notice and information.[62] This system, discussed below, effectively ensures that people are not surprised by others' claims to title or right of encumbrance.

The only catch is that the system only works so long as the claims and rights at issue are widely understood.[63] Recovery fees—though not entirely new—probably do not qualify as being widely understood. This is because they constitute a variation on an old theme, which creates enough novelty and surprise to upend property's informational role.[64] Accordingly, these interests do present some dangers that legislators and academics would do well to consider.

A. *Information and Recording in the United States*

Covenants generally fit in nicely with the way the U.S. property law system currently operates, given the manner in which property rights function. Property is in rem (as opposed to in personam).[65] This means that property rights—that is, the entitlements of a particular owner of property—are defined in the context of the property owned, as opposed to being defined in the context of the owner of the property.[66] Accordingly, items of property must themselves effectively communicate an owner's rights and obligations to the world at large, as fixed rights flow from the property regardless of who owns it or what claims those owners make.[67]

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62. Pomeroy, *Ending Surprise Liens*, *supra* note 13, at 148.

63. Pomeroy, *Shape of Property*, *supra* note 58, at 808.

64. *See id.* at 808–09.

65. *See* Thomas W. Merrill & Henry E. Smith, *What Happened to Property in Law and Economics?*, 111 YALE L.J. 357, 359 (2001) [hereinafter Merrill & Smith, *What Happened*].

66. This conflicts with the view of property rights as a "bundle of rights." *Compare* JEREMY BENTHAM, THE LIMITS OF JURISPRUDENCE DEFINED 164 (Charles Warren Everett ed., Greenwood Press 1970) (1789), *and* ADAM SMITH, LECTURES ON JURISPRUDENCE 10 (R.L. Meek et al. eds., 1978), *with* Felix S. Cohen, *Dialogue on Private Property*, 9 RUTGERS L. REV. 357, 370 (1954) (characterizing property instead as an "exclusive right to control an economic good").

67. *See* Merrill & Smith, *What Happened*, *supra* note 65.

> In order to avoid violating another's property rights, [individuals] must ascertain what those rights are. In order to acquire property rights, [individuals] must measure various attributes, ranging from the physical boundaries of a parcel, to use rights, to the attendant liabilities of the owner to others (such as adjacent owners).

Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property:*

This is generally easy to accomplish if the interests at issue are well-known and if there is an efficient mechanism to communicate these interests. We will come back to the first of those two requirements momentarily. The second, however, is easily met because, in the United States, recording acts permit interested parties to assess and analyze potentially competing interests[68] in real property.[69] This happens as a result of the statutory schema inherent in the acts and as a result of tradition and common knowledge.

> The statutory schema rests upon written, public notice.
>
> The concept of recording written documents, tentatively begun in England, started to gain widespread acceptance and usage by colonial times.[70] America was founded at a time when the importance of land was shifting from its historical role of a font of family wealth and status to its modern role as a commodity to be bought and sold . . . .[71] This was particularly true in the new world, which was not bound by the contemporary mores and aristocratic values still prevalent in the old world.[72] . . . .
>
> [As this shift accelerated,] [i]ndividuals and entities increasingly required an efficient and reliable method to review prior conveyances. The fitful writing and notice requirements then available did not suffice, [as] few owners possessed a complete record of prior conveyances.[73] Even those who did could not be trusted to produce [a full list of

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The Numerus Clausus *Principle*, 110 YALE L.J. 1, 26 (2000) [hereinafter Merrill & Smith, *Optimal Standardization*].

68. *Interest* is meant broadly and includes both claims of ownership and claims of control.

69. Pomeroy, *Ending Surprise Liens*, *supra* note 13, at 182 (noting recording acts "require all parties to put the public on notice of their claimed interests").

70. Even prior to the Norman Conquest, there was a system of voluntary registration of land deeds overseen by local monasteries. John Hanna, *The Extension of Public Recordation*, 31 COLUM. L. REV. 617, 619–20 (1931). Recording, though, was not strictly mandatory, and there was no uniformity. *See id.* at 619–20.

71. Arthur R. Gaudio, *Electronic Real Estate Records: A Model for Action*, 24 W. NEW ENG. L. REV. 271, 272 (2002). This shift was only heightened by the widespread advent of mortgage liens, a direct outgrowth of the new view of land as a resource to be utilized commercially. *Id.*

72. The first known recordation in the United States occurred in 1627 at Plymouth Colony. Ray E. Sweat, *Race, Race-Notice and Notice Statutes: The American Recording System*, PROB. & PROP., May/June 1989, at 27, 27.

73. Gaudio, *supra* note 71.

relevant claims].[74]

It is in this context that colonial legislatures began to establish the first "American" land recording systems.[75] In 1640, the General Court of the Massachusetts Bay Colony adopted the first modern recording act. The act stated that an unrecorded instrument was good as between the parties even [if] not recorded, but required [the instrument] to be recorded within a specific amount of time to be good against unknowing third parties.[76] A full recitation of all relevant facts was not required, and only the essential elements of the conveyance (such as the name of the grantor and grantee, a description of the property and estate granted, and the date of transfer) had to be recorded.[77]

Though simple in nature, this represented an important change from the haphazard English system.[78] Public, written notice was no longer a matter of local custom or a technicality easily avoided if desirable. Under this new system, [one had to put others on notice of a conveyance in order to effectively transfer a defensible interest in real property]. [This was an important advancement, and it] provided the basis for the more sophisticated recording statutes of today.[79]

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74. *Id.*

75. *See id.* This intensified throughout the Industrial Revolution, which created an "unprecedented demand for credit" that eventually spread from real to personal property. *See* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 2.1 (5th prtg. 2007).

76. *See* 1 RECORDS OF THE GOVERNOR AND COMPANY OF THE MASSACHUSETTS BAY IN NEW ENGLAND, 1628-1641, at 306 (Nathaniel B. Shurtleff ed., 1853). . . .

77. Sweat, *supra* note 72, at 27–28.

78. These recording acts, while [supporting the informational nature of property] by publicly promulgating the type of information needed by third parties, were also likely viewed as revenue generating systems, as they effectively operated as a tax on conveyances . . . . Indeed, "there is a substantial direct cost associated with the filing systems required by the reporting acts . . . because many of these systems have filing fees and ultimately serve as direct revenue streams for county and other local governments. *See, e.g.*, Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 EMORY BANKR. DEV. J. 421, 484–85 (2005)." Pomeroy, *Ending Surprise Liens*, *supra* note 13, at 158 n.110.

79. Initially, a simple paper system whereby the recorder manually copied the transfer document into the records of the town or county was reasonably workable and sufficient to impart the requisite notice . . . . [A]s time has gone by, [however,] document records have multiplied, initially due to the passage of time and concomitant accumulation of transfers but increasingly due to the complicated and sophisticated nature of real property commerce and finance. *See* Gaudio, *supra* note 71, at 272–74.

Like much of real property law, the rules regarding recording are local. Most governing law is based on state statutes and state-court interpretations of these statutes.[80] There are, however, broad rules applicable across all jurisdictions.[81] In particular, there are three generic types of recording acts, known as "notice," "race-notice," and "race."[82] Under the notice acts, unrecorded conveyances are invalid against subsequent transferees without notice, regardless of who records first.[83] Under the race-notice acts, the subsequent transferees have priority only if they are without notice of the first transferee and they record first.[84] Finally, under the pure race-type acts, the subsequent transferees have priority if they record before the initial transferee, even if aware of the earlier conveyance.[85] This type of statute creates a "race to the courthouse."

Initially, recording acts were primarily of the race type, but most

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This complexity was initially addressed by the introduction of indices tied first to names and later to parcel numbers. *See id.* at 273. Recently, this complexity has been addressed with more efficient copying systems, computer databases, and Internet capabilities. Still, the basic goal and function of these systems remain the same: to publicize information regarding title to real property [and thus protect the informational requirements of an effective real property system].

80. Sweat, *supra* note 72, at 28.

81. *Id.*

82. *Id.*

83. These statutes generally read as follows: "No conveyance, transfer or mortgage of real property shall be good and effectual in law or equity against creditors or subsequent purchasers for a valuable consideration and without notice, unless the same be recorded." *Id.*

84. These statutes generally read as follows: "Every conveyance of real estate [that] shall not be recorded shall be void as against any subsequent purchaser in good faith, and for a valuable consideration of the same real estate or any portion thereof, whose conveyance shall be first duly recorded." *Id.*

85. These statutes generally read as follows: "No conveyance of land . . . shall be valid to pass any property interest as against a purchaser for valuable consideration . . . but from the time of recording." *Id.*

modern recording acts are of the notice type.[86][87]

Regardless of the type of recording act adopted, the intent (and clear practical effect) of these statutes is to protect subsequent transferees from hidden or unknown claims or interests.[88] So long as recovery fees are recorded, then all interested parties should have adequate knowledge and the informational element of property discussed above should be well served.[89]

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86. *Id.* . . . The different types of statutes may have a different effect on the subsequent transferees. For example, assume that Allison transfers Blackacre to Audrey for valuable consideration on January 1 and then again transfers Blackacre to Sophie for valuable consideration on February 1. Neither Audrey nor Sophie records their interest upon transfer, and Sophie has no notice of Audrey's interest. Under a race[-]type statute, if Audrey records first, she will have priority, even if she knows of the subsequent transfer to Sophie; likewise, if Sophie records first, she will have priority. Under a notice statute, Sophie will have priority, regardless of who records first, because, at the time of the transfer to her, Sophie had no notice and Audrey had not recorded. Finally, under a race-notice statute, Sophie will have priority only if she records first.

87. Pomeroy, *Ending Surprise Liens*, *supra* note 13, at 145–47.

88. Sweat, *supra* note 72, at 28.

> The effectiveness of recording statutes is further bolstered by bankruptcy protections afforded to creditors who properly record. Under the Bankruptcy Code, a trustee for a bankrupt debtor has the power to exploit defective filing by avoiding flawed transactions. *See* 11 U.S.C. § 544(a)(1) (2012). If avoided, the relevant property becomes available for distribution to all unsecured creditors. This is known as the "strong-arm power" and is borne from a concern about surprise liens. By affording a trustee the same rights as a hypothetical creditor in a hypothetical proceeding, Congress effectively ensured that the bankrupt estate will have the same rights as any other creditor. *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 18 (1973). This strong-arm power has only heightened the importance of the recording acts to interest holders whose rights are potentially voidable. *See, e.g.*, James J. White, *Revising Article 9 to Reduce Wasteful Litigation*, 26 LOY. L.A. L. REV. 823, 830–41 (1993).

Pomeroy, *Ending Surprise Liens*, *supra* note 13, at 147 n.51. On the other hand, recording acts do not alleviate all problems associated with conveyances of real property and may, in fact, create some problems. *See* Sweat, *supra* note 72, at 29–30. For example, though creating a uniform requirement for notice of some type, the recording acts do not necessarily specify what notice will be effective and what documents will provide that notice. As such, there is potential for various transferees, or ostensible transferees, to record varying types of documents and to create confusion and ambiguity for potential subsequent transferees. *See id.*

89. *See generally* Sweat, *supra* note 72 (concluding recording acts serve to "reward knowledge rather than putting a premium on ignorance").

And that is technically true.[90] However, there is often substantial space between "technical" and "practical." The reason for this space is that, as discussed above, property conveys information and recording acts work well when the interests at issue are well-known—when potentially interested parties understand the kind of interest that has been recorded and is thus being broadcast—and that is not precisely the situation here.[91]

B. *Imperfect Notice*

Recovery fees are new—to an extent.[92] Though they fall within the general oeuvre of traditional covenants, they create different consequences and are triggered under different circumstances than the kinds of covenants people are traditionally accustomed to seeing.[93] This novelty effectively undermines our notice system because new types of property undercut the in rem nature of property.[94] They make communication difficult because "third parties have to expend time and resources to gain . . . knowledge, and unusual [or new] property forms increase the cost of doing this."[95]

According to Merrill and Smith, these informational costs and burdens are legitimate drivers of normative analysis, generally, and judicial behavior, specifically.[96] More particularly, they claim that marginal informational costs of the type discussed above drive courts to apply what Merrill and Smith refer to as the ***numerus clausus***.[97] This theory seeks to explain why courts

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90. *See id.* at 28.

91. *See* Chad J. Pomeroy, *Why Is Property So Hard?*, 65 RUTGERS L. REV. 505, 528–29 (2013) [hereinafter Pomeroy, *Why Is Property So Hard?*]; *supra* Part III.A.

92. They are, so to speak, "newish."

93. *See supra* Part II.

94. *See supra* Part III.A.

95. Pomeroy, *Why Is Property So Hard?*, *supra* note 91, at 529. Merrill and Smith, who have written much on this topic in the context of the sorts of estates that are permitted under the law, focus on the costs borne by third parties. *See* Merrill & Smith, *Optimal Standardization*, *supra* note 67. They claim that "[p]roperty owners will not take . . . account of these . . . costs because they do not bear them . . . ." Pomeroy, *Why Is Property So Hard?*, *supra* note 91, at 529 n.107 (citing Merrill & Smith, *Optimal Standardization*, *supra* note 67, at 26–27). Accordingly, property "works" only when it is simple and standardized enough that all third parties can understand the rights that flow from property easily and with little or no cost. *Id.*

96. Merrill & Smith, *Optimal Standardization*, *supra* note 67, at 60.

97. *See id.* at 4. Merrill and Smith's *numerus clausus* theory attempts to explain why property law is uniquely uniform when it comes to the types of estates that courts will recognize. *See id.* at 69; *see also* Henry E. Smith, *Community and Custom in Property*, 10 THEORETICAL INQUIRIES L. 5, 35 (2009). Merrill and Smith claim that this is a "stealth

limit the forms (or estates) that property can take and posits that they do so because,

> limiting new forms of property [effectively] . . . guard[s] against the informational burdens that would proliferate if parties could create whatever property form they want to create.[98] Of course, this limitation of freedom causes frustration to society because people cannot create whatever property form they would like and are instead forced to conform their affairs and actions to the relatively limited suite of property forms that courts acknowledge and permit.[99]

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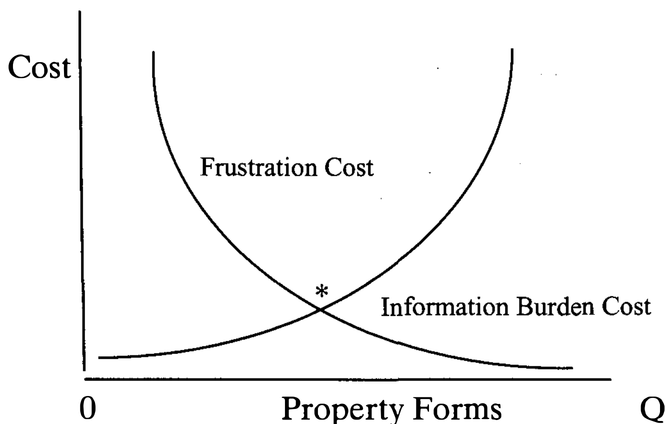
doctrine" and have largely developed it based on the case of *Johnson v. Whiton*. *See* Merrill & Smith, *Optimal Standardization*, *supra* note 67, at 22–24 (citing *Johnson v. Whiton*, 34 N.E. 542 (Mass. 1893)). The reason for this doctrine, Merrill and Smith claim, is that new property types create costs in excess of their benefits and that courts can, and should, refuse to recognize them. *See* Merrill & Smith, *Optimal Standardization*, *supra* note 67, at 7. According to Merrill and Smith, our courts do this *sub silentio*, without articulating or even acknowledging the *numerus clausus* doctrine. *See id.* at 20.

98. This judicial limitation permits everyone "to limit his or her inquiry to whether the interest does or does not have the features of [pre-existing] forms." Merrill & Smith, *Optimal Standardization*, *supra* note 67, at 33. "Perhaps the key point about the numerus clausus is informational: The forced standardization of property forms creates a kind of shorthand which, in turn, reduces information costs." Lipson, *supra* note 78, at 497. This prevents everyone from "mistakenly mak[ing] inconsistent uses of the asset or underus[ing] the asset." Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The* Numerus Clausus *Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. S373, S382 (2002). [There is good reason to think that this *numerus clausus* theory is an ultimately inaccurate explanation for our property system's closed approach to estates and property form.] *See* Pomeroy, *Shape of Property*, *supra* note 58, at 818 ("In the end, then, it appears that the numerus clausus, fashioned by Merrill and Smith as a remedy to informational overload that is uniquely applicable to property form, is a misdiagnosis and does not withstand theoretical scrutiny."). [It seems more likely, rather, that the *numerus clausus* is driven by feudal history. *See id.* at 819–30. But this criticism does not weaken the informational burden analysis underlying Merrill and Smith's explanation. *See id.* at 830. As such, analyzing recovery fees in the context of this analysis is still appropriate and instructive.]

99. *See* Merrill & Smith, *Optimal Standardization*, *supra* note 67, at 35. [A useful] way to understand [the limitations of] the numerus clausus doctrine is to . . . compare contract and property law. *See, e.g.*, Christina Mulligan, *A Numerus Clausus Principle for Intellectual Property*, 80 TENN. L. REV. 235, 237 (2013) . . . . [C]ontractual arrangements are highly customizable, while property arrangements are not. *See id.* at 237–38. This is because the default rules that govern contract law are generally alterable, whereas "a transfer of real or tangible property is forbidden unless the transfer is permitted by law and within one of 'a limited number of standardized forms.'" *Id.* at 238. When a court reviews a highly negotiated contract, it endeavors endlessly to divine the parties' intent. *See* Arthur L. Corbin, *The Interpretation of Words and the Parol Evidence*

> These opposing forces drive property law toward what Merrill and Smith call "optimal standardization," wherein the frustration costs and the information burden costs are balanced and so result in an "optimal" level of homogeneity.[100] This can be represented in graphic format:
>
> 
>
>
> "Here, the x-axis is the number of property forms allowed, the y-axis is cost incurred by society, and the two cost curves measure the social cost caused by unfettered freedom and the frustration costs caused by limits on agency."[101] The numerus clausus, in theory, balances these curves and so creates the "optimal" number of property forms that minimize the overall costs experienced by society at large.[102]

The idea is that * is the ideal number of property forms, as any number less than that (i.e., toward 0) involves a world where frustration costs exceed the informational burdens associated with the number of permissible forms, and any number more than that (i.e., toward Q) involves a world where the informational burdens associated with property forms exceed the frustrations costs (which are concomitantly lower, as Q grows).

This theory, then, is an excellent description of how additional

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Rule, 50 CORNELL L.Q. 161, 162 (1965). But "[w]hen parties try to enforce property rights that lie outside of the recognized forms, courts shoe-horn those rights into one of the existing forms." Mulligan, *supra* at 238 .... [T]his ... restriction on ... customization, so easily discerned when contrasted with contract law, ... [is] the numerus clausus.

100. *See* Merrill & Smith, *Optimal Standardization*, *supra* note 67, at 40.

101. .... This graph is derived from one created by Merrill and Smith, and I have used it a number of times in [various articles].

102. Pomeroy, *Shape of Property*, *supra* note 58, at 808–10.

property forms affect the larger property system (driving up cost) and an eloquent attempt to explain our limited set of estates.[103] It also nicely explains why recovery fees are not starkly problematic.

As discussed above, recovery fees are not new.[104] They are covenants, though perhaps by a different name and in a different context.[105] This means that they fall to the right of *, in the graph above, and that the informational burdens associated with their existence do not exceed the frustration costs associated with their prohibition. Indeed, proactively banning them would be a mistake, as it would frustrate parties and so unnecessarily restrict rights and the economic interests and benefits that flow therefrom.[106]

However, that does not mean that there are no issues associated with recovery fees. Given their relative novelty,[107] they likely fall very close to * on the graph above. They are a net positive to property law—but not by much—because the marginal informational burdens caused by their existence are high in general and high relative to their marginal decrease in frustration costs.

This is acceptable in an absolute sense and certainly indicates that recovery fees do not need to be prohibited. But it does not mean that the situation is perfect. There will still be a relatively high amount of confusion associated with recovery fees due to their relatively high informational burdens.[108] This is a kind of "imperfect notice," arising from the relatively

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103. *Id.* at 810, 810 n.63 ("I have generally referred to the 'numerus clausus' doctrine [in much of my writing] and have, more or less, entirely attributed it to Merrill and Smith. I think that is fair, given the enormous amount of attention they have brought to this concept . . . . It is worth mentioning, however, that theirs is not the only justification for the widely accepted idea that there is a 'closed number' of property forms in the common law system.").

104. *See supra* Part II.

105. *See supra* Part II.

106. *See* Merrill & Smith, *Optimal Standardization*, *supra* note 67, at 35–37; *supra* Part II.

107. Their "newishness."

108. This confusion will likely take the form of parties that purchase property subject to recovery fees unaware of what they are or the costs associated with them. Note that this is different than being completely unaware. The recording system, *see supra* Part III.A, will ensure that parties have notice (actual or constructive) of the recovery fees, and title insurance will generally protect against any problems with such notice. *See* John C. Murray, *Title and Survey Issues in Commercial Real Estate Transactions*, *in* UNDERSTANDING THE SOPHISTICATED REAL ESTATE TRANSACTION 2003, at 55, 57–59 (Peter A. Sarasek et al. eds., 2003) (indicating that title insurance indemnifies against the

new nature of recovery fees. Fortunately, there is a solution available that is short of flat prohibition, thus balancing parties' desire and need for flexibility and the potential costs associated therewith.

IV. A RESTRAINED SOLUTION

The solution is a simple one. Because the problem is not the recovery fee itself but the potential for surprise or confusion, the solution is to act to avoid such surprise or confusion. This can be done relatively easily, without prohibiting these kinds of covenants,[109] by making minor modifications to the current recording incentives applicable to covenants.

Pursuant to modern recording acts, property interests are generally recorded so that they may take effect against third parties.[110] This is true of recovery fees, of course, and they will almost always be duly recorded.[111] But, as described above, recovery fees may be novel enough that such

loss associated with nonconforming title). However, title insurance will not protect against noted exceptions, *id.* at 76–79, and a significant part of the concern regarding confusion is that parties simply will not understand a noted exception that relates to recovery fees. Thus, Mr. X could buy a home, purchase title insurance, and ultimately end up being subject to recovery fees he never anticipated or planned for.

109. Or, rather, without *attempting* to prohibit these sorts of covenants. *See supra* note 52 and accompanying text.

110. *See supra* Part III.A; *see also, e.g.*, Robert P. Hill, *Title Repositories, Recording, and Constructive Notice*, 29 ROCKY MTN. MIN. L. INST. 469, 476 (1983) ("Constructive notice (as used herein) is purely a creation of statute, and exists only for the purposes and to the extent provided in the applicable statute. In most cases, constructive notice is created by the proper recording of an instrument entitled to be recorded. Once such an instrument has been properly recorded, it gives notice of its contents to all persons, regardless of whether any particular person has actual knowledge thereof or even has reason or means to discover the existence of the document." (footnote omitted)). Indeed, recording is the predominant method of providing notice in the modern world. *See* Pomeroy, *Ending Surprise Liens*, *supra* note 13, at 147 (noting that most modern recording acts are of the notice type, which is why recording is so effective in protecting one's property claim). This is not an absolute rule, of course, and there are a number of property interests—such as adverse possession, implied easements, claims of which subsequent owners have actual or inquiry notice, and others—that take effect against third parties, even without recording. These kinds of interests are relatively rare in the modern world, however, and recovery fees do not fall within this category, in any event. As such, any person or entity desiring to enforce a recovery fee would certainly record it.

111. And, if they are not, they will not take effect and thus present no real issue. *See supra* Part III.A.

constructive notice ends up being unsatisfying in a systematic sense.[112] As such, the statutory scheme should require a recording of an explicit and specific document that clearly and plainly conveys what a recovery fee is, the magnitude of the recovery fee at issue, and the likely effect the recovery fee will have on the owner of the property.

This may seem somewhat redundant, as the recording system is built around notice, generally, and around the idea that recording will put all third parties on constructive notice, specifically.[113] Accordingly, everything that is recorded—including any document that provides for a recovery fee and attaches it to property—is public knowledge and so cannot legally surprise anyone. However, constructive knowledge is not actual knowledge, and, given the novelty discussed above, it makes sense to require a special, or exemplary, notification be filed on record so that there is no question about the nature of the fee and of its consequences.[114]

This sort of requirement would both satisfy the concerns of those who fear the potential surprise associated with recovery fees and the systemic pressure to permit efficient creativity and novelty.[115] Indeed, it is presumably for these reasons that California has adopted a statute of this nature. California's law specifically requires special notice of recovery fees—highlighted to ensure that it is noticeable and including explicit descriptions—and, in some circumstances, examples of how the fees would function.[116]

This, rather than outright prohibition, is the right result. It balances the traditional nature of these interests with the admittedly new manner in which they are applied, thus walking the line between over-regulation and under-protection. Such a system permits market participants to engage in free and open conduct within traditional boundaries, but in a manner that does not unduly surprise other property claimants.

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112. *See supra* Part III.B.

113. *See supra* text accompanying note 110.

114. The concept is akin to other requirements that certain rights or obligations be specially emphasized. *See, e.g.*, William H. Danne, Jr., Annotation, *Construction and Effect of UCC § 2-316(2) Providing that Implied Warranty Disclaimer Must Be "Conspicuous,"* 73 A.L.R.3d 248 *passim* (1976), Westlaw.

115. *See id.* To say nothing of the economic efficiency theoretically encompassed within a vehicle, such as this, which permits buyers and sellers to more finely dissect and parcel out development costs.

116. *See, e.g.*, CAL. CIV. CODE §§ 1098.5, 1102.6e (West 2017).

V. CONCLUSION

Recovery fees have received much negative publicity, but this criticism largely ignores the inherently traditional nature of these interests. They are mainly a kind of real covenant and, though fashioned in a new setting, fit well within this tradition. As such, they should neither be shunned nor prohibited, as is the current trend. That does not mean there is no need for any regulation, however. Given their relative novelty, it is reasonable to require special notice to ensure that these kinds of interests do not unduly interfere with market participants or their reasonable expectations. Requiring this sort of notice is sufficient and appropriate within our current U.S. property tradition.