Felhaber Larson Fenlon & Vogt
A Professional Association – Attorneys at Law
Issue 10 Fall 2007

REAL ESTATE REPORT

Published by the law firm of Felhaber, Larson, Fenlon & Vogt, P.A.

BUILDERS BEWARE: NEW HOME INCENTIVES MAY COST MORE THAN YOU THINK

With the recent decline in the housing market and no relief in sight, increasing numbers of builders are offering incentives to buyers. According to the National Association of Home Builders, in September of 2006, three out of four homebuilders were offering some type of incentive to buyers. This is an increase from the 58% offering incentives just one year earlier.

In an effort to compete for potential purchasers, builders are getting more creative with the incentives they are offering. Offering incentives is often more palatable to builders than lowering home prices by thousands of dollars. Recent incentives ranged from assistance with closing costs to free upgrades, boats, cars and vacations. For example, a builder recently offered a $125,000 Maserati with the purchase of a luxury townhouse worth $2.2 to 3.6 million. Hovnanian, a national builder based in New Jersey, offered finished basements for no extra charge and a $10,000 gift certificate to a furniture store. Their ad campaign was "You buy the home, we buy the furniture." Other builders have offered buyers a package of memberships to golf courses and country clubs.

Builders have reported some success in utilizing incentives. However, they should be cautious as these marketing tactics could end up costing more than just the price of the incentives. Consider the following hypothetical:

ABC Builders, Inc. is a local homebuilder that built and sold hundreds of homes during the housing boom. ABC now has inventory that it is having difficulty selling. ABC is spending thousands of dollars in carrying costs every month. ABC wants to move the homes quickly so it decided to offer various incentives to potential purchasers.

ABC is offering every buyer their choice of a finished basement, luxury vacation, or a plasma television. In addition, each person that signs a purchase agreement and deposits earnest money is entered into a drawing for a new sports car. Finally, ABC is offering $5,000 in upgrades to buyers that finance their home through XYZ Lending, a mortgage company owned by ABC.

With ABC's attractive incentives, its homes are selling like hotcakes. ABC is thrilled as the cost of the incentives is lower than the carrying costs of the homes. ABC appears to have discovered a cost effective method of selling its inventory. However, ABC may be unwittingly violating a number of state and federal laws and the incentives could end up costing more than ABC bargained for.

Real Estate Settlement Procedures Act (RESPA)

ABC's practices may draw scrutiny because at least one of its incentives is tied to the purchaser's use of ABC's mortgage company. Such arrangements are only proper if the incentive is legitimate and is not built into the price of the house or the cost of the loan. In addition, use of the affiliated mortgage company must be voluntary by the consumer. In addition, if builders offer incentives and then recover the cost by hiding it somewhere else in the transaction, they may be violating HUD regulations.

HUD identifies one of RESPA's key objectives as the elimination of kickbacks and referral fees in connection with the financing of residential real estate purchases. Many buyers are unfamiliar with the various charges associated with a real estate transaction. As a result, the opportunity exists for imposing inflated charges and the receipt of kickback compensation.

HUD has a RESPA investigative unit that is charged with investigating possible RESPA violations. HUD's RESPA investigative unit has increased its scrutiny of incentives offered by builders. HUD recently

BUILDERS BEWARE - continued on page 2

BUILDERS BEWARE - continued from page 1

bolstered its investigative staff to more than 20 and engaged the services of a private investigative firm. In addition, HUD has named Minnesota as one of a number of states where companies are being investigated for not complying with RESPA laws.

A violation of RESPA's anti-kickback provisions can carry stiff penalties, both civil and criminal. A person who is charged criminally with a violation of RESPA may be fined up to $10,000 and imprisoned for up to one year. A defendant in a civil lawsuit may be liable to the purchaser for three times the amount actually charged.

Most incentives will not fall within the scope of RESPA's anti-kickback provisions as long as the incentive is structured without the participation of real estate brokers, agents, or lenders originating loans. However, in situations like that faced by ABC, where the mortgage company is owned by the builder, a builder needs to be very cognizant of RESPA's requirements. As long as all fees and costs are appropriately disclosed to the purchaser, and the purchaser is not coerced into using ABC's mortgage company, ABC's upgrade package is a legitimate incentive.

Minnesota's Consumer Fraud Act/Deceptive Trade Practices

ABC's incentives may run afoul of Minnesota's consumer protection statutes which include the Consumer Fraud Act and the Deceptive Trade Practices Act. Essentially, the statutes prohibit misrepresentations in connection with the sale or advertisement of merchandise. Builders should be careful in making representations regarding the value of the property when they are offering significant incentives.

Builder incentives have a dollar value that must be accounted for in determining the true market price of the property. For example, if ABC's purchasers decide to take a luxury vacation worth $5,000, the market value of the home may actually be $5,000 less than the purchase price. Offering a purchaser a vacation without providing a discount on the purchase price can get ABC into problems with mortgage fraud in that the home is not actually worth the sale price on the open market.

Not every concession, however, means the home is less valuable. Those incentives that remain with the home, such as a finished basement, actually add value. The more troublesome incentives are those that can be removed from the home or are not part of the home to begin with, i.e. plasma television and luxury vacation.

In addition, ABC's representation that the incentives are "free" may not be entirely accurate. In reality, the cost of the plasma television, finished basement or luxury vacation may actually be built into the price of the home.

In all likelihood, the sale price for the home would be lower without the offered incentive. An unsophisticated consumer may not realize he or she is incurring additional debt to finance the cost of the "free" incentive.

The consumer fraud statute makes deceptive advertising a misdemeanor. In addition, it gives the attorney general the power to bring a lawsuit against the company making the deceptive statement. A builder that violates Minnesota's consumer protection statutes may also be forced to pay a civil penalty.

Minnesota's Gambling Laws

ABC's drawing for a new sports car may constitute a "lottery" and may violate Minnesota's gambling laws. Minnesota defines a lottery as a plan pursuant to which a reward is given to a person selected by chance from among participants, all of whom have given a consideration for the chance of being selected. The attorney general has opined that this includes the giving of a ticket representing a chance to get a prize with a purchase of merchandise. The key is that the game results in private pecuniary gain to the sponsors.

Here, ABC requires that purchasers sign a purchase agreement and pay earnest money to be eligible to win the sports car. The requirement that the purchase agreement be signed and earnest money paid is a requirement for payment of consideration. Such an incentive is a lottery under Minnesota law and is a misdemeanor.

FHA and Fannie Mae

ABC also has to be aware that its incentives may affect a buyer's eligibility for FHA and Fannie Mae loans. There are limitations on the amount of contributions an interested party can make to a transaction. Contributions include such things as money towards closing costs and paying down points on a mortgage. In addition, giving personal property such as furniture and automobiles is considered a contribution. If a

BUILDERS BEWARE - continued on page 6

CHANGES IN ENERGY USAGE

New Legislation and Regulations Spur Change in Ratepayer Use

Over the last two decades, ratepayers in Minnesota and in the greater Midwest have enjoyed favorably priced energy, in large part due to sufficient electric infrastructure and stable fuel costs. Infrastructure (transmission and baseload power plants) constructed mainly during the 1970s and early 1980s permitted growth without significant additional investment that would drive rates up. Fuel costs remained low and stable because the majority of our power came from coal and nuclear baseload resources. In the past few years, however, many property managers and owners have found that their energy prices, both gas and electric, have materially increased in cost and volatility. Recent experience indicates that stable rates will not be the rule moving forward, as several factors will likely drive costs up for the foreseeable future.

Among the reasons increased rates are likely: (1) consumer demand surpassed the capacity of infrastructure, requiring significant additions to transmission and generation resources; (2) fuel and power purchase prices have gotten much more volatile in recent years as there has been increased reliance on natural gas and other sources for power purchases, such as from wind resources; and (3) the passage of several pieces of new legislation will have a dramatic effect on the cost of electricity going forward. Included among the legislative changes: establishing a new Renewable Energy Standard of 25% by the year 2025 (30% for Xcel by 2020); passing new conservation or demand-side management goals for utilities mandating 1.5% annual reduction in demand from conservation/demand-side management efforts as opposed to what utilities have been currently achieving (5% to 1%); and Global Climate Change; Greenhouse Gas Emissions legislation, which creates an obligation to significantly reduce emissions during a period of increased demand for energy, which means adding baseload from generating resources other than those on which we traditionally rely.

Despite these factors, there are opportunities for ratepayers to save costs. First, companies making facility improvements through their utility's Conservation Improvement Program can boost energy efficiency and reduce energy costs. Second, companies can take advantage of favorable rates that are designed to help reduce total energy costs through interruptible electric rates or time-of-day rates if energy needs of the ratepayer can be flexible and they are able to cut back on demand or have back-up power that can be utilized during peak periods. Lastly, savings can be achieved through use of alternative sources of energy production. These options are discussed in more detail below.

Utility Conservation Improvement Programs (CIP)

Minnesota's regulated utilities have conservation improvement programs that are designed to help ratepayers conserve energy and improve efficiency of their properties. The Minnesota Department of Commerce (DOC) regulates CIP programs which offer rebates and reduced rates for customers. Additional information is available at the DOC website (www.state .mn.us/portal/mn/jsp/home.do?agency=Commerce) or through local electric and natural gas providers. Utility CIP programs change over time, but often include efficiency design assistance, rebates for replacement of inefficient motors and aid for changing to more efficient lighting options. As the utilities move toward compliance with the new and more aggressive 2007 legislation, business and commercial ratepayers can expect increased spending in these areas and an expansion of CIP programs, with more ratepayer specific opportunities.

Special Rates for Ratepayers with Flexibility.

Other options that allow ratepayers to save significant amounts include alternative rates for controlling demand/use through facility or production management. Some Minnesota utilities offer interruptible rates that provide discounts for ratepayers that are able to reduce or eliminate demand during peak periods of usage. That customer enjoys reduced rates even if they are not called on to reduce demand or be interrupted in any particular month. This is often achieved by production management that is scaled back or through use of back-up generators that can be called on by a utility a limited number of times per year. For example, ratepayers with back-up generators for reliability/safety purposes may be able to utilize those generators during peak

periods thus being "interrupted" which would give the ratepayer access to the preferred rates. Another option for demand-side management by a ratepayer is to control the time that its operations are running. An increasingly significant portion of a ratepayer's electric bill is the Fuel Adjustment Clause which passes through the cost of "fuel" that utilities offer time-of-day rates for the fuel portion of their bills. Ratepayers using more power during off-peak periods can capture savings due to reduced rates.

Other options

As the cost of electricity and natural gas goes up, many traditional utility customers opt for other sources to satisfy heat or steam/cogeneration needs. Several projects in the region have moved forward to reduce reliance on more traditional electric and natural gas resources. These projects include: (1) utilization of wood waste boilers by an industrial ratepayer that formerly purchased coal-based steam for heating and process needs; (2) a project for an industrial user to construct a facility and utilize biomass-based steam for use in electric production, in the manufacturing process and for heating needs; and (3) an educational facility that is testing use of biomass (agricultural waste) to fuel its cogeneration facility. Each of these examples demonstrates an opportunity which could also produce electricity which also allows a ratepayer to use a local utility's Distributed Generation rate. A Distributed Generation rate is designed to share the savings from reduced demand on the utility's system transmission and generation resources and allow the ratepayer to sell excess electricity to the utility.

Felhaber's attorneys have assisted clients with projects in each of these areas and have negotiated and drafted agreements with utility providers and otherwise have helped manage major energy construction projects, including the negotiation and drafting of grant contracts, development and construction contracts, management contracts and financing agreements.

Richard J. Savelkoul
651.312.6042
rsavelkoul@felhaber.com

REGISTER NOW!

Felhaber Builder Developer Seminar

Thursday, November 1, 2007
Town & Country Club - St. Paul, Minnesota
9:45 am-2:45 pm

Complimentary Breakfast & Luncheon

Please join us to learn about a broad array of legal issues that impact builders and developers today. We are pleased to offer this seminar free of charge to Felhaber clients and friends. Log on to www.felhaber. com to review the seminar agenda and the names of the presenters which include Felhaber attorneys and guest speakers.

Register Online:
Log on to **www.felhaber.com** and select **Builder Developer Seminar** on the home page.

Register by Phone or Email:
Please contact Kim Price at 651-312-6003 or kprice@felhaber.com.

MINNESOTA ADOPTS UNIFORM ENVIRONMENTAL COVENANTS ACT

Minnesota's adaptation of the Uniform Environmental Covenants Act (UECA), Minnesota Statutes Chapter 114E, became effective on July 1, 2007. The act provides clear rules for a perpetual real estate interest, an "environmental covenant", to regulate the use of brownfields when real estate is transferred from one owner to another.

Background

Environmental covenants under the UECA enable long-term enforcement of clean-up controls, such as restrictions on certain uses, prohibitions on using wells, protection of concrete "caps" and maintenance of monitoring equipment. An environmental covenant must be recorded in the real property records for the county in which the property is located and is binding on subsequent purchasers of the property.

The UECA protects valid environmental covenants from being inadvertently extinguished by application of various common law doctrines, adverse possession, tax lien foreclosures, less-restrictive zoning changes, and marketable title statutes. The UECA does not alter the priority of interests in real property in existence at the time an environmental covenant is created or amended. A person who owns a prior interest may, but is not required to, subordinate its interest to the covenant.

Statutory Requirements

The UECA provides that environmental covenants must contain certain items, such as:

(1) A statement on its first page that the instrument is an environmental covenant executed pursuant to Chapter 114E;
(2) A legally sufficient description of the real property subject to the covenant;
(3) A description of the activity and use limitations on the real property;
(4) The identity of every person who holds an interest in the real property subject to the covenant; and
(5) The name and location of any administrative record for the environmental response project reflected in the environmental covenant.

In addition, the environmental covenant must be signed and acknowledged by the environmental agency, every holder and every owner of the fee simple title to the real property subject to the covenant. In most cases, the Minnesota Pollution Control Agency (PCA) will be the environmental agency required to sign the covenant. However, another state or federal agency could be required to sign the covenant if another agency has determined or approved the environmental response project pursuant to which the covenant is created.

An environmental covenant may also include, among other things, requirements for periodic reporting describing compliance with the covenant; rights of access to the real property granted in connection with implementation or enforcement of the covenant; a description of the contamination and environmental response project; limitations on amendment or termination of the covenant; and any waiver of a party's right to consent to the amendment or termination of a covenant.

Conclusion

The UECA does not supplant or impose substantive cleanup standards or liability; rather it validates approved site-specific controls resulting from an environmental response project, and makes sure those controls are maintained as long as necessary to meet the objective for which they were approved.

Catherine L. Sjoberg
Editor
612.373.8536
csjoberg@felhaber.com

BUILDERS BEWARE - continued from page 2

buyer receives in excess of the maximum allowable contribution, the lender will be required to make a downward adjustment to the sales price of the property to reflect the amount of any contributions that exceed the limitations. The cost of contributions that are in the form of personal property always must be deducted from the sales price of the property. The maximum loan-to-value ratio must then be calculated based on the lesser of the reduced sales price or the appraised value. This, of course, may negatively impact a buyer's qualification for a loan.

Furthermore, any transaction involving undisclosed contributions is ineligible for FHA and Fannie Mae financing.

Conclusion

As builders are ratcheting up their promotional efforts, they must tread lightly to avoid unwittingly running afoul of state and federal regulations. Builders may want to consider providing their incentives to customers who have already closed on their homes in exchange for referrals. In that case, builders will not risk making representations that could be considered deceptive or false. No matter what a builder decides to do, the most prudent approach is contacting an attorney to ensure compliance with all regulations and to avoid paying more for incentives than they bargained for.

Marnie Fearon
612.373.8405
mfearon@felhaber.com

Real Estate Report

©2007 Felhaber, Larson, Fenlon & Vogt, P.A.

The Real Estate Report is an update on legal developments. It is not intended to be legal advice and should not be relied upon without consulting counsel.

www.felhaber.com

Felhaber Larson Fenlon & Vogt

220 South Sixth Street | Suite 2200
Minneapolis, MN 55402-4504