

PROMISING TO BE PRUDENT: A PRIVATE LAW
APPROACH TO MORTGAGE LOAN REGULATION IN
COMMON-INTEREST COMMUNITIES

*Julia Patterson Forrester and Jerome Michael Organ**

INTRODUCTION

From the beginning of the financial crisis through the end of 2010, approximately four million families lost their homes due to foreclosures.¹ While the loss of a home to foreclosure is clearly devastating to the homeowner, it also affects the neighbors,² particularly in common-interest communities where the homeowners are, in a sense, joint venturers in the community.³ First and foremost, studies have shown that foreclosures in a neighborhood decrease property values.⁴ Sales of foreclosed properties at fire sale prices reduce values as do homes that are left unsold and abandoned. Abandoned homes may stay empty for months or even years. They may be vandalized, stripped of appliances and fixtures, or occupied by squatters.⁵ Homeowners in common-interest communities are also affected when association dues remain unpaid. With fewer homeowners able to pay association fees to cover maintenance of common amenities, the remaining

* Julia Patterson Forrester, Professor of Law, Southern Methodist University Dedman School of Law, Dallas, Texas; J.D. 1985, B.S.E.E. 1981, The University of Texas at Austin. Jerome Michael Organ, Professor of Law, University of St. Thomas School of Law, Minneapolis, MN; J.D. 1985, Vanderbilt University Law School; B.A. 1982, Miami University. We wish to thank participants in the Joint Program of the Property and Real Estate Transactions Sections at the AALS 2012 Annual Meeting for their comments. We first discussed this Article after the 2007 Festschrift Symposium honoring Dale Whitman, and we would like to thank him, in particular, for his comments at the AALS Meeting. Professor Forrester thanks Laura Justiss for her assistance as a research librarian and SMU students Timothy Springer, Allyn Hurley, and Blake Redwine for their research assistance. Finally, Professor Forrester gratefully acknowledges support provided through the A.J. and Ann Van Wynen Thomas Memorial Endowed Research Award. Professor Organ thanks Debby Hackerson for her assistance as a research librarian and St. Thomas student Dina Nguyen for her research assistance. Professor Organ also expresses gratitude for the financial support of the St. Thomas Summer Research Grant Program.

¹ FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, at xv (2011), available at <http://www.gpoaccess.gov/fcic/fcic.pdf>.

² See G. THOMAS KINGSLEY ET AL., THE IMPACTS OF FORECLOSURES ON FAMILIES AND COMMUNITIES 13-21 (2009).

³ See *infra* notes 29-31 and accompanying text.

⁴ See, e.g., Jenny Schuetz et al., *Neighborhood Effects of Concentrated Mortgage Foreclosures 2* (N.Y.U. Ctr. for Law & Econ. Research Paper Series, Working Paper No. 08-41, 2008), available at <http://ssrn.com/abstract=1270121>.

⁵ FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at 10; KINGSLEY ET AL., *supra* note 2, at 16.

homeowners end up having to pay more for association fees at the same time that their property values are declining.⁶

Among the factors leading to the tidal wave of foreclosures was the proliferation of very risky home mortgage loans made to borrowers without the ability to pay, even at the outset.⁷ In the years leading up to the crisis, originations of high risk mortgages increased drastically from 12 percent of loan originations in 2000, totaling about \$125 million, to 34 percent of loan originations in 2006, totaling about \$1 trillion.⁸ A number of loan products that previously were not available or were rare became commonplace.⁹ The result was a dramatic increase in leverage and reduction in equity that made residential property ownership within common-interest communities more risky as an investment than at any time since the Great Depression.

This Article explores one possible private law prescription that may help common-interest communities avoid the financial disaster associated with foreclosure epidemics—a financing restriction that would limit (1) the ability of any homeowner in a common-interest community to borrow excessively against the value of her home, and (2) the ability of lenders to make loans that a homeowner does not have the ability to repay. Part I of this Article begins in the Great Depression with a discussion of *Neponsit Property Owners' Association v. Emigrant Industrial Savings Bank*,¹⁰ exploring how the case both fostered the development of common-interest communities and foreshadowed the current crisis in which common-interest communities find themselves. Part I also discusses reasons why common-interest communities may have evolved without the inclusion of a financing restriction. Part II explains the failure of the regulatory system to prevent the mortgage crisis and outlines recent regulatory changes. Part II also discusses the advantages of this private law approach in protecting common-interest communities. Part III analyzes the legal enforceability of a financing restriction, while Part IV outlines some of the practical challenges to implementing financing restrictions in the marketplace. Part V sets forth a proposed financing restriction for integration into the documents for common-interest communities.

⁶ See *infra* note 24 and accompanying text.

⁷ See FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at xxiii; U.S. DEP'T OF HOUS. & URBAN DEV., REPORT TO CONGRESS ON THE ROOT CAUSES OF THE FORECLOSURE CRISIS 25-26 (2010).

⁸ U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 20 (2011) [hereinafter WALL STREET AND THE FINANCIAL CRISIS].

⁹ See *id.* at 21.

¹⁰ 15 N.E.2d 793 (N.Y. 1938).

I. *NEPONSIT* AS CATALYST FOR THE DEVELOPMENT OF COMMON-INTEREST COMMUNITIES AND AS PREDICTOR OF THE CURRENT INSTABILITY WITHIN COMMON-INTEREST COMMUNITIES

The now famous New York Court of Appeals property law decision in *Neponsit* both solidified and foreshadowed the future of common-interest communities. *Neponsit* involved a claim by the Neponsit Property Owners' Association ("NPOA") against the Emigrant Industrial Savings Bank ("Bank") regarding past due assessments on a parcel to which the Bank had taken title through foreclosure.¹¹ At the time of the decision, the law regarding assessment covenants was unsettled.¹² Historically, courts in New York had held that assessment covenants—as affirmative covenants rather than negative covenants—did not “touch and concern” the land, and thus were not binding on successors,¹³ although in the years preceding *Neponsit*, decisions in lower courts found assessment covenants to be enforceable against successors.¹⁴ In addition, the case presented the question of whether the NPOA, as successor to the developer, had “privity” to enforce the assessment covenant against successor owners of lots burdened by the covenant.¹⁵

¹¹ See *id.* at 793-94; Stewart E. Sterk, *Neponsit Property Owners' Association v. Emigrant Industrial Savings Bank*, in *PROPERTY STORIES* 301, 308 (Gerald Korngold & Andrew P. Morriss eds., 2004).

¹² See *infra* notes 13-14 and accompanying text.

¹³ See, e.g., *Miller v. Clary*, 103 N.E. 1114, 1117 (N.Y. 1913) (finding an affirmative covenant to maintain and operate shaft connected to mill wheel not binding upon successors); *Crawford v. Krollpfeiffer*, 88 N.E. 29, 29 (N.Y. 1909) (holding affirmative covenant to contribute to cost of party wall did not run with the land to bind successors-in-interest); see also *infra* notes 117-29 and accompanying text for a discussion of the touch and concern requirement.

¹⁴ See, e.g., *Neponsit Prop. Owners' Ass'n v. Mayer*, 294 N.Y.S. 735, 735-36 (App. Div. 1937) (denying motion to dismiss claim to enforce a lien to recover annual assessment); *Lawrence Park Realty Co. v. Crichton*, 218 N.Y.S. 278, 279-80 (App. Div. 1926) (finding assessment covenant to maintain common parts of development enforceable against successor in interest).

¹⁵ *Neponsit*, 15 N.E.2d at 797. This question was complicated further in *Neponsit* because the NPOA did not hold title to any property in the development. The “common area”—a beach—had been condemned prior to the case by the City of New York. See *In re Pub. Beach*, 199 N.E. 5, 5 (N.Y. 1935); *In re Pub. Beach*, 17 N.Y.S.2d 2, 3 (App. Div. 1940). The NPOA ultimately received compensation of \$88,162.80 for the beach parcel. *Public Beach*, 17 N.Y.S.2d at 3. In addition, the City of New York already had assumed responsibility for maintaining the streets in the subdivision. See Sterk, *supra* note 11, at 307. Notably, this assumption of maintenance responsibilities by the City of New York runs contrary to the modern view that the growth in common-interest communities has arisen partly in response to “load-shedding” by municipalities seeking to shift maintenance responsibilities to homeowners' associations. Paula A. Franzese & Steven Siegel, *Trust and Community: The Common Interest Community as Metaphor and Paradox*, 72 MO. L. REV. 1111, 1112 (2007); James L. Winokur, *Critical Assessment: The Financial Role of Community Associations*, 38 SANTA CLARA L. REV. 1135, 1138-39 (1998).

The *Neponsit* court held that the assessment covenant did touch and concern the land.¹⁶ In addition, the court concluded that the NPOA could enforce the covenant because “in substance, if not in form, there is privity of estate between the plaintiff and the defendant.”¹⁷

The decision solidified the future of common-interest communities by paving the way for courts across the country to decide that assessment covenants could be enforced not only against original purchasers in common-interest communities, but also against successors-in-interest who purchased with notice of the assessment covenant.¹⁸ This meant that common-interest communities, with amenities available to all owners of land within the community, would have the ability to assess each landowner, including successor landowners, for the costs associated with maintaining the amenities without being concerned about free-rider problems resulting in some landowners incurring disproportionate maintenance costs.¹⁹ By creating a legal regime in which all involved in a common-interest community could have certainty about maintenance costs for amenities being shared across all owners within the community, *Neponsit* made possible the dramatic expansion of common-interest communities from relatively few as of the 1930s, to nearly 500 as of 1962, to 15,000 as of 1973,²⁰ and to more than 300,000 today.²¹

The decision foreshadowed the future of common-interest communities because it arose during the Great Depression when banks were taking title to many properties as a result of foreclosures,²² a circumstance plagu-

¹⁶ *Neponsit*, 15 N.E.2d at 797; see also *infra* notes 117-29 and accompanying text for a discussion of the touch and concern requirement.

¹⁷ *Neponsit*, 15 N.E.2d at 798; see also *infra* notes 130-37 and accompanying text for a discussion of privity.

¹⁸ See, e.g., *Adaman Mut. Water Co. v. United States*, 278 F.2d 842, 849 (9th Cir. 1960); *Burton-Jones Dev., Inc. v. Flake*, 117 N.W.2d 110, 117 (Mich. 1962).

¹⁹ If assessment covenants were not binding on successors, then over time, as lots change hands, the dwindling number of original purchasers would bear increasing shares of the maintenance costs absent voluntary contributions by those successors not legally bound to contribute to the maintenance costs.

²⁰ Sterk, *supra* note 11, at 321-22; see also EVAN MCKENZIE, *PRIVATOPIA: HOMEOWNER ASSOCIATIONS AND THE RISE OF RESIDENTIAL PRIVATE GOVERNMENT* 11 (1994).

²¹ Casey Perkins, Note, *Privatopia in Distress: The Impact of the Foreclosure Crisis on Homeowners' Associations*, 10 NEV. L.J. 561, 563 (2010) (citing *Industry Data*, COMMUNITY ASS'NS INST., <http://www.caionline.org/info/research/pages/default.aspx> (last visited Feb. 22, 2012)) (noting that in 1990 there were 130,000 association-governed communities with 29.6 million residents, but that by 2010 that had grown to over 300,000 association-governed communities in which an estimated 60 million Americans lived).

²² Sterk, *supra* note 11, at 319; Price V. Fishback et al., *The Influence of the Home Owners' Loan Corporation on Housing Markets During the 1930s*, at 6 (Nat'l Bureau of Econ. Research, Working Paper No. 15824, 2010), available at <http://www.nber.org/papers/w15824> (noting that in the first few years of the Great Depression, from 1929-1933, housing prices fell 30 to 40 percent, resulting in “a sharp rise in mortgage foreclosures”).

ing innumerable common-interest communities today.²³ The mortgage crisis that erupted in 2007, which has precipitated one of the longest and deepest recessions since the Great Depression, has exposed the surprisingly fragile financial balance of large numbers of common-interest communities, many of which have already tipped into a downward spiral of declining home values, foreclosures, unpaid assessments, and deteriorating common assets.²⁴

At a simple level, the common-interest community is designed to provide price support to purchasers within a residential community by giving them confidence that their investment in a home will not be eroded by inconsistent land uses.²⁵ This is manifested both by restrictions prohibiting nonresidential or noxious uses of property within a common-interest community²⁶ as well as by mandates that residential structures comply with minimum standards for size of house and for aesthetic aspects of the residential structure and associated landscaping.²⁷

At a more complex level, the common-interest community is designed to provide added value to purchasers by giving purchasers access to amenities owned in common that each homeowner can enjoy for a fraction of the

²³ See Perkins, *supra* note 21, at 562, 567-68. Due to a rash of foreclosures, common-interest communities must defer or even cut homeowners' associations services, such as landscaping services, for example. See, e.g., Kristen Mack, *Associations Suffer as Homeowners Do*, WASH. POST, Oct. 5, 2008, at C1, C4; Paul Owers, *Foreclosed Units Are Not Paying Association Fees*, SUN-SENTINEL (FLA.), Feb. 24, 2009, at 1, available at http://articles.sun-sentinel.com/2009-02-24/business/0902230565_1_condo-homeowner-associations-property-owners; Elizabeth Razzi, *Foreclosures Pick Pockets of Homeowners Associations*, WASH. POST, Nov. 9, 2008, at F5.

²⁴ See, e.g., Perkins, *supra* note 21, at 562-68. Due to foreclosures, there is a significant increase in the costs for services homeowners' associations provide as the homeowners' associations deal with loss of income from foreclosed properties, forcing residents to choose between self-help remedies to assure maintenance of properties or devaluation of their own property. See, e.g., Margaret Jackson, *Foreclosures Eat at HOAs*, DENVER POST, Mar. 22, 2009, at 1K; Owers, *supra* note 23, at 1; Kevin Turner, *Toll of Homeowners Fees*, TIMES-UNION (FLA.), July 6, 2009, at C-1; Dennis Wagner, *Skipped Dues Crunch Home Associations*, USA TODAY, May 27, 2008, at 4B.

²⁵ Franzese & Siegel, *supra* note 15, at 1112; see also EDWARD E. CHASE & JULIA PATTERSON FORRESTER, PROPERTY LAW CASES, MATERIALS, AND QUESTIONS 877-78 (2d ed. 2010) (citing RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 1.8 & ch. 6, intro. note (2000)); R. WILSON FREYERMUTH ET AL., PROPERTY AND LAWYERING 583 (3d ed. 2011); Razzi, *supra* note 23, at F5.

²⁶ See, e.g., *Gabriel v. Cazier*, 938 P.2d 1209, 1211 (Idaho 1997) (ruling on covenants restricting "business or trade or offensive or noxious activity" (internal quotation marks omitted)); *Boyles v. Hausmann*, 517 N.W.2d 610, 613 (Neb. 1994) (describing a covenant prohibiting junk cars, shacks, and temporary structures, and restricting type and number of animals).

²⁷ See, e.g., *Fink v. Miller*, 896 P.2d 649, 651 n.1 (Utah Ct. App. 1995) (noting a covenant requiring wood shingles on exterior roofs); *Hausmann*, 517 N.W.2d at 613 (describing a covenant mandating minimum size of ground floor living space and prohibiting preconstructed dwellings); Sterk, *supra* note 11, at 302 (discussing covenants in *Neponsit*, which included covenants mandating light colors and tile roofs for houses).

cost that would be associated with creating and maintaining such amenities individually.²⁸

At heart, then, these common-interest communities are inherently “joint ventures” in the sense that each purchaser buying into the community is relying on the financial wherewithal of each other purchaser within the community over time to assure both that each property is well-maintained (so as not to erode the value of neighboring parcels) and that each property owner can contribute his or her share to the costs of maintaining the common amenities that add value to everyone’s property.²⁹ One might think that joint venturers, whose financial security in their “investment” in real estate within a common-interest community is inextricably linked with the financial well-being of other joint venturers, might develop a process of assuring the financial well-being of other joint venturers or at least constraining the extent to which purchasers may borrow against the value of their parcel. But with the exception of cooperatives—a somewhat distinctive form of common-interest community more prevalent in New York City³⁰—common-interest communities generally have not imposed any restrictions on the extent to which purchasers of parcels within the common-interest communities can borrow against the value of the parcel.³¹

There would appear to be several reasons for the absence of a financing restriction constraining the ability of purchasers to borrow against the value of the parcel. First, the developer of the community typically drafts the covenants, conditions, and restrictions (“CCRs”) that apply within a common-interest community before any of the owners of parcels within the community become owners.³² The developers have an interest in selling off the lots within their development as quickly as possible so that they can generate cash flow and pay off any financing involved in launching the development. Developers, therefore, arguably have an interest in proposing CCRs that are perceived to meet the desires of prospective purchasers (i.e.,

²⁸ See, e.g., Sterk, *supra* note 11, at 302-03 (discussing the beach and parks that would be available to all residents of the Neponsit community); Razzi, *supra* note 23, at F5. These amenities might include a park, a pond and beach, a playground, walking trails or other recreational features in suburban developments with free-standing houses. In condominiums, the amenities might also include services as well, such as maintenance and security personnel and laundry facilities.

²⁹ See MCKENZIE, *supra* note 20, at 9.

³⁰ Michael H. Schill et al., *The Condominium Versus Cooperative Puzzle: An Empirical Analysis of Housing in New York City*, 36 J. LEGAL STUD. 275, 282 (2007) (noting that in a housing cooperative, the cooperative corporation “typically requires a prospective owner to apply to the board of directors before a sale can be consummated. The board will require the proposed purchaser to submit detailed financial statements and letters of recommendation and attend an interview. Cooperative corporations also frequently limit the amount of debt an owner may secure with his or her shares” in the cooperative corporation).

³¹ See *id.* at 281-82 (noting that the financial constraints of cooperatives are not generally found in other common-interest communities such as condominiums).

³² Franzese & Siegel, *supra* note 15, at 1127-29 (discussing the developer’s role in “dictating” CCRs); see also MCKENZIE, *supra* note 20, at 127.

to “attract” a significant population of prospective purchasers) without unduly constraining the universe of such purchasers.³³ Given that a financing restriction constraining the amount a purchaser could borrow against a parcel would inherently limit the universe of prospective purchasers, the developer likely would not decide to insert a financing restriction because the short-term “cost” of such financing restrictions to the developer would outweigh any perceived value to the purchasers. This outcome is likely even if a developer had considered the possibility of a financing restriction because of its potential long-term value to the purchasers of parcels within the development.

Second, from the early 1960s through the 1970s, when there was significant growth in the development of common-interest communities, “families wishing to buy a home typically went to a local bank or mortgage company, applied for a loan and, after providing detailed financial information and a down payment, qualified for a 30-year fixed rate mortgage.”³⁴ Because most lending occurred on a local level and “[t]he local bank or mortgage company then typically kept that mortgage until the homeowner paid it off, earning its profit from the interest rates and fees paid by the borrower,”³⁵ the lender retained the risk associated with the loan, giving other homeowners in a common-interest community comfort that their joint venturers were not likely to be over-leveraged on their properties.

Until a significant secondary market developed for the purchase of conventional loans (loans not insured by FHA or guaranteed by VA), savings and loans would originate loans from their deposits and hold the loans until they were paid off or foreclosed.³⁶ The size of the secondary market increased with the advent of securitization, which created new sources of funds for home mortgages. Ginnie Mae and Freddie Mac first securitized

³³ See Franzese & Siegel, *supra* note 15, at 1128 (noting that developers are interested in generating profit in the short term, not necessarily assuring maintenance of amenities in the long term).

³⁴ WALL STREET AND THE FINANCIAL CRISIS, *supra* note 8, at 17. During this period most home purchases were financed by thirty-year, fully-amortized loans. GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 11.4, at 949-50 (5th ed. 2007).

³⁵ WALL STREET AND THE FINANCIAL CRISIS, *supra* note 8, at 17; see also Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1323 (2006). Depository institutions, primarily savings and loans, made most home mortgage loans through the end of the 1970s. *Id.*; see also Cathy Lesser Mansfield, *The Road to Subprime “HEL” Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 498 n.155 (2000) (citing 125 CONG. REC. 29,930 (1979) (statement of Sen. Morgan) (stating that savings and loans made about 60 percent of all home mortgage loans up to 1979)); David F. Seiders, *Recent Developments in Mortgage and Housing Markets*, 65 FED. RES. BULL. 173, 178, 179 tbl.6 (1979) (finding that in 1978 savings and loans made half of all home mortgage loans).

³⁶ See Forrester, *supra* note 35, at 1323. Congress created Freddie Mac in 1970 as a secondary market facility for savings and loans. See NELSON & WHITMAN, *supra* note 34, at 933. At the same time, Congress gave Fannie Mae authority to purchase conventional home mortgage loans. See Forrester, *supra* note 35, at 1355.

home mortgage loans in the early 1970s.³⁷ Securitizations in the private sector began in significant numbers in the late 1970s after rating agencies began rating privately issued mortgage-backed securities.³⁸ Only with the growth in securitization did homeowners in common-interest communities really need to begin being concerned that financial institutions lending money would not be indirectly protecting them from over-leveraged joint venturers.

Moreover, in the 1960s and 1970s, home equity loans were less common than they became during and after the 1980s, so the risk associated with heightened leverage from “cash-out” mortgages was less manifest in the 1960s and 1970s than it would become in the 1990s and 2000s.³⁹

Finally, through the 1950s and 1960s, real estate in most areas of the country was appreciating, but not appreciating so rapidly as to create a fear of a boom-bust cycle.⁴⁰ The national median home value, without adjusting for inflation, grew from \$7,354 in 1950 to just \$17,000 in 1970, a rate of

³⁷ Forrester, *supra* note 35, at 1325 (citing STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* § 1:2, at 1-7 to -9 (Alan D. Ford ed., 3d ed. 2002)); Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1384-85 (1991). Fannie Mae began securitizing home mortgage loans in the 1980s. Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077, 1082 (2007) (citing Andrew R. Berman, “Once a Mortgage, Always a Mortgage”—*The Use (and Misuse) of Mezzanine Loans and Preferred Equity Investments*, 11 STAN. J.L. BUS. & FIN. 76, 92 (2005), and Shenker & Colletta, *supra*, at 1385).

³⁸ See Forrester, *supra* note 35, at 1326 (citing Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 537 (2002), and Comm. on Bankr. & Corporate Reorganization of the Ass’n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 537 (1995)).

³⁹ Total home equity debt in 1981 was \$60 billion, but by 1991, it had increased to \$357 billion. U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-93-63, *TAX POLICY: MANY FACTORS CONTRIBUTED TO THE GROWTH IN HOME EQUITY FINANCING IN THE 1980S*, at 12 fig.4, 14 fig.6 (1993). The growth rate for home equity loans from 1981 to 1991 was on average about 20 percent each year, while other consumer debt grew by only 4% per year during the same period. *Id.* at 1. Among the reasons for the increase in home equity financing were changes in tax law that made home equity interest deductible and other consumer interest nondeductible, appreciation in home values, deregulation in the financial services industry, and aggressive marketing by lenders. See *id.* at 1, 19. See generally Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government’s Promotion of Home Equity Financing*, 69 TUL. L. REV. 373 (1994) (discussing reasons for the increase in the amount of home equity financing). In 1989, the median down payment for purchasing a residential home was 20 percent—by 2007, the median down payment had declined to 9 percent, meaning home purchasers were significantly more leveraged. See Dennis Cauchon, *Why Home Values May Take Decades to Recover*, USA TODAY, http://i.usatoday.net/news/graphics/housing_prices/home_prices.pdf (last visited Feb. 22, 2012) (including chart showing median down payment for home purchases in 1989 and in 2007).

⁴⁰ See *Historical Census of Housing Tables: Home Values*, U.S. CENSUS BUREAU, <http://www.census.gov/hhes/www/housing/census/historic/values.html> (last revised Oct. 31, 2011).

appreciation of less than 5 percent per year.⁴¹ Because this was a period of relatively stable land values, neither developers nor purchasers had reason to be concerned significantly about the profound price deflation reflected in the current “boom-bust” cycle and the corresponding increase in foreclosures from having properties that were “upside-down” or “underwater.”⁴²

Thus, when the majority of CCR documents were being created and recycled around the country,⁴³ there were few reasons for developers to consider a financing restriction and few reasons for purchasers of parcels within a common-interest community to have serious concerns about the financial stability of their other joint venturers. Purchasers could rely on the existing financial mortgage regime to constrain excessive financial risk-taking by residential property owners and did not need to consider whether to amend CCR regimes to constrain the financial flexibility of parcel owners within the common-interest community.

As a result, the system of CCRs in place throughout much of the country evolved in a way that gave purchasers within common-interest communities a significant independence and autonomy regarding the extent to which they wanted to use their parcel as a financial resource by borrowing against the value of the parcel.⁴⁴ This independence and autonomy is largely responsible for the present chaos many common-interest communities are experiencing as significant numbers of homeowners in the last decade took advantage of a rising market aided by generous financing/refinancing options resulting in excessive leverage in many situations.⁴⁵ The next Part of this Article explains in more detail the regulatory structure for home mortgages in the 1990s and 2000s and describes why that regulatory structure in a changing economic environment failed to protect the average owner within a common-interest community from the financial excesses of his or her joint venturers.

⁴¹ *Id.*; see also Cauchon, *supra* note 39 (including chart showing average home price between 1950 and 2008 adjusted for inflation, which showed appreciation of about one-half of one percent per year).

⁴² Between 1979 and 2002, the percentage of mortgages that were delinquent or in foreclosure hovered between roughly 5 percent and 7 percent, but by 2008 the percentage of mortgages that were delinquent or in foreclosure had skyrocketed to 10 percent. See Cauchon, *supra* note 39 (including chart showing percentage of delinquent mortgages). The percentage of delinquent mortgages grew even worse in 2009, rising as high as 14 percent by the end of 2009. Julie Haviv, *Mortgage Delinquencies Rise to Nearly 14 Percent*, REUTERS (Mar. 25, 2010, 5:43 PM), <http://www.reuters.com/article/2010/03/25/us-usa-financial-mortgages-idUSTRE62O3UA20100325>. As of 2009, nearly one-quarter of homes were considered “underwater”—meaning that the amount owed on the mortgage was more than the value of the home. Lee Anne Fennell & Julie A. Roin, *Controlling Residential Stakes*, 77 U. CHI. L. REV. 143, 147 (2010) (internal quotation marks omitted).

⁴³ MCKENZIE, *supra* note 20, at 43-44, 145 (describing the extent to which CCR documentation was “recycled” during the period of dramatic growth in common-interest communities).

⁴⁴ See Schill et al., *supra* note 30, at 282 (noting that condominium agreements generally do not include the financial restrictions found in cooperatives).

⁴⁵ See Cauchon, *supra* note 39.

II. THE FAILURE OF THE REGULATORY STRUCTURE TO PROTECT HOMEOWNERS IN COMMON-INTEREST COMMUNITIES

A. *Regulatory System of the 1990s and 2000s*

The federal and state regulatory regimes governing home mortgage lending in the 1990s and the early part of this century were grossly ineffective. The proliferation of securitization greatly increased the availability of subprime credit. For various reasons, lenders made home mortgage loans that borrowers did not have the ability to repay,⁴⁶ and when falling real estate values made it difficult for borrowers to refinance or sell their homes, the huge rash of foreclosures began.⁴⁷ Federal and state regulation failed to prevent lenders from making loans to borrowers that the borrowers could not afford.

In response to concerns about the proliferation of predatory lending practices,⁴⁸ Congress passed the Home Ownership and Equity Protection Act (“HOEPA”) of 1994.⁴⁹ HOEPA required additional disclosures for “high-cost” loans, as defined by the Act.⁵⁰ In addition, HOEPA prohibited certain unfair terms in high-cost loans, including prepayment penalties in certain circumstances,⁵¹ increased interest rate on default,⁵² balloon payments less than five years after loan closing,⁵³ and negative amortization.⁵⁴ It also prohibited lenders from engaging “in a pattern or practice” of making high-cost loans without regard to the borrower’s ability to repay.⁵⁵ HOEPA, however, was narrow in its scope, excluding purchase-money mortgages, reverse mortgages, and home equity lines of credit.⁵⁶ Furthermore, lenders could, and did, avoid the requirements of HOEPA by making loans with interest rates and fees just under the trigger amounts for a high-

⁴⁶ See *infra* note 79.

⁴⁷ See FIN. CRISIS INQUIRY COMM’N, *supra* note 1, at 391-92.

⁴⁸ See *id.* at 76; see also Forrester, *supra* note 35, at 1316; Forrester, *supra* note 39, at 443.

⁴⁹ Home Ownership and Equity Protection Act, Pub. L. No. 103-325, §§ 151-58, 108 Stat. 2160, 2190-98 (codified as amended in scattered sections of 15 U.S.C.).

⁵⁰ 15 U.S.C. § 1602(aa) (2006) (amended 2010). The Dodd Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank”) amended the definition and added new prohibitions and requirements. See *infra* notes 102-06 and accompanying text.

⁵¹ *Id.* § 1639(c).

⁵² *Id.* § 1639(d).

⁵³ *Id.* § 1639(e).

⁵⁴ *Id.* § 1639(f). A loan that provides for unpaid interest to be added to principal, either by its terms or at the option of the borrower, is called a “negative amortization” loan because the principal initially increases rather than being paid down. See NELSON & WHITMAN, *supra* note 34, at 954.

⁵⁵ 15 U.S.C. § 1639(h).

⁵⁶ 12 C.F.R. § 226.32(a)(2) (2011).

cost loan,⁵⁷ making the Act ineffective to combat problems in the subprime mortgage market.

Beyond having inadequate legislation at the federal level, the federal government preempted states' ability to enforce effective state legislation to a great extent. The Depository Institutions Deregulation and Monetary Control Act⁵⁸ preempts state usury ceilings on any "federally related mortgage loan" secured by a first lien on residential real estate.⁵⁹ Thus, with some exceptions, states are not allowed to regulate interest rates on first lien home mortgage loans.⁶⁰ The Alternative Mortgage Transaction Parity Act ("Parity Act")⁶¹ preempted state laws that restrict alternative mortgage transactions,⁶² including adjustable rate mortgages ("ARMs"), loans with balloon payments, and negative amortization loans.⁶³ As a result, lenders could lure homeowners into loans that were initially affordable, but had back-loaded costs, such as loans with no down payment, with an initial low teaser interest rate that would escalate after a couple of years, with only interest due for an initial period, or with negative amortization. In fact, the Federal Reserve estimated that three-quarters of securitized subprime loans originated between 2004 and 2006 were ARMs with low teaser interest rates that would escalate after two or three years.⁶⁴

In addition to federal statutes that preempted state law, federal regulatory agencies preempted state consumer protective measures.⁶⁵ The Office of Thrift Supervision ("OTS") issued regulations in 1996 that preempted state laws "affecting the operations of federal savings associations,"⁶⁶ in-

⁵⁷ See *Legislative Solutions to Abusive Mortgage Lending Practices: Joint Hearing Before the Subcomms. on Hous. & Cmty. Opportunity & Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 37 (2005) [hereinafter *Hearing on Legislative Solutions*], available at <http://www.gpo.gov/fdsys/pkg/CHRG-109hrg29453/pdf/CHRG-109hrg29453.pdf> (statement of Stella Adams, Board Member, National Community Reinvestment Coalition) (explaining the downside of not including certain premiums and penalties in the trigger); U.S. DEP'T OF TREASURY & U.S. DEP'T OF HOUS. & URBAN DEV., JOINT REPORT ON RECOMMENDATIONS TO CURB PREDATORY HOME MORTGAGE LENDING 85 (2000), available at <http://archives.hud.gov/reports/treasrpt.pdf>; Forrester, *supra* note 35, at 1317.

⁵⁸ Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified as amended in scattered sections of 12 U.S.C.).

⁵⁹ 12 U.S.C. § 1735f-7a(a)(1) (2006) (internal quotation marks omitted).

⁶⁰ *Id.* § 1735f-7a.

⁶¹ Pub. L. No. 97-320, §§ 801-807, 96 Stat. 1469, 1545-48 (1982) (codified as amended in scattered sections of 12 U.S.C. § 3801).

⁶² 12 U.S.C. § 3803 (amended 2010).

⁶³ See *id.* § 3802(1) (defining "alternative mortgage transaction" (internal quotation marks omitted)). Dodd Frank amended the definition of "alternative mortgage transaction." See *infra* note 156.

⁶⁴ See *Truth in Lending*, 73 Fed. Reg. 1672, 1674 (proposed Jan. 9, 2008).

⁶⁵ See 12 C.F.R. § 560.2(a) (2005).

⁶⁶ *Id.* The regulations were issued pursuant to the Home Owners' Loan Act. See generally 12 U.S.C. §§ 1461-68. Dodd Frank eliminated the OTS, giving authority to regulated savings and loans to the OCC. See *infra* note 96.

cluding state laws that imposed requirements regarding licensing, credit terms, loan fees, disclosure requirements, origination, and interest rate ceilings.⁶⁷

Subsequently, the Office of the Comptroller of the Currency (“OCC”) issued a regulation preempting state laws governing mortgage lending as applied to national banks and their operating subsidiaries.⁶⁸ The regulation preempted state law limitations on licensing and registration, insurance requirements, loan-to-value ratios, amortization, payments, term, escrow accounts, disclosures, due on sale clauses, and other matters.⁶⁹ In addition, OCC regulations gave the OCC exclusive visitorial authority over national banks.⁷⁰ The OCC, thus, had exclusive authority to initiate either administrative or judicial proceedings to enforce state law against national banks as well as against their operating subsidiaries.⁷¹

The federal government preempted state law, but failed to provide a strong alternative.⁷² The Federal Reserve had the power to set prudent lending standards applicable to all mortgage lenders but failed to do so.⁷³

In addition to a weak federal regulatory scheme and extensive federal preemption of state regulatory regimes, the federal government failed to enforce even those laws it had available to prevent predatory lending and other practices that eventually led to high foreclosure rates.⁷⁴ The FTC had authority to enforce HOEPA and other statutes aimed at protecting consum-

⁶⁷ 12 C.F.R. § 560.2(b). The regulation did not preempt state laws that “only incidentally affect the lending operations of Federal savings associations,” such as contract and commercial law, real property law, tort law, and criminal law. *Id.* § 560.2(c). However, the regulation provided that it “occupie[d] the entire field of lending regulation for federal savings associations,” *id.* § 560.2(a), and it applied to operating subsidiaries of federal savings associations as well, *id.* § 559.3(h)(1).

⁶⁸ Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1917 (Jan. 13, 2004) (codified at 12 C.F.R. § 34.4 (2005)). The OCC described its regulations as having the same preemptive effect as the OTS regulations. *See* Bank Activities and Operations; Real Estate Lending and Appraisals, 68 Fed. Reg. 46,119, 46,129 n.91 (proposed Aug. 5, 2003); News Release, Comptroller of the Currency, OCC Issues Final Rules on National Bank Preemption and Visitorial Powers (Jan. 7, 2004), available at <http://www.occ.treas.gov/static/news-issuances/news-releases/2004/nr-occ-2004-3.pdf>.

⁶⁹ 12 C.F.R. § 34.4(a).

⁷⁰ 12 C.F.R. § 7.4000(a)(3). Visitation includes “inspection; superintendence; direction; [and] regulation.” Office of the Comptroller of the Currency v. Spitzer, 396 F. Supp. 2d 383, 401 (S.D.N.Y. 2005) (quoting First Nat’l Bank of Youngstown v. Hughes, 6 F. 737, 740-41 (C.C.N.D. Ohio 1881)) (internal quotation marks omitted).

⁷¹ *See* Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. at 1897-1900.

⁷² *See* Forrester, *supra* note 35, at 1362-63.

⁷³ FIN. CRISIS INQUIRY COMM’N, *supra* note 1, at xvii, 76.

⁷⁴ U.S. GEN. ACCOUNTING OFFICE, GAO-04-280, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 36 (2004) [hereinafter GAO REPORT ON PREDATORY LENDING], available at <http://www.gao.gov/new.items/d04280.pdf>.

ers in the home mortgage arena.⁷⁵ However, the FTC and other federal agencies focused their enforcement efforts on the biggest cases—those “that [would] have the most impact, such as those that [could] result in large settlements to consumers or that [would] have some deterrent value by gaining national exposure.”⁷⁶ Thus, smaller actors could continue with impunity. State attorneys general were limited in their ability to enforce state laws prohibiting unfair mortgage lending practices because of federal preemption,⁷⁷ and homeowners themselves did not have a remedy in many circumstances.⁷⁸

B. *Proliferation of Risky Loans*

For various reasons, brokers and originators had incentives to make loans that borrowers did not have the ability to repay, even at the outset.⁷⁹ Because HOEPA was a relatively weak response to problems in the subprime mortgage market, because states were limited in their ability to regulate, and because regulatory enforcement was lacking, the regulatory regime then existing did not prevent lenders from making loans that borrowers were not able to repay.

The number of risky loans increased dramatically in the early 2000s.⁸⁰ Some loans were risky because payments were “back-loaded.” For example, many ARMs had initial low teaser interest rates that would escalate after two or three years, resulting in much higher payments after the interest

⁷⁵ Other federal statutes the FTC used in enforcement actions included the Federal Trade Commission Act (“FTC Act”), 15 U.S.C. §§ 41-58 (2006), the Truth in Lending Act (“TILA”), 15 U.S.C. §§ 1601-1665 (2006), the Real Estate Settlement and Procedures Act (“RESPA”), 12 U.S.C. § 2603 (2006), and the Fair Debt Collection Practices Act (“FDCPA”), 15 U.S.C. § 1692 (2006). See GAO REPORT ON PREDATORY LENDING, *supra* note 74, at 106 app. I.

⁷⁶ GAO REPORT ON PREDATORY LENDING, *supra* note 74, at 40.

⁷⁷ See Forrester, *supra* note 35, at 1362.

⁷⁸ Homeowners’ remedies were limited by the holder in due course doctrine, which gives a holder of a negotiable instrument, who meets certain requirements, immunity from personal defenses, such as fraud in the inducement. *Id.* at 1329-32.

⁷⁹ One of the reasons that borrowers and lenders entered into foolish financing arrangements was their ability to benefit while imposing costs on others—the problem of moral hazard. Loan originators profited from making loans to borrowers who did not have the ability to repay. The originators earned fees for originating loans, but did not face the risk of loss from default and foreclosure because the loans were sold on the secondary market. See FIN. CRISIS INQUIRY COMM’N, *supra* note 1, at 425 (dissenting statement); Julie Forrester, *The Subprime Lending Crisis: How Did We Get Here?*, 39 QUAD 37, 37, 39 (2008). Issuers and purchasers of mortgage backed securities relied on rating agencies’ assessment of the risk of the securities rather than conducting any due diligence. See FIN. CRISIS INQUIRY COMM’N, *supra* note 1, at 426 (dissenting statement).

⁸⁰ See *supra* note 8 and accompanying text.

rate reset.⁸¹ Option ARMs allowed a borrower to choose whether to make a payment that included some principal, to pay accrued interest only, or to pay less than the amount of interest accruing each month and add that unpaid interest to the loan.⁸² Lenders often required little or no down payment.⁸³ Homeowners who did have equity in their homes could cash out that equity with a home equity loan or home equity line of credit.⁸⁴ These loan products made it more likely that the borrower would default⁸⁵ and more likely that the loan would be “underwater” if the property failed to appreciate or if it lost value. When the real estate bubble burst, home values in many areas plummeted.

Other loans were risky because borrowers were not required to show that they had sufficient income to make the payments. Many loans were “‘low doc’ or ‘no doc’ loans” because borrowers were not required to submit documentation of income or assets.⁸⁶ The use of stated-income loans, sometimes called “liar loans,” allowed borrowers to state their income without any lender verification.⁸⁷ Many of the borrowers did not in fact have the income necessary to pay. But rising home prices masked the problems with these loans⁸⁸ because borrowers could refinance or sell the home to pay off the loan. When the real estate bubble burst, borrowers could not sell their homes or refinance underwater mortgages without bringing cash to the table. Thus, the foreclosure tidal wave began.

The rest of the story is now well known as real estate foreclosures increased drastically beginning in 2006, and have continued at high levels. In response to the crisis, Congress made a significant overhaul of regulation of home mortgage loans as discussed below in Part II.C.

⁸¹ See WALL STREET AND THE FINANCIAL CRISIS, *supra* note 8, at 19-20. The Federal Reserve estimated that 75 percent of securitized subprime loans originated between 2004 and 2006 were ARMs with low teaser interest rates. See *supra* note 64 and accompanying text; see also Forrester, *supra* note 79, at 37 (discussing loans with back-loaded payments).

⁸² See WALL STREET AND THE FINANCIAL CRISIS, *supra* note 8, at 22.

⁸³ See *id.* at 23.

⁸⁴ *Id.* at 22-23. See generally Forrester, *supra* note 39, at 381-87 (discussing the risks of home equity loans).

⁸⁵ Studies have shown that a high loan-to-value ratio increases the risk of default and foreclosure. See, e.g., John M. Quigley & Robert Van Order, *Explicit Tests of Contingent Claims Models of Mortgage Default*, 11 J. REAL EST. FIN. & ECON. 99, 104 (1995).

⁸⁶ WALL STREET AND THE FINANCIAL CRISIS, *supra* note 8, at 23. “[F]rom 2000 to 2006, the percentage of Alt A loans with less than full documentation of the borrower’s income or assets rose from about 60% to 80%.” *Id.* (citing U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-09-848R, CHARACTERISTICS AND PERFORMANCE OF NONPRIME MORTGAGES 14 (2009), available at <http://www.gao.gov/new.items/d09848r.pdf>).

⁸⁷ *Id.* at 24 (internal quotation marks omitted).

⁸⁸ See *id.* at 25.

C. Congressional Response

The Dodd Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank”)⁸⁹ changed the landscape of federal regulation of home mortgage lending. The Act addresses many areas of financial regulation,⁹⁰ but of particular importance in the arena of home mortgage regulation are the creation of the new Bureau of Consumer Financial Protection, limitations on federal preemption of state consumer financial protection laws, requirements that lenders confirm a borrower’s ability to repay, and prohibitions on steering to higher interest rate loans.⁹¹

Title X of Dodd Frank established the Bureau of Consumer Financial Protection as an independent agency within the Federal Reserve System.⁹² The Bureau is charged with regulating consumer financial services, including home mortgages, “for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive.”⁹³ In particular, the Bureau is charged with enforcing federal laws that prohibit “unfair, deceptive, or abusive” practices.⁹⁴ In addition, the Act makes clear that the Bureau’s powers under federal law do not preempt state consumer protection provisions that are more protective,⁹⁵ and it limits the ability of the OCC to preempt state consumer protection laws.⁹⁶ Finally, Title X gives states the power to enforce the rules and regulations of the Bureau as well as their own laws.⁹⁷

Title XIV of Dodd Frank, the Mortgage Reform and Anti-Predatory Lending Act, reworks federal regulation of home mortgage lending.⁹⁸ Unlike HOEPA, many of its provisions apply to all home mortgage loans, not simply to high-cost loans. Title XIV prohibits fees that vary based on any loan term other than principal amount.⁹⁹ Therefore, fees cannot be used as

⁸⁹ Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

⁹⁰ Dodd Frank creates a new structure to oversee and promote financial stability in the financial services arena, *id.* tit. I, 124 Stat. at 1391, makes changes to the regulatory framework for banks and thrifts, *id.* tit. III, 124 Stat. at 1520, regulates derivatives, *id.* tit. VII, 124 Stat. at 1641, and regulates credit rating agencies, *id.* tit. IX, subtit. C., 124 Stat. at 1872, among other provisions.

⁹¹ See *infra* notes 92-106 and accompanying text.

⁹² Dodd Frank § 1011(a) (codified at 12 U.S.C. § 5491(a) (Supp. IV 2010)).

⁹³ *Id.* § 1021(a) (codified at 12 U.S.C. § 5511(a)).

⁹⁴ *Id.* § 1031(a) (codified at 12 U.S.C. § 5531(a)).

⁹⁵ *Id.* § 1041(a) (codified at 12 U.S.C. § 5551(a)).

⁹⁶ *Id.* § 1044 (codified at 12 U.S.C. § 25b). The Act eliminates the OTS, which had previously supervised thrifts, and places supervision of thrifts under the auspices of the OCC. *Id.* § 312(b)(2)(B) (codified at 12 U.S.C. § 5412(b)(2)(B)). See generally Forrester, *supra* note 35, for a discussion of the problems of federal preemption of state consumer protection laws in the context of home mortgages.

⁹⁷ Dodd Frank § 1042(a)(1) (codified at 12 U.S.C. § 5552(a)(1)).

⁹⁸ *Id.* tit. XIV, 124 Stat. at 2136-45 (codified in scattered sections of 15 U.S.C.).

⁹⁹ *Id.* § 1403 (codified at 15 U.S.C. § 1639b(c)(1)).

an incentive to steer borrowers to more expensive loans. It requires lenders to make “a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan.”¹⁰⁰ For violations of either the anti-steering provision or the ability-to-pay provisions, Dodd Frank gives borrowers a defense in a foreclosure or other collection action in the form of a claim for recoupment or set off.¹⁰¹ Thus, Dodd Frank creates a remedy for the homeowner for violations of these provisions.

Dodd Frank also includes new prohibitions and new disclosure requirements.¹⁰² For example, it restricts prepayment penalties,¹⁰³ and it prohibits single premium credit insurance and document provisions that require arbitration, among other prohibitions.¹⁰⁴ Finally, it revises the definition of a high-cost mortgage to lower the interest rate and fee triggers,¹⁰⁵ and adds new prohibitions and requirements for high-cost mortgages.¹⁰⁶

Dodd Frank imposes significant new limitations on home mortgage lending. The jury is still out on how effective this new regulation will be and how well it will be enforced. It does create a new agency to enforce home mortgage regulations, allows states to enforce both state and federal regulations, and creates a new defense to foreclosure for violations of anti-steering and ability-to-pay provisions. However, Dodd Frank does not give the neighbors any remedy to enforce violations of law that may contribute to the likelihood of a foreclosure in the neighborhood. A financing restriction would provide that type of protection.

D. *A Remedy for the Neighbors—Advantages of a Private Law Approach*

Financing restrictions in the CCRs of common-interest communities, would give homeowners and homeowners’ associations some control to prevent foolish financing decisions of their neighbors. Developers could

¹⁰⁰ *Id.* § 1411 (codified at 15 U.S.C. § 1639c(a)(1)). The borrower must have a reasonable ability to pay insurance premiums, taxes, and other assessments as well. *Id.* The Act has provisions defining how ability to pay is determined in the case of nonstandard loans, including certain variable interest rate loans, interest-only loans, and negative amortization loans. *Id.* (codified at 15 U.S.C. § 1639c(a)(6)). For example, in determining ability to repay, lenders must consider ability to repay a fully amortized loan, even if the terms of the loan provide for interest-only or for deferral of principal or interest. Dodd Frank § 1411 (codified at 15 U.S.C. § 1639c(a)(6)(C)). In addition, the Act defines a “qualified mortgage” and creates a presumption that the loan meets the requirement for ability to repay. *Id.* § 1412 (codified at 15 U.S.C. § 1639c(b)). A fully-amortized, fixed-rate loan is among the types of loans that can be qualified mortgages. *Id.* (codified at 15 U.S.C. § 1639c(b)(2)(A)(iv)).

¹⁰¹ *Id.* § 1413 (codified at 15 U.S.C. § 1640(k)).

¹⁰² *Id.* § 1414 (codified at 15 U.S.C. § 1639c).

¹⁰³ *Id.* (codified at 15 U.S.C. § 1639c(c)).

¹⁰⁴ Dodd Frank § 1414 (codified at 15 U.S.C. § 1639c(d)-(e)).

¹⁰⁵ *Id.* § 1431 (codified at 15 U.S.C. § 1602(aa)).

¹⁰⁶ *Id.* §§ 1432-33 (codified at 15 U.S.C. § 1639).

include restrictions on the type of financing that homeowners are permitted to use within the initial CCRs or a sufficient number of homeowners could amend the CCRs to include such restrictions.¹⁰⁷ Thus, neighbors and homeowners' associations could enjoin certain types of risky mortgage loans. More importantly, they could enjoin foreclosure of a loan that did not comply with CCR requirements. As a result, lenders would not be willing to make risky loans secured by property in the community, and those that foolishly made loans not in compliance with CCRs could be enjoined from foreclosing by the neighbors.

Adoption of financing covenants in common-interest communities would be a private law approach to regulating mortgage financing between parties who are burdened with externalities caused by the foolish financing decisions of their neighbors. While, this Article does not advocate replacing government regulation of mortgage financing with purely private arrangements, it does advocate private arrangements as a supplement to government regulation and to fill the gaps that government regulation has left in this realm. Government regulation is insufficient because of uncertainty regarding its substance and its enforcement, because of a lack of flexibility in its terms, and because it does not give control to all of the parties who need protection.

First, government regulation is uncertain because it can change due to politics and economic pressures.¹⁰⁸ In the context of mortgage loan regulation, the changes are evident over the past thirty years. Various administrations have encouraged more or less regulation, and economic forces have been at work. The 1980s was a period of deregulation that led to the savings and loan crisis. The early 2000s also was a period of deregulation based on pressure from lenders to permit the huge increase in outstanding credit and to permit novel forms of financing.¹⁰⁹ More recently, regulation has increased again with the enactment of Dodd Frank. A private system of financing covenants would not be subject to politics, nor would it be as susceptible to economic pressures. Financing restrictions would typically only be amended by a majority or supermajority of homeowners in a common-interest community.¹¹⁰

Second, government regulations, where they do exist, may not be enforced. Certainly, there was a lack of enforcement of regulations governing mortgage lending as discussed above.¹¹¹ A few foolish loans made by sever-

¹⁰⁷ See *infra* Part IV.

¹⁰⁸ See Susan F. French, *Toward a Modern Law of Servitudes: Reweaving the Ancient Strands*, 55 S. CAL. L. REV. 1261, 1263 n.6 (1982).

¹⁰⁹ See William Spencer Topham, *Re-Regulating "Financial Weapons of Mass Destruction," Observations on Repealing the Commodity Futures Modernization Act and Future Derivative Regulation*, 47 WILLAMETTE L. REV. 133, 133-34, 142 (2010).

¹¹⁰ For CCRs with financing covenants, the ability to amend with less than unanimous consent would be essential. See *infra* notes 181-82 and accompanying text.

¹¹¹ See *supra* notes 75-77 and accompanying text.

al different lenders are unlikely to draw the attention of regulators, but a few foreclosures can harm a community. Neighbors or a homeowners' association could enforce a financing covenant to protect the rights of joint venturers in a common-interest community. These parties would have an incentive to enforce the covenant. And they could be enforced on a small scale—against every violator.

Third, government regulations are a one-size-fits-all approach to regulating home mortgage lending rather than offering a flexible approach that depends on the circumstances. Financing covenants could be varied depending on the circumstance of the common-interest community where they are to be adopted.

Fourth, government regulation does not give control to all of the parties, in this case the neighbors, injured by foolish and/or fraudulent practices. The joint venturers in the common-interest community would have the ability to control the terms of a financing covenant through the amendment process and would have the right to enforce the financing covenant against their neighbors and against noncompliant lenders. In order to be effective, however, such a restriction would have to be enforceable against homeowners and mortgagees as a covenant running with land.

III. ANALYSIS OF THE ENFORCEABILITY OF A FINANCING RESTRICTION

The traditional requirements for a covenant to run with land to benefit and burden successor owners of lots owned by the original covenanting parties come from English common law dating to the sixteenth century or earlier.¹¹² Covenants could either run at law as real covenants with damages as the available remedy, or could run in equity as equitable servitudes enforced with remedies in equity.¹¹³ More recently, the *Restatement (Third) of Property-Servitudes* adopted an approach designed to modernize the law of servitudes.¹¹⁴

Under the traditional view, a covenant runs with land at law as a real covenant if the original parties intend for it to run, if it touches and concerns land, if the jurisdiction's privity requirement is met, and if it is in writing.¹¹⁵ To meet the intent requirement, the parties to a covenant must

¹¹² Much of the law of real covenants originated in *Spencer's Case*, (1583) 77 Eng. Rep. 72 (K.B.). Equitable servitudes originated in *Tulk v. Moxhay*, (1848) 41 Eng. Rep. 1143 (Ch.). Although *Tulk* focuses only on contract rights, later cases in England recognized the equitable servitude as a new type of covenant running with land in equity. CHASE & FORRESTER, *supra* note 25, at 827.

¹¹³ CHASE & FORRESTER, *supra* note 25, at 810; FREYERMUTH ET AL., *supra* note 25, at 585.

¹¹⁴ See RESTATEMENT (THIRD) OF PROP.: SERVITUDES intro., at 3-4 (2000). The Restatement approach is discussed *infra* notes 138-74 and accompanying text.

¹¹⁵ See *Flying Diamond Oil Corp. v. Newton Sheep Co.*, 776 P.2d 618, 622-23 (Utah 1989); *Barner v. Chappell*, 585 S.E.2d 590, 594 (Va. 2003); see also *Inwood N. Homeowners' Ass'n v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987); *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 910-11

intend not only that the covenant be enforceable as between the original parties, but also that the benefit and burden run with the land. Such language is standard in the CCRs for a common-interest community.¹¹⁶ A financing restriction, therefore, set forth in the declaration of CCRs, which is in writing and recorded, and clearly states the intent to bind successors and assigns, will meet the writing and intent requirements.

In order to run with land under the traditional view, a covenant must touch and concern the land.¹¹⁷ The effect of this “requirement is to restrict the types of duties and liabilities that [will] burden future ownership of interests in the land.”¹¹⁸ The touch and concern requirement is vague and obscure and has been used by courts to terminate covenants that the court, for whatever reason, does not want to enforce.¹¹⁹

One test to determine if a covenant touches and concerns land requires that the covenant “so affect the use, value, or enjoyment of the land itself that it must be regarded as an integral part of the property.”¹²⁰ The burdens and benefits of the covenant must relate to the landowners’ ownership interest in the land, rather than merely as members of the community at large.¹²¹ If a covenant benefits the promisee personally, not benefitting land and existing independently of it, then the covenant is personal and does not run with the land.¹²² Covenants to do, or refrain from doing, something

(Tex. 1982) (noting that “for the covenant to run with the land there must be privity of estate between the parties to the agreement” and “that the agreement [must] touch[] and concern[] the land”).

¹¹⁶ See *Lex Pro Corp. v. Snyder Enters., Inc.*, 671 P.2d 637, 639 (N.M. 1983) (noting that a covenant will be found to run with the land absent language that unambiguously negates that intent); *Dwan v. Indian Springs Ranch Homeowners Ass’n*, 186 P.3d 1199, 1202 (Wyo. 2008). Express language in the document usually satisfies this requirement, although courts may look to the nature and circumstances of the covenant in the absence of express language. See, e.g., *Smalley v. Stowe Mountain Club, LLC*, 25 A.3d 539, 543 (Vt. 2011). Even if language indicating intent that the covenant run were not included, a court could find intent based on the existence of the common-interest community as a circumstance indicating intent that the covenant run. In *Smalley*, the Vermont Supreme Court found the intent requirement satisfied by a declaration of CCRs recorded by the original developer that established a comprehensive and uniform plan of restrictions for the creation and continuation of a high-end residential subdivision and that benefitted each lot and its owner. *Id.* A Texas court found the parties intended that a covenant run where the covenant was recorded in the deeds of all of the homeowners in the subdivision. See *Nicholls v. Barnett*, 374 S.W.2d 770, 772 (Tex. Civ. App. 1964). The court stated that intent would only be lacking in this situation if there existed overwhelming evidence of a mutual mistake. *Id.*

¹¹⁷ *Flying Diamond*, 776 P.2d at 623.

¹¹⁸ *Id.*; see also French, *supra* note 108, at 1289.

¹¹⁹ RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.2 cmt. b; see also EDWARD H. RABIN ET AL., FUNDAMENTALS OF MODERN PROPERTY LAW 489 (6th ed. 2011); French, *supra* note 108, at 1289.

¹²⁰ *Flying Diamond*, 776 P.2d at 624 (quoting *Lundeborg v. Dastrup*, 497 P.2d 648, 650 (Utah 1972)) (internal quotation marks omitted).

¹²¹ See *id.*

¹²² See *Beeter v. Sawyer Disposal LLC*, 771 N.W.2d 282, 286 (N.D. 2009); cf. *Roberts v. Osburn*, 589 P.2d 985, 989, 991-92 (Kan. Ct. App. 1979) (holding covenant was personal because parties clearly expressed intent that covenant was only “by the first parties” (internal quotation marks omitted)).

physical to, or on, land have generally satisfied this traditional physical use test,¹²³ as have covenants to pay for the use of land or the improvement of land.¹²⁴ As noted in the discussion of *Neponsit* in Part I, courts have more often used the touch and concern requirement to prevent affirmative burdens from running with land than negative covenants.¹²⁵

Because the physical use test does not encompass all situations, other tests such as Dean Bigelow's test have gained in popularity, despite some criticism.¹²⁶ Under the Bigelow test, the burden of the covenant touches and concerns the land if the promisor's legal interest as owner of the land is rendered less valuable by the promise.¹²⁷ Conversely, if the promisee's legal interest as owner is rendered more valuable by the promise, then the benefit of the covenant touches and concerns the land.¹²⁸ The court in *Neponsit* applied the Bigelow test, among others, in determining that the covenant to pay assessments did touch and concern the land.¹²⁹

¹²³ See, e.g., *Chambers v. Gallaher*, 364 S.E.2d 576, 577 (Ga. 1988) (subdivision covenant prohibiting all business uses); *Waikiki Malia Hotel, Inc. v. Kinkai Props. Ltd. P'ship*, 862 P.2d 1048, 1057 (Haw. 1993) (height restriction); *Hill v. Cmty. of Damien of Molokai*, 911 P.2d 861, 867 (N.M. 1996) (interpreting restrictive covenant limiting property use to single family residence purposes).

¹²⁴ See, e.g., *Lake Arrowhead Cmty. Club, Inc., v. Looney*, 770 P.2d 1046, 1050 (Wash. 1989) (en banc); *Rodruck v. Sand Point Maint. Comm'n*, 295 P.2d 714, 721 (Wash. 1956).

¹²⁵ See RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.2 cmt. e (2000); see also *supra* notes 13-14 and accompanying text.

¹²⁶ The test was suggested by Dean Harry Bigelow and was later refined by Judge Charles E. Clark. See Jeffrey E. Stake, *Toward an Economic Understanding of Touch and Concern*, 1988 DUKE L.J. 925, 928-29 (1988). It has been criticized as being circular. *Id.* at 929.

¹²⁷ See *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982) (citing Howard R. Williams, *Restrictions on the Use of Land: Covenants Running with the Land at Law*, 27 TEX. L. REV. 419, 429 (1949)) (applying the Bigelow test to find that a covenant did touch and concern the land).

¹²⁸ See *id.*

¹²⁹ *Neponsit Prop. Owners' Ass'n v. Emigrant Indus. Sav. Bank*, 15 N.E.2d 793, 796 (N.Y. 1938). Other state supreme courts have applied the Bigelow Test to find covenants touched and concerned land. The Nebraska Supreme Court, applying the test, found that a covenant to pay dues to a homeowner's association for maintenance of a recreational facility touched and concerned land because it was "part of a common scheme of development" and gave a right of common use to all the property owners, enhancing the value of each of their individual lots. *Regency Homes Ass'n v. Egermayer*, 498 N.W.2d 783, 791-93 (Neb. 1993). The New Mexico Supreme Court found that the burden of a building setback restriction touched and concerned the promisor's land by making it less valuable, and the benefit of that covenant touched and concerned the promisee's land by making it more valuable. *Lex Pro Corp. v. Snyder Enters.*, 671 P.2d 637, 639 (N.M. 1983). Likewise, the Hawaii Supreme Court found a covenant imposing a height restriction of buildings to clearly satisfy the touch and concern requirement. *Kaanapali Hillside Homeowners' Ass'n v. Doran*, 162 P.3d 1277, 1289 (Haw. 2007). The Washington Supreme Court found that a covenant touched and concerned the land where it created a lien against the land for the expense of repairs. *Rodruck*, 295 P.2d at 721. More recently, the Washington Supreme Court found that a covenant releasing a city from liability for damages caused by soil movement adequately touched and concerned the land on the theory that "few things touch and concern land more than the soil itself." *1515-1519 Lakeview Boulevard Condo. Ass'n v. Apartment Sales Corp.*, 43 P.3d 1233, 1239 (Wash. 2002) (en banc). In yet another Washington case, the court found that "an obligation to pay

A financing restriction that limited the ways an owner could encumber land would affect the owner as a landowner, not as a member of the community at large, and would thus touch and concern land. Furthermore, the restriction would reduce the value of the burdened land because a lot owner could not obtain certain types of financing, and it would increase the value of neighbors' lots by protecting them against foolish decisions of the owner of the restricted lot that might result in foreclosure. A restriction preventing a mortgagee from foreclosing would most certainly reduce the value of the mortgagee's interest in the land, and the restriction on foreclosure would increase the value of the neighbors' lots. Thus, a court should find that a financing restriction touches and concerns land.

The traditional approach to real covenants required both horizontal privity, which is the relationship between the original parties to a covenant,¹³⁰ and vertical privity, which is the relationship between the original parties and their successors in ownership.¹³¹ Horizontal privity requires either that the covenant be made in connection with a conveyance in fee between the original parties to the covenant or that the original parties have a mutual and continuing interest in the same land.¹³² Even before the Third Restatement approach rejected the requirement of privity altogether, many states had eliminated the requirement of horizontal privity.¹³³ In a common-interest community, the horizontal privity requirement would be met by the existence of a grantor-grantee relationship between the original developer and each original purchaser of a lot. Thus, in any states that still require horizontal privity, a financing restriction imposed at the initial development of the community satisfies the requirement. A financing restriction imposed as an amendment to an existing set of CCRs should satisfy the horizontal

assessments for the maintenance of neighborhood property touche[d] and concerne[d] the land." *Lake Arrowhead*, 770 P.2d at 1050. Montana and Utah have found covenants to pay royalties to the surface owner for oil and gas royalties underlying the land adequately touched and concerned the land. *See Farley v. Booth Bros. Land & Livestock Co.*, 890 P.2d 377, 382 (Mont. 1995); *Flying Diamond Oil Corp. v. Newton Sheep Co.*, 776 P.2d 618, 626-27 (Utah 1989).

¹³⁰ *See Sonoma Dev., Inc. v. Miller*, 515 S.E.2d 577, 579 (Va. 1999).

¹³¹ *Barner v. Chappell*, 585 S.E.2d 590, 594 (Va. 2003); *see also In re Foster*, 435 B.R. 650, 660 n.11 (B.A.P. 9th Cir. 2010) (applying Washington law).

¹³² *See Foster*, 435 B.R. at 660 n.11; *Kaanapali Hillside*, 162 P.3d at 1289; *Gallagher v. Bell*, 516 A.2d 1028, 1037 (Md. Ct. Spec. App. 1986); *Runyon v. Paley*, 416 S.E.2d 177, 184-85 (N.C. 1992).

¹³³ *See Gallagher*, 516 A.2d at 1037. The horizontal privity requirement serves no useful purpose and should be eliminated. *See id.*; RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 2.4 cmt. b (2000). Courts may criticize or question the continued validity of the requirement, but do not eliminate it in cases where the requirement is met, probably because to do so would be dicta. *See, e.g., Kaanapali Hillside*, 162 P.3d at 1290 n.13 ("We express no opinion regarding the view that horizontal and mutual privity should not be required for a covenant to run Rather, we only note that horizontal and mutual privity exist here"); *Lake Limerick Country Club v. Hunt Mfg. Homes, Inc.*, 84 P.3d 295, 302 (Wash. Ct. App. 2004) ("To whatever extent 'horizontal privity' might still be required, it is easily met here").

privity requirement because the CCRs would be a mutual and continuing interest in the land.

The requirement of vertical privity is essentially an allocation device that determines when the benefits and burdens of a covenant run to successor owners of interests in the benefitted and burdened tracts and conversely when they do not run. The traditional approach requires strict vertical privity for a burden to run to a successor so that the burden runs only to a transferee of the same estate as that held by the original covenantor.¹³⁴ Thus, the burden of the covenant would not run to a tenant of the covenantor, but would stay with the landlord. On the benefit side, however, the traditional approach reflects a loose vertical privity requirement so that the benefit runs to any successor owner, even one receiving a lesser interest in the benefitted property.¹³⁵

For a financing restriction in a common-interest community, the burden would run to successor lot owners who would have vertical privity with their predecessor owners. The more interesting question is whether a financing restriction limiting the rights of a mortgagee to foreclose a mortgage or deed of trust securing a prohibited debt could in fact run to that mortgagee. A court applying the traditional requirement of strict vertical privity could hold that the covenant would not run as a real covenant and thus make the damages remedy unavailable to neighbors who tried to sue after the fact. A court could, on the other hand, focus on the intent of the parties and hold that the parties expressly designed the covenant to run to a mortgagee based on a provision to that effect in the CCRs. Therefore, a financing restriction most certainly would be enforceable against successor owners under a traditional real covenant analysis and might be enforced against a lender as well.

Under the traditional view, the requirements for a covenant to run with land in equity as an equitable servitude are that the parties to the covenant intend for it to run, it touches and concerns land, the owner of the burdened tract has notice of the burden, and it is in writing.¹³⁶ The intent, touch and concern, and writing requirements are the same as for a real covenant and are discussed above. Recording the covenant in the real property records satisfies the notice requirement.

Unlike a real covenant, privity is not required for the burden of an equitable servitude to run.¹³⁷ Thus, the burden of an equitable servitude runs to all successor owners. Therefore, a financing restriction should be enforceable against a successor owner of a lot in the subdivision by an injunction

¹³⁴ See RESTATEMENT OF PROP.: SERVITUDES § 535 (1944).

¹³⁵ See *id.* § 547.

¹³⁶ See, e.g., *Lex Pro Corp. v. Snyder Enters.*, 671 P.2d 637, 639 (N.M. 1983).

¹³⁷ See RESTATEMENT OF PROP.: SERVITUDES § 539. Under the First Restatement approach, relaxed vertical privity is required for the benefit to run in equity. *Id.* § 539 cmt. k. The benefit of a covenant limiting financing would run to neighbors both in law and in equity.

prohibiting the forbidden financing. In addition, a covenant prohibiting foreclosure of a lien securing forbidden financing should be enforceable by the neighbors against a foreclosing lender. Against a lender, neighbors would probably prefer injunctive relief instead of damages. To effectively exercise this remedy, however, neighbors would have to be aware of the foreclosure.

The Third Restatement eliminates the terms “real covenant” and “equitable servitude,” and makes no distinction between them other than a historical one.¹³⁸ Instead, the Restatement uses the term “covenant that runs with land.”¹³⁹ Both legal and equitable remedies are available to enforce a covenant that runs with land under the Third Restatement approach.¹⁴⁰ In order for a covenant to run, the Restatement requires a writing that satisfies the Statute of Frauds,¹⁴¹ or an exception to the Statute,¹⁴² and that the parties intend that the covenant run.¹⁴³ For a covenant limiting financing in a common-interest community, the writing and intent requirements would be satisfied as discussed above. Although the Restatement does not expressly require notice, an unrecorded covenant could be terminated by operation of a recording act.¹⁴⁴ A recorded declaration of CCRs satisfies the requirements of the recording act. In addition, a covenant will not run with land if “it is illegal or unconstitutional or violates public policy.”¹⁴⁵

The Third Restatement drops the requirement of privity—horizontal privity because it serves no useful function,¹⁴⁶ and vertical privity because it does not provide a satisfactory method for determining the succession of benefits and burdens of covenants.¹⁴⁷ The succession of the burdens and benefits of covenants are instead addressed directly,¹⁴⁸ and the rules of succession are formulated to meet the expectations of the parties to the cove-

¹³⁸ RESTATEMENT (THIRD) OF PROP.: SERVITUDES, § 1.4 & cmt. a (2000) (internal quotation marks omitted).

¹³⁹ *Id.* § 1.4 (internal quotation marks omitted); *accord* Hollis v. Garwall, Inc., 974 P.2d 836, 840-41 (Wash. 1999) (en banc).

¹⁴⁰ *See* RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 1.4 cmt. a.

¹⁴¹ *Id.* §§ 2.1, 2.7-2.8.

¹⁴² *Id.* §§ 2.1, 2.8-2.9, 2.14; *see also* PMZ Oil Co. v. Lucroy, 449 So. 2d 201, 208 (Miss. 1984) (equitable estoppel); Remilong v. Crolla, 576 P.2d 461, 465 (Wyo. 1978) (same).

¹⁴³ *See* RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 2.2. The intent required is that either the benefit or the burden runs with land. *Id.* § 2.2 cmt. i.

¹⁴⁴ *Id.* § 7.14; *see also* Witter v. Taggart, 577 N.E.2d 338, 341 (N.Y. 1991).

¹⁴⁵ RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.1 & cmt. g; *see also* Davidson Bros. v. D. Katz & Sons, Inc., 579 A.2d 288, 294 (N.J. 1990); Orange & Rockland Utils., Inc. v. Philwold Estates, Inc., 418 N.E.2d 1310, 1315 (N.Y. 1981) (enforcement of restriction that limited use of land to legally impossible use would violate public policy).

¹⁴⁶ RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 2.4 cmt. b. Formality requirements are covered in the Statute of Frauds and recording acts. *Id.*

¹⁴⁷ *Id.* ch. 5 intro. note, at 5; *see also id.* § 5.2 cmt. b.

¹⁴⁸ *Id.* § 5.2 cmt. b.

nant and their successors.¹⁴⁹ Section 5.2 of the Restatement provides: “Except as otherwise provided by the terms of the servitude . . . an appurtenant benefit or burden runs to all subsequent owners and possessors of the benefited and burdened property.”¹⁵⁰ Thus, the Restatement gives the parties “the freedom to specify the persons to whom the benefits and burdens may be transferred.”¹⁵¹

Therefore, under the Restatement approach, the parties should be able to specify that the burden of a covenant will run both to successor owners of the fee and to mortgage lenders, with the owner prohibited from obtaining certain types of financing and the lender prohibited from foreclosing on a noncompliant loan.¹⁵² Furthermore, either damages or equitable relief should be available against both the owner and the lender. Section 5.2(1) provides that a burden will not run to a party with title superior to that of the servitude creator.¹⁵³ Thus, a mortgagee with a lien senior to the covenant would not be bound by it, as would be expected.

Finally, the Third Restatement requires that a covenant not be “illegal or unconstitutional or violate[] public policy,”¹⁵⁴ as a more logical and reasoned replacement for the old touch and concern requirement.¹⁵⁵ A financing restriction would not be illegal,¹⁵⁶ nor would it be unconstitutional.¹⁵⁷

¹⁴⁹ See *id.* ch. 5 intro. note, at 6.

¹⁵⁰ RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 5.2. Appurtenant benefits and burdens pass automatically. *Id.* § 5.1; see also *Sun Valley Ctr. for Arts & Humanities, Inc. v. Sun Valley Co.*, 690 P.2d 346, 348 (Idaho 1984) (appurtenant burdens pass automatically); *Orange & Rockland*, 418 N.E.2d at 1313-14 (appurtenant benefits pass automatically).

¹⁵¹ RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 5.1 cmt. a (“[T]he parties are free to create servitudes as they see fit so long as they . . . do not violate public policy.”).

¹⁵² The Third Restatement contemplates “[c]omplex servitudes with multiple and varied successors,” including covenants that run to lending institutions. *Id.* § 5.1 cmt. c (emphasis omitted).

¹⁵³ *Id.* § 5.2(1); see also *Springmont Homeowners Ass’n v. Barber*, 472 S.E.2d 695, 696-97 (Ga. Ct. App. 1996) (stating that purchaser of foreclosed lots not bound by architectural-control covenants created and recorded subsequent to mortgage); *Citicorp Sav. of Ill. v. Bhatti*, 527 N.E.2d 424, 426 (Ill. App. Ct. 1988) (foreclosing mortgagee takes free of assessments levied individually on foreclosed property before possession).

¹⁵⁴ RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.1; see also *Davidson Bros. v. D. Katz & Sons, Inc.*, 579 A.2d 288, 303-04 (N.J. 1990); *Orange & Rockland*, 418 N.E.2d at 1315 (holding that enforcement of restriction that limited use of land to legally impossible use would violate public policy).

¹⁵⁵ RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.2. The touch and concern requirement “provid[ed] courts with a flexible, discretionary power to disallow and terminate servitudes.” *Id.* § 3.2 cmt. b. But the Third Restatement has adopted a more straightforward approach. *Id.* § 3.2 cmt. a.

¹⁵⁶ “An illegal servitude . . . is one that is prohibited by a statute or governmental regulation.” *Id.* § 3.1 cmt. c. See *infra* notes 169-74 and accompanying text for a discussion of the Fair Housing Act. One comment at the AALS program was that a financing restriction would in some way violate the Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.). The authors disagree. The Garn-St. Germain Act provides that “a lender may not exercise its option pursuant to a due-on-sale clause upon—(1) the creation of a lien or other encumbrance subordinate to the lender’s security instrument which does not relate to a transfer of rights of occupancy in the property.” 12 U.S.C. § 1701j-3(d) (2006). This section applies

The public policy requirement, however, could create a constraint on the ability to create too restrictive a financing limitation. The Restatement elaborates on the violation of the public policy requirement by providing that it would invalidate, among other things, “a servitude that is arbitrary, spiteful, or capricious; . . . imposes an unreasonable restraint on alienation . . . ; [or] is unconscionable.”¹⁵⁸ Public policy that may invalidate a covenant is based on judicial determination as well as legislative or constitutional provisions.¹⁵⁹ In determining whether a covenant violates public policy, courts should balance the benefit of enforcing the covenant against the harm.¹⁶⁰ However, courts should also consider the freedom of parties to consent to the adverse consequences of a covenant.¹⁶¹

A reasonable limitation on financing should not run afoul of the public policy requirement, but the requirement would create a limit on the type of restriction that could be imposed. A covenant limiting financing would not ordinarily be arbitrary, spiteful, or capricious if it protected neighbors from

to a lender’s enforcement of a due-on-sale clause and would not prohibit restrictions on mortgage loans enforced by neighbors or a homeowners’ association. The Parity Act, enacted as a part of the Garn-St. Germain Act, preempts state regulation of alternative mortgage transactions. *See supra* notes 61-63 and accompanying text. As amended by Dodd Frank, the Parity Act defines “alternative mortgage transaction” as “a loan or credit sale secured by an interest in residential real property . . . in which the interest rate or finance charge may be adjusted or renegotiated . . . described and defined by applicable regulation.” Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. § 3802(1)). The Parity Act provides:

An alternative mortgage transaction may be made by a housing creditor in accordance with this section, notwithstanding any State constitution, law, or regulation that prohibits an alternative mortgage transaction. For purposes of this subsection, a State constitution, law, or regulation that prohibits an alternative mortgage transaction does not include any State constitution, law, or regulation that regulates mortgage transactions generally, including any restriction on prepayment penalties or late charges.

Id. § 1083(c), 124 Stat. at 2081 (codified as amended at 12 U.S.C. § 3803(c)) (internal quotation marks omitted). Even if enforcement by courts of a private financing restriction were treated as a “State . . . law . . . that prohibits” certain financing, the financing restriction proposed in Part V does not prohibit ARMs and, thus, could not run afoul of the Parity Act as amended by Dodd Frank. *See id.*

¹⁵⁷ “A servitude may be invalid because it impermissibly infringes rights protected by the applicable state constitution or by the United States Constitution.” RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.1 cmt. d.

¹⁵⁸ *Id.* § 3.1.

¹⁵⁹ *Id.* § 3.1 cmt. f; *see also* *Martin v. Constance*, 843 F. Supp. 1321, 1325 (E.D. Mo. 1994) (invalidating covenant that buildings were only to be used as private residences as applied to six mentally disabled persons after considering legislative history of Fair Housing Act); *Bennett v. Comm’r of Food & Agric.*, 576 N.E.2d 1365, 1367-68 (Mass. 1991) (including additional restriction in statutory definition that reinforced a legislatively stated public purpose).

¹⁶⁰ RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.1 cmt. i; *see also* *Malcolm v. Shamie*, 290 N.W.2d 101, 102, 104 (Mich. Ct. App. 1980) (balancing competing policies of protecting valuable property and developing quality facilities for the mentally handicapped); *Crowell v. Shelton*, 948 P.2d 313, 316 (Okla. 1997) (holding that a court must balance the equities if it finds restrictions unreasonable).

¹⁶¹ *See* RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.1 cmt. i.

foreclosures resulting from foolish financing decisions.¹⁶² But one can imagine a covenant, such as one prohibiting financing from a particular institution against which a developer holds a grudge, that would be spiteful, or others that might be arbitrary and capricious. The Restatement approach would prevent enforcement of such a covenant.

A reasonable covenant limiting financing terms should not be invalidated as an unreasonable restraint on alienation. The Restatement requires that a direct restraint on alienation be reasonable, with reasonableness “determined by weighing the utility of the restraint against the injurious consequences of enforcing” it.¹⁶³ A direct restraint is one that prohibits some type of transfer,¹⁶⁴ and a limitation on financing could be seen as a prohibition on transfer of any lien that does not satisfy the requirements of the covenant. A consideration in determining reasonableness is the nature of the property interest affected, with greater restraints justified for nonpossessory interests,¹⁶⁵ such as a lien in this case. The utility of such a covenant would be great for homeowners protected from the foolish financing decisions of their neighbors that could result in foreclosed and empty properties in the community. The consequences of enforcing it against a homeowner include preventing a homeowner from entering into a risky loan, arguably a benefit to the homeowner if you take a paternalistic view. The consequences of enforcing it against a lender are entirely avoidable if the lender complies with the terms of the covenant in the first place.

If the covenant is treated as an indirect restraint on alienation,¹⁶⁶ it is invalid only if it “lacks a rational justification.”¹⁶⁷ The justification of pro-

¹⁶² The Restatement elaborates on these terms as follows:

Arbitrary normally means that the purpose is not legitimate, or that the means adopted have no reasonable relationship to accomplishment of the purpose. Spiteful means that the primary purpose of the servitude was to cause harm to another, rather than to secure a benefit to the creating party or parties. Capricious generally means that no legitimate purpose for creating the servitude is discernible.

Id. § 3.1 cmt. g.

¹⁶³ *Id.* § 3.4.

¹⁶⁴ *Id.* § 3.4 cmt. b; *see also* Spanish Oaks, Inc. v. Hy-Vee, Inc., 655 N.W.2d 390, 399 (Neb. 2003) (“A direct restraint on alienation is a provision in a deed, will, contract, or other instrument which, by its express terms, or by implication of fact, purports to prohibit or penalize the exercise of the power of alienation.”).

¹⁶⁵ *See* RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.4 cmt. b.

¹⁶⁶ Indirect restraints are those that reduce the value of property or reduce its desirability to prospective purchasers. *Id.*; *see also* Lamar Adver. v. Larry & Vickie Nicholls, L.L.C., 213 P.3d 641, 644 (Wyo. 2009) (“An indirect restraint on alienation ‘arises when an attempt is made to accomplish some purpose other than the restraint of alienability, but with the incidental result that the instrument, if valid, would restrain practical alienability.’” (quoting *Smith v. Osguthorpe*, 58 P.3d 854, 860 (Utah Ct. App. 2002))). A restriction on financing could reduce the value of property by reducing the number of eligible purchasers. However, because the covenant would be part of a scheme of identical covenants made by all of the neighbors, the benefit of covenants running with neighboring lots would increase the value of the property.

protecting neighbors from foolish financing decisions that could result in foreclosure is certainly rational. Finally, a reasonable covenant limiting financing is not unconscionable.

While a reasonable limit on financing terms should easily pass the public policy requirement, the requirement would impose a limit on the ability of a developer or homeowners to unduly restrict financing options. The Restatement approach is not intended to require reasonableness in the broad sense of having courts substitute their judgment for that of the parties to the covenant but rather in the narrow sense of invalidating a covenant “only if it is arbitrary or capricious, serves no legitimate purpose, or denies fundamental constitutional rights.”¹⁶⁸ In this context, the Restatement simply prevents a type of covenant that crosses that line.

A possible public policy argument against a financing restriction would be that it could be exclusionary. However, a reasonable financing restriction would be no more exclusionary than many provisions of CCRs in common-interest communities that make them more expensive—such as provisions requiring large homes, brick exteriors, or payment of homeowners’ association dues. Courts have applied the Fair Housing Act¹⁶⁹ to prohibit zoning regulations that exclude low-income housing on the basis of the disparate impact on persons of color shown by statistical evidence.¹⁷⁰ Courts have also applied the Act to prohibit the application of restrictive covenants to prevent group homes.¹⁷¹

The Fair Housing Act has not been applied to prohibit enforcement of restrictive covenants that make homes in a particular common-interest community more expensive. In housing discrimination cases against a private defendant, a plaintiff “may establish his prima facie case by proving the following facts: (1) that he is [a member of a protected class]; (2) that he applied for and was qualified to rent or purchase the housing; (3) that he

¹⁶⁷ RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.5(2). Given that Comment c to § 3.5(2) describes “quarter sales,” which would require a purchaser to pay a portion of the subsequent sale price to a seller, as possibly having a rational justification that would allow such restrictions to be enforceable, there should be little question that a financing restriction such as that set forth below should be found to have a rational justification and be enforceable. *Id.* § 3.5 cmt. c (emphasis omitted) (internal quotation marks omitted).

¹⁶⁸ *Id.* § 3.1 cmt. j; *see also* *Nahrstedt v. Lakeside Vill. Condo. Ass’n*, 878 P.2d 1275, 1290 (Cal. 1994) (en banc).

¹⁶⁹ 42 U.S.C. §§ 3601-3619, 3631 (2006).

¹⁷⁰ *See NAACP v. Town of Huntington*, 844 F.2d 926, 937-38 (2d Cir. 1988) (“[T]he disproportionate harm to blacks and the segregative impact on the entire community resulting from the refusal to rezone create a strong prima facie showing of discriminatory effect.”); *United States v. City of Black Jack*, 508 F.2d 1179, 1184-85 (8th Cir.1974); *Dews v. Town of Sunnyvale*, 109 F. Supp. 2d 526, 556-57 (N.D. Tex. 2000).

¹⁷¹ *See generally* *United States v. Wagner*, 930 F. Supp. 1148 (N.D. Tex. 1996). *See also* *Hill v. Cmty. of Damien of Molokai*, 911 P.2d 861, 867 (N.M. 1996).

was rejected; and (4) that the housing opportunity remained available.”¹⁷² This standard requires a showing that a purchaser is “qualified to . . . purchase” and thus can afford the housing.¹⁷³ Courts have not prohibited exclusion on economic grounds.¹⁷⁴

A financing restriction should never be used as a method of excluding persons of color. The purpose of the covenant proposed in this Article is to require homeowners and lenders, without regard to race, to act in a financially responsible manner because market forces no longer create the incentives in lenders to make financially responsible loans. Therefore, it should not be illegal or in violation of public policy.

IV. PRACTICAL CHALLENGES TO FINANCING RESTRICTIONS

What are the practical challenges to implementing the financing restriction concept in common-interest communities? Is it just a nice concept that is legally enforceable for the reasons discussed in the preceding Part but unlikely to gain any traction in the real world? While there are many obstacles to the adoption of financing restrictions in a significant number of common-interest communities, recent experiences have tilled the soil so that the seeds of the financing restriction concept can take root and flourish.

A. *Developer Resistance To Financing Restrictions in New Developments*

One of the challenges to the integration of a financing restriction into new developments might be resistance among developers to a restriction that clearly limits the universe of prospective buyers. Developers may perceive the use of a financing restriction as decreasing demand and therefore diminishing both the price that lots or houses may sell for in the development and the time period in which the parcels are sold.¹⁷⁵

¹⁷² *Robinson v. 12 Lofts Realty, Inc.*, 610 F.2d 1032, 1038 (2d Cir. 1979) (citing *McDonnell Douglas Corp. v. Green*, 411 U.S. 792, 802 (1973)).

¹⁷³ *Id.*

¹⁷⁴ *See Williams v. 5300 Columbia Pike Corp.*, 891 F. Supp. 1169, 1180 n.23 (E.D. Va. 1995) (“[D]efendant must prevail if it appears that the disparity was attributable to economic inequality rather than impermissible discrimination.”); *see also Dreher v. Rana Mgmt., Inc.*, 493 F. Supp. 930, 931-35 (E.D.N.Y. 1980) (granting defendant summary judgment in suit by tenants seeking to enjoin landlord from converting building 90 percent occupied by black tenants to housing for college students, most of whom would be white).

¹⁷⁵ *See supra* notes 32-33 and accompanying text (discussing why financing restrictions were not drafted into CCRs by developers back in the 1960s and 1970s); *see also Schill et al.*, *supra* note 30, at 283-84 (discussing decreased demand for cooperatives because of the financing conditions and the unwillingness of some purchasers to be subjected to financial scrutiny).

This perspective among developers could continue to make developers reluctant to insert financing restrictions in CCRs. But given the recent retrenchment in the real estate marketplace, with widespread foreclosures resulting from overleveraged properties triggering diminished property values and unpaid assessments in common-interest communities across the country,¹⁷⁶ a growing population of prospective purchasers may find financing restrictions to be an attractive feature within CCRs. These purchasers will value financing restrictions because they protect against foreclosure epidemics that both impact neighboring property values directly and cause indirect problems resulting from unpaid assessments on foreclosed parcels.¹⁷⁷ Moreover, it is conceivable that some lenders will begin requiring financing restrictions or encouraging the use of financing restrictions as a means of reducing risk to the underlying collateral for home mortgages.¹⁷⁸ Thus, some developers may view, or be encouraged to view, the use of financing restrictions as a market advantage.

B. *Amending Existing Common-Interest Community Regimes*

Of course, developer resistance is only a problem in new developments in which the developer is drafting the CCRs. The near future does not seem likely to involve a dramatic increase in new developments, given the current housing market and the relatively modest number of new housing starts compared to historical volumes.¹⁷⁹

¹⁷⁶ See *supra* notes 23-24 and accompanying text (discussing the impact of the mortgage crisis on common-interest communities).

¹⁷⁷ See *supra* notes 23-24 and accompanying text (discussing how rampant foreclosures directly diminish the value of neighboring parcels and indirectly diminish the value of neighboring parcels in common-interest communities because of the growth in unpaid assessments that results in diminished maintenance).

¹⁷⁸ See Joe Del Casino, *Home Buyer Beware in Distressed Market*, SUN-SENTINEL (FLA.) (Sept. 21, 2008), http://articles.sun-sentinel.com/2008-09-21/news/0809180157_1_lenders-foreclosures-prices;10_Things_A_Homeowners_Association_Won't_Tell_You, YAHOO! FIN., <http://loan.yahoo.com/m/primer13.html> (last visited Feb. 23, 2012) (noting that banks are wary of lending when a common-interest community has a significant percentage of unpaid assessments or is in litigation regarding unpaid assessments). If lenders are going to pay attention to the volume of unpaid assessments and how that might impact land values within a common-interest community, it would not be surprising if the lenders also began asking for financing restrictions (just as the securitized market resulted in the increasingly frequent inclusion of amendment provisions in CCRs). See *supra* note 43 and accompanying text (discussing how the secondary mortgage market drove some of the language development in CCRs). Of course, lenders might not be excited about financing restrictions that function to preclude foreclosure of mortgages that violate the financing restriction. Significant lender resistance would prevent financing restrictions from gaining traction in the marketplace. We discuss this challenge *infra* note 186 and accompanying text.

¹⁷⁹ With occasional significant fluctuations, housing starts averaged about 1.5 to 1.6 million per year between 1960 and 2000, but from 2000 to 2006, housing starts consistently increased from 1.5 million per year to well over 2 million per year, only to plummet back below 1 million per year as of

Nonetheless, with 300,000 common-interest communities already in existence, there is probably much more room for growth in the use of financing restrictions among existing common-interest community regimes that might consider amending their CCRs by adopting a tool that might reduce the risk of foreclosure epidemics in the future. Here the dynamics are much different because, generally speaking, in most existing common-interest communities, the developer is not in the picture anymore.¹⁸⁰ But for existing common-interest communities, there are still some challenges to the implementation of a financing restriction. The following challenges make up the remainder of this Part of the Article. First, is there an amendment provision in the CCRs? Second, are enough existing homeowners within the common-interest community likely to find a financing restriction attractive enough to vote to amend the CCR regime by adding a financing restriction? Finally, how should the financing restriction impact existing homeowners who may have trouble complying with the restriction were they to refinance?

In the absence of an amendment provision, the CCRs for a common-interest community can be amended only if all homeowners in the community unanimously agree.¹⁸¹ It is very unlikely that all homeowners in a common-interest community will unanimously agree to amend CCRs to

2008. CONG. BUDGET OFFICE, THE OUTLOOK FOR HOUSING STARTS, 2009-2012, at 2 fig.1 (2008), available at <http://www.cbo.gov/publication/20375> (follow "Document"). With housing starts projected to be below the long-term average for the next few years as excess inventory of vacant and foreclosed houses are worked through the system, the annual supply of new housing stock reflects only about one percent of all housing stock in the country. See *id.* at 21-23 (discussing three scenarios, from optimistic to pessimistic).

¹⁸⁰ As discussed in *Neponsit*, once a development is completed, the responsibility for ongoing management of common amenities is with the residents, generally functioning through a homeowners' association. In reality, however, given the mortgage crisis impact on the housing market, there probably are a significant number of existing common-interest communities that were begun in 2005 through 2007 and have lost momentum with developers (or their lenders!) still owning a significant number of lots and quite possibly the power to amend the CCRs unilaterally. See, e.g., J. Craig Anderson, *Unfinished Subdivisions Grinding To a Halt*, ARIZ. REPUBLIC (June 18, 2008, 12:00 AM), <http://www.azcentral.com/arizonarepublic/news/articles/0618biz-trendhomes0618.html?&wired> (describing subdivision with hundreds of vacant lots in foreclosure); Molly Loomis, *Boom and Bust: Reshaping Development Patterns in Teton Valley*, NEW W. (Mar. 23, 2011), http://www.newwest.net/topic/article/boom_and_bust_reshaping_development_patterns_in_teton_valley/C35/L35/ (noting that there are over 7,700 vacant lots in a community of only 8,000 people); see also Franzese & Siegel, *supra* note 15, at 1127 (discussing common-interest communities in which the developer retains significant control over the CCRs prior to the sale of a significant number of the lots in the development).

¹⁸¹ Because covenants are property rights defined by the terms of the CCR regime in place for a given development, the beginning premise is that all owners of the property right must consent to any changes in the property right unless the CCR regime specifically sets forth an amendment process that may function without unanimous consent. Even with an amendment procedure, however, there are different lines of cases regarding whether amendments may only change existing covenants or may include new covenants. See *Evergreen Highlands Ass'n v. West*, 73 P.3d 1, 4-6 (Colo. 2003) (en banc) (discussing two different lines of cases).

impose a financing restriction unless the group of homeowners is relatively small. The larger the group the more difficult it will be to get unanimous agreement.

Assuming there is an amendment provision, the next question will be what type of majority is required for amendment—a simple majority or a super majority.¹⁸² Again, it will be easier to accomplish an amendment with a simple majority requirement than with a super-majority requirement. Given the turmoil caused by foreclosures and unpaid assessments, one can easily imagine that association boards or individuals within a common-interest community might view a financing restriction as a reasonable means by which to constrain their joint venturers from excessively leveraging their homes. Individual homeowners, however, might have the same reluctance to embrace a financing restriction as developers, concerned that a financing restriction might reduce the population of qualified purchasers such that the value of the home declines.¹⁸³ This will be a question that may get resolved differently in different common-interest communities around the country and even differently within a state or a region. Different outcomes will depend on how the issue is presented, what experience those in the common-interest community had with foreclosures, and the extent to which they perceive the concept of a financing restriction as a reasonable constraint on themselves and others. If, as noted above, lending institutions begin to look more favorably upon purchasers in common-interest communities with financing restrictions, market pressure could make the use of financing restrictions even more attractive.

Finally, common-interest communities considering amending their CCRs to impose a financing restriction likely will face one more implementation challenge—what to do with existing homeowners who have little equity in their homes or are even underwater on their mortgages. In many common-interest communities around the country, relatively conservative homeowners who did not purchase with excessive leverage or did not engage in a refinancing that resulted in excessive leverage nonetheless may

¹⁸² While many common-interest communities allow amendment based on a simple majority, see, for example, *Andrews v. Sandpiper Villagers, Inc.*, 170 P.3d 1098, 1100 (Or. Ct. App. 2007), some require a super-majority vote of 67 percent, 75 percent, or more to amend the underlying covenant regime. See, e.g., *Regency Homes Ass'n v. Schrier*, 759 N.W.2d 484, 487 (Neb. 2009) (noting amendment process requiring three-quarters of members for approval); *Boulder Oaks Cmty. Ass'n v. B & J Andrews Enters.*, 215 P.3d 27, 29-30 (Nev. 2009) (per curiam) (describing amendment process requiring 67 percent of members); *Hawkins View Architectural Control Comm. v. Cooper*, 250 P.3d 380, 384 (Or. Ct. App. 2011) (describing amendment process requiring approval of 85 percent of homeowners).

¹⁸³ At some level, homeowners' receptivity to a financing restriction will be a function of the extent to which homeowners are concerned about maintaining long-term value or are interested in facilitating maximum short-term appreciation. Those interested in maintaining long-term value likely would support a financing restriction; those interested in maximizing short-term appreciation would likely prefer to foster the possibility of excessive leverage which can drive up property values in the short-term.

presently find themselves “upside down” or “underwater.” These are homeowners who have been paying their mortgages on time each month and continue to do so even though the mortgage crisis and resulting recession and epidemic of foreclosures has resulted in such a depreciation in property values in their neighborhood or region that they now have an outstanding mortgage balance that exceeds, or nearly exceeds, the value of their home. Any reasonably-sized common-interest community is likely to have a number of homeowners who fit this description. While it is conceivable that banks holding title to foreclosed properties and homeowners who are underwater would oppose an amendment that would impose a financing restriction, if they are not sufficiently numerous to defeat an amendment, then the association will have an implementation question regarding how to handle those homeowners. First, any financing restriction amendment should apply only prospectively to new “financing” actions—the sale of a property in the common-interest community or a new refinancing of a property in the community. But even with prospective application, owners without sufficient equity would be hamstrung by a financing restriction that would not allow them to benefit from an advantageous refinancing opportunity that may provide them with a lower interest rate, lower payments, and thus greater financial security. With this in mind, a financing restriction should allow homeowners to refinance without regard to loan-to-value ratio provided they are refinancing an amount no greater than their current balance plus closing costs.

Many challenges exist that may preclude the widespread adoption of a financing restriction. But in a marketplace with a variety of housing options at a variety of price points and with a variety of amenities, it would seem possible that some sets of like-minded homeowners might come together to constrain themselves from excessive financial risk-taking associated with borrowing against their homes within a common-interest community.

V. PROPOSED FINANCING RESTRICTION

The goal of the financing restriction is simple—to reduce significantly the likelihood of foreclosure by constraining homeowners from being excessively leveraged or obtaining home mortgage loans that they cannot afford to repay. To be effective, the financing restriction should both prohibit homeowners from being excessively leveraged and compel lenders to pay attention to and abide by the financing restriction. Thus, even if a lender is willing to make a loan to a borrower without the ability to repay or with little equity in the property, the financing restriction should function to discourage a lender from doing so.

Excessive leverage does not need to be anything out of the ordinary. Most conventional mortgages are available without private mortgage insurance so long as the loan to value ratio is 80 percent. While that seems to be a fairly reasonable “market-defined” parameter for thinking about the tip-

ping point between appropriate leverage and excessive leverage, a little more flexibility may be helpful to make sure the concept of a financing restriction is palatable to more homeowners, developers, and lenders. Although each common-interest community can decide its own risk tolerance and set its loan-to-value ratio accordingly, the draft financing restriction set forth below places the loan-to-value threshold at 90 percent, in an attempt to balance accessibility in the market with protection against excessive leverage.¹⁸⁴

In addition, it makes sense to require the lender wishing to enforce the mortgage to comply with Section 1411 of Dodd-Frank (requiring lenders to determine the borrower's ability to repay). Borrowers have a defense to foreclosure if a lender fails to comply with Section 1411 of Dodd-Frank, and the neighbors should also.

The financing restriction language that might work best to accomplish these goals is as follows:

Purchaser, on behalf of herself and her successors and assigns, including but not limited to mortgagees, agrees:

1. The first lien purchase money mortgage used to acquire the Property and for which the Property is security may not exceed 90 percent of the lesser of the purchase price of the Property or the appraised value of the Property used for purposes of obtaining the purchase money mortgage. Furthermore, any second mortgage, home equity loan, or other financing secured by the Property and consummated in connection with the purchase of the Property may not cause the total amount of debt secured by the Property to exceed 90 percent of the lesser of the purchase price of the Property or the appraised value of the Property used for purposes of obtaining the first lien purchase money mortgage. Following purchase, the total amount Purchaser or her successors and assigns may borrow against the value of the Property, regardless of whether the borrowing is done through a refinance mortgage, a second mortgage, a home equity loan, negative amortization of existing financing, or some other financing secured by the Property, may not exceed 90 percent of the fair market value of the Property at the time the loan is consummated. Notwithstanding the foregoing, an existing loan or loans secured by a lien on the Property may be refinanced in an amount not to exceed the balance of such loans on the date of refinancing plus closing costs for refinancing.

In determining fair market value, a lender may conclusively rely on the value estimate in an appraisal or evaluation prepared within 90 days of the date the loan is consummated in accordance with a state or federal requirement applicable to a loan of the type being made. In the event no appraisal is obtained in connection with a loan, a lender, at the lender's option, shall be entitled to rely on the value determined by the taxing authority for purposes of assessing ad valorem taxes on the Property.

This restriction shall not apply to a) a loan for work and materials used in constructing improvements on the Property, or b) a reverse mortgage that requires no payment of principal or interest until (i) all borrowers have died; (ii) the Property is sold or otherwise transferred; (iii) all borrowers cease occupying the Property for a period of longer than 12 consecutive months without prior written approval from the lender; (iv) the borrower defaults on an obligation specified in the loan documents to repair and maintain, pay taxes and assessments on, or insure the Property; (v) the borrower commits actual fraud in connection with the loan; or (vi) the borrower fails to maintain the priority of the lender's lien on the Property.

¹⁸⁴ Another option would be to have different loan-to-value requirements for purchase of a home and for subsequent borrowing against the home—e.g., 90 percent for purchase and 80 percent for subsequent borrowing or 95 percent for purchase and 90 percent for subsequent borrowing. This would make homes in the common-interest community more accessible for purchase, but protect equity to a greater extent once it is established.

2. No lender may make a purchase money mortgage, a refinancing mortgage, a second mortgage, a home equity loan, or other financing for which the Property will serve as security unless the lender makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the borrower has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments. In determining whether the borrower has a reasonable ability to repay, a lender may rely on the criteria set forth in 15 U.S.C. § 1639c(a) and regulations promulgated pursuant thereto.
3. If a lender provides a purchase money mortgage, a second mortgage, a home equity loan, or other financing for which the Property will serve as security in violation of these restrictions, the lender hereby waives any right to seek foreclosure of the Property to satisfy the loan made in violation of these restrictions.

This restriction constrains the extent to which the homeowner can use her home as security against which to borrow. It also constrains lenders and should function to discourage lenders from lending to homeowners if the loan will result in a total set of encumbrances with a loan-to-value ratio in excess of 90 percent or lending to homeowners without the ability to repay. It provides an exception for homeowners who lose equity due to depreciation rather than excessive borrowing so that these homeowners can still refinance their loans to take advantage of lower interest rates. It excludes construction and home improvement loans because they increase the value of the property as construction proceeds, and also excludes reverse mortgages that do not become due until the homeowner dies, sells the home, or moves.¹⁸⁵

The financing restriction would be relatively efficient as it would not require the implementation of a “financial review committee” within the homeowners’ association of a common-interest community (as might exist within a cooperative), but would be self-effectuating. The financing restriction, on its face, should function to deter lenders or mortgage originators seeking to make money by extending risky loans which they intend to release into the secondary market. The secondary market likely will not countenance mortgages that were made in violation of this type of financing restriction because of the inability to foreclose on borrowers who received a loan that violated this financing restriction.¹⁸⁶

That said, if the homeowners’ association wanted to be even more cautious, it could require a purchaser or refinancing homeowner to provide to a “financial review committee” the loan documents and the purchase price

¹⁸⁵ The reverse mortgage requirements are borrowed from the Texas Constitution. *See* TEX. CONST. art. 16, § 50(k)(6).

¹⁸⁶ While some may believe lenders will be reluctant to lend at all with a financing restriction in place because of the risk of inadvertent violation that results in a loss of a right to foreclose, the financing restriction contains a safe harbor to protect lenders who have a qualifying appraisal or tax assessment on which they rely in making a loan. Moreover, similar concerns were expressed when Texas amended its constitution to permit home equity loans for the first time, but required an 80 percent loan-to-value ratio. *See id.* § 50(a)(6)(B). In reality, however, Texas lenders proceeded to make home equity loans.

and/or appraisal for the committee to confirm compliance with the financing restriction. Notably, even this process would be less intrusive and involve much less discretion in the review committee than what is common in cooperatives.

This financing restriction would not be a panacea, as it does not preclude homeowners within a common-interest community from being excessively leveraged through credit cards or educational loans that are not secured by their homes. It also does not protect against decreasing property values caused by economic conditions outside the common-interest community. Thus, some risk of foreclosure will still remain. But the financing restriction would greatly reduce the risk of foreclosure that has been manifested significantly during this economic downturn—the risk of foreclosure from having borrowed 95 percent, 100 percent, or 125 percent of the value of one’s home in a market poised for price deflation or from borrowing without the ability to repay from the outset.

CONCLUSION

Since the *Neponsit* decision over seven decades ago, the desire of homeowners to have the benefits of being in common-interest communities, with CCRs regulating their use of their land and mandating contributions to common amenities, has grown substantially. For the millions of homeowners now residing in the more than 300,000 common-interest communities across the United States, however, the CCRs, which are designed to preserve property values, provided no meaningful support against plummeting property values resulting from the mortgage crisis. One reason that common-interest communities have been susceptible to the “boom-bust” real estate cycle has been the absence of any restriction on how homeowners within common-interest communities use their property as security for financial obligations. In a relatively unregulated environment, many homeowners engaged in risky financial decisions, taking out loans secured by their property that exceeded or nearly exceeded the value of their property and/or taking out loans secured by their property that they had little prospect of repaying. While this “unregulated” environment facilitated above-average appreciation in property values over several years, when the housing appreciation of the late 1990s and early 2000s finally peaked and began to subside, the fragile state of the housing market was exposed, resulting in the mortgage crisis and foreclosure epidemic that has decimated the equity of many homeowners and impaired the financial viability of many common-interest communities that have common amenities to maintain.

Given that the public law regulatory environment was inadequate to prevent this financial crisis, a private law response may be necessary to prevent similar problems in the future. Were developers and common-interest communities to embrace a financing restriction such as that set forth in this Article, the restriction would constrain homeowners from ex-

cessively leveraging their properties to their detriment and that of their neighbors and would constrain lenders from making such loans. While some practical challenges may hinder the widespread adoption of financing restrictions, there are no meaningful legal constraints. The financing restriction should be enforceable against homeowners, their successors and assigns, including mortgage lenders, under a traditional common law analysis and under the *Restatement (Third) of Property-Servitudes*. If drafted carefully, the financing restriction may be perceived as attractive by developers and homeowners who have a more conservative orientation to the “investment” aspect owning a home—those interested in maintaining long-term value rather than maximizing short-term appreciation.